Credit Suisse ESG Research

Environmental, Social and Governance (ESG) Research

Credit Suisse Environmental, Social and Governance (ESG) research seeks to focus on sustainability and accountability factors that are then integrated into the investment process.

Research Analysts

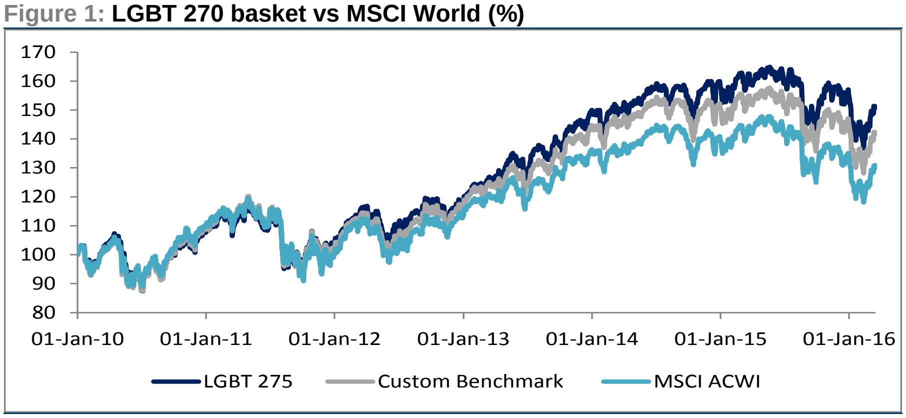
Julia Dawson
44 20 7883 3715
julia.dawson@credit-suisse.com
Stefano Natella
212 325 4217
stefano.natella@credit-suisse.com
Richard Kersley
44 20 7888 0313
richard.kersley@credit-suisse.com
Rose Thomas
44 20 7883 3962
rose.thomas@credit-suisse.com
Brandon Vair
+44 20 7888 6381
brandon.vair@credit-suisse.com

LGBT: the value of diversity

In this report, we seek to further our research into the impact of diversity on corporate performance. Following The Credit Suisse Gender 3000: Women in Senior Management, which focused on gender diversity, we decided to apply a similar analytical framework to LGBT diversity.

- Our hypothesis continues to be that diversity brings financial benefits to organisations and investors. Companies with at least 1 female director have delivered an excess share price CAGR of 3.4% over the past 10 years compared to all male boards. To test LGBT diversity, we have built a basket of 270 companies supporting and embracing LGBT employees, the LGBT 270.
- This LGBT basket has outperformed MSCI ACWI by 3.0% per annum over the past six years. Against a custom basket of companies in North America, Europe and Australia, the LGBT 270 has outperformed by 140 bps annually.
- ROEs and Cash flow returns (CFROI) are 10-21% higher than those of companies in the MSCI ACWI whilst economic profit generation is double.
- Companies in the LGBT 270 trade at a 10% discount on 12 month forward PE multiples and in line on price to book despite higher returns and profitability. Differences in leverage or dividends do not explain the difference in returns and share price performance.
- As usual in this field of research, we can only draw associations, not causality. Do better companies have better LGBT policies and attract more LGBT employees or do LGBT employees make companies better? Probably both.

Figure 1: **LGBT 270 basket vs MSCI World (%)**



Source: Bloomberg, Credit Suisse research

Diversity creates value

The debate over diversity and corporate performance has focused mostly on gender to date. Gender is a largely straightforward attribute to measure and data therefore relatively easy to collate, especially at board and senior management levels. However, gender is just one aspect of diversity standing alongside ethnicity, age and sexual orientation amongst others. In our report into the positive impact of gender diversity on corporate performance The CS Gender 3000: Women in Senior Management, we discussed the value of diverse opinions, education, experience and gender in problem solving, the decision making process and setting strategy. We find that the share prices of companies that have at least one female director outperform those with no female representation by a CAGR of 3.4% since the start of 2006. ROEs averaged 14.2% vs 11.2% for all male boards over the period 2005-13.

We also found that companies with more than 15% women in senior management positions outperformed those where women accounted for less than 10%. Analysing the results of more than 3000 companies in 2013, we see that ROEs were 52% higher at an average of 14.7% at companies with more than 15% women in senior management and that there was a 33% premium valuation with price to book at 2.6x compared to 1.9x for companies with fewer than 10% women in senior roles.

Figure 2: **Companies with at least one female director vs all male boards (2006-16)**

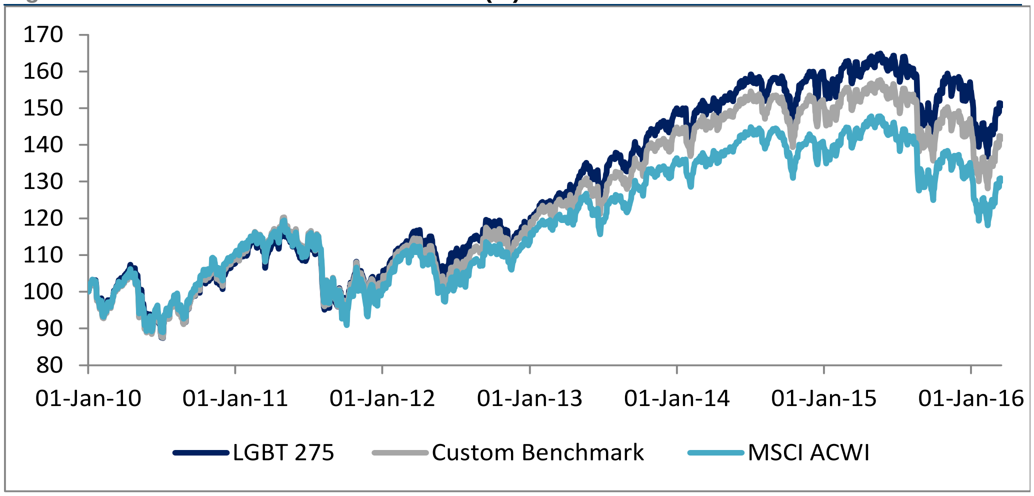
Source: Bloomberg, Credit Suisse estimates

Measuring the impact of LGBT diversity

In this report, we seek to lead the diversity debate further by exploring the possible impact of LGBTs on corporate performance. We have constructed a basket of 270 corporates globally that have either openly LGBT leaders and senior management, companies that are voted leading LGBT employers in such surveys as Stonewall's Top 100 Employers (UK), DiversityInc's Top 10 Companies for LGBT Employees (US) or whose employees are openly members of local LGBT business networks. These companies are largely clustered in North America, Europe and Australia, so we chose to compare their performance to the MSCI ACWI, as 81% of the index is made up of companies in these countries. US companies account for 53% of the total.

