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# Value relevance of analyst earnings forecasts in emerging markets

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ABSTRACT

Even though research in accounting and finance has extensively examined the role of financial analysts in developed economies, this issue has not been thoroughly examined in an emerging market setting. In this paper, I examine whether, following a market opening, analyst forecast accuracy and the market's reliance on analyst forecasts increase with time. Accuracy is expected to increase over time as analysts exert more effort and gain valuable forecasting experience. Results indicate that time is positively related to analyst forecast accuracy after controlling for a number of other firm and country characteristics. Second, I posit that time should also be related to the market's propensity to use analyst forecasts to form earnings expectations. As markets open and investors become more sophisticated, the reliance on analyst forecasts should also increase. Results are consistent with this expectation. In particular, I find that in the first sub-period earnings expectations based on random walk exhibit greater relative information content than earnings expectations based on analyst forecasts. This pattern is reversed in the third sub-period where analyst forecast errors better explain returns. Incremental information content tests produce similar results. Future research should further investigate the relation between financial analysts and other important market characteristics in emerging economies.



## 1. Introduction

Extant research has focused extensively on the role of financial analysts in the functioning of capital markets. Analyst earnings forecasts have been shown to be more accurate than time series forecasts (O'Brien, 1988) and that the market tends to rely on these forecasts to a greater extent than time series model predictions (Fried & Givoly, 1982; Hopwood & McKeown, 1990). In addition, properties of analyst forecasts have been associated with market and firm attributes. For example, analyst following and accuracy (dispersion) have (has) been positively (negatively) associated with the quality of the firm's information environment (Abarbanell, Lanen, & Verrecchia, 1995; Healy, Hutton, & Palepu, 1999; Hope, 2003; Lang & Lundholm, 1996) while studies have also documented a positive relation between accuracy and analyst following (Lys & Soo, 1995). Analyst coverage and accuracy have been positively associated with firm value (Lang, Lins, & Miller, 2003). Better information environment results in lower cost of capital and greater liquidity thus enhancing the efficiency of the market (Botosan, 1997; Frost, Gordon, & Hayes, 2006; Hail & Leuz, 2006; Leuz & Verrecchia, 2000). Analyst following has also been associated with the extent of underpricing in both seasoned equity offerings and IPOs (Bowen, Chen, & Cheng, 2003; Rajan & Servaes, 1997). Taken together the results suggest that analysts play a very important role in capital markets.

Another important recent stream of literature deals with emerging market characteristics. The term "emerging market" refers to the securities markets of developing economies which are gradually becoming an integral part of the world capital markets (Liaw, 1999). Emerging markets are typically economies with low-to-middle per capita income in a state of transition to developed economy status. Thus emerging markets offer an opportunity for investors to diversify internationally by adding some risk to their portfolios. A number of papers examine market characteristics in these emerging economies, specifically, return structures and relation with risk (Bilson, Brailsford, & Hooper, 2002; Serra, 2000), volatility (Huang & Yang, 2000), and the degree of integration with developed markets (Bekaert & Harvey, 2002; Errunza & Miller, 2000). An important stream of this literature deals with the benefits and costs of market liberalizations. Market openings for example, have been shown to positively affect market volatility (Hooper, 2001) and are also linked to increased risk of financial crisis (Ito, 2004; Krugman, 1999). Yet, other evidence suggests that market openings have positive effects on the markets as they reduce the cost of capital (Bekaert & Harvey, 2000; Henry, 2000), increase stock returns and market efficiency but without increasing volatility (Kim & Singal, 2000). As the level of foreign investment and interest in these emerging markets is growing, especially as a response to the recent financial crisis, it becomes more important to learn about the

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underlying structures that could affect investment decisions in these markets.[1]

This paper brings the two streams of literature together, to provide preliminary evidence on the role of financial analysts in six emerging markets. Analysts are a very important group of market participants, yet their role in emerging markets has not been thoroughly examined. Hoguet (2006) who examines the number of analyst earnings estimates in emerging markets, is one notable exemption. This paper examines two important analyst forecast properties: forecast accuracy and the degree to which analyst forecasts reflect market expectations of earnings. The two characteristics are inter-related. Forecast accuracy indicates the level of analyst ability and output quality in environments that do not necessarily stress the importance of information and transparency. In this environment, forecast accuracy should be of great importance to both local and foreign investors for their investment decisions. The market reliance on analyst forecasts as proxy for earnings expectations, also provides additional evidence on analyst research quality, since greater reliance on analyst forecasts would suggest that analyst forecasts exhibit desirable levels of quality. In addition, and based on Walther (1997), increasing reliance on analyst forecasts would also indicate increasing market sophistication and thus further market development. More importantly, I study the change in analyst forecast accuracy and market reliance on analyst forecasts over time. In particular, building on Henry (2000) who suggests that the benefits of market openings are gradually realized, I posit that following stock market openings, both accuracy and market reliance on analyst forecasts increase with time as investors in these markets become increasingly more sophisticated. Both of these questions are important to investors considering the international diversification of their portfolios.

