

Security Analysts and Market Reaction: Caveat for Monitoring

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Abstract

Security analysts, analyst forecast and market reaction are anecdotal in restructuring transactions, sometime conflicting and some other time imperative to the process of transaction. This article attempts to highlight a consistent association between analyst, market reaction and corporate restructuring. A close intermediation between those themes is analysed in this article, implying the relationship is contiguous. However issues of delayed price adjustment, conglomerate stock break-ups and negative earnings surprises are not discussed in this paper, though such factors are ingeniously important and crucial to the process of corporate restructuring.

Introduction

The volatility of stock price following restructuring has been a concern for firms and industry over decades. The premise behind restructuring entails a better value for share holders' return subsequently leading to enhanced performance of the firms. Nevertheless, the principal and agent conflict remains as the foremost determinant of restructuring. Most often security analysts signal information about the behaviour of share price to the investors, which in turn facilitates them to rationalise their expectation about the firms' future. Security analysts mainly rely on traditional indicators like price-earning-ratios, denoted as share price to its earnings per share and 'q' ratios, i.e., firms' market capitalisation to the book value of its assets to predict stock market. However the uncertainty surrounding stock market not always been reflected accurately by analysts forecast. The information asymmetry in conjunction with *efficient market hypothesis*, such as anyone trading on the public domain information can not earn a risk-adjusted return in excess of the information rather can only gain an overall return on the stock market on pure speculation remains debatable. In this paper a thematic discussion has been presented drawing upon arguments from the extant literature. In the main the constituent role of security analysts in corporate restructuring has been evaluated in the terms of market reaction.

The Economist and the World Bank in 2000 documented that the economies of Eastern Asia has registered a three times faster growth than the analysts forecasted a year ago. South Korea's GDP rose by 11%, Malaysia experienced a 6% growth, so as Indonesia and Thailand achieved 6% rise in their GDP during 2000(ADB, 2000). On such occasions the phenomenon of growth has been attributed to concerted economic and financial restructuring of the industries in those countries. Moreover in East Asia after post crisis era, corporate restructuring was perceived as a

comprehensive institutional framework to address corporate malaise. Over last 3 three decades similar measures were decided on to reform and institutionalise financial retirements in European and trans-Atlantic countries. Singh (1993) outlines that unlike the highly acquisitive period in the late 1960s; the 1980s have been marked by high levels of acquisitions, divestitures and buyouts. Sell-offs and changes in ownership structures are meaningful and popular in terms of potential impact they bring to the adjustment of capital structure of the firms and lowering of agency problems within relatively short span of time compared to expansion activities. Further Singh (1993) opines that restructuring is often considered by companies only after a period of sustained poor performance, culminating in action taken by stakeholders against them when they have wearied of accepting continued defaults in payment and/or breaches of undertakings given, including financial covenants.

Traditionally the firms are averse to continue with default debt to equity ratio lest the performance would decline. Typically a follow up scenario of restructuring is uncertainty where the value of any asset is not equal to the present discounted value of the future cash flow. Thus the stock market value does not reflect the present value of expected future dividend to shareholders; discounted at the appropriate risk adjusted interest payment. The outweighed debt to net present value of firms remains as a fundamental caveat concerning the firms' future. Essentially firms opt many ways to resolve untenable debts, some better than others. The best conceived way for a firm is to raise new equity and liquidate non-core businesses and assets to off-set debt by restructuring either operationally or financially. This makes firms to disengage from less profitable or loss-making businesses by downsizing and stipulating necessary financial exercise to increase its earnings and debt-service capacity. In some instances creditors reach at a consensus to convert debt into equity

or lower-yielding convertible bonds, though in practice most creditors, particularly institutional investors have serious reservation about this. The reason creditors are averse to such practices is that converting debt in to equity does not always capture the buoyancy of stock market. However creditors should not consider debt write-offs until they have exhausted all other possibilities, and they should obtain some instrument; such as equity, options, or warrants to protect their interest and participate in any recovery. In the light of Eastern Asian economic crisis, Backham (1999) and Haley (2000) suggest restructuring is a best effective way of addressing such issues in corporate sectors. However the benefit of restructuring has always been controversial and elusive but essentially it facilitates consolidation of firms' operational and financial covenants. Interestingly though stock momentum looks promising immediately after restructuring but in long run investors do not perceive that as the best signal for investment even if analysts favour the trend, rather they opt for a caution for the reason of negative stock surprise.