On a sector adjusted basis, our LGBT 270 index has outperformed MSCI ACWI by an excess 300bps per annum over the past six years returning 6.4% on average each year. Compared to a customised index including companies just in North America, Europe and Australia, these LGBT 270 companies have outperformed by 140bps annually.

Figure 3: **LGBT 270 basket vs MSCI ACWI (%)**



Source: Bloomberg, Credit Suisse research

Over the past twelve months, the share price performance of our basket has fallen by 5.1% on a sector adjusted basis compared to the fall of 6.9% in the MSCI ACWI index and a 5.6% fall in our custom benchmarket index indicating that diversity is a defensive strategy offering asymmetric returns.

Most large-scale corporates have policies supporting LGBT employees and otherwise protecting them from discrimination. Close to 90% of Fortune 500 companies have non-discrimination policies, yet we cannot find open LGBT representatives of anything close to that number. Tim Cook at Apple Inc is the only openly gay CEO. In our research, we are looking for signals that corporate support is active and central to company culture rather than just a nominal policy position that is little beyond politically correct. Inclusive policies have to translate into an "open" culture. We believe that it is at this level of active inclusion that diversity can flourish and have an impact. In this context, we can attempt to measure whether there is potentially a positive impact on corporate performance. At this stage, even though our sample is quite large, we cannot prove causality, simply correlation. Nevertheless, the growing wealth of research—including our own research on gender and sexual diversity—points to diversity being a positive contribution to corporate performance.

Credit Suisse analysts actively cover more than 3000 companies worldwide. The fact that the equivalent of fewer than 10% constitute our LGBT basket indicates the extent to which people choose not to disclose their sexual orientation in the workplace. Only 4% of the US workforce identifies itself as being LGBT, 41% of US LGBT workers and 72% of senior LGBT executives say they have not come out openly at work. This is not surprising given that the legal climate in the US has remained stagnant as detailed in the The Williams Institute report in partnership with Credit Suisse: “The LGBT Divide: A Data Portrait of LGTB People in the Midwestern, Mountain and Southern States”. Only 21 states in the U.S. provide legal statewide protection against employment discrimination based on sexual orientation.

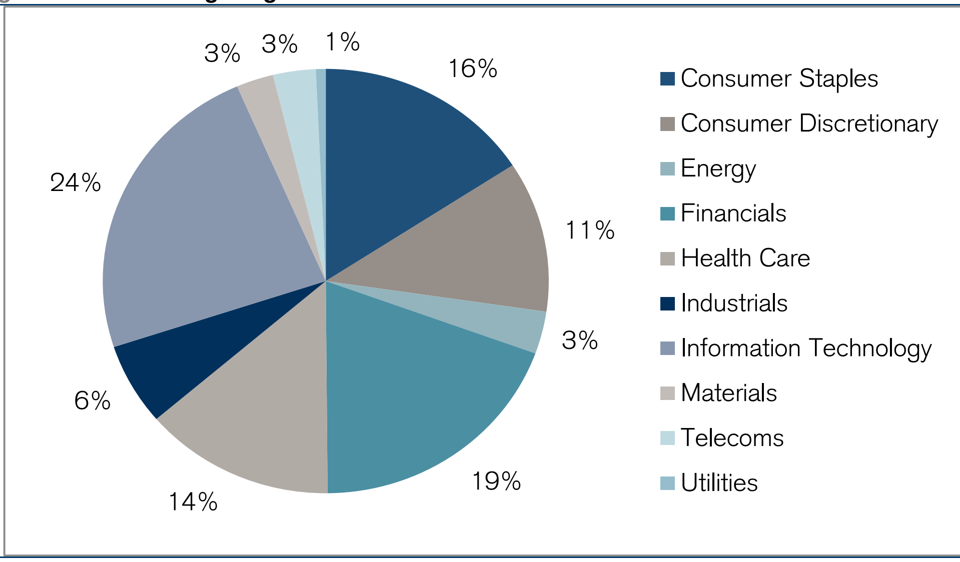
Whilst it is clear that the LGBT community is being employed by well beyond the “official data” and impacting the performance of many companies, we seek to understand if an "open" and inclusive working culture impacts performance.

The Credit Suisse LGBT 270

The basket constituting the Credit Suisse LGBT 270 includes companies across all sectors. However, close to 60% of the weighting in terms of market capitalisation comes from companies in three key sectors: information technology, financials and consumer staples. The high weighting of information technology (24%) may reflect a relatively younger workforce too which is more likely to declare their gender identity too as we discuss below. We also find good representation amongst companies in the healthcare and consumer discretionary sectors.

Companies in the energy and materials sectors have relatively low weightings at less than 10% combined. This mirrors low levels of gender diversity too in these sectors as many assets are located in countries socially and culturally less open to LGBT. It also reflects as well as to the negative impact on share prices from the current low commodity price environment. Many of the companies are multinational. All of our analysis is conducted on a sector neutral basis.

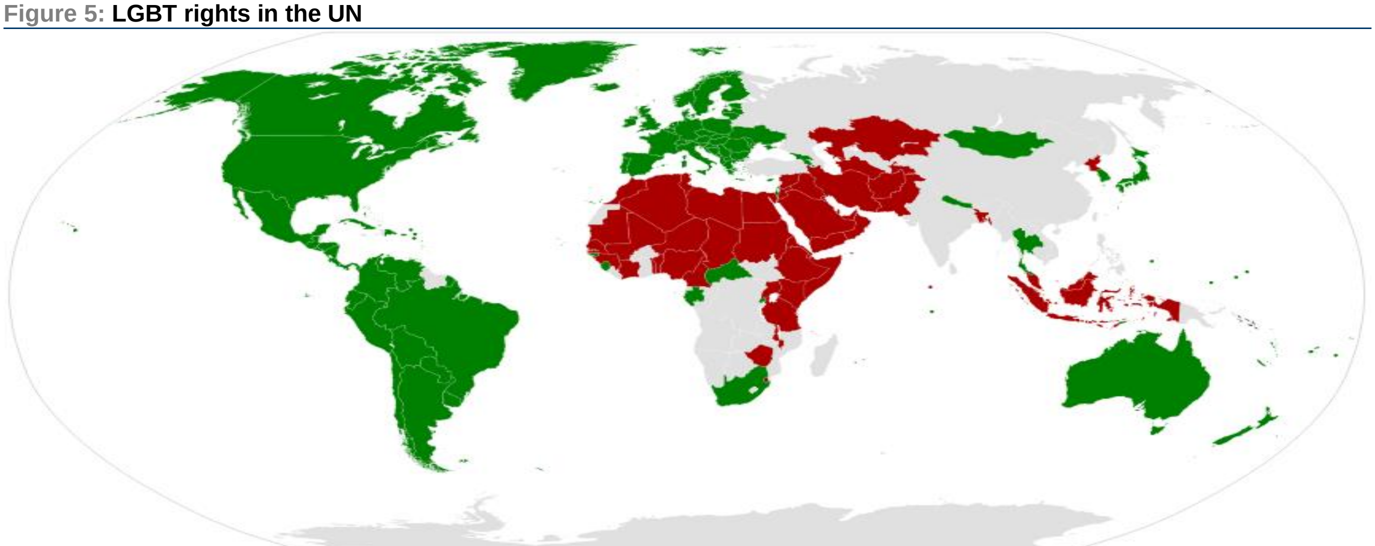
Figure 4: **Sector weightings in the LGBT 270 basket**



