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Do analyst recommendations reflect shareholder rights?

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ABSTRACT

We examine whether sell-side analyst recommendations reflect shareholder rights. Our rationale is that analysts should be influenced by external governance only if market participants do not efficiently price its value. We find that stronger shareholder rights are associated with more favorable recommendations. Further analysis reveals that analysts favor firms with strong shareholder rights only when strong rights appear to be warranted, but do not penalize firms for having strong rights when not needed. These findings occupy middle ground in the debate on the pricing efficiency of shareholder rights. Moreover, we find that firm value is positively associated with the strength of shareholder rights regardless of the expected external governance structure. The latter result is consistent with a "one-size-fits-all" interpretation, and implies that firms across the board could increase share value by reducing their number of anti-takeover provisions.

1. Introduction

Whether stock prices efficiently reflect public information is a topic of continuing interest and debate. One example is the growing literature on corporate governance and stock returns. Several studies debate whether differences across firms in the quality of corporate governance are efficiently reflected in stock prices. In their widely cited and ground breaking paper, Gompers et al. (2003) (hereafter GIM) develop a governance index (G-index) based on 24 anti-takeover provisions, and find that firms with strong shareholder rights earn risk-adjusted annual returns during 1990–1999 that are 8.5% greater than firms with weak shareholder rights. Cremers and Nair (2005) and Bebchuk et al. (2004) also provide evidence that the value of corporate governance is not efficiently incorporated into equity prices. In contrast, Core et al. (2006) and Johnson et al. (2006) argue that although good governance adds value, investors incorporate this value quickly and efficiently. In short, the evidence is mixed on whether governance is priced efficiently.

We add to this debate by studying the recommendations of sell-side analysts.[1] One of the main functions of sell-side analysts is evaluating securities with the purpose of making a judgment and recommending explicit action on the part of investors.[2] Grossman and Stiglitz (1980) argue that pricing inefficiencies must exist to compensate investors for the costly information gathering process. Security analysts are arguably among the first to uncover these inefficiencies. Prior to issuing recommendations, analysts spend considerable resources trying to identify mispricing and it seems reasonable that their recommended course of action (i.e., buy, sell, hold) reflects their beliefs regarding pricing efficiency. Favorable recommendations reflect analysts' belief that a stock is currently undervalued by market participants, and unfavorable recommendations reveal their opinion that a stock is overvalued. Indeed, the literature finds that stocks receiving favorable recommendations outperform those receiving unfavorable recommendations (e.g., Stickel, 1995; Womack, 1996; Barber et al., 2001; Barber et al., 2006; Jegadeesh et al., 2004 (hereafter JKKL); and Jegadeesh and Kim, 2006).

To the extent that a firm's governance structure influences valuation, analysts should consider the strength of corporate governance in issuing recommendations. We argue that if shareholder rights influence valuation favorably but are not efficiently reflected in stock prices, analysts will recognize this mispricing and issue more favorable recommendations to well-governed firms and less favorable recommendations to poorly-governed firms. Alternatively, if strong shareholder rights either have no effect on valua-

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[1] Sell-side analysts work with brokerage firms in contrast to buy-side analysts who are primarily associated with financial institutions.

[2] See Schipper (1991) for an excellent discussion of analysts' functions.

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tion or are quickly and accurately reflected in stock prices, analysts will place little importance on differences in governance across firms. It is not our purpose to take a stand on whether governance is a risk factor that should be priced in the financial markets. Rather, we address the question of market efficiency. Essentially, our study examines the following question: are sell-side analyst recommendations associated with the strength of shareholder rights?

This approach has a distinct advantage over prior studies in that it allows us to investigate the pricing efficiency of shareholder rights without relying on differences in long-term abnormal returns. This avoids the problem of having to identify all influential risk factors and/or matching criteria. We argue that the pricing efficiency of shareholder rights should be associated with the significance that analysts place on the G-index in issuing their recommendations. Of course, our examination of recommendations also has a joint hypothesis embedded, since we are simultaneously testing the pricing efficiency of shareholder rights and analysts' ability to recognize pricing inefficiencies with respect to shareholder rights.[3] Nonetheless, studying the recommendations of investment professionals provides a new and interesting angle to the pricing efficiency debate, since the above mentioned drawback is arguably no more severe than the problem of measuring long-term abnormal returns given that we cannot positively identify the true pricing model. Moreover, improving our knowledge of the information that analysts use in issuing recommendations is interesting on its own right (i.e., aside from pricing efficiency) because a large number of market participants follow the advice of these investment professionals.

We find that during our sample period 1995–2004 there is a significant positive association between the G-index and consensus recommendations. The median firm associated with strong shareholder rights (below median G-index) receives a consensus recommendation, 1.87, that is significantly more favorable than that of the median firm associated with weak shareholder rights (above median G-index), 2.00.[4] Similarly, the median "democracy" (G-index< = 5, GIM) receives a consensus recommendation of 1.67 whereas the median "dictatorship" (G-index> = 14) receives 1.91. This relation remains significant in regression specifications that include several variables shown by JKKL to influence analyst recommendations. In short, better governance is associated with more favorable recommendations, suggesting that analysts believe strong external governance is not priced efficiently by market participants.

