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Analyst following of privatized firms around the world: The role of institutions and ownership structure

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Abstract

We examine which factors affect the decision of analysts to follow newly privatized firms as well as the factors that determine the extent of that following. Contrary to traditional private firms, privatized firms harbor particular uncertainties related to the government's commitment toward privatization. The first-stage estimation shows that the decision by analysts to initiate coverage of newly privatized firms is positively influenced by lower political risk, better judicial efficiency, better information disclosure, and effective extra-legal institutions in the country. Conditional on the decision to initiate coverage, the second-stage results indicate that the extent of analyst following is more important: (1) when there is control relinquishment by the government, (2) when there is more participation by foreign investors and employees, and (3) for those larger firms in nonstrategic sectors. Finally, analysts' coverage is negatively related to postprivatization ownership concentration and underpricing. This latter result runs counter to the existing evidence on private firms—that is, that underpricing "buys" coverage.
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1. Introduction

A growing literature suggests that research coverage has become an essential element of the security issuance process in recent years. Bushman, Piotroski, and Smith (2005, p. 207) argue that: "The availability of information is a key determinant of the efficiency of

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resources allocations decisions in economies and their securities markets." An important role in the firms' information environment is played by financial analysts who "provide potentially important scrutiny over management's actions" (Lang, Lins, & Miller, 2004, p. 3). Thus, their role consists essentially in reducing (1) agency problems (i.e., arising from opportunistic managers' behavior) and (2) information problems (i.e., where investors are not able to distinguish between good and bad investments).

The study of analyst following of newly privatized firms (NPFs) provides us with an interesting research question that involves two contrasting predictions with respect to the demand for analysts' services and their potential role as information providers: on the one hand, the standard argument that financial analysts alleviate asymmetrical information between issuers and investors does not seem as straightforward for NPFs. Indeed, unlike private firms, NPFs are generally large, well known firms, with a long operating history, in highly regulated industries (Dewenter & Malatesta, 1997). Thus, asymmetric information between the issuer (i.e., the government) and investors should be lower in this instance, which suggests that analysts are not likely to be covering privatized firms. On the other hand, NPFs are generally exposed to particular uncertainties embedded with the reform (i.e., switch of ownership from public to private) and that are related to (1) the governments' commitment toward the privatization process and (2) the ability of new owners to make an effective transition. According to Perotti (1995) and Perotti and Guney (1993), NPFs face a policy risk that arises from postprivatization policies that may be undertaken by the government (e.g., deregulation) and that could affect former state-owned enterprises (SOEs). Policy risk is higher when privatization is not credible. In addition, as documented by Boubakri, Cosset, and Guedhami (2005a), the divested government stake is mostly absorbed by foreign investors and local institutions, followed by individuals. The new owners, particularly foreign, that can be considered as sophisticated investors, will require more transparency and a high level of disclosure about the future prospects of firms. For both of these reasons, privatization creates a demand for financial analysts' services that will be more likely, in this case, to cover privatized firms.

To the best of our knowledge, the issue related to analysts' activities surrounding privatized firms has not been explored previously, although we can put forward several reasons to stress the importance of understanding both the information intermediation and information dissemination of these firms. For instance, because foreign, institutional, and individual investors require that NPFs disclose credible information, financial analysts are likely to play a crucial role in helping build such credibility by certifying the firm's quality. In addition, since privatization is generally a gradual process, the government is likely to sell shares (and come back to the market) more often than any individual firm. Thus, analysts' coverage of privatized firms might help the government to send a credible signal to the market about both the positive prospects of these firms and the analysts' commitment to privatization. This, in turn, enhances the chances of success of the offering by maximizing proceeds.[2] Also, privatization provides us with a natural laboratory to assess

[2] Analysts can also raise doubts about the quality of the NPF if they consider it to be overvalued and its business prospective and financial projections to be overstated. In this case, coverage is likely to lead to a decrease in the value of the firm (negative signal). However, this is unlikely to be the case in privatization as it is a politically motivated reform. As such, the costs associated with a loss of credibility will be to lose voters' support. We thank the referee for raising this point.

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