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Corporate financial communication in Poland

The study of corporate financial statements, equity analyst reports and investor behavior

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Spis treści

2.2. Equity Analysts

Perhaps the greatest strength of the Polish market are the stock brokers, a professional group that developed rapidly during the early years of the economic transformation in order to support the rebirth of the free capital market. Stock brokers are licensed by a government body, the Polish Financial Supervisory Authority, to provide intermediation of trades and investment recommendations to the public (Parliament of Poland, 2005). Stock brokers and financial analysts do not tend to be licensed in developed markets, but Poland needed to quickly create the foundations for these professions and government intervention seemed to be the best solution. In addition, regulating access to professions has a long tradition in Poland where the number of licensed professions is about twice as high as in Germany. In 2014, the government considered deregulating the stock broker and investment advisor professions as part of a wide deregulation project. While one could certainly argue that these professions were developed well enough to support themselves without government intervention, there was an outcry against deregulation from the community including the Union of Brokers and Advisers. The government yielded and left the system of official exams and licenses in place.

The literature that deals with the equity analyst profession focuses on two issues which are relevant to the Polish setting: the role of analysts as information intermediaries and the behavioral bias that affects their recommendations. Regarding the role of analysts as information intermediaries it is useful to distinguish between sell-side and buy-side analysts. Sell-side analysts are employed by investment banks and brokerage firms to prepare and publish investment recommendations and analytical reports. The products of their work are usually distributed publicly without charging investors for access, although it can be possible for subscribed investors to obtain the recommendations before public dissemination (Fogarty & Rogers, 2005). Since their work is not financed by the readership of their reports it needs to be financed by other business of the institutions that employ them, which includes commissions on trading and income from corporate financial services. Consequently, sell-side analysts work in an environment where an inherent tension exists between their professional duty towards investors and the benefit their work brings to their employers. The literature does show that analysts tend to be biased towards making positive recommendations as it helps increase trading and strengthen relationships with corporations (Asquith et al., 2005; Mikhail et al., 2007). Analysts respond to these pressures by openly committing to codes of ethics and reiterating their professional integrity. The reputation of analysts is important to their employers, since only reputable analysts achieve the degree of visibility in the market that helps generate business. The awareness of bias in analyst recommendations reduces the market impact of buy recommendations relative sell recommendations (Mokoaleli-Mokoteli et al., 2009). The fact that bias exists and that market participants are aware of it suggests that the work of sell-side analysts contributes more to the market than just the biased investment recommendations: their industry knowledge presented in the reports that accompany recommendations (Imam & Spence, 2016).

Buy-side analysts are employed by investment management firms and institutional investors in order to gather information useful for investment decisions made by the firm. Their responsibility is towards the firm, not the public, which removes the conflicts of interest described above. Their work further differs from that of sell-side analysts as they do not build a reputation by making public recommendations and reports, nor do they specialize in selected industries. Instead, they need to obtain accurate information for the entire portfolio that their employer is engaged in. In order to manage their resources efficiently they rely on the reports written by sell-side analysts for broad, contextual information rather than gather it themselves. Sell-side analysts follow a limited number of companies, usually from one sector, which allows them to gather a broader range of information, develop personal contacts with the management, investigate companies more thoroughly, and eventually make more accurate assessments of company performance than buy-side analysts can (Imam & Spence, 2016).

The relations between the two groups of analysts are important in understanding the flow of information in the market. While sell-side analysts are more visible, it is buy-side analysts who have the direct influence on trading decisions of institutional investors and thus drive changes in stock prices. Consequently, issues of maintaining a public image and a good reputation are ostensibly important to sell--side analysts, but one must remember that fulfilling the information needs of buy-side analysts is their core role in the market. It may be surprising at first that "a well-understood connection between inputs and outputs in the work done by analysts does not seem to exist" (Fogarty & Rogers, 2005, p. 333), but it just serves to indicate that analysts produce useful information beyond the recommendation and target price (Mielcarz, 2016; Twedt & Rees, 2012). In any event, forecasts of target prices and earnings per share for individual companies cannot be accurate in a dynamic economic environment. Analysts respond to that challenge by a behavior called herding which involves making forecasts that are close to those of other analysts so as not to risk repeatedly making forecasts which are not only inaccurate but also contravened by other analysts. Only the highly reputable analysts can attempt to lead the herd by applying discretion in making forecasts and deviating from the consensus (Booth et al., 2014). Investors are aware of the rationale behind herding behavior: they tend to base their decisions on the consensus but they can recognize leading analysts.

