RESEARCH

Public Sector Funding in Hotels

Q1 2019

Local Authority Intervention

Historically, the role of the public sector in hotel development was largely restricted to ensuring a smooth planning process; times have changed! It is now increasingly common for local authorities to either fund or own a hotel.

So why is this happening?

First is 'place-making' and the role hotels can play in regenerating an area. A hotel which opens at a facilitating stage of regeneration in a town or city can cause a ripple effect, encouraging private sector investment in other parts of a project. As we detail in a number of case studies later in this article, a hotel can either inject life into an important, but underinvested 'gateway' location, or it can be developed to support a key 'anchor' development, such as a major visitor attraction. Local authorities can often 'take risk', investing into a hotel when it is less attractive for a private developer to do so. The local authority benefits not only from the commercial success of the hotel, but from the generation of employment (both directly and indirectly, through the supply chain), the boost to tourism and the hotel acting as a catalyst for regeneration.

Secondly, local authorities are feeling the pinch from a decline in central government funding. As a result, it is imperative for them to identify and generate new revenue streams. Many are taking a more commercial approach with the hotel sector presenting a major opportunity. Throughout most regions in the UK, hotel markets are experiencing record-breaking performance, resulting in strong appetite from hotel brands and operators to expand. This all provides an excellent opportunity for local authorities to generate revenue for years to come from hotels once they are up and running.

We now look at the background to local authority intervention in the UK; how you do you do it, who is doing it, as well as identifying the keys to success.

The Model - How do you do it?

The following tables highlights some common engagement structures.

Local Authority as Developer / Owner	Local Authority as Funder
Council as funder and owner of the hotel	Council offering commercial loan at low prudential borrowing rates
Council as developer solely or in JV with private sector partner	Grant funding
Council as tenant under a leasehold agreement	

The Model - How do you do it?

So how might this look in practice?

Let's look at an example.

The project is a 120 bedroom branded hotel operated under a management contract and located in a regional UK city, due to open in January 2020. The hotel achieves a stabilised year three occupancy of 73.2% and an average daily rate of £81.63 (in future values), resulting in an EBITDA of £990k. Taking into consideration build costs, valuation and funding, a development appraisal might look something like this:

Development Appraisal Estimates

	Values at Practical Completion	Values at Mature Trading (Year 3)
Value at Practical Completion	£9,887,373	
Value at Year 3 Trading		£10,844,913
Total Development Costs	£11,186,192	£11,186,192
Development Loan (60%)	£6,600,000	
Equity Required (40%)	£4,343,600	£4,343,600
Loan Balance at end of year 3		£5,673,944
Income Years 1-3 of Trade		£757,497
Development Profit	**-£1,298,819**	**£1,584,866**

The appraisal shows a significant funding shortfall on practical completion therefore it would be viewed as non-commercial to a private developer / investor. The Internal Rate of Return to equity at year three (before land and infrastructure costs) of 8.3% is below most developers threshold of above 12.0%

Lenders in this space would also struggle to fund this with debt servicing below their 2x comfort zone.

However, it shows a profit of £1.585m after year three highlighting that it is a positive project once it reaches stable trading. Therefore, there is a good case for the public sector to help bridge the funding gap to this point to help deliver the project, especially if this has a catalytic role in a wider regeneration project.

There are a number of scenarios that could be considered by the public sector to help facilitate the development.

These might include:

1. The debt servicing ratio as modelled might be considered too risky by mainstream banks. Middlesbrough Council provided £6m of senior debt funding at commercial interest rates (under low prudential borrowing rates) for the development of the Holiday Inn Express in the town centre (total build cost = £12.4m), when a "traditional" lender could not be secured. The justifications were that the hotel supported the on-going regeneration of the town centre, employment creation and bringing back to use commercial premises vacant for a number of years;

2. The developer might be able to secure forward funding if the hotel was operated by a third party under an income strip lease to the local authority. Under this deal, there is no requirement for capital outlay by the local authority, who instead would commit to the lease, underwriting the development and operational risk, with the right to purchase the development for £1 at the end of the lease. In such a scenario cash-flows generated by the business should provide headroom over the rent payable;

3. The local authority might fund the development of the hotel and either retain it as a revenue earning asset or dispose of it at stable trading. Whilst this requires the local authority to provide the equity for the development as well as take the operational risk, it also results in the highest returns to the local authority (all things being equal);

4. A JV with the developer could result in the local authority having a short-term stake in the hotel (to stabilisation), if the developer could be persuaded to do likewise. The appraisal shows a funding surplus of £1.585m on a year three exit; if the local authority provided 50% of the development equity (c.£2.2m), the cash to cash return might be £0.793m, or 36%;

5. The local authority could explore grant funding routes; most commonly these occur through local enterprise partnerships, or if it is a building of historical significance, through organisations such as the Heritage Lottery Fund or English Heritage.

