

Our ref:
Ask for:
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BY POST AND EMAIL
STRICTLY PRIVATE & CONFIDENTIAL
The Chief Executive Officer and The Complaints
Officer
Scarborough Borough Council
Town Hall
St Nicholas Street
Scarborough
North Yorkshire
YO11 2HG

22 October 2020

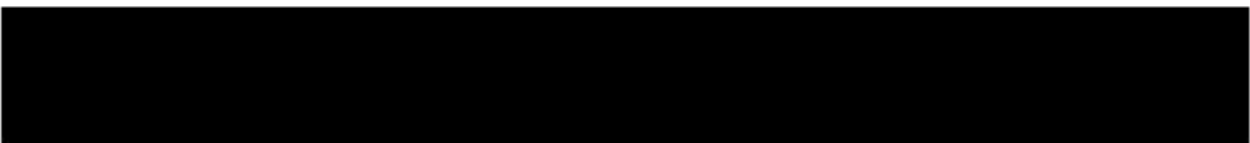
By email: mike.greene@scarborough.gov.uk
By email: complaints@scarborough.gov.uk

Dear Sirs

Second complaint

Our client:
Purchase of Travelodge Hotel, St Nicholas Cliff, Scarborough

- 1 As you are already aware we act on behalf of We are writing on behalf of our client to complain about the purchase of the Travelodge Hotel, St Nicholas Cliff, Scarborough on 10 October 2018 for £14million plus associated costs of some £828,000, made under the Council's Commercial Property Investment Strategy (RB 18/87) adopted by full Council on 14 May 2018.
- 2 Our client's complaint is based on the following grounds:
 - i. Inadequate due diligence carried out into the affairs of the tenant, Travelodge Hotels Limited.
 - ii. Failure to comply with Government Guidance "*MHCLG Investment Guidance*" as stated in para 1.0 of the Commercial Property Investment Strategy "*The Council has noted and has had regard to the Guidance. It has decided to depart from the Guidance in this instance, and within the parameters set out in this Strategy, for the purposes of maintaining a robust financial position. The Council has set out within this Strategy its approach to risk and risk mitigation, including the requirement for fully tested and scrutinised business cases, due diligence indicators and regular and formal reporting and scrutiny of investment decisions and performance*".



- iii. Failure to comply with the Council's Commercial Property Investment Strategy. In Para 7.0 it states "*The Council will appoint specialist advisors to provide training to ensure that relevant officers and members have the required skills to make informed decisions and assess the associated risks. This training will take place before any investment decisions associated with the Strategy are considered*".
- iv. A failure to adequately diversify investments to mitigate risk.
- v. The Council paid an excessive price for the asset.
- vi. The complaints set out above amount to maladministration and the Council has unreasonably suffered a material loss in relation to this investment.

3 We provide further evidence on each of these grounds of complaint as follows:

Inadequate due diligence carried out into the affairs of the tenant, Travelodge Hotels Limited

- 4 The Report presented by the Commercial Director for the Urgent Decision on 17/9/2018 reference RB 18/209 sets out the matters considered in making the decision to purchase the Travelodge. Whilst the report makes much of the valuation Report and condition of the property, very little is mentioned about the tenant, Travelodge Hotels Limited. The report states at para 3.6: "*The tenant is regarded as having good covenant strength, the lease is robust in terms of protecting an institutional landlord's position and the property is within the heart of Scarborough's tourist economy*".
- 5 It is not clear what work was done to investigate the affairs of the tenant. Para 4.3 refers to: "*confirmation that a Dun & Bradstreet credit report had been carried out which reflected a low level of risk comparable with the Experian report attached at Appendix 5*";
- 6 However, the published accounts of Travelodge are not specifically indicated as having been reviewed. The accounts for Travelodge Hotels Limited for the year ended 31 December 2017 were published at Companies House on 14 May 2018, so were available to the Council in part of its due diligence.

7 On the face of those accounts, the business appears very profitable, showing a pre tax profit for the year ended 31/12/2017 of £45.2M. However, there are certain items of note as follows:

- i. Turnover £624M
- ii. Rent payable £184M
- iii. Net Assets £316M

8 Further review of the accounts indicates the following that required further investigation:

Amount due from Group Undertakings £162m increased from £86m at 31/12/16. The note 14 in the accounts has the following footnote: *"As part of the funding of the Travelodge Group, Travelodge Hotels Limited makes loans to other Group companies which are used by these companies to settle other bank interest obligations. Amounts owed by group undertakings relates to these outstanding balances and associated interest charges owing from those companies. These amounts are unsecured and repayable on demand. An interest rate of 0 – 10% is charged on balances between fellow Group companies"*.

