Creative Industries Council
Access to Finance Working Group Report

December 2012

The UK Creative Industries: over talented, under resourced

Foreword from the chair of the Working Group

The UK is arguably the most creative nation in the world. UK music, television, film, games, fashion, design, advertising and architecture is celebrated around the world. But whilst UK creative talent might win coveted artistic awards, too often is the case that the revenue derived from their endeavours is banked overseas. Given our unique ability to create world-beating intellectual property, the opportunity to contribute more to UK GDP is often lost when content is produced on a work-for-hire basis for foreign companies and investors who see greater value in UK intellectual property than we do ourselves. If we are to truly make an economic success of the creative industries in the UK, we must aim to retain legal ownership of intellectual property in the UK so that the global taxable revenues from its exploitation flow back to the UK. Consequently, we believe there is an urgent need to better understand the critical relationship between intellectual property ownership and risk capital.

Whilst the creative industries are currently defined as a group of content, service and craft businesses, their traditional taxonomy is being challenged by the speed of technological change. Demand-led service companies are inherently less risky than supply-led content companies. In the main, content companies are under-capitalised, one consequence being that they are unable to retain ownership of their IP, typically trading it away for project finance. We decided, therefore, to focus the Access To Finance report on creative content companies whose needs are greatest and whose issues are least understood by the investment community. With the explosion of digital content being served to global markets via high-speed broadband, it is important to understand the potential of these companies to scale, thereby offering significant returns on investment.

The generation of intellectual property in the creative industries tends to come from a myriad of small or start up enterprises. These companies require finance to become established, but few have fixed assets. The intangibles assets they generate during development are difficult to value until after launch, making it difficult for financiers to invest if they do not understand the sector and its business models. Moreover, content businesses, especially digital content businesses, are 'hit driven', therefore requiring a portfolio approach to investment to mitigate risk. It is inappropriate to apply 'old world' ways of valuing these businesses. Creative ideas are being turned from concept into reality at a rate that is impossible for traditional investors to respond to. The world is moving from analogue to digital, from products to services, and from premium pricing to freemium. The new challenge is customer acquisition, retention and monetisation. Data is key to assessing risk. In the digital world, analytics and metrics are necessary to understand customer behaviour and spending, and more useful than P&Ls and their guestimate assumptions. Creative content entrepreneurs should not, therefore, think of 'old world' banks as their first port of call to raise finance. High street banks are not best placed to provide the type of investment required. Nor should they be. The real need is for equity investment, not loans, in order to scale.

Innovation will undoubtedly accelerate economic recovery. Innovation in access to finance such as crowd funding, creative industry funds or a business bank to invest in content creators will help drive growth in the creative industries. However, access to finance is just part of the bigger picture to make the UK the best place to do business and become globally competitive. In addition, critical mass of activity in the sector can only result from:

1. Sustained government commitment and support
2. Providing a skilled workforce built on the introduction of computer science in the classroom
3. Continued promotion of art and de sign in the classroom
4. Promoting the creation and retention of intellectual property
5. Better understanding of digital creative content businesses and their potential to scale
6. Investing in super high-speed broadband.

Together they will help to create a landscape in which creative minds will flourish and creative content-owning businesses will be built.

For too long the creative industries have been seen as 'fluffy' and run by 'luvvies'. For too long, they have been over-talented and under-resourced. There is a real opportunity for designers, artists and creative technologists to realise the true wealth-creating potential of their creativity and innovation. In order to grasp the opportunity, investors must learn to understand creative innovators, and creative innovators must learn to make themselves investor-ready. Working together, and with the backing of Government, the UK could double the size of the sector over the next decade. The economic benefits of our creative output as content owners is infinitely greater than our status as an award-winning but fee-earning, work-for-hire nation. The challenge for public policy is to address the shortage of risk capital in creative content companies and the dire consequences if ignored.

I would like to thank all those from the Access to Finance working group who gave their time and invaluable expertise in contributing to the report, in particular Helen Burrows who drafted the report, and also Caroline Norbury and John Newbigin for their exceptional help and guidance.

Ian Livingstone

Chair of the Creative Industries Council Access to Finance Working Group

December 2012

Continues

Contents

Executive Summary	**page 3**
Part 1: The global and UK opportunity and an overview of sector structure	**page 6**
Part 2: Understanding the Access to Finance problem	**page 11**
Part 3: Understanding the problem: drivers of structural market failure	**page 14**
Part 4: Potential solutions and recommendations	**page 17**
Appendix: The wider growth and global competitiveness context and list of the members of the Working Group	**page 22**

Continues

Executive Summary

The creative industries are growing rapidly across the globe. As a 2010 UN report says: 'In 2008, the eruption of the world financial and economic crisis provoked a drop in global demand and a contraction of 12 per cent in international trade. However, world exports of creative goods and services continued to grow, reaching $592 billion in 2008 — more than double their 2002 level, indicating an annual growth rate of 14 per cent over six consecutive years. This is… one of the most dynamic sectors of the world economy.' [1]

While the UK has an almost unique record in generating creative products and services, from music and television to architecture and design, we have a less enviable track record in turning that creativity into sustainable and scaleable businesses.

Access to finance has long been reported as a key challenge for the UK creative industries when it comes to realizing their economic potential. In May 2011, BIS and DCMS published research, 'Access to Finance for Creative Industry Businesses' [2]. This research, discussed in detail in part 2 and 3 of this report, identified a specific market failure for creative content SMEs, beyond the wider economic and finance issues that have impact on all SMEs.

At the first meeting of the Creative Industries Council (CIC) in July 2011, the Council discussed this research and agreed to set up a working group to recommend initiatives to address the situation.

The Access to Finance (A2F) Working Group's prime focus has been on the needs of creative content SMEs (gaming, music, film and TV, publishing, as well as the many innovative cross-over social and digital businesses) [3] rather than the big distribution companies and service industries which have different issues, even though they are also part of the creative industries. This is for two reasons: first the research found a specific market failure in access to finance for these sub-sectors; second, the Working Group believes that many creative content businesses, especially those that cross over into the rapidly developing social media and tech sectors, have the potential for fast, scalable growth and job creation. Nevertheless, the Working Group believes that many of the measures we suggest, will also work for SMEs in other parts of the sector, such as fashion.

A2F has often been discussed by different parts of the creative industries as a single issue, which brings the implication or expectation that there may be one simple solution. In fact access to finance in the creative industries may refer to several different scenarios. Part of the policy challenge is developing a clearer understanding of the different scenarios and their drivers and then in this context considering the possible solutions.

Broadly, A2F in the creative industries can be split into five distinct scenarios:

1. Fast growing, scalable businesses which offer the potential for high returns and are seeking investment

2. Stable growth businesses that require some form of credit

Both of these face A2F challenges driven by both the current economic environment (which affects all businesses) and the additional market failure associated with this sector identified by BIS / DCMS research. [4]

3. New business ideas and smaller / earlier stage growth businesses which are seeking seed investment

4. Smaller businesses which require some form of credit

Here, again, businesses face A2F challenges driven both by current economic circumstance and the additional market failure in this sector identified by BIS / DCMS research.

5. Creative ideas or projects that are seeking and failing to find funding

At any one time there are many film scripts seeking funding to go into production, many bands are seeking funding to record or go on tour. The fact that some of these projects have not, and may never, receive funding is not a market or business policy failure so much as a personal disappointment for the individuals involved. On the contrary, one of the requirements for a successful creative sector is to continually generate an abundance of ideas for projects, some of which will never make it off the page, although this is little comfort if it is your script or album that isn't going to get made.

The Government can and does offer funding support via the Arts Council, BFI and similar bodies for creative projects and organisations that are not or are unlikely to become commercial enterprises. While there is some cross over between the two areas (for example the notable commercial success of National Theatre productions in recent years) the focus here is on scalable businesses and business ideas that will one day grow beyond the need for support.

[1] UNCTAD and UNDP Creative Economy Report 2010 pg xxiii http://archive.unctad.org/en/docs/ditctab20103_en.pdf

[2] BIS and DCMS Access to Finance for Creative Industry Businesses Final Report May 2011 pg. 2

[3] Following the distinctions of 'content', 'service' and 'relic' businesses put forward by the Technology Strategy Board in 'Creative Industries Strategy 2009 – 2012' suggests grouping the thirteen sub sector in the creative industries into three areas: Artifact (arts and antiques, crafts, fashion) Service (Architecture, Design and Advertising) and Creative Content (Publishing, Performing Arts, Radio and TV, Film, Music, Games and Social Media) pg. 7 diagram.

[4] BIS and DCMS Access to Finance for Creative Industry Businesses Final Report May 2011

Continues

Executive Summary continued

This report reviews existing studies on the sector, examines the data and evidence surrounding access to finance for the creative industries, before recommending the following practical solutions:

- Forget traditional banking, instead create a better understanding of the availability of other avenues for investment.
- Government to work with the sector to become more 'creative industries friendly' by improving existing (and developing new) interventions.
- Help businesses to understand the value of the IP they own – improve the information and understanding between the creative and financial communities.
- Improve the data.
- Stay focused on the bigger picture, and strive to create an environment that is enabling to these businesses and competitive in the international landscape.

Returning to the global context, the Working Group has kept in mind that as the value and scale of global trade in creative goods and services grows international competition is intensifying, from major economies such as China where they form a central part of the current Five-Year Plan to small states such as Singapore and Finland that see this as an area of growth potential. Therefore, in addition to taking targeted action to improve access to finance for this sector, the UK needs to match the pro-active policies of other countries with the aim of maintaining and increasing the share of international investment that the UK wins, and encouraging the benefits of this investment to stay in Britain.

The Working Group welcomes the steps the Government has already taken towards this: the creation of the Creative Industries Council, the ambition to make the UK the technology centre of Europe in the 2012 Budget; the recent commitments to improve the broadband infrastructure; and the introduction of tax credits for video games, animation and high end drama. This last initiative is a great example of the way in which Government can act to change the rules of the game in terms of attracting investment.

The A2F Working Group believes there is an important link between the ambition to attract a larger share of global investment into the UK and the more immediate access to finance issues for UK creative micro and SMEs. In the words of Fred Mendelsohn Chairman of AXM VC Ltd which manages the Creative Capital Funds and the North West Fund for Digital & Creative: 'if UK plc. cannot produce sufficient venture backed SME market-leading digital content (and digital service) businesses, we will never be able to grow larger market-transformational businesses and we will never attract larger forms of finance to generate and sustain these larger transformational UK-based businesses. So the short to medium term highlights the strategic importance of low level and relatively small sum access-to-finance initiatives.'