Source: Bloomberg, Credit Suisse research

With homosexuality still illegal in 76 countries, the list of companies where at least one employee is publically happy to declare their non-heterosexual gender identity is by its nature skewed towards more 'liberal' societies in North America and parts of Europe. In order to measure the performance of these companies, we have constructed a specific index comprising North America, Europe and Australia to reflect the geographic backdrop. Our analysis is conducted on a sector neutral basis.

Figure 5: **LGBT rights in the UN**

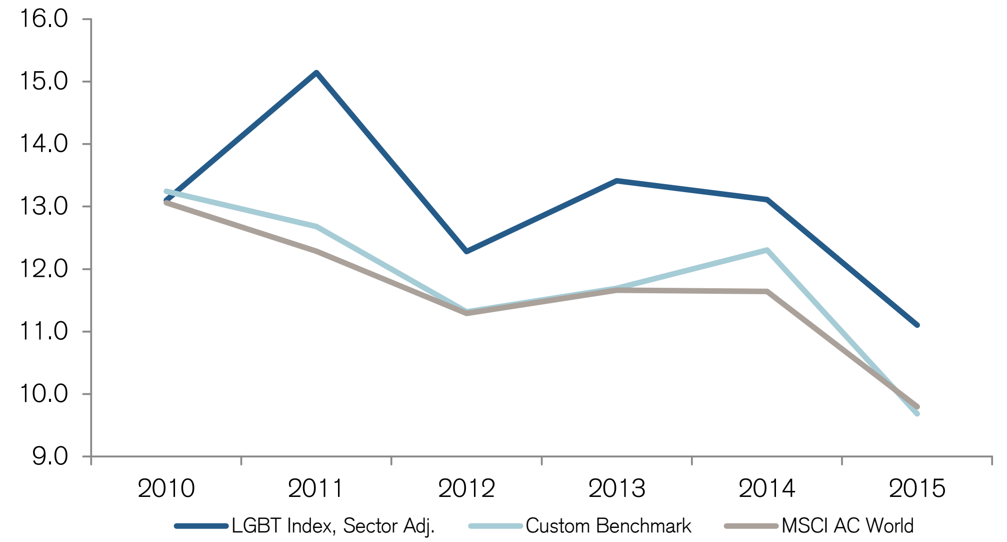


Source: Company data, Credit Suisse estimates

Why does the LGBT basket outperform?

Profitability as measured by ROE is more volatile at companies in our LGBT basket but on average have been a 120 bps higher at 13% over the past six years compared to our custom benchmark 140bps higher than the MSCI ACWI index average ROE of 11.6% over the same period. The downturn in returns in 2015 was largely driven by lower returns in the energy sector whilst the greater fall in 2012 in the LGBT was due to greater exposure of our index—given the more limited basket of stocks—to selected telecoms and consumer staples names.

Figure 6: **ROE – LGBT 270 vs benchmarks (2010 – present)**

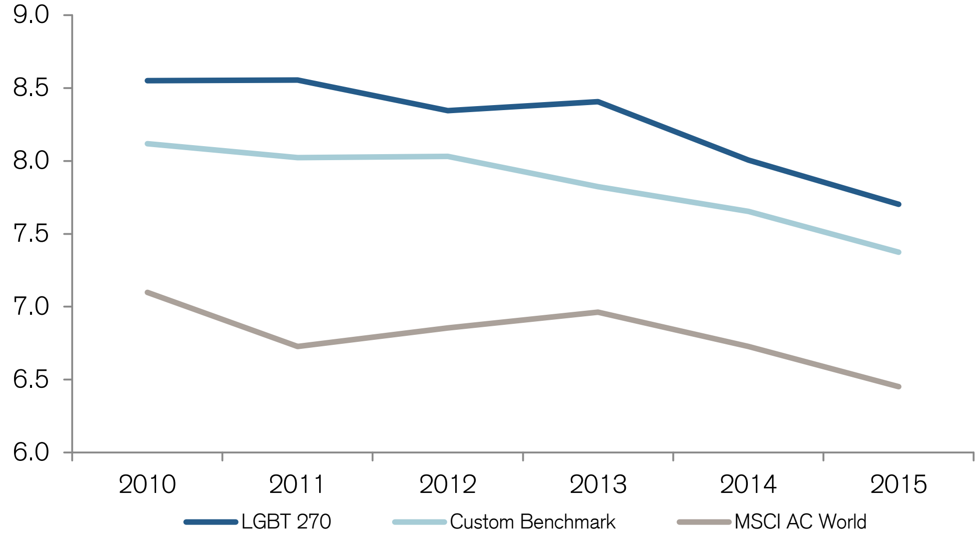


Source: Bloomberg, Credit Suisse research

Cash flow returns

Leveraging our proprietary HOLT database, we also found that cash flow returns on investment (CFROI) for non-financials and cash flow returns on equity (CFROE) for financials have been higher too at companies in our LGBT basket compared to the broader market, represented by both the custom benchmark and MSCI ACWI. Over the past six years, CFROI/CFROE for the LGBT 270 has averaged 8.3%, some 6% higher on a relative basis compared to the custom benchmark and a 21% premium relative to MSCI ACWI (Figure 7). Better returns, both ROEs and cash flow returns, would indicate better or more efficient management in its many guises and we believe that diversity is a key contributor to this phenomenon. For an academic deliberation of how diversity can lead to better decision making, please refer to Professor Anita Woolley and team's research into collective intelligence Evidence for a Collective Intelligence Factor in the Performance of Human Groups.

