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Understanding the Effect of Hedge Fund Activism on the Target Firm - A Qualitative Study on Shareholder Value

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Abstract

This thesis represents a qualitative study analyzing a comprehensive interview dataset of long-standing target executives, investment bankers, and activist specialists to improve our understanding of the effects of hedge fund activism on target firms. Hedge funds possess a broad set of tools to alter the firm's trajectory for long-term value creation or short-term gains that may compromise long-term growth. As such, engagement is shaped by several factors, including the fund's incentives, fund size, credibility, and geography. Understanding these drivers is vital in comprehending the dynamics of hedge fund activism to increase shareholder value. However, understanding engagement does not directly translate into understanding the consequences for the target firm. Therefore, this thesis provides a theoretical model grounded in shareholder theory that conceptualizes the impact of measures based on their effectiveness to unlock value in the short - or long-term horizon. This research reveals that different measures have distinct temporal implications for value creation, showing that hedge fund activists often advocate for measures aimed at unlocking immediate shareholder value, while the long-term consequences depend upon the alignment with the target firm's overarching strategy.

Keywords: hedge fund activism; shareholder theory

1. Introduction

"Activist hedge funds drive long-term value creation or short-term gains at the expense of long-term corporate growth?" This is the key question that former Commissioner of the Security Exchange Commission ("SEC"), Daniel M. Gallagher, raised in 2015 regarding the effects of hedge fund activism (Security Exchange Commission, 2015). Despite robust efforts of scholars over the last 20 years to answer the imposed question of hedge fund activism, its implications remain contentious.

One of the first hedge fund interventions was in 1927 when Benjamin Graham wrote a letter to Rockefeller Jr., the chairmen of the Northern Pipeline, to distribute excess cash. Before this, hedge funds were primarily focused on generating high returns for their investors through speculative trading strategies. However, hedge funds began to realize their potential as agents of change in the corporate world (Gramm, 2016). Activism has consistently incorporated an element of confrontation. However, in the 1980s and 1990s, the emergence of "corporate raiders" was particularly noteworthy due to their access to substantial financial resources, which set them apart from the "proxyteers" who represented dissatisfied shareholders in proxy situations but lacked the same financial firepower. One famous case of that era was Carl Icahn, one of most iconic hedge fund activists to date, who intervened in 1985 in one of the largest firms in the oil and gas sector Philips Petroleum. Icahn sent a letter to William Douce, chairmen and CEO of the target firm, offering to buy the firm or, if he is ignored, launch a hostile tender offer for control (Gramm, 2016). This active intervention, communication, and confrontation of target Boards set the stage for today's activist hedge funds. These days other highly reputable hedge funds emerged next to Carl Icahn, like Bill Ackmann ("Pershing Square Holding Ltd."), Paul Singer ("Elliott Advisors LLC"), or Daniel Loeb ("Third Point LLC"), managing up to USD 18 bn in Assets under Management ("AuM"). Because of their emergence, the shareholders' landscape faced

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significant interventions, such as the Dow Du Point merger in 2017[1], the spin-off of the power grid business of ABB Ltd. in 2016, and the breakup of Thyssenkrupp AG in 2020. Of the mentioned interventions, some had substantial upsides, but others had significant adverse effects on shareholder value. Moreover, some CEOs and target executives have responded to activism in a significantly negative way – For example, Klaus Kleinfeld, a former Chief Executive Officer ("CEO") at Samsung Electronics Co., Ltd (Appendix B2). Former Commissioner, Daniel M. Gallagher, explains activism is often posed in a binary view – For example, is activism good or bad?

Scholars of hedge fund activism have mainly used quantitative methods, analyzing large data sets from publicly available SEC filings to measure the effects of activism on shareholder value and corporate performance. Finding evidence for a significant positive effect on shareholder value caused by abnormal returns in the 7 to 8 percent range in the period surrounding the announcement day. Furthermore, the positive returns persist and are not offset in the year following the announcement (Brav et al., 2008). Broadly in line with that, similar findings are reported by Bebchuk et al. (2020), Becht et al. (2010), and Clifford and Carey (2008). However, some scholars find deviating results – For example, Greenwood and Schor (2009) find that abnormal returns can largely be explained by the ability to force the target into a takeover and returns for independent firms are not detectably different from zero. The supporter of the myopic activist claim believes that activist engagement is focused on short-term increases in stock performance and returns, ultimately leading to value destruction in the long term (John et al., 2014). Yet there is much research done on hedge fund activism. Still, research is mainly connected to quantitative research using standardized numerical data sets to explain the causes and effects of hedge fund activism. Thus, limiting the impact of hedge fund activism on numbers and publicly available information and ignoring that most engagement occurs "behind the scenes" and, more importantly, neglecting in their sampling that many activists engage below the 5 percent threshold of SEC filings (Mccahery et al., 2016). Thus, it limits the understanding of the hedge fund-target firm effect, which may have different dynamics, challenges, and outcomes below this threshold.

To follow up on the contentious debate among practitioners and scholars, I study the factors that shape hedge fund engagement and their effects by using the inductive approach proposed by Gioia et al. (2013) and the categorization framework introduced by Grodal et al. (2021) analyzing a comprehensive, hand-collected dataset characterized by long-standing target executives, investment bankers, and activist specialists.

I develop a theoretical model that is grounded in shareholder theory and conceptualize the engagement of the hedge fund-target firm's effect. I show that hedge funds are a heterogeneous group of investors shaped by target choice, style, and resolving approach. As such, target firm performance needs to be measured at a divisional level rather than a top firm level to identify conglomerate discounts caused by inefficient portfolio structures – For example, by measuring the invested capital versus the weighted average cost of capital per division. Thus, highly diversified portfolios lead to complexity, inefficient capital allocation, adverse diversification effects, and a lack of synergies. As a result, the capital market perceives these firms as having less expertise and focus, resulting in a loss of shareholder value. My thesis makes a valuable contribution to the existing literature by highlighting the significance of various factors such as capital allocation, operational underperformance, Mergers & Acquisitions ("M&A"), and corporate governance in shaping the investment hypotheses of activists.

My research establishes a relationship between the investment thesis of the hedge fund and the low shareholder returns experienced by target firms. It demonstrates that low returns are fundamental to resonate with the shareholder base and strengthen the investment thesis. The receptiveness of shareholders is vital for implementing the desired changes advocated by hedge fund activists. Thus, the success of a hedge fund activist campaign relies on gaining shareholder support. By establishing these connections and emphasizing the importance of shareholder returns on shareholders' receptiveness, my research provides insights into the dynamics of hedge fund activism.

I reveal that hedge funds exhibit diverse incentives when intervening in target firms. These incentives can range from seeking to unlock hidden value within the company or attempting to decrease the firm's stock price – For example, through shorting the target's stock. Consequently, the opposing effects substantially influence value creation within the target firm. I provide evidence that the style of activism adopted by hedge funds is influenced by factors such as fund size, geographic location, and reputation. These factors provide insights into the metrics that attract activists, the types of firms that are more susceptible to being targeted, and the extent of support they garner from the capital market, ultimately shaping their success.

I advance hedge fund literature and shareholder theory by developing a systematic approach that advances the ongoing debate by conceptualizing the impact of hedge fund activism on shareholder value. It offers an alternative view of the long-term effects, considering the correlation between value creation and the adequacy of measures to unlock value. As such, I developed a 2-dimensional matrix that assesses the adequacy of measures proposed by a hedge fund activist to address the undervaluation of a target firm. It shows that some measures focus on realizing shareholder value primarily in the short-term or long-term – For example, measures such as capital structure and spin-offs can be implemented within a relatively short period. However, operational im-

[1] "The Combination of Dow Chemical and DuPont in 2017, followed by a split into three separate companies, was a huge and highly complex transaction that transformed the chemical industry landscape" (McKinsey & Company, 2021).

provements and Environmental Social Governance ("ESG") strategies need a longer time horizon to create value and are rarely introduced to implement shareholder value in the short term. Therefore, I suggest that activists frequently propose short-term measures to realize value on a near-term horizon. Acknowledging that short-term measures can also realize value in the long term I suggest that long-term consequences can be determined by the adequacy of measures to the long-term strategy of the target.

Section 2 of this thesis derives the relevant literature on hedge fund activism and shareholder theory. Within the section, there is a summary of shareholder activism, hedge fund engagement, and its effect on shareholder value. Section 3 considers the methodological approach chosen, including the research design, data collection, interview guidelines, and analytical approach. Specifically, it is utilized to explain the adequacy of the research methodology in the context of activism and prove rigorous in qualitative research. Next, in Section 4, data and findings are presented and structured to give a differentiated perspective on the effects of hedge funds. Section 5 presents the contributions of the prior analysis, related literature, and possible future research inquiries. Ultimately, Section 6 concludes and explains the limitations of my contribution.

2. Theoretical background and relevant literature

2.1. Hedge fund activism

Investors who purchase stocks in publicly traded firms to negotiate with management are known as activists (Gordon & Pound, 1993; Klein & Zur, 2009). These investors seek to alter corporate governance and directly or indirectly impact the company's strategic direction and performance because they believe that the company's management wastes resources and thus offers an opportunity to increase shareholder value (Briscoe et al., 2015; Verstegen Ryan & Schneider, 2002). However, activism takes different forms, and each has its engagement style. Pension and mutual funds are usually large institutional investors with a long-term investment horizon, while hedge funds have other organizational structures and incentives. These differences arise from the active managerial role activist take (DesJardine & Durand, 2020). Investment managers receive a significant share of the excess returns as performance fees, sometimes up to 20 percent, which provides them with a strong financial incentive to generate profits (Brav et al., 2008). Hedge funds are also subject to less government regulation because they are only available to a limited number of institutional clients and wealthy individuals. Hedge funds may hold riskier concentrated portfolios and may utilize additional financial instruments, such as derivatives or swaps, not used by risk-averse portfolio managers (Brav et al., 2015).

Some see activism as a means of overcoming monitoring and incentive issues. As Becht et al. 2010 indicate, shareholder activists lack the skills and expertise to second-guess the target firm's management, with fund managers replacing corporate executives in pursuing private advantages such as short-term returns and their agenda (Lipton & Rosenblum, 1991). As a result, activism is frequently seen as disruptive, opportunistic, misinformed, and unproductive. Although activists often behave aggressively, they typically seek no control over the target firm and buy concentrated ownership in the target firm. Instead, they purchase concentrated ownership stakes, with the median maximum ownership around 9.1 percent, and even at the 95th percentile, the stake is 31.5 percent (Brav et al., 2008). Denes et al. (2017) have similar findings, with activists acquiring a median stake of 8.8 percent in the target firm. To gain more control, activists may use tactics such as stock lending, swap, and other derivative transactions to alter the relationship between their economic interest and voting power in the target firms (Becht et al., 2010). However, since activists do not have majority control, they rely on collaboration with the Board of Directors ("BoD") or support from the shareholder base to induce change (Becht et al., 2010; Hu & Black, 2006).

Since literature and researchers find that median ownership is over five percent, the activists must file with the SEC. As such, activists file a Schedule 13-D if they plan to be active or a Schedule 13-G if they plan to be passive (Bebchuk et al., 2020; Clifford & Carey, 2008). The activist focuses on the 13-D, which requires the activist to state the purpose of the transaction. In Germany, activists file with the Bundesanstalt für Finanzdienstleistungsaufsicht ("BaFin").

2.2. Engagement

2.2.1. Hedge fund types

There are three types of activists. Short sellers employ financial instruments to speculate on a decrease in the price of a company's shares. Using financial instruments, these activists borrow shares in the targeted firm and immediately sell them to repurchase the shares at a lower price once the campaign has achieved its desired effect. Subsequently, the activist will disseminate a report on the targeted firm, outlining an analysis of its potential weaknesses and raising awareness that the target is overvalued. When share prices fall, stop-loss mechanisms further support a decreasing share price (Aquila, 2021).

Value-driven activists are the counterpart of short-selling activists. Moreover, they seek locked values to increase the value of a firm. Potential target firms for value-oriented activists include undervalued companies, conglomerates perceived as sluggish, and companies that have failed to keep pace with rapidly evolving markets. Some activists focus on issues in different areas, such as executive compensation and regulatory compliance. At the same time, others take a broader view of value and may also pursue ESG-related topics. Pressuring management to run the company more efficiently to increase the company's valuation is the primary goal of most value-oriented activists. The company's business model and strategy are often challenged in such campaigns (Aquila, 2021).

Lastly, Aquila (2021) identified special situation activists who take advantage of situations where their votes are needed to complete a takeover or corporate action, such as a squeeze-out situation. According to Aquila (2021), there are two major thresholds target management needs to achieve; on the one hand, 90 percent is required for merger-related and 75 percent for reorganizing. Major shareholders need a domination or profit and loss agreement with the target firm to instruct management on running the business. If a domination and profit transfer agreement does not exist following an acquisition, synergies may not be realized, and the firm's cash flows may not be available to refinance the acquisition. For this reason, many public tender offers are typically subject to a tender condition of 75 percent of the company's shares. A tender offer is an offer made by a firm to acquire all or a portion of a particular firm's outstanding stock shares (Müller & Panunzi, 2004). Such requests are generally made publicly and invite shareholders to tender their shares within a specified time and at a predetermined price (Bhagat et al., 2005). Typically, the offer price will be higher than the prevailing market price, and its validity may be subject to a minimum or maximum number of shares to be sold. The tender offer mechanism is a well-established practice in the corporate landscape. It serves as a tool for hedge funds seeking to gain company control by acquiring outstanding shares (Andrade et al., 2001). However, many shareholders may choose to ignore the tender offer or hold on to their shares even if they are under 25 percent, resulting in the tender offer to fail. In such cases, when takeover rumors become more reliable or after a takeover is announced, special situation activists acquire shares in the company. They significantly increase the likelihood of a successful takeover bid by agreeing with the bidder on the price they will tender their shares (Aquila, 2021).

2.2.2. Target choice

Activists often target firms that are underperforming relative to their peers or have underutilized assets. Hedge funds believe they can improve the company's performance by changing its strategy. In the literature, significant research on the target firms' strategy and performance was done by Brav et al. (2008) and Brav et al. (2015). In their empirical research, they identify five reasons, three of which characterize the strategy and performance of an activist target. In their first sample, they gathered 888 activist events. Their later study focused on 1,059 hedge fund events from 2001 to 2006 and elaborated on their prior research. The largest group in their sample, totaling 47,9 percent, was related to the target firm's undervaluation and poor stock price performance. About 23 percent were associated with business strategies such as M&A, restructuring, and operational efficiency (Brav et al., 2008, 2010). Their findings are consistent with the observations made by Greenwood and Schor (2009), who identify characteristics such as impeding strategic alternatives or obstructing proposed merger and acquisition activities as aligning factors. Based on this research, it can be deduced that undervaluation, on the one hand, and shareholder return, on the other hand, are key characteristics of target firms.

Clifford and Carey (2008) find that target firms experience poor market-adjusted returns. Market-adjusted returns are investment returns that are adjusted for overall market performance. This helps evaluate the performance of an investment relative to the overall market and determine if it is outperforming or underperforming the market average. Accordingly, firms that get targeted perform weakly compared to the overall market. Becht et al. (2010) further strengthen in examining the Hermes UK Focus fund finding that stock price underperformance is one of the three main investment criteria. They also found that hedge fund activists take other performance-related measures into account. Specifically, a target firm is characterized by a low share-price-to-book-value or Price-to-book ("P/B") ratio. In other words, a poor P/B indicates that the firm's intrinsic value is below the stock (Armour & Cheffins, 2009).

Denes et al. (2017) agree that performance is a crucial characteristic and further define that companies with poor stock returns, sales growth, and market-to-book ratios ("M/B") become targets of activist investors. Deviating from Brav et al. (2008), they find that the company also tends to have a high return on assets. Associated to the asset Key Performance Indicator ("KPI"), the EBITDA to assets ratio tends to be high (Jory et al., 2017). Clifford and Carey (2008) find that a high return on equity also characterizes performance. These findings suggest that hedge funds target firms that do not perform poorly on all levels (Denes et al., 2017). Instead, hedge funds seem to target firms with special operating characteristics that can potentially create shareholder value. However, we need to learn more about the exact metrics activists seek. However, Klein and Zur (2009) examined 151 activism events. They found that companies targeted by hedge fund activists have reasonably high stock price performance but seem to be an outlier (Denes et al., 2017).

