

**DEANS KNIGHT**  

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**INCOME CORPORATION**

**ANNUAL MANAGEMENT REPORT  
OF FUND PERFORMANCE FOR 2012**

This annual management report of fund performance (the "**Report**") contains financial highlights of Deans Knight Income Corporation (the "**Company**"). This Report should be read in conjunction with the annual financial statements of the Company for the year ended December 31, 2012 (the "**Financial Statements**"), which, if not included with this Report, can be obtained at your request, at no cost by emailing [info@dkincomecorp.com](mailto:info@dkincomecorp.com), visiting our website at [www.dkincomecorp.com](http://www.dkincomecorp.com) for contact details or on SEDAR at [www.sedar.com](http://www.sedar.com). Readers may also contact us to request a free copy of the Company's proxy voting policies and procedures, proxy voting disclosure record or quarterly portfolio disclosure.

## **A NOTE ON FORWARD-LOOKING STATEMENTS**

This Report contains certain forward-looking statements. In particular, this Report contains forward-looking statements in respect of the Company's targeted dividend payout, investment strategy, behaviour of financial markets and reflects the Company's expectations regarding the growth, results of operations, performance and business prospects and opportunities of the Company and its investments. In some cases, forward-looking statements can be identified by terminology such as "may", "will", "should", "expect", "plan", "anticipate", "believe", "estimate", "predict", "potential", "continue" or the negative of these terms or other comparable terminology. Such forward-looking statements reflect the Company's current beliefs and are based on information currently available to the Company. With respect to such forward-looking statements, the Company has made assumptions regarding, among other things, what type of debt securities will be included in its investment portfolio, currency, exchange and interest rates. A number of factors could cause actual events or results to differ materially from the results discussed in the forward-looking statements. In evaluating these statements, prospective investors should specifically consider various factors, including global equity and capital markets, business competition, technological change, changes in government regulations, unexpected judicial or regulatory proceedings, and catastrophic events and the risks outlined under "Risk Factors" in the AIF (as defined herein), which may cause actual results to differ materially from any forward-looking statement. Although the forward-looking statements contained in this Report are based upon what the Company believes to be reasonable assumptions, the Company cannot assure investors that actual results will be consistent with these forward-looking statements. Forward-looking statements are made as of the date of this Report and, other than as required by applicable law, the Company assumes no obligation to update or revise them to reflect new events or circumstances.

This Report also contains certain financial and operational information obtained from public sources in respect of certain companies included in the Company's investment portfolio. While management believes this data to be reliable, such information is subject to variations and may not be able to be verified due to limits on the availability and reliability of data inputs, the nature of the data gathering process and other limitations and uncertainties inherent in such information. Accordingly, the accuracy, currency and completeness of this information cannot be guaranteed. The Company has not independently verified any of the data from third party sources referred to in this Report or ascertained the underlying assumptions relied upon by such sources.

## **Investment Objectives and Strategies**

The Company is a closed-end, non-redeemable investment company focused on investing in corporate debt securities. The Company's assets are actively managed by Deans Knight Capital Management Ltd. ("**Deans Knight**"), a respected British Columbia-based investment firm focused on managing high income and growth mandates for high net worth individuals. Deans Knight, formed in 1992, has an experienced management team and a long history of successful investing in corporate debt securities.

The Company's investment objectives are to: (i) maximize the total return for shareholders, consisting of dividend income and capital appreciation; and (ii) provide shareholders with monthly dividends, which to date have been set at \$0.0583 per common share per month. The Company intends to continue to achieve these objectives by investing primarily in corporate debt securities rated BBB or below by Standard & Poor's Rating Services ("**S&P**") or an equivalent rating by another nationally recognized statistical rating organization. The Company may also invest in investment grade debt securities rated above BBB and non-rated debt securities from time to time. Examples of investments made during the period are detailed below in the Results from Operations.

The Company believes there are attractive investment opportunities today in owning corporate debt of businesses with tangible assets, strong cash flows and reasonable leverage.