Figure 7: **CFROI – LGBT 270 vs benchmarks (2010 – present)**

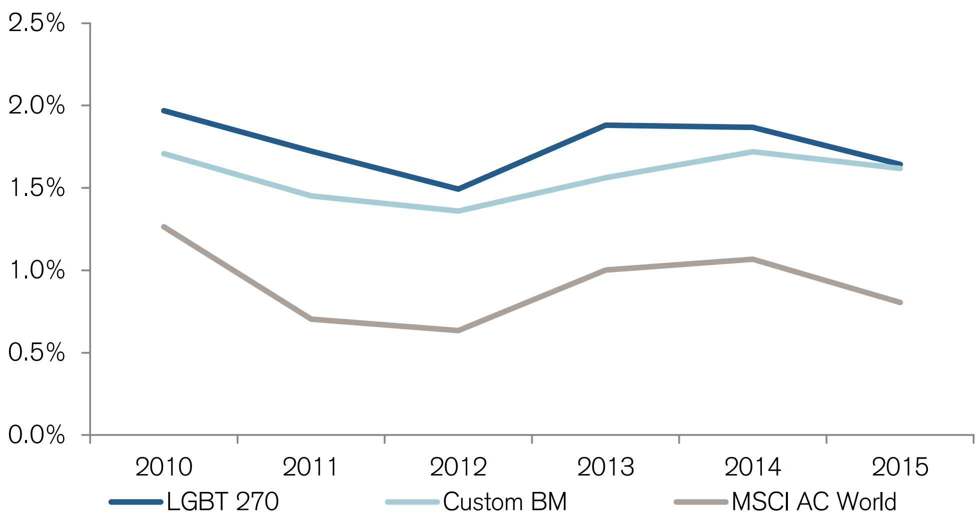


Source: Bloomberg, Credit Suisse HOLT

Economic profit

As a further measure of effective management, we include Credit Suisse HOLT's metric of economic profit, essentially the rent earned by a company above its cost of capital. When measured as a percentage of a company's enterprise value, we see our LGBT 270 companies generate 20bps higher on average compared to our custom benchmark and double that of MSCI ACWI – 1.8% of enterprise value annually for the LGBT 270 companies compared to 0.9% for MSCI ACWI (Figure 9),

Figure 8: **Economic Profit as % of EV – LGBT 270 vs benchmark (2010 – present)**

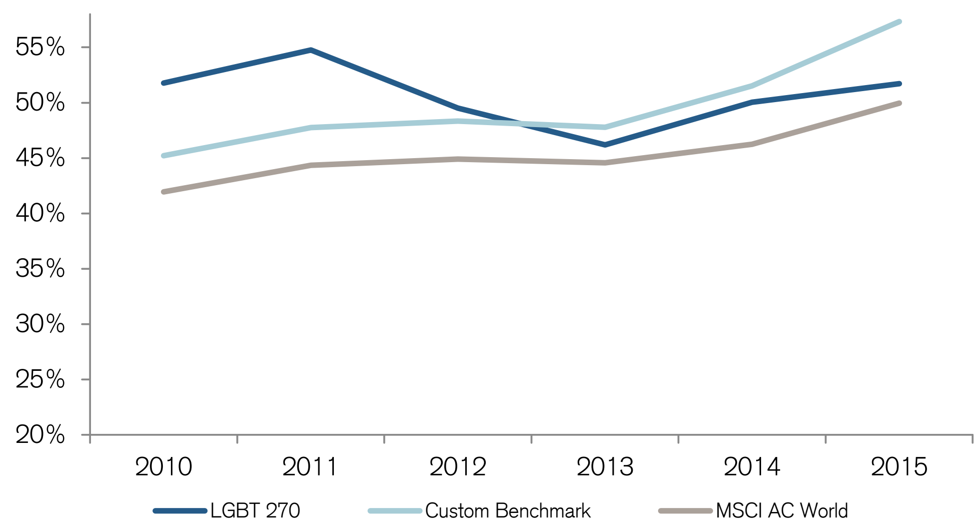


Source: Bloomberg, Credit Suisse HOLT

Leverage

On average, there is no difference in leverage between the LGBT basket and the custom benchmark with both averaging 50% net debt/equity for the non-financial companies included. We see slightly higher leverage for the LGBT 270 earlier in the period under review which goes someway to explaining the higher ROE initially seen in Figure 6. We have not considered leverage over a longer time horizon due to the potential impact of survivorship bias but we see structurally higher leverage in both our LGBT 270 and the custom benchmarket compared to the broader markets included in MSCI ACWI. The broad conclusion from these leverage levels is that there is no significant difference in style or risk appetite in the companies that are providing a more LGBT inclusive culture.

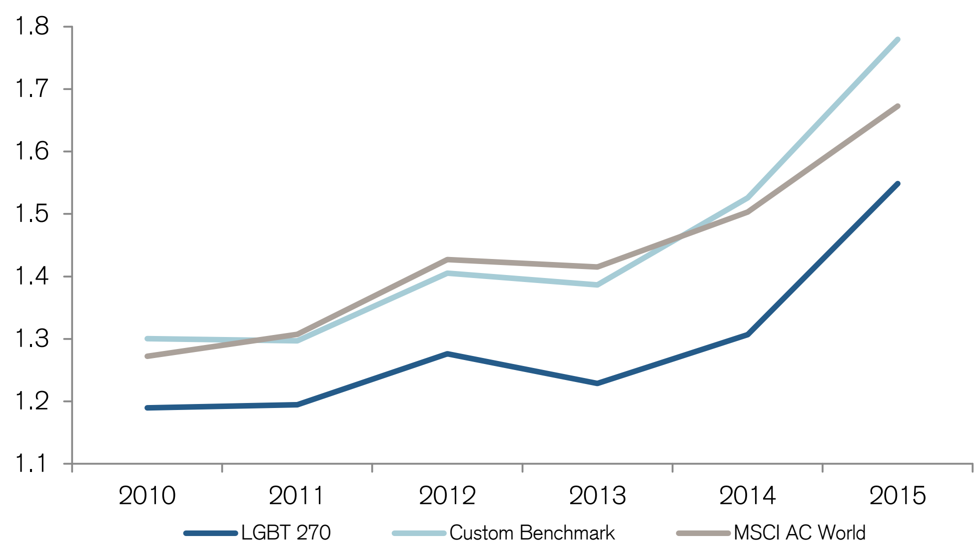
Figure 9: Net debt/equity – LGBT 270 vs benchmark (2010 – present)



Source: Company data, Credit Suisse estimates

When we consider net debt/EBITDA, however, we see a different picture with the LGBT companies running structurally lower leverage – 10% lower – than the custom benchmark and MSCI ACWI. We would not consider this 10% difference in leverage levels to be overly significant but it mirrors the higher returns discussed above.

