

Evaluation of Ratos's incentive system ahead of the 2014 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 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 2013 Annual report for more information). As regards the expressed intentions of the incentive system the following can be noted:

- "...motivated to work in the interests 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 targets set by the Board."

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.

Since Ratos is a private equity conglomerate which 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 development in Ratos with a specific 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 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 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

- Ratos has had a very low employee turnover for many years, particularly in the investment organisation.
- 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, where Ratos's fundamental values professional, active and responsible permeate the organisation.
- Ratos's actual, long-term returns in its operations have been good.
- 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.
- The economic and financial crises since 2008 has 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 Board decided in spring 2009 that call options should be offered every year instead of in three out of five years so that temporary fluctuations in the Ratos share price (up or down) would not be of such major significance. The call option programmes exercised in 2008, 2009, 2010 and 2011 have all shown a profit, while the ones exercised in 2012 and 2013 were valueless. The 2009 option series, which is exercised in March 2014, will also generate a loss (mature at no value) at the current Ratos share price.
- Ratos's annual variable salary system provided for 2009 and 2010, due to comparatively good current earnings in the holdings, despite the crisis in 2007/2008, and the effect of the earnings bank, allocations to participants. No variable salary was paid for 2011 and the outcome for 2012 and 2013 is limited relative to historical outcomes.
- 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 weakly 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 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 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 programme, a new synthetic options programme, a raised upper limit in the variable salary system and that variable salary is governed solely by recognised profit for the year. Other changes include the introduction of an earnings bank in the system for variable salary and annual invitations to acquire call options. In 2012 the threshold and ceiling for return levels for calculation of variable salary were reduced.
- 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 most of the 2000s, although share price development since 2010 has been weak. This means that for several years the incentive system has also given a good result to the employees concerned, although not as good as competing, unlisted private equity companies. In recent years, however, the result has been more limited, as a consequence of both lower earnings and a less favourable share price development.
- 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 the call option programme. 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.