S.P. 13/20

St Helena Government

PERFORMANCE AUDIT

THE 1, 2, 3 MAIN STREET HOTEL DEVELOPMENT

AUDIT ST HELENA
External Auditors

Performance Audit: The 1,2,3 Main Street Hotel Development

February 2020

Audit St Helena is the body that carries out financial and performance audits of St Helena Government on behalf of the Chief Auditor.

The Chief Auditor is a statutory position required by the Constitution of St Helena (Section 110). The Chief Auditor's responsibilities are set out in the Constitution and the Public Finance Ordinance. Section 29(2) of the Ordinance requires the conduct of performance audits on behalf of the Legislative Council to determine whether resources have been used with proper regard to economy, efficiency and effectiveness.

This report has been prepared in accordance with section 29(2) and published by the Chief Auditor, Phil Sharman. The audit team consisted of Cassidy Beard and Damian Burns, with assistance from David Brown and Vimbai Chikwenhere.

Executive Summary

Overview

This report investigates the value for money of the Saint Helena Government's (SHG) investment in a four star hotel at 1,2,3 Main Street in Jamestown (the hotel). SHG initiated the hotel development as part of its overall strategy for increasing economic development through tourism. With air access becoming a reality, the island needed an up-market hotel to both increase the number of bed spaces available for tourists and have a facility that catered to high-end customers.

St Helena Hotel Development Ltd. (SHHDL) was established in 2014 to build and operate the hotel, and is 100% owned by SHG. SHHDL employed the Mantis Group to provide operation and management services for the hotel, under a 10-year contract.

The hotel, while providing a highly rated service, has suffered financially since opening, as international tourist numbers have fallen below expectations and the low occupancy rate has adversely impacted financial performance. The hotel has been reliant on recurrent financial support from SHG to maintain the entity as a going concern in these early years of trading.

Given the ongoing concerns by the public, Legislative Council and SHG, Audit St Helena conducted a performance audit focussed on three lines of enquiry:

1) Did SHG proceed with the hotel investment with value for money in mind? *(pages 6 to 11)*

2) Are there significant risks arising from the financing and governance arrangements? *(pages 12 to 17)*

3) Is the investment contributing to SHG's overall strategy of making the island "altogether wealthier", and how is SHG ensuring this for the future? *(pages 18 to 20)*

Our key findings are presented on *page 5*. *Page 22* presents our conclusions and recommendations.

Key Findings

1. SHG set about the investment with value for money in mind, however its forecasts were overoptimistic

1.1 The island needed a hotel to achieve growth through tourism.

1.2 SHG attempted to engage the private sector, but was unable to attract an investor.

1.3 SHG made the decision to invest in the hotel development in the right way.

1.4 SHG worked on early designs so as to minimise costs, but the construction experienced delays and cost escalation.

1.5 SHHDL's business plan has proven overoptimistic.

2. The investment remains financially risky for SHG

2.1 SHG set up SHHDL to manage and deliver the project, as well as to secure financing, but the company lacked strategic vision for the hotel's future.

2.2 SHG has strengthened governance of SHHDL, however there is more to do to ensure VFM is maximised in decision making.

2.3 SHG and SHHDL are actively trying to reduce financial risks associated with the hotel's public investment.

2.4 Concerns about the hotel's management and profitability are starting to be addressed.

3. The investment has made a contribution to making the island "altogether wealthier", but next steps remain crucial to ensure value for money is realised

3.1 The delivery of the hotel fulfils the vision of SHHDL's business plan.

3.2 However, it is widely accepted across SHG that government should not own and operate a hotel.

3.3 SHG commissioned a consultant to consider the hotel's performance and the options for divestment. Its report suggested some options for SHG.

3.4 SHG has committed to maintain financial support, however has started seeking expressions of interest from potential buyers.

3.5 Overall value for money of the investment depends on a well crafted divestment strategy that aligns with the strategic objective of making the island altogether wealthier.

Part One

SHG set about the investment with value for money in mind, however its forecasts were overoptimistic

1.1 The island needed a hotel to achieve growth through tourism. The UK's Department for International Development (DFID) stated in its business case for the air access project that tourism numbers would have to grow in order for the project to achieve its goals. According to the business case, this growth would require adequate accommodation for visitors. Reports by the UK's National Audit Office and others highlighted that in order to achieve modest growth, at least one major hotel investment was needed. The need for SHG to enable investment in tourism accommodation was further emphasised in the 2012 exchange of letters for the airport investment agreed between SHG and DFID.