Figure 10: Net debt/EBITDA (x) – LGBT 270 vs benchmarks (2010 – present)

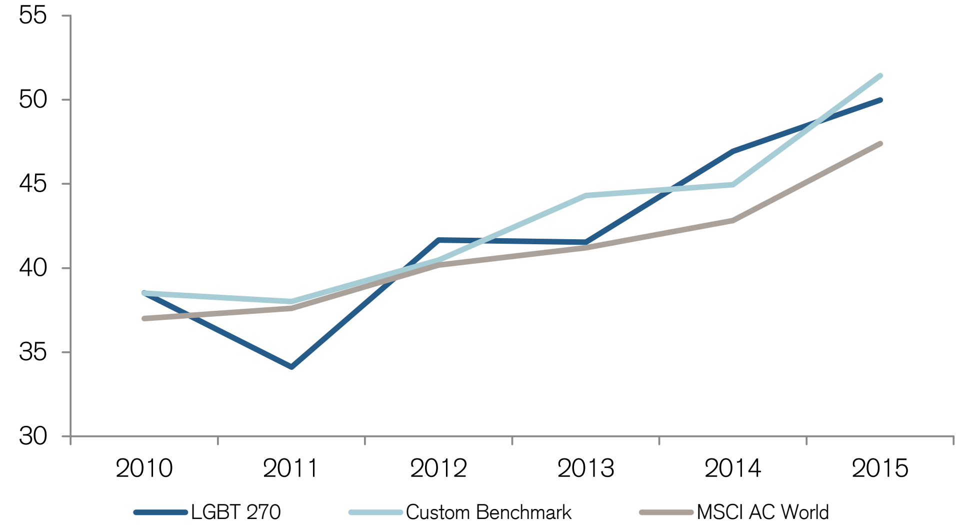


Source: Company data, Credit Suisse estimates

Pay-out ratios

We are unable to find any meaningful difference in payout ratios that might explain the share price outperformance. Over the past six years, the payout ratio at the 270 companies in our LGBT basket has averaged 42.3%, almost exactly in line with the 42.9% average of the custom benchmark though the range has been wider at times. Higher payouts in recent years have been more of a style in developed markets and noncommodity heavy markets, hence the marginally lower payout ratio seen in the broader MSCI ACWI index.

Figure 11: **Dividend payout ratio – LGBT 270 vs benchmarks (2010 – present)**

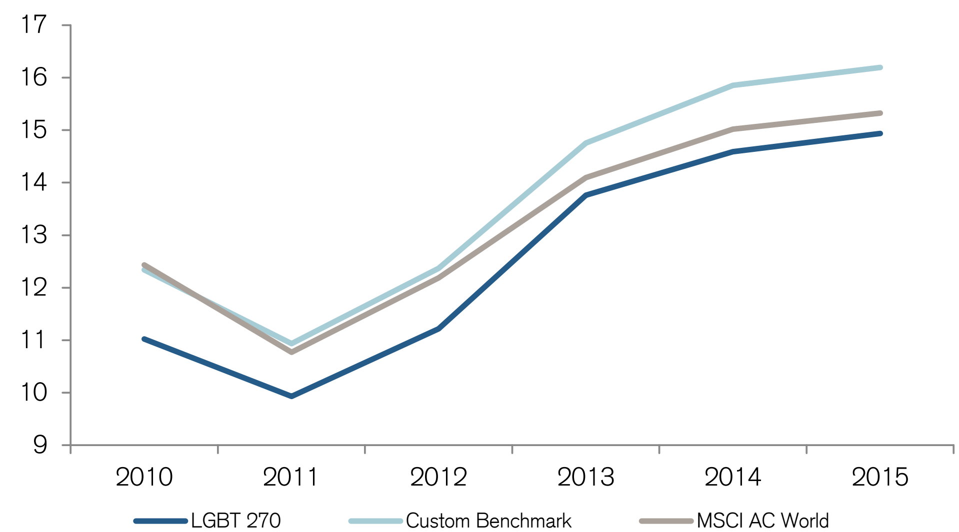


Source: Bloomberg, Credit Suisse research

And valuations?

Given the superior returns we see from the basket of 270 LGBT companies, we would expect to see the basket trade at a premium. To our surprise, we see that the companies have traded on a 12-month forward P/E basis on average at a 9% discount to our custom benchmark and a 6% discount to MSCI ACWI over the past six years on a sector neutral basis. The custom benchmark showed higher P/E multiples than MSCI ACWI due to the higher weighting of the US and lack of exposure to cheaper emerging markets. The LGBT 270 has traded at a narrow 8.8-10.4% discount to the custom benchmark throughout this period. Again, this would indicate that not only is the market failing to price in the superior returns but also that it is failing to recognise the value of these more openly diverse and acknowledged companies.

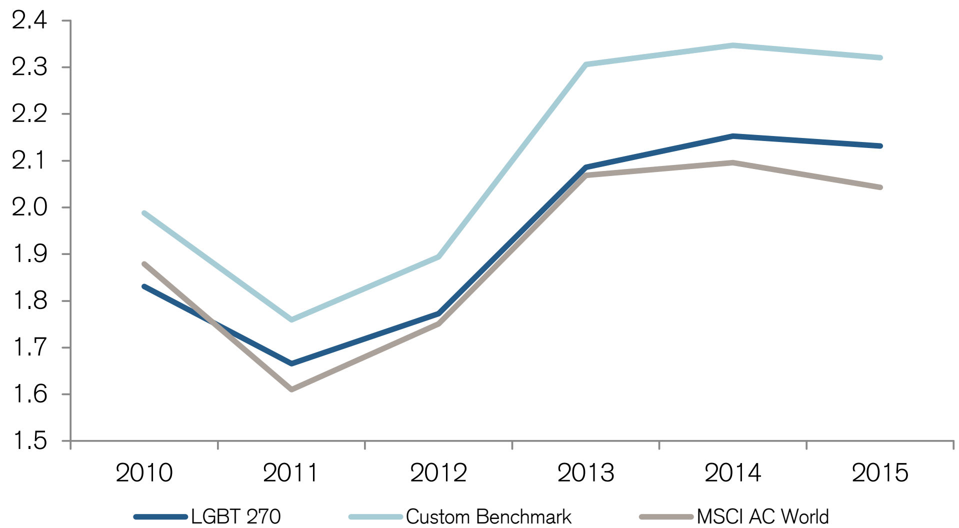
Figure 12: **12month forward P/E (x) – LGBT 270 vs benchmarks (2010 – present)**



Source: Bloomberg, Credit Suisse research

A price-to-book analysis reveals a similar discount in market multiples. Versus the custom benchmarket, the LGBT 270 has again traded at a discount of 5-9.5% over the past six years, averaging a 7.5% discount. However, the basket trades at a marginal premium to MSCI ACWI averaging 2%. This is despite generating double the economic profit, 10% higher ROEs and 22% higher CFROIs, so a market anomaly.