It is clear that the profits of Travelodge Hotels Limited are being loaned to the parent company Thame and London Limited to pay its interest.

Note 24 of Travelodge Hotels Limited accounts states:

"Travelodge Hotels Limited guarantees the debts of certain fellow Group companies. Further details can be obtained from the consolidated Group financial statements of Thame & London Limited".

9 The accounts of the parent company Thame and London Limited for the year ended 31 December 2017, were published at Companies House on 2 May 2018. They were published prior to the decision to purchase the Travelodge Hotel and disclosed a less attractive group position, with a loss before tax of £8.8m and an overall deficit on the balance sheet of £89.7m. If all the assets were disposed at the book values there would be a shortfall to pay creditors of almost £90m.

10 Further investigation at Companies House discloses a Mortgage registered against Travelodge Hotels Limited bank accounts on 28 April 2017 (prior to the decision to purchase the Travelodge). This mortgage is in favour of U.S Bank Trustees Limited, who it appears has this security in relation to the bond financing in Thame and London Limited whose debt liability is disclosed as £418m in the published accounts (note 19).

- 11 In summary a simple review of published information at Companies House would have indicated that the manner in which Travelodge Hotels Limited was structured did not provide security for its landlords nor could it be said objectively that Travelodge were a "good covenant". The high value of the property was dependent upon the high rent that was being paid. If Travelodge were to have any issues regarding its business the Council would undoubtedly suffer a loss. As events have unfolded this is the unfortunate reality.

Failure to comply with Government Guidance "MHCLG Investment Guidance"

- 12 As stated in para 1.0 of the Council's Commercial Property Investment Strategy "*The Council has noted and has had regard to the Guidance. It has decided to depart from the Guidance in this instance, and within the parameters set out in this Strategy, for the purposes of maintaining a robust financial position. The Council has set out within this Strategy its approach to risk and risk mitigation, including the requirement for fully tested and scrutinised business cases, due diligence indicators and regular and formal reporting and scrutiny of investment decisions and performance*".
- 13 Whilst we note that the Council was permitted to depart from the Guidance, in doing so it must take significant and appropriate measure to prevent a loss. The guidance is in place in order to minimise risk to Council finances. By deliberately not following official guidance and then suffering a material loss the Council has committed not only a breach of its own procedures but has acted in a grossly negligent manner. The measures and safeguards taken to mitigate this additional risk were clearly inadequate.
- 14 The Minutes of the Cabinet Meeting held on 17 April 2018 state "*The strategy report also responded to guidance recently issued by central Government on local government investments and the activity proposed by the strategy would ensure the Council took full regard of the recommendations contained within the updated guidance*". These Minutes were then presented to full Council on 14 May 2018. The Minutes do not make it clear either to Cabinet or full Council that the Council was departing from the Guidance. Whilst the Council's Commercial Property Investment Strategy did make this clear, it has not been drawn to the members attention, which if it had may well have not been brought into effect.

Failure to comply with the Commercial Property Investment Strategy

- 15 Para 7.0 of the Council's Commercial Property Investment Strategy states "*The Council will appoint specialist advisors to provide training to ensure that relevant officers and members have the required skills to make informed decisions and assess the associated risks. This training will take place before any investment decisions associated with the Strategy are considered*".
- 16 Our client has requested certain information under the Freedom of Information Act 2000. Please refer to FOIA7518. This FOI reply makes it clear that the Commercial Director has no professional qualification and has only undertaken what can be described as minimal training in relation to Commercial Property Investment. The reply indicates that he has carried out some private reading of Statutory Guidance on Local Government Investments and that he reads various journals including Property Week. Similarly the Monitoring Officer and the Section 151 Officer have either had no training or minimal self directed CPD in relation to property investment.
- 17 The Commercial Director heads up the Property Selection Team as set out in the Council's Commercial Property Investment Strategy, yet he has not received any specific training as required by Para 7.0 of the Council's Commercial Property Investment Strategy.
- 18 The Monitoring Officer and the Section 151 Officer are members of the Property Investment Governance Board as set out in the Council's Commercial Property Investment Strategy, yet they have not received any specific training as required by Para 7.0 of the Council's Commercial Property Investment Strategy.
- 19 The failure to comply with the training requirements of the Council's Commercial Property Investment Strategy has not enabled those senior officers to be in a position to make informed decisions or assess the associated risk.