Case Studies – Who is doing it?

We are aware of 21 hotels which have been successfully delivered in this space, with a development value of over £300 million; a further 14 are under construction or confirmed. Some high profile examples employing a range of delivery structures include the following.

Local Authority as Developer / Owner / Tenant

Liverpool City Council

Pullman Hotel Liverpool

Aberdeen City Council

Hilton Aberdeen Exhibition and Conference Centre

Dundee City Council

Sleeperz Hotel Dundee

AC by Marriott Dundee

1

Who:
Liverpool City Council (LCC).

Where:
Arena and Convention Centre (ACC) Liverpool.

Proposal:
216 bedroom Pullman hotel adjoining the ACC Liverpool.

Local Authority Involvement:
LCC stepped in to deliver and own the hotel when no private sector partners came forward.

Reasoning:
Any risk of failure was outweighed by LCC viewing an on hotel as being of critical importance to the success of the ACC.

2

Who:
Aberdeen City Council (ACC).

Where:
New exhibition centre; The Event Complex Aberdeen (TECA).

Proposal:
Hilton hotel conjoined to TECA (opening 2019).

Local Authority Involvement:
ACC are entering into a 35 year income strip lease agreement for TECA which includes the Hilton hotel. This ensures that the Council does not need to raise capital for the development, but the strength of their covenant has enabled the developer (Henry Boot Developments) to successfully forward fund it. The Council will then have an option to purchase the freehold for £1 at the end of the lease.

Reasoning:
The scheme is viewed by ACC as critical to the economy of the region in helping to attract major conferences and events. Although it is anticipated there will be a shortfall between annual income and rent (which ACC will have to bridge), it should be significantly lower than the current annual subsidy paid to operate the existing conference centre.

3

Who:
Dundee City Council (DCC).

Where:
Dundee Waterfront; a £1bn regeneration programme. At its centre is the new V&A Dundee museum which is expected to welcome over 300,000 visitors per year.

Proposal:
Recently opened Sleeperz Hotel Dundee. This forms part of a £14m redevelopment of Dundee Railway Station.

Proposed AC by Marriott hotel, directly opposite the V&A.

Local Authority Involvement:
Both hotels to be developed and owned by DCC. Sleeperz is managed under an operating lease, AC to be operated under a management agreement.

Reasoning:
The hotels are considered key components in regards to place-making and encouraging visitors to stay in the city.

The hotels also provide an ongoing revenue stream to the council.

Local Authority as Funder

Greater Manchester Combined Authority and Trafford Metropolitan Borough Council

Hilton Garden Inn Manchester Emirates Old Trafford

Middlesbrough Council

Holiday Inn Express Middlesbrough – Centre Square

Titanic Quarter Ltd and Heritage Lottery Fund

Titanic Hotel Belfast

4

Who:
Lancashire County Cricket Club (LCCC) along with the Greater Manchester Combined Authority (GMCA) and Trafford Metropolitan Borough Council (TMBC).

Where:
Emirate Old Trafford cricket ground.

Proposal:
150 bedroom Hilton Garden Inn integrated into the stadium (opened 2017).

Local Authority Involvement:
LCCC were unsuccessful in securing a commercial bank loan, leading to GMCA and TMBC stepping in to bridge the funding gap.

The £15m scheme was subsequently funded through a £3.4m cricket bond, £5m debt funding from GMCA and £4m from TMBC.

Reasoning:
The benefits of intervention included the creation of 70 permanent jobs, as well as ensuring the club can raise its profile moving forward in order to host international and domestic cricket, major music events and enhancing revenues of the venue's conference and meetings business.

5

Who:
Middlesbrough Council / Ashall Projects.

Where:
Centre Square, Middlesbrough town centre.

Proposal:
Holiday Inn Express hotel in a vacant building in a prominent gateway location.

Local Authority Involvement:
A £6m loan from the Public Works Loan Board towards the development when a "traditional" high street lender could not be secured.

Reasoning:
The hotel supported the on-going regeneration of the town centre, employment creation and bringing back to use commercial premises vacant for a number of years.

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Who:
Titanic Quarter Ltd (Harcourt Developments).

Where:
Titanic Quarter, Belfast.

Proposal: 119 bedroom boutique hotel located in the Category B Listed former Harland and Wolff drawing offices where the Titanic was designed.

Local Authority Involvement:
A successful application to the Heritage Lottery Fund (HLF) helped secure a £4.9m grant towards the development of the hotel. The grant formed part of the HLF's Heritage Enterprise programme which offered funds to aid the repair of historic buildings when the costs to do so are not commercially viable.

