Journal of Accounting and Economics
Volume 25, Issue 1, 26 February 1998, Pages 101-127

Underwriting relationships, analysts' earnings forecasts and investment recommendations

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https://doi.org/10.1016/S0165-4101(98)00016-0

Abstract

We examine the effect of underwriting relationships on analysts' earnings forecasts and recommendations. Lead and co-underwriter analysts' growth forecasts and recommendations are significantly more favorable than those made by unaffiliated analysts, although their earnings forecasts are not generally greater. Investors respond similarly to lead underwriter and unaffiliated `Strong buy' and `Buy' recommendations, but three-day returns to lead underwriter `Hold' recommendations are significantly more negative than those to unaffiliated `Hold' recommendations. The findings suggest investors expect lead analysts are more likely to recommend `Hold' when `Sell' is warranted. The post-announcement returns following affiliated and unaffiliated analysts' recommendations are not significantly different.

Introduction

This paper examines whether research reports issued by analysts whose employer is affiliated with a company through an underwriting relationship are more favorable than research reports issued by unaffiliated analysts. This inquiry is motivated by concern expressed in the financial press that underwriting relationships create a conflict of interest for analysts[1]:

> Morgan Stanley's powerful investment bankers often have run roughshod over the firm's research analysts, some current and former Morgan Stanley analysts say. These analysts say Morgan Stanley's bankers have repeatedly pressured them to alter negative research reports on the stocks of the firm's corporate clients – particularly those for which it did stock underwriting deals. (Siconolfi, 1992)

Because the underwriting business requires substantial investment in developing and managing relationships with issuing companies, it is argued that investment bankers do not welcome a negative investment report by a member of the research staff, and may actively discourage them.

It is also argued that an investment bank's willingness to underwrite a firm's securities requires that it have a favorable view about the client's prospects, as one analyst argued:

> It goes without saying that if you do a company's IPO, you are going to have a buy [on the stock], because frankly if you don't you shouldn't be doing the deal. . .. for every deal Salomon has done in the last 12 months, I have personally turned down two deals. (Raghavan, 1997).

If issuers select underwriters on the basis of the favorableness of the terms underwriters offer and these terms are related to their analysts' views, then the chosen underwriters' analysts are more likely to have favorable views of issuing companies' prospects.

Both arguments suggest that affiliated analysts' research reports are more favorable than those issued by unaffiliated analysts. To test this, we examine key elements of research reports, specifically, current and subsequent year earnings forecasts, long term earnings growth forecasts and investment recommendations. We consider two groups of *affiliated* analysts, analysts employed by the lead bank underwriting seasoned equity offerings *(lead underwriter analysts)*, and analysts employed by the co-underwriter bank *(co-underwriter analysts)*. We compare their forecasts and recommendations to those made by analysts at investment banks that have not served as a lead or co-underwriter for the firm (*unaffiliated analysts)*. We find that current and subsequent year earnings forecasts issued by affiliated analysts both before and after seasoned equity offerings are generally not more favorable than those issued by unaffiliated analysts. In contrast to these findings, we find that lead and co-underwriter analysts' growth forecasts and recommendations are significantly more favorable than those issued by unaffiliated analysts.

This paper also examines whether investors perceive differences in the quality of affiliated versus unaffiliated recommendations, and whether returns following the recommendations are different. Given affiliated analysts' more favorable investment recommendations, the return analysis ascertains whether investors respond differently to their announcement, and whether affiliated recommendations, if followed literally, generate poorer investment performance. We examine the returns to lead underwriter and unaffiliated investment recommendations for the 3-day period surrounding their announcement, and for longer windows in the first and second years following seasoned equity offerings. For the announcement period, we find no difference in returns to lead and unaffiliated analysts' `Strong buy' and `Buy' recommendations, but find the returns to lead `Hold' recommendations are significantly more negative than unaffiliated `Hold' recommendations. Looking at the post-announcement period, we find no difference in the returns to following affiliated versus unaffiliated analysts' recommendations.

