

# Opinions of the National Audit Office

## Solidium Oy

Solidium Oy, which is wholly owned by the State of Finland, is Finland's national financial holding corporation. The aim of Solidium is to strengthen and stabilise Finnish ownership in nationally important companies and increase the value of its holdings in the long term. Under the operating model set out for the company by the State of Finland, the role of Solidium is to act as a minority shareholder in portfolio companies and, by means of active ownership and as a long-term anchor investor, to strengthen the value of the companies in which it has holdings. In December 2014, Solidium was a minority shareholder in 12 listed companies and on 31 December 2014 the value of its holdings totalled about 7.6 billion euros.

The audit covered the operations of Solidium Oy in the between 1 January 2009 and 4 March 2015. The aim of the audit was to produce a comprehensive picture of how Solidium Oy has, by shaping its share portfolio (acquisitions, divestments, reorganisation of the portfolio) and by engaging in other activities, performed the tasks and met the objectives set out for the company in the guidelines issued by the State of Finland. In the audit, the operations of Solidium have been assessed in relation to the objectives and criteria set for the company by the State of Finland.

On 21 October 2008, the Finnish government decided to transfer corporate assets worth about 5.4 billion euros to Solidium as capital contribution. The purpose of Solidium is to acquire new holdings that are considered important for Finland as a whole and at the same time to retain its existing holdings and increase their value. When market conditions are favourable, the company may also divest holdings. The aim of the company is also to separate ownership steering of portfolio companies from political decision-making and to invest state assets in companies that are considered of national importance.

The State of Finland has issued detailed guidelines steering Solidium's operations, which have also been approved by the Cabinet Committee on Economic Policy. Solidium observes these guidelines in its operations. However, its role is not to act as a messenger for politicians but to provide its portfolio companies with its own well-considered opinions about relevant issues.

The company's share portfolio accounts for a substantial part of state-owned assets in Finland and the profits distributed by Solidium to its owner each year are an important source of revenue for the State of Finland. In 2014, Solidium distributed a total of about 1.1 billion euros in profits to the State of Finland. Between 1 January and 4 March 2015, Solidium also distributed 440 million euros in profits as capital repayments.

**Solidium's work is a matter of influencing the operations of its portfolio companies, which in addition to money flows also underlines the central role of trust**

It was found out in the audit that even though for the State of Finland the most visible benefits generated by Solidium are the cash flow created through the distribution of its profits and the market value generated by its share portfolio, the main purpose of Solidium is to support the business operations of its portfolio companies and to spur them to profitable growth. In its portfolio companies, Solidium has worked to establish itself as a shareholder that wants to help them to achieve higher performance in the long term.

## **Solidium has met its profit distribution targets - no return targets have been set**

No numerical return or profitability targets have been set for Solidium and its only requirement is to transfer a certain amount of its profits to the State of Finland. Solidium has met this requirement through its profit distribution policy. However the profit transfer requirement alone does not support the mission of Solidium in the long term.

The mission of Solidium is to strengthen Finnish ownership, increase the value of its holdings and to contribute to the growth and development of the companies in which it has holdings. Solidium's mission is not to maximise a steady transfer of profits to the State of Finland. However, it can do that if it operates successfully in accordance with its mission.

Solidium is an investment and holding company that does not and should not engage in active trading in shares with the sole purpose of maximising dividends or sales profits. Solidium is primarily engaged in share trading and takes part in the share issues of its portfolio companies in order to strengthen and stabilise Finnish ownership in companies of national importance and to increase the value of its holdings. Divesting holdings is part of everyday portfolio management, especially in a situation where share prices are rising. However, Solidium may also have to sell shares in order to meet the profit distribution targets set by the State of Finland.

The State of Finland has provided Solidium with company-specific guidelines. Based on the audit findings, Solidium has adhered to these guidelines in its operations. Solidium is required to influence the value of its portfolio companies by means of active ownership. Solidium's strategy is to support its portfolio companies in their efforts to be profitable and to require them to be profitable. Board appointments are the most important way in which Solidium can influence the operations of its portfolio companies. The nomination committees of the portfolio companies are the forum where Solidium is pursuing its role as an active owner in the most concrete manner.