The report is structure as follows:

Part 1: The global and UK opportunity and an overview of sector structure

In the context of the global growth opportunity, this section opens with an overview of the contribution to UK growth, exports and job creation by the creative industries. It offers an analysis of sector structure, looking at the relative numbers, contribution and relationships between micro, small and medium businesses, and fast and steady growth businesses. The available data on the different types and amount of funding these businesses seek is reviewed, highlighting that while most creative industries businesses are seeking relatively low amounts of credit, the demand for equity from creative industries SMEs is twice that of SMEs across the rest of the economy.

Part 2: Understanding the Access to Finance problem

An overview of research that shows access to finance is currently an issue across the economy, with structural challenges for all SMEs exacerbated by ongoing cyclical factors since the credit crunch. BIS / DCMS commissioned research shows that there are additional, specific market failures in access to finance for the creative content parts of the sector. We include an overview of the different appetite for risk between creditors and investors, how risk profiles contribute to pricing of finance, and the suitability and opportunity of equity for creative content businesses.

Part 3: Understanding the problem: drivers of structural market failure

Provides an analysis of the structural challenges in access to finance that face all SMEs, and the additional problems that confront SMEs in the creative industries.

We identify the common challenges as:

- Imperfect information on these businesses, leading to high costs of assessing loan risks in the case of creditors, and high costs of due diligence for investors.
- Lack of evidence of financial track record and additional loan collateral.
- Investors not seeking to invest where the amount sought is too low to justify the costs of carrying out due diligence. Typically, this results in a funding gap for businesses seeking anything between £250,000 - £5m.

Continues

Executive Summary continued

The additional challenges for SMEs in the creative content sector are:

- The lack of good quality data on the sector, and the variety of different sub-sectors within the creative industries.
- The lack of a recognised framework to help financiers assess skills and business abilities.
- The difficulty of predicting whether future creative products will be successful.
- The lack of a recognised framework to assess IP and business value, and business models.
- Lack of collateral (makes debt finance harder or more expensive to raise).
- Inadequate information about the sector and the relative cost of doing due diligence on small investments, making equity finance hard to raise, while debt finance is unsuitable for many creative content businesses owing to their risk profile.
- Fear - (too many financiers fear that creative entrepreneurs are more focused on creative success than commercial success).

Part 4: Potential solutions and recommendations

An overview of possible solutions to these challenges: this includes highlighting relevant initiatives already in progress and how the sector might engage and develop these, and the following recommendations on how the sector can work together, with Government, to enable access to finance for the creative industries:

Recommendation 1: Government and industry to work together to enable new funding solutions and champion investment opportunities in this sector.

Recommendation 2: The sector and Government to work together to improve existing business financing interventions and make the most of new ones.

Recommendation 3: Supply side: Sector experts, HEIs, research bodies and financiers to work together to improve investor readiness and understanding of the sector.

Recommendation 4: Demand side: Sector to work together to improve investment readiness and understanding of finance among creative industries businesses, enabling them to think beyond the banks, and beyond credit.

Recommendation 5: Data, knowledge and frameworks – Government and the sector to work together to improve the data collection and availability on this sector, with both top down and bottom up measures.

Recommendation 6: Help the UK's creative content businesses build assets and scale so that they can leverage existing success and attract a larger share of the international market to the UK.

Appendix

An overview of the wider growth and global competitiveness context and list of the members of the Access to Finance Working Group

Continues

Part 1: The global and UK opportunity and an overview of sector structure

It is generally acknowledged that the trade in creative goods and services, albeit with some variations in their definition, is one of the fastest growing elements of the global economy. The creative industries are increasingly seen as having a long-term benefit for national economies that goes beyond their immediate commercial value by driving innovation and enterprise. A report by the European Commission Directorate for Enterprise and Industry in 2010 argued that the creative industries 'are not only an important factor in themselves, they also fuel the economy with knowledge and dynamism.' [5] This perception of the significance of the creative industries is gaining credence with governments around the world, from major economies such as China where they form a central part of the current Five-Year Plan to small states such as Singapore and Finland. These Governments see this as an area of enormous growth but also of intensifying competition, and are developing policies in accordance with that view.

While the UK has an almost unique record in generating creative products and services, from music and television to architecture and design, we have a less enviable track record in turning that creativity into sustainable and scaleable businesses, or in retaining and building on the IP value we create. Both of these are significant shortcomings, the failure to achieve scale, and the failure to retain IP value, are partly attributable to a lack of sophistication in the relationship between Britain's creative businesses and its finance sector. While this report focuses on immediate and practical proposals that the Working Group believe will benefit the UK's small creative content businesses, our view is that addressing the issue of access to finance for the creative industries is now of strategic significance for the UK's future prosperity. International competition is intense; the fiscal, commercial and educational policies of other governments are increasingly sophisticated and ambitious. The stakes are high but the potential benefits to our economy of a more productive relationship between creative entrepreneurs and financiers are considerable.

A strong contribution to UK GVA and growth

The creative industries account for between three and six per cent of UK gross value added (GVA), depending on the exact scope of the definition, with most studies putting the figure at around six per cent. [6], [7] The UK Government's most recent economic estimate of the sector showed that an the sector made an increased contribution to total UK growth of 0.07 per cent [8] even in 2009, surely one of the most economically challenging years.

Studies using data from the past decade have shown that in the UK the creative industries sector is 'growing at twice the rate of other sectors… [and is]… proportionately the largest of any in the world.' [9]

A strong contributor to UK export sales

The creative industries accounted for 10.6 per cent of the UK's exports in 2009, with publishing and TV and Radio accounting for the highest exports of services (3.1 per cent and 2.6 per cent of the UK's exports respectively). [10]

A labour intensive industry that punches above weight in contribution to UK employment

The latest figures show the sector contributes just over five per cent (5.14 per cent) of UK employment. 1.5 million people are employed in either the creative industries or in a creative role in another industry. Music & Visual and

5 European Commission Paper 'Creative Europe – A new framework programme for the cultural and creative sectors (2014 – 2020)' http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2011:0786:FIN:EN:HTML

6 Analysis of DCMS figures in Nesta's Creative Clusters and Innovation: Putting Creativity on the Map November 2010 pg. 3

7 DCMS's Creative Industries Economic Estimates Report 2011 revised the selection of standard industrial classification (SIC) codes included in the definition to come to a more precise view of one of the largest sectors within it: software and electronic publishing. On this refined definition, the sector accounted for 2.89 per cent of GVA in the UK in 2009: 'This release has had two key changes from the 2010 release. SIC07 codes 62.01 and 62.01/1 have been removed from the Software/Electronic Publishing sector and the scaling factor that was previously applied to the GVA estimates has been dropped (see page 10). The impact of these has caused a considerable reduction in the estimate of GVA, but these changes make the estimates in this release a more accurate representation of the creative industries.' pg. 2

8 Creative Industries Economic Estimates Report 2011 Update pg. 5

9 Analysis of DCMS figures in Nesta's Creative Clusters and Innovation: Putting Creativity on the Map November 2010 pg. 3

10 DCMS Creative Industries Economic Estimates Report 2011 Update pg. 5

Continues

Part 1: The global and UK opportunity and an overview of sector structure. Continued.

Performing Arts are the largest employers in the creative industries with 300,000 employed in 2009 (one per cent of UK employment). [11]

A key role in stimulating an export-led, job creating, economic recovery

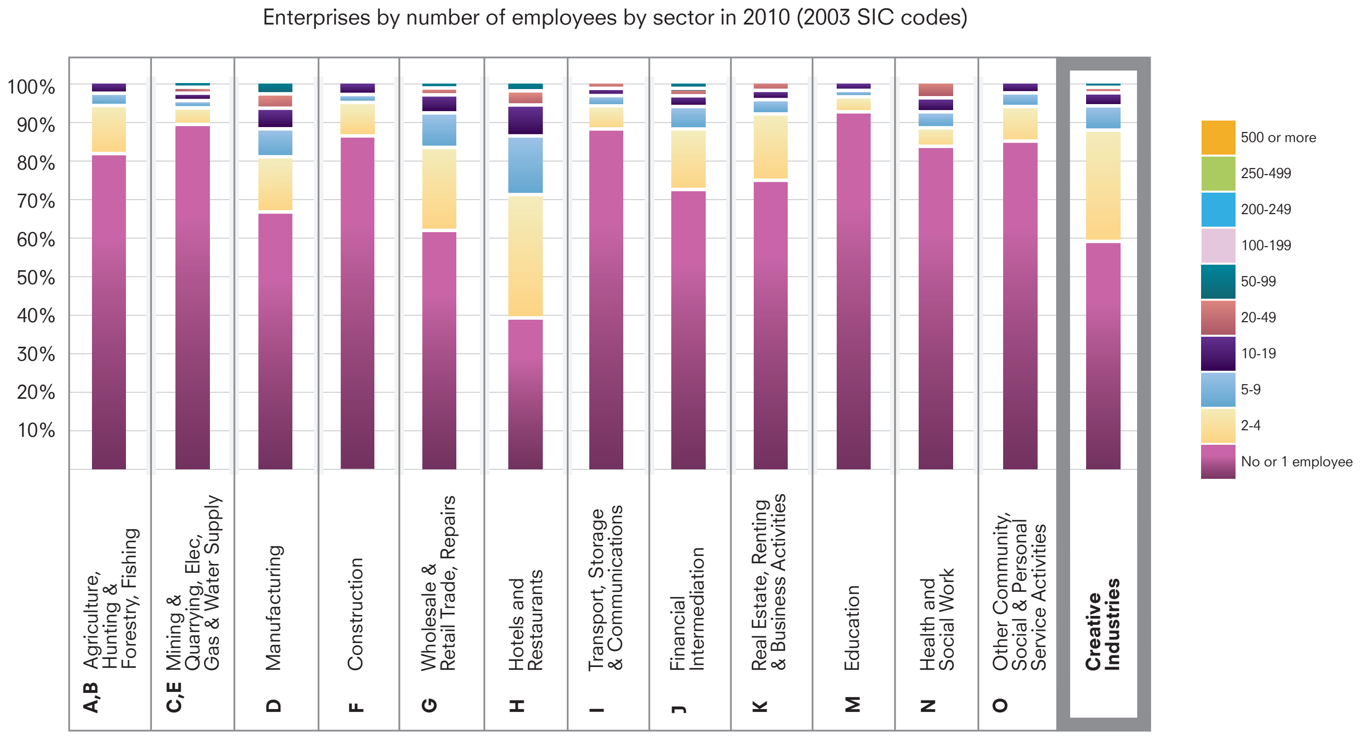
The data and research shows that the UK creative industries have been growing quickly, have strong export sales, and have the capacity to punch above their weight in job creation. Combined these attributes suggest the sector has a key role to play in achieving the Government's ambitions for an export lead recovery, rebalancing and returning the UK economy to sustainable growth and employment.

