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Liquidity, the Value of the Firm, and Corporate Finance

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Abstract

The theory of corporate finance has been based on the idea that a company's market value is determined mainly by just two variables: the company's expected after-tax operating cash flows or earnings, and the risk associated with producing them. The authors argue that there is another important factor affecting a company's value: the liquidity of its own securities, debt as well as equity. The paper supports this argument by reviewing the large and growing body of evidence showing that differences—and changes—in liquidity can have major effects on the pricing of corporate stocks and bonds or, equivalently, on investors' required returns for holding them.

The authors also suggest that the liquidity of a company's securities can be managed by corporate policies and actions. For those companies whose value is likely to be increased by having more liquid securities—which is by no means true of all companies (mature firms that don't need outside capital may well benefit from having more concentrated ownership and hence less liquidity)—management should consider actions such as reducing leverage and substituting dividends for stock repurchases as well as measures designed to increase the effectiveness of their disclosure and investor relations program and the size of their investor base.

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