To invest or not to invest?
The effect of Capex announcements

The profits a firm generates can either be distributed to its shareholders through dividends/share buybacks, reduce its debt or be used to invest. A company invests in its future organic growth either through Research and Development or by engaging in Capital Expenditures (Capex). As of January 2021, the net Capital Expenditures on sales ratio reached 2.54% for US companies[1].

The impact of these R&D and Capex investments on the company's future growth and its performance has been studied in the financial literature[2]. Capex spendings in the past tend not to translate into higher future returns, rather the contrary as firms having overinvested in the past versus peers tend to under-perform over the long-term[3]. What we want to study here is the reaction of the market when these new Capex decisions are announced by the company, signalling future investment plans. Companies don't have to publicly announce Capital Expenditures, as opposed to earnings: it can thus be argued that Capital Expenditures news are announced when considered as positive by the company, in its communication to the market. We will investigate this aspect in the present piece.

We will examine using alternative news-flow data, the signalling effect of Capex announcement, and the predictive power of these Capex announcements on future returns of the company. We will also analyse the potential to generate significant excess returns with a strategy investing into companies on their Capex announcement depending on the recent news sentiment on them.

DATA

This study analyses companies in a European All-Cap investment universe, from January 2013 to January 2021. We retain for the analysis Capex news on all small, mid- and large-cap companies with a minimum market cap of EUR 150M and EUR 500k minimum daily turnover. We will provide Size and other style analytics in the Style Analysis section of this paper.

In total, 2'600 companies and 17'000 Capex announcement news by these companies have been analysed in the past twenty years. The Capex topic information and the relevance to the company is retrieved from a RavenPack dataset.

We then used RavenPack and in-house built sentiment metrics to scale positions within the Capex strategy.

The lag between the primary source publishing the news and its appearance in the dataset is smaller than 1 second: this solves the issue coming from typical integration lag. We can assess the direct impact of the Capex announcements on stock performance.

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[1] A. Damodaran, NYU, 2021
[2] Titman et al (2004), *Capital Investments and Stock Returns*
[3] Anderson, Garcia-Feijóo (2000), *Empirical Evidence on Capital Investment, Growth Options, and Security Returns*

IMPACTS OF CAPEX ANNOUNCEMENTS

We do an event study where we look at the mean cumulative performance of stocks relative to the MSCI Europe after the occurrence of Capex announcements.

The following chart shows that the simple occurrence of Capex news is predictive of higher future returns.
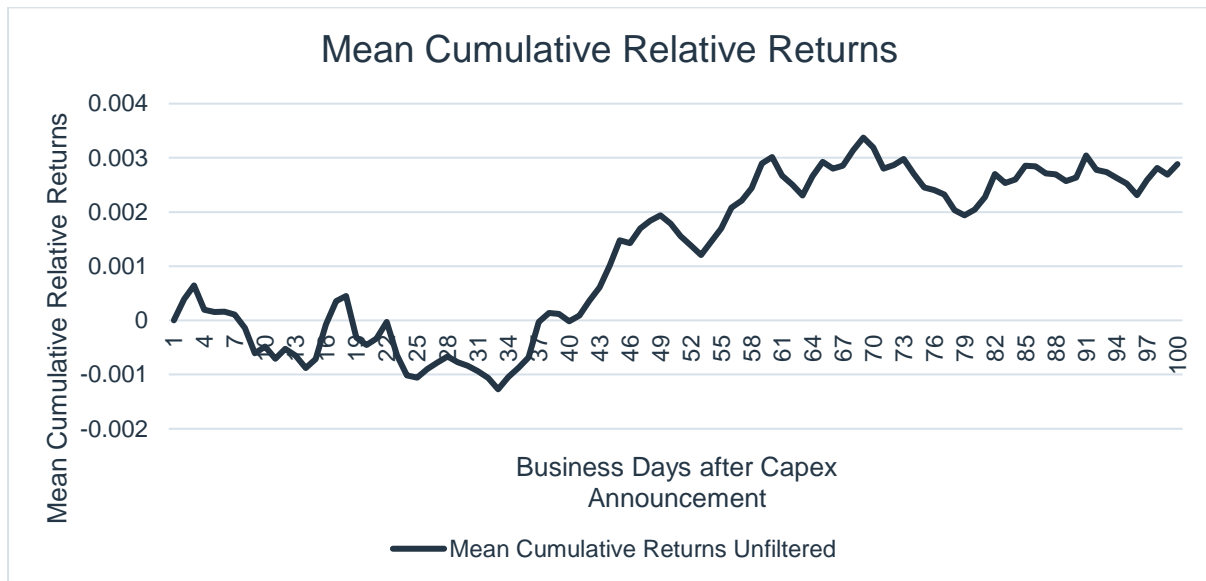

