ESG Engagement and Disclosure Report 2020

Summary of the Results

Responsible investment is core to our approach across BMO Global Asset Management. With over three decades of experience, we believe that Environmental, Social and Governance (ESG) factors can reduce risk and underpin long-term returns, and we are committed to integrating ESG in all asset classes. As a strong supporter of the UN Sustainable Development Goals (SDGs), we also believe in using our influence as an investor to promote long-term sustainability. We were a founding member of the UN Principles for Responsible Investment (PRI) and have held an A+ rating for Strategy and Governance for the past three years. In late 2020, we also committed to an ambition to reach net zero emissions by 2050 for all our invested assets.

As part of this ESG commitment, BMO Global Asset Management Private Equity (BMO PE) actively engages with its underlying fund managers (General Partners or GPs) to encourage them to develop responsible investment policies that address ESG risks, both during the pre-investment due diligence phase and throughout their tenure as shareholders.

This report is published as the coronavirus pandemic continues to have devastating effects on people's lives around the world. Given the impact of the pandemic on every company within our and our GPs' portfolios we decided to delay our annual report. This was to allow managers to prioritise the critical support that they have provided portfolio management teams to ensure the safety of their staff and customers and to adapt business models to the lockdowns that have been enforced in an attempt to slow the advances of the virus. It was also to ensure that the report was not immediately out of date due to changes resulting from the pandemic.

With the roll-out of vaccines now underway the end of the pandemic is hopefully within sight. We also have a better view on how the pandemic has impacted ESG practices within private equity. At the onset of the crisis it was not clear if it would further accelerate the adoption of responsible investment practices or if the crisis would delay adoption, as was seen in the wake of the global financial crisis, when people re-focussed on purely financial performance metrics in an attempt to ensure businesses recovery and survival.

So far it appears that the pandemic has further accelerated adoption of responsible investment practices. COVID-19 is a global crisis and needs to be tackled on a global basis. No nation can fully protect its citizens until the pandemic has been tackled worldwide, removing pockets where the virus will otherwise continue to mutate and potentially give rise to vaccine resistant strains. The global nature of the pandemic has led to an increased focus on sustainability and resilience. It has shone a light on the role business plays in society, and increased focus on other global threats such as climate change.

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Importance of ESG continues to rise

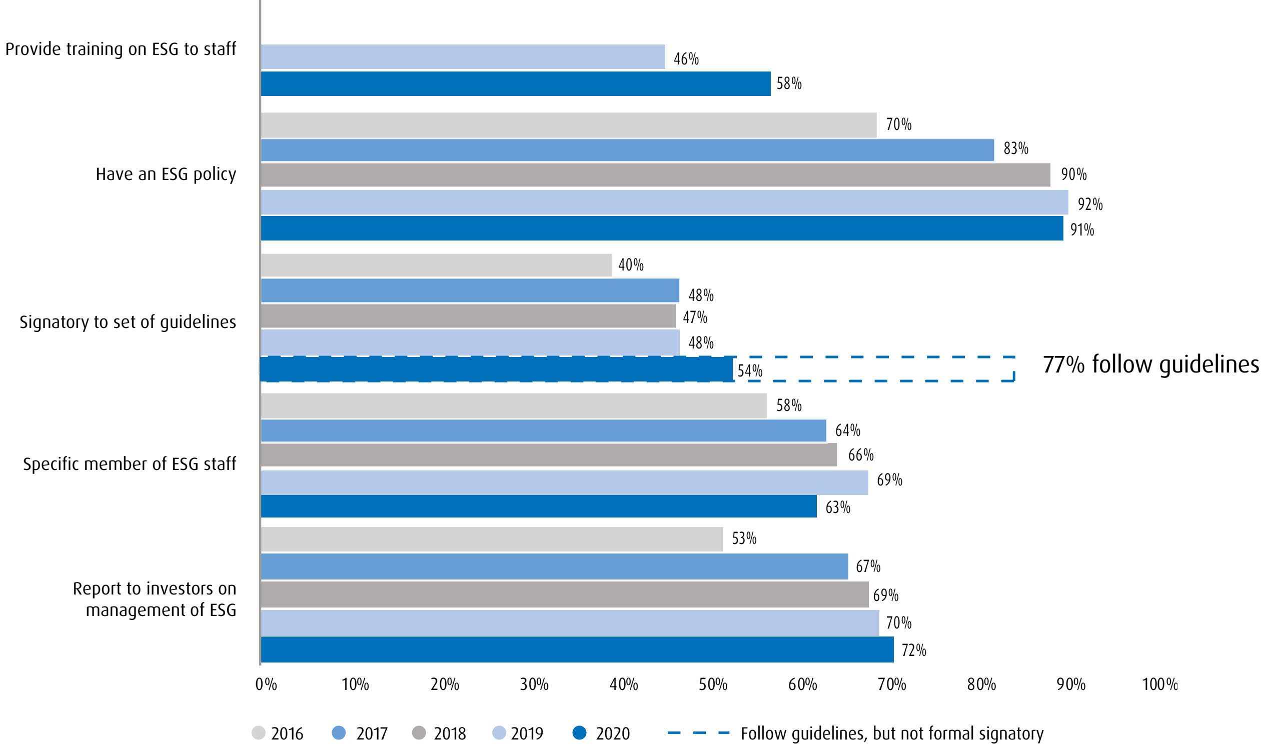
Covid-19 has further accelerated adoption of responsible investment practices.