Figure 13: **P/B (x) – LGBT 270 vs benchmarks (2010 – present)**



Source: Bloomberg, Credit Suisse research

LGBTs in the workplace

There are no generally accepted figures for the size of the LGBT community and indeed it would be difficult to define the exact parameters of who constitutes or represents the LGBT community but 3.8% of Americans identify themselves as LGBT according to a Gallup survey published in May 2015 (Americans Greatly Overestimate Percent Gay, Lesbian in US). Gender identity can also be fluid and numbers may be under-represented due to an ongoing reluctance to confirm gender orientation or transition to avoid discrimination. Equally, many might believe that gender identity is a private matter irrelevant to their performance in the workplace. This would explain in part why we find just 270 companies where LGBT employees openly disclose both their gender identity and their workplace.

This stands in stark contrast to the many hundreds of companies which have LGBT supportive policies. In the 2016 Corporate Equality Index (CEI) report by the Human Rights Campaign Foundation (HRC), for example, 407 major businesses — spanning nearly every industry and geography in the U.S. — earned the top rating of 100%. This is 48% of the total number of companies in the index (Corporate Equality Index 2016). According to the report, 75% of the Fortune 500 and 93% of the entire CEI universe of businesses offer explicit gender identity non-discrimination protections in the US (Figure 14).

Despite this, Out Now's LGBT 2020 study of US employees found that 24% of lesbians, 30% of gay men, 40% of bisexuals and 55% of transgender employees believed that coming out could impact future promotions.

Figure 14: Fortune 500 Businesses' Commitment to LGBT Employees

	All Fortune 500	Fortune 500 Participants	Fortune 500 Non-Responders
Sexual Orientation in US Non-Discrimination Policy	**93%**	**99%**	**81%**
Gender Identity in US Non-Discrimination Policy	**75%**	**94%**	**40%**
Domestic Partner Benefits	**64%**	**98%**	**16%**
Transgender-Inclusive Benefits	**40%**	**63%**	**0%**
Organizational LGBT Competency	**51%**	**79%**	**0%**
Public commitment to the LGBT Community	**56%**	**87%**	**0%**
Average Score	**61**	**88**	**13**

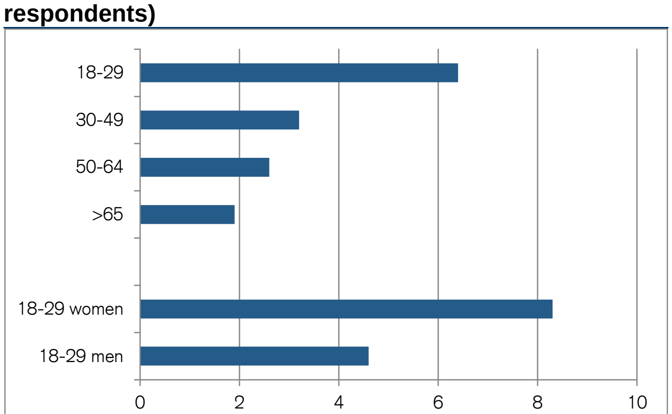
Source: Human Rights Campaign Foundation – Corporate Equality Score 2016

In a study by the National Centre for Transgender Equality and the National Gay and Lesbian Task Force, 71% of transgender people in the US said they hid their gender or gender transition to avoid discrimination. According to the 2010 US national census, 89,667 people had changed their names and 21,833 had also changed their sex out of a population of 309m. Again, these numbers are likely to understate the numbers living in different gender circumstances.

In the UK's Integrated Household Survey, 1.1% of the population identified themselves as gay or lesbian and a further 0.4% as bisexual. This is low compared to UK government estimates that 6% of the population is LGBT.

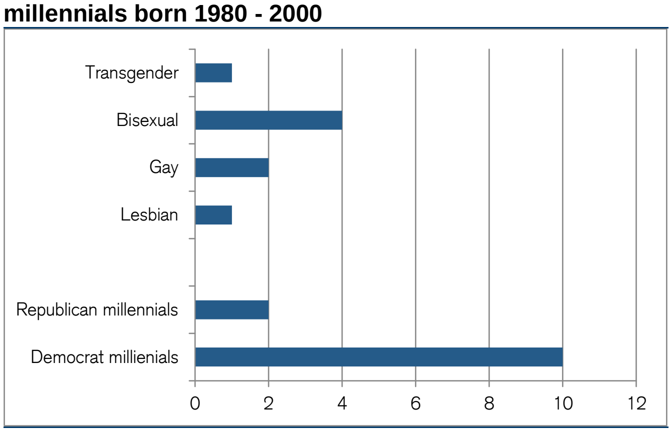
Younger people are more likely to self identify as LGBT. 7% of US millennials between 18 and 35 identify themselves as LGBT against the average 3.8% according to a Public Religion Research Institute (PRRI) report in 2015 or 3.4% average in a 2012 Gallup survey. This is higher than the 1.9% self identifying in the over 65 age group. The reasons are multifold but the apparent increase amongst younger generations is more likely to do with growing social acceptance rather than increasing numbers. Attracting millennial LGBT talent at the outset is therefore key given increasing employment options for qualified graduates.

Figure 15: Do you personally identify as LGBT? (% of US respondents)



Source: Gallup survey, June 1 – Sept 30 2012

Figure 16: Sexual identity and Attraction amongst US millennials born 1980 - 2000



Source: Public Religion Research Institute 2015

The Talent Pool

Companies embracing LGBT employees are likely to benefit from lower staff turnover rates and better retention, both of which directly reduce operating costs. Sylvia Ann Hewitt, the founder of the Center for Talent Innovation, writing in the Harvard Business Review (For LGBT Workers, Being "Out" Brings Advantages) says that closeted LGBT employees who feel isolated at work are 73% more likely than "out" employees to leave their job within three years. Oxford Economics calculates the cost to employers of replacing a single employee in the UK to be £30,600. This compares to the average national salary according to the Office of National Statistics of £26,500.

The Oxford Economics report, The Cost of the Brain Drain, finds that it takes 28 weeks to reach optimum productivity, a cost of £25,000 to employers with a further £5,000 attributed to other operating and logistical costs as new employees are recruited and onboarded. 72% of LGBT allies say they are more likely to accept a job at a company that is supportive of LGBT employees than one that is not, implying that there could potentially be higher costs associated with non-LGBT employee retention too.

