Creative financing

Those who manage the arts enhance our culture – but how are they at enhancing the bottom line? Chris Higson, Oliver Rivers and Martin Deboo propose a value narrative to analyze how creative industries can become better businesses and alluring investments.

Creative industries form a large and growing part of the modern economy – for example, Martin Scorsese's *The Departed,* by the time it won Best Picture at the 2007 Academy Awards, had generated more than $131 million in US box office receipts alone. Yet, from the perspective of an investor, creativity can look like a risky endeavour. When speaking about businesses that revolve around fine art, theatre and performance, literature, music in all its forms, television and film, and recent derivatives such as games, two pervasive prejudices persist: first, that they need large commitments of resources to create an intellectual product that has no certainty of finding a market, and, second, that they are run by people who put art before profit.

To us, creative businesses are no different from other businesses, and the tools of financial analysis are equally applicable to creative firms. It is a fact that creative product businesses operate with a high degree of uncertainty, and this affects the way in which investors view them. Sources of uncertainty include demand (in advance of release, no one knows whether a film, recording or play will be a success or a flop), and technological and regulatory change. For example, Steve Jobs, the CEO of Apple Computer, was in the news last February with a proposal to recording companies that they remove digital rights management from all music. This drew a heated response from Warner Music CEO Edgar Bronfman, but one can readily see how the proposal could affect investor confidence in Warner stock.

When they talk to investors, managers of creative businesses need to be able to craft a convincing value narrative that explains the risks and returns – why money will be made and how value will be created for investors. Viewed from the other side, investors need to use just the same framework to consider the prospect of placing their money behind creative businesses. So we pose the question of value creation in terms of a dialogue.

Crafting the value narrative

From a financial perspective, a firm creates value for investors when it earns a return on capital in excess of its cost of capital, and it creates more value the more it grows. So value creation is a function of the firm's ability to earn and sustain a superior return on invested capital. But in a perfectly competitive world, firms just earn a fair return and no more; the firm that achieves a superior return gives a signal for others to enter the market and drive down the rate of return again. So the sceptical investor should start with the presumption that a firm cannot create value; accordingly, the creative firm's value narrative needs to explain convincingly why it can. In sum, this process is about creating a narrative, using a framework built on three stages. →

Special report

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→ **Grasp the industry** The first step in crafting the value narrative is to describe the industry structure. Knowing where power lies in the value chain will help to predict which industry participants will capture the most value and why. There are three steps in industry analysis:

- Describe the industry value chain and locate the firm within it.
- Assess the attractiveness of the firm's position within the value chain.
- Identify whether and to what extent changes in technology or the regulatory environment are affecting, or will affect, the industry within which the target firm is situated.

Hunt the intangibles Even if the target occupies an unfavourable position within the value chain, it may still possess (or be able to develop) intangible assets that will enable it to generate shareholder value. So the second step is to identify the resources or capabilities that confer competitive advantage on the firm.

Weigh the risks The final part of the value narrative is an analysis of risk. The high returns that valuable intangibles could bring may also incur high risk: tastes may change, eroding the value of established content; technological change may render a firm's organizational capabilities and intellectual property obsolete; brand may be impaired through scandal or mismanagement; human capital may walk out the door. Risk assessment will enable the investor to understand whether, or how, the target's competitive advantage may be eroded.

Each of these three parts of our framework deserves extended discussion, which is why we have been compiling case studies that exemplify how a fruitful discussion of each of these three areas can reap not only good analysis but also capital-raising or investment prospects, depending on whether you are managing a creative business or thinking about investing in one.

Creative structures

Our analysis has revealed that there are two types of creative products – pure and design – and thus, two types of companies that generate them. A *pure creative product* can potentially be consumed as a stand-alone good. The pure creative category includes fine art, theatre and performance, literature, music in all its forms, television and film, and computer games. A *design product* must be inherently embodied within another. The other product may be a tangible or physical good, or it may be intangible or digital. For examples of design products, think of architecture, fashion, product and web design and advertising.