- Over 90% of our managers have a formal ESG policy for the second year running. Demonstrating a comprehensive approach to ESG management is a high-priority requirement for investors
- 77% of our managers follow a recognised code of conduct or international set of standards with regards to responsible investment
- Over half (58%) of our GPs are providing training to staff on ESG matters, up from 46% last year
- The number of GPs reporting to investors on ESG (72%), and the quality of reports continues to improve. Many managers are now linking investments to UN SDGs

Over the last few years our investment partners have moved from having a broad awareness and uneven adoption of ESG, to accepting it as a standard part of doing business. ESG is now mainstream, and investors are demanding greater ESG integration and transparency from private equity firms. There is enhanced global regulatory focus around ESG, and a continuous `raising of the bar' in terms of market expectations on ESG practices within the industry.

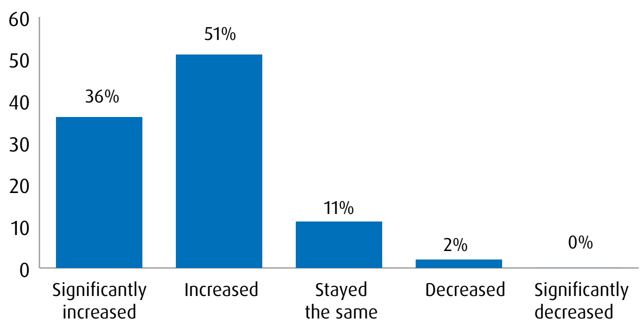
There is also increasing acceptance of the financial impact ESG can have both in terms of downside and upside: ESG risk are risks to investment returns but also market leading ESG practices are increasingly attractive to customers and potential investors and can therefore add significant shareholder value. A GP that fails to implement leading ESG within its investment portfolio therefore not only fails to mitigate risks, but also leaves substantial value on the table. ESG initiatives can also reduce costs across the portfolio, for example through lowering energy and water consumption, or even reducing finance costs.

Results of the 2020 Survey of Managers

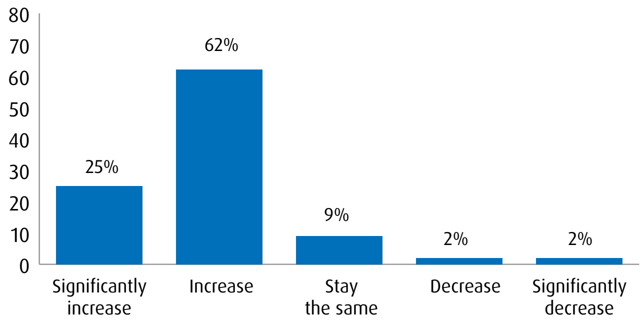


The majority (87%) of our managers highlighted that they expect the importance of ESG to continue to increase over the next three years, bringing ESG to the forefront of their portfolios.

ESG Importance – previous 3 years

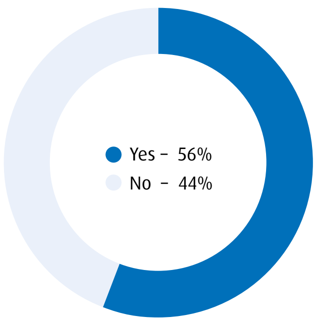


ESG Importance – next 3 years

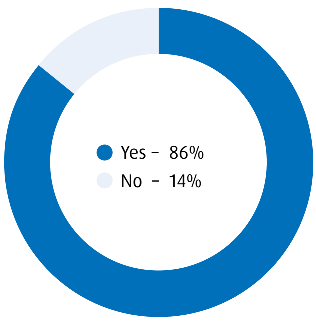


ESG and the investment strategy

Use ESG as a source of differentiation



ESG factors influence investment decision



When we first published an ESG report in 2014, 55% of our investment partners had a formal ESG policy in place. This number has now hovered at 90% for the past two years. This is no surprise as a comprehensive approach to ESG is now seen as essential by many investors. The more powerful revelation is that 86% of our managers have stated that ESG factors influence their overall investment decisions, with 56% using their approach to ESG as a differentiating factor from competitors. These numbers show clearly that ESG has moved from a niche market to a phenomenon that is shaping the private equity industry.