Activist investors may examine a company's balance sheet to identify areas where it can improve its financial position, such as reducing debt, increasing cash reserves, or improving the quality of its assets. By changing its balance sheet, the company can become more financially stable and better positioned to pursue growth opportunities. Capital structure refers to the proportion of equity and debt used to finance its operations and growth. The ratio of equity to debt is called leverage. Debt components encompass various forms of borrowing, such as bonds, loans, and other types of obligations, while equity comprises common stock, preferred stock, and retained earnings. The capital structure affects a target's financial risk, the cost of capital, and their ability to raise additional funds. Therefore, balancing debt and equity is essential to achieve financial goals with minimum risk (Miller, 1988; Wainwright, 2005).

Scholars found that the characteristics of a target firm are often reflected in its capital structure. Specifically, they discovered that targets tend to have a slightly higher leverage ratio, so a lower cash-to-assets ratio, and a significantly lower dividend payout than their peers. This is reflected in both the dividend yield and the payout ratio (Brav et al., 2008). According to Jensen (1986), managers prefer spending free cash flows on value-decreasing investments rather than redistributing to shareholders. Therefore, it is unsurprising that high levels of cash holdings draw the attention of activists (Desai et al., 2004; Klein & Zur, 2009). However, the level of debt and, consequently, the leverage ratio is controversially discussed. Jory et al. (2017), like Brav et al. (2008), find that debt levels are high, with a total debt ratio of 67 percent. Deviating from them, Bessler and Vendrasco (2022) find that firms that get targeted have a low level of debt, are more diversified, and have less capital expenditure. They argue that hedge funds are not sector experts, do not conduct in-depth operational analysis, and therefore target fewer complex firms (Bessler & Vendrasco, 2022). Similarly, Klein and Zur (2009) find that debt negatively correlates with activism.

Corporate governance is a set of principles, rules, and procedures designed to ensure that managers act in the best interest of shareholders by promoting transparency, accountability, fairness, and sustainability in the organization (Daily et al., 2003). Hedge fund activists become involved when they believe that a target company's management is not maximizing shareholder value and focus on governance aspects such as executive compensation, regulatory compliance, or changes to the BoD. However, some activists have a broader definition of value and may also advocate for environmental, social, or governance ("ESG") measures (Aquila, 2021; Brav et al., 2015).

Governance-related activism revolves around the issue of control and ownership separation, where a few managers hold a significant amount of control through a small number of shares. At the same time, the owner faces a collaborative problem monitoring the manager. This creates a conflict of interest between the principal and the agent, as the manager may act in their best interests rather than the firms. Besides, being a shareholder grants the right to influence the agent regarding important business decisions through its voting rights. Thus, highlight the importance of ensuring that shareholders' interests are protected and that companies are managed responsibly and transparently. However, there are often conflicts of interest between shareholders and management, particularly regarding executive compensation, Board independence, and antitakeover provisions (Hu & Black, 2006). The latter is used by management to act more independently from shareholders. Thus, the more antitakeover provisions there are, the less accountable to the market for control management, making them more susceptible to acquisitions that increase the firm's influence but reduce shareholder influence (Masulis et al., 2007). Furthermore, each provision allows management to counter various forms of shareholder interference, including demands for special meetings, altering the firm's charter or bylaws, filing lawsuits against directors, or removing them all simultaneously (Jiraporn et al., 2006).

As a result, hedge funds often insist on eliminating poison pills, classified Boards, and supermajority antitakeover amendments from corporate charters (Gillan & Starks, 2007). Greenwood and Schor (2009) find that activists in the United States often successfully obtain a Board seat, make existing boards resign, and remove poison pills. A target frequently overcompensates its Board members even though the firm's performance might not reflect that. Thus, activists often suggest introducing a mandatory advisory annual shareholder vote, also called a "say-on-pay" vote, on the executive compensation report included in the proxy statement (Ferri & Sandino, 2009). According to Gillan and Starks (2007), next to executive compensation, Board independence gets more prevalent. Activists frequently demand an increase in director ownership and limit directors' terms to ensure independence. Other voting-related measures are to go against the Board or management, also known as a "vote no campaign" during a proxy (Gillan & Starks, 2007).

2.2.3. Measures

The measures undertaken to induce change and unlock value are closely associated with the target choice. Not all proposed measures are publicly accessible and included in public campaigns, such as whitepapers or proxy fights. Instead, they are included in "behind the scenes" engagements (Mccahery et al., 2016). However, from available information, research derives a broad set of measures around corporate governance, M&A, operations, and capital allocation. Klein and Zur (2009) identify that the market reacts positively to activist purpose statements, especially when the activist asks for a board seat. Gillan and Starks (2007) deepen that activists pursue Board seats for either input, control, or information purposes. Moreover, there are also other measures on corporate governance, such as proposing for change of board composition, expressing concerns with corporate governance, replacing the Chief Executive Officer ("CEO"), and cutting executive compensations (Klein & Zur, 2009). According to Bebchuk et al. (2020), Klein and Zur (2009) state that activist investors are more inclined to enact measures concerning the appointment of new directors rather than measures aimed at replacing the CEO. Scholars suggest this may be because CEO replacement is a more drastic measure requiring more significant shareholder support and coordination. Moreover, it shows an incremental change rather than a radical transformation (Bebchuk et al., 2020).

In addition to the governance-related measures, M&A measures are also frequently proposed by shareholder activists. These measures include opposing a merger, selling the firm, merging with another firm, and buying stock to acquire a significant share in a firm. Greenwood and Schor (2009) suggest that in recent years, the term "strategic alternatives" has become synonymous with "spin-offs," indicating that strategic alternatives can also be a measure to change a firm's strategic direction. Klein and Zur (2009) elaborate that activists propose to buy back shares or pay dividends to the shareholder, which is also in line with Greenwood and Schor (2009), who adds that changes to the capital structure are utilized to improve the target's leverage.

Strategic and operational measures to propose changes to the strategic direction rarely occur and are associated with the least abnormal returns (Gillan & Starks, 2007; Klein & Zur, 2009). Other research scholars oppose that and show that exploring new strategic alternatives are more likely (Bebchuk et al., 2020). Additionally, changing Board decisions to increase influence on the strategic decision is a frequent measure by an activist (Gillan & Starks, 2007). Typical measures related to the strategic direction are breakups, whereas operational measures are related to performance improvements through personal cuts and spin-offs of non-core assets.

2.2.4. Communication

One of the critical assumptions of activist scholars is that activists act on a lack of performance and address management deficiencies (Brav et al., 2008; Gillan & Starks, 2007; Klein & Zur, 2009). Accordingly, a shareholder can vote with or against management in the Annual General Meetings ("AGM"), representing one of his fundamental rights. According to Hirschman (1980), shareholders have two main options when they are dissatisfied with a firm they have invested in: "voice" or "exit." The concept of exit, also called the "Wall Street walk" or "voting with their feet", involves shareholders selling their shares and withdrawing their investments from the firm. This option can be an effective way for shareholders to show their dissatisfaction and can decrease the firm's share price. However, it is essential to note that the threat of exit can also be used as a mechanism by shareholders to change the firm's management or policies, even if they do not actually sell their shares. This type of threat can be difficult to observe, as the shareholder may not follow through if the firms respond to their concerns satisfactorily (Hirschman, 1980).

Management compensation is linked to share prices and the activist is willing to drive the price down to privately incentivize management without exit. Therefore, the threat may be essential for behind-the-scenes negotiations (Admati & Pfleiderer, 2009; Mccahery et al., 2016). Accordingly, the threat can be seen as a "voice" since the activist engages rather than remains passive. Investors that use "voice" try to engage with Management and collaboratively take corrective actions to change a corporate strategy (Goranova & Ryan, 2014; Mccahery et al., 2016). Data and evidence on "voice" are way better obtainable since activists often suggest how the organization needs to change – For example, the possible activist tactics within "voice" range from private to public channels (Keeley & Graham, 1991). "Exit" is less considered as it is associated with the sale of stock. Public channels include options such as resolutions enabled by the SEC rule 14a-8 of the Securities and Exchange Act of 1934 (Goranova & Ryan, 2014). Hence, shareholders can submit a proposal at the annual general meeting, including a 500-word supporting argument in the firm's proxy materials. The topic of these proposals is subject to SEC review and shareholder votes during the proxy season (Denes et al., 2017). However, the proxy process has enabled the activist to raise concerns about performance and governance (Gillan & Starks, 2007).

In contrast, proxy contests are funded by the activist and occur less frequently than shareholder proposals (Denes et al., 2017). According to Mccahery et al. (2016), extreme engagement channels have a high usage rate, with 15 percent taking legal actions and 13 percent publicly criticizing their portfolio firm. Such actions, including proxy fights, are described as confrontational activist campaigns (Klein & Zur, 2009). However, there are also non-confrontational campaigns.

Becht et al. (2010) and Mccahery et al. (2016) studied the possibilities that activism might take place behind the scenes and might therefore be predominantly executed privately. Those private engagements, sometimes called "quiet diplomacy," are expected to be a more powerful option as they are less disruptive and prevent public embarrassment and adverse effects on the firm's reputation (Goranova & Ryan, 2014). However, on the one hand, private activism is difficult to be observed for researchers as it includes letters, phone calls, meetings, and ongoing dialogues (Goranova & Ryan, 2014). On the other hand, public or private activism are not mutually exclusive events. Hence, private activism does not exclude the possibility of public activism, as activists may initiate a public campaign early or as a subsequent step if their attempts at quiet diplomacy fail to achieve the desired outcomes (Brav et al., 2008; Gantchev, 2013; Goranova & Ryan, 2014). Accordingly, Gantchev (2013) constructed a sequential decision model that shows the potential activist process.

According to Gantchev (2013), the campaign begins with announcing the activist's intentions, usually reported in Schedule 13D, as mentioned earlier. In the next stage, the activist contacts management and formally informs them, usually in a letter to the BoD, addressing demands and ideas that have emerged from the investigation – For example restructuring inefficient operations. During the demand stage, management can adopt a position regarding the demand that can rationalize possible inefficiencies. As a result, the activist investor chooses to sell their stock and exit the situation or proceed. Afterward, the Board phase commences, and the activist requests Board representation. When the activist is unsuccessful in obtaining Board representation, they can garner support from other shareholders by submitting an initial proxy statement (Brav et al., 2008; Gantchev, 2013). The last stage, known as the proxy stage, is the most expensive and confrontational and is pursued by the hedge funds only when they are confident in their ability to succeed – For example when the activist expects to have the shareholder support its assertions. Throughout this phase, the activist's approach transitions from private methods like negotiations with management to public ones, such as public letters, proposals, or proxies (Gantchev, 2013).

Besides the reasons to engage, there are also constraints to activism that are closely associated with agency theory. Free-rider problems arise since engagement benefits are shared among all shareholders even though they do not bear monitoring costs. According to Gantchev (2013), costs include the "time and effort of negotiating with a target company, disclosure, legal and other fees of hiring proxy advisors, corporate governance experts, investment banks, public relations, and advertising firms." Therefore, missing incentives led Admati et al. (1994) to assume that only large shareholders are incentivized to monitor a target to partic-

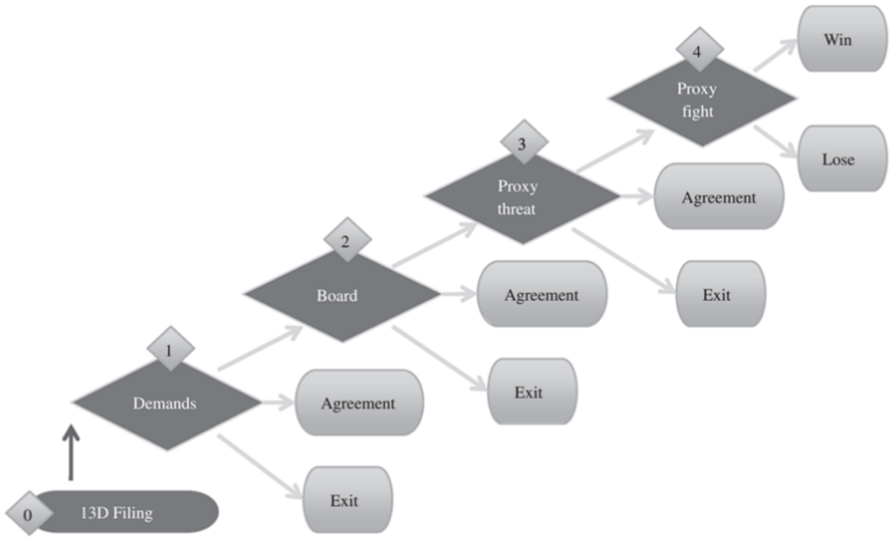

Figure 1: Activist decision model (taken from Gantchev (2013))

ipate proportionally to stake in capital gains to cover costs associated with monitoring. Accordingly, investors will only monitor when the share is large enough to cover the cost. However, holding a large ownership share is costly, especially when the investor is risk-averse (Admati et al., 1994; Danis, 2020). Jensen (1986) expands that view and argues that shareholders are only incentivized when ownership is significant, concentrated, and not diffusely held.

Consequently, a large shareholder with many portfolio firms also engages less in monitoring activities. Since hedge fund activists, with their concentrated ownerships, rely on collaboration with large shareholders, that effect would be determinantal to activism. Next, to freeride problems, scholars identified liquidity as an impediment to hedge fund activism. Generally, liquidity describes the ability to trade large amounts of stocks without profoundly impacting the stock price. Whether the liquidity is high or low can be observed with the bid and ask spread. “Bid" represents the maximum price at which an investor is willing to buy, and “ask" represents the minimum price at which an investor is willing to sell. Consequently, with a persistently large bid- and ask-spread, the trading volume is low, liquidity is low, and vice versa.

Scholars controversially discuss the effects of a portfolio firm’s stock liquidity on engagement. On the one hand, literature agrees that low liquidity reduces engagement since stocks with concentrated institutional ownership, especially with hedge funds, tend to have low returns with lower liquidity and, therefore, no incentive to monitor (Kumar & Misra, 2015). On the other hand, the perception of the effects of high liquidity is ambiguous. Mccahery et al. (2016) found in their empirical research that high market liquidity discourages activism. Accordingly, high levels of liquidity lead shareholders to engage less since it is easier to “cut” and “run” rather than engage (Mccahery et al., 2016). This is broadly in line with Back et al. (2015), who also interpret high liquidity as a limiting factor to activism. However, other research concludes that high stock liquidity makes the exit threat more credible and supports activism since engagement costs are better reflected in the stock price. Additionally, stock liquidity favors block formation and incentivizes shareholders to intervene (Maug, 1998). That’s also in line with Bessler and Vendrasco (2022) that explain that higher liquidity helps activists to build their stake, on the one hand, more silently and quickly and on the other at a lower cost.

2.3. Effect on the target firm

In Friedman’s (1962) shareholder theory, the shareholder owns a company and appoints an agent to operate the company in the principal’s best interest. Therefore, the agent’s primary objective is directing firm resources and concentrating action on wealth creation for the shareholder. On an institutional level, shareholder theory states that the only responsibility of a firm is to engage transparently in a competing environment without deception or fraud, maximizing shareholder value through growing performance and profits (Queen, 2015). Shareholder value is created through increased stock prices, higher market capitalization, and cash payouts such as dividends. Collecting dividends or having the opportunity to sell stocks at a higher price than the buy-in improve shareholder welfare. Accordingly, in shareholder theory, share price and dividends are the main metrics to evaluate a business’ success. Therefore, all management decisions tailor to improve these metrics. In activism theory, there are three ideas on the effect of activists on shareholder value: (1) Help to monitor the agent and reduce agency costs and thereby improve shareholder value both in the short- and the long-term (2) Activists are focused on the short-term, and its actions are determinantal to shareholder value in the long-term. (3) The pure presence of activist leads to spill-over effects and create shareholder value even for yet-to-be-targeted firms.

Activists assume that target management engages in value-reducing activities such as shirking, perquisite consumption, or conglomerate building (Core et al., 2006). For example, they are growing a firm beyond optimal favors the agent since compensations are often connected to sales growth. This creates a conflict of interest between the principal and the agent since resources are not used to maximize shareholder value. Thus, the principal increases payouts to reduce management resources and requires the agent to monitor resources more efficiently (Jensen, 1986). Accordingly, activists are seen as a resolution to agency problems and help govern a company more effectively, positively correlating with short- and long-term returns. However, the effect of hedge fund activism on shareholder value is controversially discussed by scholars.

