

CABINET

11 December 2018

Title: Institutional Funding Proposal – Hotel Investment	
Report of the Cabinet Member for Finance, Performance and Core Services	
Open Report with Exempt Appendices 2 - 8 (relevant legislation: paragraph 3 of Part I of Schedule 12A of the Local Government Act 1972 as amended)	For Decision
Wards Affected: None	Key Decision: Yes
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Accountable Strategic Director: Claire Symonds, Chief Operating Officer	
Summary <p>This report sets out proposals for the Council to enter into an investment arrangement with an Institutional Investor and Travelodge Hotels Limited (Travelodge). The proposal would generate significant annual revenue for the Council; support local charity work and support new employment. The development of the new hotel will provide employment for over 200 construction workers and, once complete, over 30 hotel staff benefitting East London as a whole.</p> <p>A site for the new hotel has been secured by Travelodge. The new hotel would be funded and built to a design, standard and specification agreed between Travelodge and their contractors. All development funding would be provided by the Institutional Investor who would also assume full site acquisition, construction risk and project due diligence. The agreement is conditional upon the grant of planning permission.</p> <p>The proposed transaction is a lease and leaseback arrangement between an Institutional Investor (long leaseholder), the Council (head lessee) and Travelodge as tenant of the Council. No rent is payable between the parties until the new hotel is constructed and Travelodge have entered their lease. Under this arrangement the Council would pay a guaranteed and indexed head rent to the funder for the term. Simultaneously, the Council would receive a matching guaranteed and indexed rent from the hotel operator for the term of the agreement. The rent payable by Travelodge to the Council is higher than the rent payable to the Institutional Investor, providing a profit rent to compensate the Council for providing the rental guarantee. The hotel operator assumes full operating, maintenance, insurance and room occupancy risk for the term of the Travelodge lease.</p> <p>A key element of the proposal is that a grant payment of £750,000 would be made to the Council to support social and community development in Barking & Dagenham. This payment will be made from the Community Fund of the Institutional Funder, established to help support delivery of the 'UN Sustainability Goals' as part of their Corporate Social Responsibility (CSR) programme.</p>	

Recommendation(s)

The Cabinet is recommended to:

- (i) Approve Option B1, as detailed in Appendices 2 and 3 to the report, as the preferred option in respect of the Council's participation in the proposed investment arrangement;
- (ii) Subject to (vii) below, agree to the Heads of Terms between the Council and the Institutional Investor as detailed in Appendix 5 to the report;
- (iii) Subject to (vi) and (vii) below, agree that the Council enter an Agreement to Lease with the Institutional Investor and Travelodge Hotels Limited on state aid compliant market terms;
- (iv) Subject to (vi) and (vii) below, agree that the Council enter a 50-year Head Lease with the Institutional Investor on state aid compliant market terms;
- (v) Subject to (vi) and (vii) below, agree that the Council grant a 35-year sub-lease with an option to renew to Travelodge Hotels Ltd;
- (vi) Delegate authority to the Chief Operating Officer, in consultation with Director of Law and Governance and the Cabinet Members for Finance, Performance and Core Services and Regeneration and Social Housing, to negotiate final heads of terms, final commercial and lease terms and agree the contract and ancillary legal documents to fully implement and effect the proposals set out in the report;
- (vii) Authorise the Director of Law and Governance, or an authorised delegate on her behalf, in consultation with the Chief Operating Officer to execute all the legal agreements, contracts and other documents on behalf of the Council; and
- (viii) Delegate authority to the Chief Operating Officer to incorporate a special purpose vehicle (whether a company or Limited Liability Partnership) if, in the Chief Operating Officer's, that would be necessary (such incorporation to include such shareholders or member's agreement as may be required);

Reason(s)

The proposals in this report would help to deliver the objectives of the Investment and Acquisition Strategy community development and help to deliver regeneration in East London.

1. Introduction and Background

- 1.1 An opportunity has been presented to the Council under the Investment and Acquisition Strategy (IAS) to participate in an institutional funded hotel investment. The proposals in this report would be held within the commercial property asset class of the IAS which includes an allocation for investment in hotel and leisure properties.

