Deal or no deal

A decade on from setting up Custodian Property Income REIT, Richard Shepherd-Cross faces a shifting market. And although the last planned deal didn't work out, he tells Tim Burke, he is hunting for the next

"You go through the five stages of grief. I'm parked in the rage phase at the moment, and I'm not planning to move on anytime soon."

It doesn't feel like the right time to obsess over semantics and tell Richard Shepherd-Cross that the second stage of grief is usually defined as anger rather than rage. The managing director of Custodian Capital is talking about his reaction to losing out on a £1bn merger earlier this year, when shareholders in Abrdn Property Income Trust voted against a tie-up with Custodian Property Income REIT.

Give the man space to grieve.

But Shepherd-Cross laughs. "No, let's be clear: I've accepted it," he says, speaking with EG in late June.

"Someone asked me the other day, 'Are you put off corporate activity on the back of it?' I said, 'Absolutely not'. I feel like a terrier that's been bitten by a rat. I'm now really angry and I really want to do one."

That's not ego talking; at least not in isolation. A decade on from setting up the REIT, Shepherd-Cross and his Custodian colleagues believe they have proved the firm's investment strategy pays literal dividends. But with the REIT regime shifting around them and smaller players being swallowed up or pushed to the brink of going out of business, the team acknowledges a pressing need for scale.

"When we launched, a £150m trust was big enough," Shepherd-Cross says. "It ain't big enough today."

By the book

Shepherd-Cross has spent three decades in the real estate business; half of that as an agent, mostly at JLL, and the other half in fund management, working for wealth management group Mattioli Woods.

"The very reason we launched Custodian Property Income REIT was to meet a very specific demand from the private clients of Mattioli Woods, and that requirement was they wanted long-term secure income," Shepherd-Cross says. "A lot of property funds have been set up by either fund managers or property jocks

"The metrics investors are focusing on are fear and greed. They are always unhelpful metrics in investment. Then there's time scale – everyone is far too short-term"

Assets from the Custodian portfolio: Parkway One, Sheffield

that have a good idea and think 'we could raise some money in the public markets and this idea would fly'.

"We came at it from the other end. The question we asked was not, 'What's going to be popular?', but 'We need to provide long-term secure income, what's the best way to do that?'"

Over the 10 years since, the REIT has grown from a portfolio valued at £150m to one of £590m, raising £350m of new equity along the way and joining in a wave of corporate M&A with the 2022 acquisition of Drum Income Plus REIT. But the market is tough for a business like this, Shepherd-Cross says.

"I thought I learnt in the textbooks that investment is about risk and return," he says. "Well, that's not what you would glean if you walked around the City for the past 10 years trying to raise money. It appears to be about liquidity and cost – and what a rubbish way to make decisions. To determine whether or not you are going to invest based on the liquidity of the vehicle you're investing in when you are buying already into an illiquid asset class just seems extraordinary. But that is where we find ourselves."

In Shepherd-Cross's view, one of the challenges is unintended consequences stemming from well-meant regulation, not least since the downturn of 2007 and 2008.

"Post-global financial crisis, we've seen a huge increase in regulation, particularly in the financial services sector," he says. "That regulation appears to be favouring liquidity, favouring scale and, of course, both those things work against return, and they also work against risk. We built this fund for private clients who are building pension funds, investing ISA monies, and we've got a post-baby boomer generation which has underfunded pension schemes. But they cannot make the investments they need to make because regulation doesn't allow it."

He believes Custodian has found "a niche" that lets the REIT target a higher income return without adding unnecessary risk. Smaller lot sizes and a diverse tenant base across its 150 properties work in the business's favour, he says.

"We have 10 times as many properties as some of our equivalent-size peers, and we've probably got three times as many properties as funds that are three times the size of us," he says. "But we have no one property let to any single tenant that is more than 1.5% of the rent roll. We don't have that concentration risk. And as well as diversification by lot size, we have diversification by sector, as we reduce our exposure to the high street and increase our exposure to retail warehousing. It is very consistent."