2.3.1. Direct effect

Using a case study approach, Becht et al. (2010) examined the efforts of Hermes U.K. Focus Fund and found economically significant and statistically positive abnormal returns around the announcement day. Brav et al. (2008) identify that activism leads to significant positive average abnormal returns in the 7 to 8 percent range in the period surrounding the announcement (-20, +20). There is a noticeable rise in both the target company's stock price and trading volume, starting 1 to 10 days before the Schedule 13D is filed; he further finds that these positive returns persist and are not offset over time, as there is no indication of a negative abnormal decline in the year following the announcement (Brav et al., 2008). In the cross-section analysis, they find that the most significant positive abnormal partial effect results from changes in business strategy, such as refocusing and spinning off the non-core asset (Brav et al., 2008; Clifford & Carey, 2008; John et al., 2014). However, balance sheet reallocations such as dividends and share repurchase show positive abnormal returns but are insignificant. A possible explanation is that this is due to market inefficiency since changes in strategy generally do not materialize in a 20-day time frame. However, Brav et al. (2008) argue that market reaction is not merely a stock-picking effect since performance increases exante. Therefore, measures such as dividend payouts, book value leverage, and market value of equity increased compared to peers.

Similarly, they find that operating margins improved, such as EBITDA to assets or Return on Assets ("RoA"). Those findings align with Boyson and Mooradian (2011), Clifford and Carey (2008), and Klein and Zur (2009). Other research suggests limited evidence for improvements in operating performance (Del Guercio & Hawkins, 1999; Wahal, 1996). Deviating from that, Greenwood and Schor (2009) assume that abnormal returns can largely be explained by the ability to force the target into a takeover and returns for independent firms are not detectably different from zero. That would imply that an activist generates shareholder value by finding the best owner for an asset or target company.

The supporter of the myopic activist claim believes that activist engagement is focused on short-term increases in stock performance and returns, ultimately leading to value destruction in the long term (John et al., 2014). Accordingly, activism would oppose the idea of shareholder theory. John et al. (2014) did not find evidence to support that claim in their empirical study, which is also in line with the findings of Mccahery et al. (2016) and Gillan and Starks (2007). Nevertheless, John et al. (2014) and Denes et al. (2017) find that corporate advisors and jurisdiction have influenced and supported targets to defend against shareholder activism by adopting firm- and state-level antitakeover provisions. Resulting in defense mechanisms such as staggered Boards, poison pills, or changes to shareholder rights – For calling a shareholder meeting. Accordingly, the agent makes it more difficult for the principal to govern and obtain control or ownership in the target company (Becht et al., 2010; Cremers & Nair, 2005; Gordon & Pound, 1993).

2.3.2. Indirect effect

Some scholars like Wilhelm George, former CEO of Medtronic, assume that activists aim for a quick increase in the stock price by advocating for significant changes publicly, causing a temporary bump in the stock price which is detrimental to long-term value. However, John et al. (2014), who studied 2000 interventions between 1994-2007, found no evidence of long-term underperformance. In general, it is challenging to determine if activism was the direct cause of improvements in a company's performance or increased stock value, even if such activism leads to positive outcomes in the following years (Gillan & Starks, 2007). However, some also argue that activists do not need to buy ownership since the pure presence and threat to a peer could lead to positive spill-over effects. Accordingly, activism would cause positive externalities that enhance shareholder value. Firms that activists have not yet targeted perceive a sense of threat and take proactive measures by collaborating with advisors to assess their policies and reduce vulnerabilities to potential activist attacks. This proactive approach, often called an "activist fire drill," results in the implementation of actual policy changes. These changes can include actions like spinning off divisions or implementing programs to return capital, aiming to prevent dissent from arising in the first place (Becht et al., 2010). As a result of this proactive response, a spill-over effect positively impacts shareholder value. Prior studies by Gantchev (2013) and Maffett et al. (2022) have supported this notion, highlighting how implementing such changes leads to increased shareholder value.

3. Research methodology

3.1. Research design

Hedge fund activism has garnered significant attention in financial research, with scholars seeking to understand its causes and effects. While qualitative methods have been recommended to delve into the nuances of this phenomenon, scholars predominantly relied on quantitative research utilizing standardized numerical data sets. Thus, qualitative research limits the understanding of the effects of hedge fund activism as it tends to focus on measurable outcomes and publicly available information, often overlooking that a significant portion of activist engagement occurs “behind the scenes" and relies more on strategic maneuvering than rigid scientific principles (Mccahery et al., 2016). As Gioia et al. (2013) already cited Einstein, “Not everything that can be counted counts, and not everything that counts can be counted” (Gioia et al., 2013, p. 2). Accordingly, that offers the opportunity to use a qualitative research methodology, particularly detailed observations by firsthand informants, for developing new theories (Eisenhardt et al., 2016; Nowell & Albrecht, 2019).

Thus, limit feasibility because it is essential to recognize that not every hedge fund follows the same approach or utilizes identical measures to unlock value. This diversity among activist strategies restricts the generalizability of findings across the entire activism landscape. Moreover, the choice of measures employed by activists can affect shareholder value differently. Each activist may employ their own unique set of metrics, which necessitates a nuanced understanding of the specific measures employed in each case. Furthermore, the effects on shareholder value resulting from activist interventions are often not triangulated with those of peer companies or the overall market environment. This lack of contextualization makes it difficult to separate the effect of activist measures from the prevailing market conditions, thereby only partially attributing the outcomes to hedge fund activists (Gantchev, 2013). Accordingly, existing theories do not offer feasible answers to reveal the actual effects of hedge fund activism, making an inductive design for this master thesis suitable to answer the research question (Nowell & Albrecht, 2019). Accordingly, this thesis follows the structured inductive approach proposed by Gioia et al. (2013), focusing on how organization members construct and understand their experiences. I used a semi-structured interview guide to have the desired flexibility for individual answers and give voice to the informants (Eisenhardt et al., 2016; Gioia et al., 2013). This approach is suitable since it facilitated a less restricted theory-building process in which findings emerged without the structured methodology limitations and through frequency, dominant, and significant themes inherent in raw data (Thomas, 2006). Hence, making sure that specific topics are covered.

To follow the urge in qualitative research to be rigorous, I used a mix of primary and secondary data and a methodological approach for my primary data to ensure that experiences and opinions were not formed uniformly and different perspectives on the phenomena were considered. Hence, inside perspectives from the target and advisors to activism from the business, legal, and activist close advisors were considered. Furthermore, secondary data was used to enrich the objectivity. The reasons for that are twofold. First, the chairmen’s letters cause and call for change. Second, reports provided by interviewees offer broad insights into industry trends. Thereby allowing us to put experiences and numbers of prior research into context. Acknowledging the concerns of Pratt et al. (2022) and Eisenhardt et al. (2016) that the availability and wide use of templates in qualitative research is a concern for quality, this master thesis uses, in addition to Gioia et al. (2013) the active category framework proposed by Grodal et al. (2021) to precisely demonstrate how I used, collected, coded, and analyzed the data when generating theory.

3.2. Data collection and sources

The data sources of this thesis include 20 interview data from leading industry experts and 7 secondary data from various sources to study the focal phenomena of hedge fund activism. I utilized a broad set of industry experts to study the phenomena from different standpoints and took the target perspective and associated advisors to activism to also triangulate results. The tables 1 and 2 give an overview of primary and secondary data used to answer the research questions.

Interviews represent the main data source of primary data. The Interviews were conducted within a timeframe of two-month beginning in January 2023, to build the fundamental knowledge of this master thesis. Interviews were obtained through the network of interviewees who offered to connect me to other professionals. Interviewees were then further selected based on their area of profession and the employer’s reputation. The sample includes the target companies and related advisors from the banking, strategy, and law side to view the phenomena from different perspectives. In total, ten banks were surveyed, focusing on bulge bracket banks such as J.P. Morgan, Morgan Stanley, and Bank of America, and other leading global banks such as Deutsche Bank, Citibank and Credit Suisse. Investment banks play an essential role in hedge fund activism by serving as advisors or intermediaries between the hedge fund and the company in which the hedge fund has invested. Investment banks can support the target in evaluating takeover offers, identifying defense strategies, and executing M&A.

Furthermore, investment banks support their clients to anticipate the threat of a possible activist campaign before such vocal investors show up (Gantchev, 2013). Therefore, Investment banks have the expertise and experience in capital markets and global reach to adequately provide me with insights. Moreover, they work with the largest corporations and financial institutions and typically have the resources and knowledge to handle the largest and most complex financial transactions. Besides, I have interviewed boutique banks such as Rothchild & Co., Greenhill and Moelis & Company. The interviewed bankers come from major financial centers in the United States, Great Britain, and Germany and hold Managing Director (“MD”) positions within the M&A services department. Some also have a specific focus on shareholder engagement and therefore represent suitable interview set to answer the research questions.

Target firms play a crucial role in understanding the effect of an activist. For this purpose, I interviewed five senior strategic and merger and acquisition-related Executives. I have chosen senior executives since activism and related engagement are not transparent to the entire organization it

Table 1: Primary data

Company	Interview Responded	Background	Country
Credit Swiss	Managing Director	Investment Bank	US
Greenhill	Managing Director	Investment Bank	UK
Bank of America Merrill Lynch	Managing Director	Investment Bank	GER
Deutsche Bank	Managing Director	Investment Bank	GER
United Bank of Switzerland	Managing Director	Investment Bank	UK
Rothschild & Co	Managing Director	Investment Bank	GER
Citibank	Managing Director	Investment Bank	UK
JP Morgan Chase	Managing Director	Investment Bank	UK
Morgan Stanley	Managing Director	Investment Bank	GER
Moelis & Company	Managing Director	Investment Bank	GER
Target Firm	Global Head of M&A	Industry	n/a
Target Firm	Global Head of M&A	Industry	n/a
Target Firm	Global Head of Strategy	Industry	n/a
Sullivan Cromwell	Partner	Law firm	GER
Wachtel, Lipton, Rosen & Katz	Partner	Law firm	US
Alvarez & Marsal	Managing Director	Consulting	GER
Alvarez & Marsal	Managing Director	Consulting	GER
n/a	Activist advisor	n/a	GER
Deloitte	Partner	Consulting	GER
Investment Bank	Board Member	Investment Bank	n/a
Total	20		

Table 2: Secondary data

Characteristics	Title	Date
Activist Letter to Board	Trian vs. Disney	2023
Activist Letter to Board	Elliott vs. GSK	2021
Activist Letter to Board	Elliott vs. Alexion	2020
Proxy Statement	Pershing Square vs. ADP	2017
Activist Letter to Board	Third Point vs. Nestlè	2017
Management Letter to Activist	Kleinfeld to Singer	2017
Activist Letter to Board	Third Point vs. Sotheby's	2013
Total	7	

is located at the top of an organization's hierarchy - For example, Senior Strategy or M&A Executives and Board members. Generally, Board members receive the initial contact letter, which is also referred to as "Dear Chairmen." Furthermore, the mentioned executive, as their role of an agent, plays a crucial role in understanding the principal-agent relationship of an activist and its target firms, as well as the effect on the strategic direction. Lastly, other relevant advisors in activist situations were interviewed. Target firms often seek attorneys to defend against the hedge fund's efforts and protect their interests which includes advising on issues such as shareholder rights, proxy contests, and M&A. In addition, several businesses and hedge fund advisors were interviewed.

The Interview Guide is semi-structured to gain both a retrospective and a current perspective from individuals who are directly experiencing the phenomenon of interest and can be derived from Appendix A. Hence, I chose this approach to get an in-depth insight into the motivations, opinions, and experiences while covering certain topics (Bryman, n.d.; Gioia et al., 2013). The sample consisted of various respondents with diverse international backgrounds with a broad awareness of the phenomena (Eisenhardt et al., 2016). German interviews were translated into English and then checked for correctness. To adequately give voice to the interviewee's discretion was important. First, the respondents were asked for their consent to record the interview for analysis purposes.

Moreover, I involved interviewees in the evolving analysis, models, and even manuscripts to protect their interests; however, I did not grant a veto other than reporting of sensible data (Gioia et al., 2013). Besides, interviews were informed that data is anonymized and will not contain names or references to the company. Since the opinions of the interviewees on such a highly sensitive topic are detrimental to honest opinions, I decided to further protect them by randomly assigning names to the transcript and interview numbers. Interviews took place mostly via a virtual conference such as Microsoft Teams or Zoom, some also at sight, and generally took 40 to 60 minutes. Furthermore, the interviews were transcript within one week after the interview. However, efforts to anonymize data interviews still have their limitations.

Secondary data comes from different sources. However, "Dear Chairman" letters, which represent letters from a shareholder to the Chairmen of the Board, represent the prime secondary data source. First, they show how they engage with the company and what the shareholders think of the company. Second, it shows how he plans to unlock and thereby increase shareholder value. In total, I gathered 10 "Chairmen" letters which can also be found in Appendix B1. To support that I collected presentations, newsletters, and studies from the interviewees that can be derived from Appendix B2 Those are mainly private, however, not confidential analysis presentations to corporate clients on the activism industry. Discovered documents during desk research, which included publicly available industry reports, newspaper articles, annual reports of target firms, and filings with the Security Exchange Commission. For detailed information on target firms, I used statistics and information from Bloomberg Terminal and Refinitive workspace. Such information includes stock price developments, ownership or "cap" tables, and valuation information.

3.3. Interview guidelines

Interview guidelines. The interview guide was only sent upon request to allow exploratory research. As a result, the interview questionnaire was only sent four out of twenty-one times. Additionally, no concepts or ideas were given as a priori explanations to verify an observation. However, the interview topics were defined in buckets ex-ante. This research aligns with an inductive research approach proposed by Gioia et al. (2013).

The first interview phase in January 2023 served to ask general questions about the phenomenon of hedge funds and shareholder impact. A screening of existing literature was made for the creation of the questions. This resulted in two blocks: (1) Activist formation and (2) Shareholder impact. The first block addressed the activist formation's definition, causes, and engagement characteristics. Then, the impact was asked on a short, medium, and long-term basis. Therefore, questions were asked to understand what the interviewee considers shareholder activism, what objectives and motivations are behind engagement, what problems an activist identifies, and what factors can potentially enable activism. Additionally, questions were asked to clarify the process of an activist and how it can impact shareholder value in different time horizons. Finally, it was to be clarified if the interviewee could illustrate an engagement using a specific case. This section was not covered in the second interview round in February 2023 due to confidentiality towards the clients.

The second interview phase went beyond the existing and general questions. The block structure was maintained as it covers the "effects" comprehensively, but it was clear from the first interview phase that activism is a concept that cannot be generalized and is very situational. Therefore, to consider this level of complexity, the questions were posed more specifically ex-ante. Questions related to activist formation were thus expanded and aimed at distinguishing from other shareholder groups, the different shapes and styles of activists and the significance of some characteristics of their essentiality. Regarding causes, more targeted questions were asked about the analysis an activist undertakes to identify a target and what measures result from it and if they can be classified in terms of implementation by the target company.

3.4. Data analysis

This empirical research is based on 20 interview transcripts, thereof 11 Investment Banks, five Target firms, and six advisors closely associated to hedge fund activism. Note that data was structured accordingly before being analyzed. According to the grounded theory approach by Gioia et al. (2013), the thesis analysis follows a two-step approach. First, these transcripts were analyzed inductively and openly coded using the qualitative research software MAXQDA. According to the 1st-order analysis, "I tried to adhere faithfully to informant terms" (Gioia et al., 2013, p. 20). Second, I began to abstract this functional collection of themes into higher-order themes. In research, this is achieved by attaining "theoretical saturation," according to Glaser and Strauss (2017). To further abstract categories, I explored the feasibility of further simplifying the emerging second-level themes into 2nd-order aggregate dimensions (Gioia et al., 2013; Glaser & Strauss, 2017). The emerging categories thereafter become the concepts and mechanisms to form my theory (Eisenhardt et al., 2016). This is also in line with Pratt et al. (2022) and Gioia et al. (2013), which further conclude that it shows how concepts relate to each other based on structured evidence. Categorization theory and its scholars argue how rigor can be achieved in qualitative research. Grodal et al. (2021) propose that researchers can prove rigor by detailing more precisely how they have purposely used a broad set of moves to engage with the data; Therefore, I followed the active categorization framework proposed by Grodal et al. (2021). I considered eight different moves that can be categorized into three stages: Generating initial categories, refining tentative categories, and stabilizing categories (Grodal et al., 2021).

To generate initial categories, I focused on finding puzzles, where I paid attention to surprising and salient information that deviates from existing literature. According to Locke et al. (2008) that helps abduct new insights that may be inherited in the raw data. Scholars refer to such puzzles as "negative cases" or "unusual incidents" (Grodal et al., 2021). This is particularly suitable since I expect to find activist engagements that deviate from the literature's positive findings. Second, this is important not only to find planned effects but also to describe the actual effects. In line with Thomas

(2006) "identifying any significant unplanned or unanticipated effects or side effects" is an important evaluation task.

