Internet Appendix for
"The dark side of analyst coverage: The case of innovation"

This internet appendix provides robustness tests and supplemental analyses to the main results presented in "The Dark Side of Analyst Coverage: The Case of Innovation". Section A presents the robustness checks for the baseline results reported in Section 4 of the paper. Section B explores a possible rationale for the direct effect of analyst coverage on firm innovation: the adverse consequences of missing earnings targets.

A. Robustness checks for baseline results

We conduct a rich set of robustness tests for our baseline results and report them in Table A1. To save space, we only report the coefficient estimates for the key variable of interest, *LnCoverage*, and suppress those of all other controls.

First of all, we repeat the baseline OLS regressions by using various subsamples. We start with the subsample of firms that are in the S&P 500 index to check if our results are driven by small and young firms that are typically covered by fewer analysts but are more innovative. We report the results in Panel A. The coefficient estimates of *LnCoverage* are negative in both columns and significant at the 10% and 1% level, respectively, suggesting that our results hold for large and mature firms.

We then focus on the subsamples defined by firms' patenting, namely, firms with at least N (N = 1, 2, 3, or 5) patents in the sample period, and report the results in Panel B. We observe that the coefficient estimates of *LnCoverage* are all negative and significant at either 5% or 1% level, except for the case when we require N ≥ 5 and *LnPatent* is the dependent variable. Next, we impose stricter restrictions on the subsamples. In columns (1) and (2) of Panel C, we require the firms to have non-zero patents in most (more than 50%) of the years they appear in our sample. The coefficient estimates of *LnCoverage* are negative in both columns and significant at the 5% level in column (2). Third, in columns (3) and (4) of Panel C, we impose the strictest restriction by requiring the firms to have non-zero patents in every single year in the sample period. The coefficient estimates of *LnCoverage* are still negative in both columns but become insignificant. This loss in statistical significance mainly comes from a decrease in the power of the test due to the dramatic drop in sample size from 25,860 to 1,321.

We further examine subsamples defined by different thresholds of analyst coverage. We impose various threshold values for the average annual number of analysts a firm needs to have to appear in the subsample: N = 5, 15, or 25, and report the results in Panel D. In columns (1) and (2), we require $N \geq 5$ analysts. The coefficient estimates of *LnCoverage* are negative and significant at the 1% level in both columns. In columns (3) and (4), we require $N \geq 15$ analysts. The coefficient estimates of *LnCoverage* are negative in both columns and significant at the 1% level in column (4). In columns (5) and (6), we require $N \geq 25$ analysts. The coefficient estimates of *LnCoverage* are negative in both columns but not statistically significant. It is consistent with the findings in the Difference-in-Differences (DiD) framework reported in Table 3 Panel C of the paper, suggesting that the negative effect of analyst coverage on innovation disappears when firms are covered by many analysts.

Second, we check whether our baseline results are robust to alternative proxies for analyst coverage and innovation. We start with using alternative proxies for analyst coverage following Yu (2008) to address the concern that analyst coverage is associated with many factors that could also affect firms' innovation productivity. Specifically, we construct the "residual coverage" measure to remove the confounding effects of these factors. Following Yu (2008), we first estimate the model below:

$$\begin{aligned} LnCoverage_{i,t} &= \alpha + \beta_1 LnAssets_{i,t} + \beta_2 PastPerf_{i,t} + \beta_3 Growth_{i,t} + \beta_4 ExternalFinancing_{i,t} \\ &+ \beta_5 CFVolatility_i + Year_t + \varepsilon_{i,t} \end{aligned} \tag{A1}$$

where i indexes firm and t indexes time. Firm size is measured by the natural logarithm of total assets; past performance is measured by the lagged ROA; growth is measured by the growth rate of total assets; external financing activities are measured by the net cash proceeds from equity and debt financing scaled by total assets; and cash flow volatility is measured by the standard deviation of cash flows of a firm in the entire sample period, scaled by lagged assets. We then take the residual from the above regression, label it *ResCoverage*, and use it as an alternative analyst coverage measure in the robustness tests. Panel E reports the results. In columns (1) and (2), we report the OLS results. The coefficient estimates of *ResCoverage* are negative and significant at the 1% level in both columns. In columns (3) and (4), we report the 2SLS results with *ResCoverage* instrumented by *ExpCoverage*, discussed in Section 5.2 of the paper, to address the endogeneity concern. We continue to observe negative and statistically significant coefficient estimates.