1.2 SHG attempted to engage the private sector, but was unable to attract an investor. Enterprise St Helena (ESH), the body tasked with St Helena's economic development, approached investors in order to establish whether there was an appetite for investing in a high-quality hotel on the island. In 2013, the Financial Secretary and Chair of the Economic Development Committee attended an event in Cape Town arranged by ESH. The event pitched St Helena to South African based hotel brands with a view of attracting investors to design, build and operate an up-market hotel on St Helena. This led to initial contact with two South African companies – Pam Golding and Protea. At this stage, the proposal was for a multi-site establishment across Jamestown. However it became clear that neither firms were willing to invest capital given the high-risk environment, preferring instead to operate a hotel through management contracts. This prompted SHG to approach DFID in an attempt to secure funding to invest in hotel facilities itself.

1.3 SHG made the decision to invest in the hotel development in the right way. DFID responded that it was not prepared to fund the construction of a hotel, however it had already assisted SHG by commissioning Ernst & Young (EY) to undertake:

1. a cost benefit analysis on six possible developments, alongside a "do nothing" option; and,
2. a value for money study on the two preferred options from this analysis: a development at Ladder Hill Fort and the development of 1 Main Street (as EY referred to the 1,2,3 Main Street site).

The two studies, completed in 2013, concluded that a redevelopment of 1 Main Street in Jamestown was the option which would provide the highest benefit to cost ratio, and thus achieve the greatest value for money **(Figure 1)**. Many of the assumptions that underpin the analysis, such as estimated tourist growth rates, were the same as what DFID used in its analysis for the airport construction. The studies also concluded that it would be highly unlikely for SHG to attract the desired funding from the private sector, so would be required to provide some up-front capital as well as seek loan financing.

Figure 1. Ernst & Young Cost Benefit Analysis (CBA) Results

Evaluation	Scenario 1: 1 Main Street	Scenario 2: Ladder Hill Fort
BCR	3.67	2.06
CBA NPV (£000)	29,387	19,488
Net development position NPV (£000)	820	(9,660)
Funding requirement (£000)	10,008	17,614
Construction employment (FTE total)	135	209
Direct employment (FTE annual average)	51	35
Indirect employment (FTE annual average)	70	49
Total direct and indirect long term employment (FTE annual average)	121	81
Year occupancy reaches capacity	6	4

Source: EY analysis

Notes:

1. ***NPV = Net Present Value, which is an estimate on a project's return on investment, discounted to its current value over the full life of the project***
2. ***BCR = Benefit Cost Ratio, which summarises the overall estimated value for money of an investment. It is the ratio of benefits to costs expressed in monetary terms. A higher BCR indicates greater VFM.***

1.4 SHG worked on early designs so as to minimise costs, but the construction experienced delays and cost escalation. Executive Council (ExCo) considered the results of the EY studies and agreed that SHG would subsidise the project rather than fully fund it. ExCo also chose the Main Street development as the preferred option. However the costs of the originally proposed development were too high, with the upper limit of construction costs estimated at around £10 million. SHG revised the plans and reduced the size from a 65 bed multi-site to a 30 bed single-site development on 1,2,3 Main. This reduced the project's proposed construction and development costs from potentially over £10 million to a budget of £3.9 million, including £3.6 million in construction costs and £0.3 million pre-opening costs.

After a competitive procurement round, SHHDL selected AGMAC as the preferred bidder for construction and the contract was agreed for £2.05 million. Mantis Developments Ltd. provided construction oversight on behalf of SHHDL at a contracted cost of £105,000. Other costs included a fee to Basil Read for early designs as well as other professional fees. Total capitalised spend for the project was £4.7 million, indicating the budget overran by 20% **(Figure 2)**.