Security Analysts: Do they monitor?

Most often the role of security analyst in *modus operandi* of restructuring is perceived as key constituent of major decision making process. Doukas and Kim (2000) argue security analysts act as a monitoring mechanism to reduce the agency cost associated with separation of ownership and control of the firm. In essence, the separation of agent and principals' interest underpins the process of restructuring. Traditionally analysts forecast works as an index for stock market and influences investors' preferential decisions. Security analysts, therefore undertake measures to illustrate the volatility of market with caution, particularly following restructuring. Jensen and Meckling (1976) observed that the monitoring activity of security analysis helps reduce the agency costs related with the separation of ownership and control by

restraining the managers to non value maximising activities. Nonetheless, restructuring activities are essentially undertaken to mitigate this conflict. Interestingly Doukas and Kim (1998) reported that monitoring of multi-segment companies by security analysts fails to add shareholder value. As evidenced, if analysts fail to add value to shareholders, the purpose of restructuring is obviously not attained, which necessarily needs to maximise shareholders return. In that instance, the role of analysts is taken with scepticism both by market and investors.

However stock prices supposed to change effectively in analysts forecast of earnings than they do change in earnings themselves, showing the crucial importance of analysts earnings forecast. Security analysts enhance the firm specific information transparency by disseminating the information and increasing interest among potential investors. However information in public domain influences investors' preference over analyst's decision, no matter how astute they can be. Restructuring signifies value and performance changes of firms, which often taken as an institutional axiom. Nevertheless, in effect the creation of value essentially differs for different types of restructuring. In this context Jensen and Meckling (1976) outline that security analysts impart a positive influence on firm value. Lang, Stulz and Walking (1989) document abnormal returns in tender offers which is related to the Tobin's q ratio of the target and bidder. Furthermore they add that bidders with high Tobin's q have significant positive abnormal returns when they engage in restructuring transactions. They report that the best takeovers in terms of value creation are those with higher Tobin's q. In practice market react more to dividend changes of low q firms than to those of high q firms during share repurchases as a form of restructuring transactions. Most of the studies take five major performance measures to explain firm value and performance effects following restructuring transactions, such as; abnormal return on stock,

expenses/revenue, cash flow/ market value of the assets, return on equity and return on assets. The cash flow to market value of assets improve relative to industry, return on equity also improve relative to the industry, where as there is a positive significant abnormal return during announcement period resulting a cumulative excess return over the period of 1-3 years. The positive significant abnormal return mainly indicates that analysts' forecast has underlying effect in swaying investors' decision.

Womack (1996) found that stock prices are duly influenced by analyst forecast. Following a restructuring, when investors and market is interested to learn more about stock performance, analysts provide information which incentives shareholders risk adjusted return bringing in further investment from market. Doukas, McKnight and Pantzalis(2002) say despite the enormous growth of the information intermediaries industry, little is know about the influence of analyst coverage may have on firm value and the agency cost problem between managers and outside shareholders in the UK settings. Further, effectiveness of analyst coverage in restructuring and how it restricts the agency conflict is very sketchy. Moyer, Chatfield and Sisneros (1989) confirmed Jensen and Meckling's finding and indicated that analyst presence works as a potential monitoring mechanism in reducing agency cost. Also they reported evidence in support of stock prices are influenced by the analysts' forecast of earnings growth rates than historical growth rate measures. They further added that analysts could play an important role in making the security market more information efficient so the controlling mechanism for agency conflict should be positively related to the potential economic value of the information being generated. Their study is consistent with the evidence provided by Linke (1982); Peterson and Peterson (1982); Stanley, Lewellen, and Schlarbaum (1984); and Timme and Eisemann (1986). No doubt, reduction of agency cost is the key reason behind

undertaking restructuring, but does restructuring really address the issue? If it does, does the reduction of agency cost really restricts negative NPV investments of managers?