When evaluating securities to purchase for the Company, Deans Knight focuses on the following:

- amount of security or collateral within a business to support the value of the securities;
- the position of the debt in the capital structure;
- covenants;
- liquidity;
- the business' ability to reduce or refinance the debt; and
- the overall term of the debt and yield to bondholders.

Deans Knight uses the above credit-based analysis to identify corporate debt for inclusion in the Company's investment portfolio with attractive valuations in order to maintain its targeted dividend payment.

## **Risk**

The overall risks of the Company are as described in its annual information form of the Company dated March 11, 2013 (the "**AIF**").

Prior to the reorganization and change in business as discussed in Note 1 of the Financial Statements, the Company generated significant tax losses and other tax attributes as a result of its prior businesses and research activities. The Company has recorded, as a tax asset, the full amount of the potential tax benefit of such items to the extent of its projected taxable

income. There is uncertainty as to whether the tax authorities will allow the Company to deduct some or all of the tax losses and other attributes. Should the Company be denied the deductions in full, the recorded amount of the tax assets as well as such amounts claimed to date would be recorded as a charge to income. The total tax assets recognized and tax losses and other attributes claimed to date, which are subject to uncertainty, amount to \$21,154,044 (2011 - \$21,024,806), representing \$2.01 per common share at December 31, 2012 (2011 - \$2.00).

There were no significant changes during the year ending December 31, 2012 that affected the overall risk of investing in the Company. Given the type of investments made by the Company, an investment in the Company may be considered to be speculative. An investment in the Company is generally suitable for investors who are looking to receive income, yet are willing to tolerate volatility in the value of their investment.

### Results of Operations

The net assets of the Company at December 31, 2012 were \$142,275,000 or \$13.50 per common share (2011 - \$141,539,920 or \$13.43 per common share). The net assets of the Company consisted of the following components:

	<b>December 31, 2012</b>		
	\$	Per common share <sup>(1)</sup>	%
Investments <sup>(2)</sup>	118,788,753	11.27	83.5
Cash and short-term deposits	20,091,125	1.91	14.1
Accrued income	1,662,373	0.16	1.2
Prepaid expenses	56,460	0.00	0.0
Future income tax asset <sup>(3)</sup>	2,390,000	0.23	1.7
Accounts payable and accrued liabilities	(713,711)	(0.07)	(0.5)
	<u>142,275,000</u>	<u>13.50</u>	<u>100.0</u>

(1) Based on 10,537,263 common shares, including 10,191,592 voting common shares and 345,671 non-voting common shares, as outlined in the notes to the Financial Statements.

(2) The details of the investments are outlined in the Summary of Investment Portfolio below.

(3) Refer to the Taxation note to the Financial Statements for more detail.

**December 31, 2011**

	\$	Per common share <sup>(1)</sup>	%
Investments <sup>(2)</sup>	129,918,543	12.33	91.8
Cash and short-term deposits	4,997,715	0.47	3.5
Accrued income	2,339,751	0.22	1.7
Prepaid expenses	73,151	0.01	0.0
Future income tax asset <sup>(3)</sup>	4,920,000	0.47	3.5
Accounts payable and accrued liabilities	(709,240)	(0.07)	(0.5)
	<u>141,539,920</u>	<u>13.43</u>	<u>100.0</u>

(1) Based on 10,537,263 common shares, including 10,191,592 voting common shares and 345,671 non-voting common shares, as outlined in the notes to the Financial Statements.

(2) The details of the investments are outlined in the Summary of Investment Portfolio below.

(3) Refer to the Taxation note to the Financial Statements for more detail.

The Company began operating as an Investment Company in March 2009 to take advantage of attractive pricing in the high yield market with the objectives of: (i) maximizing the total return for Shareholders, consisting of dividend income and capital appreciation; and (ii) providing Shareholders with monthly dividends targeted to payout a minimum of 75% of net earnings annually. During 2012, the Company made monthly dividend payments totalling \$7,371,869, or \$0.70 per common share (2011 - \$7,371,869, or \$0.70 per common share). This represented approximately 83.9% of net investment income (2011 – 83.4%).

