

# Management Report of Fund Performance



## COVINGTON FUND II INC.

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This interim management report of fund performance contains financial highlights but does not contain the complete semi-annual financial statements of Covington Fund II Inc. (the "Fund"). You can obtain a copy of the semi-annual financial statements at your request, and at no cost, by calling 1-866-244-4714, by writing to us at Covington Capital Corporation, 36 Distillery Lane, Suite 440, Toronto, Ontario M5A 3C4, by visiting our website at [www.covingtonfunds.com](http://www.covingtonfunds.com) or on SEDAR at [www.sedar.com](http://www.sedar.com).

Shareholders may also contact us using one of these methods to request a copy of the Fund's proxy voting policies and procedures or proxy voting disclosure record.

**FORWARD LOOKING STATEMENTS**

This report may contain forward-looking statements about the Fund, its future performance, strategies or prospects, and possible future Fund actions. The words "anticipate", "could", "should", "may", "expect", "believe", "plan", "intends", "estimate", "forecast", "objective", "would"; and similar expressions are intended to identify forward-looking statements.

Forward-looking statements involve inherent risks and uncertainties, both about the Fund and general economic factors. It is not possible to guarantee that future performance, liquidity, predictions, forecasts, projections or other forward-looking statements will be achieved. Factors such as economic, political and market factors in Canada, the United States and internationally, interest and foreign exchange rates, global equity markets, business competition, technological changes, changes in laws and regulations, judicial or regulatory judgments, legal proceedings or catastrophic events could cause actual events or results to differ materially from those expressed or implied in any forward-looking statement made by the Fund. Please consider these and other pertinent factors before making any investment decisions and do not place undue reliance on forward-looking statements. All opinions contained in forward-looking statements are subject to change without notice.

## CLASS A SHARES

[in \$000's of Canadian dollars except for per share amounts, number of shares and percentages]

### INVESTMENT OBJECTIVES AND STRATEGIES

The investment objective of the Fund is to realize long-term capital appreciation on part of the investment portfolio, and current yield and early return of capital on the remainder of the investment portfolio. The strategy to accomplish this is by investing in two different types of situations. The first is in companies which the Fund anticipates will have significant growth potential in early stage or expanding markets. The second is in more established steady growth companies which the Fund anticipates will provide current yield and early return of capital to the Fund. The Fund combines the tax benefits of a Labour Sponsored Venture Capital Corporation ("LSVCC") and a Labour Sponsored Investment Fund ("LSIF") while giving investors access to the venture capital market.

The Fund is now in its twentieth year of operations. The Fund has neither sold new subscriptions nor undertaken new investments in the past several years. In May 2018, the Manager announced that the primary focus is on optimizing the value of the investment holdings as it seeks out opportunities to exit the remaining portfolio investments over the next approximately 18 to 24-month period and return capital to unitholders.

Since the merger with the VenGrowth Funds in 2011, approximately 63% of the outstanding shares of the Fund have been redeemed for cash.

### RISKS AND UNCERTAINTIES

The Fund is suitable for investors with a long-term investment focus and higher risk tolerance than conventional investment funds as discussed in the Fund's Annual Information Form.

**Liquidity risk** – Liquidity remains the largest risk factor facing the Fund. As at February 28, 2019, the Fund's investment portfolio consisted of 18 companies of which 2 are publicly traded and 16 are privately held. Due to minimal cash reserves, the majority of the Fund's total assets are held within private companies. The private illiquid nature and the follow-on funding required to support these companies continues to place liquidity pressures on the Fund. Exit opportunities for private companies within the portfolio are not certain and these investments cannot be readily converted to cash on an as needed basis. The exit strategy for venture backed companies is typically through mergers and acquisitions ("M&A") whereby strategic buyers may seek to augment their portfolios by purchasing smaller, private companies or, private companies may seek to grow themselves by accessing the public equity markets through an initial public offering ("IPO"). Uncertain M&A and IPO activity contributes to additional liquidity strain on the Fund.

The tax credit program for purchases of LSIFs has been phased out by the Ontario government. Additionally, the Federal government announced the phase-out of the LSVCC program after 2016 but reversed this stance in March 2016. The elimination of the program provincially along with market pressures has, in recent years, restricted the ability of all investment funds operating in this sector to raise significant amounts of capital. The Fund is closed to new subscriptions; as such, the Fund is dependent upon internal growth and portfolio exits in order to meet its investment objectives and provide liquidity to its shareholders via redemptions.