Next, we check whether our results are robust to alternative proxies for innovation activities. While, as we discussed in the paper, R&D is a noisy measure for only one of the many observable innovation inputs, we use it as an alternative innovation proxy and report the results in Panel F. We find that analyst coverage is negatively related to a firm's R&D expenditures only in the contemporaneous year. However, we do not find analyst coverage to be significantly associated with a firm's R&D expenditures in subsequent years. These findings are consistent with the notion that the short-term pressure imposed by analysts tends to affect innovation input (e.g., R&D expenditures) quickly, but it takes a longer time to observe its total effect on innovation output (e.g., patents and citations).

Third, besides the pooled OLS specification, we use a few alternative econometric models to check the robustness of the baseline results. We start with the Poisson model when the dependent variable is the number of patents to take care of the discrete nature of patent counts and report the results in Panel G. The coefficient estimate of *LnCoverage* is negative and significant at the 1% level in column (1) when the number of three-year-ahead patents is the dependent variable. We also use the zero-inflated Poisson model (reported in column (2)) and find consistent results. If we look at the number of patents generated five years down the road, we obtain similar results, as shown in columns (3) and (4). Next, since our dependent variables, patents and non-self citations, are right skewed (e.g., less than half of our sample have a non-zero number of patents), we adopt the quantile regression model at the 80th percentile.[1] We report the results in Panel H. The baseline results continue to hold. We obtain similar findings if we run the quantile regressions at the 75th, the 85th, or the 95th percentile. Further, given the non-negative nature of patent and citation data, we use the censored quantile regression (CQR) model, which places no requirement on the distribution of the errors and produces consistent estimates in the presence of heteroskedastic errors for censored innovation variables. The results are reported in Panel I and are robust. The coefficient estimates of *LnCoverage* are negative and significant.

Furthermore, a reasonable concern is that large firms often enhance their innovation through acquisitions of innovative target firms (Sevilir and Tian, 2012). In the meantime, analyst coverage for such firms may also change after their acquisitions are completed. This is because

[1] Since the quantile regression model is non-linear and does not converge if firm fixed effects are included, we de-mean all variables at the firm level to absorb any time-invariant firm characteristics before running the quantile regressions. Similarly, we only controlled for industry fixed effects when running the Poisson model because including firm fixed effects will adversely affect model convergence. Due to the count data nature for patents, we could not demean it at the firm level for the Poisson model.

the analysts who covered the target firm, now as a new subsidiary of the acquirer, may choose to cover the acquirer after the transactions (Tehranian, Zhao, and Zhu, 2010). Therefore, our baseline findings may be affected by firms' acquisitions. To address this concern, we construct a variable, *AcqAssets*, which equals a firm's acquisition expenditures normalized by its total assets, and include it in our set of controls. We report the results in Panel J and observe consistent results with our baseline findings.

Finally, Panel K reports the baseline OLS results after excluding R&D from the set of control variables. Panel L examines the effect of firm innovation on its market valuation (one-year-ahead Tobin's Q). We discuss the findings reported in these two panels in the paper.

Overall, the comprehensive robustness checks presented in this section for the baseline results reported in Section 4 of the paper suggest that the negative relation between analyst coverage and firm innovation is robust to alternative subsamples, alternative proxies for analyst coverage and innovation, alternative econometric models, and alternative empirical specifications.

B. A possible rationale for the direct effect of analysts on innovation

While we show a direct (residual) effect of analyst coverage on innovation in the main text of our paper, a natural question that comes up is how financial analysts have the ability to directly alter managers' incentives of investing in long-term innovative projects. In this section, we attempt to explore a possible rationale for the direct effect of analyst coverage on firm innovation: the adverse consequences of missing earnings targets.

