Journal of Corporate Finance 35 (2015) 211–231

Contents lists available at ScienceDirect

Journal of Corporate Finance

journal homepage: www.elsevier.com/locate/jcorpfin

The effects of stock liquidity on firm value and corporate governance: Endogeneity and the REIT experiment

William Mingyan Cheung [a], Richard Chung [b], Scott Fung [c,*]

[a] Department of Finance and Business Economics, Faculty of Business Administration, University of Macau, Macau, China
[b] Department of Accounting, Finance and Economics, Griffith University, Gold Coast, QLD, Australia
[c] Department of Accounting and Finance, College of Business and Economics, California State University, East Bay, Hayward, CA 94542, United States

ARTICLE INFO

Article history:
Received 10 October 2014
Received in revised form 2 September 2015
Accepted 3 September 2015
Available online 8 September 2015

JEL classification:
C31
G12
G23
G30
G34
G39

Keywords:
Stock liquidity
REITs
Corporate governance
Institutional ownership
Endogeneity

ABSTRACT

This study examines the effects of stock liquidity on firm value and corporate governance using the Real Estate Investment Trust (REIT) setting. The unique features of the REIT industry, including homogeneity of the investment structures, the high payout requirement, and the importance of institutional investors, highlight the positive effect of stock liquidity on firm value through corporate governance. To address the endogeneity problem, we perform a difference-in-differences test based on the propensity score matching estimator. The result shows that REIT stock liquidity has a causal and positive effect on firm value, as measured by Tobin's Q. Importantly, REIT stock liquidity is conducive to better corporate governance through the channel of institutional ownership. REIT stock liquidity leads to higher institutional ownership, particularly for institutional investor types that are active monitors and institutional investors with multi-firm ownership in their REIT portfolios.

1. Introduction

Stock liquidity is not only a subject of market microstructure but can also be studied from the perspective of corporate finance. A general view is that stock liquidity has a feedback effect on firm value by lowering the cost of capital and affecting corporate investments (Foucault et al., 2013).[1] Another argument is that stock liquidity can enhance the informativeness of stock prices and consequently, managers learn from informative stock prices and make value-enhancing corporate decisions. In the presence of agency problems, stock liquidity has an economic effect on firm value through corporate governance. This study provides a unique industry experiment to demonstrate that stock liquidity has a positive effect on firm value and is conducive to better corporate governance via the channel of institutional ownership.

Existing theories provide different perspectives on how stock liquidity enhances corporate governance. Diamond and Verrecchia (1982) and Holmström and Tirole (1993) show that information embedded in stock prices is useful for managerial incentive contracts

* Corresponding author at: California State University, East Bay, 25800 Carlos Bee Boulevard, Hayward, CA 94542, United States. Tel.: +1 510 885 4863.
E-mail addresses: wcheung@umac.mo (W.M. Cheung), r.chung@griffith.edu.au (R. Chung), scott.fung@csueastbay.edu (S. Fung).

[1] Fang et al. (2009) conclude that the effect of stock liquidity that is related to the cost of capital is minor, and such effect is more likely related to managerial decisions, as discussed below.

http://dx.doi.org/10.1016/j.jcorpfin.2015.09.001
0929-1199/

and performance monitoring. Faure-Grimaud and Gromb (2004) suggest that a liquid stock market can generate information about the monitor's activity and incentivize large shareholders (such as institutional investors) to monitor. Nevertheless, there are competing views on whether a more liquid stock should deter or enhance corporate governance. On the one hand, Coffee (1991) and Bhide (1993) argue that a liquid stock market lowers the costs of exit and thus reduces the appeal of voice for potential monitors. On the other hand, Kyle and Vila (1991) and Maug (1998) argue that a liquid stock market lowers the cost of acquiring shares and helps investors to accumulate the blocks that generate sufficient incentives to voice or intervene. Edmans (2009) shows that stock liquidity provides a governance mechanism through investors' trading of a firm's shares, including the actual exit by selling shares ex post and the threat of exit by incentivizing the manager ex ante.

