



SFB/Transregio 266

## ACCOUNTING FOR TRANSPARENCY

### Research on Corporate Transparency Element 16: Financial Analysts

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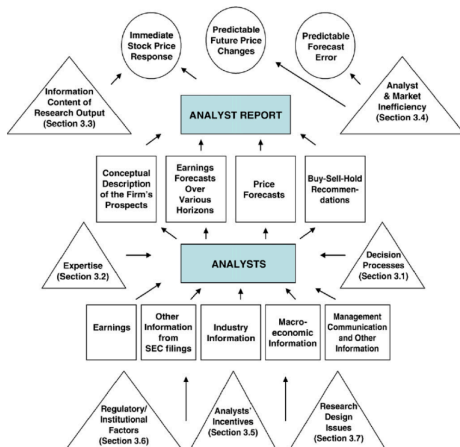
TRR 266 Accounting for Transparency

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## What characterizes an financial analyst?

- Financial analysts are employed by the “sell side” or the “buy side”
- On the sell side, institutions offer products to institutional and retail clients. E.g., brokerage firms that buy and sell securities for their clients.
- Sell-side financial analysts give buy, hold and sell recommendations, issue forecasts and provide analysts reports. This information is publicly available, but often only for (selected) clients
- On the buy side, institutions (e.g., mutual funds or hedge funds) make their own investment decisions
- Buy-side financial analysts use a variety of information sources (such as sell-side analyst reports) to produce investment recommendations for in-house portfolio managers. This information is not publicly accessible
- In the accounting literature, “financial analysts” generally refers to sell-side analysts.

## The sell-side analyst world



Ramnath et al. (International Journal of Forecasting, 2008, p. 37)

# What sell-side analysts do

## Daimler

(DAX, Automobile & Parts)



Hold	Value Indicators:	EUR	Share data:	Description:
EUR 75.00	DCF: 88.83	Boerse:	DAX BR	Automobile and commercial vehicle manufacturer
(EUR 74.00)	FCF-Value Potential avg.: 72.82	Reuters:	DAIGR	
	Self: 78.74	ISIN:	DE0007100000	
Price	Market Snapshot:	0.01 m	Shareholders:	Risk Profile (WRe):
EUR 70.80	Market cap: 70,742	Freefloat:	80.3 %	2016:
Upside	No. of shares (m): 1,079	Kursat:	7.6 %	Price / Book: 1.2 x
5.9 %	EV: 87,802	Renault/Nissan:	3.1 %	Equity Ratio: 28 %
	Freefloat M/G: 87,802			
	B Trade Vol (GB): 287.81			

### EUR 1bn positive net earnings impact from US tax reform and other tax issues

Daimler is expecting a positive effect on tax expenses to the tune of EUR 1.7bn in its FY 2017 accounts as a result of the US tax reform, the company announced on 22 December 2017. The reduction of the US federal income tax rate from 35% to 21% leads to revaluation of Daimler's deferred tax liabilities and deferred tax assets in the U.S. with the corresponding positive effect on net income.

The effect from the re-measurement of deferred tax assets does not have any impact on FY 2017 EBIT and FCF for the Daimler Group.

As some opposing effects on tax expenses from issues unrelated to the US tax reform, amounting to about EUR 0.7bn, must also be considered, the net positive effect on Daimler's net profit is expected to reach EUR 1bn.

Daimler is currently evaluating the impact of the US tax reform on its tax expenses from 2018 onwards. In addition to the reduction of the federal income tax rate some negative effects have to be considered here too.

We have considered the EUR 1bn positive impact on Daimler's tax expenses for FY 2017. For 2018 and 2019, we have reduced our tax rate estimate by 1pp to 30.8% and 30.7% respectively. In the scope of the DCF valuation, we have kept our tax rate assumption for the Industrial business constant at 30%. Revenues generated in the NAFTA region represent 29% of group sales.

Furthermore, Daimler said on 27 December that it is expecting sales of ca. 469k vehicles at its Daimler Trucks division for FY 2017 following a sales increase of 12% from January through November. This figure is broadly in line with our 464,250 estimate for volume sales for this division.