Happy employees are also more productive, according to research at the University of Warwick. We believe that LGBT employees who feel able to "come out" at work are likely to be happier in that work environment. It would follow therefore that they are likely to be more productive according to University of Warwick economists. In laboratory tests, they found that happiness made people 12% more productive, a figure close to the 10% cited by Stephen Frost in his book, *The Inclusion Imperative* "When gay people remain in the closet, they are 10% less productive than when they feel able to be themselves."

According to the Williams Institute report in partnership Credit Suisse: “The LGTB Divide: A Data Portrait of LGTB People in the Midwestern, Mountain and Southern States”, 48% of same sex couples in the U.S. have a college degree compared to 34% for different-sex married couples. Also 39% of LGBT individuals in the 21 states which prohibit employment discrimination based on sexual orientation have a college degree versus 38% for non-LGBT individuals.

There are clearly costs tied to providing equal right to LGBT employees, yet the benefits in terms of job motivation, access to a more educated talent pool, creativity, retention and loyalty are far superior. This may be one of the key reasons why we have seen higher profitability and returns at the companies in the LGBT 270 basket.

Yet, when we run the same performance analysis against the HRC Corporate Equality Index (CEI) overall, we do not find much correlation. Favourable LGBT policies might help employees be more open about their sexuality, but it is not enough. Policies and culture are different things.

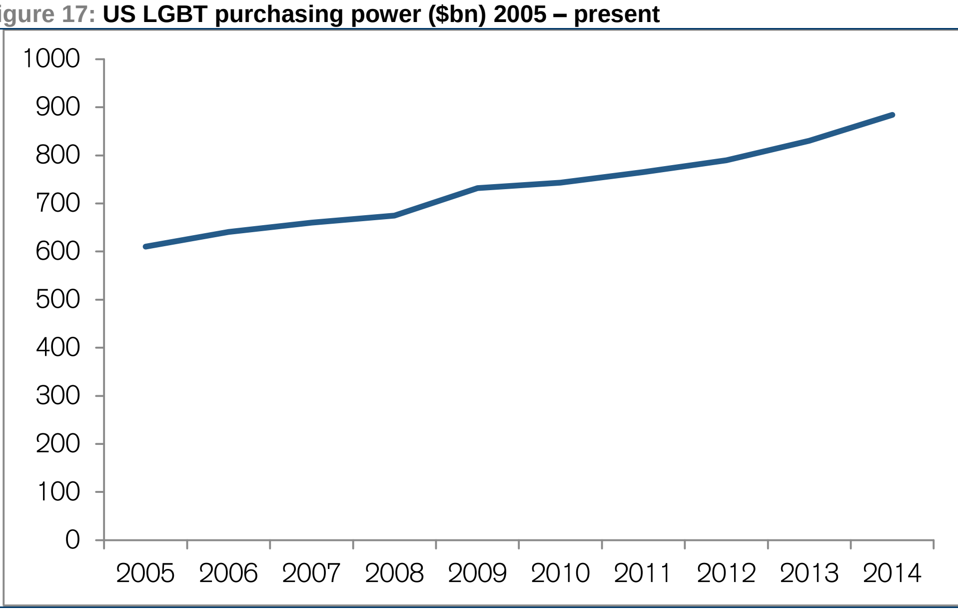
The Consumer Pool

It is often argued that gender diversity enables companies to sell better to female consumers who now account for some over 70% of purchasing decisions. The same should therefore be true of LGBT embracing companies and LGBT customers. Indeed, 87% of LGBT say they would consider purchasing from a brand that is supplying equal benefits to their LGBT employees and 23% of LGBT adults say they have switched products or services because a different company was supportive of the LGBT community. Also, 71% of LGBT people say they would stay loyal to that brand even if purchasing that brand was less convenient or more expensive.

Global LGBT purchasing power is estimated at $3.7tr according to LGBT Capital in 2015, with the U.S. accounting for $900bn and the EU $950bn of the total. To provide some context, the global purchasing power of the LGBT community is therefore equal in size to Germany's GDP in 2015, or 5% of global nominal GDP of $73.5tr (Figure 18).

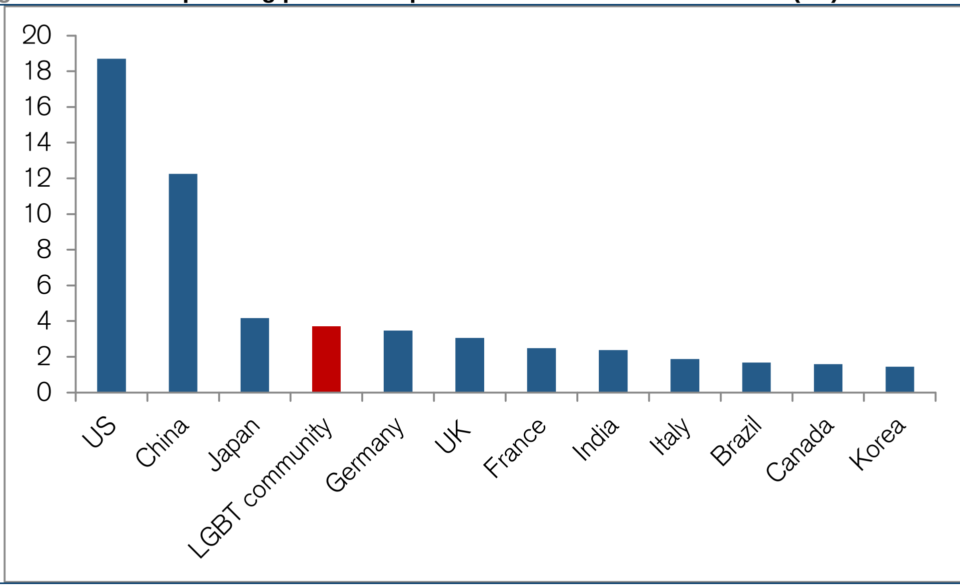
And it is not just about consumer loyalty. Out in the World: Securing LGBT Rights in the Global Marketplace by the Center for Talent Innovation highlights that LGBT-inclusive companies help innovate for potentially under-served market segments. Hiding their sexual identity, impacts LGBT employees' ambition and their ability to innovate: 27% of LGBT employees who are not out say that hiding their identity at work has held them back from speaking up or sharing an idea. According to the same report, at companies with a supportive attitude towards LGBT employees, 62% of LGBT employees say that their team is not afraid to fail versus 47% at companies with a negative attitude towards LGBT employees.