The return analysis therefore suggests that analysts are overoptimistic, on average, when issuing a `Hold' recommendation, and that lead analysts are overoptimistic to a greater degree than are unaffiliated analysts. If issuing companies select the underwriter whose analyst has the most favorable view, one would expect greater announcement returns for all unaffiliated recommendations. The finding of less negative announcement returns only for unaffiliated versus affiliated `Hold' recommendations suggests that affiliated analysts strategically avoid `Sell' recommendations to a greater extent than unaffiliated analysts to maintain client relations. However, the findings indicate that lead analysts' `Strong Buy' and `Buy' recommendations are not overoptimistic relative to those issued by unaffiliated analysts.

The study's findings contribute to two streams of literature. The first stream examines analysts' forecasts and forecast errors around initial and seasoned public equity offerings. Hansen and Sarin (1996)calculate adjusted forecast errors, where the earnings performance of the firm is a control variable, and find that the adjusted forecast errors are not significantly different from those by analysts at other times. They also examine the forecasts of lead and other analysts and do not find a difference. Hansen and Sarin conclude that analysts are disciplined by reputational forces and consequently forecast credibly around equity offerings. Our finding for earnings forecasts of affiliated versus unaffiliated analysts is consistent with theirs. Our finding of significant differences in growth forecasts and investment recommendations, however, suggests that studies focusing solely on near-term earnings forecasts cannot resolve the question of whether concern for reputation is sufficient to offset pressures from investment banking relationships. The present paper contributes to the literature by analyzing earnings forecasts, growth forecasts and recommendations for a comprehensive sample of affiliated and unaffiliated analysts, and documenting significant differences in growth forecasts and recommendations.

Ali (1996)finds that analysts' forecasts of earnings for the year of the offering are not overoptimistic, but that earnings forecasts issued in the five years following offerings are significantly overoptimistic. Dechow et al. (1998)document that their sample of lead underwriter analysts' earnings growth forecasts around seasoned equity offerings are significantly more favorable than those of unaffiliated analysts. Their findings, and those of Ali (1996), suggest the difference between our results for earnings forecasts and recommendations may reflect differences in analysts' expectations of long-term earnings growth. Our evidence from analysts' long-term earnings growth forecasts is consistent with this conjecture, as we find that lead analysts' growth forecasts are significantly greater than those of unaffiliated analysts. The mean difference in growth forecasts is small however, at 0.56%, leaving open the question of whether greater long-term growth expectations are sufficient to explain affiliated analysts' more favorable recommendations.

This study also contributes to the literature on analyst affiliation and investment recommendations. Similar to our study, Dugar and Nathan (1995)find that recommendations by investment banker analysts are more favorable than those by unaffiliated analysts. In contrast to our study, they find no evidence of stock price response to recommendations by affiliated or unaffiliated analysts. Our findings indicate that affiliated and unaffiliated analysts' recommendations are associated with significant return response, and suggest that their ability to detect a difference in returns in the announcement and post-announcement periods may have been limited by their smaller sample size.

Recent studies by Lin and McNichols (1998)and Michaely and Womack (1996)find that affiliated analysts' recommendations at the time of initial public offerings are significantly more favorable than those of unaffiliated analysts. Our findings suggest that similar influences also affect analysts' recommendations at the time of seasoned equity offerings. Michaely and Womack document that three-day size-adjusted returns centered on the announcement of analysts' `Strong buy' and `Buy' announcements are significantly more positive for unaffiliated than affiliated analysts. We find that three-day size-adjusted returns centered on the announcement of lead and unaffiliated analysts' `Strong buy' and `Buy' recommendations are not significantly different. However, the three-day returns associated with affiliated `Hold' recommendations are significantly more negative than those associated with unaffiliated `Hold' recommendations, indicating that investors correct for greater bias in affiliated analysts' `Hold' recommendations.