A large body of literature has shown that controlling for firm size and other relevant factors, more analyst coverage is associated with a faster and more complete price adjustment to both market-wide common information (Brennan, Jegadeesh, and Swaminathan, 1993) and firm-specific information (Hong, Lim, and Stein, 2000; Gleason and Lee, 2003). These findings imply that if a firm is followed by a larger number of analysts, its managers will have a stronger incentive to avoid missing earnings target because such bad news will be more rapidly and fully incorporated into its stock price, which ultimately reduces the managers' compensation and hurts their reputation and future career. Such adverse consequences to managers include significant declines in the firms' stock prices (Bartov, Givoly, and Hayn, 2002) and therefore managers' stock-based compensation, reduced CEO bonuses (Matsunaga and Park, 2001), and an increased probability of management turnover (Mergenthaler, Rajgopal, and Srinivasan, 2011). Therefore, the adverse consequence of missing earnings targets when followed by a large number of analysts is a substantive threat to managers, who will in turn respond to such pressure by cutting back investment in innovative projects.

To test this conjecture, we examine how market reactions to negative earnings surprises (i.e., when firms miss their earnings targets) are related to the number of analysts following the firms. We first construct a sample of firms that report negative quarterly earnings surprises in our sample period, i.e., the reported earnings fall short of the consensus forecast outstanding at the earnings announcement. We define the consensus forecast as the median earnings per share forecasted by analysts in the three months prior to the announcement date. We compute cumulative abnormal returns (CARs) over a two-day [-1, 0] window around the earnings announcement date, as well as three-day [-1, +1], four-day [-1, +2], and five-day [-2, +2] event windows. We use the CRSP value-weighted return as the market return and estimate the market model parameters over 200 trading days ending 50 trading days before the announcement date.[2]

In an untabulated univariate analysis, we observe strong and significantly adverse market reactions to negative earnings surprises (both for mean and median values of CARs and for all four event windows considered here), which is consistent with the existing literature. In Table A2, we report the regression results estimating the following model:

$$CARs_{i,t} = \alpha + \beta LnCoverage_{i,t} + \gamma X_{i,t} + Firm_i + Year_t + Quarter_t + \varepsilon_{i,t} \qquad \text{(A2)}$$

where i indexes firm and t indexes time. The observational unit of our analysis is firm-quarter. The dependent variables are the CARs calculated based on the four different event windows. *LnCoverage* is the natural logarithm of one plus the average number of analysts following the firm over the three months prior to the earnings announcement date. We follow Hotchkiss and Strickland (2003) to construct a vector of control variables, X, which includes: (1) the magnitude of unexpected earnings (*ForecastError*); (2) the price-earnings ratio based on the stock price 30 days prior to the announcement (*PEratio*); (3) the natural logarithm of the quarterly market value of equity (*LnMV*); (4) the quarterly Tobin's Q (*TobinQ)*; (5) the average of annual sales growth over the prior three years (*SalesGrowth*); (6) the quarterly dividend yield (*DivYield*); (7) the average market-adjusted stock return for the 12 months prior to the announcement (*Runup*); and (8) the institutional ownership at the calendar quarter end prior to the current quarter (*InstOwn*).

[2] Our results are robust if we use CRSP equal-weighted returns as the benchmark return.

We obtain quarterly firm accounting information from Compustat Quarterly database. $Firm_i$, $Year_t$, and $Quarter_t$ capture firm, year, and quarter fixed effects, respectively. We cluster standard errors at the firm level.

The coefficient estimates of *LnCoverage* are negative and significant in all four columns, suggesting that firms followed by more analysts experience a larger (more negative) stock price reaction when they fail to meet consensus earnings targets. Based on the coefficient estimates reported in column (2), increasing analyst coverage by one from its sample median (4.58) is associated with a 0.12% drop in cumulative abnormal stock returns during the three-day period [-1, +1], which is economically nontrivial, given that the mean of CARs for the same window in our sample is -1.1%.[3]

Overall, the evidence suggests that more analyst coverage is related to a larger decline in stock returns if a firm misses its earnings target. To avoid potential severe consequences such as a reduction in stock-based compensation, a loss of reputation, as well as damage to their future career prospects, the firm managers, when followed by a large number of analysts, may cut down long-term investments in innovation to avoid missing near-term earnings targets, which could partially explain the direct effect of financial analysts on firm innovation.

[3] For completeness, we also examined how the CARs upon positive earnings surprises (i.e., when a firm beats its earnings target) are related to the number of analysts following the firm. We do not find analyst coverage significantly affects CARs. This finding is consistent with the implication of the evidence reported in Hong, Lim, and Stein (2000) who conclude that analyst coverage makes a difference mainly for negative news but not for positive news.