Except for Sampo, all portfolio companies have a Solidium management or Board member in their nomination committees. In about half of the companies, the Solidium representative also serves as the committee chair. More direct ways of influencing developments in the portfolio companies that Solidium has made use of as a shareholder have included involvement in corporate restructurings. Solidium has played a major role in restructurings in such companies as Kemira, Outokumpu and Rautaruukki.

Maintaining and strengthening trust between Solidium and the portfolio companies is essential and important for ensuring that Solidium can perform well and that the prerequisites for successful performance exist.

## **No use has been made of the cost-effectiveness indicator set out in the guidelines in the monitoring of Solidium's operations**

The owner has not set explicit targets for Solidium's management cost ratio or other cost-effectiveness indicators. Solidium has kept its management cost ratio at less than one tenth of a per cent. Solidium's cost structure is in accordance with the assessment that the company provided to the State of Finland when it started operations. In management costs, Solidium compares well with other similar operators. Cost-effectiveness comparisons are made more difficult by the fact that no use of the cost-effectiveness indicator set out in the guidelines has been made in the monitoring of Solidium.

## **Credible anchor ownership requires continuous work as well as sufficient size and capacity**

Solidium can only make difficulty restructuring decisions concerning its portfolio companies and pursue them if the State of Finland is committed to ensuring that Solidium can operate and make decisions independently.

Finland is a small market area in the periphery and in relative terms the consequences of a nationally important company leaving the country or closing down a substantial part of its Finnish operations are more severe than in large markets.

Finland has few players in the same scale as Solidium that operate as owners on a long-term basis and that are guided by national interest. The difference between Solidium and active traders (portfolio investors) is that in accordance with its role as a long-term investor Solidium also aims to support its portfolio companies through temporary problems. For example, Solidium's participation in a share issue may in practice guarantee its success even though there was no rapid improvement in the prices of the company's shares and its overall situation.

Solidium shareholders' equity totalled about 5.7 billion euros on 30 June 2009 and about 4.0 billion euros on 31 December 2014. Solidium will only be able to maintain its operational performance if it can maintain a strong balance sheet. Solidium and the State of Finland must ensure that Solidium has adequate balance sheet resources so that it can remain a credible player in the eyes of the outside world and can, if necessary, quickly acquire shares in new companies or provide funding for its portfolio companies. The crucial question concerning Solidium's future operating prerequisites and the direction of its operations is how much of the proceeds generated by the sales of shares the State of Finland leaves for the company's own use.

**The danger is that Solidium is transformed from a long-term manager of national wealth into a seller of shares operating on a short-term basis the purpose of which is to cover the budget deficit**

During 2014, the shrinking of the revenue base of the state's on-budget activities manifested itself as higher and partially unforeseen profit transfer requirements.

As a long-term investor, Solidium must be in a position to contribute to capital management in its portfolio companies in proportion to its ownership and take part in funding arrangements in them. This underlines the role of the monitoring of the companies and the markets and the need for anticipation in the management of Solidium's liquid assets and balance sheet and in the planning of share acquisitions and divestments and corporate restructurings. Operating as a limited company allows Solidium to make quicker decisions than if it was part of the budget procedure. When preparing for decisions, Solidium constructs an expert organisation the purpose of which is to support decision-making and to allow the company to react quickly to developments in the market. The company's decision-making organisation is balanced and supplemented (and sometimes slowed down to a slight degree) by a requirement under which it must seek the approval of the Cabinet Committee on Economic Policy before its Board can make certain decisions concerning share transactions.

It has been necessary for the State of Finland to ensure that the revenue transferred to the state budget is of sufficient size and that it can be anticipated. The aim has been to ensure that the transfer of profits to the State of Finland is on a steady basis. The State of Finland has issued guidelines concerning Solidium's tasks and objectives and such issues as the minimum amounts transferred are set out in the document.

During its operations, Solidium has transferred to the State of Finland as dividends a total of 1.8 billion more than it has received from its portfolio companies as dividends. Sales proceeds have totalled 3.5 billion euros and the capital gain about 1.3 billion euros. The sales proceeds have been about 2.3 billion euros higher than the cost of acquiring the shares. With the sales of the shares, Solidium also loses the dividends paid on them.

