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Working paper TOPIC 2 – The challenge of financing

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Executive summary

The issue of access to financing by the cultural and creative industries (CCIs) is at the heart of any intellectual and policy approach to the larger issue of how to support them in their role as promoters of social and economic growth.

Cultural and creative industries share difficulties and challenges in this matter with other small and medium size companies. But they have specific characteristics that have a direct impact on their access to financing and the sustainability of their activities. Among those, the intangibility of cultural assets and the lack of market intelligence and business skills among both cultural operators and financial intermediaries come first in relevance. At the same time, there are important differences among subsectors within the cultural and creative industries, in their structure, in their value chain and in their relationship with markets, but also between developed and developing countries. Therefore, there is not a common remedy or financing model which can be universally applied or recommended to cultural and creative industries. As Governments' contributions are limited, a better understanding on how to finance culture and creativity in the contemporary and future development context is needed, and new forms of funding to be sought.

It is essential therefore to expand the role of the private sector and civil society in the financing of culture. Public funding should become a facilitator and a promoter of private support, within new financing and credit mechanisms combining both dimensions.

Existing instruments such as venture capitals, tax incentives, vouchers, financial guarantees, should be further developed and adapted in order to enable a sustained impact for the cultural sector. Corporate social responsibility can be used to invest in cultural and creative projects valuing cultural diversity in least developed countries or in countries in fragile situations. But such a transformation, in particular if it is to happen cross border, requires regulatory and legal changes – notably regarding the respect of intellectual property rights - as well as some creativity in the structuring of new effective schemes and tools, together with an effort in the professionalization and capacity building of cultural actors.

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1. Context and background

Before listing the main possible options for a funding of the Cultural and Creative activity that favours its sustainability, it is worth to put the matter in context, and to provide a first view of the challenges they face.

As the policy interest and the intellectual production about the important contribution of the Creative Economy have grown in the last two decades, so has the parallel debate about the relation of the CCIs with finance. The academic, consultancy and policy related discussions on the topic have resulted in a number of public consultations, experts' and stakeholders' dialogues, and in a subsequent series of papers and studies of diverse quality and depth[2]. After some general analysis commissioned by the European Commission, in Europe it is probably in the UK where these policy and consultation efforts discussing finance and the CCIs have produced the most effective results, and have materialized in the most innovative finance solutions and tools, as described below when listing debt and equity finance schemes. However, not all these "Anglo centric" solutions, which are directly related to that country's legal and financial structure, travel well beyond its borders. In that sense, some documents and proposals may create outside the UK a fake image or mirage of possibilities.

Still within the EU context, in November 2015 the OMC[3] group's work on access to finance for cultural organisations and creative small and medium-sized enterprises delivered its final Report of a work it had started in 2014, producing what is probably the most important or complete document on the issue up to now.

The analysis of the needs of CCIs remains mostly valid in principle if we widen the focus from a national or European perspective to the developing countries. As some recent studies have explored[4], the identified challenges for CCI's access to funding in those countries are not different in principle. But it is certain that issues such as the lack of a solid legal framework or a mature financial sector, or the existence of a very large informal economy, poses even greater challenges for CCIs in less developed economies. In this context, the lack of proper data becomes more relevant and poses critical difficulties to any long term policy effort.

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[2] See the attached short bibliography as well as the longer lists of references included in them.

[3] Open Method of Coordination, a light but structured way EU Member States use to cooperate at European level in the field of culture.

[4]. K. Nurse, *Study on alternative and innovative funding mechanisms for ACP Cultural industries*, EuropeAid/131180/D/SER/MULTI, 2016

2. Main core challenges and opportunities

“All happy families are alike; each unhappy family is unhappy in its own way”. This principle famously formulated by Tolstoi in Anna Karenina is somehow applicable -duly adapted- to the financial reality of the CCIs. Each underfinanced creative industry is underfinanced in its own way. And while it is possible to have a general discussion on finance and the CCIs, it would not be reasonable or realistic to believe that there can be some kind of one-size-fits-all solution in this matter. It is not true within a single country, it is not true across Europe, and it is not true in the relations of Europe with other partners. We may agree that the term ‘Creative Industries’ (CI’s) refers to those industries which have their origin in individual creativity and which have potential for wealth and job creation through the exploitation of intellectual property. But the different forms of classification of the different CCI subsectors are not part of some kind of academic discussion: they reflect different approaches in the challenges they face, in the nature and structure of their value chain, and in the public and private financial instruments they may have access to.