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Table A1

Additional robustness tests for baseline regressions.

This table reports various robustness tests for the baseline regression. Panel A reports the results using the S&P 500 firms. Panels B and C report the tests using subsamples defined by firm' patenting. Panel D reports the results using subsamples defined by different thresholds of analyst coverage. Panel E reports the results using an alternative proxy for analyst coverage: *ResCoverage* that is constructed as the residuals from the following model: $LnCoverage_{i,t} = \alpha + \beta_1 LnAssets_{i,t} + \beta_2 PastPerf_{i,t} + \beta_3 Growth_{i,t} + \beta_4 ExternalFinancing_{i,t} + \beta_5 CFVolatility_i + Year_t + e_{i,t}$, where $LnAssets_{i,t}$ is measured by the natural logarithm of total assets, $PastPerf_{i,t}$ is measured by the lagged ROA, $Growth_{i,t}$ is measured by the growth rate of total assets, $ExternalFinancing_{i,t}$ is measured by the net cash proceeds from equity and debt financing scaled by total assets, and $CFVolatility_i$ is measured by the standard deviation of cash flows of a firm in the entire sample period, scaled by lagged assets. Panel F reports the results using an alternative proxy for innovation: R&D expenditures per share. Panel G reports the results using the Poisson model. Panel H reports the results using the quantile regression model. Panel I reports the results using the censored quantile regression model. Panel J reports the results after controlling for a firm's acquisition expenditures. Panel K reports the results after excluding R&D from the set of control variables. Panel L examines the effect of firm innovation on its market valuation. ***, **, and * indicate significance at the 1, 5, and 10 percent levels, respectively.

Panel A: S&P 500 firms

	(1)	(2)
Dep. Var.	$LnPatent_{t+3}$	$LnCitePat_{t+3}$
LnCoverage	-0.072*	-0.197***
	(0.041)	(0.039)
Controls	Yes	Yes
Firm fixed effects	Yes	Yes
Year fixed effects	Yes	Yes
Observations	5,349	5,349
R^2	0.869	0.676

Panel B: Firms with at least N patents over the sample period (N = 1, 2, 3, 5)

	Patent≥1		*Patent≥2*	
	(1)	(2)	(3)	(4)
Dep. Var.	$LnPatent_{t+3}$	$LnCitePat_{t+3}$	$LnPatent_{t+3}$	$LnCitePat_{t+3}$
LnCoverage	-0.050**	-0.078***	-0.049**	-0.070***
	(0.020)	(0.021)	(0.022)	(0.022)
Controls	Yes	Yes	Yes	Yes
Firm fixed effects	Yes	Yes	Yes	Yes
Year fixed effects	Yes	Yes	Yes	Yes
Observations	14,141	14,141	12,699	12,699
R^2	0.804	0.619	0.796	0.629

	Patent≥3		*Patent≥5*	
	(5)	(6)	(7)	(8)
Dep. Var.	$LnPatent_{t+3}$	$LnCitePat_{t+3}$	$LnPatent_{t+3}$	$LnCitePat_{t+3}$
LnCoverage	-0.052**	-0.075***	-0.040	-0.068***
	(0.024)	(0.023)	(0.025)	(0.024)
Controls	Yes	Yes	Yes	Yes
Firm fixed effects	Yes	Yes	Yes	Yes
Year fixed effects	Yes	Yes	Yes	Yes
Observations	11,863	11,863	10,793	10,793
R^2	0.789	0.641	0.781	0.652

Panel C: Firms generating patents more than 50% of years or every year in our sample

	Patent Most Year		*Patent Every Year*	
	(1)	(2)	(3)	(4)
Dep. Var.	$LnPatent_{t+3}$	$LnCitePat_{t+3}$	$LnPatent_{t+3}$	$LnCitePat_{t+3}$
LnCoverage	-0.035	-0.050**	-0.004	-0.026
	(0.031)	(0.025)	(0.057)	(0.065)
Controls	Yes	Yes	Yes	Yes
Firm fixed effects	Yes	Yes	Yes	Yes
Year fixed effects	Yes	Yes	Yes	Yes
Observations	8,403	8,403	1,321	1,321
R^2	0.765	0.716	0.913	0.840