Since commencement of its investment business, the Company has made monthly dividend payments totalling \$26,415,864, or \$2.51 per common share. This represents approximately 90.3% of net investment income earned since March 17, 2009. On January 4, 2013, the Company announced it will maintain monthly cash dividends at \$0.0583 per common share for each of the first three months of 2013.

The net assets of the Company grew in 2012 from \$13.43 per common share to \$13.50. The net asset value was actually down 3.4% for the first 6 months of the year but was up 4.0% in the second half contributing to the \$0.07 increase in our net assets per common share. Since inception, the Company's net assets per common share have appreciated from the issue price of \$10 by 35%. Over half of the capital appreciation came in the first twelve months following the issue as the economy showed signs of life from the 2008/09 credit crunch. Since that time, we have added additional value as spreads continued to narrow and from a handful of creatively structured private debt financings. The private debt financings are typically short term in nature; pay a high coupon; in some cases are fully secured; and, provide the aforementioned capital growth through "equity kickers" in the form of warrants or convertible debt.

As an example, in April 2012, Deans Knight structured a secured debt financing with Petroamerica Oil Corp. for \$35 million, of which \$4.0 million was subscribed to by the Company. The debentures mature on April 19, 2015 and bear interest of 11.5%. In addition to the coupon, the Company received a commitment fee of 1.5% and warrants to purchase 100 common shares per \$100 of debt at an exercise price of \$0.20 per share, which mature on April 19, 2015. Petroamerica is an oil producer with assets in Colombia. They started 2012 producing 200 barrels of oil equivalent per day (“boepd”) with proceeds from the debt financing to be used to develop and appraise their assets. They drilled 5 wells on their Las Maracas property which, at year end, were producing 4,000 boepd net to Petroamerica. In addition to the Las Maracas asset, Petroamerica announced a new discovery at La Casona in November 2012 with one well testing at 480 boepd net to Petroamerica. With this success, Petroamerica’s stock was trading at \$0.35 per share at December 31, 2012, almost double the exercise price. Deans Knight Capital Management, the Company, and related parties did not receive compensation for structuring the debt financing.

## **Recent Developments**

### *Comparison of net asset value and net assets*

National Instrument 81-106 (“NI 81-106”) permits investment companies to have two different net asset values: (i) one for financial statements, which will be prepared in accordance with Canadian Generally Accepted Accounting Principles (“GAAP”) including Section 3855 (and referred to as “net assets”) and (ii) another for all other purposes, including unit pricing for investor transactions (referred to as “net asset value”). The main difference in calculating net assets and net asset value is that GAAP requires bid price to be used in valuing securities traded in an active market where quoted prices are readily and regularly available, rather than the use of a price between the bid and the ask price currently used for determining net asset value. This difference results in an insignificant difference of approximately \$0.08 per common share at December 31, 2012 (2011 - \$0.06 per common share), as outlined in the notes to the Financial Statements.

### *International Financial Reporting Standards*

The Company will be required to adopt international financial reporting standards (“IFRS”). The Canadian Accounting Standards Board (AcSB) previously announced January 1, 2011 as the date international financial reporting standards (IFRS) would replace current Canadian standards and interpretations as GAAP for publicly accountable enterprises, which include investment companies.

In December 2011, the AcSB issued a decision to defer adoption of IFRS for investment companies currently applying Accounting Guideline 18 - Investment Companies until years beginning on or after January 1, 2014.

Under the above noted decision, the Company's first set of financial statements to be reported on under IFRS would be for the semi-annual period ending June 30, 2014. These statements would include corresponding comparative financial information for 2013, including an opening statement of net assets as at January 1, 2013. However, the Company has a termination date of April 30, 2014, and as such will not be required to issue statements reported on under IFRS. The Company will continue to monitor any further AcSB decisions that may affect the Company's requirement to adopt IFRS.