A sector where the UK has unique talent:

The UK is one of only three countries in the world (along with the USA and Sweden) to be a net exporter of music repertoire, [12] and in 2011 UK artists Adele, Marsha Ambrosius and Mumford & Sons occupied the top three places in the US album chart. Batman: Arkham City is one of the highest rated games of 2011 and was developed by London based Rocksteady Studios, which Grand Theft Auto series has topped well over 100 million sales and was created by Rockstar North in Edinburgh. In TV, hits such as Downton Abbey and Undercover Boss drive international success: in 2010 revenues in the UK independent TV and radio production sector were £2.3bn and revenues from international subsidiaries and overseas commissioning grew by £126m (over 34 per cent). [13] The success of Harry Potter in books and film is well known, while the Publishers Association Yearbook 2011 shows that total book sales in the UK amounted to £3.1bn and that consumer digital sales (including consumer eBooks, downloads and audiobooks) showed the most rapid growth, having increased by 318 per cent since 2009 from £4m to £16m. [14]

Sector Structure

Chart 1: Relative numbers of sole traders, micro, small and medium businesses



Source: Demos, Risky Business, from ONS data pg. 31

11 DCMS Creative Industries Economic Estimates Report 2011 Update pg. 5

12 http://www.prsformusic.com/creators/news/research/Documents/AddingUpTheUKMusicIndustry2010.pdf pg. 5

13 PACT Independent Production Sector Financial Census and Survey 2011 summary version pg. 6

14 http://www.publishers.org.uk/index.php?option=com_content&view=article&id=1755:the-publishers-association-reveals-accelerated-growth-in-2010-digital-book-market&catid=503:pa-press-releases-and-comments&Itemid=1618

Continues

Part 1: The global and UK opportunity and an overview of sector structure. Continued.

As the graph shows, the creative industries, like other sectors of the economy, are made up of a high proportion of sole traders and micro businesses (less than ten employees) indicated by the purple, yellow and aqua. The proportion of small businesses (ten to 50 employees) is relatively low, with the percentage of medium and large sized businesses being lower still.

High growth businesses are important…

In a 2009 Nesta paper 'Measuring Business Growth' analyzed data from across the economy between 2005 and 2008, to show that just six per cent of firms employing ten or more people accounted for more than half (54 per cent) of new jobs. [15] This small cohort of firms have a key role to play in economic growth and job creation, and exploring ways to identify them and support their access to finance needs was key priority for the Working Group.

But so are steady growth businesses…

If this is correct, the remaining 94 per cent of businesses account for the other 46 per cent of new jobs created, and as the chart shows, many of these businesses are small and micro firms.

As economists at Morgan Stanley, examining Bank of England data, say: 'While the Bank of England often highlights that large businesses account for the majority of total investment, the relative importance of SMEs is much greater when it comes to the labour market. Indeed, since June 2001 (when the data series began), SMEs (typically defined as firms with less than 250 employees) have on average accounted for 41 per cent of labour market vacancies.' [16]

So this large cohort of steady growth businesses are still important for growth and job creation, even if their needs, including their financing needs, are different to those of fast growth businesses.

Micro businesses matter too

Evidence suggests that micro businesses generated a million jobs between 2002 and 2005 and accounted for more than one in six of jobs across the economy.[17] The Working Group noted that in the creative industries sole traders are often pivotal figures and key contributors to high value creative innovation. For example, many of the songwriters and producers that work with Adele, or script writers and actors that worked on Harry Potter or the King's Speech will have been sole trading freelancers or running their own microbusinesses, yet their work was right at the heart of value creation projects run by much larger businesses. Therefore, in our view, the aggregate success of different sizes and types of business is interlinked.

Finally, and to come full circle, we note that all large businesses begin as micro businesses. In order to find the scalable, fast growth businesses of the future, working with and addressing the financing needs of the very large cohort of micro businesses is the only place to start.

15 Nesta, Measuring Business Growth: High-growth firms and their contribution to employment in the UK, October 2009 pg. 4 'A firm is defined to be a high growth firm if it has a minimum of ten employees at the beginning of the period and achieves an average annualized employment growth greater than 20 per cent over a three year period.'

16 Jonathan Ashworth and Charles Goodhart, Morgan Stanley 'UK Economics: Credit Easing – What Could the Chancellor Do?' 21 October 2011 pg. 3 'Indeed, since June 2001 (when the data series began), SMEs (typically defined as firms with less than 250 employees) have on average accounted for 41 per cent of labour market vacancies. Moreover, this period was marked by an especially aggressive public sector employment expansion and, hence, it likely understates the SMEs' importance. In addition, some proportion of the firms with between 250-2,499 employees, who on average accounted for 21per cent of all vacancies during the period, would likely fall into the SME bucket when measured in revenue terms.'

17 Nesta, Measuring Business Growth: High-growth firms and their contribution to employment in the UK, October 2009 pg. 11-12

Continues

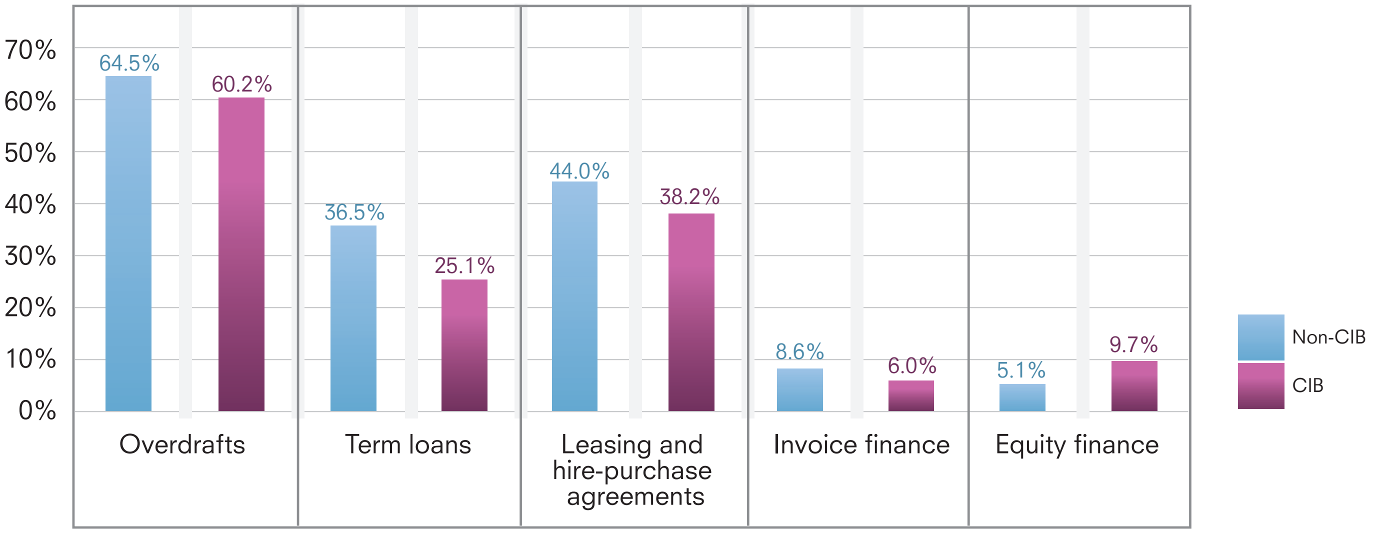
Part 1: The global and UK opportunity and an overview of sector structure. Continued.

Businesses of different sizes and growth models have different financing needs

The pattern of business financing needs fits with the above economy wide data on the different contributions to job creation of fast growth and steady growth businesses: research shows that 'the average amount of loan finance sought [by SMEs across the economy] is £180,000 (median £10,000) but overdrafts are smaller at £29,000 (median £5,000).' [18] The difference between the average and medians in these numbers suggests that there are a small proportion of businesses seeking larger amounts of funding and a large proportion of businesses seeking lower amounts of funding.

Research into the financial demands of creative industries businesses (red, on the right) in comparison to non-creative industries businesses (blue, on the left) over four years 2004, 2005, 2008 and 2009 is shown in the chart below. [19]

Chart 2: Financial demands [20]



Source: UKSMEF 2004, 2005, 2008, 2009

18 BIS Economics Paper No 16, SME Access to External Finance January 2012 pg. 3 referencing the BDRC Continental (2011) SME Finance Monitor Survey (November 2011)

