Equities

Price Pressure Around Mergers

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It has been well documented that when companies use stock as the currency in a takeover, the acquiring company's share price tends to fall around the time a deal is announced. Common interpretations of this reaction are that acquirers pay with stock because they believe their stock is overvalued and that the market perceives the merger to be a value-destroying investment project.

Evidence presented in this paper suggests that a substantial part of the negative reaction to stock merger announcements is due to downward price pressure caused by merger arbitrage short selling of acquirers' stocks around merger announcement dates. In particular, if excess demand curves for stocks are downward sloping in the short-run, then increases in the supply of stock will cause the equilibrium price to decrease. Although the common assumption that stocks' supply curves are vertical and fixed may be reasonable in many situations, it is unlikely to hold around merger announcements, when short sellers dramatically increase the effective supply of shares.

This paper examines the trading behavior of professional investors around 2,130 mergers announced between 1994 and 2000. We estimate that nearly half of the negative announcement period stock price reaction for acquirers in stock-financed mergers reflects downward price pressure caused by merger arbitrage short selling, suggesting that previous estimates of merger wealth effects are biased downward.

eliminate the risk of experiencing investment losses.

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