Share Issuance as a Predictor of Stock Price Performance

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September 29, 2020- The year 2020 will go down in history as one of the strangest, amongst other things.

The global pandemic upended the economy and disrupted our daily lives. Effects of the pandemic were far reaching - from working at home, to social distancing, to mask wearing. Tragically, it led to death and suffering around the world.

COVID's impacts on financial markets were unique and somewhat unpredictable. If one knew for certain that a global pandemic was about to hit, the notion of the S&P 500 quickly dropping -35% wouldn't be surprising. However, the worldwide calamity caused by the coronavirus created additional market events that no one could have predicted.

Year-to-date, a boom in special purpose acquisition companies has occurred, surprising even the most ardent believers of the new asset class. The pandemic has created another unexpected quirk in the capital markets - the resurgence in at-the-market ("ATM") equity offerings.

What is an At-The-Market Equity Offering?

In an at-the-market equity offering, a company sells shares directly into the market at the prevailing price, obtaining capital from whoever is buying the stock at that particular time, be it retail or institutional investors. In contrast, in a traditional equity offering, an investment bank buys stock from an issuer at a set price and resells it to large institutional investors. Capital flows from these large institutional investors to the investment bank underwriting the deal and then to the issuer. Equity offerings typically lead to a significant increase in shares outstanding of the issuing company, referred to as shareholder dilution.

Similar to SPACs, ATM equity offerings were a dirty word prior to 2020. Historically, at-the-market equity offerings have been used by low quality companies that lack access to capital from institutional investors. Typically, ATM equity offerings relied heavily on participation from unsophisticated speculative retail traders, and were, therefore, frowned upon by traditional investors.

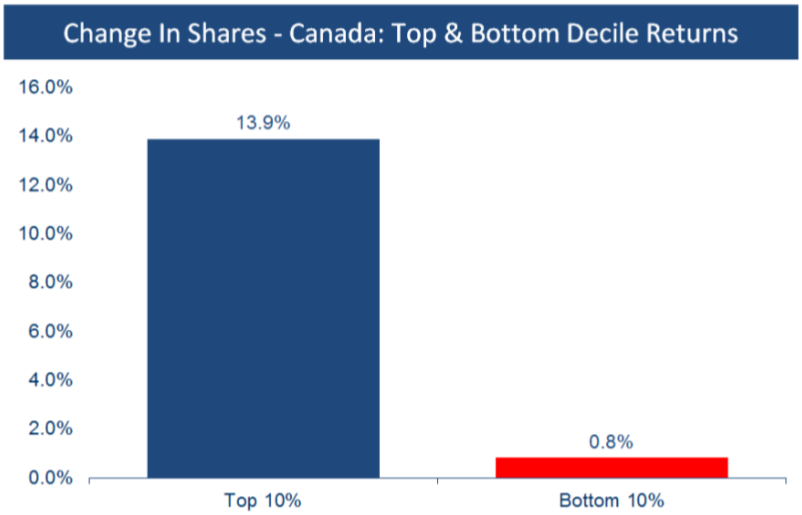
The most infamous ATM offering this year was from bankrupt car rental company Hertz, who attempted to capitalize on irrational retail speculator demand for its worthless stock by selling up to $500 million of new shares in an ATM offering. Thankfully, Hertz suspended the equity issue once the SEC intervened.

Other companies that recently completed ATM offerings are retail favourite Tesla, who raised a stunning $5 billion in their at-the-market equity offering, and former tech bubble favourite Ballard Power, who recently announced a $250 million ATM equity program.

Is Share Issuance or Repurchases a Predictor of Future Stock Performance?

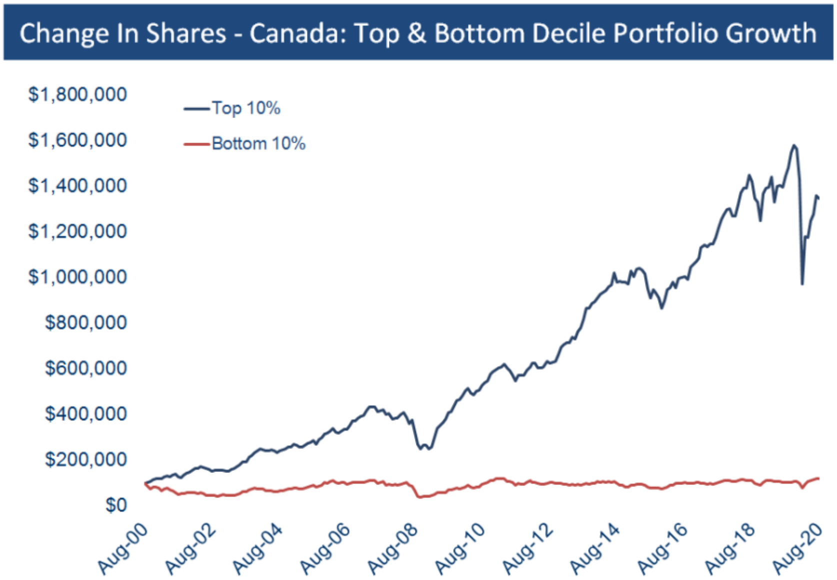
A historical analysis was conducted on North American equities to determine the predictive nature of share issuance on future stock price performance. All liquid Canadian and U.S. stocks were segmented into deciles based on their last 12 months of equity issuance. The bottom 10% bucket was represented by stocks of companies that issued the most shares over the past year, while the top 10% bucket was represented by shares of corporations that issued the least / negative amount of shares over the past 12 months (i.e. they were net share repurchasers). In the simulated portfolio performance, each portfolio decile was rebalanced monthly over the 20-year timeframe.