- 1.2 The site has been identified to construct the new hotel at Oregano Drive, Poplar E14 (a location map is included at Appendix 1). This will replace Travelodge's existing hotel on a nearby site which will be redeveloped as a data centre. Grant of Planning Permission for the new hotel is expected in April 2019. The total cost of developing (land, construction, fee and developers profit) the new hotel is c£90m.
- 1.3 Travelodge tendered for a forward funding partner to the institutional investment market to provide land acquisition and construction funding. A preferred funding partner (referred to as the Institutional Investor in this report) has been selected. This Institutional Investor will fund all site acquisition, construction costs and will also take planning and construction risk. Travelodge have appointed development and construction partners to acquire the site and construct the new hotel on behalf of the Institutional Investor and Travelodge. If the Council participates in this deal the Council will be party to the design and construction warranty package and have step-in rights if required.
- 1.4 A key investment objective of the Institutional Investor is to create stable and low-risk long-term returns to pay future pension liabilities. Such investors commonly aim to reduce their income risk by seeking to insert an intermediary tenant (in this case the Council) to sit between themselves and the ultimate occupational tenant (in this case Travelodge) and who has a better credit rating than the occupational tenant. In return the intermediary tenant receives a profit set at a level commensurate with the level of risk transferred. This risk transfer allows the Institutional Investor to fund schemes at competitive funding rates and to make available funding to support CSR objectives.
- 1.5 Consequently, the Council has been approached by the Institutional Investor with a proposal under which the Council would pay a guaranteed and indexed head rent to the Institutional Investor for a fixed lease term. In return the Council would receive a guaranteed and indexed rent from Travelodge for the term of the agreement.

2. Proposal and Issues

- 2.1 Under the proposals the Council would pay a guaranteed and index linked rent for a term of 50 years to the Institutional Investor. Simultaneously, Travelodge will enter into a 35-year lease with the Council (with an option to renew) matching the same index linked profile as the Authority's lease with the Institutional Investor. Rents will increase every 5-years in line with RPI subject to a collar of 1% and a cap of 5%. The hotel operator assumes full operating, maintenance, insurance and room occupancy risk during their 35-year lease term.
- 2.2 At the end of their 35-year lease the hotel operator has the option to renew their lease in which case the Council will continue to benefit from the profit rent.
- 2.3 If Travelodge did not renew their lease the Council has the option to either seek a new hotel operator or to redevelop the site for residential and/or office use. The lease terms agreed with the Institutional Investor allow for this possibility through renegotiation of the head lease and funding arrangements or by terminating the lease through the exercise of a break option (if this offered a financially better alternative).

Investment Returns

- 2.4 The proposals contained in this report would help to deliver the Council's Investment and Acquisition strategy (IAS) objectives by increasing properties held within the commercial property asset class in the sub-regional area. There is no capital outlay required from the Council.
- 2.5 The investment proposal has been appraised by adopting two options: one where the council retains the asset at the end of the lease and one where the asset would remain with the Institutional Investor. The first table at Appendix 2 summarises the financial returns to the Council under the options considered. A detailed report provided by the Council's external financial advisors on the proposed options is contained at Appendix 3 - these appendices are in the exempt section of the agenda as they contain commercially confidential information (relevant legislation - paragraph 3 of Part 1 of Schedule 12A of the Local Government Act 1972 (as amended)) and the public interest in maintaining the exemption outweighs the public interest in disclosing the information.
- 2.6 It is considered that option B1, as described in Appendices 2 and 3, is the preferred option. This option provides a balanced approach between the objectives to generate income returns whilst retaining long-term ownership and capital value. The second table at Appendix 2 compares the qualitative aspects of each option.
- 2.7 In each of the options the Council will be paid an arrangement fee by the Institutional Investor. This fee is being charged to reflect the strength of the Council covenant that is being procured through the transaction reflecting the nature and length of the transaction.

Project Delivery Structure

- 2.8 The transaction structure is a lease and leaseback arrangement between an Institutional Investor (long leaseholder), the Council (head lessee) and Travelodge Hotels Ltd as tenant of the Council.
- 2.9 The lease and project structure are summarised in the diagram at Appendix 4. The Heads of Terms between the parties are contained at Appendix 5 - these appendices are in the exempt section of the agenda as they contain commercially confidential information (relevant legislation - paragraph 3 of Part 1 of Schedule 12A of the Local Government Act 1972 (as amended)) and the public interest in maintaining the exemption outweighs the public interest in disclosing the information.