We confirm our Hold recommendation and slightly increase our PT from EUR 74 to EUR 75.

Changes in Estimates:						Comment on Changes:							
FY End 31.12.	2017e	+/-	2018e	+/-	2019e	+/-							
in EUR m	(m)		(m)		(m)								
Sales	153,279	0.0 %	166,300	0.9 %	176,800	0.6 %							
EBIT -xL	14,521	1.8 %	14,580	3.1 %	15,082	2.4 %							
EBIT	14,186	4.3 %	14,310	3.1 %	14,802	2.5 %							
EPS	6.98	11.0 %	6.91	0.9 %	6.30	-0.5 %							
DPS	5.50	0.0 %	5.50	2.9 %	5.65	1.4 %							
FY End 31.12. in EUR m													
2013	2014	2015	2016	2017e	2018e	2019e	2013	2014	2015	2016	2017e	2018e	2019e
Sales	117,862	126,872	146,407	153,281	163,341	176,259	117,862	126,872	146,407	153,281	163,341	176,259	178,219
Change Sales yoy	3.2 %	12.1 %	15.1 %	2.5 %	6.6 %	4.4 %	3.2 %	12.1 %	15.1 %	2.5 %	6.6 %	4.4 %	8.2 %
Group profit margin	21.3 %	21.7 %	20.9 %	20.9 %	20.9 %	20.9 %	21.3 %	21.7 %	20.9 %	20.9 %	20.9 %	20.9 %	20.5 %
EBITDA	15,187	15,780	18,570	18,360	20,360	21,943	15,187	15,780	18,570	18,360	20,360	21,943	23,413
Margin	12.3 %	12.1 %	12.4 %	12.0 %	12.2 %	12.1 %	12.3 %	12.1 %	12.2 %	12.0 %	12.2 %	12.1 %	12.0 %
EBIT	10,810	10,702	13,186	12,902	14,700	15,168	10,810	10,702	13,186	12,902	14,700	15,168	15,810
Margin	9.2 %	8.3 %	8.8 %	8.4 %	9.1 %	8.7 %	9.2 %	8.3 %	8.8 %	8.4 %	9.1 %	8.7 %	8.5 %
EBIT -xL	7,821	10,448	13,820	14,243	14,700	15,448	7,821	10,448	13,820	14,243	14,700	15,448	16,000
EPS	6.40	8.81	7.87	7.88	9.94	8.98	6.40	8.81	7.87	7.88	9.94	8.98	8.20
DPS	2.30	2.48	3.20	3.28	3.50	3.60	2.30	2.48	3.20	3.28	3.50	3.60	3.70
Dividend Yield	4.4 %	3.8 %	4.0 %	4.0 %	4.0 %	4.0 %	4.4 %	3.8 %	4.0 %	4.0 %	4.0 %	4.0 %	3.8 %
FCF/PS	4.70	4.18	3.47	3.78	4.31	3.68	4.70	4.18	3.47	3.78	4.31	3.68	3.71
FCF/Market cap	6.4 %	5.2 %	5.4 %	5.8 %	6.7 %	6.2 %	6.4 %	5.2 %	5.4 %	5.8 %	6.7 %	6.2 %	6.0 %
EV / Sales	0.4 x	0.5 x	0.5 x	0.4 x	0.4 x	0.4 x	0.4 x	0.5 x	0.5 x	0.4 x	0.4 x	0.4 x	0.4 x
EV / EBITDA	3.0 x	4.3 x	4.2 x	3.2 x	3.3 x	3.2 x	3.0 x	4.3 x	4.2 x	3.2 x	3.3 x	3.2 x	3.2 x
EV / EBIT	4.9 x	8.3 x	5.9 x	4.5 x	4.5 x	4.5 x	4.9 x	8.3 x	5.9 x	4.5 x	4.5 x	4.5 x	4.5 x
P / E	7.0 x	10.5 x	10.2 x	7.8 x	7.1 x	7.0 x	7.0 x	10.5 x	10.2 x	7.8 x	7.1 x	7.0 x	7.7 x
FCF/Potential Yield	6.0 %	4.6 %	5.1 %	7.6 %	8.6 %	7.2 %	6.0 %	4.6 %	5.1 %	7.6 %	8.6 %	7.2 %	7.8 %
Company events:													
01.02.18	BPC	Not Debt	-3,969	-4,147	-8,817	-11,589	-11,484	-11,370					
02.04.18	AUM	ROCE (NOPAT)	23.7 %	18.3 %	21.2 %	16.4 %	21.7 %	17.6 %	18.3 %				
26.04.18	Q1	Guidance	2017: IFRS EBIT significant ahead of 2018										
26.07.18	Q2												