#### *Harmonized Sales Tax*

The Company is subject to non-recoverable Harmonized Sales Tax on its expenses. The BC Government has announced that the Harmonized Sales Tax will be replaced by the Federal Goods and Services Tax and a Provincial Sales Tax in April 2013; however, this is not expected to have a significant impact on net assets per common share.

#### **Related Party Transactions**

The officers, and certain directors, of the Company are also employees of Deans Knight, the Company's investment advisor. These officers, and directors, are not paid by the Company. Deans Knight provides investment management services to the Company, as well as administration, financial reporting and other ancillary services required by a publicly listed company. Management fees, for the services outlined above, are computed and paid quarterly, at an annual rate of 1.5% of the net asset value plus applicable taxes, and adjusted for certain non-investment related assets.

For the year ended December 31, 2012, management fees totaled \$2,311,284 (2011 - \$2,283,158). At December 31, 2012, \$589,251 (December 2011- \$575,224) was owed to Deans Knight, which was included in accounts payable and accrued liabilities in the statement of net assets, and is payable immediately. In calculating the management fee, the net asset value was reduced by the value of the future income tax asset included in the statement of net assets.

A director of the Company is a partner at a law firm that provides legal services to the Company. During the year ended December 31, 2012, the Company incurred \$14,014 (2011 - \$42,750) in legal services and disbursements received from this related party. At December 31, 2012, accounts payable and accrued liabilities include \$226 (2011 - \$4,185) due to the law firm for legal fees and disbursements.

## Financial Highlights

The following tables show selected key financial information about the Company and are intended to help you understand the Company's financial performance since it began operating its new business of investing in corporate debt in March 2009.

### *The Company's Net Assets per Common Share* <sup>(1)</sup>

	2012	2011	2010	Period March 17 to December 31, 2009
	\$	\$	\$	\$
Net assets, beginning of year <sup>(2)</sup>	13.43	13.60	12.21	9.12
Increase from operations				
Total revenue	1.10	1.10	0.94	0.62
Total expenses	(0.26)	(0.26)	(0.24)	(0.20)
Realized gains	0.44	0.36	1.82	1.25
Unrealized losses	(0.27)	(0.52)	(0.27)	1.21
Future income taxes	(0.24)	(0.15)	(0.16)	0.62
Total increase from operations <sup>(2)</sup>	0.77	0.53	2.09	3.50
Dividends <sup>(2)(3)</sup>	(0.70)	(0.70)	(0.70)	(0.41)
Net assets, end of year <sup>(4)</sup>	13.50	13.43	13.60	12.21

(1) The information is derived from the Company's audited annual financial statements. Common shares outstanding are 10,537,263, including 10,191,592 voting common shares and 345,671 non-voting common shares.

(2) Net assets and dividends are based on the actual number of common shares outstanding at the relevant time. The increase/decrease from operations is based on the weighted average number of common shares outstanding over the year.

(3) Dividends were paid in cash.

(4) The net assets per common share presented in the financial statements differs from the net asset value per common share calculated for fund pricing purposes due to the provisions of CICA Handbook Section 3855. An explanation of the differences can be found in the notes to the financial statements.

### *Ratios and Supplemental Data* <sup>(1)</sup>

	2012	2011	2010	Period March 17 to December 31, 2009
Net asset value (000's)	\$143,065	\$142,178	\$143,880	\$128,930
Number of common shares outstanding (000's)	10,537	10,537	10,537	10,537
Management expense ratio <sup>(2)</sup>	1.96%	1.90%	1.91%	5.51%
Portfolio turnover rate <sup>(3)</sup>	14.79%	79.90%	86.60%	36.69%
Trading expense ratio <sup>(4)</sup>	0.01%	0.00%	0.01%	0.01%
Net asset value per common share	\$13.58	\$13.49	\$13.65	\$12.23
Closing market price – common share	\$12.69	\$11.84	\$12.54	\$11.40

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

(2) Management expense ratio is based on total expenses for the period and is expressed as an percentage of weekly average net asset values over the year.

