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The impact of ownership concentration and analyst coverage on market liquidity: Comparative evidence from an auction and a specialist market

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ABSTRACT

This paper examines the relationships among market liquidity, ownership structure and public information production in Italy, where the share market setting might have a considerable effect. Our findings suggest that both the private information held by the largest blockholder and the public information provided by financial analysts have an impact on market liquidity. The percentage of shares owned by the controlling shareholder harms market liquidity, whereas analyst coverage improves it. The study demonstrates that the results differ with the stock market setting. We find that the effects of these two key variables are significantly lower in a specialist market than in a non-specialist market. These results emphasize the importance of distinguishing between auction and specialist market structures when studying the impact of corporate governance and analyst coverage on market liquidity. Notably, the study demonstrates that the sign and the intensity of the effect of analyst coverage on market liquidity changes according to the varying levels of ownership concentration, suggesting that private information and public information may act as complements.

1. Introduction

Stock market liquidity is a fundamental concept in the financial community, having a positive impact on both the micro level of firm value and the macro level of the entire economic system (Amihud and Mendelson (2008)).¹ Liquidity is a hot topic because it is widely assumed that it allows firms to make their money work for the business.² Market liquidity is shaped by several factors, which include the magnitude of transaction costs, market participants' behaviour, asset characteristics, market structure and level of transparency. Potentially opportunistic problems are embedded in many of these factors, and this study thus examines the relationships among market liquidity, ownership concentration and public information production by financial analysts.

The relationship between corporate governance and market liquidity has been extensively investigated. The assumption emerging from the empirical literature is that ownership, one of the mechanisms of corporate governance, has a central role in the relationship (e.g. Becht, 1999). The main debate about ownership concentration and market liquidity

focuses on problems of transparency and the effects of asymmetric information between the market forces exercised by investors and market operators. Ownership can affect market liquidity by either altering the firm's trading activity or by increasing the probability of informed trading. Yet most research on this topic has been conducted in the US (e.g. Heflin and Shaw, 2000; Chung et al., 2010), and the extent to which the findings and explanations hold in other countries has been largely unexplored. Single-country European evidence is limited to French firms (Ginglinger and Hamon, 2012), as well as both German and Belgian firms (Becht, 1999).

Despite the private information held by blockholders, public information may positively impact on liquidity. The information disclosed by financial analysts is scrutinized, and this serves as a mechanism that improves transparency and reduces asymmetry issues among managers, shareholders and outside investors. In a broad sense, this mechanism implicitly decreases the cost of opportunism with a direct impact on economic value. Previous studies have found that financial analysts disseminate sensitive information directly in their financial reports (e.g.

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¹ In terms of risk and returns on an asset, when volatility is stationary then the expected return required by investors is a monotonically decreasing function of liquidity (Amihud and Mendelson, 1986). An illiquid stock increases the expected return demanded together with its transaction costs (Brennan and Subrahmanyam, 1996). Likewise, low market liquidity generates an increase in volatility, implying a loss in the traded volume.

² Concerning the relevance of market liquidity, an in-depth analysis is available on "Why market liquidity is important", The Economics 5th June 2008.

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Brennan and Subrahmanyam, 1995).

However, to the extent of our knowledge, no study has yet examined the role of market setting in shaping the impact of ownership structure and outside information production on market liquidity, the sole exception being Chung et al. (2010). Unlike Chung et al. (2010), we compare a specialist market, the ‘STAR segment’ of the Italian Bourse, and an auction market, the ‘non-STAR segment’.

Most liquidity comparisons of specialist markets (such as the NYSE) and other market structures (such as the NASDAQ) have been US-based (e.g. Bessembinder and Kaufman, 1997; Huang and Stoll, 1996). As highlighted by Frino et al. (2008), the nature of trading on the NYSE, which comprises a specialist competing with limit order flow, obfuscates the comparison. Thus, comparisons from various markets, (i.e. Italy), which introduced a specialist segment to its stock market in 2001, are likely to enhance our understanding of the impact of the type of market structure.

In this paper, we address this gap in the literature by clearly distinguishing between two market structures to gain greater insight into how they affect the impact of large shareholders and of the public information provided by financial analysts on market liquidity. Our study highlights the effects of ownership concentration and analyst coverage on market liquidity by examining whether the presence of specialists in the STAR segment leads to different results from those of the order-driven markets of the non-STAR segment. In the Italian Bourse, the quote-driven market (STAR market) has specialists who guarantee that deals are closed, which provides higher liquidity *per se*. Asymmetric information problems and public information effects may therefore be at margin compared with non-specialist equity markets (e.g. Frino et al., 2008; Nimalendran and Petrella, 2003). We thus expect that the potential links among ownership, financial analysts and liquidity would be considerably shaped by the organizational structure of the market.