To refine tentative categories I included different moves to make the categorization an iterative process characterized by reducing and increasing the number of categories. On the one hand, that is done by merging or dropping categories to either overarching categories, as emphasized by Gioia et al. (2013) and Elliott and Gillie (1998) or dropping them. Dropping categories is suitable when in the analysis process, categories turn out to be not relevant or do not emerge stable patterns. Conversely, I tried to find subordinate domains through "unbundling" or "splitting" categories. Thereby increasing the number of categories to limit overgeneralization. Furthermore, I compared and contrasted categories by specifying the relationships or lack of relationships among them. This differs from merging themes since I recognize connections between categories that may not necessarily belong to the same overarching category. Lastly, I considered the sequential relationships to find the dynamics and causal connection of categories in the data. Thereby decoding the relationship between an action and an object and determining concepts and mechanisms (Grodal et al., 2021). Furthermore, the end of the study was achieved at the point where no further themes evolved. In the last stage, stabilizing categories, I tried to re-analyze the categories and integrate identified mechanisms and concepts to check if the data supported the theoretical conclusions made (Grodal et al., 2021).

4. Findings

Comparing the primary interview data from 20 interviews and following Gioia et al. (2013) and Grodal et al. (2021), 12 first-order themes were aggregated and further abstracted into 2nd-order themes and dimensions. Finding that my independent variable hedge fund engagement cannot be viewed as a homogeneous group of investors since different factors determine the effects on shareholder value. I found evidence in my data that these factors include target choice, style, and resolving approach of the activist. Target choice refers to the specific internal factors such as waste of company resources, leverage ratio or operating KPIs, and external factors such as stock price, shareholder return, and shareholder concentration. I further found similarities that underline that the activist's shape and style effect the measures' choice. Hereby shape and tone are determined by the incentives of the activist to produce returns for their shareholder, geography, size, and reputation. Lastly, how the activist plans to resolve his investment hypotheses affects shareholder value. That's because the measures proposed can be short-term or long-term orientated in nature, and how aggressive the activist is while communicating publicly or privately influences the target firm.

The observed consequences for the dependent variable in this thesis can be categorized into two main aspects. Firstly, there is a direct impact on the target firm, affecting both short-term and long-term outcomes. Secondly, activism can also have an indirect effect through activist engagement with peers resulting through either taking corrective actions ("target response") or through a broader "market response," where the market reacts to anticipated changes. As such, the market response can be explained by the capital market anticipation of the changes to generate shareholder value. However, these overreactions seem to result from market inefficiencies rather than legitimate improvements in the target firm. The figure 2 illustrates the coding tree and structure of the emergent findings.

4.1. Hedge fund engagement

Hedge fund activist engagement is a case-by-case driven event and can change on almost all levels depending on the situation. However, activism is more a symptom than a cause (Interview 11). It shall rather be seen as a catalyst for unpleasant or even tough decisions (Interview 5). This chapter elaborates on the factors that shape engagement.

4.1.1. Target choice

Hedge funds are diligent when identifying a target firm before engaging. My findings reveal that hedge funds look for two relevant characteristics in a target firm. Internal-management-related factors build the backbone of the investment hypothesis. More specifically, they construct a storyline about why something needs to change. Whereas external-investor-related factors determine the receptiveness of the investment thesis with the shareholder base, which is necessary to implement change. The table in figure 3 illustrates the identified dynamics around target choice.

Internal, management-specific factors are linked to the financial and operational performance of the target firm. Common sense suggests that when a firm demonstrates strong performance across these dimensions, an activist has limited incentive to get involved and incur the associated monitoring costs, as the potential to generate alpha for their investors is insignificant. As highlighted by one of the interview respondents, well-performing companies are typically not targeted by activists.

> *"(...) one must not forget when the activist looks at a company that is performing outstandingly, producing its earnings at an absolute level, and just as strong as the competitors. Then the activists are not attracted at all"* (Interview 6).

Conversely, Interview 19 explains that a solid performance from a capital market perspective puts a firm in a strong position so that the activist has no point of contact – For example, have strong operative result and trading on a multiple "where there is not much room for improvement" (Interview 19). As such, my elaboration is vastly associated with target performance typically below the target firm and industry-specific ability to produce shareholder value. More specifically, activists analyze historical performance and management decisions within a time horizon of three to five years. Thus, evaluate if major milestones are achieved or

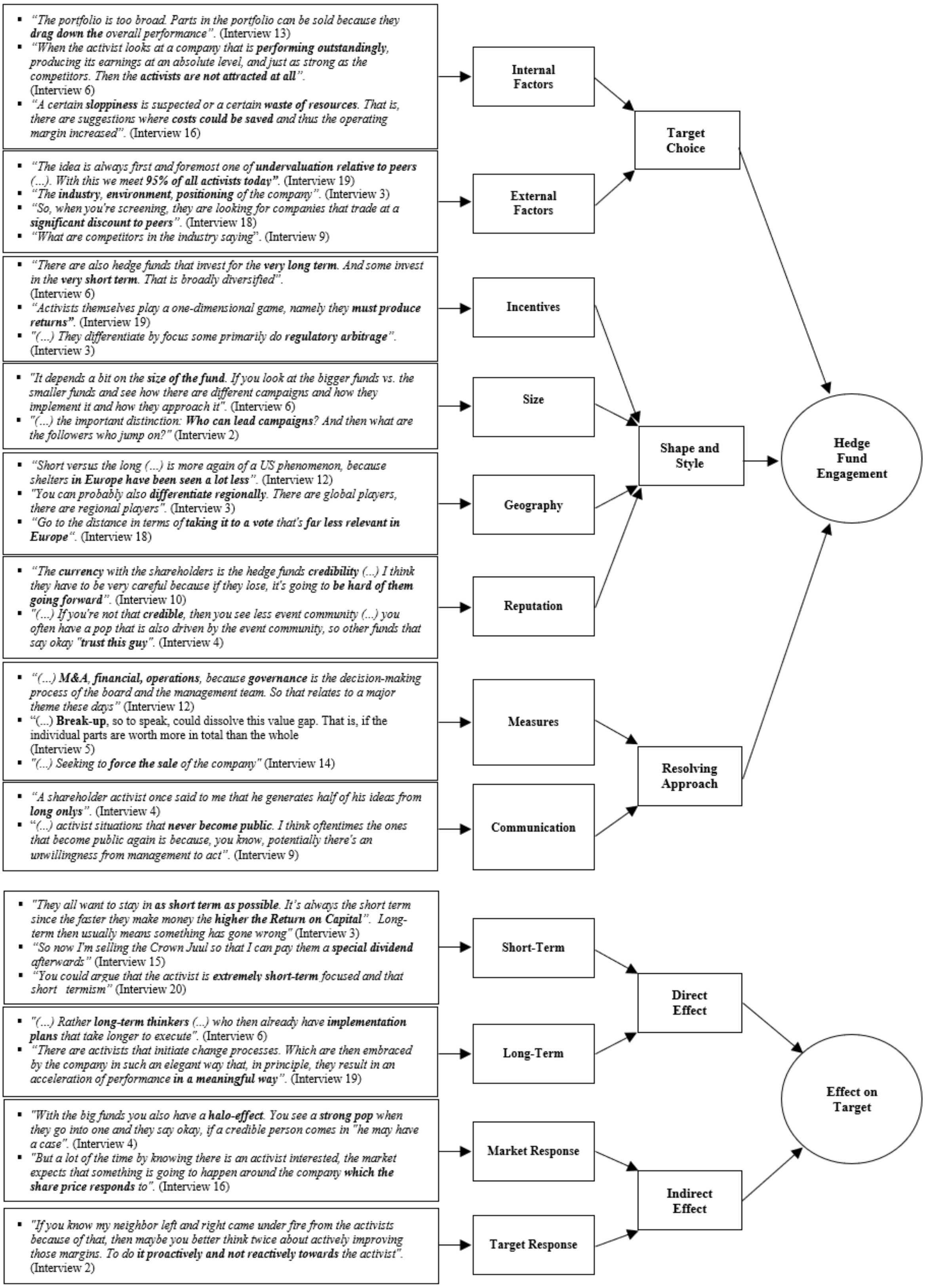

Figure 2: Coding tree.

missed and if management decisions have led to a company being in a compromised position from the capital markets perspective, thereby impacting its outlook over the following years (Interview 9). Underperformance is a central theme

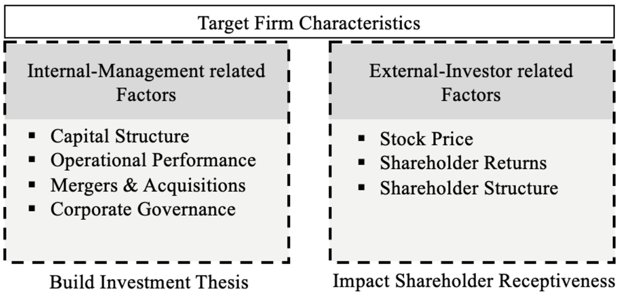

Figure 3: Target firm characteristics and relationships.

Note: Factors identified are not exhaustive or mutually exclusive

for an activist to engage in, and it needs to be considered that different factors lead to underperformance.

First, there needs to be a competitive cost structure. I observe that activists look at companies with too many operating costs and weak operating results. Interview 9 further explains that activists look at financial KPIs that show they are underperforming in terms of profitability (Interview 9). This is especially true for German companies, which, according to Interview 7, have performed well in the last twelve months regarding the "topline" and have withstood the competition with their peers. However, they are lagging internationally in terms of the profitability of the business. An activist then puts forward an investment hypothesis on how to make the cost structure competitive to make up this gap (Interview 7). In line with that, an activist may confront the target firm with a question such as, "While your competitors achieve an EBIT margin of 10 percent, yours stands at 6 percent. I want to understand the reasons behind this disparity" (Interview 19). The illustration 4 shows an analysis published in a letter from Elliott Advisors Limited ("Elliott") to the BoD of Alexion ("Target Firm") in FY20 (Appendix B1).

It can clearly be seen that the Enterprise value ("EV") to EBITDA decreased. In other words, the firm's value compared to the operative result decreased. This can have different causes. Either the market does not value the firm the same because of various factors, or operating activities are reduced in profitability. Acknowledging that reduced EBITDA results from revenue and costs, this is either related to a reduction in sales, the market demand shifted, or costs increased. However, decreasing profitability over five years gives the activist a reason to believe that the target management does not manage it well.

Second, M&A encompasses acquiring and divesting assets, which involves strategically managing a firm's portfolio and executing its corporate strategy. It revolves around evaluating the allocation of financial resources and determining whether they are appropriately invested in the core assets (Interview 8). As such, portfolio management is to ensure that a firm's portfolio of assets is in strong alignment with its overarching strategic goals. It involves making effective resource allocations to optimize long-term growth and profitability, maximizing shareholder value. One senior target firm executive mentioned that the investment hypothesis is that the target management does not appropriately focus on high-value, so-called "core assets" and miss allocates budgets (Interview 4). Activists argue that these assets should be divested to focus on the core assets and thereby improve competitiveness and shareholder value. As such, shareholder value is unlocked by selling these non-core assets and reinvesting proceeds to strengthen the core assets – For example, by investing in Research & Development ("R&D"). Besides, the sale proceeds of non-core assets can also be used to pay off debt, buy back shares, or distribute special dividends, further improving shareholder value.

In addition to diverting management's attention away from the firm's core assets, an interviewee highlights that an excessively broad portfolio can potentially have a detrimental effect on overall performance (Interview 13). Non-core assets may encompass subsidiaries, divisions, or product lines that are unprofitable or no longer align with the firm's strategic direction, resulting in a lack of synergies. Synergies can arise when certain functions like R&D can be utilized across multiple businesses or when administrative services can be shared as a backbone for a conglomerate. As such, another interviewee responds that - a firm can be diversified to the extent the portfolio setup is synergistic and logical (Interview 2). Logical in the perception of the capital market and plausible as to why an asset is useful to the portfolio. This approach is in corporate strategy often described as a "pure play"- strategy. A senior target firm executive explains that non-performing units or units with great value on a "stand-alone" basis do not necessarily have to be in the conglomerate from an investor's point of view (Interview 2).

Another respondent mentions that the disconnect begins when the asset is not sufficiently considered in a valuation, and the sum of part is significantly higher (Interview 4). That phenomenon is also referred to as a conglomerate discount, which describes a situation where the market value of a diversified conglomerate company is lower than the sum of the individual businesses or assets that make up the company. In other words, the total value of the conglomerate is less than the sum of the parts. Conglomerate discount is calculated as the difference between the market value of a conglomerate and the sum of the market values of its business units. This

Figure 4: Elliott analysis of EV/EBITDA of Alexion (taken from Elliott Advisors Limited).

discount occurs because investors often perceive diversified companies as having less focus and expertise in each business area than companies that specialize in a single industry or product. In other words, the asset is not fully utilized from a "best owner perspective", leading to high complexity, adverse diversification effects, inefficient capital allocation, and lack of synergies in a conglomerate structure (Interview 19). As a result, investors may be more hesitant to invest in conglomerates and may require a higher rate of return to compensate for the perceived risks.

Additionally, conglomerates may face challenges in managing multiple business units with different priorities and growth prospects, which can further contribute to the discount. One interview respondent stated that a conglomerate discount would - certainly be one of the most decisive factors (Interview 15). To illustrate, ThyssenKrupp AG, a German conglomerate, sold its elevator business ("TKE") to be more pure play due to the lack of synergies between elevators and its traditional steel business. According to Interview 12, there are various ways for an activist to identify a conglomerate discount:

> *"(. . .) a very important one is returns over invested capital versus your weighted average cost of capital, not only at a group level but at a divisional level so that you can see whether each company division controls several divisions, is creating value for shareholders. Because sometimes, top companies, which is group performance in terms of return over invested capital versus the weighted average cost of capital, can obfuscate. That might be very positive but could be covering or hiding the underperformance of a division that has never actually met its own cost of capital. And that is because there are two or three other divisions that are, you know, knocking it out of the park every evening. They are earning so much more than their cost of capital that the group is allowed to maintain divisions that are suboptimal and destroying value."* (Interview 12).

Following this viewpoint, activists prefer maintaining a "pure play" focus. As one of the interviewees articulates, "Activists desire organizations to maintain a clear focus; they become uncomfortable if there are too many diversions" (Interview 20). Likewise, stated that activists have an aversion to conglomerates and diversification.

Third, capital structure. Target firms tend to have a "lazy balance sheet" where there is a lot of access capital, which could be used to pay out to shareholders regarding dividends or share buybacks. Intuitively that makes sense because if a firm, cash is not used to that generate higher returns on capital than interest rates. Conversely, having a low level of capital on the balance sheet hinders investments, leads to high debt levels, and makes it more complex to secure financing of M&A. Target firms with high levels of cash, as elaborated previously, can pay special dividends, or buy back shares, thereby on the one hand increase shareholder returns and the other overall shareholder value (Interview 4). Interview 12 further details that leverage levels compared to their peers are relevant.

> *"The more the target company is unlevered relative to the median and average leverage level of their peers in the industry, the more that company will potentially be a target because the activist will go in requesting greater leverage".* (Interview 12).

That makes intuitive sense since peer leverage levels indicate which amount of debt to assets can be maintained to run the operative business of the firm. Consequently, when a target firm has a lower level of leverage relative to its industry peers, indicating a lower debt-to-assets ratio, it tends to operate with reduced risk compared to its competitors. However, this conservative approach to capital structure may result in slower growth and a potential loss of competitiveness. Another respondent explained that very liquid balance sheets, either a combination of low net debt EBITDA or a reasonable percentage of cash as a percentage of your market cap, get you on their radar (Interview 18).

Next to internal and management-related factors, I observed that external factors that relate to the investor's perspective and are essential to understand why a firm becomes a target. To investors, various metrics such as stock price, dividends, and total shareholder return determine investors' receptiveness toward an activist's investment thesis. The stock price is one of the most visible metrics that reflects the market's perception of a firm's value. A rising stock price indicates that investors have confidence in the company's future growth prospects, while a declining stock price can signal the potential shortcoming of management strategy or a special event – For example, major lawsuits like the Bayer & Monsanto case. My prior elaborations show that undervaluation is a decisive criterion for the choice of the target firm (Interview 11). Interview 18 further breaks undervaluation down to the target firms' divisions compared to its peers.

> *"(. . .) relative valuation, the sum of the part, the sum of the parts story, you look at the company versus each of the individual peer sets for each business. And when you're lagging, you're demonstrating that the status quo isn't sufficient."* (Interview 18).

