

# Management Report of Fund Performance



## COVINGTON FUND II INC.

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This annual management report of fund performance contains financial highlights but does not contain the complete annual financial statements of Covington Fund II Inc. (the “Fund”). You can obtain a copy of the interim or annual financial statements at your request, and at no cost, by calling 1-866-244-4714, by writing to us at Covington Capital Corporation, 87 Front St. East, Suite 400, Toronto, Ontario M5E 1B8, 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.

**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 seventeenth year of operations. As such, some of the portfolio investments have matured from start up to expansion and later stages of their growth cycle. The Fund continues to manage these investments by working with the investee companies to grow revenues and profits while moving toward successful exits with a focus on obtaining and managing liquidity for shareholder redemptions in an orderly fashion.

On September 8, 2015, the Fund announced that it has temporarily suspended redemptions as a result of significant and increasing requests for redemptions since the Fund opened its restricted share series on September 2, 2015. The decision was taken given a significant increase in redemption requests that had the potential to eliminate the liquidity required to operate the Fund in an efficient manner. The Board of Directors concluded that the temporary suspension was required to maximize returns for all shareholders and was in the best interests of the Fund.

## CLASS A SHARES

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

### RISKS AND UNCERTAINTIES

The Fund is and always has been 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 August 31, 2016, the Fund's investment portfolio consists of 28 companies of which 1 is publicly traded and 27 are privately held. More than 85% of the Fund's net asset value is 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"). Slow 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 Funds operating in this sector to raise significant amounts of capital. Additionally, the Fund is closed to new subscriptions; as such, the Fund is dependent upon internal growth of its portfolio in order to meet its investment objectives and provide liquidity to its shareholders via redemptions.

These on-going liquidity pressures as well as a significant and increasing requests received in early September 2015, lead to the temporary halt in redemptions of the Fund as of close of business on September 4, 2015, the reopening and subsequent closing of the Fund on January 18, 2016. Please see "Recent Developments".

As laid out in the Fund's original prospectus and annual information form, in any financial year, the Fund is not obligated to redeem greater than 20% of the Net Asset Value of the Fund as at its preceding fiscal year-end.

**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** – More than 96% of the Fund's venture holdings are 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; now, in 2016, this sector presents 26% of the portfolio value held in 21% 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 August 31, 2016, the total net assets attributable to holders of redeemable shares of the Fund ("NAV") were \$140,830. The comparative NAV as at August 31, 2015 was \$214,588. The decrease in net assets of \$73,758 is due to a loss from operations of \$30,788 and redemptions of \$42,970. At August 31, 2016, the Fund held \$15,428 in cash to provide the Fund with liquidity. The use of cash has been not only to fund redemptions and operations but also to support existing companies within the venture portfolio.

The Fund's venture portfolio has decreased in value to \$119,436 from \$193,450 as at August 31, 2016 and remains invested in 28 companies over a broad group of industries. By value and number of investments, the technology sector remains the Fund's largest investment concentration at approximately 44% of both number of companies and portfolio value of venture investments. The Fund realized net losses of \$32,575 from exits of investments during the year.

The Fund completed approximately \$20,539 in cash follow-on financings to support the venture portfolio companies in the fiscal year. Non-monetary additions to the portfolio totaled \$39,342 coming largely in the form of stock proceeds from successful milestone targets and debt conversions on existing portfolio investments. Interest for distribution purposes and dividend income for the year ended August 31, 2016 amounted to \$24,288, an increase of \$22,179 over the same period in 2015. The increase was due in part of a deemed dividend distribution of \$14,296 related from an investee company share repurchase. Total expenses for the period have decreased by approximately \$4,361 driven mainly by the decrease in net assets and the fees that are generated based on the net asset balance.

The annualized MER of Series I of the Fund excluding CIPA is approximately 4.29%. The annualized MER of Series II of the Fund excluding CIPA is approximately 4.50%.