Figure 2. Hotel Development Costs and Budget	£ million
Build cost – AGMAC	2.83
Build cost – other	1.55
Equipment and designs	0.14
Pre-opening costs	0.17
Total build	***4.69***
Budget	3.90
Overspend	0.79
Overspend %	***20%***

Source: SHHDL financial statements and hotel business plan

Overspend on the hotel was driven by unavoidable delays, as well as an unhedged exchange rate used in the contract, with the UK's decision to leave the EU having an adverse impact on the construction cost. This was identified in the business case as a high risk to the project, however the proposed mitigations did not address the foreign exchange risk and were neither sufficient nor actioned to prevent cost escalation. These other mitigations included:

- ensuring appropriate contingency and optimism bias were factored in at all stages of development;
- employing suitably qualified staff to ensure contractors costing was in line with an outlined and detailed cost plan; and,
- ensuring there was suitable project management experience in place.

Our review of project updates found that the hotel opening was delayed by 2 months, from 01 September to 01 November 2017. The main reasons for the delays were out of the contractor's control, and included:

- Island water shortages delaying essential works
- Unexpected discovery of igneous basalt rock on site
- Delays in shipping of material due to a breakdown of the Royal Mail Ship (RMS) St Helena

In addition to these limitations, the Public Accounts Committee (PAC) reported to Legislative Council (LegCo) in May 2018 that a defects warranty on the multi-million pound investment was for only 3 months, which was not suitable for the level of investment. SHG informed us that this is all that could be accommodated within the project's budget.

1.5 SHHDL's business plan has proven overoptimistic. In June 2014, SHHDL developed its own financial model based on the redesign which underpinned its own business plan for the hotel. The document was updated in July 2016 and April 2017. The business plan and financial model contained a number of key assumptions on annual occupancy rates and revenue forecasts that have proven overoptimistic. Annual occupancy rates for financial year 1 (the six months from October 2017 to March 2018 for reporting purposes) were half what was predicted, and the total loss for the six months was over five times larger than expected. For financial year 2 (April 2018 to March 2019) expected total comprehensive loss was £193,750. SHHDL's financial statements report a loss for this period of £747,429, almost 4 times larger than expected **(Figure 3).** According to the plan, the hotel was expected to break even in the third year of operation, however SHHDL is currently forecasting a loss for years 3 and 4, reducing to break-even or better in year 5.

The assumptions also differ from the EY analysis, for example the hotel now has fewer rooms and lower average room rates. Without access to EY's CBA model, we cannot say what impact these assumptions would have on the value for money case, however given the large variance in the actuals against the forecasts, it is likely to be significant.

Figure 3. Snapshot of Hotel Financial Performance against April 2017 Business Plan Forecasts

	Year 1 (October 2017 to March 2018)			Year 2 (April 2018 to March 2019)		
	Forecast in business plan (year 1 2017)	**Actual**	**Difference**	**Forecast in business plan (year 1 2018)**	**Actual**	**Difference**
Annual occupancy	40%	22%		45%	25%	
Room rates (£)	135	149		140	150	
Loss (£)	(93,703)	(507,183)	**-413,480**	(193,750)	(747,429)	**-553,679**

Source: Audit SH analysis of the hotel financial model, business plan, financial statements and BDO report

The business plan forecasts were based on the 'moderate' visitor growth projections outlined in The Journey Tourism Consulting & Management report, *Visitor Demand Assessment after the Completion of St Helena Airport* (September 2013). These assumptions also were used for DFID's original airport business case and the Ernst and Young CBA. Average annual occupancy rates were forecast to increase year on year based on increased non-St Helenian business and leisure visitors. It is now clear that the modest growth scenario modelled by Journey has proven optimistic.

For example, from November 2017 through October 2018, 2,191 non-St Helenians arrived for holiday and business compared to the 2,800 forecast by Journey. In the following 12 months, November 2018 through October 2019, fewer than half of the 4,300 forecasted non-St Helenian leisure and business travellers arrived, and the combined total actually fell by 122 from the previous year, to 2,069 **(Figure 4)**.

These tourism projections should no longer be used as a basis for decision making for this project nor should they be used by SHG when designing any other policies or projects. SHG informed us that it is not aware of any other current projects relying on Journey's projections. At the time when the hotel business plan was being generated these figures were considered the most up-to-date and relevant projections available.