In line with that view, Interview 2 explains the importance of valuation in activist situations as part of the 3V, which is Value, Variety, and Vote. Valuation involves the estimation of the financial value of a firm. There are various ways in corporate finance to determine the value of a firm, such as Discounted-Cash-Flow method ("DCF"), Multiples, or Price-to-Earnings ("P/E") ratios. All of these try to estimate the firm's intrinsic value, considering factors such as its earnings, cash flows, and growth prospects. Performing poorly on these metrics increases the target firms' vulnerability toward activism. (Interview 2). Interview 19 further explains that valuation primarily expresses the perceived potential for the share price to grow (Interview 19). The potential is often also defined by the relative potential compared to peer firms (Interview 4). The illustration 5 shows an analysis published in a letter from Elliott Advisors Limited ("Elliott") to the BoD Alexion ("Target firm") in FY20 (Appendix B1).

In the letter, Elliott proves to the shareholder of Alexion that the ratio of EV to EBITDA compared to the peer group has been significantly below expected. In five consecutive years, Alexion traded at a discount of 50 percent compared to other industry peers (Appendix B1). Stock performance is also compared to the index (Interview 5). However, not only the firm but also individual divisions are analyzed since the entire firm can be undervalued, but also individual divisions that drag down overall valuation (Interview 6). It is essential to emphasize that when they look at undervalued companies, they are looking at not companies that are "basket cases, but generally strong companies with reasonable cash flows" that are undervalued in the market (Interview 18). So next to an undervaluation, there must be a reasonable explanation if locked values could be resolved to increase the stock price (Interview 20).

According to another response, total shareholder return ("TSR") "is one of the first references for target identification" (Interview 2). That makes intuitively sense since, from an investor's perspective, next to any gains in the stock price, the dividend yield is an important metric that provides a more comprehensive measure of the return on investment than just looking at the stock price. It also indicates how receptive other shareholders are when the activist wants to implement changes (Interview 3). TSR is a financial metric measuring the total return an investor receives from investing in a particular company's stock over a specific period. TSR monitors the overall value a shareholder receives from his investment, considering both capital appreciation (changes in the stock price) and dividends, thereby including valuation and payments to shareholders. So weak Total Shareholder returns result in a low shareholder payment, making investors more receptive to special dividends or share buyback, which results in higher shareholder value, specifically when it is inferior to peers and index over a longer period. The illustration 6 shows Third Point LLC ("Third Point") approaching the BoD of Nestlè ("Target Firm"), highlighting that total shareholder returns have been inferior to peers for ten consecutive years (Appendix B1).

Shareholders that received less in their returns on their investment are more likely to support the activist's thesis. One interview respondent explains that an activist selects a target firm by weighing how likely he is to implement his investment hypothesis by looking at shareholder structure (Interview 3). Similarly, interview 14 calls on the importance of the shareholder base as an important context (Interview 14). A high level of shareholder concentration can be crucial when an activist hedge fund makes an investment decision, giving the fund more significant influence over the company and its decisions. A high level of shareholder concentration enables an activist hedge fund to gain more voting rights and greater control with less investor interaction. Accordingly, the power and influence of an activist hedge fund can be amplified through the concentration of shareholders who are aligned with its investment thesis. As one of the interview respondents mentioned, the higher the shareholder concentration, the worse it is for the target (Interview 3). Another explained that they look for a concentrated shareholder base and have some other funds they know to leverage their thesis (Interview 20); however, in traditional companies such as BMW, where major shareholders such as the family, Klatten own around 45 percent of the shares. This makes it difficult for activists to launch successful campaigns against these companies, as the family shareholders are unlikely to support them (Interview 14). To improve the target choice, the activists often approach proxy solicitors and do a "deep dive" into the shareholder base to understand the shareholder profile better. One of the respondents explained that he wants to figure out whom to talk to when they need to escalate pressure here in any way, thereby elaborating on where people might be supportive and where people are not supportive (Interview 18).

4.1.2. Shape and style

Next to the target choice, different shapes, and styles" can vary in the effectiveness of creating value depending on the situation. As such, Activists appear in different shapes and styles - For example, some activist investors may be more aggressive, publicly criticizing management and demanding significant changes. In contrast, others may be more collaborative, working behind the scenes with management to achieve mutually beneficial outcomes. How a hedge fund engages a target firm is strongly associated with its incentives, size, credibility, or geography. The underlying rationale is that the complexity and situation make different engagement styles better suitable.

For most, Hedge funds are diligent and highly analytical financial investors generating alpha for their investors. How-

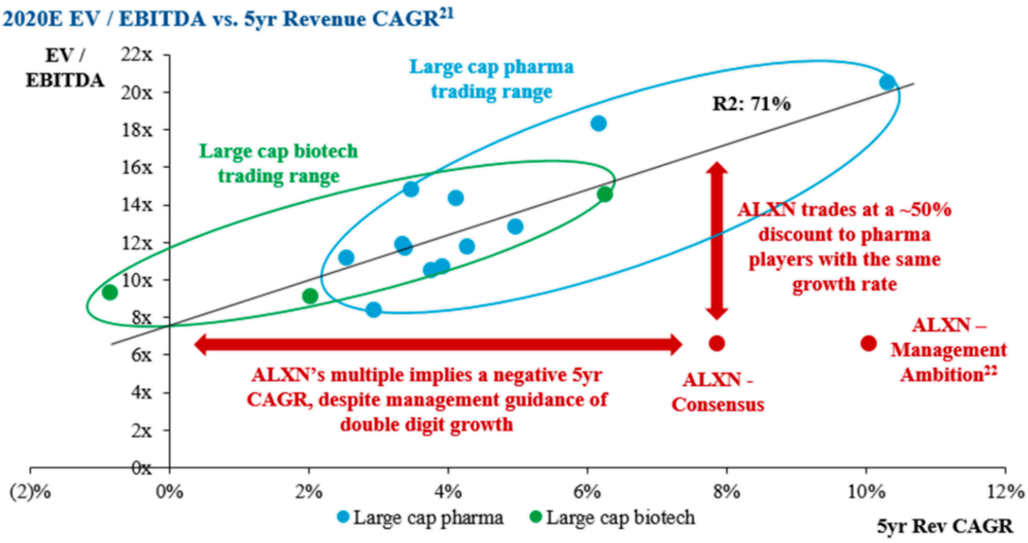

Figure 5: EV/EBITDA vs. 5-year revenue CAGR (taken from Elliott Advisors Limited).

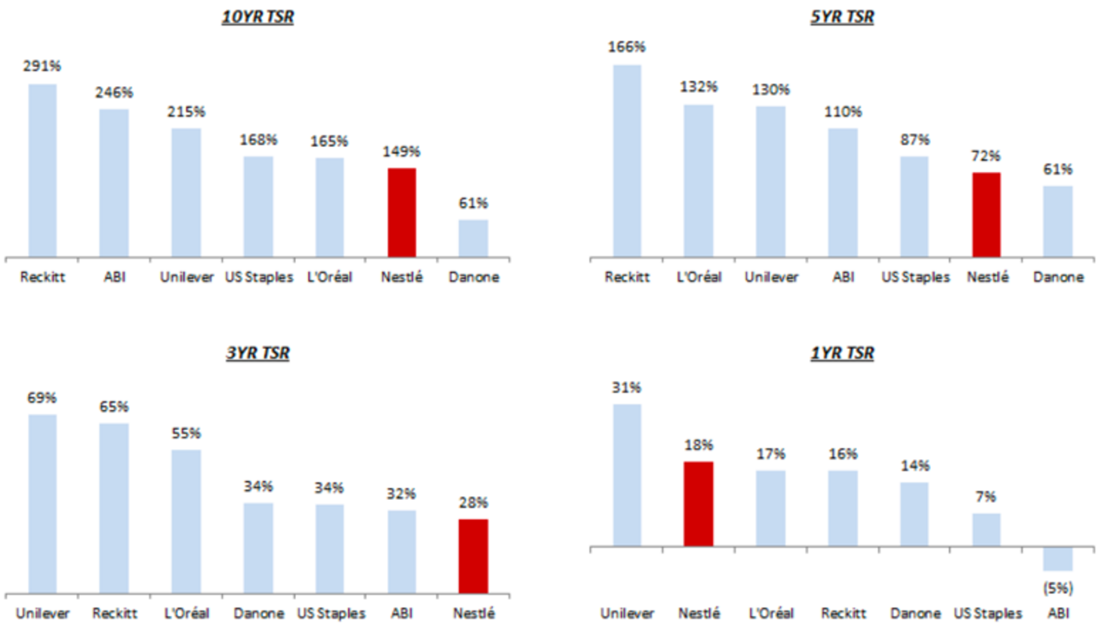

Figure 6: Comparing Nestlé's TSR to consumer industry peers (taken from Third Point).

ever, the way an activist engages can vary: (1) Value-driven activists build their investment criteria to find companies that are, undervalued and seek strategic or financial actions to unlock the value. (2) Activists who identified malpractice or financial opportunities to go short on a target firm bet on the demise of the share price (3) Special situation activists take advantage of situations in which decisions are directed to the shareholder base to benefit from arbitrage situations.

Interview 19 explains that it is not only about alpha but even about absolute returns. Thus, an activist wants to make more returns periodically, no matter what happens to the market. That makes intuitive sense since a hedge fund is responsible to its investors for producing dividends. Suppose a hedge fund now drives an activist, so a particular investment or specific investment strategy in which the activist seeks to go into the dialogue with the companies, to change something, to force some activity (Interview 19). This change must resonate significantly with the capital market since a hedge fund and returns must be greater than the market average due to the greater risk for their investors. To follow up on that fund's hedge market and industry risk, thus generating an idiosyncratic risk profile. In other words, the alpha they create should not be the one that moves the general market but reflect greater returns (Interview 4).

Connecting these two statements: The incentive of a hedge fund is to increase the value of the underlying investment so that the hedge fund can pay its investors higher dividends than the market average. Since a hedge fund pays its investors yearly dividends, the investment needs to increase in value within a specific time frame. One could now assume that investments are structured so that each year on investments pays off; however, it seems reasonable to assume that every investor, particularly a hedge fund, intends to maximize returns as fast as possible.

Interview 6 emphasizes that there are different types of hedge funds and that there are those that invest for the very short term and those that invest for the long term. Accordingly, in a proxy statement filed by Pershing Square Holdings, Ltd ("Pershing Square") directed by Bill Ackman, the hedge fund explains ADP ("target firm") that it "intends to be long-term shareholders and will only propose changes that are in the company's long-term best interests" (Appendix B3).

One exciting statement of an interviewee associated with that is that the long-term benefit is more of a quote-on-quote "fortunate coincidence." Or, as another senior executive at Interview 3 indicated, a sign that something went wrong. The reason is that the activist does not have the staying power to concentrate on one investment to unlock the long-term value frequently. My findings suggest that the reasons for that are twofold. On the one hand, a hedge fund's objective is to have the liquidity to have sizable positions to increase or decrease a position in a firm – For example, to stay agile and use capital most efficiently if there is an investment opportunity. On the other, their incentive system, through the carried interest of the profit they generate for investors, does not enable them to stay long-term. A viable argument for that is if you suggest significant change so that the target firm will be better off in five years if they do specific changes, the investor will need to stay those five years invested. Agreeing with that, an interview respondent mentions that:

> *"(...) many times, corporate strategic decisions unlocked value in the long term and do not create value in the short term, rather the opposite, because sometimes you have to make large investments or take actions short term that are not enhancing earnings to be a stronger company and create value for the medium to long term"* (Interview 12).

Next, an interviewee explained that some activists *base their campaigns on overvalued companies instead of being undervalued and betting on their demise* (Interview 3). As a result, the campaigns are utilized to explain to the capital market why a company is overvalued or sometimes even why the company might be a fraud. This practice refers to so-called short strategies. Short selling, commonly referred to as "going short" on a stock, is a trading strategy wherein an investor borrows shares of a stock from a broker, sells them in the capital market, and anticipates repurchasing them later at a reduced price to return to the broker. The investor will make a profit if the stock goes down but stand to lose if it goes up. The risk of short selling is that there is no limit to how high a stock price can go. This means that the potential for loss is unlimited. There are prominent cases in which a hedge fund exposed itself to a short strategy, such as Pershing Square Vaillant (Appendix B1).

Besides short-selling and value-driven activists, there are also so-called arbitrage activists. One banker explains that bump arbitrage has attracted many activists, "*especially in Germany, and has been the entry point for many funds in the German market*" (Interview 6). Bump arbitrage refers to situations where a buyer pushes for a squeeze-out. A squeeze-out situation occurs when a majority owner group of a firm decides to "squeeze out" or "push out" the remaining shareholders and take full control of the firm. Generally, 75 percent is the required threshold for a domination agreement to achieve a squeeze-out threshold of 90 percent is usually more expensive for the majority shareholder so that the remaining shares are acquired at a premium at a price higher than the current market value of the shares.

The activist can then buy in the tender and demand a higher price, which the acquiring firm needs to pay (Interview 14). Then there are two outcomes. When the deal drops, the acquirer must pay your shareholders a 5 percent guaranteed dividend (MD, Interview 6). Next, to bump arbitrage, there are M&A-related arbitrage situations where one buys stock in the acquiring and acquired firm, where you take a short in the acquiring firm and a long position in the acquired, since in a merger, prices for the acquired firm tend to decrease while the other increase. Interview 4 adds that some activists also engage a target firm to prevent large takeovers because they expect that the target firm is overpaying and there need to be more synergies to pay the price.

"If you compare the larger to the small funds, you see that campaigns and implementation differ; An interview respondent mentioned that he thinks that's a differentiator as to why there are certain activists who are more aggressive and more public than the others (Interview 6). In line with that, another interview respondent elaborated that *mostly "the smaller, newer, high momentum* funds are more incentivized to go public more quickly. According to Interview 9, that's due to their incentive to build or raise their profile. The larger the size, the more established and the longer the track record, the more a hedge fund becomes institutionalized. However, the interviewee argued that it does not impact their general willingness to go public. Still, they choose to go public if they feel they're not getting anywhere bilaterally with management (Interview 9).

Similarly, Interview 2 explains that *"the ability to lead a campaign is an important distinction."* The respondent points out two significant questions regarding the size and ability of an activist: First, who can lead campaigns? Second, who follows? Referring to the campaign leadership *"the higher you go in the escalation level, the fewer people there are that have the appetite, the resources, and ultimately the burning issues to do that"* (Interview 2). The second question refers to a typical problem the activist faces "ownership vs. control," which results from the activist's small ownership. To overcome this, activists must talk to other activists or shareholder, and convince them that their analysis and arguments must be implemented to gain control. Larger groups of activists and shareholder are called “wolfpack” by practitioners (Interview 6). The term “wolfpack" is often used to describe activists who aggressively pursue their goals, using tactics such as public criticism, shareholder proposals, and proxy fights. Interview 15 further deepens that substantial funds have multiple strategies, so size is a factor that impacts the way a hedge fund engages a target firm.

Next to the size, credibility is essential to consider when talking about hedge fund engagement (Interview 19). highlights that track record and reputation are critical success factors for everything concerning the capital market. Accordingly, mentioning that credibility is closely associated with the quality and potential of the activist proposal. In line with that, Interview 20 highlights that credibility can be seen as the “currency” for an activist because if they cannot get anyone to follow them, *“they basically don’t have a business”*. Further highlighting “*the activist must be very mindful the whole time”* navigating through capital markets time (Interview 15). Consequently, the activist continuously reflects on *“Can I win?”, “Is this going to create value for the other shareholders?”*. Reflecting these question makes intuitively sense since the unsuccessful campaign and unachieved propositions do not cause other shareholders to believe in success the next time. Agreeing with that, the Interview 20 further mentions, *“If they do not create value, other shareholders will be less likely to follow me next time”* (Interview 20). Interview 12 further explains that:

> *“Public perception and brand name are crucial to their success. Indeed, it’s kind of the most significant barrier to entry of that type of business is your track record because the more successful you have been in your campaigns or in unlocking value out of targets you have selected to invest in, the more your campaign thesis will resonate more quickly with long goal investors. They’d pay attention to what they say because they would be afraid to miss a good investment opportunity if they didn’t follow you”* (Interview 12).

Associated to the impact of credibility on the capital markets Interview 4 response:

> *“(...) you often see a short-term pop because you have many investors who just say okay, especially with credibility, so if you’re not so creditworthy, you see less event community. So now think again of your investors, the smart funds, the smart money. They carefully look at who invests in a case like this”* (Interview 4).