### RECENT DEVELOPMENTS

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#### Temporary Suspension of Redemptions

On September 2, 2015, the fourth anniversary of the Merger, the redemption restriction expired on all Class A shares that have been issued and outstanding for eight years or more. On September 8, 2015 the Fund announced a temporary halt to redemptions of the Fund given the magnitude of redemption requests had the potential to eliminate the liquidity required to operate the Fund in an efficient manner. On January 18, 2016, the Fund re-opened to redemptions and was halted again after the cumulative redemptions for fiscal 2016 reached approximately 20% of the NAV as at the last day of fiscal 2015.

On August 25, 2016 the Board of Directors of the Fund announced that it had approved the re-opening of the Fund on October 24, 2016 to allow for the Fund to honour redemptions up to approximately 20% of the NAV of the Fund for the 2016/2017 fiscal year as contemplated in the Fund's prospectus disclosure. The Fund is not required to redeem Class A Shares, in any financial year having an aggregate redemption price exceeding 20% of the NAV of the Fund as at the last day of the preceding fiscal year. The Fund met its obligation and closed the Fund on October 24, 2016. The Fund anticipates that the next redemption opportunity will not occur until after September 1, 2017.

The fair value of the Fund's portfolio will continue to be determined every week and there are no anticipated changes to the value of its private investments as a result of this decision. The challenge remains to optimize exits value for the private investments while trying to meet redemption requests of 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 2016 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>Year ended August 31, 2016</b>	Year ended August 31, 2015	Year ended August 31, 2014	Year ended August 31, 2013 <sup>(3)</sup>	Year ended August 31, 2012 <sup>(3)</sup>
Net assets attributable to holders of redeemable units, beginning of year <sup>(1)</sup> <sup>(2)</sup>	\$ <b>8.16</b>	\$ 8.98	\$ 8.58	\$ 7.48	\$ 7.95
Increase (decrease) from operations:					
Total revenue	<b>1.22</b>	0.08	0.02	0.07	0.28
Total expenses	<b>(0.39)</b>	(0.46)	(0.63)	(0.80)	(0.52)
Realized gain (loss) on investments	<b>(1.46)</b>	0.89	1.13	0.22	0.33
Unrealized gain (loss) on investments	<b>(0.77)</b>	(1.32)	(0.22)	1.61	(0.73)
Total increase (decrease) from operations <sup>(2)</sup>	<b>(1.40)</b>	(0.81)	0.30	1.10	(0.64)
Net assets attributable to holders of redeemable units, end of year <sup>(1)</sup> <sup>(2)</sup>	\$ <b>6.83</b>	\$ 8.16	\$ 8.98	\$ 8.61	\$ 7.48
<b>SERIES II</b>					
Net assets attributable to holders of redeemable units, beginning of year <sup>(1)</sup> <sup>(2)</sup>	\$ <b>7.78</b>	\$ 8.59	\$ 8.28	\$ 7.32	\$ -
Increase (decrease) from operations:					
Total revenue	<b>1.19</b>	0.07	0.02	0.07	0.20
Total expenses	<b>(0.39)</b>	(0.48)	(0.66)	(0.88)	(0.63)
Realized gain (loss) on investments	<b>(1.44)</b>	0.85	1.15	0.21	0.32
Unrealized gain (loss) on investments	<b>(0.69)</b>	(1.25)	(0.18)	1.64	(0.52)
Total increase (decrease) from operations <sup>(2)</sup>	<b>(1.33)</b>	(0.81)	0.33	1.04	(0.63)
Net assets attributable to holders of redeemable units, end of year <sup>(1)</sup> <sup>(2)</sup>	\$ <b>6.50</b>	\$ 7.78	\$ 8.59	\$ 8.32	\$ 7.32

(1) This information is derived from the Fund's audited 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.

(3) Historical figures are based on Canadian GAAP.