## What information do they use?

*Survey Responses to the Question: How Useful Are the Following for Determining Your Earnings Forecasts (Stock Recommendations)?*

**Panel A: Summary statistics for the EF version**

Responses	Average Rating	Significantly Greater Than	% of Respondents Who Answered	
			Very Useful (5 or 6)	Not Useful (0 or 1)
(1) Your industry knowledge	5.15	2–11	79.35	0.54
(2) Private communication with management	4.70	5–11	65.76	3.26
(3) Earnings conference calls	4.67	5–11	61.96	1.63
(4) Management's earnings guidance	4.65	5–11	61.41	1.63
(5) Quality or reputation of management	4.22	9–11	46.45	2.73
(6) Recent earnings performance	4.18	9–11	41.30	3.26
(7) Recent 10-K or 10-Q	4.16	9–11	42.39	4.89
(8) Primary research (e.g., channel checks, surveys, etc.)	3.96	9–11	46.20	14.13
(9) Other analysts' earnings forecasts <sup>a</sup>	2.16	11	7.07	36.41
(10) Your stock recommendation <sup>a</sup>	2.06	11	7.07	42.39
(11) Recent stock price performance	1.72	–	3.80	46.74
Total possible $N = 184$				

*(Continued)*

Column 1 reports the average rating, where higher values correspond to greater usefulness. Column 2 reports the results of *t*-tests of the null hypothesis that the average rating for a given item is not different from the average rating of the other items. We report the rows for which the average rating significantly exceeds the average rating of the corresponding items at the 5% level, and use Bonferroni-Holm-adjusted *p*-values to correct for multiple comparisons. Column 3 (4) presents the percentage of respondents indicating usefulness of 5 or 6 (0 or 1).

Brown et al. (JAR, 2015, p.11)

## Conflicts of interests for sell-side analysts

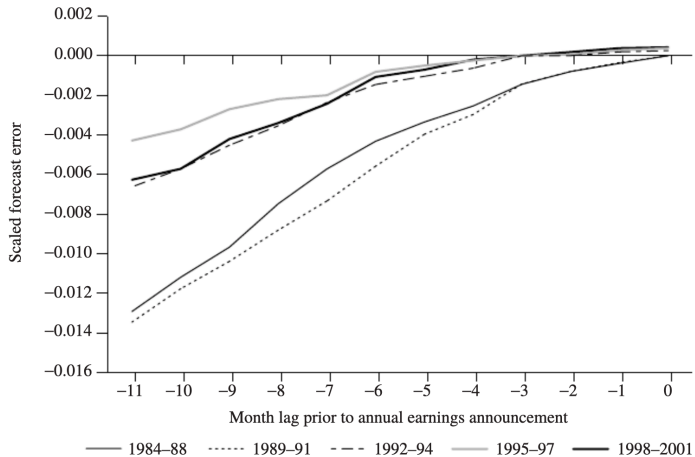
*Survey Responses to the Question: How Important Are the Following to Your Compensation?*

Responses	Average Rating	Significantly Greater Than	% of Respondents Who Answered	
			Very Important (5 or 6)	Not Important (0 or 1)
(1) Your industry knowledge	4.95	3–9	72.18	1.93
(2) Your standing in analyst rankings or broker votes	4.73	5–9	66.85	4.97
(3) Your accessibility and/or responsiveness	4.73	5–9	63.54	2.21
(4) Your professional integrity	4.69	5–9	63.99	3.60
(5) Your written reports	4.17	7–9	38.95	2.76
(6) Your relationship with management of the companies you follow	4.14	8–9	44.63	7.16
(7) The profitability of your stock recommendations	3.94	9	35.08	5.52
(8) Your success at generating underwriting business or trading commissions	3.65	–	44.20	20.17
(9) The accuracy and timeliness of your earnings forecasts	3.59	–	24.10	7.76
Total possible $N = 363$				