These on-going liquidity pressures in conjunction with significant and increasing redemption requests received immediately upon the Fund re-opening for redemptions have caused the Fund to temporarily close for redemptions.

**Valuation risk** – The process of valuing venture investments for which no published market exists is subject to inherent uncertainties and the resulting values may differ from values which would have been ascribed had a ready market existed for those investments. This is valuation risk as described in the Fund's financial statements.

**Portfolio risk** – Approximately 97% of the value of the Fund's venture portfolio is in private companies. As the portfolio matures and exits occur, the portfolio concentration may change. For example, investments in the biotechnology sector are typically longer-term holds with varying levels of economic outcomes; as such, the weighting of biotech holdings within the portfolio as a whole may fluctuate over time. This is a concentration risk which may impact portfolio performance as different sectors experience market and economic fluctuations differently from one another. For example, at its peak, the biotechnology/health science sector has accounted for as much as 56% of the Fund's overall venture portfolio value but was represented by 25% of the companies within the portfolio. At period end, this sector represented 32% of the portfolio value held in 22% of the holdings. Volatility within the public markets could also place additional market risk within the venture portfolio.

## CLASS A SHARES

[in \$000's of Canadian dollars except for per share amounts, number of shares and percentages]

### RESULTS OF OPERATIONS

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As at February 28, 2019, the total net assets attributable to holders of redeemable share of the Fund ("NAV") were \$63,065 as compared to \$65,957 as at August 31, 2018. The decrease is mainly due to operating expenses of \$1,758 and net losses related to portfolio activity. As at February 28, 2019, the Fund held \$5,886 in cash to provide the Fund with liquidity to not only fund operations and support to existing companies within the portfolio but also future redemptions. The Fund's venture portfolio as at February 28, 2019 was at \$63,047 in value compared to \$70,874 as at August 2018. The Fund received \$4,222 in debt repayments to provide liquidity for follow-ons and operations, and in specific circumstances, redemptions

The Fund completed \$214 in cash follow-on financings to support the venture portfolio. Interest income for the period ended February 28, 2019 totalled \$4,273. Expenses for the six month period ended February 28, 2019 were \$1,758 and have declined by \$523 compared to the same period in 2018. Net asset based fees have declined consistently with the decline in average NAV over the period.

The annualized MER for both of the Class A Shares, Series I and Series II was 5.4%.

### RECENT DEVELOPMENTS

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On May 7, 2018, the Fund was re-opened for redemptions totalling approximately \$10,000. Upon completion of this redemption, the Manager announced that the primary focus is on optimizing the value of the investment holdings as it seeks out opportunities to exit the remaining portfolio investments over the next approximately 18 to 24-month period and return capital to unitholders.

On September 8, 2015, the Fund announced a temporary hold on redemptions given the magnitude of redemption requests had the potential to eliminate the liquidity required to operate the Fund in an efficient manner. The Fund was re-opened again January 18, 2016, October 24, 2016, and May 7, 2018; and subsequently halted each time as available cash limits were reached.

The fair value of the Fund's portfolio will continue to be determined every week and there are currently no changes to the valuation approach to its private investments as a result of the recent suspension of redemptions event. The challenge remains to optimize exit values for the private investments while trying to meet redemption requests from shareholders. It is not in the best interest of the Fund nor the portfolio companies to accelerate exits to the detriment of obtaining a fair value on those exits in the current marketplace.

### RELATED PARTY TRANSACTIONS

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The Manager and Sponsor are deemed to be related parties to the Fund. Please refer to the section entitled "Fees and Expenses" which outlines the fees paid to these related parties or Note 8 in the Fund's 2019 interim financial statements.

**CLASS A SHARES**

[in \$000's of Canadian dollars except for per share amounts, number of shares and percentages]

**FINANCIAL HIGHLIGHTS**

The following tables show selected key financial information about the Fund and are intended to help you understand the Fund's financial performance.