Panel D: Firms with an average of at least N analysts over the sample period (N = 5, 15, 25)

	Coverage≥5		*Coverage≥15*	
	(1)	(2)	(3)	(4)
Dep. Var.	$LnPatent_{t+3}$	$LnCitePat_{t+3}$	$LnPatent_{t+3}$	$LnCitePat_{t+3}$
LnCoverage	-0.087***	-0.110***	-0.081	-0.162***
	(0.021)	(0.021)	(0.065)	(0.060)
Controls	Yes	Yes	Yes	Yes
Firm fixed effects	Yes	Yes	Yes	Yes
Year fixed effects	Yes	Yes	Yes	Yes
Observations	12,456	12,456	3,422	3,422
R^2	0.850	0.654	0.881	0.693

	Coverage≥25	
	(5)	(6)
Dep. Var.	$LnPatent_{t+3}$	$LnPatent_{t+3}$
LnCoverage	-0.136	-0.066
	(0.424)	(0.319)
Controls	Yes	Yes
Firm fixed effects	Yes	Yes
Year fixed effects	Yes	Yes
Observations	521	521
R^2	0.869	0.803

Panel E: Residual coverage

	OLS		2SLS (2nd stage)	
	(1)	(2)	(3)	(4)
Dep. Var.	$LnPatent_{t+3}$	$LnCitePat_{t+3}$	$LnPatent_{t+3}$	$LnCitePat_{t+3}$
ResCoverage	-0.067***	-0.096***	-0.115***	-0.159***
(or instrumented)	(0.016)	(0.018)	(0.024)	(0.026)
Controls	Yes	Yes	Yes	Yes
Firm fixed effects	Yes	Yes	Yes	Yes
Year fixed effects	Yes	Yes	Yes	Yes
Observations	25,750	25,750	13,389	13,389
R^2	0.834	0.621	0.148	0.255

Panel F: R&D expenditures per share as the dependent variable

	(1)	(2)	(3)	(4)	(5)
Dep. Var.	$R\&D_t$	$R\&D_{t+1}$	$R\&D_{t+2}$	$R\&D_{t+3}$	$R\&D_{t+5}$
LnCoverage	-0.027***	-0.011	-0.014	-0.006	0.005
	(0.008)	(0.008)	(0.008)	(0.008)	(0.009)
Controls	Yes	Yes	Yes	Yes	Yes
Firm fixed effects	Yes	Yes	Yes	Yes	Yes
Year fixed effects	Yes	Yes	Yes	Yes	Yes
Observations	35,936	33,477	30,717	25,829	18,224
R^2	0.868	0.868	0.872	0.878	0.899

Panel G: Poisson regressions

Dep. Var.	*Patent*$_{t+3}$	*Patent*$_{t+3}$	*Patent*$_{t+5}$	*Patent*$_{t+5}$
	(1)	(2)	(3)	(4)
	Ordinary Poisson	*Zero-inflated Poisson*	*Ordinary Poisson*	*Zero-inflated Poisson*
LnCoverage	-0.129***	-0.144***	-0.105*	-0.103*
	(0.047)	(0.047)	(0.060)	(0.062)
Controls	Yes	Yes	Yes	Yes
Ind fixed effects	Yes	Yes	Yes	Yes
Year fixed effects	Yes	Yes	Yes	Yes
Observations	25,195	25,195	22,037	22,037

Panel H: Quantile regressions

	(1)	(2)
Dep. Var.	*LnPatent*$_{t+3}$	*LnCitePat*$_{t+3}$
LnCoverage	-0.013**	-0.066***
	(0.007)	(0.010)
Controls	Yes	Yes
Ind fixed effects	Yes	Yes
Year fixed effects	Yes	Yes
Observations	25,691	25,691
Pseudo R^2	0.055	0.095

Panel I: Censored quantile regressions

	(1)	(2)
Dep. Var.	*LnPatent*$_{t+3}$	*LnCitePat*$_{t+3}$
LnCoverage	-0.013**	-0.053***
	(0.005)	(0.007)
Controls	Yes	Yes
Year fixed effects	Yes	Yes
Observations	25,860	25,860
Pseudo R^2	0.053	0.090

