Conflicts of Interest and Research Quality of Affiliated Analysts: Evidence from IPO Underwriting

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Abstract

The quality of financial analysts' equity research is pivotal for an efficient capital market. This study investigates the quality of earnings forecasts and stock recommendations for initial public offerings (IPOs) in Germany. The empirical study includes 12,605 earnings forecasts and 6,209 stock recommendations of individual analysts for the time period from 1997 to 2004. The focus of this study is on analyzing the potential conflicts of interest and agency problems that arise when the analyst is affiliated with the underwriter of an IPO. In a universal banking system these conflicts of interest are usually more pronounced and therefore interesting to investigate. The empirical findings for the German financial market suggest that the earnings forecasts and stock recommendations of the analysts belonging to the lead-underwriter are on average inaccurate and biased, indicating some conflicts of interest. Moreover, the stock recommendations of the analysts that are affiliated with the lead-underwriter are often too optimistic resulting in a significant long-run underperformance. In contrast, analysts of the co-underwriter as well as unaffiliated analysts provide superior earnings forecasts and stock recommendations.

Keywords: conflicts of interest, research quality, analyst behavior, earnings forecasts, stock recommendations, initial public offerings, underwriting.