

Evaluation of Ratos's incentive system ahead of the 2016 Annual General Meeting

Background

A functioning incentive system is a key tool for Ratos in order to retain 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 is regularly evaluated by Ratos's Compensation Committee and Board and the formal decisions are, at least, made yearly.

The intentions of Ratos's incentive system

Ratos presents the company's remuneration system in the 2015 annual report. In summary, the purpose of Ratos's incentive system is to recruit, retain and motivate employees and to create a shared identity with Ratos's shareholders. In concrete terms the emphasis is on the possibility to motivate employees to work in the interests of shareholders and to identify with them, to offer competitive terms of employment and to encourage them to remain within Ratos and that performance must be linked to clear targets set by the Board.

Since Ratos at some point sells its holdings, it has been possible to link the results of Ratos's incentive system more closely to the long-term returns that benefit shareholders than would be 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 actual development in Ratos with a situation without an incentive system. This cannot be done, however. Another method might be to conduct a survey among those involved in order, for example, to examine motivation effects and willingness to seek employment elsewhere. However, it can be dubious how such surveys should be interpreted and therefore how valuable they are. Another method might be to point to certain objective facts which indicate the fulfilment or non-fulfilment of the intentions with the incentive system. The following such observations can be made:

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 Ratos's high requirements.
- At employment interviews in recent years many applicants have 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

- It is extremely important for Ratos to have an incentive system that is perceived by employees as in line with the market and attractive. However, Ratos's incentive system is not

quite as attractive as those offered by most competing venture capital companies and other unlisted private equity companies.

- Ratos has had a very low employee turnover for many years, particularly in the investment organisation, but has felt increased competition in recent years from competitors with more attractive incentive programmes, which has resulted, among other things, in some employees leaving the company.

Motivate

- Ratos's employees have a very good understanding of the content of the incentive programme.
- Ratos has a strongly returns-oriented corporate culture, where Ratos's fundamental values permeate the organisation.
- 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 action which contravenes the interests of shareholders. The only exception would possibly be the upper limit in the variable salary 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.
- Ratos's actual, long-term return in its operations has been good. The economic and financial crises since 2008 have, however, had a negative impact on the value of the incentive programme. The value of acquired call options and synthetic options has decreased and the potential in the annual variable salary programme has decreased in the short term. The outstanding call options series and some synthetic options have decreased so much in value that the probability that they will in the end provide a profit is judged very low. If marginal value improvements in operations do not affect the value of these instruments, they will no longer have any motivation enhancing effect. The potential loss of invested amounts has worried employees.
- The call option programmes exercised in 2012, 2013, 2014 and 2015 were valueless. The option series which is exercised in March 2016, will also generate a loss (mature at no value) at the current Ratos share price.
- Ratos's annual variable salary system provided for no variable salary for 2011 and the outcome for 2012 and 2013 is limited relative to earlier historical outcomes. The outcome for variable salary in 2014 and 2015 have been higher, but are still at the lower end of the bonus interval.
- Ratos's incentive system has a large element of options and a variable salary 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 have often lain deep in the money and thus acquired the character of shares, with a downside if operations start to perform badly. An unrealised increase in value of a holding, which can be lost means that even the annual variable salary programme at any time contains a significant risk of loss in the form of accumulated profits. Decisions on acquisitions 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. 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 most of the 2000s, although share price development since 2010 has been weak. This means that for several years the incentive system has given a good result to the employees concerned, although not as good as competing, unlisted private equity companies. In recent years, however, the result, as a consequence of both lower earnings and a less favourable share price development, has been weak with significant investments in the programme maturing at no value.
- 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.
- Ratos aspires as much as possible to have defined contribution pension solutions. The old ITP system which applies to Ratos's employees born before 1979 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 variable salary is not pensionable.
- The company's costs for the incentive system comprise the costs for the variable salary and the costs of subsidising option programmes. By hedging the call option programme, the call option programme in general for all programmes exercised provided revenue for Ratos. The synthetic option programme means that options are acquired at a market price.

Conclusions

- Ratos's aim to recruit, retain and motivate employees 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.
- 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 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.
- Payments of variable salary 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.