Figure 1 - Unfiltered Mean Impact of Capex Announcements.
Source: RAM Active Investments, FactSet, RavenPack

We then decided to test whether using more context to select companies can help build a more profitable strategy: companies are not legally forced to disclose their tangible assets investments, but the market can perceive them as negative, considering the allocation as sub-optimal, or because of prior bad outcomes on management decisions.

To take more context into account, we integrate into the selection process an in-house sentiment aggregator. Sentiment is a measure of how well news are perceived. By aggregating news' sentiment, we build an overall sentiment factor for each company at any given date. As the sentiment is built using news related to a given company, it can be very noisy, we thus smooth it and get a measure considering all past sentiment values.

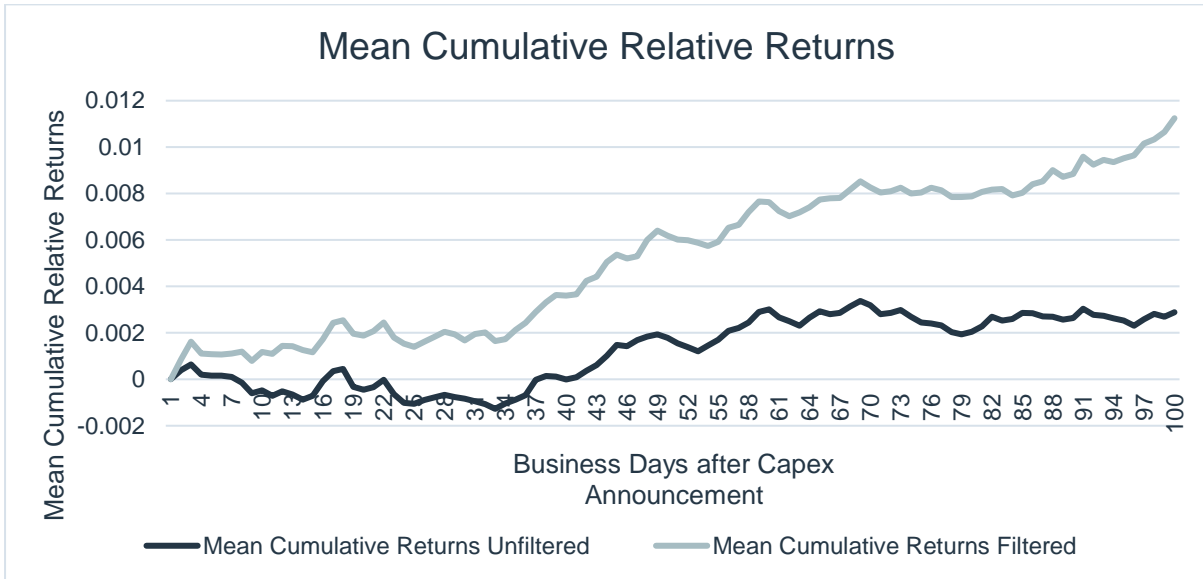We only retain news with a positive enough aggregated sentiment using our sentiment overlay.

