Impact of companies’ internal factors on stock liquidity in Baltic markets

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Abstract

Together with such essential characteristics as expected return and risk, the aspect of liquidity is especially important to investors when they decide which stock is investment-attractive. Under the same economic conditions, liquidity of individual stocks is significantly different, so the question arises – what internal factors of a company have the greatest impact on stock liquidity.

The purpose of this paper is to investigate which internal factors of companies are most affecting the stock liquidity in markets of the Baltic countries. The research was performed in two parts. In the first part, the stock liquidity of Baltic companies was analyzed as well as its changes during the period of 2005 – 2012. In the second part, it was investigated the dependence between the stock liquidity of the Baltic companies and the company-level factors, such as size of a company, return on assets, liquidity of assets, financial leverage, fact of profit/loss, market to book value of assets ratio.

The research evidenced that the higher liquidity of the stock of Estonian companies was significantly influenced by higher financial leverage, higher liquidity of assets, and profit. The stock liquidity of Latvian companies during the period of 2005–2012 was influenced only by size of the companies. The stock liquidity of Lithuanian companies during the research period was influenced positively only by the size of the companies and return on assets; however financial leverage had a negative impact.

Keywords: Stock liquidity; bid-ask spread; corporate financial ratios; Baltic stock markets.

1. Introduction

The significant impact on decision about investment-attractiveness of a stock is made not only by expected return, stability of a company, openness to investors, but by liquidity as well.

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If other conditions are equal, investors prefer liquid stock and in case of illiquid stock they require certain bonuses thus making liquidity a risk factor. Definition of the stock liquidity includes several important aspects. Some authors emphasize the pace of transactions (Jang, Kang & Lee, 2012; Plerou, Gopikrishnan & Stanley, 2005; Fernando & Herring, 2001), arguing that liquidity is the ability to make a transaction quickly and without negative impact on the price (or with minor price change). Other authors describe the liquidity as low transaction costs or as high activity of transactions. Shwartz and Francioni (2004) propose that liquidity may be treated as frequency of stock trading in a market. Generalization of these considerations suggests that the stock liquidity is the ability to buy or sell stock quickly and in a high-volume without any significant impact on price and without incurring high transaction costs.

Company-level factors affect not only return on investments, but also stock liquidity which is an important factor to an investor when assessing the stock. Since under the same economic conditions, stock liquidity of individual companies is different, the question arises: what factors of a company have bigger impact on this? The importance of ownership structure to stock liquidity is emphasized in studies of Attig, Gadhoum & Lang (2003) and Brockman, Chung & Perignon (2008). The impact of the size of a company on stock liquidity is evidenced by the research results of Chordia, Shivakumar & Subrahmanyam (2004), Heflin, Shaf & Wild (2000), Jain, Kim & Rezae (2005), Khediri & Daadaa (2011). Various authors (Heflin et al., 2000; Jain, et al., 2005) have shown that a significant impact on stock liquidity is made by company’s policy of information disclosure to investors. A number of researchers analyzed the interaction of stock liquidity and capital structure, for example Lipson & Mortal (2005), Lesmond, O’Connor & Senbet (2008), Frieder & Martell (2006). However, their results are rather controversial: in some countries higher financial leverage leads to higher stock liquidity, while in other countries a negative impact of financial leverage on liquidity was observed. Another important factor affecting stock liquidity is liquidity of assets. The research of Gopalan, Kadan & Pevzner (2009) evidenced that a significant positive relationship exists between liquidity of assets and that of stock. Choi & Cook (2005) found that stock liquidity is significantly impacted by short-term liabilities to assets ratio, other liabilities to assets ratio, liquid assets to total assets ratio, amount of assets, market to book value of assets ratio, return on equity, growth of assets and sales. Lipson & Mortal (2005) also examined the impact of companies’ financial ratios on stock liquidity and found that stock liquidity of individual companies is influenced by profit before interest and taxes to assets ratio, market to book value of assets ratio, R & D expenditures to assets ratio.

The results of the researches evidence that company-level factors have a significant impact on stock liquidity; however both set of indicators and the level of the impact are quite different in different countries. Moreover, the most of empirical studies have been carried out in developed stock markets (due to better availability of information), though some researchers have tried to study developing stock markets like Malaysia or Indonesia as well. However the factors influencing stock liquidity in Baltic markets have not been researched so far.

The purpose of this paper is to assess the impact of company-level factors on the Baltic companies’ stock liquidity.

The object of the research is the Baltic companies’ stock liquidity.

2. Method

In order to explore the relation of Baltic stock liquidity and company-level factors, the two-part empirical research was carried out. For this purpose, 32 non-financial companies belonging to various sectors of economic activity were selected out of 79 companies listed in the Nasdaq OMX Baltic. The research covers the period of 2005–2012. In the first part of the research, stock liquidity of the Baltic companies and its changes during the period of 2005–2012 was analyzed. In the second part, the correlation and multivariate regression analysis was performed in order to establish the impact of the company-level factors on the stock liquidity.

In the research, following independent variables that characterize company-level factors were used:
- Size of a company S (company’s asset value);
- Financial leverage FL (debt / equity);
- Ratio describing liquidity of assets – current solvency ratio CSR (current assets / current liabilities);
- Return on assets ROA (net profit / total assets);
- Fact of profit or loss P (the binary variable where 1 means profit and 0 means loss);
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