Event community represents similar as mentioned in chapter 4.2.2.2. Followers in terms of other activities (“Wolfpacks”), but also other large shareholders such as mutual, pension funds, and the broader public that act on the announcement of the activist and cause a pop in the stock. He further mentions that this event community evaluates if it is:

> *“(...) someone rattling the cage or someone who has done some work comes in with credibility and says," Okay, there must be something, I’ll go along with that. You often see a pop that is also driven by the event community, other funds that say okay, “trust this guy," or that of, and then I’ll go with it. But you also see with others that it’s not necessarily the smart money that goes along, but other investors who jump out and sometimes long only. They say, “Hey, maybe there’s change, and then we’ll see what happens," according to the motto that it’s not necessarily sustainable afterward because then you come in and make a bit of a racket, but that may or may not lead to anything at that point* (Interview 4).

However, credibility can also affect smaller activists’ engagement with a shorter track record (Interview 19). In line with that, Interview 18 explains that activists and shareholders are not given credibility, they must fight hard, and that’s partly why they were much more public and had to be more public more quickly” (Interview 18). The theme was also taken up by another respondent who explained that it is essential to convince the event community that they have the “power" to make the next fund they launch, more prominent in investment size. Building on that, the interviewee notes that it is not about making returns on every engagement but, sometimes, as a marketing for the next fund and their portfolio to grow (Interview 6).

The geographic location and jurisdiction have a notable impact on hedge fund engagement. Based on my research, it is evident that the approach taken by activists in engaging the target firm can vary significantly depending on the country, particularly when comparing Germany and the United States. Interview 2 highlights this difference: “The first important distinction to consider is whether the activist is American or not." This emphasizes the significance of considering the nationality or origin of the activist when analyzing their engagement strategies. Agreeing with that, another interview respondent highlights a particularly significant difference in engagement (Interview 17). The statement makes intuitive sense to me as the United States economy operates on a shareholder-centric model. This model emphasizes the firm’s primary responsibility to maximize profits and enhance shareholder value through dividend payments and share price appreciation. Correspondingly, pronounced stakeholder approach in Europe is the fundamental reason for the notable disparities observed between the two regions. The strong consideration given to various European stakeholders contributes to the contrasting approaches to shareholder engagement. In economies that prioritize stakeholder thinking, the BoD is bound by obligations to the shareholders and the various stakeholders involved. The stakeholder approach considers all stakeholders’ interests and is responsible for balancing their interests. As dividends and share prices are important, employment and wages are essential for employees and long-term contracts for a supplier. Interview 2 declares that activism in jurisdictions with more stakeholder thinking, such as Germany and France, differs significantly from countries like the UK, Nordics, Switzerland, and Italy (Interview 2).

Similarly, an Interview 9 mentioned that shareholders in the US are more open to having the shareholder dialogue: In continental Europe, there seems to be a prevailing perspective that shareholders are granted an opportunity to express their views during the Annual General Meeting (AGM) once a year. It is perceived as the designated time for shareholders to take the podium and voice their opinions. However, for the remaining 364 days of the year, the expectation is that shareholders should remain silent and refrain from actively engaging with the company (Interview 9).

Another interviewee mentions Japan as another jurisdiction where shareholder activism seems less present than in the US. This observation may be attributed to the prevalence of cross-shareholdings in Japan, which can deter shareholder activism. As such, Japanese firms hold shares in each other, and they have an understanding that if any outsider comes in, for example, to try to do a hostile takeover or if an activist were to come, or if any other external party tries to tell them what to do all the other corporates vote with the management. The companies within a particular network tend to support each other's management teams, as they know that mutual support will be reciprocated in return.

4.1.3. Resolving approach

The most intuitive finding affecting hedge fund engagement is the choice of measures and associated communication with the capital market. Measurements refer to any actions taken to resolve the undervaluation and unlock value. Measures are generally related to the area where the weakness is identified. Accordingly, measures introduced and proposed by a hedge fund generally relate to the target firm characteristics identified in Chapter 4.1.1.1. So, for example, keeping all conditions equal, an interview respondent explains that when a firm is trading like its peers, on the exact multiples, not undervalued in terms of share price, trading in the middle of the pack compared to its peers, the balance sheet is levered correctly, but one out four divisions is a "stellar performer."

Consequently, the proposed measure by an activist is to sell the underperforming unit and reinvest returns in strong performing, most of the time core assets (Interview 12). However, it must be noted that measures are not mutually exclusive. Communication is associated with how hedge funds communicate those changes privately or publicly with the capital market. M&A is one-way activists solve undervaluation. One senior target firm executive explains that a break-up can make sense if there is a significant gap between the sum-of-parts valuation of the target and the market capitalization of a listed firm on the capital market (Interview 12). Elliott Advisors Limited ("Elliott") proposed such a measure in a letter to the BoD of GSK ("Target Firm") in FY21 (Appendix B1).

> *"GSK has a substantial value creation opportunity: We believe there is significantly more value to be realized at GSK with superior execution. Our analysis suggests that GSK has an opportunity to generate up to a 45% upside in its share price in the lead-up to its full separation and much more in the years beyond" (Elliott, Activist letter).*

That makes intuitive sense to me, as it is logical that companies that do not complement each other cannot generate synergies, which hinders the realization of their full potential. The unlocking of value occurs because, within the capital market, there may be a potential acquiring entity better suited to own the asset in terms of its ability to create synergies. As a result, this acquirer is willing to pay a premium for the takeover, recognizing the potential for enhanced value through synergistic effects. This also links to core versus non-core businesses associated with conglomerate discounts that can be unlocked through M&A. For example, ThirdPoint LLC. ("ThirdPoint") suggested Nestlè ("Target firm") in FY17 monetize the L'Oréal stake ("asset of target firm") because the portfolio is "not strategic and shareholders should be free to choose whether they want to invest in Nestlè or some combination of Nestlè and L'Oréal"; Furthermore, they suggest reevaluating the portfolio comprising over 2000 brands in the Food & Beverage and Health care market to unlock value (ThirdPoint, Activist letter).

On the other hand, I was surprised to learn that activists prevent M&A deals. An activist who wants to avoid a takeover does so in the belief that the buyer will overpay and miss synergies (Interview 6). In addition, selling off specific segments, i.e., focusing on certain business segments and giving up non-profitable divisions, can also be a measure, i.e., through a spin-off (Interview 14).

A frequent measure taken by activists is related to corporate governance. That includes personnel change in the BoD (Interview 2). Interview 4 concurs with this perspective and further note that in Europe, in a two-tier governance structure, the focus is not typically on directly replacing the CEO but rather on attempting to change the Chairman of the Board. Furthermore, replacing and proposing a candidate for the BoD serves as the "entry angle" for the hedge fund to have greater transparency and scrutiny of the firm's operations. Interview 11 highlights that in Germany, for instance, removing the CEO requires obtaining a 75 percent majority of the members of the Supervisory Board. In addition to CEO replacements, compensation issues are important in activist engagements. (Interview 11). That makes it intuitive because most target firms are undervalued, suggesting management compensation should be lower and utilized to improve the business. For example, Trian Fund Management, L.P. ("Trian") approached Disney ("Target firm") in FY23 and called for a set of governance changes. Trian explains that the targe firm failed to plan succession, over-the-top compensation, and minimal shareholder engagement, including an apparent unwillingness to engage constructively with Trian (Appendix B1).

Corporate governance includes Environmental, Social, and Governance ("ESG") measures. Within corporate governance, activists identify weaknesses in ESG strategy and propose measures there (Interview 12). Interview 6 explains that ESG is a relatively new field for activists to propose measures. However, it becomes essential through societal reshuffling and public pressure. Interview 12 explains that this includes typical questions such as: Have you done enough for your firm regarding environmental stewardship? Are you effectively minimizing your carbon emissions? or are you sufficiently diverse in your BoD (Interview 12).

Additionally, frequent measures are to reduce gender pay gaps and introduce quotas for gender diversity in BoD (Interview 19). According to another interviewee, activists sometimes utilize "perceived valuation triggers" when a change in the BoD occurs. They anticipate positive returns from this change. Interestingly, activists may suggest a course of action that would have happened regardless of their involvement. Subsequently, the activist can claim success when the share price rises by 10 percent to 15 percent. This measure and strategy are commonly known as the "Free rider" approach, where the activist takes advantage to enhance their perceived impact. Another measure activists frequently take relates to capital allocation. That includes, on the one hand, the steering of capital structure. For example, when there is too much cash on the balance sheet to relevel and adjust through a change in dividend policy, initiation of share buyback, or special dividend unlocking the value (Interview 2). Interview 18 explains that extracting capital from the firm through a share buyback makes liquidity and a few other items essential.

For example, in ThirdPoint LLC. ("ThirdPoint") versus Nestlè ("Target firm") case, the activist explains, "Buybacks offer an attractive alternative to M&A given the high multiples in Nestlé's sector, offering similar EPS uplift with none of the integration risks." (ThirdPoint, Activist). Another case was between Trian LLC ("Trian") and Disney ("Target Firm"); Trian explains that Earnings per share ("EPS") decreased, target firms management showed poor judgment on M&A efforts overpaying 21st Century Fox assets and bidding aggressively for Sky plc (Appendix B1).

It should be noted that high cash levels are not pleasant situations for Boards. There are situations in which cash and capitalization are held for M&A, not only because it is a safety buffer but because they may have plans, they do not want to share (Interview 4). However, the issue of share buybacks is ultimately also a declaration of failed management since they don't know what to do with the money (Interview 11). Building on that, management became more professional since capital allocation and lazy balance sheets were more present 15 to 20 years ago. An interviewee mentioned seeing much less today (Interview 3). However, to a target firm executive, "Governance is always just a crutch. The activist is a financial investor who is only interested in financial gain and has no altruistic motives."

Operative changes encompass actions that pertain to the operational aspects of a business. Proposed measures typically involve enhancing operational efficiency, making cost structures more competitive, reducing headcount or full-time equivalents (FTEs), and implementing reorganization efforts. These measures aim to optimize the company's day-to-day functioning and drive improvements in its operational performance (Interview 7). This means operating margins must be improved, increase growth, and optimize cash flow (Interview 2). Margins generally refer to revenue and key financial performance indicators relative to revenue. Accordingly, consider Gross Profit ("GP"), EBITDA, EBIT, and Net Income - margins when it comes to the Profit and loss ("P&L") statement.

Making operational changes requires hard work, which means headcount reduction and some adjustments to the footprint on time (Interview 2). Accordingly, operational changes require a deep understanding of the business, take a long time to implement, and positive returns will be effectively produced even after that. Furthermore, it must be considered that activists have an outsider's perspective and no inside data on different businesses (Interview 20). In line with that, another interviewee mentions that an activist understands the capital markets, but their expertise needs to be running a firm. There are also situations in which significant cost-cutting is also the reason for an activist to go against management – For example, ThirdPoint LLC ("ThirdPoint") and Sotheby's ("Target firm") (Appendix B1). In this case, the cost-cutting was, according to ThirdPoint, not the right strategic decision. ThirdPoint explains in a letter to the chairmen:

> *"(...) it is our understanding that it has been Sotheby's who has most aggressively competed on margin, often by rebating all the seller's commission and, in certain instances, much of the buyer's premium to consignors of contested works. We believe that Sotheby's should be competing based on the quality of its service, expertise, and ability to generate the highest possible price for its customer." (ThirdPoint, Activist letter).*

According to a senior executive, activists often aim to facilitate a firm breakup. This involves initiating the firm's division into distinct parts or spinning off specific segments as separate entities. Such strategic actions entail selling or separating various business units or assets to create smaller, independent entities, eliminating the parent firm. This approach can help organizations focus on their core strengths and enhance overall financial performance, but it also has significant implications for the long-term trajectory of the firm. Additionally, Interview 11suggests that there are instances were separating a firm and installing new management can prove advantageous. This implies that having a new leadership team in a separate entity can bring positive outcomes for the firm. Interviewees often associate Trian LLC ("Trian") and Dow DuPont ("Target firm") cases.

In my last discovery, I investigate the impact of hedge fund engagement on the communication of strategies and measures among the target firm, activist investor, and the capital market. This communication occurs through both public and private channels. As my prior elaboration highlighted, when an activist believes there is an opportunity for value creation, they invest and initiate contact with the target firm's management to persuade them regarding their thesis (Interview 5). This is often initiated privately through a letter to the BoD followed by a personal dialog (Interview 19). Certain activists also meet with individuals with previous or current affiliations with the targeted firm. This interaction allows them to validate and assess the viability of their thesis. These individuals may have insights and knowledge about the company that can provide valuable input to the activist's analysis (Interview 2). This part of the communication is *"behind the scenes*" and is often characterized as *"friendly".*

The extent of further communication typically depends on the response of the target firm's management to the initial contact made by the activist. As a Managing Director clarifies, the activist is awaiting indications of receptiveness and seriousness from the management to proceed with potential changes or further dialogue (Interview 7). On the other hand, the target firm's management receives the demands and communication from the activist and must contemplate how to respond to the contact. The mere receipt of the activist's letter places pressure on the management, as it can potentially escalate into a public engagement. As stated by one interviewee, "no target wants topics to be discussed in public." Consequently, the target firm's management frequently assesses its vulnerability, considering factors such as investor relations efforts and the management team's reputation (Interview 19).

If the management then engages not sufficiently with the activist, or if the activists feel that they are not being listened to and that this is being ignored for the wrong reasons, pressure is increased via public writing or writing circulated via media, such a measure is more confrontational (Interview 7). Accordingly, if there's a potential unwillingness from management and they ignore the criticism that the hedge fund is delivering, there's a certain level of frustration that reaches some point where the activist feels that he is not getting anywhere (Interview 18). Consequently, it highlights that public communication increases with an unwillingness to engage with the activist (Interview 19).

Interview 18 objects and explains that certain activists claim they only engage behind the scenes, but that is only partly true. Of course, they speak to the press and use it to their advantage. Next to these highly aggressive activists, there are also less publicly aggressive. Interview 12 explains that these seek private engagement with the Boards and executive management teams. They don't publish white papers; they don't publish their views. They don't aggressively or publicly try to discredit and undermine corporations (Interview 12). Sometimes they call themselves *"constructivists".* They are interested in a private and constructive engagement with management to unlock value collaboratively. The higher form is the "suggestive," which only advises or suggests the target firm on the measures. However, Interview 18 explains that all processes start constructively except in unique situations. It's incorrect when people and advisors constantly come in and say: "The white paper comes out of the blue; it never comes out of the blue; There's always some sort of dialogue." (Interview 18). An interviewee mentions that this is sometimes very professional but can then also become very personal on both sides. For example, Klaus Kleinfeld ("Target executive") wrote a letter to the activist urging him to observe him and his private life (Appendix B2).

Generally, it can be observed that this step can be on a continuum from most publicly aggressive to least publicly aggressive. Interview 12 explains that the most publicly aggressive hedge funds run campaigns whereby they will publish their thesis directly through white papers. Consequently, everything will be fought in the public domain, which is usually quite detrimental and concerning for the target firms. Interview 6 also explains that contact is initiated with others long only. Sometimes also with other hedge funds' the formation is called "wolfpack." In line with that, an MD at Interview 4 elaborates on the nature of the communication between institutional investors and activists. Accordingly, there are discussions between both camps. Sometimes, institutional investors approach the activist when they feel insufficient movement, even suggesting the activist rattle the cage (Interview 4). It's more challenging when the target firm is in the public domain because, with all the inside knowledge, they can see the complexity, which is not necessarily driving the market. The interviewee refers to the fact that markets also tend to have inefficiencies and act on information quickly, sometimes neglecting the complexity of some data. Accordingly, the target firm, on the one hand, must work closely with the investor's relation department and, on the other, distill some of those messages to "win the hearts and minds of your shareholders?" (Interview 18). Another interviewee at Interview 4 refers to this point as information asymmetry a target firm must deal with and calls the interaction with the capital market "educational work"; Accordingly, the target firms need to explain the situation, and then you or do not have the market tolerance (Interview 4). One interviewee goes into more detail. Accordingly, it is crucial to demonstrate the "piece of math". So, the target firm knows about its business's valuation and current performance and can justify or present a detailed plan.

4.2. Effect on target firm

4.2.1. Direct effect

The direct effect represents the immediate consequences of the engagement on the target firm. My findings suggest that the effect of a hedge fund on a target firm is diverse and affects it in different ways, both in the short and long term. Moreover, measures identified in Chapter 4.1.3.2 affect the target firm during the engagement and after that. The following chapter provides an overview of how the engagement affected the target firm on these two-time horizons. The first effect on shareholder value often occurs when an activist investment is announced. Interview 19. explains that management's and all other market participants' expectation that something will change drives up performance and share price, creating positive excess returns. But this is surprising because the activist has not changed the firm's performance. It is simply the market's expectation that there will be a discussion that drives the share price up. Thus, communication and reputation are crucial when communicating with the capital market. It is explained that the activist creates the impression of change, and reputation creates returns (Interview 19). Interview 12 explains that financial measures such as buying back shares or paying dividends are short-term strategic measures. Similarly, selling an undervalued firm and collecting a premium is a predominantly short-term measure (Interview 12). Another respondent adds that governance is short-term (Interview 2).

