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# Research for sale: Determinants and consequences of paid-for analyst research ☆

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ABSTRACT

I examine the determinants and market impact of paid-for coverage using a hand-collected sample of paid-for reports over 1999–2006. More than five hundred publicly listed US companies paid for analyst coverage since 1999. Yet little is known about the informational consequences of this analyst research. Firms with greater uncertainty, weaker information environments, and low turnover are more likely to buy coverage as they have the most to gain from analyst coverage but are unlikely to attract sell-side analysts. Despite the inherent conflicts of interest, I find paid-for reports have information content for investors based on 2-day abnormal returns. After the initiation of coverage, companies experience an increase in institutional ownership, sell-side analyst following, and liquidity. In addition, the results are strongest for the fee-based research firm with ex ante policies that reduce potential conflicts of interest.

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## 1. Introduction

This study examines the recent spike of public companies paying for analyst research and the informational consequences of this research. While the existing literature suggests that analysts are important information intermediaries, it is unclear whether the inherent conflicts of interest in paid-for research preclude it from being a viable alternative to traditional sell-side analyst coverage. This question has become particularly important as economic and regulatory changes over the last decade such as Regulation Fair Disclosure (Reg FD), the Sarbanes-Oxley Act (SOX), and the Global Settlement have accelerated the drop in sell-side analysts' coverage of small- and mid-cap stocks (Leone, 2004).[1] Lack of analyst coverage affects the majority of publicly listed firms and "impacts company valuation, liquidity and ultimately the welfare and growth of public companies."[2] Citing the adverse effects for individual companies from this lack of coverage, the Securities and Exchange Commission (SEC) Advisory Committee on Smaller Public Companies has recommended that the SEC encourage the use of paid-for research as a way for firms to access the benefits of analyst coverage (SEC, 2006).

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[1] Bushee and Miller (2008) find that investor relations professionals view Reg FD and SOX as decreasing the analyst following of small- and mid-cap firms and that attracting analysts for these firms is unlikely. Analysts told the investor relations professionals that their clients lack the trading volume (and thus commissions) to warrant coverage.

[2] Bob Greifeld, president and chief executive officer of Nasdaq, quoted in Financial News (2006).

However, there is no empirical evidence examining the viability of this equity research model.[3]

Motivated by this regulatory deliberation and the current void in the literature on this emerging analyst research model, my study analyzes ten fee-based research firms (i.e., those offering analyst coverage for money) from 1999 to 2006, including the top five firms in the fee-based research industry. The sample contains more than six thousand hand-collected analyst reports from the research firms' websites and archives. I identify more than five hundred US firms that purchased coverage over this period, reflecting the burgeoning demand for paid-for research among firms with little or no analyst coverage and providing an opportunity to examine the determinants and consequences of paid-for research.

In paid-for research, companies hire a fee-based research firm to prepare one or many reports. By providing public information they can help aid investors' decisions in allocating resources across securities and make the market more efficient while also providing benefits for the covered company such as increased liquidity and lower cost of capital (Healy and Palepu, 2001; Barth and Hutton, 2004; Irvine, 2003). Despite the potential benefits of analyst coverage, critics allege that the inherent conflict of interest robs the research of any value making it "one of the most scurrilous practices in investor hyping" (Metzger, 2003, p. 5). The following empirical results shed light on the economic determinants and market impact of this analyst research.

First, I provide evidence on what types of companies buy research and model a company's decision to pay for analyst coverage conditional on not having sell-side coverage. I focus my analyses on the set of firms that did not have prior sell-side coverage to reflect the SEC's concern and the target population for paid-for coverage.[4] I find that managers are more likely to buy analyst coverage for firms that are younger, smaller, from high-technology industries, with increased research and development (R&D) intensity, with higher return variability, and with more growth opportunities. This is consistent with the notion that firms with weaker information environments, lower visibility, higher information asymmetry between insiders and outsiders, and greater uncertainty about future earnings and cash flows have the most to gain from analyst coverage and reducing this uncertainty (Lang, 1991; Botosan, 1997) but at the same time are unlikely to attract sell-side analysts as brokerages are loathe to devote resources to firms requiring more effort to cover (Bhushan, 1989; Barth, Kasznik, and McNichols, 2001). Likewise, I find firms with low share turnover are more likely to buy analyst coverage as sell-side analysts are unlikely to generate enough commissions to justify covering small, thinly traded stocks (Irvine, 2003; Bushee and Miller, 2008). Consistent with a diminished marginal benefit from paid-for research incremental to the information intermediary role of institutional investors, I find buying analyst coverage is negatively associated with institutional investor ownership. I also find that buying analyst coverage is positively associated with prior stock returns. Overall, I find firms rationally trade off potential costs and benefits when deciding to purchase coverage.

Second, I investigate the market impact of paid-for research by examining investors' reactions to the issuance of a report and the information within the report. Despite the inherent conflicts of interest, I find that these reports provide information content to the market based on the two-day [0,+1] cumulative abnormal returns (CARs) centered on the report date. Reports initiated with *Strong Buy* recommendations are related to a size-adjusted return of 2.6% and a *Buy* initiation of 1.6%, while initiations at other levels are insignificantly different from zero. Investor reaction is not limited to the initiation sample. Specifically, consistent with intuition and the sell-side literature, *Strong Buys, Buys,* upgrades, and reiterations from paid-for analysts are associated with positive and significant abnormal returns. *Holds* are associated with negative and significant abnormal returns, and downgrades are associated with negative but statistically insignificant abnormal returns. However, the lack of statistical significance for downgrades should be interpreted with caution as it is likely due to a small sample size restricting the power of the tests.

Third, I examine the changes in a firm's information environment after hiring an analyst. I use propensity score matching combined with a difference-in-differences analysis to take into account the endogeneity of the decision to hire an analyst and to construct a suitable control group. I find increases in institutional ownership, the number of sell-side analysts, and liquidity in the quarters following the initiation of paid-for coverage.

Finally, I investigate how investor reactions and consequences vary across the two major fee-based research firms depending on how each firm uses ex ante business operations and policies to manage potential conflicts of interest. Credit rating agencies, which have used a fee-based model since the 1970s, have similar inherent conflicts of interest that they argue are manageable through policies and procedures such as imposing investment restrictions and maintaining cash-based fixed fee schedules (SEC, 2003). Analyst industry associations echo this sentiment and recommend that fee-based firms restrict the analyst or the firm from holding and trading client stock or maintaining other business relations with clients. Consistent with my predictions, I find clients of the fee-based firm with lower potential conflicts of interest have greater abnormal stock returns to initial recommendations, upgrades, and reiterations. I also find that these clients experience significant increases in institutional investor ownership, sell-side coverage, and liquidity after initiating paid-for coverage. However, clients of the fee-based firm with higher potential conflicts of interest had no significant changes in most of these variables after matching against a control company.

This study is important for securities regulators, practitioners, and academics. I contribute to the analyst, disclosure, and reputational bonding literatures by examining a relatively

[3] For example, Lang, Lins, and Miller (2004) find that analysts tend not to cover firms with severe agency problems despite the fact that these firms could benefit the most from the monitoring effect of analyst coverage. They state: "It is possible that some managers of firms with concentrated ownership might prefer to have greater analyst following but do not have a ready mechanism with which to attract analysts" (p. 596).

[4] I thank Amy Hutton (referee) for this suggestion.

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