19 BIS and DCMS Access to Finance for Creative Industry Businesses Final Report May 2011 pg. 25 - 42

20 BIS and DCMS Access to Finance for Creative Industry Businesses Final Report May 2011 Appendix 1 pg. 25

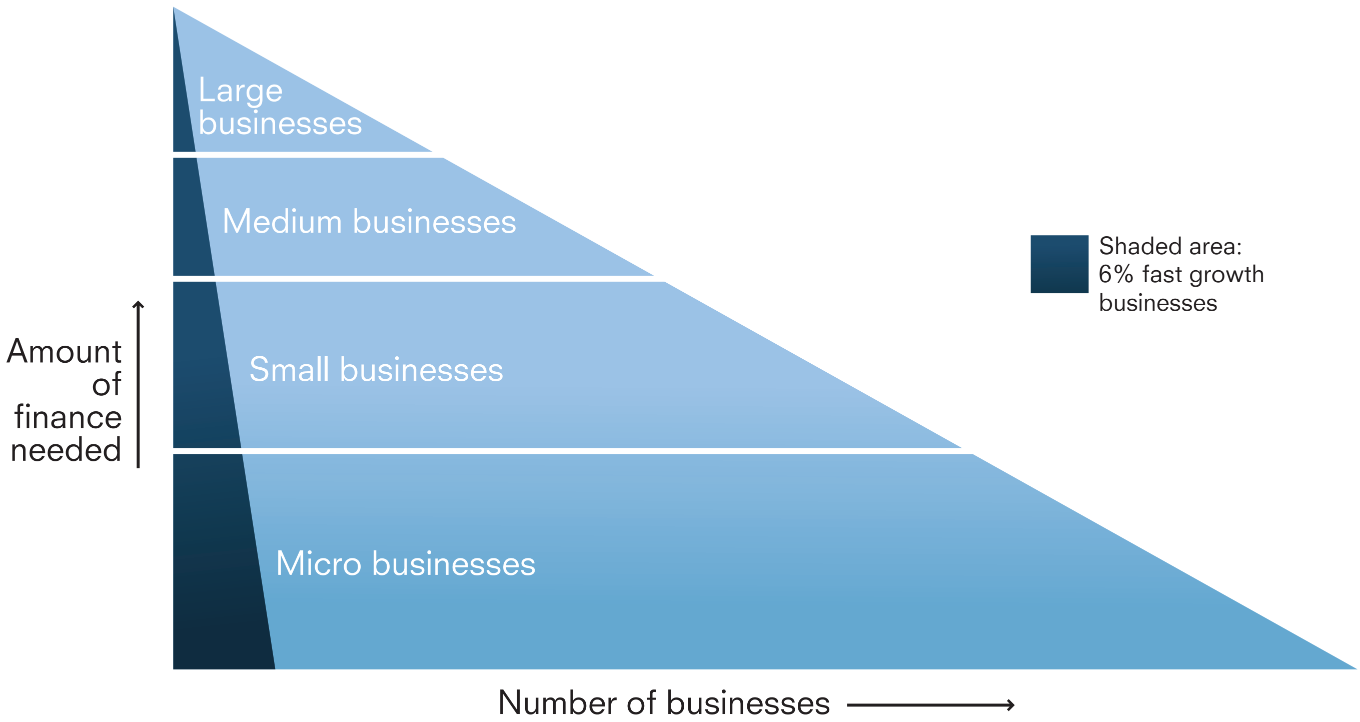
Continues

Part 1: The global and UK opportunity and an overview of sector structure. Continued.

The BIS and DCMS commissioned study found that the main demands among creative industries businesses (and, for that matter, non creative industries businesses) are for credit: 'overdrafts, leasing and hire purchase agreements and term loans.' [21] While among a smaller proportion of firms 'demand for equity finance is higher among creative industries businesses than non-creative industries businesses' [22] over a four year period, 9.7 per cent of creative industries businesses sought equity in comparison to 5.1 per cent of other SMEs.

These research findings chime with discussion within The A2F Working Group of Group members' direct experience of the differing finance needs of fast growth, scalable creative businesses (a small number of businesses seeking large amounts of money) and other creative businesses that have a steady growth business models (a large number of businesses seeking smaller amounts of money), as shown in the illustrative chart below.

Chart 3: The sector is made up of businesses of different sizes with different models and growth rates



21 BIS and DCMS Access to Finance for Creative Industry Businesses Final Report May 2011 pg. 9.

22 BIS and DCMS Access to Finance for Creative Industry Businesses Final Report May 2011 pg. 18

Continues

Part 2: Understanding the Access to Finance problem

In this section we provide an overview of research that shows access to finance is a structural issue across the economy, with the structural challenges for SMEs exacerbated by cyclical factors since the credit crunch. Research shows that there are additional, specific market failures in accessing finance for some parts of the creative industries sector for both equity and debt finance.

Structural factors: Access to Finance is an economy wide issue for SMEs

Recent BIS research (Economics Paper No 16, Published January 2012) into SMEs across the economy accessing external finance shows that: half of businesses use external finance and around 20 per cent are seeking finance at any one time. Of those who have used external finance in the past year, bank finance is still the primary source of finance. In the last year, 28 per cent of all SMEs have used an overdraft and 11 per cent have used a bank loan.

Whilst, across the economy as a whole, the majority of firms seeking finance do receive it (74 per cent of SME employers) there are: 'a number of structural market failures restricting some viable SMEs from accessing finance. This is due to imperfect or asymmetric information between finance providers and small businesses. This manifests itself in a debt funding gap affecting businesses that lack collateral or track record; and in an equity gap affecting SMEs seeking between £250,000 and £5m of equity finance.' [23]

Cyclical factors: Access to credit finance has got more difficult for SMEs across the economy since the credit crunch

This research also demonstrates that, for SMEs across the economy, debt finance is now harder to obtain than before the credit crunch. This is driven both by supply side factors: the stock of bank lending peaked in 2009 and has been declining ever since, with the stock of bank lending in November 2011 6.1 per cent lower than a year before; and demand side factors: SMEs are focused on paying off existing debt rather than borrowing . The value of applications by SMEs for new term loans and overdraft facilities in the six months to February 2011 was 19 per cent lower than in the same period the year before, and around three per cent of all SMEs delayed borrowing due to the current economic climate.

Overall, 21 per cent of SME employers that sought finance in 2010 were unable to obtain any finance from any source, a 'significant increase from the eight per cent seen in 2007/08.' [24] Clearly, cyclical factors created by the current economic environment are causing difficulties in access to finance for SMEs across the whole economy.

The A2F Working Group notes that policy approaches that may have seemed a good solution prior to the credit crunch, e.g. enabling credit lending, may now be less workable. As many economists and researchers are discussing, the consequences of the credit crunch continue to play out in commercial credit markets and may do so for some time, [25] in ways that are well beyond the scope of this paper to predict or solve.

Recognising the particular challenges the credit markets current face, the Government recently invited an industry led working group to look at the potential of alternative debt markets. The A2F Working Group welcomes that report published in March 2012, Boosting Finance Options for Business (BFOB) which pointed out that 'the UK has one of the most sophisticated global financial centres, but UK finance does not fully serve the needs of smaller businesses. UK businesses that use external finance are currently heavily reliant on bank lending' [26] and there is 'significant risk' associated with this reliance on one single source finance. Modeling for BFOB suggests that the finance gap from now to the end of 2016 'could be in the range £84bn to £191bn' for all businesses in the UK. [27]

BFOB says 'the arguments for alternative sources of financing are strong. More diverse financing gives businesses greater choice, promotes competition amongst finance providers, potentially reducing cost, and leads to greater resilience in the financial system. Some countries, particularly the US, have a wider range of bank and non-bank finance options for businesses creating a more diverse and efficient market. It is worth noting that external equity funding is significantly under-used by smaller UK businesses: only three per cent of small businesses use equity finance, whereas 55 per cent use credit cards. Equity, along with alternative channels for debt capital, can potentially benefit these businesses in the early stages of their development. These smaller businesses often need significant capital injections to achieve their potential and may often be deemed inappropriate for bank finance alone due to their innovative nature.' [28]

The A2F Working Group agrees with this view and, where relevant, makes recommendations which seek to build on BFOB's approach. As we shall see, the particular characteristics of creative content businesses mean that they are better suited to equity funding than to credit funding.

Access to Finance for Creative Industries

Policy makers and researchers have been discussing and exploring access to finance in the creative industries for many years, most recently as part of the Creative Economy Programme. In 2007 DCMS commissioned Staying Ahead, the Economic Performance of the creative industries from the Work

23 BIS Economics Paper No 16 'SME Access to External Finance' January 2012 pg. vi

24 BIS Economics Paper No 16 'SME Access to External Finance' January 2012 pg. vi

25 For example see Chief Economics Stephen King of HSBC Global Research paper, From Depression to Repression http://www.spectator.co.uk/article_assets/articledir_15605/7802833/HSBC%20on%20QE.pdf

26 Boosting Finance Options for Business, Report of industry-led working group on alternative debt markets, March 2012 pg. 2

27 Boosting Finance Options for Business, Report of industry-led working group on alternative debt markets, March 2012 pg. 15

28 Boosting Finance Options for Business, Report of industry-led working group on alternative debt markets, March 2012 pg. 2

Continues

Part 2: Understanding the Access to Finance problem. Continued.

Foundation. This report highlighted that businesses in the sector find obtaining finance difficult through both formal (through investors, venture capital, bank loans or bank overdrafts) and informal (from angel investors or intercompany financing) sources. [29]

Prior to this, the DCMS commissioned studies into specific sectors in the creative industries, such as music and access to finance. [30] The music sector's own research consistently shows that access to finance is a key issue. The most recent annual AIM (Association of Independent Music) survey shows that: 'Access to finance and funding is the second most common concern for AIM member labels in 2011 (37 per cent) and 17 per cent of our members have noted that their main concern, outside of increasing overall turnover and sales, is accessing funding and investment.' [31]

New research into access to finance for creative industries SMEs

To explore whether there are differences between creative industries businesses (CIBs) ability access to finance compared to similar businesses in other sectors of the economy, BIS and DCMS commissioned specific research that was published in May 2011.

The *Access to Finance for Creative Industry Businesses* report re-examined data from a longitudinal study of UK SME finances from 2004 – 2009, to analyze both supply side and demand side factors. It compared the outcomes for 314 instances of use or application for any type of finance (overdrafts, term loans, leasing and hire-purchase agreements, invoice finance and equity finance) with 5,306 non CIB applications for any types of finance. [32] This econometric / quantitative analysis was supplemented with 40 qualitative 'in-depth' interviews with 22 CIBs, seven 'otherwise innovative' SMEs and 11 general SMEs that had problems gaining finance. [33]

The Working Group notes that the creative industries sector has concerns over the relevance of the businesses in the econometric sample, in particular that the sample contained no music businesses.

Sector specific structural factors: market failure in access to finance for creative industries businesses

The key finding from Access to Finance for Creative Industry Businesses is its identification of sector specific market failure. The report showed that businesses in some parts of the creative industries do have greater difficulties accessing finance than other comparable businesses: 'Analysis carried out on separate sectors reveals that Creative Content sectors, in particular: Software and Other Creative Content sectors (consisting of Publishing; Video, Film and Photography; and Radio and TV) are more likely to have their finance applications rejected by finance providers that non-creative industries businesses with similar risk profiles.' [34]

What sort of finance?