We view the value chain for a creative product as having three parts: *origination*, *distribution* and *exploitation*. Origination describes the creation and production of creative goods, and the process may be complex and involve many independent parties. In the distribution stage, the creative product is delivered to the final consumer, perhaps through a series of intermediaries and through aggregation. In the exploitation stage, further value is added by making creative products into joint products with others. This taxonomy can be illustrated.

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The boundaries of these categories are, of course, flexible; and there are many other ways to look at the industry, but this simple scheme is helpful in understanding how value is created and captured in the creative industries. In our taxonomy, the creative industries represent all the parts of the pure creative product value chain as well as the origination part in the design industries (shown in figure 1).

The quest for intangibles

Intangibles are, by definition, hard-to-define aspects of a creative work that nonetheless affect its viability and, quite possibly, its profitability. The intrinsic content of a creative product, the "process" used to lasso intellectual property assets, brand value, and the specialness of the human talent involved – these are four of the most significant assets of a creative product that are usually intangible.

Content involves the creation, ownership and control of intellectual property. Intellectual property (IP) assets are valuable because they are highly differentiated; for the consumer who wishes to see *Gone with the Wind* or to listen to *Penny Lane,* there are no close substitutes available. Furthermore, some hits have the added attraction of being highly durable. Thus a hit may generate stable revenues over a period of time limited only by the duration of the applicable copyright.

The bad news is that, in advance of their creation, the value of intellectual property assets is unknown; the creator faces extreme demand uncertainty. For example, no one could guarantee that *The Departed* would win the top Academy Award. In consequence, financing content

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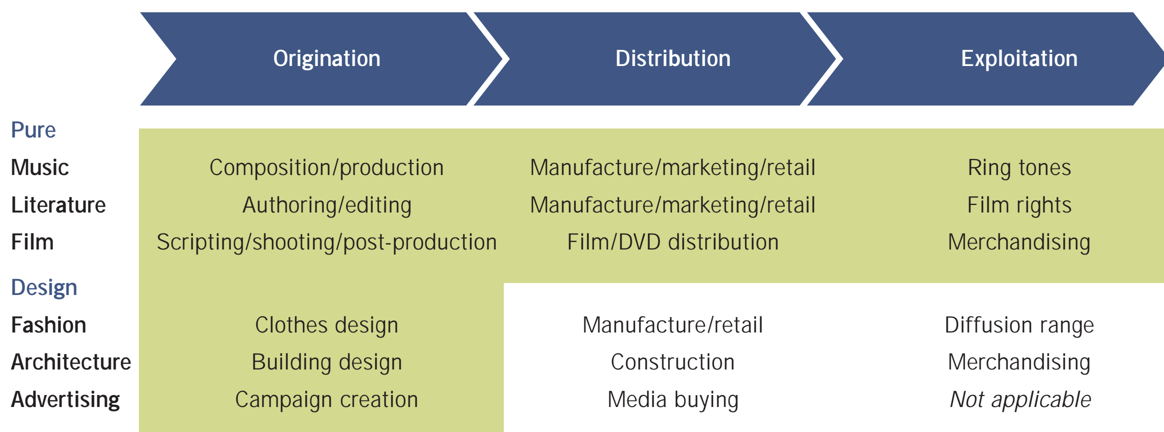

	Origination	Distribution	Exploitation
Pure			
Music	Composition/production	Manufacture/marketing/retail	Ring tones
Literature	Authoring/editing	Manufacture/marketing/retail	Film rights
Film	Scripting/shooting/post-production	Film/DVD distribution	Merchandising
Design			
Fashion	Clothes design	Manufacture/retail	Diffusion range
Architecture	Building design	Construction	Merchandising
Advertising	Campaign creation	Media buying	*Not applicable*

Figure 1: The creative value chain.

creation is a challenge, and the providers of finance – banks with expertise in media investments, major film studios, or record labels – will seek to structure deals in order to protect themselves from the likelihood that they will lose their investment. This means option-based structures, which grant providers of capital the right to stage their investment in various ways (for example, a recording contract that allows a label to terminate or to continue a relationship with an artist), and agreements that protect the investors' downside, such as film production deals that enable distributors to recoup all their costs before producers receive any share of box office receipts.