Figure 4. 'Moderate' Visitor Growth Projections Used in the Hotel Business Case

Hotel year	Year 1	Year 2	Year 3	Year 4	Year 5
Forecasted non-St Helenian leisure and business visitors per year	2,800	4,300	5,600	6,600	7,700
Actual non-St Helenian leisure and business visitors per year	2,191	2,069	N/A	N/A	N/A

Source: The Journey Tourism Consulting & Management, Visitor Demand Assessment after the Completion of St Helena Airport, September 2013, taken from SHG's hotel business plan; SHG Statistics Office

Notes:

1. ***For this analysis year 1 is November 2017 through October 2018; year 2 is November 2018 through October 2019. This differs from our financial assessment, which uses financial years.***
2. ***The assumptions of Journey's projections were:***
    - ***One major hotel investment of 45 bedrooms coming on stream from year 1 with a target trading occupancy of 50%***
    - ***Growth in the independent accommodation sector***
    - ***Introduction of a second Cape Town flight in year 2***

Part Two
The investment remains financially risky for SHG

2.1 SHG set up St Helena Hotel Development Ltd. (SHHDL) to manage and deliver the project, as well as to secure financing, but the company lacked strategic vision for the hotel's future. SHHDL was incorporated as a private company limited by shares on 24 June 2014 under the provisions of the Companies Ordinance 2004, with an aim to develop the first international standard hotel in St Helena. St Helena Government is the 100% shareholder.

According to the hotel business plan the original mission statement for the hotel was to "*[develop] a pathfinder hotel in the centre of Jamestown that provides 4-star quality accommodation in the early years of air access, helps to prove St Helena as a tourist destination and offers training opportunities that support development of the hospitality sector*" by achieving the following objectives:

- Raise finance of £3.9m to fund the development of a 30-bed hotel in Jamestown.
- Secure appropriate buildings.
- Achieve occupancy of 40% in year 1 rising to 50% by year 3.
- Repay debt financing over the first 10 years of operation.
- Implement a pricing strategy that achieves occupancy levels that still leave a viable market for competing local accommodation providers.

While the board has been successful in constructing and opening the hotel, it did not have a strategic vision from the outset as to its aims for the hotel's future, nor did it achieve some of its above objectives, such as the occupancy rates. No exit strategy was designed at the outset, nor has one been fully developed to date.

2.2 SHG has strengthened governance of SHHDL, however there is more to do to ensure VFM is maximised in decision making. The original directors represented both the St Helena Government and Enterprise St Helena. Since then, the structure of the board has changed to include representatives from the private sector as well as SHG's Finance Business Manager (FBM). The latter acts as a non-executive director on the boards of State-Controlled Entities (SCEs) and is charged with strengthening governance of the board.

Our 2018 report *Governance of State Controlled Entities* contained 16 recommendations to improve the governance of bodies such as SHHDL. SHG has been implementing these recommendations, beginning with the appointment of the FBM. This director has been in place since February 2019 and has worked to strengthen governance of SHHDL by:

- Developing an ownership policy for all SCEs, including SHHDL;
- Aligning the objectives of the hotel with government policy;
- Setting stronger objectives for SHHDL; and,
- Developing better performance reporting systems

SHG still has more work to do, including:

- developing polices on public disclosure of information;
- developing a remuneration policy and attendance policy for board members – although SHHDL board members are not presently compensated, this practice has not been formalised; and,
- establishing a regulatory authority for the industry.

Figure 5. Roles and Responsibilities

Construction phase

Operational phase

St Helena Government (SHG)
Owners

St Helena Hotel Development Ltd (SHHDL)
Stewards: Tasked with oversight of the construction, operation and future divestment of the hotel

Board composed of ESH and SHG representation

Board now composed of ESH, SHG and private sector representation

Mantis Development SA (PTY) Ltd.
Contracted to deliver two phases:

1. Phase One responsibilities included:
   - Day to day monitoring of the Contractor's performance
   - Advising on development constraints
   - Advising on commercial viability of designs
   - Checking costs
   - Advising on proposed changes to specifications
   - Advising on preparation of the hotel construction contract and associated documents
   - Supporting contract negotiations
2. Phase Two responsibilities include:
   - Effectively managing the hotel contract on behalf of the Contracting Authority

Basil Read
Responsible under a letter of intent (January 2018) for design and build of the hotel. Responsibilities eventually limited to early design work.