Considering our results, our managers have two main approaches to ESG integration into the investment strategy – risk management and value creation. The former is dominant although in our view there is a natural development from risk management to a more holistic view of returns optimisation.

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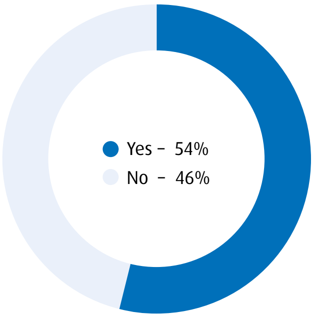
Codes of Conduct

Signatories to a set of guidelines

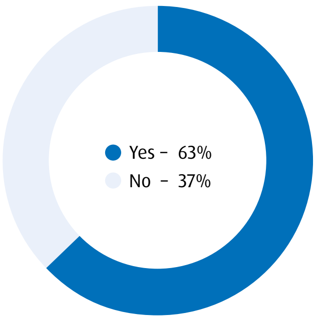


Over half (54%) of our managers are signatories to a code of conduct. This is an increase from the c.48% seen over the last three years. Furthermore 77% of our GPs have said they follow a recognised code of conduct, although they may not be formal signatories, up from 74% last year. PRI remains the most favoured set of guidelines for responsible investing (54% of our managers who are signatories chose PRI). As a founder signatory to the PRI we will continue to encourage our managers to consider adding their names to the list. Signatories must report on their responsible investment performance, driving increased demands on private equity firms for action and information.

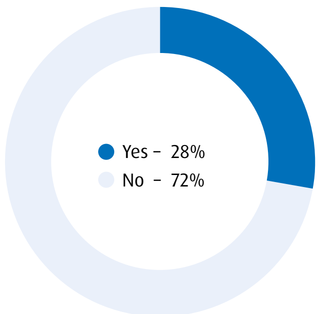
We feel that being required to produce various responsible investment reports will encourage GPs to think more deeply about a comprehensive implementation plan. It will also help standardise reporting across the industry.

ESG oversight and training

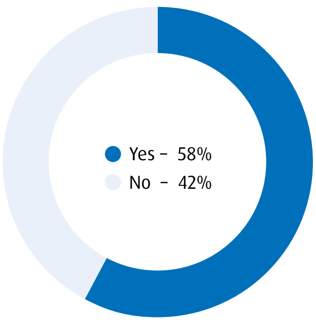
Specific member of ESG staff



Specific ESG oversight committee



Provide training on ESG to staff



Responsibility for the implementation of ESG across the firm is increasingly being shared within our managers. 63% of respondents have a specific member of staff accountable for ensuring proper implementation of the policies that the GPs have put in place, and over a quarter (28%) of respondents have some form of committee oversight function for ESG implementation compared with 24% last year. We feel this is a positive development.

We note that many of our managers have stated they are simply too small to justify a specific oversight function. In many of these cases, oversight responsibilities lie with the Chief Operating Officer or other senior individuals of the firm. We believe this is still positive as buy-in at the senior level is a valid way to ensure adherence to a firm's stated policy and ensure good ESG management permeates down to the junior levels. However, it is one thing for a manager's Chief Operating Officer to champion sustainable investing, and quite another for it to be practiced by those responsible for carrying out due diligence and day-to-day investment decisions. Therefore, emphasis on properly training investment staff on ESG will be very important. Encouragingly, there has been a 12% increase in managers who provide training to staff in the last 12 months, with the proportion providing training now standing at 58% of respondents.

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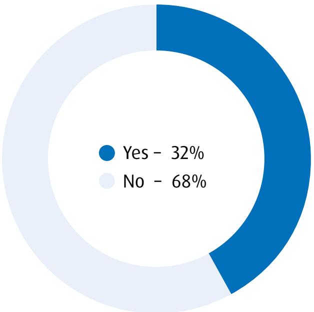
Managing ESG risks – it's not one size fits all

GPs that have declined an investment opportunity in the last year due to ESG risk



Undetected ESG risks can result in material outcomes that affect long-term value creation and performance in an investment portfolio. Identifying ESG risks are sometimes misinterpreted as undertakings that require organisations to adopt a set of one-size-fits-all policies that must be implemented in a set order. In reality, implementing high-quality, comprehensive, and accurate processes to identify risks is a significant undertaking.

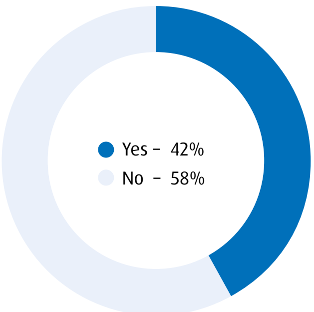
This year we specifically asked managers to highlight the key risks in their portfolios. Each of our managers operate in different markets and industrial segments and face different ESG challenges. However, there were some common themes, with the main ESG risks identified as:

Climate change	23%
Health & safety	19%
Corporate governance	16%
Bribery & corruption	9%
Diversity & Gender parity	5%

Interestingly, almost a third (32%) of respondents have declined an investment opportunity within the last year due to an identified ESG risk although most managers have declined to report further information on the investments they did not make.