Raising forecasts because they are not ambitious enough is another short-term measure - For example, one of the interviewees recalls a situation in which the CEO went out to the market after four to six months of discussions and raised all the targets. As a result, the share price went up, and the activist left. On the earnings call, management could not meet those targets, and the target firm's stock price dropped. According to a senior target firm executive, activists are often interested in factors that can immediately affect a firm's value, such as management changes, divestitures, or improvements in ESG credentials. These actions can positively affect investor sentiment and help increase a firm's value in the short term (Interview 4). These actions can be implemented quickly and have a measurable short-term effect, which makes intuitive sense. Another interview respondent takes it further and explains that hedge funds want to change to be implemented as short as possible because the shorter, the higher the return on capital. That makes intuitive sense since financial investors want to generate returns for their shareholders as quickly as possible.

Moreover, changing the capital structure, doing spin-offs, putting firms up for sale, blocking management compensation, criticizing ESG strategy, or changing Board composition is implementable within twelve months. Accordingly, hedge funds rarely pursue operational measures and settle over the years because too much capital is locked in an investment. Moreover, activists rarely fire 20,000 people and wait for a better EBITDA margin in four years (Interview 3). Another interview respondent explains that:

> *"The problem is, and this is what the activists are looking for, is a substantial return of capital at the cost of Capex and bolt-on M&A. So, it can eviscerate your growth strategy going forward. It could be turned into an effective yield vehicle. So, in terms of long-term growth and valuation targets, that is intuitively not ideal"* (Interview 18).

Interview 4 explains that abnormal return often comes from when you bring about an M&A event because that's when the takeover premium crystallizes (Interview 4). To better understand that activists are good at assimilating information instantaneously and immediately given a view on the value of something. However, they do not go in-depth on qualitative factors as they are hard to factor in. These factors are often not considered in the markets but can affect long-term valuation (Interview 20). One interviewee mentioned that he thinks it's an effective discipline mechanism, but it's there's a limit to it, and it can lead to some answers that are, you know, sometimes a little too short-term. It is difficult to change the firm's trajectory within a short period. Activists may not see the benefit of it in the longer term, but they can claim the public win because it caused the firm to take a specific action. A target firm executive explains that you can press certain levers in the short term and get a result in the short term. Financially, it is quite hard. Next to short-term measures, the more exciting part is to see how the interviewees view the long-term effect on the target firm. One exciting response to evaluate the shareholder effect on the long-term value also considering short-termism is that:

> *"There are not only the good in the long term versus the good in the short term, which is then bad in the long term, but there is also the good in the short term, which are also good in the long term. And there is also the good in the long term. Which are still not good in the long term because they are simply an alibi, an excuse for doing nothing in the short term* (Interview 19).

Accordingly, short-term actions do not always lead to long-term value loss. For example, a spin-off of a business in which two firms have no synergies creates value in the short and long term. Moreover, if the capital budgeting process deprives one division of much-needed investments in favor of another division that does not earn its cost of capital, splitting up the firms also creates long-term value (Interview 12). Often activists propose to lever or unlever a balance sheet changing capital structure. To better understand the effect on shareholder value. If the target firm was overcapitalized before, the hedge fund had a legitimate point. Is capitalization too weak afterward because the hedge fund paid out too much or because the management got carried away with paying out too much? It has negative consequences for the target firms and disrupts the operational activity in the future, reducing the firm's value for the future (Interview 14). This aligns with the view of an Interview 12 who further explains that operational measures such as cost cutting, restructuring, investing, reinvesting, and divesting take a long time to implement and produce returns (Interview 12). That makes intuitive sense since changes take time before they positively affect EBITDA. However, a cost-cutting program to improve quarterly financial performance is a short-term measure and will lead to underinvesting in the short term (Interview 12). Agreeing with that, an economic theory suggests that even short-term actions could be considered long-term if they make a firm more profitable in the short term. That is due to short-term cash leading to better competition and reinvestment opportunities in the future. However, implementing a cost-cutting program that leads to underinvestment will only create short-term value (Interview 4). A positive example of a positive change in capital structure was the Bill Ackman ("Pershing Square") versus Nestlè ("Target firm") case. According to an interviewee, they initiate change processes that the firm absorbed in such an elegant way that, in principle, they accelerate performance in a very meaningful way.

However, looking at the campaigns and the motivation, the interviewee explains that operational campaigns are more noise and a way of getting shareholder support, suggesting that it is more about convincing the shareholder base. However, operational campaigns are mostly not the genuine motive activists seek. Although there are campaigns where operational change is why the hedge fund engages. However, activists that spend more time on operational changes are often less performant in generating alpha for their investors. Besides, it is much harder to accomplish because activists are not an operator (Interview 18). That makes sense, Interview 2 further explains that the execution of operational measures and a spin-off needs some preparation. However, he highlights that if it is a separate business, it can also be executed in the short term (Interview 2).

Interestingly, one of the interview respondents gives a perspective on determining the effect. Combining the previous statements gives a perspective on the effects of measures on shareholder value. First, does the proposed measure make sense in the longer term? In other words, does the short-term measure also make sense regarding the longer-term implications for the firm? Intuitively that makes sense because it allows for an objective. For example, a share buyback does not make sense in the long run when the company builds cash reserves for a suitable M&A transaction aligned with the core business. Second, is the measure implementable? Meaning that the measures must align with the shareholder base. For example, if you have core shareholders and more than 50 percent of the shares, it will be up to management alone to decide. An activist proposal can then be defeated with 50 plus-one ownership. So, it's always a question of feasibility or ability to implement and how strong your action is regarding longer-term value creation for the firm (Interview 3).

ESG seems to affect long-term engagement. One interview respondent argues that ESG activists are long-term activists that seek value optimization, long-term value optimization. Specifically, giant funds can really make a difference with their capital and have invested and take longer implementation and are often start in private conversations, trying to proceed analytically and efforts to come to terms with the management (Interview 6). Building on that, if the activist strives for Board representation, the probability tends to be high to the fund seeking long-term commitment with a longer-term value-creation effort. After all, these are usually designed to last at least a year, often even longer.

4.2.2. Indirect effect

The indirect influence of hedge fund activism refers to effects not arising from the direct interaction between the activist and the target firm. Instead, the market behavior influences shareholder value or the presence of activists which causes the target firm to act without hedge fund engagement. Market response refers to so-called Halo effects, which are biases that occur when an initial impression or perception of an organization affects our subsequent behavior. One interviewee explains that with credible funds, "you see a sharp pop in stock price" (Interview 4). The reasons why that surprised me are twofold.

On the one hand, I expected any activist to cause that pop in the stock price since every activist has similar measures that he potentially utilizes. However, that highlights that reputation is essential to understanding the abnormal returns caused by activism. The interviewee further elaborates and explains that the shareholder considers credible activists as signs of change and quote-on-quote *"watch out! He may have a case and I'll go along with it" (*Interview 4). Similarly, interview 2 agrees on the effect and elaborates that the capital market acts because it expects something to happen (Interview 2). On the other hand, I was surprised that the market acts before change happens, and one of the bankers highlights that sometimes it is clear that some of the proposed measures "(...) have no chance to go through, but because there is an activist, the stock pops (Interview 3). On top of that, the interviewee explains that sometimes it is not observable since the activist buys a stake below the threshold and sells it off; nobody notices (Interview 3).

Interview 12 explains it is a self-fulfilling prophecy when a certain activist's track record and branded reputation align. Especially when the investment thesis is to unlock shareholder value and the activist makes its position public. According to the interviewee, that is due to everyone knows that it's likely that they will succeed, and they will likely be right. That is interesting since the price bump is not based on any fundamental performance or analytical tool (Interview 12).

The response of a target firm when an activist investor becomes involved is a critical factor in determining the outcome of the engagement. One interviewee notes that when activists target peers, the firm can take proactive measures to improve their margins and decrease the likelihood of becoming a target. This proactive response makes sense, as activists target underperforming firms relative to their peers. By improving their performance, firms can reduce their vulnerability to activist attacks and strengthen their position in the market (Interview 2). It is important to note that the response of the target firm must be proactive rather than reactive. A reactive response may indicate a lack of initiative or strategic planning on the firm's part, which could make them an even more attractive target for activists. Therefore, target firms must be aware of the potential for activist engagement and take proactive steps to improve their performance and decrease their vulnerability to attack. Future research could explore the effectiveness of different types of proactive responses and their impact on the outcome of activist engagements (Interview 2).

5. Discussion

My theoretical model, grounded in shareholder theory, makes several contributions to activist literature, and suggests several corresponding directions for future research. The model in figure 7 conceptualizes the engagement of the hedge fund and target firms comprising the impacting factors on shareholder value. My model's overarching perspective presents an alternative view of the dimensions that shape hedge fund engagement. It proposes that to comprehend the effects of hedge fund engagement on the target firm, it is crucial to consider that hedge funds are not homogeneous financial investors; instead, engagements differ in target choice, style, and resolution approach. Each of these dimensions operates within a cause-and-effect framework, which is critical in determining the extent to which shareholder value is unlocked.

Moreover, the style of an activist is determined by the incentive, fund size, geography, and reputation, and illuminates which metrics are appealing to an activist, which firms an activist can target, and how successful the capital market will support the hedge fund. Target choice narrows down on the technicalities and target firm characteristics activists seek to engage and determines which measures are used to unlock shareholder value. Further contributions are conceptualized within this model and broader literature and logical structure to answer the research question of this thesis.

The first key contribution of my model is the explication of target choice. Research has consistently shown that activist hedge funds target firms that are undervalued in terms of stock price and have weak operating results, poor corporate governance, and inefficient capital allocation (Brav et al., 2015; Denes et al., 2017; Mccahery et al., 2016). My findings align and further suggest that target choice builds the fundament for the activist investment thesis. Moreover, this allows for a subjective reason based on analysis and represents the necessary "piece of math" to engage and justify why the target firm needs to change.

Scholars such as Denes et al. (2017) have observed that target firms tend to exhibit poor stock returns, sales growth, and market-to-book ratios. However, other scholars, such as Brav et al. (2008), Clifford and Carey (2008), and Jory et al. (2017), have found that certain metrics, such as return on assets or return on equity, respectively, tend to be high. These conflicting findings suggest that hedge funds may target firms not performing poorly on all levels (Denes et al., 2017). Instead, hedge funds target firms with special operating characteristics that can create shareholder value. However, we need to learn more about the exact metrics activists seek.

In my research, activist investors tend to target firms with diversified portfolios that exhibit conglomerate discounts, which occur when a parent firm's valuation is lower than the sum of its subsidiary parts. These firms often have a broad portfolio, leading to complexity, inefficient capital allocation, adverse diversification effects, and a lack of synergies. As a result, the capital market perceives these firms as having less expertise and focus, resulting in a loss of shareholder value. Activists target these firms because investors can diversify and optimize their returns. This leads to double diversification and inefficiency, causing the firm to be run in a way that is not in the shareholders' best interests.

Furthermore, management may allocate capital to non-core assets that do not produce synergies, leading to operating inefficiencies. Activists identify these target firms by measuring invested capital versus the weighted average cost of capital at the divisional level to ensure each division produces shareholder value. They check that one division is not earning significantly more than its cost of capital, causing the group to maintain divisions that are destroying value. Activists propose a spin-off or divestiture of non-core assets to unlock shareholder value. A potential acquirer may be willing to pay a premium for these assets and use them synergistically in their portfolio, leading to higher returns for the shareholders. The target firm can use this premium to strengthen its core business or return it to shareholders through share buybacks or dividends, ultimately increasing its value.

Research is needed on the optimal level of diversification necessary to create value. One possible area of inquiry is the nature of the relationship between diversification, hedge fund engagement, and shareholder value. There may exist a non-linear, parabolic relationship between these variables, wherein an optimal level of diversification may be reached that maximizes the benefits of hedge fund engagement while simultaneously increasing shareholder value. While diversification can help firms spread risk across multiple areas and reduce exposure to individual market fluctuations, it may also dilute focus and resources. This may, in turn, impede the ability of firms to engage with hedge funds or deliver value to shareholders effectively. Future research can help firms better understand the trade-offs involved and make more informed decisions regarding their strategic direction by exploring the relationship between diversification, hedge fund engagement, and shareholder value.

My conceptualization of the impact of hedge fund engagement also suggests that shareholder returns and structure are essential in the targeting process of a hedge fund activist. In the prior elaboration, I build and extend the ongoing debate on stock returns. Moreover, my theory offers an alternative answer to why stock price and shareholder returns are key characteristics of a target firm.

To date, literature has extensively debated the relationship between stock returns and the likelihood of a firm becoming a target of shareholder activism. While some scholars suggest that low returns are associated with a higher likelihood of becoming a target (Clifford & Carey, 2008; Denes et al., 2017). Others argue that high stock returns are more likely to attract activist attention (Klein & Zur, 2009). However, there needs to be more research on why stock returns are a significant factor in the targeting process.

I suggest significantly impacting the likely hood of an investment thesis resonating with the shareholder base, which is necessary to implement the change. Specifically, low total shareholder returns, which are the overall value a shareholder receives from his investment, tend to characterize a target firm. Moreover, TSR is the first reference an activist looks at and suggests a connection between an investor's willingness to support the investment thesis and low total share-

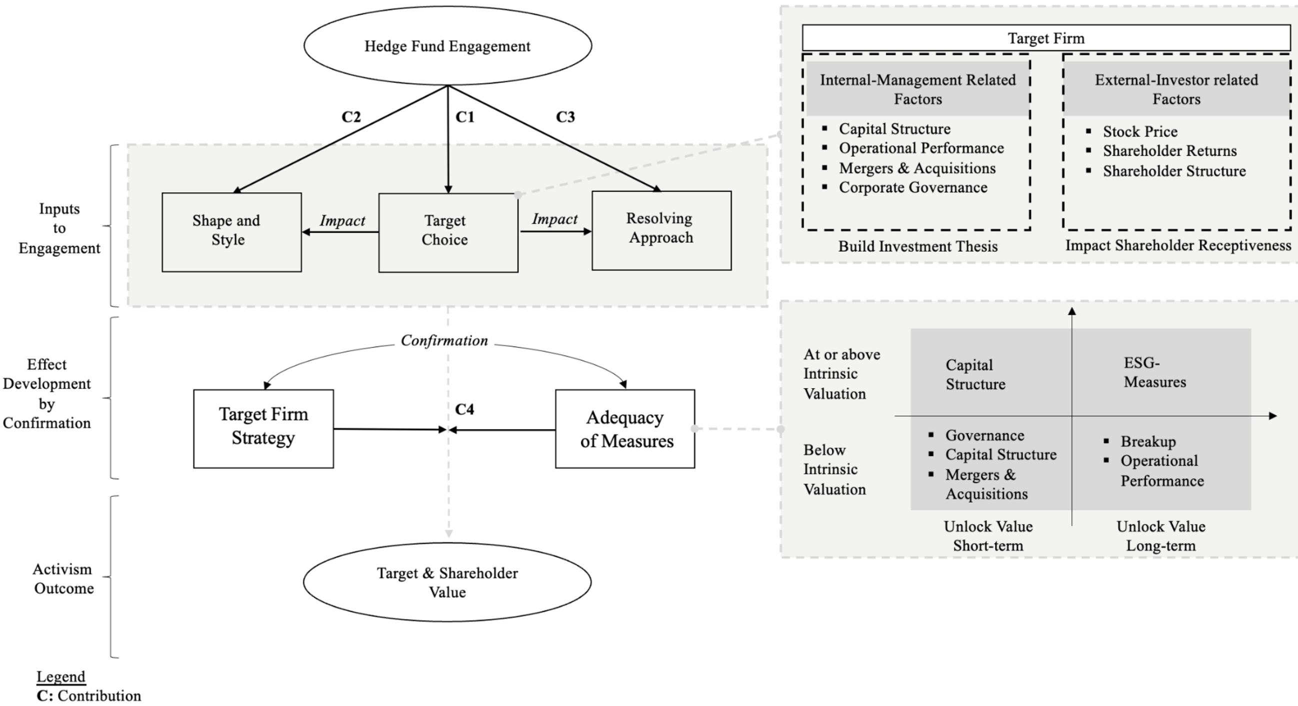

Figure 7: A Shareholder theory-based model of the hedge fund-target firm effect.

holder returns. The reason is that the combination of both low capital appreciation and dividends negatively impacts shareholder returns making the investor more receptive to short-term measures to unlock value - For example, spin-offs of non-core assets or special dividends. My research further expands that next to shareholder returns, the shareholder structure is vital in determining a target firm; however, it is scarcely covered in prior literature. I identified the three areas within shareholder structure that are important for target selection profile, structure, and concentration. These factors are crucial in the targeting process of an activist to make the investment thesis resonate effectively with a significant proportion of the shareholder base.

