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Bias in the post-IPO earnings forecasts of affiliated analysts: Evidence from a Chinese natural experiment

Nancy Huyghebaert [a,1], Weidong Xu [a,b,*,2]

[a] KU Leuven, Faculty of Economics and Business, Department of Accountancy, Finance and Insurance, Naamsestraat 69, 3000 Leuven, Belgium
[b] Fonds Wetenschappelijk Onderzoek (11C7912N), Belgium

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ABSTRACT

Investment banks and issuers of Chinese domestic IPOs became fully responsible for IPO offer prices only on June 10, 2009. Before this regulatory reform, the optimistic bias in post-IPO earnings forecasts is highly comparable across affiliated and unaffiliated analysts. Afterward, the forecasts of affiliated analysts are 33 percentage points more positively distorted on average. In the first 90 days after an IPO, this relative forecast bias even increases to 63 percentage points and enlarges further when the issuer's stock price drops in the aftermarket. Affiliated analysts distort especially their forecasts for fiscal years further away from the forecast release date.

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1. Introduction

In the literature on the role of financial analysts in capital markets, a stream of research has focused on the investment advice of *affiliated analysts*, that is, analysts working at an investment bank/brokerage that maintains another relationship with the firm being covered.[3] This research generally shows that affiliated analysts issue more positively biased investment recommendations, earnings forecasts, and target prices than unaffiliated analysts do (for a review, see Mehran and Stulz, 2007; Ramnath et al., 2008). However, this research has not yet been able to determine the exact mechanism driving this *relative bias* (e.g., Kolasinski and Kothari, 2008; Lin and McNichols, 1998; Mehran and Stulz, 2007; Ramnath et al., 2008). Affiliated financial analysts may be genuinely more optimistic about the firms they follow. Or they may intentionally and strategically distort their investment advice because of improper incentives.

To explore what drives this relative bias, we examine a regulatory change in China, using it as a natural experiment to focus on the effects of analyst affiliation arising from IPO underwriting. Several aspects of this relationship may induce an optimistic bias in the investment advice of affiliated analysts. First, an investment bank that values a listing candidate more highly faces a better chance of being chosen as lead manager for that firm's IPO (i.e., a self-selection bias arises). The corporate finance department and the research department of an investment bank often collaborate in IPOs to generate

* Corresponding author.
E-mail addresses: nancy.huyghebaert@kuleuven.be (N. Huyghebaert), weidong.xu@kuleuven.be (W. Xu).
[1] Tel.: +32 16 326737; fax: +32 16 326683.
[2] Tel.: +32 16 326660; fax: +32 16 326683.
[3] Sell-side financial analysts work at an investment bank/brokerage that offers investment advice to external clients. Buy-side financial analysts work for institutional investors at the investor's own account. Like most of the literature, we consider only sell-side financial analysts in this study. In the remainder of the paper, the term "financial analyst" or "analyst" refers to sell-side financial analysts.

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synergies. Financial analysts working for the IPO lead manager could thus be intrinsically more optimistic about the issuer, given that their employer obtained the IPO underwriting mandate. Those analysts may then also release more positive research reports shortly after the firm's listing. We refer to this explanation as the "analyst-optimism view".

Once their employer obtains the IPO underwriting mandate, analysts affiliated with the IPO lead manager may also be able to set up and maintain more extensive contacts with firm management and hence can accumulate a deeper understanding of the issuer's business and financial position. If those analysts subsequently rely on their better and private information to develop their forecasts, their forecast errors should be small and random, that is, not in one direction. In contrast, the forecasts of unaffiliated analysts will be based less on such firm-specific inputs and could thus be influenced more by prevailing stock market conditions (e.g., Bergman and Roychowdhury, 2008; Hribar and McInnis, 2012; Walther and Willis, 2013). We thus expect the sentiment-induced bias in earnings forecasts to apply particularly to unaffiliated analysts. As a result, unaffiliated analysts might exhibit positive forecast errors especially in bullish stock markets, while their forecast errors could be much smaller or even negative when stock markets are bearish. We label this idea as the "information-advantage view".