A possible distinction is made between a) Visual and digital arts and Performing arts; b) Cultural industries (film & video, tv & radio, music, books & press, video games), and c) Creative industries (fashion, design, advertising). Official documents in the UK call for a segmentation between Content and Service. Content Creative Sectors are comprised of Software, Computer Games and Electronic Publishing; Music and the Visual Performing Arts; Publishing; Video, Film and Photography; and Radio and TV. Service Sectors are Advertising and Architecture. The European Commission has its own classification (with a direct impact in its own policy and financing approach) between the Creative Industries under DG Connect or those under DG EAC; or the generous and market oriented concept of CCIs used by DG Grow.

It is important to note that most Cultural and Creative Organizations would fall in the category of SMEs. Therefore, they share with other SMEs some of their difficulties in the access to finance of their activities and projects. [5]

As a result of this fact, an essential component of the policy debate in this matter is about how much sector- specific should the solutions be, or whether part of the finance difficulties in the CCIs would be sorted out just by better facilitating their access to general schemes and instruments generally designed for SMEs.

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[5] This includes African creative production constraints (e.g. due to minimum order quantities creative enterprises purchase materials at retail prices, little access to technology). All this leads results in uncompetitive products and pricing, limiting market access, as it is difficult to enter in traditional distribution channels.

In any case, it is unanimous among those who have analysed this matter [6] that there are specific characteristics of CCS organisations that reinforce their difficulties in access to finance. These include:

- **Intrinsic characteristics of CCS activities**: lack of tangible assets and dependence on intangible assets (IP, essentially), as well as the difficulties related to the valorisation of those assets; lack of collateral; high uncertainty of market demand; generation of value over long and uncertain periods of time, etc.
- **Characteristics of organisations and entrepreneurs within the CCS**: perceived lack of business skills (or "the lack of formality of the creative and cultural industries", which the important UNCTAD Report on the matter of 2008 already identified as being a major hindrance to the development of the industry); a too strong dependence on public investment and public funding schemes; the personal nature of CCS activities as entrepreneurs, resulting in their fear of losing control of their business; a limited forward planning, directly linked to the fact that most often SMEs in the CCS tend to seek funding for individual projects, rather than for their business in general (which makes them less attractive to proper investment, e.g. equity finance).
- **Specific market conditions**: size of market (e.g. cultural and linguistic fragmentation of CCS markets across borders); lack of good market intelligence, pressure on existing business models (due to digital shift, among others); etc.
- **Miscommunication** among relevant stakeholders: lack of information on available sources of funding; lack of understanding of the CCS' unique characteristics by financiers, including banks.

Each one of these challenges deserves long comment and analysis, and is not identical in each of the different Culture and Creative subsectors. They also reflect with different intensity from country to country, which is true within Europe, and among developing economies. Among those elements, the issue of the importance of IP rights is particularly essential, and most specific to CCIs, wherever the intellectual property is the main asset linking a creative activity with an economic or market activity, and therefore with some sort of possible monetization and revenue. It is a challenge in terms of legal certainty in the first place: the creative economy can only survive and develop within a legal system where IP is protected by law and duly enforced, and if the CCIs know how to protect it from the start. Secondly, investors use to their financial analysis by 'correcting balance sheets' and discarding all intangible assets. The standard accounting rules are inappropriate in the field of CCIs, as they give too much weight to other assets more easily "appreciated" by accountants, auditors, and bankers. And the value of those IP based assets (which will define their use as collateral, for example) is very difficult to assess. Sure, a full catalogue of movie or book titles owned by a

[6] See detailed list of reports in the bibliographical Annex.

producer or a publisher, or the rights of a consolidated music band can be established by experts in the matter; but what was the value of the movie rights to *The Lord of the Rings* when the future blockbuster was only a most expensive project?