Hotel Investment Assessment

- 2.10 The Council have instructed a third-party property consultant (GVA) to assess the investment proposal and to value the asset. The full report is contained at Appendix 6. GVA have confirmed that the proposals within this report provide an acceptable investment for the Council and meet the investment objectives of the Council IAS. The key findings of the report are summarised in the table at Appendix 7 - these appendices are in the exempt section of the agenda as they contain commercially confidential information (relevant legislation - paragraph 3 of Part 1 of Schedule 12A of the Local Government Act 1972 (as amended)) and the public interest in

maintaining the exemption outweighs the public interest in disclosing the information.

Corporate Social Responsibility (Institutional Investor)

- 2.11 The Institutional Investor has established a Corporate Social Responsibility programme. The objectives of this CSR programme are to support delivery of the 'United Nations Sustainability Goals' among which is to encourage inclusive social, community and economic development.
- 2.12 A sum of £750k will be made available to the Council to help fund local social and community development programmes. This grant is being made voluntarily by the Institutional Investor in recognition for the parties' long-term investment commitments in the borough through the hotel proposal and in line with their Corporate Social Responsibility policies. It does not constitute part of the consideration for the commercial deal and should not be factored into evaluating the investment merits of the transaction.
- 2.13 Under the arrangements negotiated with the Institutional Investor the following payments will be paid to the Council who will then grant funds for the following illustrative community outcomes:
- Vulnerable housing need activities - £250k
 - Community Sport and Education Facility - £500k
- 2.14 The exact use of the proposed CSR payment and grant making arrangements will be subject to consultation with the community in Barking and Dagenham and in discussions with the Institutional Investor.

Project Timetable

- 2.15 The timing of the transaction and payment of Corporate Social Responsibility (CSR) grant funding to the Council would be as follows:

Date	Milestone
October 2018	Submission for Planning Permission
November 2018	Final hotel operator Investment Committee approval
December 2018	Transaction documentation finalised and signed by The Institutional Investor, Travelodge and LBBB conditional upon grant of Planning Permission
February 2019	Grant of Planning Permission
April 2019	Construction commences
April 2019	Agreement of use of CSR funds with Institutional Investor

April 2021	<p>Practical Completion, Travelodge sign the building off as completed, Travelodge enter their lease, LBBB enter their lease and revenue commences.</p> <p>Payment of arrangement fee</p>
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3. Options Appraisal

- 3.1 The Council has been approached to participate in a new Travelodge development on the Isle of Dogs. Construction of the new Travelodge has been commissioned by Travelodge and will be delivered by their development and construction partners. An Institutional Investor has been identified who will forward fund the project through to practical completion and will earn an indexed rental return for the duration lease term with the Council.
- 3.2 To reduce income risk, the Council has been approached to enter the lease structure between the Institutional Investor and Travelodge. Commercially the Council would pay a guaranteed, indexed annual rent to the Institutional Investor and in return retain a profit rent to compensate the Council for providing a rental guarantee. The Council would not be required to provide any capital funding either during construction or during the lease term.
- 3.3 **Scenario 1 – Do Nothing**
- 3.3.1 The Council has the option to not participate in the arrangement. In this case the Institutional Funder would seek another Local Authority partner or retain the profit rent itself. The Council would lose the opportunity to earn an annual profit rent. No arrangement fee would be made to the Council.
- 3.3.2 In addition, Council would not benefit from the Corporate Responsibility payment.
- 3.4 **Scenario 2 – provide a rental guarantee to the Institutional Investor in return for a long-term profit rent.**
- 3.4.1 Paragraphs 2.4 to 2.7 above set out the rental guarantee options considered under which the Council could participate in the investment proposal. These options have been modelled to provide the Council with a range of income and asset owning choices.
- 3.4.2 The profit rent and arrangement fee payable to the Council would generate sustainable long-term returns to support the financial sustainability of the Council in line with the objectives set-out in the IAS.
- 3.4.3 In addition, the ability to redevelopment the site for housing in the future provides a long-term asset that would support future housing delivery objectives of the Council through direct development or disposal to realise capital value for investment within the borough.

