THE BENEFITS OF SELL-SIDE RESEARCH

An Extensive Review of the Literature
BENEFITS

- Sell-side equity research plays an important role in capital markets
- For over ~40 years, increased analyst coverage has been associated with increased stock trading activity (liquidity) toward the securities under interest
- Stock prices are observed to follow the recommendations derived from analyst coverage
- Increased analyst coverage typically causes investors to believe that more superior information will be priced into a stock’s prospects and value
- Analyst coverage catches the attention of retail investors and thereby boosts liquidity
- Reductions in the cost of capital are possible through increased analyst coverage
- Analyst coverage adds the most value during volatile economic periods or ‘bad times’
- In emerging markets, weakly distributed information presents a lack of firm-specific information from being incorporated into stock prices
- Smaller companies are in line to benefit the most from analyst coverage off their limited visibility
- Losses in analyst coverage increase the likelihood of a company delisting.
- If analyst coverage is stopped, there is a high chance that the coverage will not be picked up at a later period
- The SEC Advisory Committee on Smaller Public Companies officially endorsed the paid-for research model in 2011
- Overall, there are severe drawbacks for losses in analyst coverage as well as large benefits for increased levels of coverage
INTRODUCTION

Sell-side equity research continues to play an important role in capital markets. A collection of investment banks within the United States alone spends in excess of one hundred million dollars annually on equity research. Extensive research indicates that institutions rely on sell-side equity analysis to market their securities, boost liquidity and aid in investment decisions1-5.

Equity research frequently includes several core components, namely: earnings forecasts, a stock recommendation (such as buy, sell, or hold) and a price target. This is alongside extensive quantitative and qualitative analysis supporting such claims.

Equity research analysts process a large quantity of information to conduct and compare security valuations. They usually possess superior information and a superior information processing ability and through introducing new information to the market and changes in analyst recommendations, investors are incentivised to trade on such information, which increases liquidity6.

From a general perspective, research shows that analyst coverage improves firm valuation7, enhances stock liquidity3, and reduces the cost of equity8.

As there is no natural benchmark that exists against which to accurately assess the value of analyst research, we conducted a thorough literature review on the topic, obtaining information that dates back over several global business cycles. Overall, we identified many benefits arising from analyst coverage.

STOCK PRICES MOVE IN LINE WITH ANALYST COVERAGE

In 1978, researchers9 studied the market’s reaction to analyst recommendations appearing in the Wall Street Journal and later in 1980, followed the market’s reaction to forecasts published by Merrill Lynch analysts10. The research revealed larger swings in stock price returns under the heightened analyst activity.

Later in 1987, further research confirmed that such price movements were not occurring by chance and that a change of direction in analyst recommendations caused stock prices to move significantly11. In 1997, researchers were able to directly measure any extreme returns at the opening of the bourse following analyst recommendations12 (up to ~4% for NYSE stocks and up to
~7% for NASDAQ stocks). In 1998, the impact of initiation analyst research was measured and found that significant (~3%) extreme returns followed initial buy recommendations\textsuperscript{13}.

After examining 2128 analyst recommendations and the corresponding companies under analysis, similar extreme stock price movements were witnessed in 2003 after the initiation of coverage by sell-side analysts\textsuperscript{3}. The research also highlighted that the commitment of resources by research houses toward the analysis of a stock, indirectly attached value to the stock’s prospects.

Later research demonstrated that bullish recommendations by analysts typically lead to stock price outperformance in comparison to bearish analyst sentiment which lead to stock price underperformance\textsuperscript{14}.

It was then further exhibited that investors bought on the recommendations of analysts’ earnings and growth forecasts, with the strongest occurrence in the U.S. and Japanese equity markets, with weaker occurrences in almost every other developed economy except Italy\textsuperscript{15}.

By 2004, researchers provided evidence and confirmed that changes in the direction of analyst recommendations were strong predictors of future stock performance\textsuperscript{4}.

In 2007 it was found that companies with cutbacks in analyst coverage experienced significant stock price declines\textsuperscript{16}. It was also demonstrated how investors overreacted to a decrease in the number of analysts covering a stock and that a drop in analyst coverage could lead to increased negative price returns within as little as one year\textsuperscript{17}. In 2010, researchers commented on a similar effect where the stock price of firms that had been temporarily neglected by analysts rose significantly as the analysts resumed coverage of these firms\textsuperscript{18}.