(3) The Company's portfolio turnover rate indicates how actively the Company manages its portfolio investments. A portfolio turnover rate of 100% is equivalent to the Company buying and selling all of the securities in its portfolio once in the course of the year. The higher a portfolio turnover-rate in a year, the greater the trading costs payable by the Company in the year. There is not necessarily a relationship between a high turnover rate and the performance of the investment portfolio.

(4) The trading expense ratio represents total commissions and other portfolio transaction costs expressed as an annualized percentage of daily average net asset value during the period. This expense is \$11,318 for 2012 (2011- \$nil), as the purchasing and selling of bonds do not generally attract a commission from the buying or selling party.



## Management Fees

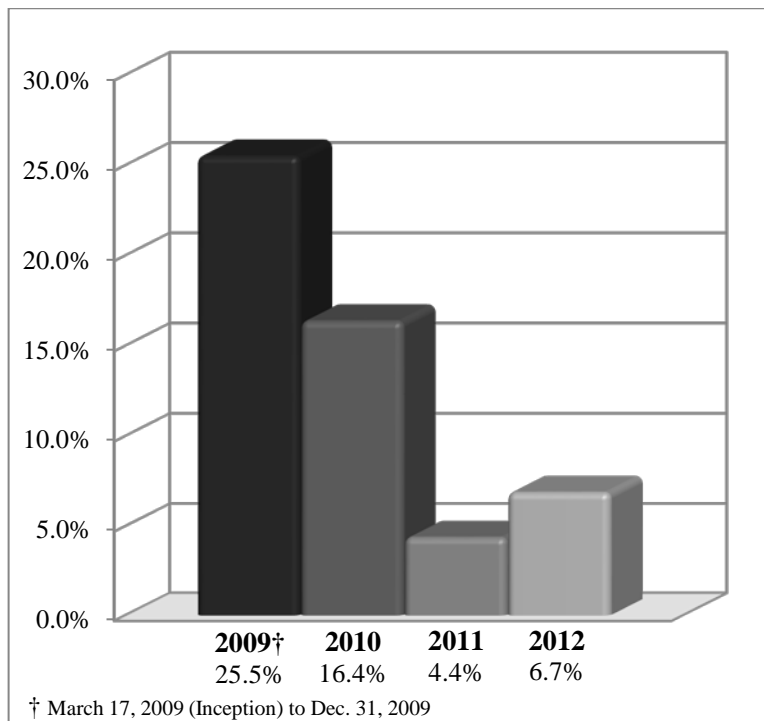
Deans Knight provides investment management services to the Company, as well as administration, financial reporting and other ancillary services required by a publicly listed company. Management fees are computed and paid quarterly, at an annual rate of 1.5% of the net asset value plus applicable taxes, and adjusted for certain non-investment related assets.

## Past Performance

This section shows the Company's past performance, since it began operating its business as an investment fund. The past performance information includes changes in net asset value and assumes the reinvestment of all dividends paid to common shareholders. It is important to note that the past performance will not necessarily indicate what performance in the future will be.

### *Year-by-year Returns*

The accompanying bar chart shows the Company's performance for the years shown and illustrates how the Company's performance has changed from year to year. The bar chart shows, in percentage terms, how much an investment made from when the Company began its operation as an investment fund on March 17, 2009 to December 31, 2009, and how much an investment made for the years ending December 31, 2010, 2011 and 2012.



## Annual Compound Returns

The table below summarizes the Company's annual compound total returns for the periods ended December 31 as indicated. As a basis for comparison, we have provided the performance of the Merrill Lynch Canada High Yield Bond Index ("Index"). The Index is a broad based index that tracks the performance of the Canadian high-yield bond market. As the criteria for determining the constituents of the Company's investment portfolio and the Index differ, it is not expected that the Company's performance will mirror that of the Index. Further, the return of the Index is calculated without the deduction of management fees and fund expenses whereas the performance of the Company is calculated after deducting fees and expenses.