Panel J: Controlling for acquisition expenditures

Dep. Var.	(1) *LnPatent*$_{t+3}$	(2) *LnCitePat*$_{t+3}$
LnCoverage	-0.064***	-0.075***
	(0.017)	(0.019)
Controls	Yes	Yes
Firm fixed effects	Yes	Yes
Year fixed effects	Yes	Yes
Observations	24,470	24,470
R^2	0.832	0.621

Panel K: Baseline regressions without R&D as a control

Dep. Var.	(1) *LnPatent*$_{t+3}$	(2) *LnCitePat*$_{t+3}$
LnCoverage	-0.050***	-0.075***
	(0.017)	(0.019)
Controls	Yes	Yes
Firm fixed effects	Yes	Yes
Year fixed effects	Yes	Yes
Observations	25,860	25,860
R^2	0.833	0.619

Panel L: The effect of patent and citations on Tobin's Q

Dep. Var.	(1) *TobinQ*$_{t+1}$	(2) *TobinQ*$_{t+1}$
LnPatent	0.022*	
	(0.013)	
LnCitePat		0.061***
		(0.008)
Controls	Yes	Yes
Firm fixed effects	Yes	Yes
Year fixed effects	Yes	Yes
Observations	42,771	42,771
R^2	0.672	0.672

Table A2

Regressions of CARs around earnings announcements on analyst coverage.

This table reports regressions of the cumulative market model abnormal returns (CARs) over different windows around quarterly earnings announcement on analyst coverage when the reported earnings fall short of the consensus forecast outstanding at the earnings announcement date. *LnCoverage* is the natural logarithm of one plus the average number of analysts following the firm over the three months prior to the earnings announcement date. The other explanatory variables include: forecast error (*ForecastError*), which is the difference between the reported quarterly earnings and the consensus analyst forecast (the median analyst forecast over the three months prior to the earnings announcement date), deflated by the stock price 30 days prior to the announcement; the price-earnings ratio based on the stock price 30 days prior to the announcement (*PEratio*); the natural logarithm of the quarterly market value of equity (*LnMV*); the quarterly Tobin's Q (*TobinQ)*; the average of annual sales growth over the prior three years (*SalesGrowth*); the quarterly dividend yield (*DivYield*); and the average market-adjusted stock return for the 12 months prior to the announcement (*Runup*). Each regression includes a separate intercept as well as year, quarter, and firm fixed effects. Robust standard errors clustered by firm are displayed in parentheses. ***, **, and * indicate significance at the 1, 5, and 10 percent levels, respectively.

	(1)	(2)	(3)	(4)
Dep. Var.	$CAR_{-1,0}$	$CAR_{-1,+1}$	$CAR_{-1,+2}$	$CAR_{-2,+2}$
LnCoverage	-0.002**	-0.006***	-0.004***	-0.003**
	(0.001)	(0.001)	(0.001)	(0.002)
ForecastError	0.109***	0.207***	0.235***	0.256***
	(0.013)	(0.018)	(0.019)	(0.021)
PEratio	-0.000*	-0.000**	-0.000***	-0.000***
	(0.000)	(0.000)	(0.000)	(0.000)
LnMV	-0.009***	-0.013***	-0.015***	-0.017***
	(0.001)	(0.001)	(0.001)	(0.001)
TobinQ	-0.000	-0.000	-0.000	-0.000
	(0.001)	(0.001)	(0.001)	(0.001)
SalesGrowth	-0.001	0.000	0.000	0.000
	(0.001)	(0.001)	(0.001)	(0.001)
DivYield	0.091	0.185	0.212	0.174
	(0.147)	(0.193)	(0.219)	(0.225)
Runup	-0.108***	-0.198***	-0.266***	-0.300***
	(0.012)	(0.017)	(0.018)	(0.020)
InstOwn	-0.009***	-0.017***	-0.016***	-0.022***
	(0.003)	(0.004)	(0.005)	(0.005)
Firm fixed effects	Yes	Yes	Yes	Yes
Year fixed effects	Yes	Yes	Yes	Yes
Quarter fixed effects	Yes	Yes	Yes	Yes
Observations	65,830	65,830	65,831	65,831
R^2	0.176	0.196	0.197	0.198