The Predictive Role of Analyst Coverage Intensity: Evidence from Cross-Listing in the US

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Abstract

This paper investigates financial analysts' predictive power of future performance and earnings quality, using a sample of firms cross-listed in the US. We find that analyst coverage is positively related to analysts' expectations about firms' future performance and negatively related to analysts' concern over firms' earnings quality. Country-level legal origin and disclosure index are two significant determinants of analyst coverage of cross-listed firms. In addition, the intensity of analyst coverage can predict future abnormal stock price performance. While documenting the substantial informational benefits to cross-listing, our study suggests that these benefits may not be complete since analysts appear to have predictive power and selectively provide coverage for firms with favorable future prospects.

JEL Classifications: M41, G14, G15

Keywords: analysts' selective coverage, cross-listed firms, legal institutions, earnings quality

Data Availability: The data used in this study are available from public sources identified in the text.

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1. Introduction

As "information intermediaries" who issue earnings forecasts of individual companies, equity analysts specialize in the production of firm-specific information. Analyst coverage is an important part of a firm's information environment, as among other benefits it may lead to greater investor recognition of a firm (Merton, 1987). Due to the importance of analyst coverage on this information environment, an extensive literature has developed on the relationship between firm characteristics and sell-side financial analyst coverage (e.g., Bhushan, 1989; O'Brien and Bhushan, 1990; Lang and Lundholm, 1996). The evidence suggests that analyst coverage has a variety of benefits, including a reduction in asymmetric information and an increase in liquidity. Given these benefits, one obvious question is whether the intensity of analyst coverage has predictive power about future firm performance.

Building on Das et al. (2006), who test whether the intensity of analyst coverage helps explain abnormal performance surrounding IPOs, we use the setting of non-US firms that cross-list on the US stock exchanges, since those firms are known to experience an increase in analyst coverage of varying degrees (e.g., Lang et., 2003). These non-US firms are usually associated with severe information asymmetry issues prior to cross-listing. One concern that has been raised over the post-IPO setting studied by Das et al. (2006) is the extensive evidence of mis-pricing following IPOs (Ritter, 1991; Loughran and Ritter, 1995). The benefit of our research setting is that cross-listing firms are already listed and there is no evidence of mis-pricing following cross-listings.

Existing evidence on analyst coverage suggests that analysts are more likely to provide coverage for firms about which their true expectations are favorable (e.g., McNichols and O'Brien, 1997; Das et al., 2006). We thus hypothesize that analysts' decisions to provide coverage contain information about their expectations of future prospects of covered firms, since analysts tend to follow cross-listed firms with better performance or growth opportunities. Analysts' demands for quality financial disclosure also allow them to play a monitoring role regarding firms' earnings quality. In particular, analysts may stay away from non-US firms with a high likelihood of accounting fraud. Furthermore, we hypothesize that legal institutions of home countries where the cross-listed firms are incorporated have residual impact on the intensity of analyst coverage, even after these firms are cross-listed in the US.

Consistent with prior literature (e.g., Baker et al., 2002; Lang et al., 2003), our results show that analyst coverage increases after cross-listing, particularly for firms from common law countries and countries with low disclosure quality. Our results suggest that firms from weaker investor protection regimes benefit most from cross-listing given the large improvement in the information environment within these firms.

Using multivariate regression analysis, we find supporting evidence that coverage intensity for newly cross-listed firms is positively associated with analysts' expectations of future performance, but negatively associated with analysts' concerns over earnings quality. We also find that country-level legal origin and disclosure index are two significant determinants of analyst coverage of cross-listed firms. We also compare the determinants of residual coverage before and after cross-listing. While earnings growth and our proxy for earnings quality are not important determinants of analyst coverage prior to cross-listing,