Vanguard Investment Stewardship Voting Insights

Vanguard

Contested board elections at Leonardo and Enel

May 2023

Company: Leonardo SpA (Leonardo); Enel SpA (Enel)

Meeting date: May 9, 2023; May 10, 2023

Proposal: Leonardo—Item 4—Appoint directors (slate election)—Choose one of the following slates: 4.1 Slate 1 submitted by Ministry of Economy and Finance; 4.2 Slate 2 submitted by GreenWood Investors LLC; 4.3 Slate 3 submitted by institutional investors (Assogestioni).

Enel—Item 6—Appoint directors (slate election)—Choose one of the following slates: 6.1 Slate 1 submitted by Ministry of Economy and Finance; 6.2 Slate 2 submitted by institutional investors (Assogestioni); 6.3 Slate 3 submitted by Covalis Capital LLP and Covalis (Gibraltar) Ltd.; Item 7.1—Elect Paolo Scaroni as board chair; Item 7.2—Elect Marco Mazzucchelli as board chair.

How the funds voted

At the annual general meeting of Leonardo, a global aerospace and defense company that is 30% owned by the Italian government, the Vanguard-advised funds[1] supported the board slate presented by GreenWood Investors, a dissident shareholder.

At the general meeting of Enel, Italy's largest listed company and a leading utility company that is 25% owned by the Italian government, the funds supported the board slate presented by Assogestioni, the Italian association of asset management companies.

Vanguard's principles and policies

The Vanguard-advised funds vote on a case-by-case basis on all proposals related to the election of director slates in Italy, including contested board elections, with an assessment of what is in the interest of shareholders' long-term value as the determinant of the funds' votes. The funds apply a governance-centric approach that takes into consideration inputs from various sources, such as company disclosures, engagements with company representatives, discussions with dissident shareholders and/or the nominees put forward by the dissident, third-party research, public materials, and, in select cases, other Vanguard investment professionals.

Our evaluation of a proxy contest focuses on three key areas:

Strategic case for change. Does the dissident make a compelling case that a change in the target company's strategy and/or in its board composition is likely to create value for long-term shareholders? When engaging with the dissident, we seek to understand the perspective on the company's current state and future trajectory and the recommended changes the dissident believes would benefit the company and be in the best interest of long-term shareholder value creation.

1 Vanguard's Investment Stewardship program is responsible for proxy voting and engagement on behalf of the quantitative and index equity portfolios advised by Vanguard (together, "Vanguard-advised funds"). Vanguard's externally managed portfolios are managed by unaffiliated third-party investment advisors, and proxy voting and engagement for those portfolios are conducted by their respective advisors. As such, throughout this document, "we" and "the funds" are used to refer to Vanguard's Investment Stewardship program and Vanguard-advised funds, respectively.

Company's approach to governance. Does the company demonstrate good governance practices? By reviewing a company's public reporting and disclosures, and through engagements, we seek to understand how the board's directors serve as engaged, effective stewards of shareholders' capital through independent oversight of company management, strategy, and material risks.

Quality of directors. Do current directors appear to bring the necessary capabilities to the company's board? Assessing a board's composition starts with understanding the company's strategy and how the board's skills (collectively and individually) align with that strategy and position the board to provide effective oversight on behalf of all shareholders. Vanguard's Investment Stewardship team also assesses dissident nominees to understand how their skills align with the company's strategy and/or the dissident's strategic case for change. We seek to understand the qualifications and perspectives of all nominees so we can make informed decisions about which nominees are best positioned to represent the interests of long-term shareholders.

Analysis and voting rationale

The majority of Italian public companies are controlled, meaning that a significant part of the company's share capital is held by founders, a group of investors under a shareholder agreement, or government-related entities. As a result of these ownership structures, a distinct corporate governance practice in Italy is slate voting, a system under which shareholders with a given minimum stake in a company can nominate a slate of candidates for the company's board of directors. This practice is designed to protect minority shareholders' interests, as it provides minority shareholders with a mechanism to increase independent oversight on the board. Under this practice, investors must vote on a bundled slate, and cannot vote on directors individually.

At most Italian companies, the largest shareholders typically submit a list of nominees in order to appoint the majority of board members, including the board chair and CEO. Pursuant to Italian law, at least one seat is reserved for a director elected from a minority list, usually presented by minority shareholders.

Shareholders can vote for only one director slate, and directors are selected from the competing slates in proportion to the votes they receive. Given this mechanism and system of representation, most board elections in Italy are not contested. Occasionally, however, contested elections do occur in the market.

During the 2023 Italian proxy season, contested board elections at two state-controlled companies, Leonardo and Enel, were particularly noteworthy. The newly elected Italian government undertook a complete refresh of the boards of both companies, including replacing the sitting chairs and CEOs, which led minority shareholders at each company to put forward alternative slates. Vanguard's Investment Stewardship team reviewed publicly available information and engaged with the parties involved in each proxy contest to gather perspectives and inform the funds' votes.

At **Leonardo SpA**, shareholder GreenWood Investors submitted a minority slate with four candidates competing for the seats that had historically been filled by the nominees put forward by institutional investors through Assogestioni (the Italian association of asset management companies).

GreenWood argued that despite Leonardo's having significant assets, strengths, and capabilities in its portfolio, the company's total shareholder return had underperformed peers over multiple years. GreenWood also highlighted weaknesses in Leonardo's margins, earnings quality, free-cash-flow generation, and capital allocation. GreenWood presented an action plan aligned with the company's strategy that primarily focused on deleveraging the company's balance sheet to provide additional flexibility for growth. GreenWood noted opportunities for Leonardo to create long-term shareholder value by solidifying its position and tapping into the opportunities from expected increasing defense spending as a result of evolving geopolitical factors. GreenWood proposed four board candidates who would bring skills and experience to help management navigate rapidly changing industry dynamics and sustain profitable growth.

