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Chaebol-affiliated analysts: Conflicts of interest and market responses

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A B S T R A C T

Some Korean business groups, or chaebols, have a large stake in securities firms that issue analysts' reports on their member companies. This structure is unique in that industrial companies and securities firms are affiliated and operate within the same group. We investigate the informational content of earnings forecasts, stock recommendations and target prices made by the chaebol-affiliated analysts, using data collected between 2000 and 2008. The chaebol analysts tend to make more optimistic earnings forecasts for the member companies. The mean EPS forecast error (5.36%) of the affiliated analysts for the same chaebol company are significantly larger than that (3.23%) of other chaebol and independent analysts. The chaebol analysts also assign better recommendations by almost one level and set target prices 2.5% higher to the member companies after controlling for company and analyst characteristics. These results are consistent with the hypothesis that chaebol analysts' reports are biased by conflicts of interest. Stock market reactions do not differ in response to announcements of stock recommendations issued by affiliated vs. non-affiliated analysts. This suggests that capital markets do not recognize the conflicts of interest inherent in chaebol analysts' reports.

1. Introduction

Since the late 1990s, much attention has been focused on sell-side research that is tainted by conflicts of interests between investment banking and research departments of securities firms in the United States. These conflicts of interests have aggravated the mistrust of the general public regarding the information content of analysts' reports and have increased demand for regulation. Investigation of these conflicts of interest has led regulators and 10 of the largest securities firms to reach the Global Research Analysts Settlement in 2003, which mandates that investment banks separate their banking and analysis departments with internal firewalls. Similar regulations have spread across the globe with the goal of curbing these conflicts of interest.

We are interested in investigating conflicts of interest inherent in analysts' reports from a different perspective. Even though business groups dominate the economy in many emerging markets, South Korea is unique in that it allows industrial companies to be affiliated with a securities firm within the group. Some business groups, known as chaebols in Korea, have a long history of owning securities firms as member companies, and other Korean chaebols have recently tried to acquire such firms. The following press release, dated January 13, 2008, from the *Dow Jones International News*, is one of the latest acquisition examples:

> *"Hyundai Automotive Group said Monday it has signed an agreement to acquire a controlling stake in a small securities firm, Shinheung Securities, in a move to enter the capital markets industry ... Like others, Hyundai would aim to grow as an investment banking firm, but it may have to continue to rely largely on the retail brokerage business at the initial stage as the local investment banking market is still immature."*

The Korean chaebol structure can naturally incur conflicts of interests since industrial companies and securities firms are affiliated and operate within the same group. The analysts in the chaebol-affiliated securities firms issue reports for member companies and also provide insight for chaebol members' direct competitors, which are either independent or belong to other chaebols. This relationship might force the chaebol-affiliated analysts to issue more favorable reports for member companies within the same group. This study analyzes whether chaebol-affiliated analysts (hereafter referred to as "chaebol analyst") incur conflicts of interest when they make earnings forecasts, stock recommendations or target prices for the member companies.

Chaebols have an extensively interwoven ownership structure through pyramidal and cross-shareholdings among the affiliated

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companies (hereafter referred to as "chaebol companies"). A survey by the Korea Development Institute in 2003 reports that the owner-managers of chaebols have established the general direction of the group as a whole. They also influence the individual member companies' personnel matters and financial projects. The owner-managers usually have the power to transfer capital and managerial resources among the member companies. The ability to transfer assets in a weak system of minority shareholder protection can cause expropriation of minority shareholders. Bae et al. (2002) find that the pyramidal or cross-shareholding structures in chaebol companies facilitate tunneling at the expense of minority shareholders. There is also anecdotal evidence that chaebol-affiliated securities firms have illegally supported the issuance of securities of the member companies for controlling shareholders. For instance, *Maeil Business News* reported on February 17, 2008, that "Samsung Securities CEO and others accused of Samsung SDS' issue of bond with warrant (BW) at an irrationally low price to their controlling family members were also summoned and investigated as reference status." The securities firms within chaebols also tend to obtain brokerage businesses from other member companies. This close relationship may compel chaebol analysts to reveal positive information quickly and to avoid issuing negative recommendations or price forecasts for the member companies. This suggests that chaebol analysts might issue more optimistic earnings forecasts, stock recommendations or target prices on the member companies than non-affiliated analysts. In this study, we test this "conflicts of interest hypothesis." Since the potential for conflicts of interest is intrinsic in their organizational structure, Korean chaebols provide a unique environment to test this hypothesis.