Mean Cumulative Relative Returns

Figure 2 - Filtered Mean Impact of Capex Announcements.
Source: RAM Active Investments, FactSet, RavenPack

To assess the concentration of returns in the respective stock selection, we look at the median return curve of companies Capex announcements through time, with and without our sentiment overlay filter.
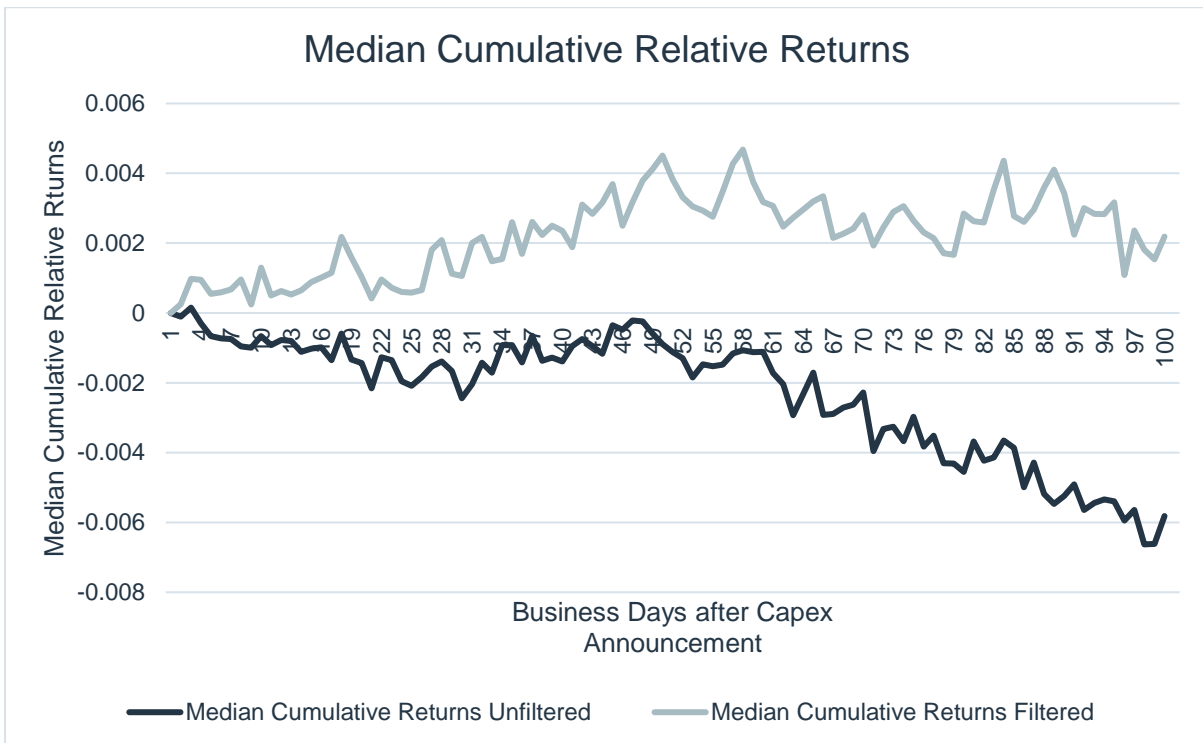
Median Cumulative Relative Returns

Figure 3 - Filtered Median Impact of Capex Announcements.
Source: RAM Active Investments, FactSet, RavenPack

First, we see that taking any Capex announcement yields a positive cumulative mean return compared to the MSCI Europe. However, the median cumulative relative return stays in negative territory, hinting that the actual positive mean return comes from some extreme positive market reactions.

Once we apply our sentiment filter, we shift the median cumulative returns to the positive side and get a much more stable mean cumulative relative return. We also notice that the mean cumulative performance reaches a plateau after ~65-70 business days, in both the filtered and unfiltered cases: This shows that the positive effect of Capex announcements is limited over time.

We therefore conclude that on average Capital Expenditures lead to a positive market reaction. Considering a sentiment filter greatly enhances the cumulative performance, showing that the overall market sentiment about the company combines well with the announcement itself.

BUILDING A STRATEGY AROUND CAPEX ANNOUNCEMENTS

Thanks to our impact study, we can build an optimal strategy that combines tangible assets investments news and our aggregated sentiment to select and scale positions.

