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Discussion of "What Determines Financial Analysts' Career Outcomes During Mergers?"

Paul M. Healy

Harvard Business School, Boston, MA 02163, USA

A R T I C L E I N F O

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A B S T R A C T

Wu and Zang [2009. What determines financial analysts' career outcomes during mergers? Journal of Accounting & Economics, forthcoming] examine how mergers and acquisitions in the investment banking/brokerage industry affect financial analyst employment. They find evidence of abnormally high analyst turnover following mergers that appears to reflect the acquirer's elimination of duplicate research capabilities and top analysts at the newly merged firm being hired away by competitors. Finally, they show that the increased analyst turnover at merged firms is related to decreases in analyst coverage and analyst performance post-merger.

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1. Introduction

Wu and Zang (2009) examine how mergers and acquisitions in the investment banking/brokerage industry affect financial analyst employment. They find evidence of abnormally high analyst turnover following mergers that appears to reflect the acquirer's elimination of duplicate research capabilities and top analysts at the newly merged firm being hired away by competitors. Finally, they show that the increased analyst turnover at merged firms is related to decreases in analyst coverage and analyst performance post-merger.

A central premise of the paper is acquirers of financial institutions will quickly rationalize their research departments by eliminating surplus analysts. Wu and Zang's findings indicate how this typically takes place. Sample firm analysts were more likely to be eliminated if they had a poor track record (measured by their 3-year record forecasting earnings), if they covered similar stocks to another analyst at the target or acquirer, and if they worked for the target rather than the acquirer. These findings suggest that acquirers decisions on which analysts to retain were based on past performance and redundancy. The acquirers' revealed preference for their own analysts (as opposed to the targets') could reflect a desire to retain analysts who were 'known commodities' rather than taking a risk on less known target analysts. It could also have reflected "merger politics" with acquirers using their power to support their own people in the merger consolidation.

Wu and Zang also show that financial sector mergers have unfavorable outcomes for acquirers through the loss of highly talented analysts (again measured by past forecast accuracy) to competitors. This is likely to occur for several reasons. First, given the uncertainty they face over merger integration, high-performing target firm analysts are likely to be seen as 'in-play' by competitors leading them to receive attractive job offers. And second, a merger is likely to destroy firm-specific human capital of high-performing analysts at the target firm, making them more susceptible to leave. For example, target

E-mail address: phealy@hbs.edu

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analysts who had strong relations with trading and sales personnel that contributed to their past success may anticipate that their relationships will be severed as the merged firm rationalizes these segments of the business.

The study also examines the frequency of promotions that take place at mergers. Analysts were more likely to be promoted to management positions at the merged firm in the aftermath of a merger if they had extensive experience and were from the target firm. They were more likely to be hired into management positions at other firms if they had extensive experience, were rated as All-Stars by Institutional Investor, and were made redundant by the merger.

Finally, Wu and Zang examine the relation between analyst turnover at mergers, and subsequent changes in stock coverage, forecast frequency, and forecast accuracy. They hypothesize that the documented post-merger analyst turnover will be accompanied by a higher frequency of stocks with dropped coverage, a lower frequency of forecast updates, and less accurate forecasts. Their evidence largely confirms these predictions. The findings indicate that an increase in analyst turnover at the merger is accompanied by an increase in the frequency of stocks with dropped coverage and a decrease in forecast revision frequency. The decline in forecast revision frequency is even more severe for mergers with higher turnover among top forecasters. Finally, perhaps not surprisingly, an increase in turnover among top forecasters at the merged firm is accompanied by a significant decline in post-merger average forecast accuracy.

Overall, the paper's findings suggest that mergers in the investment banking/brokerage industry generated economies of scale in equity research but had a negative effect on the quantity and quality of output of equity research departments.

Below, I review the strengths and insights of the paper, and then point out some of its limitations and outstanding questions.

2. Strengths of the paper

The authors have done a good job of identifying an interesting setting to examine how mergers and acquisitions affect retention and promotion for lower level employees in the target and acquiring firms. Prior research has focused on the impact of mergers on senior management turnover, typically for CEOs. There have been few studies on turnover at lower levels in the organization. For firms whose human capital is a key asset, understanding how a merger will affect planned and unplanned turnover is an important issue. The findings of this paper are therefore of interest to a broad audience of scholars and practitioners. Scholars interested in the findings include those who study the analyst industry, as well as those who research mergers and acquisitions in accounting, finance, strategy, human resources, and organizational behavior. Practitioners are likely to be particularly interested in turnover among key employees around mergers, since this can affect the likelihood of a transaction's ultimate success.

Wu and Zang should be commended for the care they took in generating a sample and collecting data to undertake the study. Tracking the many banking mergers over time to identify qualifying mergers is no mean feat. The authors appear to have done a thorough job of performing this task in constructing their sample. They also deserve credit for the hand-collection of data on analyst turnover and promotion. The use of Nelson's Directory of Investment Research to hand check the IBES database must have been time-consuming. However, it has paid off. It revealed a disturbingly large number of errors in turnover information on IBES, which should be of concern to other researchers using the database for turnover information. By investing in hand collecting and checking their data, Wu and Zang enable readers to have considerable confidence in the reliability of the findings.

3. Unresolved questions

The study leaves a number of unresolved questions and opportunities for follow-up research.

3.1. Acquirer diversity

The sample of acquirers of US investment banks/brokers is diverse. It includes insurance companies, commercial banks, international banks/brokers, and domestic investment banks/brokers. These are likely to have very different motives and implementation challenges. For acquirers who do not have a strong presence in the US brokerage business (such as insurance firms, entering commercial banks, and foreign firms), there are likely to be few issues of analyst redundancy and conflicting predictions about the likelihood of losing top performing analysts to competitors after the merger. Given the typical intention to retain the existing departments, target analysts in these acquisitions may be less likely to worry about loss of firm-specific human capital. Of course, they may well have other concerns about whether the acquirers have the expertise to manage their more diverse businesses. For example, given the pay differentials between US investment banks, insurance companies, commercial banks, and non-US firms, target firm analysts may have concerns that an acquisition by such an acquirer will lead to lower pay, accelerating turnover among the top performers. The current tests attempt to assess how these factors affect turnover by including dummy variables for commercial and international firms and conclude that their effects are insignificant. However, these tests are weak. They fail to distinguish between acquisitions by commercial banks/non-US firms that already have a strong presence in the US investment banking/brokerage market and those that do not. There is room for follow-up work in this area to understand the impact of acquisitions by firms with and without experience in the business.

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