Finally, as noted in the work of Michaely and Womack (1999) and James and Karceski (2006), analysts affiliated with the IPO lead manager might intentionally release a more positively distorted opinion as to the issuer to achieve some other goals. Post-IPO price support—that is, underwriter activities to keep the aftermarket stock price above the offer price—is a common practice in the United States (e.g., Aggarwal, 2000; Hanley et al., 1993). The IPO underwriting contract between issuers and their investment banks often provides for an overallotment option, penalty bids, etc., to stabilize the issuer's stock price in the aftermarket; in the United States, this is usually done over the first 30 days after listing (Aggarwal, 2000). Alternatively, investment banks may also take it upon themselves to support an issuer's stock price, possibly over a window longer than 30 days. Indeed, primary-market investors could blame the IPO lead manager for having set a too high offer price once the issuer's stock price plummets in the aftermarket and hence lose their desire to buy into any of its future IPOs (e.g., Dunbar, 2000). To preserve their reputation among primary-market investors, IPO lead managers may provide (extra) post-IPO price support via optimistic research reports on the issuer (see also Lewellen, 2006). Arguably, this wish/need of providing price support is stronger when the issuer's stock price comes under pressure in the aftermarket.[4] We refer to this as the "post-IPO price-supporting view".

We test the empirical validity of these three views by relying on the annual earnings forecasts for IPO firms that were released in the first year after the firm's listing in Mainland China. China proves interesting for this kind of research because a major regulatory change took place on June 10, 2009: investment banks in Chinese domestic IPOs became—for the first time—fully responsible for fixing IPO offer prices, together with issuers. Before, IPO offer prices were largely set by the Chinese regulator, by applying a maximum P/E ratio to the issuer's earnings. As of June 10, 2009, this P/E ratio cap was abolished, and IPO lead managers henceforth set final offer prices after a book-building procedure among institutional investors. This regulatory reform provides a natural experiment to test the causal relation between the need for post-IPO price support and the forecast bias of affiliated analysts. If analysts affiliated with the IPO lead manager only exhibit optimism or are only better informed than other analysts, they should not behave differently before vs. after this regulatory change. In contrast, IPO lead managers' incentives to sustain an issuer's stock price in the aftermarket were hugely affected by the IPO pricing reform of June 10, 2009. Obviously, the pre-condition for providing post-IPO price support is that investors perceive investment banks to be responsible for fixing IPO offer prices.

We examine the annual earnings forecasts issued by affiliated and unaffiliated analysts in the first year after IPO for the firms becoming listed in Mainland China during 2004–2011. Although the stock exchanges in Shanghai and Shenzhen had already been re-opened at the beginning of the 1990s, the business of financial analysis has a much shorter history but has grown exponentially. The first ranking of financial analysts appeared only at the end of 2003. Analysts in China usually release their opinions on listed companies by means of annual EPS forecasts and investment recommendations; they do not circulate target prices. In our dataset, over 90% of investment recommendations were either "buy" or "strong buy." This lack of variation in investment recommendations prevented us from meaningfully analyzing this type of analyst output, which is the main reason why we focus on EPS forecasts. Yet the huge number of buy and strong buy recommendations already suggests that the investment advice of financial analysts in China could be hugely distorted.

Our findings overwhelmingly confirm the view that the desire to provide post-IPO price support motivates analysts affiliated with the IPO lead manager to produce more positively distorted earnings forecasts than unaffiliated analysts do. Specifically, we find that, over the full sample period, the EPS forecasts of both affiliated and unaffiliated analysts are severely biased upwards. However, before June 10, 2009, this positive forecast bias does not differ significantly across the two groups. But after the regulatory reform, the average forecast error of affiliated analysts is 33 percentage points higher. Moreover, during the 90-day institutional lock-up period, this relative forecast bias even increases to a stunning 63 percentage points and enlarges further when the issuer's stock price drops below the IPO offer price in the aftermarket.

[4] We do not say that unaffiliated analysts face no incentives whatsoever to issue a positively biased investment opinion. For example, as pointed out by James and Karceski (2006) and Mehran and Stulz (2007), both affiliated and unaffiliated analysts may inflate their advice to attract future corporate finance and brokerage business, to build and maintain good relationships with firm managers, etc. However, those incentives are common among affiliated and unaffiliated analysts. If the behavior of affiliated analysts is driven *only* by those incentives, we do not expect to find any differences between the forecasts of affiliated versus unaffiliated analysts. What we argue is that the post-IPO price-supporting incentive is *unique* to affiliated analysts, which could motivate those analysts to release a *more* positively biased opinion on the IPO firm.

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