We also engaged with representatives of Assogestioni who voiced concerns regarding the perceived risks of the proxy contest at Leonardo, including sensitivities related to the company's operations in a strategic sector, and emphasized the qualifications of Assogestioni's own director nominees.

After conducting our independent analysis of Leonardo's performance, we determined that there was a strong strategic case for change, given the company's persistent underperformance in total shareholder return relative to peers over multiple time horizons. We concluded that the GreenWood slate could add relevant expertise (including expertise across the industrial sector and the defense industry, operational execution expertise, and capital markets expertise) and bring more diverse perspectives into the boardroom, including relevant international experience.

GreenWood demonstrated a track record of constructively challenging and collaborating with the companies in which it invests, which we considered could be beneficial to support the new board at Leonardo and contribute to oversight practices for long-term value creation.

The GreenWood slate received the majority of votes, and all directors from its slate were elected. All the directors from the Italian government's slate were also elected, including the government's nominee for CEO. None of the Assogestioni nominees was ultimately elected to the board, as the slate did not receive sufficient support. We plan to continue to engage with leaders at Leonardo to understand how the newly formed board settles in and carries out the governance of the company.

At **Enel SpA**, Covalis Capital, a boutique fund manager focused on energy investments, submitted a slate of six director nominees in opposition to the government-nominated candidates. Assogestioni presented a minority list of three director nominees.

In our conversations with Covalis representatives, they outlined various concerns with the nominating process that the government followed and argued in favor of stronger independent representation of international institutional investors in Enel's boardroom. Covalis also proposed an independent chair candidate in opposition to the one put forward by the government, and said that if its chair candidate was elected, the new board would appoint a CEO. Covalis also outlined a balanced view of its six director nominees while highlighting its nominees' key strengths.

During our engagement with representatives of the Italian government, we asked about the thought process behind replacing the CEO and the entire board and whether it signaled a desire by the Italian government to change company strategy. We also inquired about considerations regarding board continuity, director selection, and the designation of a nonindependent chair.

The representatives of the Italian government spoke to a rigorous and transparent process for director selection, highlighted the strong industry experience of the designated chair and CEO, and stressed the importance they placed on strategic continuity, strong governance, and institutional stability.

In this case, our engagements and independent analysis did not reveal a strong case for change at the company. We noted that long-term performance under the departing management team had been strong relative to peers, and we did not find concerns with the company's approach to governance. However, we had reservations about supporting either of the majority slates, given the lack of clarity on the expected strategic direction.

We determined that, in this situation, it was in the best interest of the funds' investors to support the independent candidates in the minority slate presented by Assogestioni. We determined that these nominees were best positioned to exercise effective, independent oversight of management and protect the rights and interests of minority shareholders. In addition, Assogestioni's candidates possessed relevant skills and experiences in the industrial sector, capital markets, and corporate governance.

The funds also supported the government's chair nominee, recognizing the individual's sector expertise and institutional role. Although the nominee did not qualify as independent according to the Vanguard-advised funds proxy voting policy (because of his previous role as Enel CEO in 2002–2005), we did not have material concerns regarding his ability to carry out independent oversight.

The government slate received the majority of votes, with all six candidates elected, including the designated chair and CEO. All three of Assogestioni's candidates were also elected to the board. None of the candidates proposed by Covalis was elected, as the slate did not obtain the minimum votes necessary. The chair proposed by the government received almost unanimous support.

We will continue to engage with Enel on important governance matters and monitor how the board provides robust independent oversight of management.

Market observations

The Italian slate system presents some differentiated governance practices compared with most developed markets. These practices reflect market-specific factors, including the historical context of the predominance of controlling shareholders. They can serve as an important tool to ensure an adequate independent check to the candidates proposed by the largest shareholder in order to safeguard minority shareholders' interests. At the same time, as illustrated in the cases of Leonardo and Enel, the system does present some challenges for institutional investors on evaluating governance matters, given that investors cannot support individual candidates and must, instead, vote for a bundled director slate. We will continue to engage with relevant market participants to refine our understanding of the unique dynamics in the Italian market and how the funds can best promote the interests of long-term investors.

Vanguard publishes Investment Stewardship Policy and Voting Insights to promote good corporate governance practices and to provide public companies and investors with our perspectives on important governance topics and key votes. This is part of our growing effort to enhance disclosure of Vanguard's investment stewardship voting and engagement activities. We aim to provide additional clarity on Vanguard's stance on governance matters beyond what a policy document or a single vote can do. Insights should be viewed in conjunction with the most recent region- and country-specific voting policies.

The funds for which Vanguard acts as investment advisor (Vanguard-advised funds) retain the authority to vote proxies that the funds receive. To facilitate the funds' proxy voting, the boards of the Vanguard-advised funds have adopted Proxy Voting Procedures and Policies that reflect the fund boards' instructions governing proxy voting. The boards of the funds that are advised by managers not affiliated with Vanguard (external managers) have delegated the authority to vote proxies related to the funds' portfolio securities to their respective investment advisor(s). Each external manager votes such proxies in accordance with its own proxy voting policies and procedures, which are reviewed and approved by the fund board annually. The Vanguard Group, Inc., has not been delegated proxy voting authority on behalf of the Vanguard-advised funds.

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