Accordingly, activists interact with other shareholders, former executives, and senior employees of the target firm to challenge its investment thesis. Moreover, activists often approach proxy solicitors and "deep dive" into the shareholder base to understand the shareholder profile to figure out whom to talk to when they need to escalate pressure. Accordingly, activists elaborate on which thesis shareholders might support or not. Doing so is essential because the minority share of an activist need to be scaled to implement change, and shareholder structures make engagement detrimental to an activist. I propose that the Activists seek targets firms with a highly concentrated shareholder base or have some other funds they know to leverage their thesis. Moreover, a high level of shareholder concentration enables an activist hedge fund to gain more voting rights which are essential to increase pressure on management and the likelihood of succeeding in a proxy contest. However, targets firms with large shareholders that support management are unattractive to activists. I further propose that shareholder structure, especially the profile, impacts value creation. Because, like hedge funds, other funds and shareholders have incentives and are supportive of different proposals impacting the measures and, thereby, the shareholder value.

While the literature has shed some light on the effectiveness of hedge fund activism in improving the performance of targeted firms, more research is needed regarding the influence of the identity and characteristics of the target firm's shareholders on the outcomes of such activism. Perhaps, future research could investigate how shareholders' size, concentration, and investment horizon affect their level of support for hedge fund activism and, consequently, the success or failure of such efforts. Institutional investors represent a critical stakeholder group that warrants closer examination in the context of hedge fund activism. As large-scale investors, institutional investors have the potential to shape the outcomes of activism campaigns through their voting power and influence on corporate governance decisions. Therefore, a better understanding of their attitudes towards hedge fund activism, including their motivations for supporting or opposing such campaigns, through more qualitative research could provide valuable insights into the potential for activism to drive positive change in corporate performance.

The second key contribution of my model is the explication of the dimension shapes and styles of activists that shapes engagement. In my prior elaboration, I suggest that hedge funds may approach engagement with target firms differently. For example, some hedge funds prefer to negotiate privately with management behind closed doors. In contrast, others prefer to take a more public approach, making demands through the media or filing public proxy statements. In addition, some hedge funds focus on short-term gains and push for changes that can quickly drive up the stock price. Others are more focused on long-term value creation and push for changes that can lead to sustainable improvements in the firm's performance. Consequently, I build a new theory on the impacting factors to hedge fund engagement.

Scholars have identified three distinct types of activists. The first type of activist targets overvalued firms and seeks to profit by betting on their decline. This can occur due to market inefficiencies, malpractice, or other factors that lead to inflated stock prices (Aquila, 2021). The activist will use financial instruments to go "short" on the target firm and actively communicate their thesis with the capital market. If the market perceives its thesis as credible, stock prices will fall, decreasing shareholder value for most shareholders. The second type of activist is value-driven and seeks to increase shareholder value by pressuring management to operate more efficiently (Aquila, 2021). These activists look for "locked-in" values within the firm that can potentially increase the stock price. By advocating for changes in corporate governance, executive compensation, or other areas, they aim to improve the firm's valuation and create long-term value for shareholders. In addition to these two types of activists, special situation activists focus on decisions that directly affect the shareholder base. These activists may seek to influence M&A, shareholder buybacks, or other strategic decisions that could impact shareholder value (Aquila, 2021).

As per my previous analysis, it is evident that hedge funds have dissimilar motives for participating in activism, which is consistent with the research by Aquila (2021). Nevertheless, I argue that irrespective of their approach, their primary goal is to generate alpha for their investors, which is their core responsibility as financial investors. Therefore, if they determine that shorting a stock is the most effective approach to achieving their objective, they will do so. Alternatively, if they identify a firm's division that is not generating returns that cover the cost of capital, they will strive to create value by spinning. Moreover, special situation activists are attracted to technical arbitrage situations that do not aim to improve value.

Additionally, my findings expand on prior literature, and consequently, I suggest that the size of the hedge fund, its credibility, and its geography impact engagement and its ability to produce shareholder value. Looking at the size of a hedge fund, I find that the smaller, newer, high-momentum funds are more incentivized to go public more quickly. That's due to their incentive to either build or raise their profile. I suggest that to build their profile, these activists focus on short-term measures. This is because engagement, especially long-term measures such as operational improvements, is cost intensive. In line with that, credibility is connected to the proposal and track record. In my findings, I suggest that credibility is the currency for an activist because they need to sell their thesis to the capital market. Accordingly, if an activist engagement fails, other shareholder investors are less likely to follow the next time. Geography is about the jurisdiction; in a stakeholder economy like Germany, a two-tier Board impacts how and how a hedge fund engages with a target. On top of that, in a shareholder-orientated economy, there is more engagement.

More research needs to be done to explore how hedge funds' geographic location, size, trustworthiness, and incentives influence their engagement with target firms and their ability to create shareholder value. While hedge funds operate in different geographic regions, their objectives, and strategies for engaging may differ based on the market in which they operate. Therefore, the impact of geography on engaging and creating value remains unclear. In addition, the size of the hedge fund is another critical factor that may influence its ability to engage effectively with target firm. Larger hedge funds may have more substantial resources and more extensive networks, enabling them to exert greater influence on the strategic direction of the target firm. However, smaller hedge funds may be nimbler and more flexible in their investment decisions, allowing them to take advantage of emerging opportunities.

The third key contribution of my models is detailing the hedge fund resolution approach. Previous studies have identified various measures used by hedge funds based on SEC filings but have not thoroughly explained them. Therefore, by providing a more comprehensive understanding of the measures used by hedge funds to resolve firm undervaluation, my research extends existing theory.

Scholars identified that activists use various measures to resolve target firms' undervaluation (Bebchuk et al., 2020; Brav et al., 2008; Gillan & Starks, 2007; Klein & Zur, 2009). These measures include proposals related to corporate governance, such as changes to Board composition, seat acquisition, and compensation reductions (Bebchuk et al., 2020; Gillan & Starks, 2007; Klein & Zur, 2009). Another common approach is through M&A, which may involve selling a firm or opposing a merger (Greenwood & Schor, 2009). Other measures include balance sheet changes, such as share buybacks and dividends, and operational improvements, such as breakups, personnel cuts, and KPI enhancements (Bebchuk et al., 2020; Brav et al., 2008).

I propose that measures differ for the activist's styles shown before. Accordingly, short seller and special situation activists focus on financial measures or technical situations which do not enhance shareholder value and, therefore, differ from value-driven activists. Furthermore, my prior elaboration extends that measures are not mutually exclusive and often relate to each other, which is not yet covered in the literature. For example, governance measures, such as ESG issues, are used as a pretext to place the actual reasons that would more obviously generate more value.

While some studies have focused on identifying the measures proposed by activists through SEC filings, there is a need to go beyond this and understand the specific reasons behind these proposals. This could involve analyzing the letters and proposals submitted by activists to identify the underlying motivations and goals behind their proposed measures. Moreover, it is important to track which measures were ultimately implemented and how they influenced the target firms' performance. This can provide valuable insights into the effectiveness of different activist styles and measures in creating shareholder value. To achieve a more comprehensive understanding of the relationship between activist styles and measures and their impact on shareholder value, future research could employ a mixed-methods approach.

The fourth key contribution of my model is its explication of measures and their impact on shareholder value. It builds and extends on the recent discussion on the long-term consequences of activism on shareholder value that has to date, consistently shown that hedge fund activism can positively affect the target firm in the short and long term.

Scholars find that hedge fund engagement causes economically significant and statistically positive abnormal returns. Specifically, around announcement day, hedge fund activism leads to positive average abnormal returns in the 7 to 8 percent range (Brav et al., 2008). Narrowing the effect down to a particular measure, the largest positive returns result from changes in business strategy, such as refocusing and spinning off the non-core asset (Brav et al., 2008; Clifford & Carey, 2008; John et al., 2014). However, some scholars believe that activist engagement is focused on short-term increases in stock performance and returns which ultimately lead to value destruction in the long term (John et al., 2014). Accordingly, the key question addressed by Commissioner of the Security Exchange Commission ("SEC"), Daniel M. Gallagher, persists that activist hedge funds drive long-term value creation or whether short-term gains to activism are at the expense of long-term corporate growth (Security Exchange Commission, 2015).

My systematic approach advances the ongoing debate by conceptualizing the impact of hedge fund activism on shareholder value. It offers an alternative view of the long-term effects, considering the correlation between value creation and the adequacy of measures to unlock value. I suggest that a hedge fund creates long-term value when proposed measures aim to solve the target firm's undervaluation and confirm the long-term strategy of the target firm. The figure 8 illustrates the adequacy of measures to unlock shareholder value.

My 2-dimensional matrix assesses the adequacy of measures proposed by a hedge fund activist to address the undervaluation of a target firm. The y-axis of the matrix represents the firm's current stock market valuation, while the x-axis represents the benefit horizon of a given action. The cells in the matrix represent different combinations to evaluate the adequacy of hedge fund measures based on their expected impact on the firm's value in the stock market over different time horizons. For example, measures that have a short-term impact on the firm's value, such as a spin-off or leveraging the capital structure, will boost valuation in the near term.

Moreover, hedge fund activism tends to focus on undervalued firms, where a range of short-term and long-term measures can be implemented to unlock value. Measures such as governance, capital structure, and spin-offs can be implemented within a relatively short period of time. These measures aim to raise forecasts, put firms up for sale, block management compensation, or change Board composition. On the other hand, strong-performing firms face less activism, but even they can face activist attacks that focus on financial engineering to improve the short-term valuation, such as changes to capital allocation rather than changing management or operational improvements.

As shown in my prior elaboration, hedge fund activism typically focuses on short-term measures and despite the short-term focus of these measures, scholars have found that hedge fund activism can lead to positive returns (Brav et al., 2008). I suggest that the effectiveness of hedge fund activism largely depends on the circumstances in which it is applied. While activists frequently use short-term measures related to governance, capital structure, and M&A, it is important to consider their long-term impact.

Further research is needed to identify the parameters that separate beneficial short-term measures from those that may have negative long-term consequences. It is also important to recognize that what may seem beneficial in the short term may not necessarily have positive long-term consequences. Activists and practitioners need to consider both short-term and long-term consequences when evaluating the effectiveness of proposed measures. There may be situations where short-term measures are necessary to address immediate issues, but there should also be a long-term strategy in place to ensure sustainable growth and success. Conversely, sometimes long-term measures may be necessary, but it is important to ensure that they are not being used as an excuse for inaction or avoiding taking immediate steps to address problems. Careful consideration of both short-term and long-term consequences is crucial for effective hedge fund activism and sustainable corporate success.

6. Conclusion and limitations

6.1. Concluding statement

Hedge fund activists' engagement with target firms and their Boards has become increasingly important in the shareholder landscape. This thesis provides a systematic overview of the effects, analyzing a comprehensive, hand-collected dataset characterized by long-standing target executives, leading investment bankers, and specialists, to identify the drivers and consequences to shareholder value. It is the first study to provide a holistic analysis of this multifaced phenomenon, and the findings have important implications for hedge funds, shareholder activism, and strategic decision-making literature.

I use the inductive approach proposed by Gioia et al. (2013) and the active categorization framework by Grodal et al. (2021) to provide rigorous qualitative research and identify the factors determining hedge fund engagement. I show that hedge funds are heterogeneous investors and engagement is shaped by target choice, style, and resolving approach of the hedge fund activist. Moreover, induced measures depend on the style of the activist and the target choice.

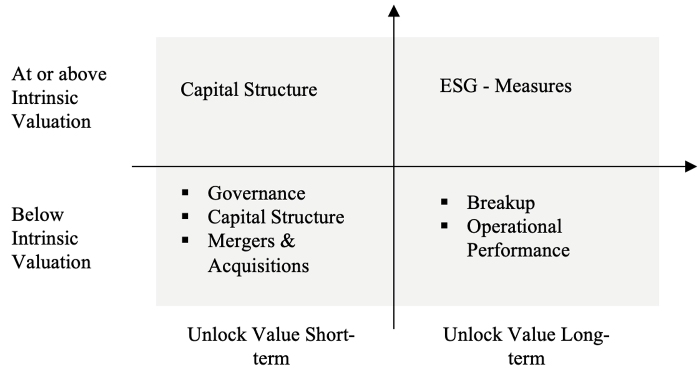

Figure 8: Adequacy of hedge fund measures to unlock shareholder value.

My results prove that hedge fund engagement occurs at target firms characterized by inefficient operations, capital- and portfolio structure, and weak shareholder returns relative to their peers. These inefficiencies build the investment thesis, and poor returns determine the receptiveness with management. My prior analysis highlights that activists have different shapes in terms of size, track record, and credibility, which can be seen as the currency when dealing with other shareholders and the capital market – as it determines how likely an investment thesis will resonate. I further identify that activists use a broad set of measures intended to induce change, including suggesting or blocking M&A, such as buying or selling a firm, spin-off, or entire breakup of the target firm.

Moreover, measures relating to capital structure or corporate governance include blocking management compensations, replacing the Board, and diversity. I provide evidence that the measures are communicated through private letters to the BoD and show that communication depends on the interaction with the target firm, especially when the activist is being ignored for the wrong reasons, pressure is increased via public letters, and engagement turns confrontational. Thereby contributing empirically to hedge fund literature and answering my first research question, which factors shape hedge fund engagement.

I further provide a systematic model, grounded in shareholder theory, that tailors the effect of hedge fund activism to the induced measures and respective adequacy to unlock shareholder value. I show that the adequacy of measures to create shareholder value depends on two dimensions: The target firm's valuation and adequacy to unlock value short or long-term. I provide evidence that measures induced to change the target firm realize value in the short term. However, firms that perform at or above their intrinsic valuation face activism, which is not addressing strategic or operational changes but is limited to financial engineering and ESG-related measures. Moreover, I acknowledge that measures, either in the short or long term, create value when they confirm the long-term strategy of the target firm. In addressing the second research question of how hedge fund engagement affects the target firm, my analysis underscores the factors that shape the hedge fund-target firm engagement.

The results of my thesis contribute significantly to understanding hedge fund activism and its role in inducing change. The empirical findings and systematic model presented in this thesis provide a fundament for future research on hedge fund activism and its impact on the value creation of target firms. As such, my research offers valuable insights into the relationship between hedge fund activism and the shareholder landscape, contributing significantly to the Management field.

6.2. Limitations

This research has limitations that must be considered when interpreting the findings. While the research design and methods were carefully chosen to address the research question, several factors could have affected the reliability and validity of the results. The section is structured according to methodological and researchers' limitations and prioritized in the context of hedge fund activism.

I choose a primary data set that contains large investment banks such as Interview 18, and Interview 4, and stock-listed target firms, which may limit the empirical contribution to large engagements, activist funds, and campaigns. Moreover, prior mentioned investment banks have a natural bias towards the target firms due to more sizable and timewise more prolonged industry mandates. Furthermore, the interview set consists of senior executives and bankers, which may also contribute to this bias, as they may have faced more extensive campaigns that may result in different findings. Consequently, the results of this thesis are limited to the elaborated context of the participants in this thesis. They may not be generalizable to small or medium-sized hedge fund engagements. I focus on publicly traded firms and associated activism and do not consider private firms.

Consequently, the findings of this study may not apply to activist situations for private firms, which may have different dynamics, challenges, and outcomes - for example, they may be less proficient in dealing with activism and do not have the capital to hire external advisors. I did not capture the activist's perspective – for example, through additional interviews. Thus, it may limit my understanding of the activist incentives to engage and unlock shareholder value. Accordingly, my primary data have an outside-in perspective, limiting information so that the activist view would help us better understand intentions, behind-the-scenes engagement, and induced strategies. Moreover, I did not study other forms of activism or vocal investors that use their shareholding, which might limit the scope of empirical contribution.

Besides, I chose a qualitative inductive approach proposed by Gioia et al. (2013) which allows for a rich exploration of interviewees' experiences and stays close to informant terms; However, the abdication of overarching categories is subject to the interpretation and analysis of the data. Although efforts were made to minimize these biases by using the active categorization framework by Grodal et al. (2021), inheriting eight moves to prove more rigor in the analysis, it is subjected to subjectivity bias in the analysis and interpretation of the raw data.

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