Every restructuring announcement and process has its own benefit of informing outside investors to rationalise the information in their advantage. However market does not always depicts a clear picture about share prices as much as analysts do. A number of theoretical studies suggest that the payment in restructuring activities related to the value of firms has a favourable effect on stock prices over a positive market reaction (Myers and Majluf, 1984; Fishman, 1989; and Brown and Ryngaert, 1991). Similarly Kaplan (1989) and Lichtenberg & Siegel (1989) found increased performance measures for the restructured firms suggesting that this enhanced performance is attributable to restructuring in sending a signal bearing positive effect on market; which subsequently reflects how market reacts to the restructuring announcement and maximises the market value of the restructured firms. This examines evidence from value maximisation hypothesis. This hypothesis has two prominent aspects. First, the *enhanced value maximisation hypothesis*, which predicts that initially the market will regard restructuring more favourably in response to value maximisation than performance enhancement subsequently leading to later one. Second, this provides evidence showing that the market's response to restructuring announcement has changed compared with past research, and further that there has been a change over the last decade. In this regard, the results found in the research of Chan(2001) provides evidence in favour of the *enhanced value maximisation hypothesis*, as firms on average earn positive abnormal returns following the announcement, compared with negative abnormal returns for companies in more stable industries. Significantly analysts' coverage contributes to realise positive

abnormal return on firms bringing investments form market, though the negative NPV investments of restructured firms' manager is not accurately explained . Furthermore, his findings also show that investors perceive restructuring add positive value to the firms.

The market reaction to the abnormal positive return of stock prices implies value creation through restructuring for the firms. In a different note, it is reasonably perceived that the effect of different restructuring transactions on analysts' forecasts usually assessed by both forecast accuracy and dispersion. On the contrary what market and investor achieve after restructuring, Chaney et al. (1999) provide evidence that analyst forecast accuracy is impaired by restructuring. However, they find no robust link between prior restructuring events and forecast accuracy. In contrast to the findings of Chaney et al., Lopez and Clement (2000) predict that analysts will learn from prior restructuring charges and have positive impact on firm's value. This result is consistent with the findings of Hanna (1999). Though, their results outline that restructuring creates uncertainty for analysts that lasts for at least two years subsequent to the announcement of the event. He further adds that types of transaction influence the analysts' coverage by providing information to investors to follow the market reaction. However, Hong and Stein (1999) make two key assumptions about analysts' forecast in terms of restructuring, first; firm specific information diffuses gradually across the investing public, second; investors can not perform rational expectation extracting information from price. Following this argument Gilson et al. (2001) suggested that analysts work as a conduit to generate information for the investing public informing them about the performance of the firms on the announcement of restructuring and following afterward. Furthermore, they implied that types of restructuring have crucial influence on analyst forecast. Similarly

Nandelstadh and Sandvall (2001) reported that analysts forecast significantly vary on the characteristics of value involved with restructuring. In the main the sequential and simultaneous warnings have different anecdotal evidence for one key content, i.e., it conjectures analysts' reputation. The negative and positive warning following a restructuring traditionally rely upon retrospective questions faced by industry, which subsequently warrants analysts to base their forecast on. However such aspects are more elaborately discussed in cognitive finance literature, which we believe is beyond the scope of this article.

Conclusion

Analysts essentially play a major role prior and posterior to restructuring, though market reaction do not always relate to forecast accuracy and firm evaluation in terms of earning based systematic difference on perceived credibility of management. Further, the restructured firms sometimes impair their market position by showing inadvertent proclivity towards the analysts' forecasts. Nevertheless debriefing the above discussing it emerges consistent with main empirical-archival literature that analysts and forecasting process are involved with significant under reaction and overreaction both by market participants, i.e., investors and shareholders alike. A more detailed exploration in this context is imperative, which needs further investigation to duly realise the dynamic nature of restructuring, analysts' forecasts and market reaction.

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