Ultimately, analyst recommendations play a major role in the continuous fluctuations of stock prices.

**ANALYST COVERAGE LEADS TO INCREASES IN LIQUIDITY**

In 1995, Brennan and Subrahmanyan developed their liquidity theory which suggested that an increase in analyst coverage caused increased liquidity\textsuperscript{19}. In 1998, researchers reiterated this by showing that liquidity was positively related to the number of analysts following a company\textsuperscript{20}. Their findings additionally demonstrated that analyst coverage caught the attention of retail
investors and thereby boosted liquidity. More so, discontinuations of coverage caused a liquidity slowdown.

In 2004, heightened stock liquidity was observed on the Toronto Stock Exchange for 10 days after revised analyst forecasts and recommendations were released\(^21\). In 2005, a similar occurrence was found when analyst research recommendations and earnings forecasts were released for the Australian stock market, as well as finding that optimistic recommendations had a greater impact on increased stock liquidity\(^22\). Such effects were also identified within the US equity market in 2015\(^23\).

Ultimately, when analyst updates are released into the market, new information is essentially ready to be analysed, priced-in and traded on, thereby leading to increases in liquidity.

**ANALYST COVERAGE CAUSES HIGHER INSTITUTIONAL AND RETAIL TRADING**

In 2001, researchers found that changes in analyst recommendations often encouraged fund managers to trade\(^24\) and in 2005, it was again highlighted that fund managers seemed to place large importance on the information content of analyst recommendations\(^25\). More recently in 2013 it was revealed that mutual funds actually ‘herded’ on changes in analyst recommendations\(^26\).

Modern Portfolio Theory would suggest that in a perfectly efficient market, analysts would not be able to add any value since any information they have would already be reflected in market prices\(^27\). However, above-mentioned research\(^15\) confirmed that even countries that have the most developed stock markets in the world were semi-strong form efficient when analysed (not all information is priced into stock prices) and there was still high potential for analysts to provide additional information to the market and ultimately, encourage fund managers to trade on such information.

From a retail perspective, the average investor who commonly holds smaller stakes in securities, usually retains limited resources to produce a thorough analysis of company value and prospects. As a result, this creates demand for analysts who can produce high quality information for such uninformed investors.
ANALYST COVERAGE REDUCES THE COST OF CAPITAL FOR COMPANIES

In 1985 it was shown that analyst coverage could reduce information asymmetry (where one party has more or better information than another party)\(^{28}\). Information asymmetry often resulted in less attraction to investing in financial markets as uninformed investors became hesitant to trade against potentially more-informed investors.

Owing to this, when issuing new equity, companies would mostly issue their shares at a discount to counteract any risk concerns of uninformed investors. Such discounting lead to smaller proceeds going to the issuing company and ultimately a higher cost of raising equity capital. The information asymmetry worked against the company when the firm was undervalued and was unable to issue equity, however, when it was overvalued, it was presented with a window of opportunity given its inability to issue equity more regularly.

Later in 2006 it was showed that firms that received less coverage (usually smaller firms) issued equity less frequently, but when they were presented with a window of opportunity, they issued a larger amount of equity, which could often be harmful in the long-run to the firm’s capital structure\(^{29}\). When information asymmetry was reduced the cost of raising equity capital was reduced, as investors required lesser returns off the perception of lower risk conditions. The same occurrence was later reiterated in 2008, when analyses of 4,766 seasonal equity offerings (SEOs) between 1984 and 2000 were conducted.

<table>
<thead>
<tr>
<th>Amount of analysts</th>
<th>Effect of coverage on cost of capital</th>
</tr>
</thead>
<tbody>
<tr>
<td>Group 1 (no coverage)</td>
<td>0</td>
</tr>
<tr>
<td>Group 2</td>
<td>1 to 4</td>
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<tr>
<td>Group 3</td>
<td>8 and above</td>
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*Table 1. The effects of analyst coverage and cost of capital*\(^{30}\)

The research proved that when compared with companies without analyst coverage, companies with even fluctuating levels of analyst coverage demonstrated a lesser cost of capital (see the results in Table 1)\(^{30}\).
THE BENEFITS OF ANALYST COVERAGE DURING ‘BAD TIMES’

In 2014 it was demonstrated that the value of analyst work differed substantially in ‘bad times’ (characterised as either macro or microeconomic issues) as during such conditions, analysts became more active and their outlooks became more significant.\(^{31}\)

This was particularly proven earlier in 2012, when it was demonstrated that analyst coverage became more valuable and in greater demand when company financials provided weaker signals about future cash flows (an example of ‘bad times’).\(^ {32}\)

Overall, during difficult market conditions, it became almost impossible for uninformed traders to assess the prospects of stock, and even informed traders began to rely on the views of other informed traders. This occurred particularly on a relative valuation basis, as during bad times, it was often easy to arrive at a conflicting view or companies often lacked the resources to adequately value a company and had to rely on other analysts’ abilities to gather and price in information.