The complexity of the setting in which analysts work is reflected in the results of the interviews that we carried out with analysts in Poland. When we began our interviews with a set of questions based on the fundamental notions from the literature, the first analyst we approached was quick to point out that we need to take a broader picture:

Maybe you should go to a brokerage firm and spend a few days with them, with someone, so that you would understand how this works, or with some traders. Because it seems to me… I get the idea from this conversation that you may have a wrong impression as to what is important and what is not [Analyst 2].

As mentioned before, sell-side analyst need to pass a professional exam at the PFSA to obtain a licence that allows them to publish reports and recommendations. While the major brokerage houses issue reports to the public, there are many analysts who serve private investors and never publish their reports. The analysts we interviewed underscore their technical abilities that allow them to produce useful reports:

Whether this is associated with a revision of the recommendation or not, that's a whole other issue. Mainly, we try to predict what will happen in the future and what effect the present events will have on what will happen in the future... and the cash flows of companies [Analyst 8].

Their work involves becoming familiar with the companies that they follow, so that they can form expectations about future performance, revise these expectations when results are published and learn from the past. When companies publish results, the first element that analysts notice are any deviations from previous forecasts and expectations that need to be explained and understood. The next element is the revision of forecasts which involves the assessment of whether the long-term trends have been altered or if the events that occurred are will only have a temporary effect. This is achieved by drawing information from a number of different sources and comparing them: financial statements, management disclosures and presentation, the press, the internet. Hard data is obviously important:

We are, we have more analytical brains, financial, not linguistic [Analyst 2].

The overall trends, the business story, form the background of the analysis. That is why the information contained in management reports and the notes to financial statements can be useful when an analysts initiates coverage of a new company or covers and initial public offering. Once an analyst knows a company well, he or she will be primarily interested in operational information:

We know very well what they will build, what they will do, and we can talk with them about how much money they will spend (…). I would say, about the fifteen companies that I follow, that I know quite well how they will spend their cash [Analyst 8].

Information from meetings with the management is a major element that allows analysts to form expectations about the future. Poland is small enough geographically to make it feasible for analysts to visit all companies, although that can be difficult during the reporting season. As one company representative stated:

Our investors, they are institutions, they prefer to talk one-on-one, to meet, to talk. Because it works that way, we know each other, that's the order of things which suits both them and us [CFO 9].

However, the information provided by the management needs to be corroborated, so it is best if the information provided to analysts during meetings is also available through other channels:

> *It's best if whatever the company tells investors during small meetings with institutional investors is also written in the report* [Analyst 2].

Analysts can find it frustrating if a company reserves too much information for personal meetings and analyst presentations:

> *And then you have to meet again to find out anything, right? That is, you know, I don't think that this is super sensitive information, but it is very useful for investors* [Analyst 3].

Direct contacts between the management and analyst can lead to selective disclosure practices that involve the management disclosing price sensitive information to chosen analysts. However, the analysts we talked to affirmed their values, cited compliance procedures and stated that such practices are damaging in the long run:

> *[The meetings,] this is not the grey area. It's only later, when people talk behind the scenes, but more and more companies learn not to engage in that. What's interesting is that many analysts learn that this does not lead anywhere. In my view it's a huge mistake to base on this grey area* [Analyst 6].

Summing up, the interview results suggest that Polish analysts function in a setting which is characterised by complexity similar to that found in developed markets. They are an important group of information intermediaries who facilitate the flow of information between management and investors. Sell-side analysts are employed by brokerage houses, so we can assume that the structure of their incentives causes a positive bias as described in the literature. In fact, all the analyst reports that we study include disclaimers stating that conflicts of interest may be present. Analysts who produce publicly available reports draw on a variety of sources and maintain contacts with the management to develop an understanding of the business models and strategies. The financial statements and regulated management disclosures provide allow them to revise their expectations and fine-tune their predictions. We study the use of communication strategies in analyst reports in the last chapter of the book.

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Companies listed on stock exchanges need to actively engage with investors. Little research has been done into corporate communication practices in emerging markets. The goal of this book is to fill this gap and describe select aspects of communication between companies listed on the Warsaw Stock Exchange, equity analysts and investors. We present the results of three empirical studies of financial texts written in the Polish language: financial reports, letters to shareholders and sell-side analyst reports. The studies combine the methods of finance and linguistic pragmatics to develop a rich picture of the causes and effects of financial communication.

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