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# Abnormal returns to rivals of acquisition targets: A test of the 'acquisition probability hypothesis'☆

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**Abstract**

We develop and test the *Acquisition Probability Hypothesis*, which asserts that rivals of initial acquisition targets earn abnormal returns because of the increased probability that they will be targets themselves. On average, rival firms earn positive abnormal returns regardless of the form and outcome of acquisition. These returns increase significantly with the magnitude of surprise about the initial acquisition. Moreover, the cross-sectional variation of rival abnormal returns in the announcement period is systematically related to variables associated with the probability of acquisition. In addition, rivals that subsequently become targets earn significantly higher abnormal returns in the announcement period. © 2000 Elsevier Science S.A. All rights reserved.

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## 1. Introduction

An extensive literature, beginning with Eckbo (1983,1985) and extending through Mitchell and Mulherin (1996), finds that rivals of acquisition targets earn significant, positive abnormal returns. The most widely cited explanation is that horizontal mergers eliminate competitors and facilitate collusion among the remaining firms. Yet, Eckbo (1983,1985,1992), Stillman (1983), and Eckbo and Wier (1985) all reject the collusion hypothesis, leaving the explanation for positive returns to rivals unclear. Moreover, we have little explanation for the wide cross-sectional variation in abnormal returns to rivals or the finding that only 50–60% of rival firms earn positive abnormal returns.

In this paper, we develop and test an alternate explanation for positive rival returns. Our explanation, the "acquisition probability hypothesis", asserts that rivals earn abnormal returns because of the increased probability that they will be targets themselves. In our model, the appearance of a bidder willing to pay a premium over the market price for a firm is *prima facie* evidence of a valuation differential for at least one firm in the industry. This differential may result from expected synergies or from target management's failure to anticipate and incorporate needed changes. In any case, the appearance of an unexpected acquisition attempt within an industry generates shock waves that cause firm-specific reassessment of the probability of an acquisition attempt for rivals.

The implications of the acquisition probability hypothesis are quite different from those of the collusion hypothesis. For example, acquisitions need not be horizontal to generate abnormal returns to rivals, nor must they be successful. The acquisition probability hypothesis also helps explain the cross-sectional differences in abnormal returns to rivals. Under our hypothesis, revisions in a rival's stock price occur because of *changes* in the perceived probability of acquisition attempts, and these changes vary systematically with individual firm characteristics.

Section 2 reveals the intuition behind the acquisition probability hypothesis and develops testable implications. Section 3 describes the data and methodology of the research. In particular, we develop a procedure to identify unexpected acquisitions within an industry. We then test the implications of the acquisition probability hypothesis on a sample of 141 unexpected acquisitions and 2459 rival firms over the 1982–1991 period. The results, all consistent with the acquisition probability hypothesis, are documented in Sections 4 and 5: (1) rival firms earn positive abnormal returns regardless of the form (horizontal or nonhorizontal) and outcome (successful or unsuccessful) of the initial industry acquisition. Abnormal returns to rival firms are significantly positive in all categories except horizontal acquisitions. (2) The abnormal return to rival firms tends to increase with the magnitude of surprise about an acquisition. (3) The characteristics of target firms are distinct from those of non-targets, but similar

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