In the Canadian market over the past twenty years, shares of companies that issued the most amount of shares gained only 0.8% annually, while shares of companies that were the most aggressive repurchasers of shares (negative share issuance) compounded at 13.9% per annum.



Source: Accelerate, S&P Capital IQ, Compustat

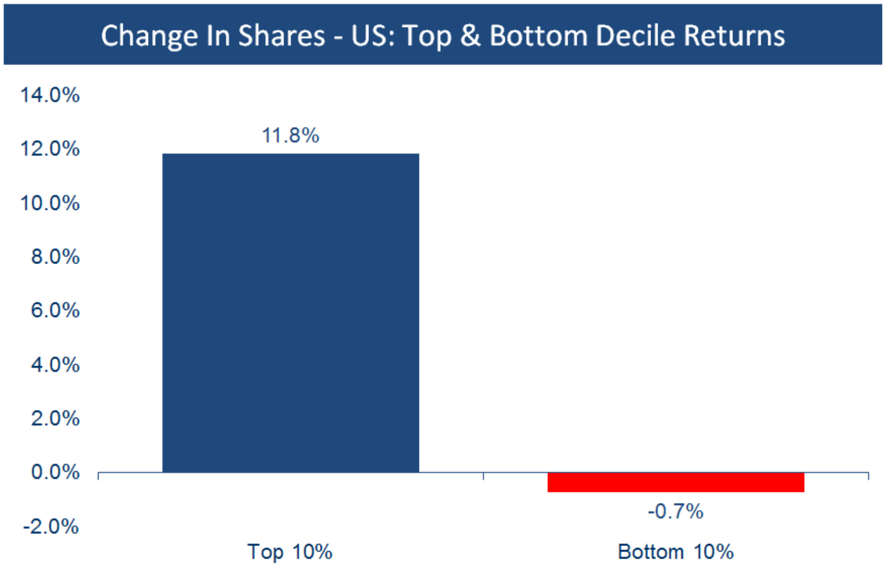
A $100,000 investment into the highest share repurchasers would have turned into over $1.3 million, while the equivalent investment into stocks of companies with the highest amount of equity issuance would have ended up with less than $120,000.



Source: Accelerate, S&P Capital IQ, Compustat

Similar to Canadian stocks, U.S. companies that issued a large number of shares underperformed significantly while shares of companies that aggressively repurchased stock outperformed by a substantial margin.

Over the past two decades, a portfolio of U.S. stocks with declining share counts attained share price performance of 11.8% per year. A portfolio of publicly traded U.S. companies with the highest amount of shareholder dilution, represented by the greatest annual increase in shares outstanding, exhibited poor performance, dropping by -0.7% per year.



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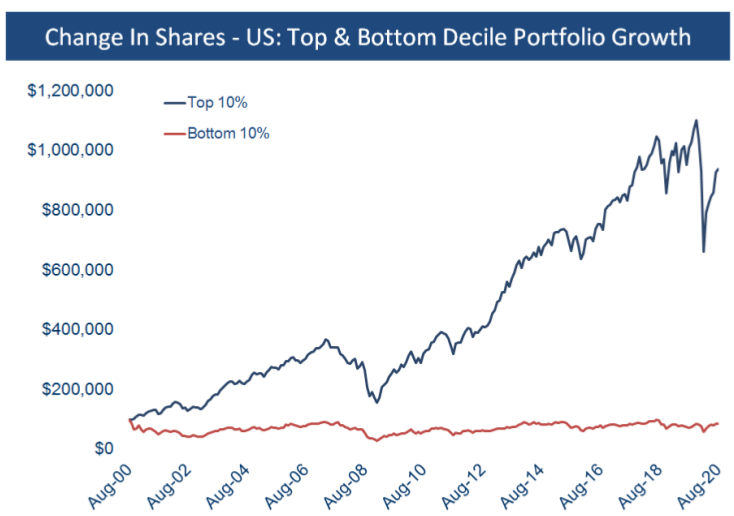
A $100,000 investment in the top decile portfolio of shares with declining share counts would have turned into nearly $950,000 over the past two decades. The same investment into a portfolio of companies that issued the most amount of shares (such as with an ATM equity program) would have declined to less than $90,000, representing a double-digit loss after a 20-year hold.



Source: Accelerate, S&P Capital IQ, Compustat

Beware of ATM Equity Offerings and Serial Stock Issuers

The coronavirus pandemic has brought with it unexpected knock-on effects in the capital markets, one of which included the increasing use of at-the-market equity offerings. These ATM offerings typically lead to a significant increase in shares outstanding of a company.

As seen in the above analysis, share issuance, or lack thereof, has historically been a good predictor of future share prices returns. Over the past two decades, a portfolio of North American stocks that have decreased their shares outstanding has outperformed markedly, while a portfolio of companies issuing shares has unperformed considerably. In layman's terms, share issuance = bad, share repurchases = good.

Given the predictive nature of the change in a company's shares outstanding, it is regarded as a robust factor in predicting future share price performance and is used in systematic multi-factor funds such as the Accelerate Absolute Return Hedge Fund (TSX: HDGE) and the Accelerate Enhanced Canadian Benchmark Alternative Fund (TSX: ATSX).

If you see a company announce an ATM program, or a firm that is constantly issuing new shares, be cautious regarding its prospects. Historically, this shareholder dilution has cost investors dearly.

-Julian