As discussed in Part 1, there are many different types of business (by business model, size and ambition) and they need different levels and different types of finance. As Demos' Risky Business report discussed in detail, the key difference between credit and equity finance is the financier's appetite for uncertainty or risk. The key priority for lenders is comfort that the loan will be repaid, so they prefer more predictable, lower risk business propositions. The key priority for equity investors is growth potential; they will back less predictable, higher risk business propositions if they believe there is potential for high growth. [35]

Uncertainty and risk plays a role in pricing both credit and equity. In both cases costs to the business of accessing finance will be higher (a higher interest rate and /or collateral for a loan, or a greater stake in the business for equity) the more uncertain the business proposition.

Risky Business also discussed what type of funding suits different types of business, showing that for creative content businesses like music, games, TV and film developers, particularly those that are attempting to build their own value rather than operate on commissions from other firms, equity rather than credit is the most workable source of funding owing to the inherent uncertainty in developing new creative products. [36]

Data bears this out: Chart 2 in Part 1 shows that demand for equity finance from creative industries businesses is nearly twice that of businesses in the rest of the economy.

The Chart 4 illustrates the risk / reward profile of different financial products and representative range of average deal sizes for businesses across the economy.

29 Work Foundation, Staying ahead: the economic performance of the UK's creative industries, pg. 155

30 In 2006 (SME Music Businesses: Business Growth and Access to Finance Report) and in 2001 (Banking on a Hit). Both surveyed borrowers or potential borrowers, rather than attempting to make an analysis by looking at lending patterns.

31 Source: Association of Independent Music via UK Music

32 BIS and DCMS Access to Finance for Creative Industry Businesses Final Report May 2011 pg. 6

33 BIS and DCMS Access to Finance for Creative Industry Businesses Final Report May 2011 pg. 6 - 7

34 BIS and DCMS, Access to Finance for Creative Industry Businesses Final Report, May 2011 pg. 2

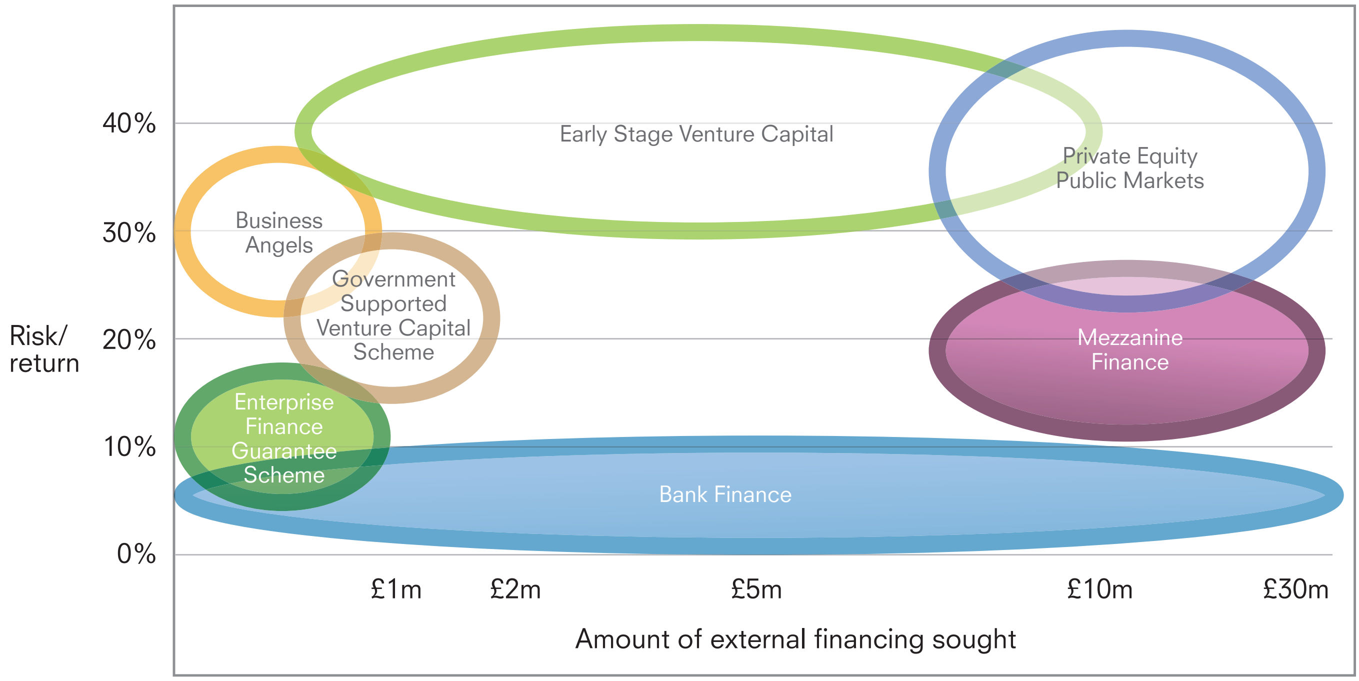
35 Demos, Risky Business, pg. 44 - 48

36 Demos, Risky Business pg. 44 and 95 - 97

Continues

Part 2: Understanding the Access to Finance problem. Continued.

Chart 4: Illustrative mapping of risk/return profile against amount sought (white denotes equity, colour filled denotes credit)



Source: BIS Economics Paper No 16, SME Access to External Finance, January 2012 pg. 16

Given the suitability and demand for equity funding from creative industries businesses, a key area of focus for the A2F Working Group was to explore how to enable more to access to equity type financing. As we shall see in Part 3, there are supply and demand side issues here, and thus in Part 4, we put forward both supply side and demand side solutions. The Working Group explored opportunities in venture capital funding, angel funding and newer sources such as crowd funding. Crowd funding can be split into three different areas: crowd investment (with many investors putting in small amounts in return for an equity share) peer to peer lending, and pledge funding (where no financial return is sought by those pledging, although they may receive other benefits – perhaps, exclusive access to work in progress, a copy of the finished product, or an invitation to the launch event).

Continues

Part 3: Understanding the problem: drivers of structural market failure

This section considers the problems all SMEs have in accessing finance and then looks at the additional problems particular to SMEs in the creative sector.

Problems that are common to all SMEs in accessing finance

The BIS economy-wide research on SME Access to External Finance identified the following issues:

- Imperfect or asymmetric information between finance providers and small businesses which manifests itself in a debt financing gap affecting businesses that lack collateral or track record
- The costs of distinguishing between high and low risk propositions (for creditors) or of due diligence (for investors).

Creditors address these issues by requiring borrowers to provide:

- Evidence of a financial track record and / or
- Collateral as security for the finance

This results in a structural credit funding gap for some new or young businesses that may have viable propositions but lack track record, collateral or both. As BIS research on economy wide SME access to finance says: 'It is difficult for the lender to distinguish between high and low risk entrepreneurs without incurring significant costs. To avoid the costs associated with gathering this information, lenders often require borrowers to provide evidence of a financial track record and / or collateral as security for the finance. This means, some young businesses with viable business propositions that lack a track record or collateral are prevented from raising the finance they need.' [37]

Investors, meanwhile, simply don't invest when the (largely fixed) costs of due diligence are too high relative to the amount of investment sought, resulting in an equity financing gap affecting SMEs seeking between £250,000 and £2m of equity finance:

'It is widely recognized that an 'equity gap' exists in the provision of modest amounts of equity finance to SMEs. This is also due to asymmetric information between the investor and the business on the likely viability and profitability of the business. Assessing the quality of SME proposals and associated risks is difficult and leads to the investor to incur transaction costs of undertaking due diligence. These transaction costs are generally fixed and do not vary generally between £20,000 - £50,000. They are therefore higher as a proportion of the investment deal size for smaller investments, and for a small investment in a technically complex company, the costs can easily account for 10 per cent or more of the investment. This results in a structural gap in the market where investors and risk capital fund managers focus on fewer, larger investments in more established (lower risk) businesses at the expense of early stage venture capital. This leaves potentially viable businesses with growth potential not being able to obtain equity finance.' [38]

This analysis points to the following solutions for all SMEs:

- Improve the quality of and access to information and driven analysis of SMEs.
- Help with lender risk assessment / investor due diligence costs.
- Improve SMEs' ability to showcase their financial track record.
- Provide collateral on loans for (viable) businesses that lack it.
- Provide or incentivize equity funding into the gap for (viable) businesses.

As the factors driving market failure are interrelated, so are the potential solutions:

Access to better quality information would bring down lending or due diligence costs; contributing to these costs would lead to more assessments being carried out and thus help drive an increase in better quality information. But for the Government to provide collateral on loans for viable businesses that lack it would simply shift the 'information problem' ("which businesses are viable?") from the creditor to the collateral scheme, or from the investor to the equity scheme.

The Government is bringing forward a number of initiatives to address these economy-wide issues, so this report simply notes the most relevant of these, and how they can work (or work better) for creative industries SMEs in the following section (Part 4).

Additional problems in accessing finance that particularly affect SMEs in the creative sector

These additional problems can be summarized as follows:

- The lack of official data and the great variety of different sub-sectors within the creative industries.
- The lack of a recognised framework to help financiers assess skills and business abilities.
- The difficulty of predicting whether future creative products will be successful.
- The lack of a recognised framework to assess IP and business value, and business models.
- Lack of collateral, making debt finance hard to raise.
- Inadequate information about the sector and the relative cost of doing due diligence on small investments, making equity finance hard to raise, while debt finance is unsuitable for many creative content businesses owing to their risk profile.

37 BIS Economics Paper No 16, SME Access to External Finance, January 2012 pg. 9

38 BIS Economics Paper No 16, SME Access to External Finance, January 2012 pg. 9 - 10

Continues

Part 3: Understanding the problem: drivers of structural market failure. Continued.

- Fear: too many financiers fear that creative entrepreneurs are more focused on creative success than commercial success.

Several studies and research papers have aimed to identify the particular factors that contribute to market failures in the creative industries, including the 2011 BIS and DCMS creative industries access to finance study, the Work Foundation's paper, several EU papers and studies and the 2011 Demos Risky Business Research. Many of the problems that confront SMEs in the creative sector are simply more acute forms of the issues that face all SMEs set out above. What follows, therefore, is a re-statement of the economy-wide drivers of market failure, further analyzed to identify the drivers of additional market failure in the creative industries.

