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The relationship between liquidity, corporate governance, and firm valuation: Evidence from Russia

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ABSTRACT

This paper examines the hypotheses that liquidity improves corporate governance, and better governance enhances valuation of Russian firms. We find a positive causal relationship between measures of liquidity and corporate governance. Additionally, we document the strong positive impact of corporate governance on valuation. Our results are economically significant. For example, we document that a 10% decrease in the proportion of zero return days implies a 0.34% increase in transparency and disclosure, which in turn leads to a 9.6% increase in firm valuation. Our research findings shed light on the important role of liquidity in improving corporate governance and valuation.

1. Introduction

This paper examines the channel relationship between stock market liquidity, corporate governance, and firm valuation of Russian firms from 2002 to 2009. The impact of liquidity on corporate governance is still a subject of debate in academic literature. One strand of literature argues that market liquidity has a negative impact on efficiently governed firms as excess monitoring by small investors can undermine the control of large active institutional investors.[3] On the other hand, Maug (1998) argues that liquid equity

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[3] Bhide (1993), Coffee (1991), Kahn and Winton (1998), and Roe (1994) are excellent examples of this research.

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markets allow large investors to profit from monitoring through informed trading and helps to alleviate the free-rider problem. The active debate over the role of liquidity as a mechanism to improve corporate governance is one of the motivating factors for the current research. Furthermore, most empirical studies on the relationship between market liquidity and corporate governance focus on developed markets, which are often dissimilar to emerging markets. The current research is also related to the literature that investigates the impact of corporate governance on firm value.[4] The majority of evidence from this literature finds that firms with better corporate governance ratings or stronger shareholder rights have higher valuations. Motivated by these two lines of research, we study the causal relationship between liquidity, corporate governance, and firm valuation of Russian firms.

This paper focuses on Russian firms partly due to the accelerating growth of Russia in global financial markets. Fig. 1 displays the evolution of the Russian Trade System (RTS) index over the period of 2002–2009. During the period from 2002 to 2007, the RTS index increased 539%. The RTS shows a sharp decline at the onset of the global financial crisis, but even accounting for this, the RTS added 302% over the sample period. Moreover, according to a global survey conducted in 2008 by Ernst & Young, the capital raised by Russian initial public offerings in 2007 ranked the fourth, behind only China, the U.S., and Brazil. With vast natural resources still underutilized, one would anticipate the ability of Russian firms to obtain external capital to increase in the years and decades to come. The Russian business environment is characterized by weak legal frameworks, high ownership concentration, significant state involvement in management, and underdeveloped equity markets.[5] The nature of the Russian business environment makes the gains from small improvements in corporate governance significantly high. An example of the impact of corporate governance on valuation comes from Russia's largest company, Gazprom. Lazareva et al. (2007) report that Gazprom's valuation reflects only $1 per barrel of proven reserves, while western oil companies, such as Exxon Mobil or Royal-Dutch Shell, are valued at approximately $18 per barrel of proven reserves. As Fig. 1 illustrates, Russia has seen improvement in its corporate governance over recent history, but still lags behind many western countries.[6] As more investors seek to capitalize on the growth of the Russian equity market, the importance of corporate governance will become paramount.

Few empirical studies examine the relationship between liquidity, corporate governance, and firm valuation. Although Fang et al. (2009) find a positive relationship between liquidity and firm value for U.S. firms; they do not model the impact liquidity on governance variables. In a paper most related to the current study, Lang et al. (2012) investigate the relationship between firm-level transparency, stock market liquidity, and valuation across 46 countries over the period of 1994–2007 using a fixed effect model. They document the positive significant impact of transparency on liquidity and firm valuation. The current study is distinct from Lang et al. in that they do not include Russian firms in their sample and their model does not allow them to explore the causal relationships between governance, liquidity, and firm valuation.

In a paper on Russia, Black et al. (2006) address the impact of corporate governance on firm valuation. They document a strong positive relationship between corporate governance and firm valuation for Russian firms from 1999 to 2005. We build on the work of Black et al. (2006) by directly incorporating liquidity into the empirical framework, which was absent from their study. The present research incorporates all three variables and aims to provide empirical evidence of the channel relationship between liquidity, corporate governance, and firm valuation in Russia.

To examine the causal relationship between liquidity, corporate governance, and firm value, we study a broad cross section of Russian firms over the period of 2002 to 2009. Liquidity has multiple dimensions. To capture these various aspects, three liquidity measures are used following existing literature on liquidity.[7] The data are paired with the transparency and disclosure (TD) scores provided by Standard and Poor's

[4] For some recent examples, see Ammann et al. (2011), Balasubramanian et al. (2010), Black (2001), Black et al. (2006), Connelly et al. (2012), Durnev and Kim (2005), Gompers et al. (2003), and Klapper and Love (2004).

[5] For details, please see Djankov et al. (2008), Lazareva et al. (2007), and Standard and Poor's transparency and disclosure survey reports.

[6] For example, the Standard and Poor's survey report documents that the composite transparency score for 127 U.K. firms is 71 in 2003, which is higher than that of Russian firms.

[7] We follow existing literature and use the following three measures of liquidity: the log of dollar trading volume (ln \$*volume*), the Amihud (2002) illiquidity ratio (*ilq*), and the proportion of zero-return days *pzr*. For further details on the construction of these variables, please refer to Table 1.