Column 1 reports the average rating, where higher values correspond to greater importance. Column 2 reports the results of  $t$ -tests of the null hypothesis that the average rating for a given item is not different from the average rating of the other items. We report the rows for which the average rating significantly exceeds the average rating of the corresponding items at the 5% level, and use Bonferroni-Holm-adjusted  $p$ -values to correct for multiple comparisons. Column 3 (4) presents the percentage of respondents indicating importance of 5 or 6 (0 or 1).

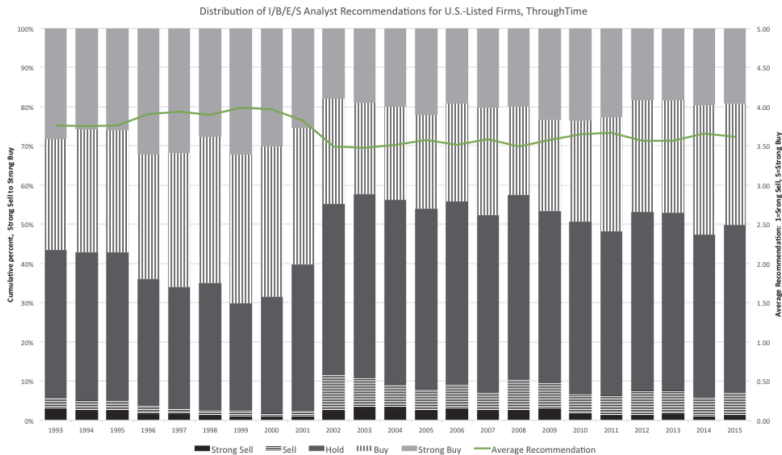
Brown et al. (JAR, 2015, p.26)

## Sell-side analyst biases: Walk-down of optimistic forecasts



Richardson et al. (CAR, 2004, p.898)

## Sell-side analyst biases: Stock recommendation bias



Bradshaw et al. (Foundation and Trends in Accounting, 2016, p.164)



## Sell-side analyst biases: Some Reasons

*Survey Responses to the Question: How Likely Are the Following Consequences to You of Issuing an Earnings Forecast (Stock Recommendation) that Is Well Below the Consensus?*

**Panel A: Summary statistics for the EF version**

Responses	Average Rating	Significantly Greater Than	% of Respondents Who Answered	
			Very Likely (5 or 6)	Very Unlikely (0 or 1)
(1) An <i>increase</i> in your investing clients' perception of your credibility	3.16	2–7	21.43	18.13
(2) Loss of access to management	2.53	3–7	16.48	32.97
(3) Being “frozen out” of the Q&A portion of future conference calls	2.21	6–7	13.59	43.48
(4) Damage to your employer's business relationship with buy-side clients who hold stock in the firm	1.94	6–7	6.01	43.17
(5) Damage to your employer's business relationship with the company	1.92	6–7	7.61	47.28
(6) Promotion less likely	0.76	–	1.63	77.72
(7) Lower bonus/compensation	0.74	–	1.09	78.80
Total possible $N = 184$				

Column 1 reports the average rating, where higher values correspond to greater likelihood. Column 2 reports the results of  $t$ -tests of the null hypothesis that the average rating for a given item is not different from the average rating of the other items. We report the rows for which the average rating significantly exceeds the average rating of the corresponding items at the 5% level, and use Bonferroni-Holm-adjusted  $p$ -values to correct for multiple comparisons. Column 3 (4) presents the percentage of respondents indicating likelihood of 5 or 6 (0 or 1).

Brown et al. (JAR, 2015, p.35)

## Sell-side analyst biases: Interview evidence

“It’s a needle you have to thread sometimes, between being intellectually honest yet not offensive. It’s always in the back of your mind, because one of the biggest things the buy-side compensates sell-side research firms for is corporate access: road shows, meetings, access to management teams. So you obviously want to keep an amicable relationship with the companies that you follow.”