Process IP, the *way* that content is assembled in a creative product, is another key intangible. We define process IP as some sort of proprietary approach or model, set of routines, organizational structure or simply a way of seeing the world that is of value to the firm's customers and that is capable of generating sustainable advantage, and hence, value creation. For example, part of the reason for Miramax's rapid growth in the 1990s lay in the firm's understanding of how to market art-house films to mainstream audiences, something that had previously been considered impossible in the American movie business.

Process IP can be transformed into competitive advantage whenever the process itself shows value beyond the content. For example, an investor can look at attributes like:

- *Scalability,* in that the proprietary process can become independent of key individuals and can be replicated among individuals and entities who may lack the perspicacity of the "founding fathers" (but who are usually cheaper to hire and more numerous).
- *Defensibility,* in that the process may be difficult to copy *per se* (or, perhaps, even legally protected), or builds time-based advantage as the result of repeated application and/or a reservoir of experience and benchmarks that it is difficult for late-entering competitors to emulate.

Branding, of course, is a well-known business asset. Traditional brands – be they corporate brands like Virgin or IBM, or product brands like Coke and Tide – are frequently the property of large, vertically integrated firms. At first blush, branding in the traditional sense of the word might be thought to play a peripheral role, at best, in the creation of value in creative businesses, where value seems most obviously to reside in the creative properties and the talent that creates them and the ability of the organizing firm (be it creator, distributor or exploiter) to capture the economic rents from that content and talent. However, such an analysis ignores the important role that brands also play in the creative industries. At their most basic, brands act as a risk-reduction mechanism for their consumers, their owners, their investors and their channel intermediaries. Given the prevalence of the "no one knows" phenomenon in the creative industries, this ability to reduce risk should be highly prized. From an investor perspective, there are four principal ways in which a brand can enhance the attractiveness of a creative enterprise.

- *By reducing risk for the consumer and channel intermediary* Creative products are risky purchases; and, in general, the origin of the product is a limited guarantee of its success. However, there are circumstances in which the presence of a brand can reduce risk. For example, when "genre" values are important: if one is looking for an animated film that's safe for family consumption, Pixar (www.pixar.com) has made itself a byword for success in this genre. Another example occurs when bundling enhances the economics of a product. Much of the profit in the film and music industry in particular arises from the "long tail", in other words, the back catalogue where, despite slower sales, margins are traditionally high. Even though back catalogue operations tend to be logistically complex, exploitation of a back catalogue brand can therefore again act as a mark of quality to consumers and intermediaries (think Penguin Classics). →

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Type of Intangible	Key Risks	Protection through lawyerly intervention?
Content	Demand failure	Low. Protection of downside through option-based contracting, structuring of financing packages.
	Copyright infringement	High. Defining of rights, assertion of ownership, litigation to punish infringement.
Process IP	Technological / economic change renders process obsolete	None.
Brand	Passing off / piracy	High. Litigation to pursue pirates.
Human capital	Walking out the door	Medium / high. Employment contracts to tie in key talent.

Figure 2: Key risks for intangibles.

- *By acting as a draw for talent* Success in creative businesses often depends on having access either to the best talent at whatever the price or adequate talent at lower cost than competitors. The omnipresent risk is that major talent bargains away the extra value it creates. Therefore creative brands that can foster even marginal improvements in the clearing price for talent are enormously valuable. Woody Allen's continuing ability to employ leading Hollywood talent in his movies at bargain rates is an example.
- *By increasing marginal preference* A defining characteristic of the creative industries is that the marginal cost of supplying an additional unit of consumer "experience" (for example, giving a cinema admission or a downloaded track along with the purchase of a DVD) is usually close to zero. Therefore, rates of marginal profit are high and, accordingly, the economic break-even from small differences in volume preference is low. Consequently one does not have to believe much about the influence of a producer brand to believe in its economic effectiveness.
- *By reducing earnings volatility* In the light of all the above, it can be seen that a composite benefit of a creative brand is that it can lower the earnings volatility that plagues creative businesses by reducing both demand risk (giving the benefit of the doubt and increasing marginal preference) and supply risk. This should therefore reduce the risk-adjusted cost of capital of a creative business that owns a strong brand.