4. Consultation

- 4.1 The Cabinet Member for Finance, Performance and Core Services has been consulted and have raised no objections to the proposals in this report.

5. Investment Analysis

5.1 Investment and Acquisition Strategy (IAS)

- 5.1.1 The proposals in this report would help to deliver the investment objectives of the Investment & Acquisition Strategy. The new hotel would be held within the Commercial asset class of the IAS and would generate a profit rent to compensate the Council for agreeing to guarantee a head lease payment to an institutional investor.

- 5.1.2 Under the terms of the arrangement the Council will not provide any development funding or incur any future hotel operating costs (capital or revenue). All development risks will be borne by the developer and build contractor appointed by Travelodge with ultimate development risk borne by the Institutional Investor.

5.2 Risk

- 5.2.1 The Authority's payments under its lease will be fixed irrespective of whether Travelodge continue to meet their obligations under the terms of its own lease. The Authority has several options available should Travelodge default, which include contracting with other hotel operators, or converting the use to residential and/or office accommodation.

5.3 Lease Classification

- 5.3.1 Irrespective of which of the two options are taken by the Authority, the lease from the Institutional Investor to the Authority will be deemed a finance lease as substantially all the risks and rewards associated with the asset are passing to the Authority.

- 5.3.2 This will result in the asset being recognised on the balance sheet with an equivalent liability recognising the payments to be made to the Institutional Investor over the lease term. Each lease payment made will split between reducing the outstanding liability and servicing the interest costs implicit within the lease.

- 5.3.3 The Authority will recognise the asset as an Investment Property, as it will be held solely to earn rentals or for capital appreciation purposes or both.

- 5.3.4 The subsequent lease between the Authority and Travelodge can be assessed using a number of classification tests to determine the appropriate lease classification. Reviewing the current proposals in association with these tests suggests that the lease can be classified as an operating lease, in which case all income will be deemed to be revenue.

6. Financial Implications

Implications completed by: Helen Seechurn (Finance Director) and David Dickenson (Investment Fund Manager)

- 6.1 The full financial implications and associated risks of the proposed investment are contained in the exempt document at Appendix 8 (this appendix is in the exempt section of the agenda as it contains commercially confidential information (relevant legislation - paragraph 3 of Part 1 of Schedule 12A of the Local Government Act 1972 (as amended)) and the public interest in maintaining the exemption outweighs the public interest in disclosing the information). Members should note the key financial benefits of the scheme include an upfront arrangement fee anticipated to be received by 2020/21 dependent on the option approved by Cabinet.
- 6.2 Any returns on this scheme are assumed to be revenue contributions which will assist delivery of savings as defined in the MTFs (£10m required for 2020/21).
- 6.3 However, the arrangement with the Council acting as head lessor is not without risk. The financial modelling provided by our independent advisers Link Asset Services and GVA indicate the initial rental income the Council will receive from Travelodge and after payment of rent to the institutional investor will leave a profit rent of £0.33m under the preferred option, with future rental payments uplifted 5 yearly for inflation (RPI). The profile of these figures may change as detailed negotiations progress although the overall return will not change over the life of the lease.
- 6.4 Other risks that affect the financial position include the credit rating and security of the hotel. The Council will retain step in rights to secure another operator in the event of operator failure. These are dealt with in the GVA property report at Appendix 6.
- 6.5 The arrangement is such that the Council will own the freehold to the land at the end of the lease term for a peppercorn and will in turn benefit from increased land value growth over this period. Over the lease term land values are expected to increase significantly. Not considering land price inflation over the lease term (which is difficult to predict with any certainty) the Council will be able to buy the site for £1 at the end of the term because the Institutional Funder will have fully amortised their debt over the lease term.
- 6.6 Set up costs and SDLT incurred by the Council up to an agreed amount will be funded by the institutional investor.
- 6.7 Beyond the agreed initial lease period with the hotel operator, the council will remain responsible for the asset with the head lease obligation remaining lease term. This currently presents future options to the council including renewal of hotel arrangement or possibility of commercial or residential potential. The current financial appraisal assumes the renewal of hotel operations. However, the Council can terminate the lease with the Institutional Investor at the end of the Travelodge lease by enacting an early repayment clause.
- 6.8 The Investment and Acquisition strategy approved by Cabinet 16 October 2018 allows for investment: 'To establish a property portfolio to generate long-term revenue and capital growth, targeting an initial revenue return of £5.2m by 20/21

and indexed at CPI thereafter'. The proposal in this report would contribute to achieving this objective.