Synergy Property Solutions
Project management support

AGMAC
South African based contractors hired to construct the hotel

Local contractors
Subcontracted by AGMAC for various works

Mantis Management (PTY) Ltd.
Contracted under the Hotel Management Agreement (April 2017) for a 10-year period from the date of opening. Services include (among others):

Pre-opening services
- Establishing a staffing plan and recruiting employees
- Preparing a marketing plan
- Preparing a pre-opening services plan
- Monitoring pre-opening costs against SHHDL's budget
- Designing environmentally friendly operating processes
- Establishing management and financial control procedures
- Training employees
- Determining room rates and a credit policy
- Planning and costing menus and bar tariffs
- Designing food and beverage control procedures

Operating services
- Appointing a general manager
- Operating the hotel as a four star facility as described by the Tourism Grading Council of South Africa
- Hiring and training all staff
- Establishing and operating a marketing plan
- Establishing and implementing all charges, rates, discounts etc.
- Keeping the hotel in good repair
- Having due regard for all guests
- Compiling and maintaining all accounts

2.3 SHG and SHHDL are actively trying to reduce financial risks associated with the hotel's public investment. The development of the hotel was financed though the provision of equity capital (buildings), SHG cash in exchange for shares and loan financing from the Bank of St Helena (BOSH). **Figure 6** overleaf breaks down the total public investment in the hotel.

In terms of shareholders equity SHG has invested £2.45 million being £1.85 million in cash and £0.6 million in property. ESH has exchanged loans of £0.184 million into shares. In addition BOSH has advanced loans of £2.803 million with £1.303 million secured against property, £1.0 million with a formal guarantee by SHG and a further £0.5m backed by a letter of intent from the Governor.

Separate to the capital finance the hotel also received £0.4 million from SHG in 2019/20 in the form of recurrent subsidy with further subsidy of £0.2m anticipated in 2020/21 after implementation of cost-reduction measures proposed by the operator.

At the time of receiving the loans, interest payments were granted a holiday period of 18 months until June 2019. However, this period has expired for the first loan and the SHHDL board have sought an extension for cash flow purposes. The bank approved this extension to 1 April 2020.

At the time of obtaining the loans, SHG and SHHDL had little option but to seek the credit though Executive Council initially resisted this move. While the plan was to have all loans paid off within 10 years, SHHDL soon realised it needed to lower the amount of debt. In the August 2018 Special Meeting of the Board of Directors, it discussed a forward strategy that included SHG maintaining a majority shareholding while raising sufficient capital to keep the company running and paying off the two largest loans. Options discussed included offering community shares and an outright sale. A report by consultants BDO states that £2 million in capital would be needed to cover the loans.

Figure 6. SHG's Financial Exposure

Type of finance	Amount (£ million)	Terms
<u>SHG Investment</u>		
Equity capital	0.600	Transfer of the buildings on 1,2,3 Main Street to SHHDL December 2016
Cash investment	1.500	Initial equity investment in SHHDL May 2016 @ £1 per share
ESH equity shares	0.184	Originally a loan converted to shares May 2018 @ £1 per share
Special warrant	0.350	Additional equity injection as working capital July 2018 @ £1 per share
Total	***2.634***	
<u>Loans</u>		
BOSH 1	1.000	Secured term loan agreed 28 Sep 2016 repayable over 10 years at 3% interest above 12-month GBP LIBOR. First repayment due Jun 2019. SHG requested extension for cash flow reasons
BOSH 2	1.303	Granted by BOSH 17 May 2017. Secured against property under construction at an interest rate of 4% plus 12-month LIBOR
BOSH 3	0.500	Granted by BOSH in March 2018 secured against a letter of intent from the Governor's office. Letter of intent requires payment by 2020. Loan at 5% plus 12-month LIBOR
Total	***2.803***	
SHG Operating Subsidy	***0.400***	Financial year 3 operating subsidy
Total	**5.837**	

Source: Audit St Helena analysis of SHHDL and SHG financial information

2.4 Concerns about the hotel's management and profitability are starting to be addressed. Mantis Management Ltd. is employed to operate the hotel under the terms of a Hotel Management Agreement (HMA) and for the first three years of operation, it was to earn a fixed fee of £50,000 per annum. In May 2019, Mantis agreed to lower its management fee to £36,000. In October 2020, the arrangement will change whereby Mantis will earn 4% of Adjusted Gross Revenue plus an incentive fee of 9% Gross Operating Profit. Were this applied to the hotel's reported performance for 2018/19, Mantis would receive £39,000 despite an operating loss of £747,000 (see **Figure 7**).