## 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>Year ended August 31, 2016</b>	Year ended August 31, 2015	Year ended August 31, 2014	Year ended August 31, 2013	Year ended August 31, 2012
Total net assets attributable to holders of redeemable units <sup>(1)</sup>	\$ <b>84,636</b>	\$ 127,748	\$ 151,028	\$ 151,633	\$ 145,915
Number of shares outstanding	<b>12,385,692</b>	15,655,888	16,824,904	17,673,307	19,463,229
Management expense ratio <sup>(2)</sup>	<b>5.35%</b>	5.33%	7.13%	10.10%	6.45%
Management expense ratio before IPA <sup>(2)</sup>	<b>4.29%</b>	4.69%	6.68%	4.77%	5.24%
Portfolio turnover rate <sup>(3)</sup>	<b>39.54%</b>	20.42%	18.88%	41.54%	28.48%
Trading expense ratio <sup>(4)</sup>	<b>0.07%</b>	0.08%	0.17%	-	-
Net assets attributable to holders of redeemable units per unit	\$ <b>6.83</b>	\$ 8.16	\$ 8.98	\$ 8.58	\$ 7.50
<b>SERIES II</b>					
Total net assets attributable to holders of redeemable units <sup>(1)</sup>	\$ <b>56,194</b>	\$ 86,840	\$ 109,562	\$ 123,972	\$ 123,583
Number of shares outstanding	<b>8,645,176</b>	11,166,508	12,747,483	14,966,676	16,845,039
Management expense ratio <sup>(2)</sup>	<b>5.56%</b>	5.81%	7.79%	11.49%	8.00%
Management expense ratio before IPA <sup>(2)</sup>	<b>4.50%</b>	5.17%	7.31%	6.14%	6.79%
Portfolio turnover rate <sup>(3)</sup>	<b>39.54%</b>	20.42%	18.88%	41.54%	28.48%
Trading expense ratio <sup>(4)</sup>	<b>0.07%</b>	0.08%	0.17%	-	-
Net assets attributable to holders of redeemable units per unit	\$ <b>6.50</b>	\$ 7.78	\$ 8.59	\$ 8.28	\$ 7.34

(1) This information is provided as at August 31 of the years shown.

(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.

#### 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 83% 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 17% for the implementation of communications, sales, marketing, and distribution strategies. Over time, the allocation of management resources has increased for investment and portfolio management relative to sales, marketing, and distribution.

CLASS A SHARES

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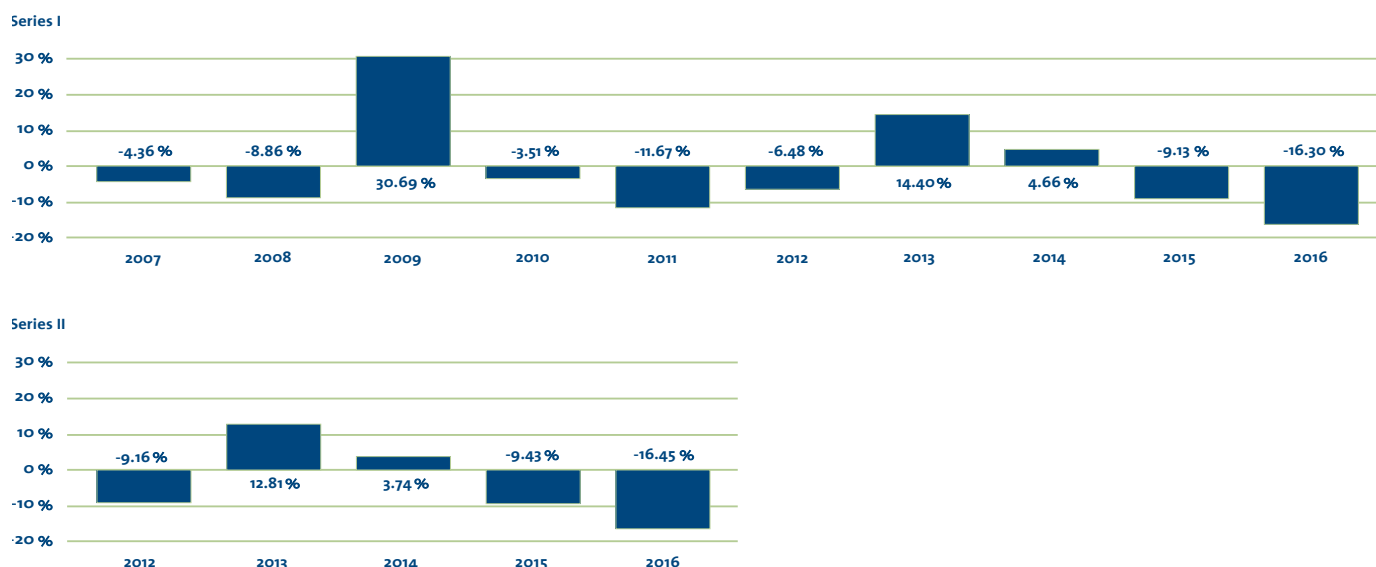
MANAGEMENT FEES - Continued

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 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.