- 6.9 This strategy also, subject to regular review, allows up to 10% of the investment asset portfolio structure (currently £100m allocation) being 0.64% net yield (after debt). Whilst this decision will not score against the £100m target because it will not be financed through prudential borrowing. The expected yield (based on capital costs for comparison purposed) to be achieved from the scheme is expected to be above the target net yield (after finance costs) for this asset class.
- 6.10 It should be noted that although there is no additional borrowing required to enter this deal that the Council will be assuming obligations under the head lease with the Institutional Investor and the risks associated with this lease (principally the obligation to pay an indexed rent for the lease term) will need to be taken into account when making future investment decisions.
- 6.11 The pre-development and development costs will be met by the Developer. Consequently, the council will not be responsible for development cost overruns.
- 6.12 In making this decision members should also refer to the legal implications as detailed in that section.
- 6.13 It should be noted that although not located in this borough this project will increase business rates in the London Business Rates Pool of the Council is a constituent member.

7. Legal Implications

Implications completed by: Suzan Yildiz, Deputy Head of Legal Services (Trowers and Hamlin are also advising the Council on the transaction).

7.1 Council's powers to enter into the proposed arrangements

- 7.1.1 The Council has a variety of powers to enable it to enter into the proposed transaction. These are subject to the Council also complying with its fiduciary duties to its taxpayers/residents.
- 7.1.2 The actual powers which the Council relies on is to an extent governed by its purpose/intention in entering into the arrangements and whether any of the limitations or restrictions of those powers conflict with the proposals made by the fund.
- 7.1.3 We have separated the proposed transaction into relevant stages.

7.2 Entering the Lease with the Institutional Investor

- 7.2.1 Section 120 of the Local Government Act 1972 (section 120) gives the Council the power to acquire land (including a leasehold interest) for a purpose relating to any of its powers or pursuant to duties under any enactment (other purpose).
- 7.2.2 The Council in exercising section 120 may acquire land within or outside its area.

7.2.3 This means that the Council is required to identify another function (power or duty) which it seeks to exercise/rely on. Two powers which may be available include the general power and its investment power under Section 12 of the Local Government Act 2003.

7.3 **The general power**

7.3.1 The general power is set out in chapter 1 of the Localism Act 2011 and permits the Council to do anything which an individual may do. The general power is subject to several limitations which include that it cannot be used to circumvent any prohibition or restriction which exists in legislation which precedes the general power. We are not aware of any contravening legislation which would apply to the proposed transaction.

7.3.2 The general power is also subject to the limitation under section 4 of the Localism Act 2011, namely that if it is used for a commercial purpose then the Council must do that thing through a company or society registered or deemed to be registered.

7.3.3 Should the Council rely on the general power to directly enter the lease (rather than using a Council-owned company to do so) the Council would have to satisfy itself that it was not acting predominantly for a commercial purpose. In doing so it would have to analyse whether the letting of a hotel (in terms of the arrangements) was 'trading'. If the general power is to be relied on it will be necessary to analyse whether the circumstances of this proposal amount to 'trading'.

7.4 **Section 12 – the Local Government Act 2003 (LGA 2003) (Power to invest)**

7.4.1 The Council's power to invest (Section 12, LGA 2003) may be exercised for any purpose relevant to its functions or for the purposes of the prudent management of its financial affairs. In exercising this power, the Council would rely on the second limb, namely that the proposals aid prudent financial management and should have regard to relevant statutory guidance. The financial implications consider how the proposals assist the prudent management of the Council finances.

7.4.2 The Ministry of Housing Communities and Local Government (MHCLG) issued new statutory guidance (attached to the email) under section 15 of the Local Government Act 2003 on local authority investments on 1 April 2018 (MHCLG Guidance). In approving the proposals both officers and decision makers should have regard to relevant aspects of the MHCLG Guidance.