Shrinking pool

Genuinely diversified REITs are becoming an endangered species, Shepherd-Cross notes. If you strip out those winding down there is just Custodian, Picton Property Income, Schroder REIT and AEW UK REIT left, he adds, and his own has the highest covered dividend of the bunch.

"It has been fashionable of late to invest in single-sector funds," Shepherd-Cross says, before catching himself. "I'll rephrase that. It has been fashionable of late to invest in industrial and logistics

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CUSTODIAN PROPERTY INCOME REIT

sector funds. As they become more fashionable, so they start to get called things like 'pure play funds'. I always think these euphemisms are trying to hide something. And what they are hiding is that they are high-risk funds because you are invested in one sector.

"When the market is going well there is high risk, high return. But intu was a single-sector fund; high risk, awful return."

Custodian's latest annual results showed rental growth of almost 6%, occupancy up from 90% to 92%, and a FY25 dividend target of 6p.

"These are all really key markers for a healthy property market, but if you ask investors, they say 'no, we don't invest in property, we're not interested'," Shepherd-Cross says. "They must be saying that because look at the discounts to net asset value that we are seeing, and look at the dividend yields that you can get."

At the time of going to press, Custodian trades at a discount to NAV of about 18%.

Are investors focused on the wrong metrics? "The metrics they are focusing on are fear and greed," Shepherd-Cross says. "They are always unhelpful metrics in investment. Then there's time scale – everyone is far too short-term. We started talking about rental growth in 2019 and it hasn't actually made it into the portfolio for nearly five years, but that's the nature of real estate. We don't get the opportunity to increase rents more than once every five years on average."

There is also an "undue focus" on NAV, he adds. "We should be following the architects of the REIT regime, the US, and be looking at earnings. Every trading company that anyone has ever invested in, the key metric is earnings. [But when] it comes to real estate, they say, 'Oh, it's all about asset value'. But it's not, because it's the earnings that come from the rent that support the dividend."

The bell is ringing

There are deals to be done picking up assets at knock-down prices, Shepherd-Cross says, and anyone saying the bell doesn't ring at the bottom of the market is kidding themselves.

"The bell's ringing left, right and centre," he says. "This is the time to invest and if the investment company rules were different, if we had more of a US model around REITs and weren't hamstrung by references to NAV, this would be a fantastic time to raise money to buy earnings-accretive property.

"But, of course, we can't raise money unless our share price is ahead of NAV without shareholder approval. And if we went to shareholders, they would say, 'But NAV, that's the most important metric', and round and round we go."

That lack of ability to raise new equity was among the reasons the REIT pursued API. When Custodian and API agreed the terms of their all-share merger, Shepherd-Cross told EG the deal was the result of Custodian having "seized the opportunity".

"In markets where you cannot raise money because the share price and NAV metrics don't allow it, then consolidation through merger is another way to look at it," he said then.

Now API is working through what its team has called a "managed wind-down", after shareholders rejected the deal and an alternative offer from Urban Logistics failed to get traction.

Shepherd-Cross has little time for real estate jargon and euphemisms.

"It's a closing-down sale," he says. "It's called an orderly wind-down in order not to frighten the shareholders, but it's a closing-down sale."

Hence the grief. "What I think is terribly sad is that nobody has won from this deal not happening," he says. "The market was clamouring for larger funds. Here were two funds with very similar investment strategies. And 65% of API shareholders that voted, voted in favour. Unfortunately, the 30-odd-per cent of their register who are retail investors didn't really engage in the voting process at all. And in the end, it was only 14%, and only about four shareholders, that swung the needle because they were so desperate to see cash.

"We are now going to see that portfolio sold at – if I was a betting man – a 15% discount to net asset value. We offered them NAV."

But, like the angry, rat-bitten terrier, Shepherd-Cross remains on the hunt.

"It might be public markets," he says, adding that Balanced Commercial Property Trust, also being wound down, is not in his sights. "It might be privately. We have had conversations over the years and we will continue to have conversations with private propcos that might want an exit without exiting. You do a majority paper deal and you keep a hand in the game."

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