We scale the strategy positions using our in-house sentiment and a new importance factor, measuring the significance of a Capex event based on the news volume covering it. We hold each position for 3 months and rebalance on a weekly basis.
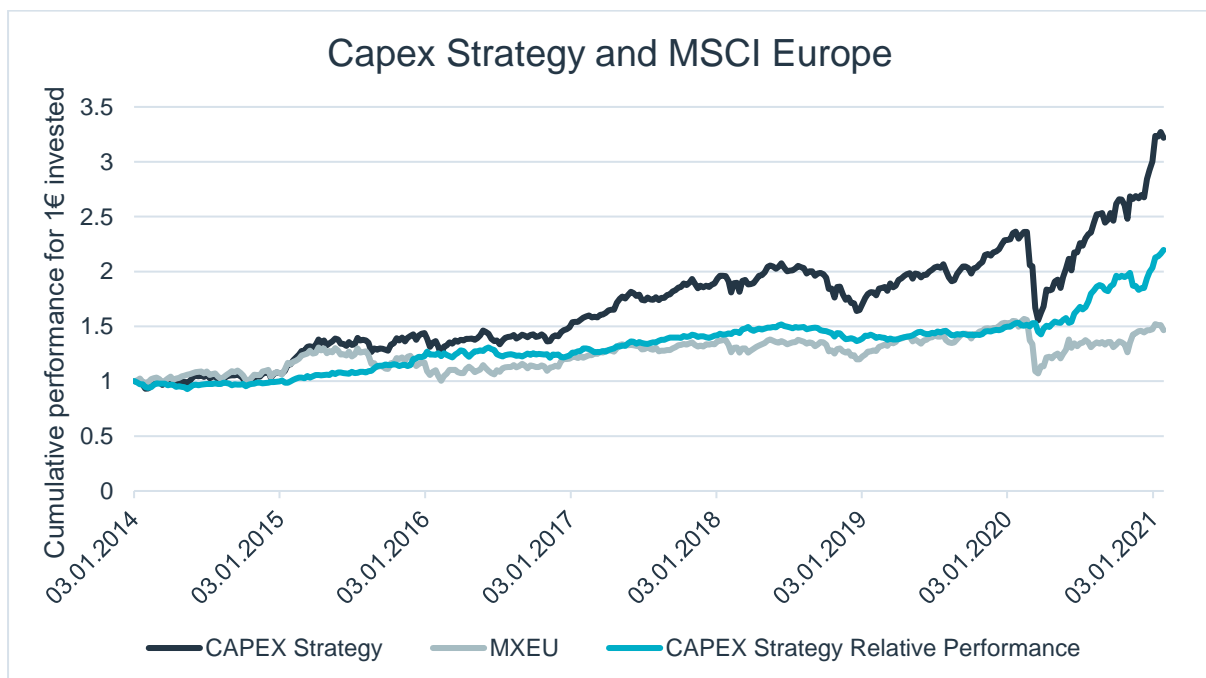

Figure 4 - Performance of our CAPEX Announcements Strategy.
Source: RAM Active Investments, FactSet, RavenPack

	Annualized Mean Returns	Annualized Standard Deviation	Information Ratio	Maximum Drawdown
Capex Strategy	18.31%	18.86%	0.9710	-34.25%
MSCI Europe	6.91%	17.24%	0.4006	-31.60%

Table 1 - Statistics for our CAPEX Announcements Strategy.
Source: RAM Active Investments, FactSet, RavenPack

Our Capex strategy greatly outperforms the MSCI Europe and doubles its Information Ratio. Both Maximum Drawdowns happened in March 2020, as Covid lockdowns were enforced across Europe.

STYLE ANALYSIS

As companies that report high asset variations perform poorly compared to companies which report small tangible investments, using these reports as a proxy for Capex can lead to the creation of value strategies[4].

We analyse the style of our strategy to figure whether the use of news shifts Capex strategies from value to growth.

	Intercept	Mkt – Rf	SMB	HML
Coef.	0.0025	1.9325	1.4939	-3.0188
p-value	0.062	0.000	0.134	0.000

Table 2 - Style Analysis for our CAPEX Announcements Strategy, using the Fama-French 3 Factors Model.
Source: RAM Active Investments, Kennet R. French (2021), Bloomberg

The presented Capex sentiment strategy exhibits significant positive alpha, a high level of market directionality with a bias towards high-beta growth stocks, which explains the very strong performance of the strategy in the post-Covid high-beta rebound.

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[4] Montagu et al (2018), *Searching for Alpha: Profiting from Capex*