

Evaluation of Ratos's incentive system ahead of the 2011 Annual General Meeting

Background

A functioning incentive system is a key tool for Ratos in the creation of a high-class organisation which in turn is essential if Ratos is to achieve its business goals. The stock market requires incentive systems to be evaluated in relation to their purpose. Ratos's incentive system has over the years been regularly evaluated by Ratos's Compensation Committee and Board. This was also the case this year.

The intentions of Ratos's incentive system

Ratos presents the company's compensation system in the annual report (see Ratos's 2010 Annual report pages 41-42). As regards the expressed intentions of the incentive system the following can be noted:

- "...motivated to work in the interest of shareholders."
- "...encouraged to have the same perspective as the company's shareholders..."
- "...offer competitive terms... in an industry where competition for qualified employees is intense..."
- "...and at the same time be encouraged to remain within Ratos..."
- "...performance must be linked to ... set targets."

In summary, the purpose of Ratos's incentive system is to recruit, retain and motivate employees in the business organisation and to create a shared identity with Ratos's shareholders.

Since Ratos is a private equity conglomerate which ultimately sells its holdings, it is possible to link the results of Ratos's incentive system more closely to the long-term returns that benefit shareholders than is possible for other listed companies which conduct their business as a going concern without an exit phase. Ratos's incentive system is therefore tightly linked to the long-term performance of Ratos's organisation.

How have the intentions been met?

Ideally one would like to compare the development in Ratos with an incentive system with a situation without an incentive system in the respects stated in its intentions. This cannot be done, however.

Another method might be to conduct a survey among those involved in order, for example, to examine motivational effects and willingness to seek employment elsewhere. However, it can be dubious how such surveys should be interpreted and therefore how valuable they are.

Recruit

- At employment processes Ratos has been able to recruit the employees it wanted. Despite a large number of qualified applicants there are, however, only a few who meet all of Ratos's high requirements.
- At employment interviews in recent years applicants have without exception made a positive reference to Ratos's incentive system and in particular to the programme introduced in 2007 with synthetic options.
- The importance of being able to offer an attractive incentive system remains high. In a few cases suitable candidates have been lost because Ratos's incentive system was not sufficiently attractive compared with competing offers.

Retain

- Ratos has had a very low employee turnover for many years.

- Ratos's incentive system is not as extensive as that of competing, unlisted private equity companies.

Motivate

- Ratos's employees have a very good understanding of the content of the incentive programme.
- Ratos has a strongly returns-oriented corporate culture.
- Ratos's actual return has been good.
- The results of the incentive programmes have generally been good for the participants (see below, however).
- Ratos's incentive system means that employees are invited to invest considerable amounts in securities.
- Considerable efforts have been made to ensure that the incentive system is based on clear and in practice well established legal rules.
- There are no signs that Ratos's incentive system has created incentives to actions which contravenes the interests of shareholders. The only exception would possibly be the upper limit in the bonus system which creates an incentive to even out exit gains over the years. The system has therefore been adjusted to include an "earnings bank" which allows some levelling out between the years.
- The 2008/2009 financial crisis had a negative impact on the current value of the incentive programme. The value of acquired call options and synthetic options has decreased and the potential in the annual bonus program has decreased in the short term. In particular the option series 2007 and 2008 and some synthetic options have decreased so much in value that the probability that they will in the end provide a profit over time is judged very low. If marginal value improvements in operations do not affect the value of these instruments, they will no longer have any motivational effect. The potential loss of invested amounts (the organisation invests substantial sums) has worried particularly younger employees with limited assets. The Board decided in spring 2009 that call options should be offered every year instead of in three out of five years (same total volume) so that temporary fluctuations in the Ratos share price (up or down) would not be of such major significance. The economic recovery, in general and for Ratos, and the general stock market upturn have mitigated the described effects significantly. No participant in the programme has had to realise losses. The call option programmes exercised in 2008, 2009, 2010 and 2011 have all shown a profit.
- Ratos's annual bonus system provided for 2009, due to comparatively good current earnings in the holdings, despite the crisis, and the effect of the earnings bank, allocation to participants. Continued improved current earnings and completed exits mean that a bonus will also be paid for 2010.
- In the public debate there is discussion as to whether incentive programmes encourage exaggerated risks. This refers to programmes, such as options, which have a large positive result for those involved if the underlying operations develop very well, but 0 result, or a weak negative result, if operations develop medium well or poorly. Those involved are then not encouraged to pay sufficient attention to the risk of loss when making decisions. Ratos's incentive system has a large element of options and an annual bonus system that does not require own investment. This could encourage a much too strong risk propensity. There are, however, several counteracting factors. The option programmes require substantial investment on the part of the participant. These are investments that can be lost. Older option programmes that have not been exercised have often lain deep in the money and thus acquired the character of shares, with a significant downside if operations start to perform badly. An unrealised increase in value of a holding, which can be lost means that even the annual bonus programme at any time contains a significant risk of loss in the form of accumulated profits. Decisions on purchases and sales of holdings are made by Ratos's Board which is not included in the incentive programme. The incentive programme therefore provides an opportunity for significant profits for those included in the event of a positive development without encouraging exaggerated risk propensity.