Reasoning:
Job creation, place-making as part of Belfast's Titanic Quarter (a major tourism district of the city) and bringing a historic building back into public use.

Keys Success Factors

So what are the 'keys to success' that local authorities, developers, owners, brands and operators need to be aware of?

Strong and bold leadership

For a local authority to be involved in a hotel project it requires strong and bold leadership from the offset; if the political appetite isn't there, the project will not happen.

Middlesbrough Council is an excellent example of this. For the development of the Holiday Inn Express Middlesbrough, the Council became the lender of 'last resort' when the developer failed to secure commercial debt funding. The Council enabled a £6m loan from the Public Works Loan Board at a competitive rate, passing it on to the developer. The Council foresaw the opportunity to use its advantageous covenant to unlock this scheme, creating jobs and revenue. As Sam Gilmore, Acting Head of Economic Growth at Middlesbrough Council notes:

> "It's all about pump-priming - the Council will become involved where there is market failure, to prove a concept and stimulate the market, then pull back. We are not trying to replace the private sector and will not cherry pick profitable ventures".

Many of the examples were only possible with strong and innovative leadership; from Liverpool and Dundee City Councils developing and owning hotels, to Aberdeen City Council taking a 35 year lease on the new Hilton.

The benefits are not just financial – consider the bigger picture

Yes, a successful hotel can provide a much needed revenue generating asset for a local authority, but they should be aware of the wider benefits.

Our case studies show how a hotel can boost the performance of an events venue (Liverpool and Old Trafford), rejuvenate a key area of a town centre (Middlesbrough), or support an anchor visitor attraction and gateway regeneration project (Dundee). This is about place-making through pump-priming development. Developing hotels in a key gateway location can overcoming poor impressions of a town and enhance the sense of place, particularly at a time where traditional high street retailers are struggling.

In all cases the hotels benefit the wider economy in terms of job creation and business rates. Sam Gilmore adds "Middlesbrough Council are at the forefront of setting the architectural benchmarks, and creating high value town centre jobs".

Beware the pitfalls

Councils need to follow strict state aid regulations and ensure that demonstrable market failure would occur without intervention. Using appropriate guidance, including the Market Economy Investor Guidance Principle, is important to measure the risk profile.

In our experience of projects in this arena, there have been differing practices in regards to operator selection and the implementation of an OJEU (Official Journal of the European Union) tender process. Some local authorities have gone straight to market, while others have followed a strict OJEU process. While a private and closed process is quicker, it obviously carries more risk in terms of accountability for the local authority. Local authorities should ensure they follow proper legal advice on whatever route they choose.

An anti-embarrassment (or on-sale clause) is often useful for local authorities to prevent quick sales and profiteering from the public sector.

Thorough due diligence from the onset

The Councils mentioned in this article can be considered 'pioneers' for stepping into the commercial hotel sector. But they have not done so without proper due diligence on the market opportunity, assessing the risks and ensuring that state aid regulations have been met.

As Graham Dodd, Managing Director of Development at Hilton Worldwide notes "Hilton's projects in this sector as a catalyst for regeneration and further inward investment, have been subject to significant, professional diligence by local authorities and their advisors prior to moving forward."

The more groundwork undertaken early on, the more credibility Councils gain with both the private sector and in gaining internal 'buy-in'.

Hotel operators RBH Management have been involved in a number of local authority schemes. Andrew Robb, Chief Business Development Officer details "The hotel industry is a unique market and hotel development can hugely benefit local markets, but without expert advice it can be a daunting industry to enter into for local authorities. I would always recommend for a local authority to surround themselves with expertise and advisors who have knowledge and a track record within the hotel industry to help facilitate the process so that projects can be advanced."

Develop rewarding relationships between the local authority and private sector

For local authorities and private sector parties to be able to work together on a hotel project, it requires a strong and understanding relationship.

For the private sector, they should be aware that decision making can be slow for a number of reasons, including the impact of the election cycle. But at the same time there is a responsibility for the local authority to keep stakeholders informed and up to speed on the process. Having an 'open book' relationship with transparency and flexibility are important factors.

Muse Developments have worked on a number of local authority intervention projects, including in Stockport and Blackpool. Phil Mayall, Development Director notes that "It is incumbent on the private sector to understand the constraints and sensitivities of the public sector" while also suggesting that "It is key for the local authorities to have good market knowledge to give them the confidence to make informed decisions to underpin their aspirations"

Avison Young have been involved in a number of projects discussed in this article. This is an exciting opportunity for local authorities and developers alike. The case for the viability of local authority hotel intervention has been proven; it is now up to the next wave of Councils to seize the initiative.

If you'd like to talk to one of our team to discuss this report, please get in touch.

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