Results for sample firms indicate that in the period following market liberalizations analyst forecast accuracy increases over time after controlling for a number of other firm and country characteristics that can affect analyst accuracy. In addition, even though for the first sub-period the markets rely mostly on random walk to form earnings expectations the trend changes toward the end of the study's period as analyst forecast errors become increasingly more important. It thus seems that significant learning curves exist that affect both analyst forecast accuracy and the market's reliance on analyst forecasts.

## 2. Hypotheses development

The paper's main objective is to provide preliminary evidence on analyst research quality in emerging markets and in particular to test whether analyst research quality increases with time following a market opening. Market openings signify the point in time when regulations are introduced by the authorities to allow the flow of foreign funds. This is an important turning point for all market participants. In this paper, I argue, that after markets open the demand for better quality information increases, in turn affecting the quality of analyst research. Related research has shown that market openings provide a number of other benefits to emerging markets. Henry (2000) shows for example, that the equity price index on aggregate, exhibits abnormal returns of 3.3% during the eight month window leading up to the implementation of liberalization, consistent with a reduction in the cost of equity capital. Similarly, Bekaert and Harvey (2000) also document a decrease in their estimate of the cost of capital after stock market liberalizations while Kim and Singal (2000) find that stock markets become more efficient following market liberalizations. In this spirit, I posit that market liberalizations also affect analyst research quality by introducing strong incentives for analysts to improve the quality of their research.

Even though the quality of analyst research can be measured in a number of ways, in this paper, I examine two very important attributes of analyst earnings forecasts; analyst forecast accuracy and the market reliance on analyst forecasts. In short, I argue, that the period following a market opening constitutes a learning period, for analysts to improve their forecasts and for investors to rely on them. Forecast accuracy has been shown to be beneficial to capital markets. First, accuracy has been shown to be related to the level of firm disclosure (Lang & Lundholm, 1996). Second, both accuracy and analyst following have been shown to be positively associated with firm value (Lang et al., 2003), while greater accuracy reduces the implied cost of capital (Gebhardt, Lee, & Swaminathan, 2001). Given its importance in the functioning of capital markets I examine analyst accuracy and changes therein over a period of twelve years. Prior research shows that individual analysts improve their performance with experience (Mikhail, Walther, & Willis, 1997). Market liberalizations which allow the flow of foreign capital are expected to introduce a powerful incentive for analysts to improve the quality of their research, leading to increased accuracy. One of the benefits of market openings is improved disclosure and transparency as these characteristics are important to the investment decision of foreign investors (Kim & Singal, 2000). Consistent with this, Aggarwal, Klapper, and Wysocki (2005) find that US institutional investors tend to invest in countries with high quality accounting standards. I thus posit that conditional on a market opening analyst forecast accuracy, on aggregate, increases with time as analysts respond to increased foreign demand for higher quality research by exerting more effort. As they gradually become more accustomed to an emerging market's characteristics they gain valuable forecasting experience, in turn enhancing the accuracy of their forecasts.[2]

**H1.** Following market openings in emerging markets, the accuracy of analyst earnings forecasts increases with time.

Greater analyst accuracy can only be beneficial to the market if investors rely on analyst forecasts. Prior US research has documented that the market tends to rely more on analyst forecasts than forecasts employing time series models (Fried & Givoly, 1982; Hopwood & McKeown, 1990). This has been attributed to both the timing and informational advantage of analysts (Brown, Richardson, & Schwager, 1987; Fried & Givoly, 1982; Hopwood & McKeown, 1990; Kross, Ro, & Schroeder, 1990). Whether emerging market participants rely on analyst forecasts however has not yet been examined. I posit that market expectations are more likely to be based on the naïve random walk model as investors are less informed about underlying market structures. Early US evidence is also consistent with the market relying on random walk earnings predictions (Bernard & Thomas, 1990; Rendleman, Jones, & Latané, 1987).

Following market liberalizations, I expect that the market's reliance on random walk earnings (analyst earnings forecasts) decreases (increases) over time as investors become more informed and analyst forecasts become more reliable. As markets open, more foreign investors enter the market increasing the demand for better information. Related research suggests that market liberalizations result in a number of economic benefits including increases in abnormal returns and reductions in the cost of capital (Bekaert & Harvey, 2000; Henry, 2000), increases in efficiency but no related

[1] Emerging markets have recently received increasing attention from investors in response to the recent financial crisis as emerging market equities seem to dramatically be outperforming their developed world peers. The fact that emerging market banks are not as exposed to toxic assets as their western counterparts are, led to a recent emerging market rally with investors and equity funds significantly increasing their holdings in these markets (Oakley & Kassel, Financial Times, 2009).

[2] Both hypotheses are stated in the alternative form.