Does Market Liquidity Matter for Firm Value?  
Evidence from Real Estate Investment Trusts

William Cheung†, Richard Chung† and Scott Fung‡

Abstract

This study investigates how market liquidity can improve firm value of Real Estate Investment Trusts (REITs). Using a sample of REITs in US from 1992 to 2008, we find that market illiquidity, measured by Amihud illiquidity, effective spread, quoted spread and percentage of zero volume days, has a significant and negative impact on future firm performance (Tobin’s Q and ROA). The impact of market illiquidity on firm value is more economically significant for Cyclical REITs, and for REITs with higher idiosyncratic risk, with no analyst coverage, and with no hedge fund equity ownership. These findings suggest that market liquidity can increase firm value by stimulating informed trading and mitigating information asymmetry. Moreover, the impact of market illiquidity on firm value is more significant for Diversified REITs than other REITs, suggesting that the monitoring effect of market liquidity is more important for REITs with moral hazard problems. Further, market liquidity improves the efficiency of managerial incentive contracts by enhancing CEO’s Pay-for-Performance-Sensitivity. Lastly, market illiquidity has a time-varying impact on firm value, with a larger impact during the subprime and financial crises.

Keywords: Market Liquidity; REIT; Asymmetric Information, Corporate Governance; Managerial Compensation

JEL Classifications: G12, G14, G29, G30, G34, G39

† University of Macau; email: wcheung@umac.mo
‡ Hong Kong Polytechnic University; email: afrchung@inet.polyu.edu.hk
∥ California State University, East Bay; email: scott.fung@csueastbay.edu
* Chung and Fung gratefully acknowledge the financial support from the Hong Kong Polytechnic University Research Grant. We are grateful to James Shilling and Rose Lai for valuable comments.
Does Market Liquidity Matter for Firm Value?
Evidence from Real Estate Investment Trusts

Abstract

This study investigates how market liquidity can improve firm value of Real Estate Investment Trusts (REITs). Using a sample of REITs in US from 1992 to 2008, we find that market illiquidity, measured by Amihud illiquidity, effective spread, quoted spread and percentage of zero volume days, has a significant and negative impact on future firm performance (Tobin’s Q and ROA). The impact of market illiquidity on firm value is more economically significant for Cyclical REITs, and for REITs with higher idiosyncratic risk, with no analyst coverage, and with no hedge fund equity ownership. These findings suggest that market liquidity can increase firm value by stimulating informed trading and mitigating information asymmetry. Moreover, the impact of market illiquidity on firm value is more significant for Diversified REITs than other REITs, suggesting that the monitoring effect of market liquidity is more important for REITs with moral hazard problems. Further, market liquidity improves the efficiency of managerial incentive contracts by enhancing CEO’s Pay-for-Performance-Sensitivity. Lastly, market illiquidity has a time-varying impact on firm value, with a larger impact during the subprime and financial crises.

Keywords: Market Liquidity; REIT; Asymmetric Information, Corporate Governance; Managerial Compensation

JEL Classifications: G12, G14, G29, G30, G34, G39