Figure 7. Estimated Mantis Operating Fees Based on Current Hotel Performance

Incentive measure	2018/19	% share	Potential Pay-out
Adjusted gross revenue	864,000	4%	£34,560
Gross operating profit	46,000	9%	£4,140
Total			***£38,700***

Source: Audit SH analysis of SHHDL financial information

Notes:
1. ***Estimates based on unaudited financial statements***
2. ***Total operating loss for the financial year is £747,000***

Reasons for the hotel operating losses are well documented, including a high cost and inefficient workforce structure, high utility costs and low room occupancy. While the performance of some aspects of the business are outside of Mantis' control – such as local workforce availability – it could be doing more to improve the hotel's financial performance by identifying further operational efficiencies and improving its marketing strategy. SHG should review the hotel management agreement and consider whether there is adequate incentive in place for Mantis to keep up with its obligations, including whether there is enough incentive for the operator to ensure profitability.

Beyond the issues with the structure of incentives in the HMA, the SHHDL board has scope for improvement of its oversight of the company's performance. The board do not currently compile and monitor a formal risk register, leaving the organisation exposed to short, medium and long term operational and financial risk. It is clear that SHHDL lacked sufficient executive capacity and therefore was unable to exercise effective oversight of the operator. Such contract management arrangements are essential for holding Mantis to account for the management of the hotel as a business in accordance with the terms of the HMA. This is especially important given the direct effect of poor management of the hotel on the public purse.

Recent evidence has shown the board's oversight of Mantis improving, for example through their review of a business improvement plan that began in July 2019. While the board have been content with the results of the improvement plan so far, the solvency of the hotel for 2020/21 remains dependent on SHG's continued support.

Part Three

The investment has made a contribution to making the island "altogether wealthier", but next steps remain crucial to ensure value for money is realised

3.1 The delivery of the hotel fulfils the vision of SHHDL's business plan. The hotel has drawn positive reviews from international guests and the local population, and is contributing to the island's overall prosperity. The aim of the hotel was to fill a gap in the local hospitality offering that was not being filled by private investors. To this end, it has provided a facility that didn't previously exist and SHHDL have successfully "*[developed] a pathfinder hotel in the centre of Jamestown that provides 4-star quality accommodation in the early years of air access, helps to prove St Helena as a tourist destination and offers training opportunities that support development of the hospitality sector*", as the hotel's mission statement promised.

A report by consultants BDO, commissioned by SHG, confirms that the hotel is high quality and fills a previous gap in the hospitality market. Positive reviews from high-end tourists and business visitors corroborate this assessment. Tripadvisor gives the hotel an average rating of 4.5 stars out of 5 from 81 reviews. Booking.com rates the hotel as "superb". Our scan of guest reviews, confirms that the hotel is living up to what is expected of it from the consumer's point of view.

3.2 However, it is widely accepted across SHG that government should not own and operate a hotel. SHG is committed to releasing the hotel to the private sector. The island's Governor made clear in his welcome speech that he was committed to enabling private investment to flourish on St Helena. St Helena's Legislative Council (LegCo), the body of elected members responsible for creating island legislation, has expressed a desire to release the hotel from public control. Finally, the SHHDL Board, on which the Financial Secretary sits, are committed to releasing the hotel to the private sector and are working to pursue this goal.

3.3 SHG commissioned a consultant to consider the hotel's performance and the options for divestment. Its report suggested some options for SHG. In March 2019, SHG received a report from BDO which gave it four options that it could take forward **(Figure 8)**. The report concluded that the hotel's trading performance is not sufficiently robust to attract external funding. Instead, it recommended that SHG continue to subsidise the hotel for the next 2 years, in the anticipation that it will break even at the earnings before interest, taxation, depreciation and amortisation (EBITDA) level in 2021/22. The report recommended that once this is realised, SHG should review its divestment options such as considering either attracting external investment for equity share or a community share offer. BDO's analysis used revenue forecasts that were more positive than the hotel's actual performance for 2019/20.