- **Imperfect or asymmetric information.**
- **The costs of distinguishing between high and low risk propositions (creditors) or due diligence (investors).**

These two interrelated issues are a greater problem in the creative industries for the following reasons:

1. Lack of data: This is undoubtedly a greater problem for the creative industries than most other sectors of the economy.

   I. *The sector is underreported in official data, not having a presence either in the top level 'sectoral' distinctions of ONS data, nor being examined as a distinct sector in Government departments on research programme.* [39]

   II. *This in turn means the sector is under researched by the private sector, both academics and commercial analysts.* [40]

   III. *It is made up of many sub sectors, each represented by different (sometimes multiple) associations and trade bodies. While some of these bodies regularly research and report on their part of the sector, overall sector driven research is patchy.*

   IV. *Lack of a framework to assess business leader's skills and talents (as one financier asked: how are we in a position to judge if someone is a good filmmaker?)*

The A2F Working Group's view is that improving the quality and frequency of reporting on the businesses that operate in the sector could be transformative.

2. Greater uncertainty about the viability of these businesses. [41] Past success is no guarantee of future success for businesses in this sector. As one record label boss says: 'We're not trying to sell music that customers want; we're trying to sell new music that they don't yet know they want.' [42] While this may echo Henry Ford's 'If I had asked my customers what they wanted they would have said faster horses,' the distinguishing factor for some creative industries businesses, especially creative content businesses is:

   I. *The frequency with which creative content business bring new products to market.*

   II. *That the potential success of each of these products is inherently unpredictable, with past performance not necessarily a guide to future success (how to predict that a game where angry birds explode pigs, or a film about a stammering king, would be successful?)* [43]

3. The difficulty of valuing intangible assets such as IP.

   It is difficult to value IP as a balance sheet asset. The EU Commission's recent Green Paper on Unlocking the potential of cultural and creative industries specifically cited the problem of valuing copyright as an asset. [44] This, combined with the risk of investing in a 'hit' or 'flop', results in some investors remaining 'unwilling to consider creative industries as an investment asset class.' [45]

Creditors

- **Requiring borrowers to provide evidence of a financial track record**

BIS / DCMS research shows that for creative industry businesses, longer financial relationships between creative industries businesses do not reduce the likelihood of rejection or discouragement.

- **Using collateral as security for finance**

Creative content businesses are much more likely to lack collateral within their businesses, as their assets are likely to be intangible (IP) rather than tangible (machines, physical stock, a property, a patent).

The investment funding gap common to almost all SMEs arises because the costs of due diligence and deal making are uneconomic where only modest amounts of finance are being sought. Discussions with equity investors confirm their 'sweet spot' is for investment in businesses that already have a turnover of between £2m and £5m. [46] These specialist investors have expressed to us their concerns that small creative industries businesses with potential to scale, (especially those with high risk profiles which make them unsuitable for credit funding), are unable to access early stage funding to grow to the level where they become a viable proposition for venture capital investors.

39 Demos, Risky Business, October 2011 pg. 99 - 115

40 Demos, Risky Business, October 2011 pg. 99 - 115

41 BIS and DCMS Access to Finance for Creative Industry Businesses Final Report May 2011 pg. 4

42 Demos, Risky Business, October 2011 pg. 42

43 Demos, Risky Business, October 2011 pg. 44

44 Green Paper, Unlocking the potential of the creative and cultural industries, EU Commission, pg. 11

45 Work Foundation, Staying ahead: the economic performance of the UK's creative industries, pg. 157

46 Demos, Risky Business, October 2011 pg. 45

Continues

Part 3: Understanding the problem: drivers of structural market failure. Continued.

The 'bottom up' view of this from a chairman of several early stage creative businesses is that the biggest gap is at the series A stage (i.e. external investment after seed funding) where businesses are looking to raise around £1 – 3 million as working capital and growth finance. In his view, 'traditional VCs have retreated to later B or C rounds where the growth of the business had progressed further and the risk is lower.' As a 2006 BOP / Pembridge report says 'the real challenge for growth in this sector is not start ups or early-stage businesses, but established SMEs aged three years and older… in the turnover range £300 – 400,000, with perhaps 8 – 10 staff… the potential return on investment could be greater if public intervention were focused on helping that small number of the 'stuck' SMEs that are serious about growth to move onwards and upwards.' [47]

Research has identified further finance issues particular to the creative SME sector, as follows:

Supply side (financiers looking to fund the sector)

- EU research suggests that there is a problem of "investor readiness" as financial institutions lack knowledge of these sectors, often fail to understand the risk profiles and are not ready to invest in building up the expertise required. [48]

- A lack of financier understanding of the sector: the perception is often of general 'riskiness', with no systematic framework to assess and distinguish between different parts of the sector, different business models and different risk factors.

- Angel investors do not, in the words of one expert, 'recognize the creative industries as a sector. Of 26 networks of angel investors around the UK, covering about 6000 investors, as well as syndicates and groups of angels… Only one specifically targets investing in creative industries businesses (the CAIN Creative Arts Investment Network) even though all angel networks are investing widely in digital media and content. Greater market intelligence would encourage other investors and provide an important basis for valuation of creative industries deals.'

Demand side (creative businesses pitching to financiers)

- Creative industry business owners lack 'credibility' with finance providers.

- Creative industry business owners have a mixed awareness, and understanding, of finance.

Perceptions of the sector as risky

This factor operates on both the supply and demand side.

- On the supply side, the stereotype is of a creative entrepreneur more motivated by art than profit: The BIS / DCMS creative industries research describes it in economic terms as concern about a 'Misalignment of interests between these CIBs and finance providers.' (Concern that CIB owners are pre-occupied with the creative process rather than commercial objectives may lead to a situation of moral hazard where the failure to adhere to commercial objectives, after the finance is received, increases the risk to the finance provider).

- On the demand side, the sector is perhaps more comfortable celebrating creative rather than business success, with the 'Nobody Knows Anything' myth of unknowable success generated by a genius with a Midas touch, too often offered up as the explanation for (business) success, in place of rigorous analysis of the contributing factors.

This issue was thoroughly discussed in Demos' Risky Business report that showed that, contrary to these perceptions, overall business survival outcomes in the sector slightly out perform the rest of the economy. The key point for the purposes of this report, is not that the sector is, or is not, 'risky' but rather that, as in other sectors of the economy, the businesses within it display a range of risk profiles, from the low risk (an agency model) to high risk (a developing a new TV show or game). What is needed is for the sector to more fully explore these questions, so that financiers can develop frameworks that identify and assess different business models, assets and risk profiles, isolating those where uncertainty is inherent from the rest, and developing finance solutions as appropriate.

47 Laura Clayton at BOP and Hugh Mason at Pembridge Partners LLP, The Financing of UK Creative Industries SMEs, July 2006, pg. 11

48 European Commission Paper, Creative Europe – A new framework programme for the cultural and creative sectors (2014 – 2020), http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM2011:0786:FIN:EN:HTML

Continues

Part 4: Potential solutions and recommendations

Access to finance, and the right type of finance, is a key issue for small and medium sized creative content companies. The above evidence and analysis points to possible solutions in the following areas:

Forget traditional banking, instead create a better understanding of the availability of other avenues for investment.

Traditional business lending by banks to SMEs operates on the basis of 'knowable' risk. Creative content businesses that deal in 'unknowable risk' need to understand they need investment, not credit, in order to scale. Financiers, particularly investors need to understand there is under resourced talent, and therefore growth opportunities in this sector. The international marketplace is growing rapidly bringing both opportunity and competition. Unlocking investment from the private sector is the key to transforming this sector, therefore the sector and Government must work together to encourage the sector and financiers to embrace the opportunities of the new world, improving understanding of business models and finance, changing attitudes to risk and portfolio investing, and enabling new forms of funding.

Recommendation 1: Government and industry to work together to enable new funding solutions and champion investment opportunities in this sector.

I. *The Government to consult with the FSA and quickly introduce an enabling legal framework for crowd funding, showcasing the opportunity to both businesses and investors to create momentum.*

II. *Task Creative England to work in partnership with the relevant bodies in Scotland, Wales, Northern Ireland and industry to ensure better co-ordination of schemes and information and to implement the following recommendations.*

The Working Group believes serious consideration should be given to the potential for engaging new investors through crowd-funding and peer-to-peer lending innovations for the creative industries. These platforms offer individuals with modest assets, who are not currently receiving a good return from traditional retail financial products such as ISAs, the opportunity to put some of their money to work. To enable such investment potential for the creative industries and the rest of the economy, we urge the Government to introduce a suitable regulatory framework, to reassure and encourage investors, as the US has done in the recent JOBS Act.

There are lessons the UK can learn and apply from the US lead: The US Federal Government used speed of action, and high profile championing of the initiative by the President, to set a clear direction of travel and create momentum. This strongly signals to individuals with assets that they should consider invest in small and new businesses and to businesses to seek this new source of funding, with Forbes describing it as 'the Act to jump start the jobs market' [49] and Time magazine as 'a giant step for entrepreneurship in America.' [50]

As discussed in Part 2 all types of business (fast growth / steady growth, sole trader / micro / small / medium) have a contribution to make to economic growth and job creation. Like other sectors of the economy, there are a large number of sole traders and micro businesses, most of which have relatively modest access to finance needs and a smaller proportion of businesses with the potential for fast growth that need, or will need, a different magnitude of funding to fulfill their promise. And businesses with different business models will be better suited to different types of funding.

Our view is that fostering a coherent and integrated approach will give the best chance of enhancing the sector as a whole, as well as the best chance of identifying those few but important businesses with fast growth potential. The Government should work with Creative England to come up with an effective bid to the Regional Growth Fund to enable the recommendations of this report to be implemented.

Government to work with the sector to become more 'creative industries friendly' by improving existing (and developing new) interventions.

Recommendation 2: The sector and Government to work together to improve existing business financing interventions and make the most of new ones.

In particular:

I. *Implement Recommendations 2a and 2b of Boosting Finance Options for Business as a matter of urgency, and in doing so ensure that the new body has specialist expertise in the creative industries.*

II. *A coordinated initiative lead by sector experts to review all existing finance support schemes (such as the EFG, ExEFG, RGF, ECF, EIS, SEIS, NLGS and BFP as well as the patent box and R&D tax credit) and come up with practical recommendations for how those with the best potential for the creative industries can be improved; to be implemented by Government.*

49 http://www.forbes.com/sites/work-in-progress/2012/04/05/jobs-act-to-jumpstart-the-job-market/

50 http://business.time.com/2012/04/06/the-jobs-act-signing-a-giant-step-for-entrepreneurship-in-america/

Continues

Part 4: Potential solutions and recommendations. Continued.

