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The impact of all-star analyst job changes on their coverage choices and investment banking deal flow ☆

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Abstract

Using a sample of all-star analysts who switch investment banks, we examine (1) whether analyst behavior is influenced by banking relationships and (2) whether analyst behavior affects investment banking deal flow. Although the stock coverage decision depends on the relationship with the client firms, we find no evidence that analysts change their optimism or recommendation levels when joining a new firm. Investment banking deal flow is related to analyst reputation only for equity transactions. For debt and M&A transactions, analyst reputation does not matter. There is no evidence that issuing optimistic earnings forecasts or recommendations affects investment banking deal flow.

JEL classification: G24; G32

Keywords: All-star analyst; Analyst coverage; Market share; Investment banking relationships; Conflicts of interests

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1. Introduction

Is investment banking deal flow affected by analyst behavior? Anecdotal evidence from the popular press suggests that it is:

> *David Komansky, former chief executive of Merrill Lynch, and Dennis Kozlowski discussed ways to improve research coverage of Tyco and hiring an analyst the company liked, according to an e-mail introduced at the ex-Tyco chief's trial. After Merrill hired the analyst, Phua Young, Tyco immediately responded by awarding the investment bank work on a $2bn bond offering, according to an e-mail sent in 1999 to Mr. Komansky by Samuel Chapin, Merrill's vice-chairman. 'To demonstrate the impact this hire has on our relationship, Dennis Kozlowski called me on Phua's first day of work to award us the lead management of a $2.1bn bond offering,' Mr. Chapin wrote in the e-mail of August 31 1999…*[1]

Moreover, is analyst behavior influenced by investment banking relationships between the bank and the firms the analyst covers? The popular press suggests that analysts might be pressured to cover firms that they would not otherwise cover, as well as give favorable coverage to firms that they would otherwise downgrade.[2]

In this paper, we analyze a sample of 216 cases in which an *Institutional Investor* All-America Research Team analyst ("all-star" hereafter) moves from one investment bank to another over the 1988 to 1999 period. We investigate two questions. First, we examine whether the all-star's behavior changes when he switches investment banks. An all-star who moves from Goldman Sachs to Merrill Lynch, for example, might choose to continue covering only those stocks that are likely to generate investment banking business for Merrill. In addition, the analyst might issue more favorable reports for Merrill clients than when at Goldman. Hence, we study whether, in the period following a job change, all-stars choose to continue covering stocks and whether they become more optimistic about the stocks they cover, based on the relationship between the firms being covered and the investment bank employing the all-star. Second, we examine whether analyst reputation and coverage affect investment banking deal flow after the all-star joins the new bank.

We investigate all-star job changes, instead of job changes across all analysts, because prior research by Krigman, Shaw, and Womack (2001) and Dunbar (2000) documents that firms value all-star research coverage. Specifically, Krigman, Shaw, and Womack find that the perceived quality of coverage, as proxied by all-star coverage, is an important driver in a firm's decision to change the lead underwriter in a follow-on offering. Dunbar (2000) finds a strong positive relation between changes in an investment bank's *Institutional Investor* All-America Research Team ranking and subsequent changes in the bank's market share in the initial public offering market. If we find no effect on investment bank market share when an all-star analyst moves, it is unlikely we will find an effect for non-all stars. We examine both capital-raising (debt and equity underwriting) and corporate control (M&A) transactions to develop a comprehensive understanding of the relations among stock coverage, analyst reputation, investment bank reputation, and deal flow.

With respect to our first research question, our results show that an all-star analyst's decision to cover a firm is influenced by the investment bank's relationship with the firm. In

[1] Bowe and Silverman (2004).

[2] See, for example, Schroeder and Smith (2002).