**FUND'S NET ASSETS ATTRIBUTABLE TO HOLDERS OF REDEEMABLE UNITS**

<b>SERIES I</b>	<b>Period ended February 28, 2019</b>	Year ended August 31, 2018	Year ended August 31, 2017	Year ended August 31, 2016	Year ended August 31, 2015	Year ended August 31, 2014
Net assets attributable to holders of redeemable units, beginning of period <sup>(1)</sup> <sup>(2)</sup>	\$ <b>4.58</b>	\$ 5.58	\$ 6.83	\$ 8.16	\$ 8.98	\$ 8.58
Increase (decrease) from operations:						
Total revenue	<b>0.30</b>	0.01	0.07	1.22	0.08	0.02
Total expenses	<b>(0.12)</b>	(0.28)	(0.44)	(0.39)	(0.46)	(0.63)
Realized gain (loss) on investments	<b>0.00</b>	(0.06)	0.27	(1.46)	0.89	1.13
Unrealized gain (loss) on investments	<b>(0.37)</b>	(0.67)	(1.11)	(0.77)	(1.35)	(0.22)
Total increase (decrease) from operations <sup>(2)</sup>	<b>(0.19)</b>	(1.00)	(1.21)	(1.40)	(0.84)	0.30
Net assets attributable to holders of redeemable units, end of period <sup>(1)</sup> <sup>(2)</sup>	\$ <b>4.39</b>	\$ 4.58	\$ 5.58	\$ 6.83	\$ 8.16	\$ 8.98
<b>SERIES II</b>						
Net assets attributable to holders of redeemable units, beginning of period <sup>(1)</sup> <sup>(2)</sup>	\$ <b>4.36</b>	\$ 5.31	\$ 6.50	\$ 7.78	\$ 8.59	\$ 8.28
Increase (decrease) from operations:						
Total revenue	<b>0.29</b>	0.01	0.07	1.19	0.07	0.02
Total expenses	<b>(0.12)</b>	(0.27)	(0.43)	(0.39)	(0.48)	(0.66)
Realized gain (loss) on investments	<b>0.00</b>	(0.06)	0.25	(1.44)	0.85	1.15
Unrealized gain (loss) on investments	<b>(0.35)</b>	(0.64)	(1.04)	(0.69)	(1.21)	(0.18)
Total increase (decrease) from operations <sup>(2)</sup>	<b>(0.18)</b>	(0.95)	(1.15)	(1.33)	(0.77)	0.33
Net assets attributable to holders of redeemable units, end of period <sup>(1)</sup> <sup>(2)</sup>	\$ <b>4.18</b>	\$ 4.36	\$ 5.31	\$ 6.50	\$ 7.78	\$ 8.59

(1) This information is derived from the Fund's audited annual financial statements and the most recent semi-annual financial statements. The net assets attributable to holders of redeemable units per unit presented in the financial statements may differ from the net asset value per unit calculated for fund pricing purposes.

(2) Net assets attributable to holders of redeemable units are based on the actual number of shares outstanding as at the stated dates. The increase/(decrease) from operations is based on the weighted average number of shares outstanding over the fiscal period.

# COVINGTON FUND II INC.

## CLASS A SHARES

[in \$000's of Canadian dollars except for per share amounts, number of shares and percentages]

### RATIOS AND SUPPLEMENTAL DATA

<b>SERIES I</b>	<b>Period ended February 28, 2019</b>	Year ended August 31, 2018	Year ended August 31, 2017	Year ended August 31, 2016	Year ended August 31, 2015	Year ended August 31, 2014
Total net assets attributable to holders of redeemable units <sup>(1)</sup>	\$ <b>39,059</b>	\$ 40,847	\$ 56,758	\$ 84,636	\$ 127,748	\$ 151,028
Number of shares outstanding	<b>8,899,488</b>	8,914,877	10,165,503	12,385,692	15,655,888	16,824,904
Management expense ratio <sup>(2)</sup>	<b>5.40%</b>	5.43%	6.87%	5.35%	5.33%	7.13%
Management expense ratio before IPA <sup>(2)</sup>	<b>5.39%</b>	5.53%	6.41%	4.28%	4.69%	6.68%
Portfolio turnover rate <sup>(3)</sup>	<b>2.44%</b>	7.38%	3.94%	39.54%	20.42%	18.88%
Trading expense ratio <sup>(4)</sup>	-	-	-	0.07%	0.08%	0.17%
Net assets attributable to holders of redeemable units per unit	\$ <b>4.39</b>	\$ 4.58	\$ 5.58	\$ 6.83	\$ 8.16	\$ 8.98
<b>SERIES II</b>						
Total net assets attributable to holders of redeemable units <sup>(1)</sup>	\$ <b>24,006</b>	\$ 25,110	\$ 35,552	\$ 56,194	\$ 86,840	\$ 109,562
Number of shares outstanding	<b>5,749,392</b>	5,760,376	6,699,307	8,645,176	11,166,508	12,747,483
Management expense ratio <sup>(2)</sup>	<b>5.40%</b>	5.37%	6.95%	5.56%	5.81%	7.79%
Management expense ratio before IPA <sup>(2)</sup>	<b>5.39%</b>	5.47%	6.49%	4.49%	5.17%	7.31%
Portfolio turnover rate <sup>(3)</sup>	<b>2.44%</b>	7.38%	3.94%	39.54%	20.42%	18.88%
Trading expense ratio <sup>(4)</sup>	-	-	-	0.08%	0.08%	0.17%
Net assets attributable to holders of redeemable units per unit	\$ <b>4.18</b>	\$ 4.36	\$ 5.31	\$ 6.50	\$ 7.78	\$ 8.59

(1) This information is provided as at August 31 of the years shown, except for the most recent which is February 28, 2019.