III. *Sector experts with Government to look again at existing investment funds such as the London Technology Fund, Creative Capital Fund, Regional Venture Capital Fund and Business Growth Fund, and ask them to focus on the creative industries sector, and seek matching funds for their investments.*

IV. *Sector bodies and financiers to work together to bid for a share of the £100m of the Business Finance Partnership (BFP) that has been allocated to stimulate innovative and sustainable forms of finance that can reach smaller businesses for funding innovations targeted towards creative industries businesses.*

V. *Subject to negotiation between the EU Commission and Member States, for an appropriate body or consortium to bid for these funds to run a finance guarantee scheme for the creative industries sector in the UK.*

VI. *Individual sector bodies to explore ways of stimulating new sources of private funding and share lessons of success.*

VII. *Creative England to convene the relevant partnerships to better co-ordinate and promote funding initiatives for SMEs; providing clear accessible guidance to businesses in the sector on what support is available, appropriate and from what organization.*

Boosting Finance Options for Business growth noted that 'businesses themselves need to be better enabled to be better consumers of finance. Government can start by clearing up the 'alphabet soup' of business support schemes, learning from countries that do it well.

We endorse this view and call on the Government to implement BFOB's Recommendations '2a: Improve communication of Government support programmes through the creation of a single brand for its interventions.' And '2b: Responsibility for delivery of Government Access to Finance programmes should be consolidated into a single delivery agency.' This single entity could provide more effective delivery of the full range of existing Government programmes (the EFG, ExEFG, RGF, ECF, EIS, SEIS, NLGS and BFP) through the creation of a 'one-stop shop'. Additionally such an agency could ensure that the objectives of each intervention lead to coherent outcomes as a whole. [51]

The sector reports that some specific characteristics of creative content businesses excludes these businesses from schemes that are working well in other sectors to incentivize funding, for example music businesses are frequently based on retained IP and this currently excludes them from using the EIS.

Additionally a key issue we have identified is the funding gap: the lack of finance available for businesses with a turnover of below £2m, seeking funding after start up rounds (which are supported by the SEIS and EIS). These 'Series A' funding rounds are still too small value to attract VCTs.

The range of interventions available ought to offer solutions to both these issues. Therefore the sector should lead a coordinated project to review all the current interventions, and bring to the Government specific recommendations for changes and tweaks which will to ensure they work for this sector. For example, the sector led review should examine the many publicly–backed venture capital funds in the UK, [52] and advise the Government on how it can focus the most appropriate on the creative industries sector where the Series A funding gap is most acute.

In order to increase the level of match funding a key issue is to reduce the level of bureaucracy, and strings, attached to these funds.

We welcome Recommendation 8 in Boosting Finance Options for Business: 'Government should explore the potential for the Business Finance Partnership to make commercially attractive investments in the following:

- Online Receivables Exchanges
- Mezzanine Loan funds; and
- P2P lending platforms'

We also welcome the Government's response that, 'The Government intends to invest up to £700m in seven short listed loan funds that can lend directly to mid-sized businesses through the Business Finance Partnership (BFP). The Government also allocated an additional £200m to the BFP.' and 'the Government supports the aim to use the BFP to stimulate innovative and sustainable forms of finance that can reach smaller businesses. The Government has allocated £100m of the BFP to invest through non-traditional channels that can reach smaller businesses, which could include peer-to-peer lending as well as mezzanine loans and asset-based finance. The Government will request proposals for investment in May.' [53]

We also note and welcome EU activity in this area, including the possibility of a finance guarantee scheme for businesses in this sector from 2014 onwards which may bring another opportunity to enable crowd funding and micro financing. And we welcome Arts Council England's recently launched micro finance pilot scheme offering business development loans of £5,000 – 25,000 repayable over a maximum of three years. [54] Our Working Group noted that this approach is similar to the Princes' Trust Enterprise Scheme which has been running for many years, suggesting there may be opportunities to collaborate and share learnings.

51 Boosting Finance Options for Business, Report of industry-led working group on alternative debt markets, March 2012 pg. 18 - 19

52 Capital for Enterprise Ltd: Overview of publicly backed venture capital and loan funds in the UK, January 2012.

53 Boosting Finance Options for Businesses: Government response to the industry taskforce, Developing new financial products, pg. 5, 19 - 21

54 http://www.artscouncil.org.uk/news/arts-council-news/micro-finance-scheme-creative-entrepreneurs/

Continues

Part 4: Potential solutions and recommendations. Continued.

The Working Group notes that some parts of the creative industries have been adept at building new and direct relationships with potential funders, and would encourage the sector trade bodies to share ideas and approaches. We are thinking here in particular of the British Fashion Council (BFC)'s Vogue Fashion Fund and relationships with Coutts, HSBC and Lloyds which fund investment into young fashion labels mentored by the BFC. In addition A2F Working Group welcomes are new private sector initiatives: for example, Telefonica's O2 has opened their own digital businesses accelerator, Wayra, in London, one of ten the company has launched globally. [55]

The above is a long but not exhaustive list of the many economy wide and sector specific initiatives, public and private, offering or enabling finance. For example there is also support available from the Technology Strategy Board and sector lead initiatives run by trade bodies. There is a danger here of duplication and confusion so work to encourage co-ordination and improvement of the support available, as well as advice and guidance to businesses and financiers is essential.

Help businesses to understand the value of the IP they own – improve the information and understanding between the creative and financial communities

The evidence we reviewed demonstrated two core problems that creative content businesses (the demand side) frequently encounter when looking for finance: (1) they are not clear about what type of finance they need and (2) they are unclear on how to present themselves and their business to potential financiers and investors.

There are similar inadequacies on the supply side: a paucity of sound market intelligence available to investors, particularly with regard to creative content businesses and those where IP assets are core to the business model. Unlike other sectors of the economy, financier understanding of the risk profiles of the sector is weak, and specific expertise to develop frameworks to assess value, risk or project potential is lacking.

Recommendation 3: Supply side: Sector experts, HEIs, research bodies and financiers to work together to improve investor readiness and understanding of the sector.

In particular to develop and provide guidance on:

I. *Frameworks for assessing business models and project success.*

II. *Frameworks for assessing when and how it is (and is not) possible to value creative IP with a view to generating a Statement of Recommended Practice (SORP).*

Jenny Tooth, Director of the British Business Angels Association says: 'angel investors generally have a range of perceptions and misconceptions around creative industries entrepreneurs that affects their willingness and approach to investing. In parallel with a programme of investment readiness for creative business entrepreneurs it is important to also organize a programme of investor awareness and capacity building to increase their understanding of the potential of creative industries business and increase the level of overall angel deals in creative industries businesses. There are 26 networks of angel investors around the UK, covering about 6000 investors, as well as a number of syndicates and groups of angels. These offer a key entry point to reach angel investors. Angel networks can provide an important forum for access to investors, as well as investment readiness support. There is only one angel network currently specifically targeting investing in creative industries businesses: Creative Arts Investment Network (CAIN) [56] which is specifically focused on film and performing arts, however all angel networks are investing widely in digital media and content.'

Recommendation 4: Demand side: Sector to work together to improve investment readiness and understanding of finance among creative industries businesses, enabling them to think beyond the banks, and beyond credit.

In particular, Creative England, in collaboration with Creative Scotland and other relevant agencies in the home nations, should co-ordinate and, where necessary, lead work to support the growth of creative content businesses by:

I. *Emphasising the importance of business skills and business planning to achieve investment and growth*

II. *Promoting programmes to teach and nurture these skills (in collaboration with Creative Skillset and CC Skills)*

III. *Working with the main accountancy bodies (ACCA, ICAEW and ICAS) to build on their commitment in BFOB to 'create a shared scheme specifically for those accountants that offer advice on finance for smaller businesses'* [57] *to enable and encourage accountants to develop specialisms in the creative industries.*

55 http://blog.o2.co.uk/home/2012/03/wayra-comes-to-london-o2-opens-doors-to-uk-academy.html

56 www.cainuk.com

57 Boosting Finance Options for Business, Report of industry-led working group on alternative debt markets, March 2012 pg. 18

Continues

Part 4: Potential solutions and recommendations. Continued.

IV. *Promoting 'Investor Readiness' programmes to improve understanding amongst investors of this sector; and an 'Investment Readiness' programme for creative industries businesses*

V. *Building and extending networks between creative industries businesses and financiers, particularly angel investor networks*

The need for these proposals is highlighted by the BFOB report which says that, across the economy, 'only one in four (23 per cent) of those responsible for making finance decisions in SMEs has a financial qualification or financial training; for SMEs as a whole, a minority have a financially trained person… Alongside this lack of in-house expertise, there is also a failure to source external advice: only 9 per cent of SMEs sought advice when seeking an overdraft and 16 per cent of SMEs seeking a bank loan sought advice.' [58] We therefore endorse Recommendation 1 of the BFOB report which calls for the introduction of a Business Finance Advice Scheme. [59]

A 2006 Study, 'The Financing of UK Creative Industries SMEs' suggests that 'greater awareness of the need for business planning in SMEs could help to establish their credibility when seeking finance.' [60] While the businesses in this study were biased towards growth [61] just 35.9 per cent of them had a formal business plan, with 34.9 per cent having 'some ideas written but not a formal plan' and 29.2 per cent having no business plan at all. [62] The sector by sector analysis in the same report showed that there was wide variation, with 46.3 per cent of the design businesses and 40.6 per cent of film and TV businesses having a formal business plan, but just 28.9 per cent of music businesses. [63] As the authors suggest from their analysis 'the low use of business planning by SMEs in this sector may be a significant factor impeding growth.' [64]

Improve the data

A recurring issue throughout our work has been the paucity of data to assess risk, understand business models, make investment decisions, and have a clear picture on the performance of the sector as a whole. As discussed in Part 3, this is one of several inter-related issues that contribute to market failure in this sector and must be urgently addressed.

