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Do analysts matter for governance? Evidence from natural experiments[☆]

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ABSTRACT

Building on two sources of exogenous shocks to analyst coverage (broker closures and mergers), we explore the causal effects of analyst coverage on mitigating managerial expropriation of outside shareholders. We find that as a firm experiences an exogenous decrease in analyst coverage, shareholders value internal cash holdings less, its CEO receives higher excess compensation, its management is more likely to make value-destroying acquisitions, and its managers are more likely to engage in earnings management activities. Importantly, we find that most of these effects are mainly driven by the firms with smaller initial analyst coverage and less product market competition. We further find that after exogenous brokerage exits, a CEO's total and excess compensation become less sensitive to firm performance in firms with low initial analyst coverage. These findings are consistent with the monitoring hypothesis, specifically that financial analysts play an important governance role in scrutinizing management behavior, and the market is pricing an increase in expected agency problems after the loss in analyst coverage.

1. Introduction

Do financial analysts matter for corporate governance? In their seminal paper, Jensen and Meckling (1976) emphasize the governance role of analysts in reducing the agency costs associated with the separation of ownership and control. Specifically, they point out (*p.* 354) that they, "would expect monitoring activities to become specialized to those institutions and individuals who possess comparative advantages in these activities. One of the groups who seem to play a large role in these activities is composed of the security analysts employed by institutional investors, brokers and investment advisory services". Analysts can serve as an external governance mechanism through at least two channels. First, analysts track firms' financial statements on a regular basis and

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interface with management directly by raising questions in earnings announcement conference calls, which can be regarded as direct monitoring.[1] Second, analysts provide indirect monitoring by distributing public and private information to institutional investors and millions of individual investors through research reports and media outlets such as newspapers and TV programs (Miller, 2006), helping investors to detect managerial misbehavior.[2] We refer to the hypothesis that analysts matter for governance through direct and indirect monitoring as the monitoring hypothesis.

Nevertheless, much of the academic research in this area centers on the conflicts of interest between analysts and sell-side or buy-side clients, which results in an optimistic bias in earnings forecasts (e.g., Das, Levine, and Sivaramakrishnan, 1998; Gu and Wu, 2003; O'Brien, McNichols, and Lin, 2005; Ke and Yu, 2006; Mola and Guidolin, 2009; Groysberg, Healy, and Maber, 2011).[3] There is a striking paucity of papers that have explicitly tested for a corporate governance role of analysts. In fact, Leuz (2003) points out that the link between analysts and firm value is not clearly established in the literature and calls for more research. Chung and Jo (1996) find a positive correlation between analyst coverage and Tobin's q, but there is an under-researched and crucial issue: What are the channels through which analysts increase corporate value? More recently, Yu (2008) examines the effects of analyst coverage on earnings management, and finds that firms followed by more analysts manage their earnings less, which is consistent with the monitoring hypothesis.[4] Yet none of the extant papers has looked at the role of financial analysts in monitoring other major corporate decisions. Therefore, we try to fill this gap by taking a holistic approach to the monitoring role of analyst coverage in mitigating managerial extraction of private benefits from outside shareholders.

The lack of the research could be partially driven by potential endogeneity concerns (i.e. analyst coverage is likely endogenous). For instance, analysts could tend to cover firms with less severe agency problems. If this is the case, simple OLS regressions of governance outcomes on the number of analysts following the firm would bias toward finding significant results. Unobservable firm heterogeneity correlated with both analyst coverage and corporate decisions and policies could also bias the estimation results. To overcome the endogeneity problem, we rely on two natural experiments, brokerage closures and brokerage mergers, which generate exogenous variation in analyst coverage. These two experiments directly affect firms' analyst coverage but are exogenous to individual firms' corporate decisions and policies.[5] News of brokerage closures and mergers can easily reach investors through press releases and media outlets. A key advantage of this identification approach is that it not only resolves endogeneity concerns, but also deals with the omitted variable problem by allowing multiple shocks to affect different firms at different times. Using these two natural experiments, we successfully identify 46 brokerage closures and mergers between 2000 and 2010, associated with 4,320 firm-year observations that experience exogenous analyst coverage decreases. We compare the monitoring outcomes of the firms from one year prior to the brokerage exit ($t-1$) to one year after the brokerage exit ($t+1$) to ensure that we are capturing only the effect due to the exogenous shocks to analyst coverage, after controlling for a battery of other factors. We provide three distinct and robust sets of evidence in support of the hypothesis that analyst coverage plays an important monitoring role in a firm's overall corporate governance.

Specifically, we look at the effect of an exogenous decrease in analyst coverage on the marginal value of cash holdings, CEO compensation, and acquisition decisions. As liquid assets, cash reserves are the assets most vulnerable to corporate governance problems for a firm, and entrenched mangers can divert cash for private benefit (Frésard and Salva, 2010). CEO compensation is one of the central issues of governance, and CEOs earn greater compensation when governance structures are less effective (Core, Holthausen, and Larcker, 1999). Anecdotal evidence shows that analysts recently have tried to curb excessive executive compensation through comments in their reports. For example, longtime bank analyst Mike Mayo points out in his report that, "…I laid out my case again: declining loan quality, excessive executive compensation, headwinds for the industry after five years of major growth driven by mergers".[6] Mergers and acquisitions are one of the largest investments for a firm, and the availability of the terms and characteristics of takeover transactions enable us to pin down the agency problems more easily (Jensen and Ruback, 1983). In a study of the agency problems at dual-class firms, Masulis, Wang, and Xie (2009) look at the value of marginal cash holdings, compensation, and acquisitions, and we use a similar framework to study the monitoring role of analysts. Finally, we revisit the result on earnings management (Yu, 2008) to provide direct evidence on the monitoring effect of analysts.

First, we investigate how the exogenous decrease in analyst coverage affects the marginal value of cash holdings. Cash provides managers with the most discretion over how to spend it, making it especially prone to agency problems. Jensen (1986) argues that entrenched managers would rather retain or invest cash than increase distributions to shareholders when firms do not have good investment

[1] For instance, Dyck, Morse, and Zingales (2010) find that, compared with analysts, the SEC and auditors play only a minor role in detecting corporate fraud. Analysts have been directly involved in the detection of fraud in firms such as Compaq, Gateway, Motorola, and PeopleSoft.

[2] In a survey of 401 CFOs, Graham, Harvey, and Rajgopal (2005) report that more than 36% of managers rank analysts as the most important economic agent in setting the stock price of their firm.

[3] Firth, Lin, Liu, Xuan (2013) provide a recent review of this literature.

[4] We differ by looking at broader aspects of monitoring by providing three sets of evidence from the marginal value of cash holdings, CEO pay, and acquisition decisions. Moreover, we utilize natural experiments to overcome endogeneity concerns. We also revisit the effects of analyst coverage on earnings management using our natural experiments framework, both complementing our main results and corroborating Yu's findings.

[5] These settings have been used in recent literature, such as Derrien and Kecskes (2013) and Irani and Oesch (2013).

[6] Mike Mayo, "Why Wall Street Can't Handle the Truth", *The Wall Street Journal*, November 8, 2011.