Michaely and Womack also find that IPOs recommended by affiliated analysts substantially under-perform IPOs recommended by unaffiliated analysts over the two-year period following analysts'

recommendations. Dunbar et al. (1997)document that when returns for `Buy' recommendations are measured up to the date of a subsequent downgrade, but not beyond, only initial recommendations of analysts appear over-optimistic. We extend the methodologies in these two studies by measuring returns to analysts' recommendations only for the period the recommendation is `live'. Specifically, we measure returns from the recommendation announcement to the analyst's subsequent recommendation, and do not include returns past the date an analyst has dropped coverage of the company or is no longer employed at the brokerage firm.

We find no difference between the post-announcement returns to lead underwriter and unaffiliated analysts' recommendations issued in the two years after seasoned equity offerings. Our evidence therefore indicates that although affiliated analysts' recommendations are more favorable, their `Strong buy' and `Buy' recommendations are not more overoptimistic than those issued by unaffiliated analysts. If affiliated analysts intentionally bias their recommendations or if issuing companies select banks as underwriters when their analyst's view is more favorable than other analysts, then affiliated recommendations should contain greater error. In such a case, one would expect a strategy of following affiliated recommendations literally to lead to weaker investment performance. Our evidence indicates that if intentional or selection bias cause affiliated recommendations to contain greater error, offsetting forces, such as affiliated analysts' potentially greater access to information, reduce such error.

The paper proceeds as follows. Section 2briefly describes the brokerage firm business and discusses potential influences on analysts' coverage and reporting decisions. Section 3presents our hypotheses. Section 4describes the data and sample selection. Section 5describes the research design and test results, and Section 6concludes the paper.

Section snippets

Investment banks and underwriting deals

The investment banking or corporate finance department of an investment bank helps a corporation issue securities to the public by acting as its underwriter in return for a commission comprised of an underwriting fee, a management fee and a selling concession. These fees are significant to both participating investment bankers and the investment bank (Smith, 1991; Raghavan, 1996). Annual bonuses are typically a substantial portion of investment bankers' total compensation, and depend on their...

Hypotheses

The hypotheses we test focus on three related questions. First, we examine whether lead and co-underwriter analysts issue more favorable forecasts and recommendations than unaffiliated analysts in the period shortly before a client's equity offering. Second, we examine how investors respond to affiliated versus unaffiliated analysts' recommendations. This test provides evidence on whether the market perceives differences in the credibility of affiliated vs. unaffiliated analysts. Third, we...

Data

The tests of our hypotheses require data on securities offerings, analysts' earnings forecasts and recommendations, analysts' long-term earnings growth forecasts, annual earnings per share (*EPS*), stock splits, and security prices. We collected information about public offerings in US markets by domestic issuers from the Securities Data Company, Inc. (SDC) Public Offering database. Data on investment bank analysts' earnings per share forecasts and recommendations were provided by Research...

Research design and test results

This section describes the research design, results of and inferences from our tests of differences between lead and co-underwriter analysts' research reports and those of unaffiliated analysts....

Summary and conclusions

This paper examines the effect of investment banks' underwriting relationships on analysts' earnings forecasts and recommendations for a sample of 2,400 seasoned equity offerings issued in 1989–1994. The findings indicate that lead and co-underwriter analysts' growth forecasts and particularly their recommendations are significantly more favorable than those of unaffiliated analysts, although their near-term earnings forecasts are generally not. These findings may reflect the greater incentives ...

Acknowledgements

We thank Tom Elliott, Dan Hill and Jeff Kemp of Research Holdings Ltd. for providing data used in this study and for many helpful discussions. We thank Chris Jones for his assistance in programming. Maureen McNichols gratefully acknowledges the support of the Bob and Marilyn Jaedicke Faculty Fellowship and of the Financial Research Initiative of the Stanford Graduate School of Business. The authors appreciate the many constructive suggestions of S.P. Kothari (the editor) and Charles M.C. Lee...

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