(2) Management expense ratio includes all fees, expenses, capital taxes, HST and the Manager's conditional IPA and is expressed as an annualized percentage of the average net assets administered during the period. Conditional IPA is the determination of the bonus that would be payable to the Manager if the Fund were to dispose of its venture investment at its carrying value as at the dates shown. The Manager is entitled to this bonus only upon realization of certain conditions as outlined in the Fund's prospectus and/or annual information form.

(3) The Fund's portfolio turnover rate indicates how active the Fund's portfolio advisor manages its portfolio investments. A portfolio turnover rate of 100% is equivalent to the Fund buying and selling all of the securities in its portfolio once in the course of the period. The higher a fund's portfolio turnover rate in a period, the greater the trading costs payable by the fund in the period, and the greater the chance of an investor receiving taxable capital gains in the period. There is not necessarily a relationship between a high turnover rate and the performance of a fund.

(4) The trading expense ratio represents total commissions and other portfolio transaction costs expressed as an annualized percentage of daily average net assets during the period.

**CLASS A SHARES**

[in \$000's of Canadian dollars except for per share amounts, number of shares and percentages]

**MANAGEMENT FEES**

Covington, as the Manager, is responsible for directing the business, operations and affairs of the Fund and for implementing the investment strategy, monitoring the Fund's investments and providing management assistance to portfolio companies. Because the portfolio companies of the Fund are generally small in size and at an earlier stage of development relative to conventional mutual funds, the Fund requires a greater level of management involvement in the analysis, monitoring support and development activities.

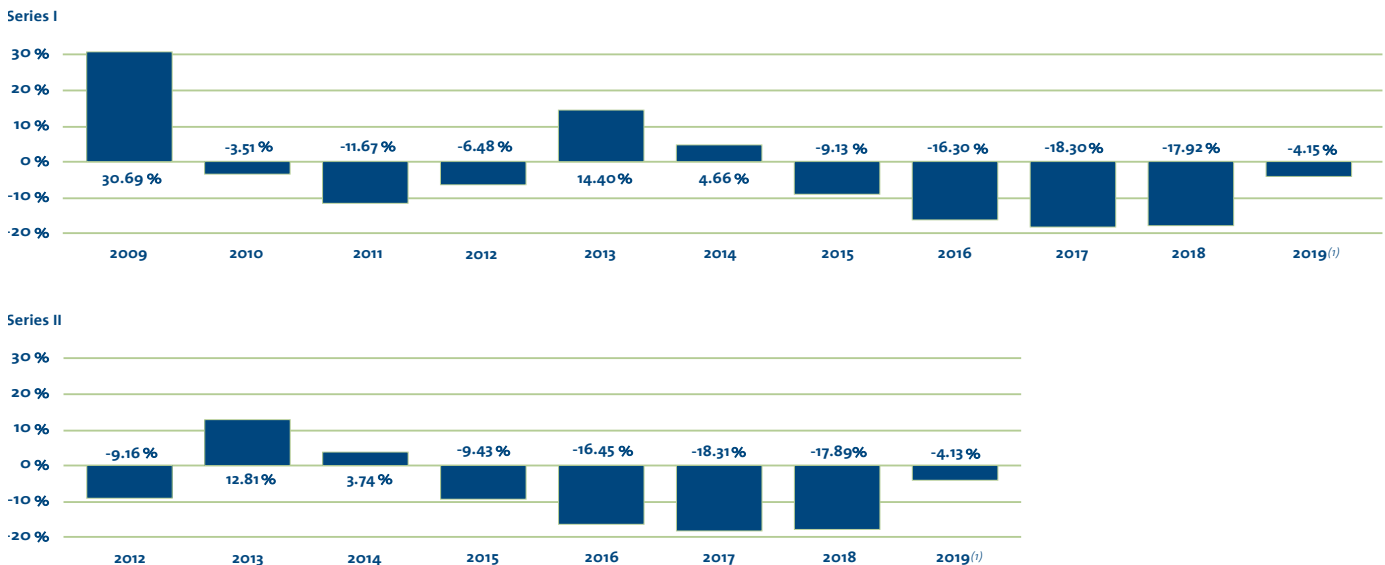
Covington uses its management fees to finance its operations as follows: approximately 98% for general administration over the affairs of the Fund including implementation of the Fund's investment strategy, portfolio management and financial monitoring, retaining and supervising service providers and managing its overall business affairs and 2% for the implementation of communications, relationship, and distribution strategies.