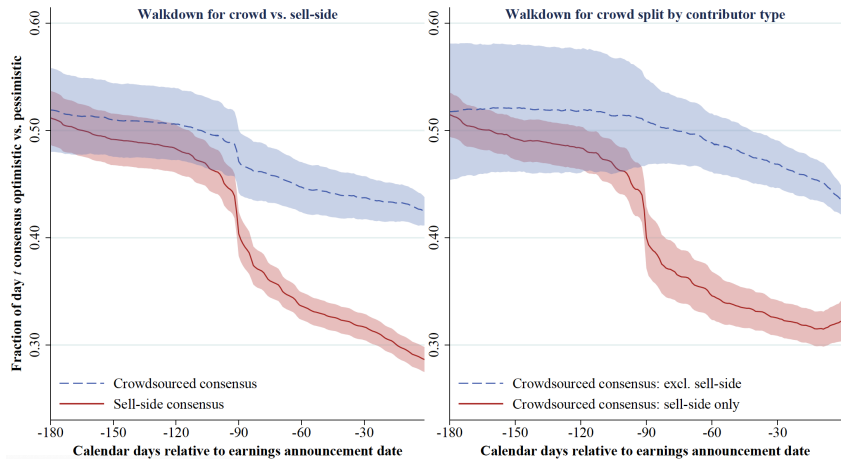
“Most of the sell-side is worried more about what management thinks of them than they are about whether they’re doing a good job for investors.”

“Something like two-thirds of our clients are long-only shops. So even if you have a sell, the best the client can do is either own less of it or just not own it. They can’t do much with a sell rating; unless they’re a hedge fund, they can’t profit directly from it.”

“Equity analysts ... are very, very reluctant —even after the Spitzer rules— to upset the investment bankers, because the investment bankers bring in so much more profitability ... They certainly realize that the success of their company is tied to the performance of this much higher-margin business than the business that they’re part of.”

— anonymous financial analysts, Brown et al. (JAR, 2015)

## Crowd-sourced forecasting



Schafhäutle and Veenman (SSRN, 2021, p.41)

## Do sell-side analysts add value?

- Currently, the most convincing evidence is based on “exogenous” brokerage closures (Kelly and Ljungqvist, RFS 2012) or mergers (Hong and Kacperczyk, QJE 2010)
- Coverage losses reduce liquidity, increase information asymmetry and cost of equity capital (Kelly and Ljungqvist, RFS 2012)
- Coverage loss seems to reduce asset growth (Derrien and Kecskés, JoF 2013) and increase managerial rent taking (Chen et al., JFE 2015) but also motivate managers to use accrual earnings management instead of real earnings management (Irani and Oesch, JFQA 2016)
- But: All these findings do not reflect the direct costs of analyst activities
- Also, they do not factor in alternative information intermediaries that might emerge when financial analysts “disappear”

- Bradshaw, Eritmur and O'Brian (Foundation and Trends in Accounting, 2016): <http://dx.doi.org/10.1561/14000000042>
- Brown, Call, Clement and Sharpe (JAR, 2015): <https://doi.org/10.1111/1475-679X.12067>
- Chen, Harford and Lin (JFE, 2015): <https://doi.org/10.1016/j.jfineco.2014.10.002>
- Derrien and Kecskés (JoF, 2013): <https://doi.org/10.1111/jofi.12042>
- Hong and Kacperczyk (QJE, 2010): <https://doi.org/10.1162/qjec.2010.125.4.1683>
- Irani and Oesch (JFQA, 2016): <https://doi.org/10.1017/S0022109016000156>
- Kelly and Ljungqvist (RFS, 2012): <https://doi.org/10.1093/rfs/hhr134>
- Ramnath, Rock and Shane (International Journal of Forecasting, 2008): <https://doi.org/10.1016/j.ijforecast.2007.12.006>
- Richardson, Teoh and Wysocki (CAR, 2004): <https://doi.org/10.1506/KHNW-PJYL-ADUB-ORP6>
- Schafhäutle and Veenman (SSRN, 2021): <http://dx.doi.org/10.2139/ssrn.3444144>