As the State of Finland has seen a decrease in the flow of revenue from many of its other sources of income, there is an increasing risk that the amounts transferred from Solidium to the state budget as capital repayments are so large that they weaken Solidium's ability to achieve the other objectives set for it.

The holdings of the State of Finland transferred to Solidium in November 2008 as capital contribution were entered into the company's balance sheet as fixed assets. The balance sheet liabilities originally contained an invested unrestricted equity reserve totalling 5.1 billion euros as counterpart entry. This provides the State of Finland with a flexible instrument to withdraw the necessary amount of money as dividends because under the Limited Liability Companies Act, the assets of a company can be distributed by distributing profits and by such means as distributing funds from a reserve for unrestricted equity.

The procedure described above may, however, blur the concept of the distribution of profits: The State of Finland may transfer to itself the dividends to be paid annually on the basis of the profit for the financial year and the profits accumulated during previous financial years and at the same time gradually spend the equity by recording capital repayments from the reserve for invested unrestricted equity. The reserve is a capital component entered in the books. Solidium does not have the amount of money allocated to the reserve on hand as the amounts entered in the reserve have been invested in shares. For this reason, transferring profits to the State of Finland usually requires that Solidium divests of shares so that it can acquire funds for capital repayments paid as dividends. In practice this means that assets generating a flow of dividends are realised for the purpose of covering on-budget deficits.

The interest rate payments on central government debt may be considered as an alternative to the capital repayments transferred from Solidium. When the transfers of payments from Solidium to on-budget activities are assessed and when targets for them are set there should also be an overall economic analysis of the ratio between costs and targeted benefits.

### **Solidium's liabilities make it more difficult for general government actors to accumulate debts**

Solidium has accumulated debts totalling 950 million euros, which are included in Finland's EDP debt (general government debt). This should be taken into account in the debate on what level the indebtedness of Solidium should be set. The debts accumulated by Solidium are, however, not entered in the state budget or considered when spending limits are determined. On the other hand, the dividend payments by Solidium are included in the state budget and spending limits. For this reason, examining Solidium's money flows solely from the perspective of on-budget activities may give an incomplete picture of the role that the company plays in central government finances.

In its spending limits decision in March 2014, the government decided that an additional 1.9 billion euros will be acquired through sales of state property in the years 2014 and 2015. The danger here is that most of the additional income will come from Solidium. Compared with many other asset categories, shares in listed companies are more liquid in nature and can be converted into cash quite quickly. The danger is that Solidium will become a residual for central government finances: If the State of Finland has failed to convert other assets into cash or fill the revenue quota by other means, it can rely on the shares owned by Solidium as a kind of a backup fund.

After the spending limits decision, Solidium has sold shares worth about 1.7 billion euros (between March 2014 and March 2015), compared with sales of about 1.8 billion euros during its operational history until then. Within a period of 12 months, Solidium has transferred about 1.5 billion euros to the State of Finland and of this total 900 million euros was transferred by the decision of the company's annual general meeting in August 2014 in connection with the approval of the financial statements. Moreover in two extraordinary general meetings (December 2014 and March 2015), it was decided to transfer an additional 0.6 billion euros to the State of Finland.

Even though Solidium's assets are in liquid form, good asset management also requires a long-term approach when financial transactions are made. Even though Solidium is in a position to

react quickly to changes in the markets, the company operates on a market basis and the need of the State of Finland for additional funds and the optimal moment to sell shares do not necessarily concur.

The danger that the national wealth contained in Solidium's share portfolio will shrink is partially overshadowed by the growth in the net worth of Solidium's portfolio and changes in it. Favourable market trends have allowed Solidium to distribute substantial amounts of profits and at the same time to remain in good operational shape. During the early years of Solidium's operations, share prices at Helsinki Stock Exchange were very low. The total yield of OMX Helsinki Cap index between 11 December 2008 and 31 December 2014 was 134 per cent, while the figure for Solidium's share portfolio was 118 per cent. This means that the index has outperformed the total yield of Solidium's portfolio. The annual yield of Solidium's share portfolio (13.7%) has also remained below the annual index yield (15.0%).