A failure to adequately diversify investments to mitigate risk.

- 20 The Council has only purchased one property under the Council's Commercial Property Investment Strategy. This was confirmed to our client following a question he raised at Cabinet on 21 July 2020.

- 21 It is a basic principle of investment that risk is mitigated by diversification. Effectively by purchasing a single property of such high value the Council has been deprived of the mitigation that a diversified portfolio would have given.

The Council paid an excessive price for the asset.

- 22 The Travelodge hotel was purchased for £14million on 10 October 2018. The vendor had purchased the property on 11 December 2014, less than 4 years earlier, for £7.3million.
- 23 The Council has paid excessively for this asset because it was able to borrow funds for an extended period (40 years) at a very low interest rate. In effect the Council was able to pay a higher price and achieve a lower yield than that acceptable to a private sector investor, because of its ability to utilise the Public Works Loan Board.
- 24 It is highly unusual for an Investment property to almost double in value in less than 4 years, when there is no change in external factors. The tenant has not changed and the same lease exists over the property. The lease was dated 15 July 2008.
- 25 The substantial increase in price should have served as a warning to indicate that the price was excessive.

Maladministration and a material loss in relation to this investment.

- 26 In summary it is clear that the Council has not investigated the purchase of this investment property correctly and has failed to identify that the tenant's business was structured in a way that did not serve to benefit its landlords. This has been clearly demonstrated when Travelodge Hotels Limited entered a Company Voluntary Arrangement on 19 June 2020.
- 27 A report presented to Cabinet on 15 September 2020 indicated that the Council has lost rent on the Travelodge Hotel Ltd lease of £762,000 (para 3.1.7) as a consequence of the CVA.
- 28 The Council's draft statement of Accounts published on the Council Website shows a reduction in the value of the Investment in the Travelodge Hotel of £2,928,000. Within Note 13 of the Statement of Accounts it states "*The Fair Value adjustment loss shown during the year relates to the Travelodge Hotel in Scarborough. Creditors approved Travelodge Hotels Limited's CVA proposal on 19 June 2020 and the result of this is that the council will receive a lower level of rent during 2020 and 2021. The fair value*

of the property is calculated on an investment basis and the value adjustment reflects the variation in terms and the perceived risk associated with Travelodge's covenant strength as a result".

- 29 The valuation in the Statement of Accounts has been carried out internally by the Council's own valuer. Whilst not questioning the valuer's skill or integrity, an internal valuation does not carry the same credibility as a professional independent valuation.
- 30 Our client has been exercising his rights under Section 26 Local Audit and Accountability Act 2014 in relation to the Council's accounts for the year ended 31 March 2020. In a reply dated 19 October 2020, sent to our client by the Director Nick Edwards, comments were provided from the Council's internal valuer. These comments clearly demonstrate that the valuation included in the Council's draft accounts is no more than mere speculation. The value used is stated to be estimated at £11.9m. The true valuation can only be determined if the market was tested. Our client believes that the Council would not be able to achieve the estimated value in an attempted sale and that the stated valuation is still excessive in part for the reasons given by the internal valuer. It is also inaccurate as a consequence of the disclosures regarding "going concern" that are in the latest published accounts for Thame and London Limited for the year ended 31 December 2019 (filed at Companies House on 2 September 2020) together with the comments of the auditor under the heading "Material Uncertainty related to going concern – Group and Parent Company" in their report on those accounts.
- 31 Whilst it may be claimed that Travelodge Hotels Limited has been adversely affected by the Coronavirus pandemic, this is no excuse for the Council. The facts remain that the Council has suffered a material loss of rent and a significant reduction in the capital value of its asset. The measures taken to mitigate the risk (whatever they were) were inadequate and have failed.
- 32 The Council has taken the decision to make this investment, which is contrary to official Government Guidance and the Council has now suffered a material loss.
- 33 The failure to follow official guidance and the suffering of a material loss is prima facie evidence of maladministration.

Yours faithfully