People (or human capital) represents the talent in individuals and groups that enables the serial creation of valuable content and enables organizations to respond flexibly and innovatively to new opportunities or changes in the competitive environment. The challenges of managing human capital in the creative industries can be formidable. Perennial squabbles between recording labels and artists illustrate the challenges of achieving contractual arrangements in the creative industries that are satisfactory to all parties.

Labels make substantial upfront investments in artists, in the form of production and marketing expense; and at the outset of a musician's career, nobody knows whether these costs will be recouped. In 1966, would you have put money in the career of Reginald Dwight? Soon thereafter, Dwight became Elton John. Hence, the option-like nature of many recording contracts. Ideally, from the label's point of view, the contract will grant it the right to terminate its relationship with an artist whose albums have flopped, while at the same time enabling it to demand new releases from an individual or band that storms the charts.

Controlling risks

Each of the classes of intangible asset just described is vulnerable to particular risks. We highlight the key risks faced by each class in figure 2 and indicate the potential for protection through lawyerly intervention. Even lawyers can do little to mitigate demand failure in a hit-based business, and they can do nothing to avert technological obsolescence. But lawyers have enormous potential to reduce the risks associated with IP, brand and human capital.

In general, risk for creative businesses is a function of uncertain demand, business model choices, and time. All creative businesses face the risk of product failure: the client may reject the advertising agency's pitch for new work; the architect loses the competition to design a new building; the studio's hoped-for blockbuster turns out to

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be a flop. The production process also introduces a series of risks into the equation; multi-stage production processes are vulnerable to hold-up problems. Finally, the risk profile of content businesses may change markedly over time as they build libraries that generate stable, long-lived cash flows. The key risks to focus upon include the following:

Demand failure risk is, simply, too few buyers for the product. The impact of product failure is felt acutely by content businesses, since it is not feasible to market-test an incomplete product until a substantial amount of expenditure has already been incurred. For example, Hollywood test screenings take place after most of the production budget has been spent. The financial and legal strategies employed by film studios to militate against product failure include portfolio diversification, staging of investment decisions, and deal structure.

Production process risk involves something going wrong as the creative product is being assembled. The production of creative goods is usually a multi-stage process, dependent on the inputs of many different workers, each essential to the successful completion of the task. If output quality at each stage falls below some minimum level, then the creative good will turn out a failure. Thus, each production stage becomes critical to the ultimate success of the creative good. This can give rise to contracting problems, as participants at each stage of the creative process may seek to exploit their bargaining power.

Time risk is hinged on whether a product ages well or poorly. Thanks to the back catalogue, the risk profile of certain kinds of creative business can change quite markedly over time. Consider a film distribution company. Each year it pays an advance to acquire the rights to distribute a slate of films in a given territory for a specified period – typically 25 years or more. From the moment a distributor takes on a film, it's uncertain whether it will be a blockbuster or a turkey. But after release, the film's financial performance is quickly known, information that is a reliable guide to the film's likely future earnings. As the size of the film distributor's back catalogue grows, the degree of uncertainty faced by the business decreases, both because sales from new titles form a smaller proportion of total sales and because back catalogue sales are more stable. The same dynamic applies to games publishers and to record labels.

What is typically exciting about those who work in creative industries is their ability to think outside the box. This trait is avidly desired by many in more strait-laced businesses. Nonetheless, if companies in the creative realm are to be seen as more mainstream businesses – and, thus, ripe for investment, a fundamental framework of financial criteria tied to all stages of the creative process needs to be better defined, understood and used by both managers and investors. Thinking inside the box is the parallel challenge to creativity.

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Special report

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