7.4.3 Local Authorities are required to adopt an updated investment strategy as is required in that guidance. The Council's Investment Strategy contains provision for commercial investments in hotel and leisure facilities. The report and accompanying financial reports (which are confidential and exempt) address how the proposals are aligned with the investment parameters for the commercial asset class.

7.4.4 The Guidance references 'non-financial assets' which includes certain property portfolios: 'non-financial assets that the organisation holds primarily or partially to generate a profit; for example, investment property'.

- 7.4.5 There are specific requirements for non-financial investments, and property portfolios, set out in paragraphs 37 to 40 of the Guidance. The Guidance requires local authorities to consider whether the asset retains enough value to provide security of investment using the fair value model in International Accounting Standard 40: Investment Property as adapted by proper practices.
- 7.4.6 In taking forward the proposals finance and legal officers should discuss the impact of MHCLG's guidance and whether the arrangements qualify as 'non-financial assets' under it. Consideration of the financial implications should include the extent to which the proposals amount to fair value and any proposed mitigation of risks.
- 7.4.7 Members should note that the CSR funding of £750,000 is being voluntarily made by the Institutional Investor for the purposes of future grant making to local organisations / charities and does not constitute any form of consideration to the Council. As such members should evaluate the merits of the investment on their own terms without having regard to the CSR payment. The Council will administer these future grants to suitable charitable organisations in line with the Institutional Investor's CSR programme and following local consultation.
- 7.4.8 The Council has the power to administer the CSR grant funding by virtue of the general power of competence under Section 1 of the Localism Act 2011, which provides the Council with the power to do anything that individuals generally may do. Section 1(5) of the Localism Act provides that the general power of competence is not limited by the existence of any other power of the authority which (to any extent) overlaps with the general power of competence. The use of the power in section 1 of the Localism Act 2011 is, akin to the use of any other powers, subject to Wednesbury reasonableness constraints and must be used for a proper purpose. In effect, the Council will simply be acting as the administrator of the grant funding from the Institutional Investor to ensure it is channelled appropriately for local needs. Providing that the grants are made to charitable or not for profit organisations who are not operating for commercial purposes or competing with the private sector, the grants should not amount to state aid. In any case, the funds are not public funds but are the funds of the private Institutional Investor which the Council will administer. The funds should be held in a separate designated account in the General Fund.

7.5 Power to grant a lease to Travelodge

- 7.5.1 The Council has a power to grant a leasehold interest in the property to Travelodge under section 123 of the Local Government Act 1972. In doing so it should ensure that it receives the best consideration which reasonably could be obtained. A valuation report confirming this should be obtained.

7.6 The Council's Fiduciary Duties

- 7.6.1 The Council's fiduciary duties could be briefly summarised as it is acting as a trustee of tax and public sector income on behalf of its residents' rate and tax payers. The Council in effect holds money but does not own it; it spends money on behalf of its residents' business rate and council tax payers.
- 7.6.2 The Cabinet in agreeing the recommendations should consider the risks and rewards of approving them and the proposed arrangements. In practice the Cabinet

should consider whether the proposals are on market normative terms which a prudent investor on the open market would enter into, whether the Council will achieve an appropriate return for the risk it is taking and whether the risk and potential cost to it of entering into the arrangements can be appropriately mitigated. Those the Cabinet delegate to should also consider the Council's Fiduciary Duties in finalising and agreeing the documentation.

7.7 Procurement structuring

7.7.1 The primary purpose of the transaction appears to be one of landlord and tenant and as such there is a strong legal argument that it falls outside of the Public Contracts Regulations 2015.

7.7.2 In finalising the documentation and structure advice should be obtained to ensure that any risk of procurement challenge is mitigated and minimised. Advice should be obtained at an early stage of negotiations about this.

7.8 State aid compliance

7.8.1 Under the proposals the Council will be entering into the arrangements mainly for mainly financial purposes. The leasing and letting of hotel accommodation are market activity and in agreeing final terms for both the Institutional Investor and Travelodge leases, the Council should be satisfied they are state aid compliant. To do this the Council should ensure it acts as a market operator would, meaning the terms it agrees should be such that an operator or investor in the private sector would agree to those terms in the same or similar circumstances). The Council should seek evidence from a commercial adviser whether in their opinion market/private sector parties in the same circumstances would be likely to do agree to the same or broadly comparable terms which constitute the market norm. Such a report (confirming that private/market sector parties will do so) will evidence state aid compliance.