Assuming these challenges, and the fact that not all financing instruments are available or even convenient for all CCS companies or projects, we can put together a range of funding opportunities potentially available to CCIs at the beginning of a creative company or project. Some of these are clear examples of public funding, and have taken full priority in the financing of CCIs up to now. Others are based on private funding. And some of them allow for creative combinations of public and private financing, if the proper structure for that purpose is put in place.

A global view of those financing opportunities would include

A) Direct support measures

a. Grants, or direct financial contributions to finance an action or the functioning of a body. They can take the form of matching grants, stimulating private corporate donations. In developing countries, CCS grants have too often been restricted to non-profit organizations, without potential market growth perspective[7].

   - They are usually public funding, but they can also have private origin from large non-profit organizations (foundations).

b. Creative or innovation vouchers: a scheme entitling the holder to a payment of free goods or services. They are a most suitable tool enticing companies to make use of creative services (B2B), this creating innovative forms of collaboration in the value chain

   - Public-funding

c. Tax incentives. Tax incentives can be used to stimulate some forms of equity finance, or crowdfunding, or corporate giving (patronage).

   - Public funding

d. Repayable contributions, conditioned to the company's performance

   - Mostly public funding, but potentially Public Private if channelled through entities with this nature

B) Debt finance

a. Loans, for a specific one time amount or open-ended credit with a ceiling.

b. Microfinancing or microcredit.

[7] As well discussed in Cunningham, Stuart D. and Ryan, Mark D. and Keane, Michael A. and Ordonez, Diego (2004), "Financing Creative Industries in Developing Country Contexts".

c. Peer to Peer (P2P) finance: it is the practice of lending money to individuals or businesses through virtual platforms that match lenders directly with borrowers. It eliminates the role and costs of traditional banks. Depending on the scheme used, P2P finance can in fact turn into a form of cooperative financing.

- In the three cases, debt finance can be public or private funding depending on the origin, but it is mostly private.

C) Equity finance

a. Venture capital, usually providing capital for start-ups and young high growth innovative sectors such as ICT

b. Business angels: knowledgeable private individuals who indirectly invest part of their personal assets in new and growing businesses in their own sector; normally acting earlier than most venture capital firms

c. Seed capital: financing provided to study, assess and develop an initial concept, normally at the very early stages of young innovative companies or projects. Sometimes CCIs might also benefit from business accelerator seed funding programmes which combine traditional business incubator services and coaching/mentoring with small amounts of investment capital;

- This are all usually forms of private funding. But they can also be means of public funding if channelled through proper entities and funds, as it has been the case in developing countries with the *International Fund for Cultural Diversity (IFCD)*[8] or the *HEVA Fund* that operates out of Kenya and is being offered across East Africa.

D) **Crowdfunding** which is in fact a funding method adopting different forms and results: rewards based crowdfunding (with a non-financial reward); donation based crowdfunding,; revenue sharing crowdfunding; equity crowdfunding (essentially similar to how common stock is bought or sold on a stock exchange); crowdfunding for lending, similar to P2P finance, and other hybrid formats

- Private funding. But if it has a tax incentive it becomes public/private funding

E) **Risk mitigation schemes**: loan guarantee schemes aimed at stimulating investment in CCS by sharing the risk of investors.

[8] https://en.unesco.org/creativity/ifcd

- These are schemes usually supported with public funding. The strongest example in developing economies (available to CCIs but not specific) is the *African Guarantee Fund*[9]

F) Corporate direct funding

a. Sponsorship, where the sponsoring company expects the promotion of its name, its products or its service in return of a direct monetary contribution

b. Corporate giving or donations, where the donor does not expect a direct benefit, but fulfils a corporate responsibility obligation or a social purpose.

- Both are examples of private funding (with obvious nuances in the case of State controlled corporations). However, tax incentives that reinforce the interest of these donations turn them into a public/private scheme.