In 2015, researchers gathered the transcripts of 46,000 analyst conference calls that occurred between 2002 and 2013, and demonstrated that investors placed significant value on analyst views because analysts were/are viewed as informed investors who offer a superior understanding of companies and their prospects.\(^ {33}\)

At this, an increased amount of analyst coverage typically causes investors to believe that more superior information will be priced into a stock’s prospects and value.

THE FIRM-SIZE EFFECT OF ANALYST COVERAGE

In 1989, it was argued that larger companies tended to be more appealing to analysts while smaller firms experienced the opposite, causing smaller firm stock prices to move slower and/or irrationally.\(^ {34}\) This was mainly owed to the significant costs involved in following and analysing companies as well as the payoff usually coming in higher for following larger companies. This caused smaller companies whose prospects were more difficult to forecast to attract little-to-no analyst coverage and subsequently trade more thinly.

Ironically, smaller companies were in line to benefit the most from analyst coverage off their limited visibility, higher agency costs, larger uncertainty and higher information asymmetry. This
had become such an issue, that the SEC released a statement in 2006 that suggested that up to 83% of US firms with market caps less than $125 million had no coverage\(^\text{35}\). In the same year, the SEC Advisory Committee on Smaller Public Companies officially endorsed the paid-for research model and recommended the SEC to actively encourage it as a means for companies to obtain analyst coverage and remedy the problem.

The issue was unfortunately still prevalent in 2009, when it was protested that over the past 20 years, the number of firms listed on public exchanges had dropped by over 20% and was at least partly due to analysts failing to cover small- and mid-capitalisation stocks\(^\text{36}\). The issue caught the eye of the press as they too begun to speculate over the matter that small and medium-capitalisation firms were increasingly losing analyst coverage. (See for example, the Economist, 2009, High-speed slide, November 14, 2009, 85–86.).

**THE DRAWBACKS OF LOSSES IN ANALYST COVERAGE**

In 2012, researchers analysed a sample of 12,600 companies that went without any analyst coverage for at least one year, between 1983 and 2004. Their research showed that companies that lost all analyst coverage for one year had a significantly higher probability of delisting than their covered peers\(^\text{37}\). Such companies showed a significantly higher delisting occurrence, with companies that experience one year without analyst coverage to be 11% more likely to delist than their peers. In addition, firms with complete losses of coverage were significantly more likely to delist than firms experiencing large but not complete losses of coverage.

They also found that analysts usually dropped coverage of a firm due to that firm’s poor performance and were usually reluctant to resume coverage. This caused a ripple effect that negatively affects liquidity, turnover, and an institutional shareholder sell-off. As analysts turned off the spotlight and the company began to fall off the investment radar, the company’s survival odds in the financial markets dropped rapidly.

**THE NEED FOR MORE ANALYST COVERAGE IN EMERGING MARKETS**

In 2000, research indicated that stock prices in emerging markets contained less company-specific information as opposed to developed markets\(^\text{38}\). Their research proved that in emerging markets, information was not readily available and discouraged informed trading and therefore, prevented firm-specific information from being incorporated into stock prices.
In 2000 the immense difficulty in forecasting company prospects in emerging markets was also highlighted, owing to the lack of publicly available company-specific news due to less stringent requirements for information disclosure in certain parts of these markets\(^3\). The following year, evidence indicated that analyst coverage increased the rate with which prices embedded public information and ultimately, has the potential to remedy the issue\(^4\).

In 2004, researchers again reiterated this after having suggested that increased analyst coverage drastically lead to observed increases in firm value\(^5\). Thus, the benefits to be gained from collecting company-specific information might be high enough to provide more incentive for analysts to collect such information.

**CONCLUSION**

After careful review, we believe we have identified many benefits arising from analyst coverage. Particularly, such research provides value through introducing new and superior information to the market, ultimately moving stock prices and increasing liquidity.

**REFERENCES**


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