The Fund pays annual fees of 1.35% of the net asset value of the Fund for management services. The Fund's management expense ratio ("MER") consists of all of its operating expenses, including sales commissions, certain ongoing marketing costs of the Fund, audit and legal expenses, fees paid to any independent valuator, IPA (if any), and certain consultancy costs. The largest component of the MER are fees that are calculated as a percentage of the NAV of the Fund and these fees are the management fees, Vengrowth contract amount, the capital maintenance fees, the Co-Sponsor's fees and the Transfer Agent's fees. For a summary of these fees, please see Note 8 to the Fund's audited financial statements.

**PAST PERFORMANCE**

**Year by Year Non-Cumulative Returns**

The graph below indicates the Fund's annual performance for each of the years shown and how the Fund's performance has changed from year to year. It also shows, in percentage terms, how an investment made on the first day of each financial year should have increased or decreased by the last day of each financial year. The Fund's past performance is no guarantee of how it will perform in the future.



<sup>(1)</sup> For the six month period ended February 28, 2019.

## COVINGTON FUND II INC.

### CLASS A SHARES

[in \$000's of Canadian dollars except for per share amounts, number of shares and percentages]

#### SUMMARY OF INVESTMENT PORTFOLIO

Below is a summary of the Fund's portfolio as at February 28, 2019. This is a summary only and may change due to ongoing portfolio activity in the Fund. See the Statement of Investment Portfolio in the financial statements for a complete listing. An update is available quarterly on Covington's website at [www.covingtonfunds.com](http://www.covingtonfunds.com).

#### HOLDINGS <sup>(1)</sup>

	Debt at cost \$	Equity at cost \$	Total at cost \$
WireE Holdings International Inc.	28,515	9,377	37,892
Axela Inc.	24,149	-	24,149
Mist Mobility Integrated Systems Technology Inc.	16,385	2,250	18,635
Interface Biologics Inc.	-	17,473	17,473
PowerBand Global Inc.	3,513	8,446	11,959
Nakina Systems Inc.*	-	7,427	7,427
OTYC Holdings Inc.	-	6,820	6,820
Embotics Corporation	-	6,079	6,079
Clek Inc.	-	5,458	5,458
Ivey CSBIF I Inc.	-	1,814	1,814
Ivey CSBIF II Inc.	-	1,814	1,814
Fusebill Inc.	-	1,615	1,615
Quorum Technologies Inc.†	-	1,500	-
Fidelity PAC Metals Ltd.	1,054	-	1,054
Spartan Bioscience Inc.	-	231	231
bitHeads Inc.	98	-	98
Black Bull Resources Inc.†	-	6	6
Simex Inc.	-	-	-

\* Investment made and tracked in US\$.

† Indicates a publicly traded security.

(1) Excluding cash and short-term investments.



CLASS A SHARES

[in \$000's of Canadian dollars except for number of companies and percentages]

SUMMARY OF INVESTMENT PORTFOLIO - *Continued*

Stage of development	Number of companies	Cost of investments \$	% Total venture investments at cost %	Fair value of investments \$	% Total venture investments at fair value %
Start-Up/Early	5	66,803	46.4	35,770	56.7
Expansion	9	59,848	41.6	24,057	38.2
Later	4	17,373	12.0	3,220	5.1
	18	144,024	100.0	63,047	100.0
<b>Industry class</b>					
Biotechnology/Health Sciences	4	48,673	33.8	20,207	32.1
Financial Services	2	3,628	2.5	2,326	3.7
Technology	8	66,570	46.2	19,236	30.5
Manufacturing/Distribution	4	25,153	17.5	21,278	33.7
	18	144,024	100.0	63,047	100.0
				Fair value of investments \$	% of Net asset value %
<b>Composition of net assets</b>					
Venture investments, at fair value				63,047	99.1
Other assets, net of liabilities				18	0.1
<b>Net assets attributable to holders of redeemable units</b>				63,065	100.0

**Fund Symbols**

**Covington Fund II Inc.**

CIG912 - Closed

CIG 961 - Closed

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