Based on the importance of both firm ownership structure and analyst coverage in explaining market liquidity, our study highlights the effects of their interaction on market liquidity. Given the conflicting predictions from the theoretical work (e.g. Diamond, 1985; Kim and Verrecchia, 1994), we examine whether the public information produced by analysts and the private information from large shareholders serve as either substitutes or complements in determining market liquidity.

Our results show that ownership has a negative effect on market liquidity, while the public information provided by financial analysts improves it. We also find that results differ with the stock market setting. We find that in specialist markets the percentage of shares held by the largest shareholder slightly decreases liquidity, whereas analyst coverage slightly increases it. We also find that the interaction between the share held by the largest shareholder and analyst coverage shows a significant and negative effect on market liquidity, improving the performance of the model and suggesting that these key variables act as complements.

The paper is organized as follows. Section 2 presents the background and baseline hypotheses. Section 3 describes the methodology. Section 4 presents the results, and Section 5 provides additional analyses. Conclusions follow in Section 6.

2. Hypotheses

This section highlights the hypotheses developed to test the effect of ownership concentration, the impact caused by analyst coverage, as well as the implications caused by the difference in market structure. Finally, we also focus on the interaction between ownership concentration and analyst coverage.

2.1. Ownership concentration

Previous studies have identified two reasons for the impact of ownership concentration on market liquidity. Firstly, the trading hypothesis suggests that a greater trading volume is associated with higher liquidity (e.g. Demsetz, 1968). Secondly, ownership can be a proxy of

privileged information. For instance, when large shareholders hold private information, they may have the power to influence managerial decisions, raising the potential for opportunistic expropriation of minority shareholders and creditors. The presence of informed traders can lead to uninformed investors requiring a premium to invest on locally held firms, making them less liquid and thereby decreasing prices. The private information possessed by large shareholders might explain adverse selection problems and discounts on market liquidity (e.g. Glosten and Milgrom, 1985). In Italy, management is not separated from control, as opposed to the situation in large US corporations, and Italian managers often collude with large shareholders, being directly hired by them and remaining connected to them. Therefore, risk of expropriation could arise, which would push liquidity traders to ask for a higher spread for compensation.

Empirical studies of the relationship between ownership concentration and liquidity have been based on US data (e.g. Kini and Mian, 1995; Heflin and Shaw, 2000; Chung et al., 2010), showing that ownership concentration increases information asymmetries, which in turn reduces market liquidity. Using data on French listed firms, Ginglinger and Hamon (2012) find similar results in an institutional context characterized by high ownership concentration. As shown by La Porta et al. (1999), Lopez de Foronda et al. (2007) and Mengoli et al. (2009), among others, Italy is a civil law country with high ownership concentration. Zingales (1994) finds that the private benefits for firm control are quite high in Italy, with a voting premium of 82%, compared with 10% in the US and 13% in the UK. Asymmetric information considerably amplifies the gravity of value expropriation and opportunism, increasing informational issues and making corporate governance an important determinant of market liquidity. On the basis of the above arguments, we derive the following hypothesis.

Hypothesis 1. Ownership concentration is negatively related to market liquidity.

2.2. Analyst coverage

A further issue that influences market liquidity is analyst coverage, which refers to the role of financial analysts as *proxies* of the public information available to the market. Financial analysts use technical or fundamental signals to examine qualitative and quantitative information about firms and securities in order to guide individuals and organizations in investment decisions and provide recommendations for purchasing, selling, or holding stocks. Prior studies indicate that analysts play an important role as information intermediaries (Lang and Lundholm, 1996; Healy and Palepu, 2001). Thus, financial analysts become important providers of the public information that positively affects market liquidity. Other studies convincingly demonstrate that analyst coverage improves market liquidity (e.g. Brennan and Subrahmanyam, 1995; Brennan and Tamarowski, 2000; Roulstone, 2003); this positive role seems particularly welcome in the Italian context, given the stringent policies that regulate information divulgation to the market. Financial institutions in Italy must disclose all reports analysing the value of listed firms by publishing them on the Italian Bourse website (De Vincentis, 2009; Bonini et al., 2010). This ensures public access to a great volume of information and exhibits the uniqueness of the Italian system compared, for example, with the US, where reports are not made instantly available to investors.³

Generally, financial analysts aim to improve the quantity of information available to investors, ensuring higher liquidity as a consequence of lower adverse selection costs. Hence, our second hypothesis assumes that the information provided by analysts reduces adverse selection and

³ In the US, financial analysts could possibly gather private information on a small number of market participants, thus holding an advantage when trading. In this sense, theories suggesting the role of financial analysts as private information providers can be supported.

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