Companies with more financial analysts produce more and better-quality patents

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This study analyzes the relationship between innovation and the figure of the financial analyst. Credit: UC3M

A recent study conducted by researchers from the Universidad Carlos III de Madrid (UC3M), in collaboration with the Universidad Autónoma de Barcelona (UAB), explores the role of financial analysts on firms' innovation strategy and outcome. This study concludes that financial analysts can help companies to invest more efficiently in innovation and therefore produce a higher number of patents of better quality.

There are two effects through which financial analysts influence the innovation activity of firms. On the one hand, there is an information effect. Analysts collect firms' information and provide it to the investors, for instance, by writing reports about company activities. By reducing the information asymmetries between firms and the market, analyst coverage can increase CEO incentives to invest in innovation more efficiently.

On the other hand, there is a pressure effect. Analysts discipline managers' behavior through issuing periodic earnings forecasts. Missing the earnings forecasts is usually punished by investors. Since investments in innovation do not usually generate short-term income, managers have an incentive to cut expenditures in innovation when they have pressure to meet analyst earnings targets. "There is a tension, because financial analysts can have a positive as well as a negative effect on firms' innovation decisions," said one of the authors, AnnaToldrà-Simats, from the Business Administration Department of UC3M.

In the article, recently published in the *Journal of Financial Economics*, the authors identify these two effects and determine which effect dominates. "The positive information effect seems to dominate the negative pressure effect," said Anna Toldrà-Simats. "We have found that companies followed by more financial analysts are more likely to acquire other innovative companies, make corporate venture capital (CVC) investments, and reduce internal R&D expenses with little value added, which leads to a more efficient allocation of R&D resources," says co-author Bing Guo, also from the Business Administration Department of UC3M.

Professor David Pérez Castrillo, the other co-author from UAB, says, "Our study suggests that the disciplinary role of financial analysts leads companies to externalise their innovation activities, to make them more visible to the market. A certain level of supervision leads companies to make efficient decisions, also in terms of innovation." The study concludes that financial analysts lead to a better allocation of companies' R&D resources, an increase in the number of patents, and an improvement in their quality.

Characteristics of the companies included in the study

The study focuses on innovative companies, whether they are in high technology sectors, such as aerospace, IT or pharmaceutical industries, or in low technology sectors. The study shows that in terms of the type of innovation, analyst pressure and changes in R&D spending lead to less radical

innovation, while external acquisitions and CVC investments are related to more radical innovation.

In order to conduct this study, the research team analysed information from more than 3000 U.S. listed companies. "We have collected information from nine different databases, such as the companies' financial data, data on the financial analysts that follow these companies, and data on firms' innovation strategies, among others," says Bing Guo.

More information: Bing Guo et al. Firms' innovation strategy under the shadow of analyst coverage, *Journal of Financial Economics* (2018). DOI: 10.1016/j.jfineco.2018.08.005

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