Figure 8. BDO Divestment Options

Option 1	Continue subsidy until such a time that the hotel is able to break even at the EBITDA level
Option 2a	Attract external investment in exchange for equity share
Option 2b	Community share offering to encourage investment by locals or Saint Helenian diaspora abroad
Option 3	Disposal of hotel by sale
Option 4	Closure of hotel on a seasonal or permanent basis

Source: BDO

3.4 SHG has committed to maintain financial support, however has started seeking expressions of interest from potential buyers. The Financial Secretary wrote to the Chair of the SHHDL board in November 2019 acknowledging that the hotel would break even later than expected given that St Helena is an emerging tourist destination. The letter stated SHG's intention to continue to subsidise the hotel during 2020/21, as well as make sufficient resources available to SHHDL to meet the repayment obligations for the BOSH loans due in April 2020.

In October 2019, the hotel was officially put up for sale through the inclusion of it in the island's investment prospectus, however there is no strategy in place to drive the divestment forward beyond advertising it alongside a host of other SHG assets. This approach differs from the plan suggested by BDO.

3.5 Overall value for money of the investment depends on a well crafted divestment strategy that aligns with the strategic objective of making the island altogether wealthier. SHG must not rush this. Despite the significant strain the hotel has put on government, future decisions need to consider the welfare of the whole island in order to achieve value for money from the investment. SHG needs to weigh up the prudential financial management implications in terms of managing risk to public capital invested and developing a tourism-led economy in the medium term with the need for ongoing public subsidy in the short term. SHG stated in a formal LegCo session in March 2018 that the timing of the exit strategy would begin in the first year the hotel was expected to be profitable – 2019/20. It is now the end of that year, however the hotel is nowhere near the financial position SHG hoped.

Conclusions and Recommendations

Government's investment in the hotel was a necessary intervention given its obligations and the unfavourable market conditions, but it relied on overoptimistic forecasts. SHG was obliged under the terms of the air access agreement to ensure there were appropriate accommodation facilities on-island for mid to high-end tourist and business visitors. After attempting to accomplish this through outreach to international investors, it soon became clear that market failures existed and SHG would have to take a more active role in filling the accommodations gap. While SHG initiated its investment activities in a manner that should have maximised value for money, it was overoptimistic in its predictions for visitor numbers and financial performance. Unfortunately, this was the best information available to SHG at the time.

Government is not currently getting value for money from its investment. SHG is currently carrying significant financial risk on the back of the investment owing to the debt financing structure, and the hotel will continue to exert pressure on SHG's recurrent budget as Government continues to be responsible for subsidising the hotel's losses.

The hotel is fit for purpose but a managed exit will be crucial given the financial risk exposure. Despite the financial issues, the building and quality of service provided by the hotel are consistent with what SHG desired at the outset. Now that SHG has decided to sell the hotel business along with its associated land and buildings, it needs to develop a detailed strategy outlining its divestment goals and then pursue them actively. The hotel may provide value for money in the future, however this would depend on a continued high level of service, in line with the island's needs, as well as a careful and deliberate approach to the divestment.

SHG should consider the following recommendations:

a) The project experienced cost escalations during construction as a result of inadequate risk mitigation. SHG should strengthen its risk identification and mitigation procedures for all projects and investments to ensure this is not repeated
b) SHG should develop a methodology for including appropriate optimism bias estimates into its forecasting
c) SHG should develop a methodology for revisiting any forecasts, particularly where sensitivity analysis shows that assumptions may alter model outputs to a high degree
d) Journey's tourism projections should no longer be used for any SHG decision making. SHG should publish some revised projections for future tourist visitors as soon as possible
e) SHG should estimate the subsidy it will provide to the hotel over the coming years up until its anticipated divestment to inform a prudential financial management strategy
f) SHG should review the Hotel Management Agreement and consider whether there is adequate incentive in place for Mantis to minimise costs and maximise revenue
g) SHG should ensure SHHDL has established effective contract management arrangements for the duration that it remains in public ownership
h) SHG should design a structured divestment strategy for the hotel which outlines:
    - Timeline
    - Expected sale price
    - Buyer conditions
    - Expected benefits and costs
    - Prudential financial impact