A discrepancy between sales and acquisitions continuing over long periods of time and a discrepancy between dividends and the amount of dividends transferred to the State of Finland may weaken Solidium's operational capability and its chances of acting as an active owner of assets considered as nationally important and make it more difficult for Solidium to increase the value of national wealth held in the form of shares. In the long term, the role of Solidium as a payer of dividends and a party transferring sales proceeds to the State of Finland must be in balance with its role as a party increasing the wealth invested in shares. The audit results suggest that in this respect Solidium is slightly out of balance at the moment.

### **The company's administrative model differs from that used in other state-owned companies**

When the company was established, one aim was to separate the ownership management of the portfolio companies from political decision-making. This is in line with the overall aim of state ownership steering under which there should be clear and systematic power relationship structures in the decision-making process concerning state ownership and state ownership steering.

In Solidium's administrative model, reporting and discussions on the situation in the company and its operations and the aims of state ownership steering are communicated orally to two different recipients through two different channels. Chairman of the company's Board of Directors reports directly to the minister responsible for ownership steering, while the company's managing director reports to a public servant in the State Ownership Department. This increases the risk that the information is not conveyed at the same time, in the same form and adequately between all parties and to all parties concerned.

From the perspective of the structuring of power relationships and the setting of objectives, it should be considered whether instead of having two reporting channels there should be a procedure where the setting of targets by the State of Finland and the monitoring carried out by it are conveyed to and from Solidium through a single channel through the State Ownership Department.

The audit was mainly performed by assessing Solidium's operations in relation to the guidelines connected with the company's ownership steering. However, the guidelines are at such general level that their contents are determined and concretised on the basis of the views and interpretations held by individual persons. Considering the fact that Solidium holds a substantial proportion of the share holdings of the State of Finland, the operational objectives of Solidium should, from the perspective of target-setting and operational steering, be determined and documented in greater detail.

Realisation of the investment risk is one justification for concentrating more thoroughly on the selection and analysis of the investment targets but it is not a reason for stopping new investments

Based on the audit results, developing the share portfolio by acquiring shares in new companies has been the weak point in Solidium's operations. On average, Solidium has made investments in one new company per year. Investments have been made in three companies of which the investments in Talvivaara were a failure. Solidium invested a total of about 149 million euros in Talvivaara shares between 2011 and 2013 and entered its ownership as worthless in its interim financial statements on 31 December 2014.

The risk of shareholdings is increased by the fact that the purpose of Solidium is to act as an anchor investor. Solidium's task is to provide assistance in managing temporary problems even though the fundamental premise is that the basic business operations of the companies in which the investments have been made are healthy and that they have potential for success and profitability.

The decision to acquire Talvivaara shares was made after careful examination and at the time (spring 2011) the general opinion in the market was that the prospects for Talvivaara are promising. However, in Talvivaara's case the investment risk was realised even though Solidium worked hard to support Talvivaara after its initial investment. The problem company included in its portfolio also tied a substantial amount of Solidium's resources.

When operating environment and situations are changing, the companies and sectors that are considered nationally important are also changing. For this reason, if the Government wants Solidium to actively invest in nationally important companies, Solidium must also include investments in new companies in its operating approach and range of tools.

As expected, it was found out in the audit that only a fraction of the analyses and preparatory work concerning potential new investment targets is actually translated into acquisitions. The actual acquisition decisions are made on the basis of the conclusions made by Solidium in its own analyses, the activities of other investors, operations of the companies in which investments are planned, changes in the market and expectations for the future.

Selection of the investment targets always involves uncertainty. Based on the audit results, some of the risk connected with the selection of new investment risks for Solidium have been realised. By continuing systematic monitoring of investment targets and by making more careful analyses and well-grounded investment proposals, Solidium can decrease the investment risk. However, the risk can never be totally eliminated.

The National Audit Office recommends that

1. The Government should analyse the feasibility of the many simultaneous targets and profit distribution obligations of Solidium and make a decision on prioritising the targets and obligations and its consequences.
2. The Government should take a clear stand on active ownership and ways of implementing active ownership, such as direct representation in the portfolio companies' Boards of Directors, and on return requirements and cost-effectiveness requirements as numerical targets.
3. Solidium should focus more on the selection and analysis of new investment targets.