Figure 17: **US LGBT purchasing power ($bn) 2005 – present**



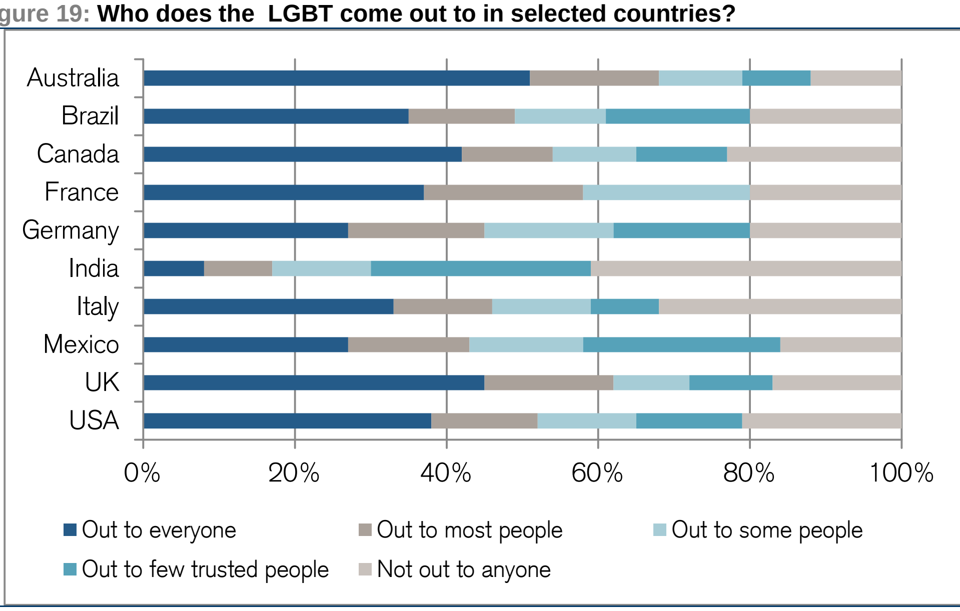
Source: Witeck-Combs Communications, Credit Suisse estimates

Figure 18: **LGBT spending power compared to selected countries' GDP ($tr)**



Source: World Bank, LGBT Capital

Figure 19: **Who does the LGBT come out to in selected countries?**



Source: Out Now Consulting

Companies Mentioned *(Price as of 14-Apr-2016)*

Apple Inc (AAPL.OQ, $112.04)

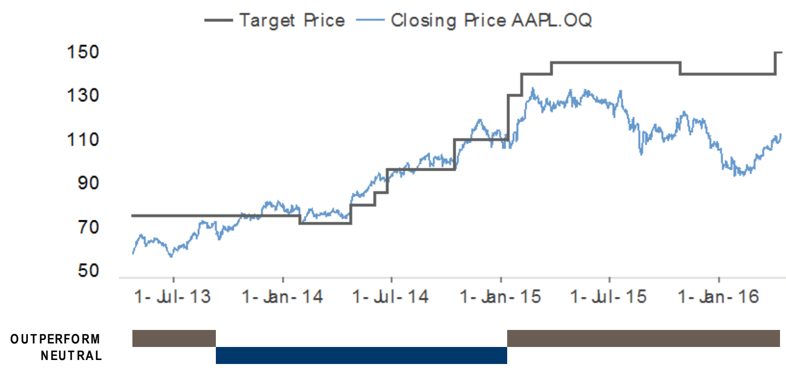
Disclosure Appendix

Important Global Disclosures

Julia Dawson and Richard Kersley each certify, with respect to the companies or securities that the individual analyzes, that (1) the views expressed in this report accurately reflect his or her personal views about all of the subject companies and securities and (2) no part of his or her compensation was, is or will be directly or indirectly related to the specific recommendations or views expressed in this report.

3-Year Price and Rating History for Apple Inc (AAPL.OQ)

AAPL.OQ Date	Closing Price (US$)	Target Price (US$)	Rating
24-Apr-13	57.95	75.00	O
11-Sep-13	66.83	75.00	N
28-Jan-14	72.42	71.43	
24-Apr-14	81.11	80.00	
03-Jun-14	91.08	85.71	
24-Jun-14	90.28	96.00	
14-Oct-14	98.75	110.00	
13-Jan-15	110.22	130.00	O
05-Feb-15	119.94	140.00	
26-Mar-15	124.24	145.00	
28-Oct-15	119.27	140.00	
04-Apr-16	111.12	150.00	



** Asterisk signifies initiation or assumption of coverage.*

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As of December 10, 2012 Analysts' stock rating are defined as follows:

Outperform (O) : The stock's total return is expected to outperform the relevant benchmark* over the next 12 months.

Neutral (N) : The stock's total return is expected to be in line with the relevant benchmark* over the next 12 months.

Underperform (U) : The stock's total return is expected to underperform the relevant benchmark* over the next 12 months.

**Relevant benchmark by region: As of 10th December 2012, Japanese ratings are based on a stock's total return relative to the analyst's coverage universe which consists of all companies covered by the analyst within the relevant sector, with Outperforms representing the most attractive, Neutrals the less attractive, and Underperforms the least attractive investment opportunities. As of 2nd October 2012, U.S. and Canadian as well as European ratings are based on a stock's total return relative to the analyst's coverage universe which consists of all companies covered by the analyst within the relevant sector, with Outperforms representing the most attractive, Neutrals the less attractive, and Underperforms the least attractive investment opportunities. For Latin American and non-Japan Asia stocks, ratings are based on a stock's total return relative to the average total return of the relevant country or regional benchmark; prior to 2nd October 2012 U.S. and Canadian ratings were based on (1) a stock's absolute total return potential to its current share price and (2) the relative attractiveness of a stock's total return potential within an analyst's coverage universe. For Australian and New Zealand stocks, the expected total return (ETR) calculation includes 12-month rolling dividend yield. An Outperform rating is assigned where an ETR is greater than or equal to 7.5%; Underperform where an ETR less than or equal to 5%. A Neutral may be assigned where the ETR is between -5% and 15%. The overlapping rating range allows analysts to assign a rating that puts ETR in the context of associated risks. Prior to 18 May 2015, ETR ranges for Outperform and Underperform ratings did not overlap with Neutral thresholds between 15% and 7.5%, which was in operation from 7 July 2011.*

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Analysts' sector weightings are distinct from analysts' stock ratings and are based on the analyst's expectations for the fundamentals and/or valuation of the sector* relative to the group's historic fundamentals and/or valuation:

Overweight : The analyst's expectation for the sector's fundamentals and/or valuation is favorable over the next 12 months.

Market Weight : The analyst's expectation for the sector's fundamentals and/or valuation is neutral over the next 12 months.

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