Annual Compound Returns

The table below summarizes the Fund's past performance for the ten, five, three and one year periods ended August 31 of the periods indicated. As a basis of comparison, we have provided the Retail Venture Capital Index as posted on www.globefund.com as of August 31, 2016 and the BMO Nesbitt Burns Cdn Small Cap Index as at August 31, 2016.

The Retail Venture Capital Index is the most representative broad-based securities market index as it accumulates all the Ontario based LSIFs. The inclusion of the BMO Nesbitt Burns Cdn Small Cap Index is only intended to give perspective to general market activity.

Compound Returns	Series I	Series II	Retail Venture Capital Index*	BMO Nesbitt Burns Cdn Small Cap Index
1 Year	-16.30%	-16.45%	-6.54%	20.67%
3 Years	-7.32%	-7.75%	-4.29%	5.73%
5 Years	-3.16%	-4.26%	-2.38%	2.51%
10 Years	-1.88%	N/A	-0.18%	3.73%
Since Inception	-2.35%	-4.26%	**	**

\* Source: globefund.com

\*\* No comparable index available for the same period.

## 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 August 31, 2016. 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).

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

	Debt at cost \$	Equity at cost \$	Total at cost \$
WireE Holdings International Inc.	27,825	8,062	35,887
Axela Inc.	25,503	-	25,503
Mist Mobility Integrated Systems Technology Inc.	15,950	2,250	18,200
Interface Biologics Inc.	-	17,473	17,473
PowerBand Global Inc.	7,291	8,446	15,737
Nakina Systems Inc.*	-	9,503	9,503
OTYC Holdings Inc.	-	6,820	6,820
Embotics Corporation	-	6,079	6,079
Clek Inc.	-	5,458	5,458
AppZero Corporation	-	3,091	3,091
2210961 Ontario Limited	2,876	-	2,876
bitHeads Inc.	113	2,342	2,455
Fidelity PAC Metals Ltd.	286	2,060	2,346
VG Mezzanine I Limited Partnership	-	2,021	2,021
Ivey CSBIF I Inc.	-	2,000	2,000
Ivey CSBIF II Inc.	-	2,000	2,000
Fuseball Inc.	-	1,615	1,615
Greenfield Ethanol Inc.	-	1,554	1,554
Signal Hill Equity Partners II, LP	-	1,474	1,474
Masstech Innovations Inc.	1,146	-	1,146
Roll-Tite Corporation	1,090	-	1,090
Active Exhaust Corporation	-	822	822
Spartan Bioscience Inc.	-	231	231
2203077 Ontario Limited	25	-	25
Black Bull Resources Inc.†	-	6	6

\* 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	76,791	46.4	54,654	45.8
Expansion	17	75,776	45.8	55,565	46.5
Later	6	12,845	7.8	9,217	7.7
	28	165,412	100.0	119,436	100.0
Industry class					
Biotechnology/Health Sciences	5	50,027	30.3	30,565	25.6
Financial Services	4	7,495	4.5	7,484	6.3
Technology	12	76,360	46.2	52,722	44.1
Manufacturing/Distribution	7	31,530	19.0	28,665	24.0
	28	165,412	100.0	119,436	100.0
Composition of net assets				Fair value of investments \$	% of Net asset value %
Cash				15,428	11.0
Restricted cash				3,090	2.2
Venture investments				119,436	84.8
Other assets, net of liabilities				2,876	2.0
<b>Net assets attributable to holders of redeemable units</b>				140,830	100.0

**Fund Symbols**

**Covington Fund II Inc.**

CIG912 - Closed

CIG 961 - Closed

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