Empirical evidence on the effects of stock liquidity on firm value and corporate governance, particularly the underlying mechanisms, remains an understudied area. Fang et al. (2009) find a positive effect of stock liquidity on firm value, which is due to more informative stock prices and better managerial incentives. However, they do not find evidence that stock liquidity affects firm value through the channels of external governance and monitoring. Edmans et al. (2013) use the setting of activist hedge funds to demonstrate that stock liquidity enhances blockholder governance through the mechanisms of exit as well as voice. In contrast, Back et al. (2015) find that stock liquidity deters blockholder activism. The following issues may explain the lack of consensus on the effects of stock liquidity on firm value in the empirical corporate finance literature: (i) an endogeneity problem, particularly unobservable firm characteristics that affect stock liquidity and firm value; (ii) heterogeneity in the relation between stock liquidity and firm value across different corporate or industry settings; and (iii) identification of the specific mechanism underlying the effect of stock liquidity on firm value.

This study attempts to tackle these empirical corporate finance issues by using the Real Estate Investment Trust (REIT) industry as a natural experiment to examine the effects of stock liquidity on firm value. Stock liquidity is a central feature of REITs because the public trading of REITs provides investors with not only liquidity and exposure to real estate assets but also the possibility of implications on firm value. Compared with other industrial firms, REITs, on average, have higher stock liquidity (see Table 1 and Section 4). Unlike other studies that examine the value effects of stock liquidity across different industries, the REIT setting can control for industry- and firm-level heterogeneity such as growth opportunities and business risks (Hartzell et al., 2014).[2] Most importantly, the REIT setting contains the following unique features that provide interesting and different perspectives on the proposition of stock liquidity affecting firm value, particularly the importance of corporate governance and the channel of institutional ownership.

1.1. Homogeneous investment structures

Stock liquidity can affect firm value through the channels of investment and corporate governance (Foucault et al., 2013). While the importance of investment vis-à-vis governance effects may vary with firms or industries, REITs provide a unique setting that can accentuate the potential effect of stock liquidity on corporate governance. REITs have homogeneous asset and investment structures,[3] suggesting that stock liquidity is less likely to have a direct impact on the investment activities of these firms. Although REITs have similar asset and investment structures, they are diversely managed and are subject to agency problems.[4] REITs do not have an active takeover market to support corporate governance due to excess shareholder provisions (Chan et al., 2003).[5] In addition, a large number of REITs are Umbrella Partnership REITs (UPREITs), which allow managers to simultaneously manage several small REITs but creates agency problems (Chung et al., 2012). Furthermore, REITs engage in significant real activities manipulation for earnings management, suggesting that corporate governance is essential for constraining such activities (Anglin et al., 2013). Hartzell et al. (2008) and Bauer et al. (2010) find significant differences in corporate governance in a cross-section of REIT firms.

1.2. High payout requirement

An increase in stock liquidity is not necessarily conducive to improvement in firm value, depending on whether stock liquidity is associated with value-enhancing activities. The REIT setting is particularly useful for examining whether stock liquidity can support value-enhancing activities such as corporate governance. REITs have a high payout requirement (i.e., distribution of at least 90% of their taxable income to investors). According to Easterbrook (1984), dividends can increase a firm's external financing needs and hence increase the opportunity of market monitoring. In the case of REITs, the high payout requirement not only forces REITs to maintain equity dependence (Boudry et al., 2010; Hartzell et al., 2014), but also increases the opportunity of market monitoring by outside investors (Hartzell et al., 2008). Further, the required payout rate in REITs can provide outside investors observable shares of profits, which may lower outside investors' monitoring costs. As such, stock liquidity may become more important in enhancing market monitoring for REITs than for other typical firms.

1.3. Outside ownership structures and institutional investors

The REIT setting highlights the importance of stock liquidity in enhancing specific corporate governance mechanisms, such as monitoring activities by institutional investors. REITs have unique outside ownership structures that require these firms to have at

[2] The existing literature, e.g., Fang et al. (2009), examines the firm value effect of stock liquidity based on a sample of industrial firms, which largely excludes REITs.

[3] REITs must have a least 75% of their total assets invested in real estate assets and cash, derive at least 75% of their gross income from real estate-related sources, and have no more than 25% of their assets consisting of non-qualifying securities or stock in taxable REIT subsidiaries.

[4] See Ghosh and Sirmans (2003), Han (2006), Hartzell et al. (2006), and Bianco et al. (2007).

[5] A majority of REITs are incorporated in Maryland, which provides a specific statute for REIT trusts and strong takeover defenses.