General

- Ratos's Board and Compensation Committee have, since Ratos's incentive system with its present main features was introduced in 2001, continuously evaluated the incentive system and initiated changes when these were judged necessary. These changes have included a larger possible investment in the call option programme, a slightly reduced percentage subsidy in the call option program (in absolute numbers the subsidy has increased), a new synthetic options programme, raised the upper limit in the bonus system and that bonus is governed solely by recognised profit for the year. Other changes include the introduction of an earnings bank in the annual bonus system and annual invitations to acquire call options.
- New rules and practice on the stock market in recent years have not given reason to change Ratos's incentive system.
- Ratos's incentive system has been very transparent towards the stock market. No significant criticism has been noted from shareholders or the media.
- Ratos and Ratos shares have performed very well during the 2000s. This means that the incentive system has also given a good result to the employees concerned, although not as good as competing, unlisted private equity companies.
- Ratos has developed a corporate culture that is perceived as positive by current and potential employees. This corporate culture clearly contributes to recruiting, retaining and motivating employees and therefore reduces the pressure on the incentive system to achieve these aims.
- Ratos aspires as much as possible to have defined contribution pension solutions. The old ITP system which applies to Ratos's employees unless special solutions are decided, is defined benefit, however. The CEO has a defined contribution solution. Many people have taken the opportunity to have a "ten-fold earner solution" which is defined contribution.
- The basic principle is that variable salary is not pensionable. An exception is variable salary which combined with other salary is below the ITP ceiling. This means for more senior executives, who receive a large portion of the total variable salary, that none of the variable salary is pensionable. For the CEO and another two executives, variable salary up to 50% of basic salary is pensionable.
- The company's costs for the incentive system comprise the costs for the annual bonus and the costs of subsidising the call option programme. By hedging the call option programme, the call option programme has otherwise provided a revenue for Ratos. The synthetic option programme means that options are acquired at market price. In pace with increased investment in the call option programme, the bonus ceiling has been raised and the number of employees in the business organisation has risen, so Ratos's costs for the incentive system have increased. At the same time, Ratos's market capitalisation and assets under management have increased substantially, so these costs as a share of Ratos's market capitalisation have decreased.

Conclusions

- Ratos's aim to recruit, retain and motivate employees in the business organisation has been met at an overall level.
- No available observations indicate other than that the incentive system, combined with other conditions, makes a positive contribution to achieving these goals.
- The shortcomings noted over the years in the incentive system, for example less extensive compared with unlisted private equity companies, have either been remedied by the Board/Compensation Committee or, at any rate partly, compensated by other factors, such as corporate culture.
- The positive effect of the incentive system has to a major extent been made possible by the very positive performance for Ratos and Ratos shares in recent years.
- The incentive system has shown that it functions even in a phase of macroeconomic downturn. The financial downturn in 2008/2009 put the incentive system to the test. The

decline in value created some anxiety, but shareholders were also worried, so the link between the situation for employees and shareholders functioned. The incentive system has even during a period of downturn provided motivation through its financial potential (one could imagine a situation where the profit potential in incentive systems disappeared). The incentive system's long-term character (long options, exit-dependent bonus, earnings bank, etc.) contributed to this.

- Although the incentive system in its principle build-up has remained unchanged for a number of years, significant changes have been made, which indicate that changes are required in order for the incentive system to function as intended and such changes can also be expected to be required in the future.
- The increased payments of bonuses and subsidies have been accompanied by higher payments of income tax and social security costs. The system is built up so that the amounts of these costs are known at decisions on each part of the incentive system.