Jenny Tooth, Director of the British Business Angels Association says: 'statistics gathered from angel networks by the British Business Angels Association (BBAA) do not show the full picture of angel investing and investments are cutting across a range of sectors including ICT telecoms; retail; business services. Angel investors are clearly investing in creative industries but they do not recognise this as a sector for investment. Better gathering of statistics related to the key creative industries sub-sectors would be extremely useful. The same applies to VC investing since British Venture Capital Association does not collect stats on creative industries or its sub-sectors. Since we know a great deal of investing is currently taking place in the creative industries such statistics could be instrumental in encouraging greater market intelligence and to encourage other investors to invest in creative industries businesses, it would also provide an important basis for valuation of CI deals.'

The tendency of creative business sectors to claim exceptionalism and present themselves as unique and unknowable is self-defeating; it militates against the collection of solid and comparable data and leaves the sector with little compelling information and analysis with which to attract finance. The view of the Working Group is that at least some of the key challenges can be addressed speedily and at relatively low cost and that this has the potential to be transformative.

Recommendation 5: Data, knowledge and frameworks – Government and the sector to work together to improve the data collection and availability on this sector, with both top down and bottom up measures.

In particular:

I. *The Government to adopt the recommendations of Hasan Bakhshi and Jeremy Silver's Data Measurement and Issues Report, in particular the need to review the definition of the 13 sectors in the creative industries, to ensure the statistical definition is keeping pace with the impact of technological and digital change, and sets up the suggested Technical Working Group (TWG).*

II. *In a 'bottom up' approach to data, trade bodies to actively participate in the proposed TWG to identify opportunities for: standardization, aggregation and collaboration in their collection of data, and taking steps to address data gaps.*

58 Boosting Finance Options for Business, Report of industry-led working group on alternative debt markets, March 2012 pg. 38

59 Boosting Finance Options for Business, Report of industry-led working group on alternative debt markets, March 2012 pg. 18

60 Laura Clayton at BOP and Hugh Mason at Pembridge Partners LLP, The Financing of UK Creative Industries SMEs, July 2006, pg. 2

61 Laura Clayton at BOP and Hugh Mason at Pembridge Partners LLP, The Financing of UK Creative Industries SMEs, July 2006, Note, the selection of creative industries businesses in the study was not random and is therefore not truly representative, the SMEs included in the data set put themselves forward as being actively interested in growth, or because they were nominated as such by the public sector bodies and so is biased towards those companies that actively want to grow, pg. 4

62 Laura Clayton at BOP and Hugh Mason at Pembridge Partners LLP, The Financing of UK Creative Industries SMEs, July 2006, pg. 8

63 Laura Clayton at BOP and Hugh Mason at Pembridge Partners LLP, The Financing of UK Creative Industries SMEs, July 2006, pg. 11

64 Laura Clayton at BOP and Hugh Mason at Pembridge Partners LLP, The Financing of UK Creative Industries SMEs, July 2006, pg. 8

Continues

Part 4: Potential solutions and recommendations. Continued.

III. *The Government to request the ONS does further work in this area in cooperation with the TWG, and provides funding for it, in particular grouping the existing or refined definition of the creative industries in all ONS data bases, prioritizing the Business Structure Data base in order (a) to enable independent and academic researchers to carry out detailed and comparative research of the sector and (b) for the sector to automatically be included in all studies in the Department of BIS economy wide research programme, for example, the regular Small Business Survey.*

IV. The sector to work together with the ONS and Government to understand and prepare for the European and UN process of continued Standard Industrial Classification (SIC) code revisions, to build a compelling case to present at all future international discussions and negotiations for expanding the International SIC framework to better serve this growing sector of the global economy.

The first issue is discussed more thoroughly in the Data Measurement and Issues report: the sector is concerned that, as technological change rapidly impacts the creative industries sector, the selection of which SIC codes are considered to be part of it is reviewed.

The Working Group encourages trade bodies that are not already collecting data to begin a regular (ideally annual) business survey of their sector and welcome the support expressed by several trade bodies that are already collecting data for the establishment of a data initiative to share best practice. This should be carried out through the proposed Technical Working Group.

There are some examples of good practice to build on; for example, the product line analysis that PACT uses in its annual 'Independent Production Sector Financial Census and Survey' that has been adopted by business in the sector to assess the profitability of specific projects within the business.

Grouping the existing definition in all ONS databases could and should be implemented immediately, it can be updated to a new definition if and when one is ready.

Stay focused on the bigger picture, and strive to create an environment that is enabling to these businesses and competitive in the international landscape.

Creative content businesses suffer many of the same problems as other SMEs. However, as this report outlines, there are distinct challenges that require additional attention. However, the Working Group has kept in mind that the best source of funding for many creative industries businesses is trading and doing deals. As we saw in Part 2, across the economy only half of businesses use external finance and around 20 per cent are seeking finance at any one time.

Recommendation 6: Help the UK's creative content businesses build assets and scale so that they can leverage existing success and attract a larger share of the international market to the UK.

For example, for many years one of the largest and most significant sources of investment into the creative content sector has been the public sector broadcasters. The A2F Working Group was keen to highlight the ongoing success of the Window of Creative Competition and Terms of Trade framework, both in enabling UK creative businesses success and in delivering excellent British content. The A2F Working Group notes imaginative approaches to partnership with independent suppliers such as the BBC's online commissioning advisory group and Channel 4's Alpha Fund.

The A2F Working Group hopes that as part of the Government's Communications Review, these initiatives may evolve and develop to ensure their continued success for all creative content businesses in an era of technological change.

Moreover, if the UK is to attract a larger share of international investment into the country – and keep it here – the Working Group recognized access to finance it is only one of a series of inter-related challenges. The establishment of the Creative Industries Council as a joint approach between industry and two government departments – BIS and DCMS – demonstrates a real willingness by Government to support the sector as a driver of growth. The IP environment, tax and fiscal policy;, skills development, infrastructure and the general business environment all have a role to play. We discuss this in more detail in the Appendix below.

65 The Corporate Tax Roadmap (http://www.hm-treasury.gov.uk/d/corporate_tax_reform_part1a_roadmap.pdf) sets out the Government's general position in relation to taxing companies. A line on general UK approach

66 Subject to State aid approval from the European Union

67 Next Gen http://www.nesta.org.uk/home1/assets/features/next_gen

Continues

Appendix - The wider growth and global competitiveness context

Discussions and contributions to the A2F Working Group have highlighted the interrelationship of multiple issues which contribute to the overall health of the UK creative industries and hence its ability to attract and access finance. The Working Group believes that, with focus, in the next decade the UK could generate explosive growth within the creative economy measured by per centage of GDP, employees, tax, revenues and the share of the global industry.

The aim must be not just to enable businesses in the sector to grow, but to help them capitalise on that growth so that more of the IP value they generate benefits the UK economy and Treasury. In addition to finance, international investors look at how attractive the UK is compared to other countries in terms of: tax, skills and talent, IP, infrastructure and enabling exports.

What follows in an overview of the current state of play for each of these issues:

A competitive tax regime

In terms of international competitiveness, an attractive tax regime is important. The A2F Working Group welcomes the Government's aim is to create the most competitive corporate tax regime in the G20 [65] and its commitment to broaden and simplify the tax base in order to fund lower rates of corporation tax, providing businesses with the competitive and stable tax system they need to succeed.

In addition the original creation of IP benefits from a low tax regime in certain countries which are keen to attract content production e.g. Ireland, France, Singapore and Canada, to name a few.

Therefore The A2F Working Group welcomes the Chancellor's announcement in the Budget 2012 that, following consultation on design, the Government will introduce corporation tax reliefs for the video games, animation and high-end television industries from April 2013, [66] as part of a package of measures to support technological innovation and to help the digital, creative and other high technology industries.

Skills and talent

While the creative and technological skills and talent nurtured in the UK are a driver for the sector's current international success, maintaining and improving on this is vital to enable the sector to build on its reputation, exploit the growing market opportunities and attract and retain businesses for the long term. Therefore, The A2F Working Group welcomes the Livingstone - Hope Next Gen report [67] and initiative and the Government's on going response to it, including the activities of the Skills Working Group which has already reported to the Creative Industries Council.

IP should be protected and piracy reduced.

The A2F Working Group notes and highlights the importance of IP in value creation for creative content businesses in the sector. Therefore The A2F Working Group welcomes the Hargreaves Review process which aims to modernise copyright so that it better supports economic growth, and the current copyright consultation is all about making sure the Government acts on the best possible evidence in this area.

A high quality national infrastructure

Overall, commitment is the key to success and therefore the A2F Working Group welcomes the Government's ambition to make UK Technology Centre of Europe. The Government commitment to superfast broadband by 2015 is a welcome, essential step to facilitate the widespread and low cost movement of content around the system and to foster a greater degree of user generated content, and local engagement.

In particular, The A2F Working Group welcomes the Chancellor's announcement in the 2011 Autumn Statement 2011, of a new £100 million Urban Broadband Fund (UBF) to enable up to ten Super-Connected Cities (London, Edinburgh, Cardiff, Belfast, Manchester, Birmingham, Newcastle, Leeds, Bradford and Bristol) to be created, and the further £50 million he announced in the Budget 2012 for a second phase of the Super Connected Cities initiative to support additional UK cities.

Nationwide access, take up and participation is important, therefore Working Group welcomes the additional support the Government is providing to ensure access in areas the market will not reach, including improving coverage of the mobile network where coverage is currently poor as the demand for mobile data increases, as well as its support for the Race Online initiative.

Continues

Appendix - The wider growth and global competitiveness context . Continued.

Enabling Exports

The A2F Working Group calls for better coordination of the international activities of UKTI and the British Council, in particular more strategic and advance planning of programmes with sector experts and trade bodies.

Members of the Access to Finance Working Group

The Working Group has been chaired by Ian Livingstone with a number of key members listed below. Additionally Ian Livingstone has invited a range of individuals to contribute to the group's work and discussions, in particular holding a workshop with interested parties across the creative and finance sectors in November 2011.

Scott Cormack, KPMG

Hasan Bakhshi, Nesta

Helen Burrows, Demos

Simon Dixon, Bank to the Future

David Glick, Edge VC

Ian Livingstone, Eidos

Fred Mendelsohn, AXM VC

John Newbigin, Creative England

Caroline Norbury, Creative England

Jenny Tooth, Angel Capital Group and British Business Angels Association

Thank you to the facilitators of the Working Group, in particular:

Sandy Grom, BIS

Tim Scott, DCMS

Continues