We collect data on analysts' earnings forecasts, stock recommendations and target prices issued on Korean companies over the period of 2000–2008. We find that eight out of the top 30 chaebols (26.67%) have securities firms as subsidiaries. We first investigate whether chaebol analysts incur conflicts of interest when they make earnings forecasts. For the whole sample, we find that chaebol analysts make more optimistic earnings forecasts than independent analysts. When we limit our sample to chaebol analysts' forecasts on the chaebol companies, we document that the chaebol analysts make more optimistic earnings forecasts on the companies belonging to their own chaebols compared to those on the companies belonging to other chaebols. The mean EPS forecast error (5.01%) by analysts affiliated with the same chaebols is significantly larger than that (3.80%) made by analysts affiliated with other chaebols. We also find that for the same chaebol company, its analysts issue more optimistic earnings forecasts than other chaebol and independent analysts (mean EPS forecast errors of 5.36% vs. 3.23%). The difference remains significant even after controlling for company and analyst characteristics in multivariate regressions.

Our second set of tests focuses on the investment recommendations and target prices analysts periodically issue on companies. We find that the chaebol analysts issue "buy" or "strong buy" recommendations more frequently for the member companies than for other chaebol and independent companies. For the same chaebol company, its analysts issue better recommendations than do other chaebol and independent analysts. After controlling for company and analyst characteristics, we document that the chaebol analysts issue better recommendations on the member companies within the same chaebol by about one level than other analysts. Similarly, results show that for the same chaebol company, its analysts set target stock prices at 2.5% higher on average than other chaebol and independent analysts. Overall, the results strongly suggest that the conflicts of interest experienced by the chaebol analysts produce biased EPS forecasts, stock recommendations and target prices, which is consistent with the conflict of interest hypothesis.

Our third set of tests investigates how capital markets respond to chaebol analysts' stock recommendations on the member companies within the same chaebol. Conflicts of interest do not necessarily have negative economic consequences nor do they lead to calls for regulation if they are adequately priced by financial markets. Investors, recognizing conflicts of interest, can downplay the informational value of the chaebol analysts' forecasts for the member companies within the same group. We test whether there is a difference in cumulative abnormal returns (CARs) on the same chaebol company's stock around the announcements of recommendations made by affiliated vs. other analysts. We do not find any statistical difference in the CARs. This result indicates that investors place similar value on recommendations issued by chaebol-affiliated and non-affiliated analysts, suggesting that investors do not recognize the conflicts of interest suggested by the results of our analysis.

Our research contributes to extant literature in two ways. First, our findings contribute to the research on business groups. Previous literature has documented the benefits and costs of the group structure. In a cross-country study, Masulis et al. (2011) find that the continuing prevalence of family groups reflects their ability to support high-risk, capital intensive companies. Bae et al. (2002) and Baek et al. (2006) document evidence of tunneling, in that the controlling shareholders of the chaebols siphon resources out of the member companies to increase their own wealth at the expense of minority shareholders. Baek et al. (2004) also find that firm value is negatively related to the separation of cash flow and control rights of controlling shareholders in the chaebols. Our research indicates that the chaebol structure induces chaebol analysts to make biased forecasts for the member companies. As long as investors do not recognize the conflicts of interest in chaebol-analysts' reports, they can be misled by the analysts' forecasts. Our evidence adds to the costs incurred by the chaebol structure.

Second, our research contributes to previous findings on analysts' conflicts of interest even though these conflicts occur in a different setting. Sell-side analysts working for an investment bank are pressured to provide optimistic recommendations on companies that can provide business to the investment bank. Analysts working in brokerage houses also feel pressure to provide optimistic recommendations to attract trading revenues because upgrades attract more business than downgrades due to restrictions in short selling.[1] The analysts' conflicts of interest are the subject of a large body of literature.[2] For instance, Dugar and Nathan (1995), Michaely and Womack (1999), Cowen et al. (2006), Ljungqvist et al. (2007), and Agrawal and Chen (2008) find evidence consistent with the conflicts of interest. The affiliated analysts are also slower to revise downward their buy and hold recommendations (O'Brien et al., 2005). In addition, they issue buy (sell) recommendations that underperform (outperform) those issued by non-affiliated analysts (Cliff, 2007; Barber et al., 2007).[3] Our research findings are broadly consistent with previous literature on the affiliated analysts' incentives and provide new evidence that analysts affiliated with business groups incur conflicts of interests.

Section 2 presents a summary of the institutional background and prior studies on Korean chaebols. Section 3 discusses the sam-

[1] In the US, the Securities and Exchange Commission makes the information about these conflicts of interest available to investors at http://www.sec.gov/investor/pubs/analysts.htm.

[2] Mehran and Stulz (2007) provide an excellent summary of this literature.

[3] Some studies cast doubts on the existence of conflicts of interest. For instance, Jacob et al. (2008) find that short-term earnings forecasts made by investment banks are more accurate and less optimistic than those made by independent research firms. Clarke et al. (2007) reports that All-Star analysts resist pressures from investment bankers. Irvine (2004) find that the increase in brokerage trading is not affected by the bias in earnings forecast in firms listed in the the Toronto Stock Exchange.