Exposure to climate related risks

Climate change has impacted investment strategy

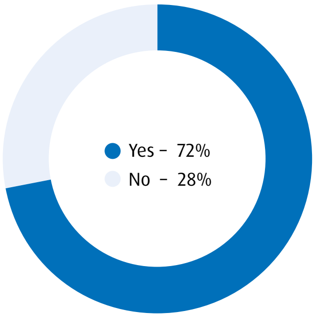


Climate change is a key risk to investment performance and long-term financial success. 42% of our respondents said that the increasing focus on climate change over the last few years has impacted their investment strategy, and 23% said it was the main ESG risk in the investment portfolio. Some managers have specifically updated and refined their policy to cover climate change. This helps to explore ways in which they can understand, measure and reduce the climate impact of their portfolio. In addition, the increased focus on climate change means additional reporting requirements which may help provide additional insights into such areas as water or energy consumption, as well as CO_2 / waste emissions.

Even prior to the COVID-19 pandemic, issues such as climate change and social inequality were featuring more prominently on Limited Partner (LP) agendas. Once life returns to 'normal', ESG will occupy a key strategic position in business thinking, particularly as investor demand for sustainable investing continues to grow.

Reporting procedures and measuring impact

Report to LPs on ESG



Almost three-quarters (72%) of our managers offer comprehensive reporting on ESG to LPs, a small increase of 2% on last year. For context, only 40% of our managers provided any such reporting in 2014. Good reporting can help build trust and confidence between GPs and LPs on how both non-financial and financial issues are managed.

An overwhelming majority (87%) of our managers plan to step up their efforts to manage and measure ESG performance in their portfolio companies over the next three years, including improving reporting procedures, which is encouraging.

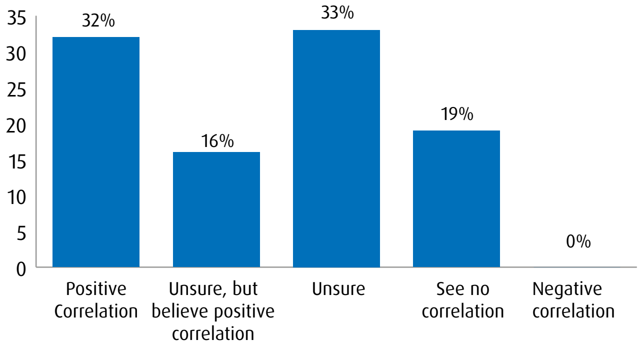
As the SDGs gain broader adoption, investors are also seeking to understand which of their portfolio companies are well aligned to support the SDGs. 58% of our managers aim to measure the positive social and/or environmental impacts of their portfolio investments. 16% of those managers are specifically linking investments to the UN SDGs. For reference, last year only 27% of our managers were measuring impact metrics.

SDG 7 `Affordable and clean energy' is the most targeted of the SDGs by respondents, with the renewable energy sector a key focus for many GPs. One of the most heavily reported measurements we have received is the tonnes of CO_2 removed from the atmosphere and corresponding reduction of carbon footprint.

ESG and the impact on investment performance

GPs beginning to include impact-style reporting

Performance and ESG



There are many studies into the link between ESG criteria and financial performance that show, on the whole, a positive correlation. Companies with robust sustainability practices do tend to have better operational performance in general. In our managers, 32% of respondents have stated they have seen a positive correlation between ESG standards and investment performance, and a further 16% believe that there is positive correlation but have not demonstrated it. Meanwhile no respondents claimed to have seen a negative correlation between ESG standards and financial performance.

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Conclusion

We are pleased to see continued progress in professionalising ESG practices by almost all our private equity managers. Managers increasingly see ESG as a means of value enhancement as well as risk mitigation, and it is interesting to see many managers (56%) looking to differentiate themselves based on strong ESG practices.

Last year we highlighted that we would focus on training and encourage managers to consider the use of impact measurement (e.g SDG targets) where relevant. Both areas have seen substantial improvement, with the proportion of managers providing ESG training in the last 12 months increasing by 12% to 58% and the proportion of managers looking to measure impact more than doubling from 27% to 58%. We will continue to track progress over the coming year. We will also increase our monitoring of diversity.

Like 87% of respondents we expect the importance of ESG to continue to increase over the next three years, and we feel that the pandemic will only accelerate the rise of ESG and sustainable investment practices.

BMO Private Equity Team

Views and opinions expressed by individual authors do not necessarily represent those of BMO Global Asset Management.

BMO Global Asset Management