8. Other Implications

8.1 Risk Management

- **Construction Risk** – All development and construction risks, including ground contamination, are borne by Travelodge Hotels Limited, their development and construction partners and by the Institutional Investor. Upon completion of the works the Council, as Head Lessee, will have the benefit of full warranty and title indemnity package etc. A tier one construction contractor has been selected by Travelodge to mitigate the potential for Contractor default. The hotel development works will be procured by Tarragon (the developer) and those works will be carried out by John Sisk & Son Limited (the contractor), backed up by a parent company guarantee from John Sisk & Son (Holdings) Limited under a fixed price contract funded by the Institutional Investor. The Institutional Investor will deal directly with the development team and will step in should there be a developer default. This approach mitigates the Council's exposure to the development risk. The Institutional Investor and the Council both have step-in rights to ensure completion of the development if this is not achieved by a long-stop date or in the case of force majeure events for example.

- **Hotel Market Risk** –The Council’s external property advisors have produced a detailed report on the investment proposals. This report is contained at appendix 6 and is summarised at paragraph 2.10 above. It is considered that this investment proposal is a market facing hotel investment opportunity that would be acceptable to other private and institutional investors.
- **Travelodge default** – The Council’s external property advisors consider that the covenant strength of Travelodge combined with full FRI lease terms and the relatively long-length of the Travelodge lease relative to other hotel investments represents a strong investment opportunity.
- **Funding risk** - The Council has no direct funding obligation in the proposed lease structure during construction or during the term of the Travelodge lease. The Council will only enter the lease structure on achievement of certain Conditions Precedent including achievement of Practical Completion and commencement of hotel operations by an agreed long-stop date.
- **Redevelopment risk** - if the Travelodge lease was determined the Council would have to find another hotel operator or redevelop/ convert the building for another use. Given the strength of the London Docklands hotel market it is considered that a new hotel operator could be appointed. A new hotel operator could be granted a new lease on the same or similar terms to the existing Travelodge lease, but they would require a rent-free period to rebrand and refurbish the building - typical such rent free period are two years (c £6m). The Council would receive no during this period. Alternatively, the Council could seek to appoint a hotel operator under a direct management contract to manage the hotel on behalf of the Council. In this case the Council would assume operations risk but could earn a significantly higher income from hotel operations than the expected profit rent.

Alternatively, the Council could seek a new planning permission to convert the building to residential use. The hotel building has been designed to allow future conversion, but conversion costings have not been provided. A conversion budget of c£14m to £20m would be likely to convert the building to provide c140 2 bed flats at a conversion cost of £143k per unit.

- 8.2 **Contractual Issues** – Contractual implications are as described and covered within the Legal Implications section of this report.
- 8.3 **Staffing Issues** – The construction stage of the project will be managed by Marwick on behalf of Travelodge and on behalf of the parties. In addition, the Institutional Investor will be supported by an Independent Certifier who will certify satisfactory completion of works and construction works payments in accordance with the build contract.
- 8.4 **Corporate Policy and Customer Impact** – The proposal in this report would help to deliver the objectives of the Council’s Investment and Acquisition Strategy and would help to provide revenue to support Council expenditure.
- 8.5 **Property / Asset Issues** – A 35-year renewable lease would exist with Travelodge. This would generate an indexed profit rent for the Council. There are provisions for rent increases every five years within the lease at 1% collar and 5% cap, based

upon the Retail Price Index. These provisions are mirrored in the Head Lease between the Council and Institutional Investor. The Travelodge would be a full repairing and insuring lease. In the longer-term the Council could seek to sell or redevelop the site for residential or mixed use to help deliver the Council's Housing Strategy at that time.

Public Background Papers Used in the Preparation of the Report: none

List of appendices:

Appendix 1: Location map

Appendix 2: Financial Returns Summary of the Lease Options (exempt document)

Appendix 3: Link Asset Services' Financial Report (exempt document)

Appendix 4: Transaction Structure (exempt document)

Appendix 5: Heads of Terms (exempt document)

Appendix 6: GVA Property Report (exempt document)

Appendix 7: Property Report Summary (exempt document)

Appendix 8: Financial Implications (contd.) (exempt document)