Is it always better to have strong shareholder rights? Or is there an optimal governance structure, determined endogenously based on firm-specific characteristics? The literature provides evidence that firms with stronger governance are associated with greater idiosyncratic risk (Ferreira and Laux, 2007; Demsetz and Lehn, 1985)[5], smaller firm size, lower stock prices, and lower institutional ownership (GIM). Moreover, there is evidence that governance mechanisms such as insider ownership and board characteristics are correlated with firm characteristics (Smith and Watts, 1992; Demsetz and Villalonga, 2001; Himmelberg et al., 1999; Hermalin and Weisbach, 2003; Lehn et al., 2008; Boone et al., 2007; Cornett et al., 2007; Jiraporn et al., 2006).

In our sample we find that firms with relatively stronger shareholder rights are typically characterized by lower market values, less likelihood of S&P 500 inclusion, more share turnover, greater idiosyncratic volatility, lower institutional ownership, lower leverage, and less board oversight. Apparently, on average the strength of shareholder rights is determined endogenously and is commensurate with the inherent need (or lack thereof) for external governance.

It is possible, however, that not all firms have external governance structures that are in line with what appears to be warranted based on firm characteristics. This could potentially be damaging for firms that are expected to have strong shareholder rights but that, in reality, have weak shareholder rights. Similarly, there could be a penalty for firms whose shareholder rights are "too strong" relative to expectations, since having strong rights when not needed could unnecessarily cause managers to burn resources fending off takeover attempts. Essentially, it could be harmful to deviate in either direction from the governance structure that appears to be optimal.

To capture these effects, we predict the level of shareholder rights that might be expected based on firm-specific traits, and control for this level in tests of the relation between recommendations and shareholder rights. First, using an OLS regression we predict the strength of shareholder rights (G-index) and categorize the top half of sample firms as having *weak predicted governance* and the bottom half as firms with *strong predicted governance*. Using two-way sorts, we find that the actual level of governance influences recommendations only for firms that have strong predicted governance, that is, only for firms whose characteristics are typical of well-governed firms. For these firms, analysts rate well-governed firms significantly better than poorly-governed firms (consensus recommendations of 1.89 vs. 2.02, respectively). Among firms that have weak predicted governance, analysts do not distinguish between well-governed and poorly-governed firms (2.05 vs. 2.02).

Second, using OLS we decompose the G-index into the portion associated with firm traits (we term this "predicted G-index") and the portion that is orthogonal to traits (termed "residual G-index"). The residual G-index is defined as the actual G-index of the firm minus the predicted G-index. Using OLS and Fama–MacBeth (1973) regressions that control for the variables JKKL identify as significant predictors of analyst recommendations, we provide evidence that both the predicted and residual G-index influence recommendations. This indicates that recommendations are influenced by firm traits that are associated with the strength of governance, but importantly, recommendations are also explained by the portion of external governance that is orthogonal to these firm traits. However, these relations are driven by the sample of firms that have strong predicted governance, which is consistent with the results of our two-way sorts.

Finally, we use propensity-score matching to pair firms that differ in shareholder rights, but that ex-ante might be expected to have similar shareholder rights. The findings again indicate that analysts are influenced by shareholder rights only for firms expected to have strong external governance. Our findings are robust to using the entrenchment index of Bebchuk et al. (2004), the alternative governance index (ATI) of Cremers and Nair (2005), five-tier rather than three-tier recommendations, and separate pre-2001 and post-2001 samples.

In the last section of the paper we examine the impact of shareholder rights on valuation (Tobin's Q). The consensus in the literature is that better governed firms are valued higher based on Tobin's Q (e.g., GIM; Chi, 2005; Johnson et al., 2006; Chua et al., 2007). We re-examine this relation using tests that control for the predicted/expected level of governance. The evidence reveals that stronger governance is associated with higher firm valuation,

[3] One possibility is that shareholder rights are efficiently priced, but analysts became aware of GIM and subsequently issued more favorable recommendations to well-governed firms. Thus we might observe that recommendations reflect shareholder rights even though shareholder rights are priced efficiently. However, our main results are robust to using only the period prior to 2001, the time when the GIM paper was first circulated. The findings are also robust to using only post-2001 data.

[4] As discussed later, we code strong buy and buy recommendation as 1, hold as 3, and sell and strong sell as 5. Thus, higher values of consensus recommendations are less favorable.

[5] Demsetz and Lehn (1985) argue that a firm's operating environment can influence its optimal governance structure. Firms in unpredictable environments are harder to monitor and require better governance, and vice versa.