G) **Indirect support**: Incubation. Early incubators focused only on technology companies or on a combination of industrial and service companies; newer incubators work with companies from a wide range of industries including the CCS. Their main role is not only to provide advisory and administrative support services, but also access to expertise, networks and investors. An incubator's primary objective is to produce successful and financially viable firms that can survive independently after the three-year incubation period

- Incubation can be both public or public/private, depending on the funding of the structuring vehicle used for it

This list of theoretical and only potential means of funding has consciously followed the trend of putting the focus in the initial phase of the activity or the support to its consolidation. But it is important to underline that much more importance should be given to the funding that may result from a proper distribution and marketing of the resulting creative production or service: market access and export. In any case, both in the financing of the initial phases of the value chain, and in the potential monetization of a creative economy product or service at the end of that chain, CCIs will face the structural challenges previously described, and the threat they may pose to a sustainable financing.

[9] AGF is formally a financial company owned by the Danish Development Aid Agency DANIDA, Spain's Agency AECID, and the African Development Bank.

3. IDEAS AND RECCOMMENDATIONS FOR THE FUTURE

- A better understanding on how to finance culture and creativity in the contemporary development context and for future resource needs is important. Governments' contributions are limited and new forms of funding must be sought.
  In this context, it is essential to expand the role of the private sector and civil society in the financing of culture in contemporary cultural policies. To do so, cultural actors need to become familiar with the new financing schemes to fully use their potential
- Public institutions and publicly funded initiatives should pay attention to the mentioned structural difficulties in the CCIs in their access to finance (in particular their lack of business skills) as well as to those related to the miscommunication or lack of understanding of CCS unique characteristics by financing actors, through capacity building and dissemination schemes and programs.
- National laws and regulations facilitating the contribution of the private sector supporting culture based on fiscal incentives or business opportunities have to be reviewed. Particular attention should be given to encouraging small entrepreneurs or investors who have a direct impact on the development and on local ownership of cultural and creative initiatives.
- Most of the existing financing opportunities are addressed to the content creation or production phase of the creative industries value chain, or the steps immediately behind that phase. But a holistic view of how to improve financial support of the CCIs should increase the focus in the barriers to success in the distribution/marketing of creative products, and the revenues that should be coming from that. Barriers that become higher when such distribution and marketing wants to become international (export).
- The efficiency of most of the described financing opportunities is strongly dependant on their regulatory framework. In particular legitimate filters and conditions imposed to prevent fraud, money laundering or tax evasion may turn some innovative instruments in purely theoretical but completely useless alternatives. Financial regulatory authorities must work together with those who are familiar with specifics of the CCS.
- Leaving aside some co-production funds in the field of cinema, few of the described opportunities for finance are really available across borders. Not even within the European Union internal market, and much less between Europe and its neighbours or between other countries. For example, incentivised cross-border crowdfunding is extremely difficult as any tax benefit attached to it ends at the border. Creative thinking should be given to the developing of schemes and structures facilitating the

cross-border interconnection of funding, .The establishment of local funds which can directly operate in some developing countries, with public and even private funding from European sources is a good model to follow.

- There is a direct link between revenues (music, publishing) and the country where the IP rights which are the base for their remuneration are registered and/or managed. Too often, these which may not correspond to the country of origin/residence of authors/creators. Policy initiatives to better connect IP revenues and their cultural country of origin would have a serious impact in the funding of some CCI subsectors, in particular in music, and reinforce local ownership.
- Support to strengthening and modernizing the regulatory framework of IP; promoting the necessary training in the matter of both finance demanders and finance providers; and exploring new instruments and schemes to officially reinforce and facilitate the value recognition of IP related assets should be a priority.
- Broader investments in infrastructure such as internet connectivity, and in education and training are necessary to ensure a vibrant ecosystem for CCIs. These do not live on their own and have higher chances to prosper if there is an audience that has been exposed to arts and culture in their formative ideas.

OPEN QUESTIONS TO THE PANEL

Do you see difficulties and challenges in the access to finance that are specific to CCIs in developing countries, in relation to the situation of CCIs across Europe? If yes, which one would those be?

What solutions do you propose to those challenges? Do you favour specific and tailor-made solutions for the financing of creative enterprises, or a better use of existing financing instruments available for small and medium size companies (SMEs)?

In your opinion and according to your experience, what are the real options of increasing private funding for CCIs and what should be the role of public funding in this context? And what are the real trade-offs of such a change?

What would be the three main priorities to facilitate access to finance for CCIs?

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