<i>Annual Compound Returns</i>	<b>Company</b>	<b>Index</b>
1 Year	6.70%	15.10%
2 Years	5.60%	9.10%
3 Years	9.10%	10.60%
Since Inception	14.00%	19.90%

## Summary of Investment Portfolio

The following is a summary of the Company's investment portfolio as at December 31, 2012. This is a summary only and will change due to ongoing portfolio transactions of the Company. A quarterly update is available at [www.dkincomecorp.com](http://www.dkincomecorp.com).

<b>Top 25 Investments</b>				<b>% of Net Asset Value</b>	<b>Portfolio Composition</b>		<b>% of Net Asset Value</b>
PARAMOUNT RESOURCES	8.250%	13-Dec-17		6.7			
WHITECAP RESOURCES	N/A	N/A		6.1			
MIRABELA NICKEL LTD	8.750%	15-Apr-18		6.0			
STONE ENERGY CORP	8.625%	1-Feb-17		5.8			
NORTH AMERICA ENERGY	9.125%	7-Apr-17		5.4			
SOUTHERN PACIFIC RES	10.500%	1-Jan-16		4.2			
CALFRAC HOLDINGS LP	7.500%	1-Dec-20		4.1			
NORTHLAND RESOURCES	13.000%	6-Mar-17		3.4			
PERPETUAL ENERGY INC	8.750%	15-Mar-18		3.4			
TEMBEC INDUSTRIES	11.250%	15-Dec-18		3.2			
CCS INC	11.000%	15-Nov-15		3.1			
PETROAMERICA OIL	11.500%	19-Apr-15		2.8			
SHERRITT INTL CORP	8.000%	15-Nov-18		2.8			
CARA OPERATIONS LTD	9.125%	1-Dec-15		2.5			
GARDA WORLD SECURITY	9.750%	15-Mar-17		2.4			
BEAZER HOMES USA	9.125%	15-Jun-18		2.4			
CONIFEX TIMBER INC	12.000%	31-Dec-13		2.1			
GATEWAY CASINOS	8.875%	15-Nov-17		2.0			
BLACK PRESS GROUP	10.000%	4-Feb-14		1.9			
PACIFIC RUBIALES	7.250%	12-Dec-21		1.8			
SURE ENERGY	6.250%	21-Jan-14		1.8			
WESTERN ENERGY SVS	7.785%	30-Jan-19		1.6			
NIKO RESOURCES LTD.	7.000%	13-Dec-17		1.5			
99 CENTS ONLY STORES	11.000%	15-Dec-19		1.5			
SHERRITT INTL CORP	7.500%	24-Sep-20		1.4			
					<b>Fixed Income</b>		
					Canadian denominated in CAD		39.9
					Canadian denominated in USD		18.2
					United States denominated in USD		14.6
					Other Foreign denominated in USD		3.4
					Other Foreign denominated in EUR		0.9
							<u>77.0</u>
					<b>Convertible Debentures</b>		
					Other Foreign denominated in AUD		-
							<u>77.0</u>
					<b>Equity and Warrants</b>		<u>6.6</u>
					<b>Investment Portfolio</b>		83.6
					<b>Cash &amp; Short-term Deposits</b>		14.1
					<b>Other Net Assets</b>		2.3
							<u>100.0</u>
					<b>Sector Breakdown</b>		
					Energy		49.9
					Materials & Metals		13.7
					Consumer Discretionary		8.4
					Forestry		6.2
					Industrial/Manufacturing		4.3
					Technology		0.9
					Services		0.2
							<u>83.6</u>
					<b>Investment Portfolio</b>		83.6
					<b>Cash &amp; Short-term Deposits</b>		14.1
					<b>Other Net Assets</b>		2.3
							<u>100.0</u>