CAPACITY BUILDING IN THE CULTURAL AND CREATIVE SECTORS

A guide to assessing loan applications from CCS SMEs

European Investment Fund

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EXECUTIVE SUMMARY

Introduction of the Cultural and Creative Sectors (CCS)

- CCS represent a crossroad between arts, business and technology
- Key common characteristics of CCS SMEs are related to their intangible nature of production and specific value chains often centered around a particular project
- Access of CCS SMEs to third party financing is hindered by specific risks inherent to their business models and overall perception of higher riskiness of CCS companies by capital providers
- As a consequence, each step of the lending and risk assessment process needs to be tailored to CCS specificities

This is a three step guide for financial institutions to assess loan applications of CCS SMEs

The "Origination" phase should include the following elements

- Raise awareness of the economic potential of CCS as well as understanding of related value chains
- Analyse CCS sub-sectors as well as the functioning of the specific value chains
- Define specific CCS strategy and identify target SMEs per sub-sector
- Identify public support schemes, potential partners and relevant business opportunities through networking in the CCS ecosystem

The "Underwriting" phase should consider the following aspects

- Understand funding needs, risks and cash flow patterns
- Understand the business practices that exist in each sub-sector of the CCS
- Analyse the strategy, business plan, financial plan, competitive environment as well as related business partners of the SME
- Understand and evaluate the business owner’s vision, track record in the CCS market and access to distribution networks
- Evaluate the intangible assets

The "Closing and monitoring" phase should entail the following elements

- Aside from standard banking practices, an additional risk management dashboard could be used to facilitate the monitoring process
- Consider participating in risk sharing schemes supported by the EU (e.g. the InvestEU Cultural and Creative Sectors Portfolio Guarantee Product, a dedicated action on CCS managed by the European Investment Fund (EIF) on behalf of the European Commission, which provides capped and uncapped portfolio (counter-) guarantees for low guarantee fees)

CCS OVERVIEW

CCS DEFINITION

CCS as a crossroad between arts, business and technology

Definition

- Creative industries correspond to ‘those industries which use culture as an input and have a cultural dimension, although their outputs are mainly functional’ (European Commission, Com 183 Final, 2010)
- Cultural activities correspond ‘to those activities, goods and services, which at the time they are considered as a specific attribute, use or purpose, embody or convey cultural expressions, irrespective of the commercial value they may have’ (UNESCO)
- Cultural and Creative Sectors (CCS) includes all sectors whose activities are based on cultural values and/or artistic and other creative expressions, whether those activities are market- or non-market-oriented, whatever the type of structure that carries them out, and irrespective of how that structure is financed. Those activities include the development, the creation, the production, the dissemination and the preservation of goods and services which embody cultural, artistic or other creative expressions, as well as related functions such as education or management.

  The CCS sub-sectors include inter alia architecture, archives, libraries and museums, artistic crafts, audiovisual (including film, television, video games and multimedia), tangible and intangible cultural heritage, design, festivals, music, literature, performing arts, publishing, radio and visual arts (EIF).

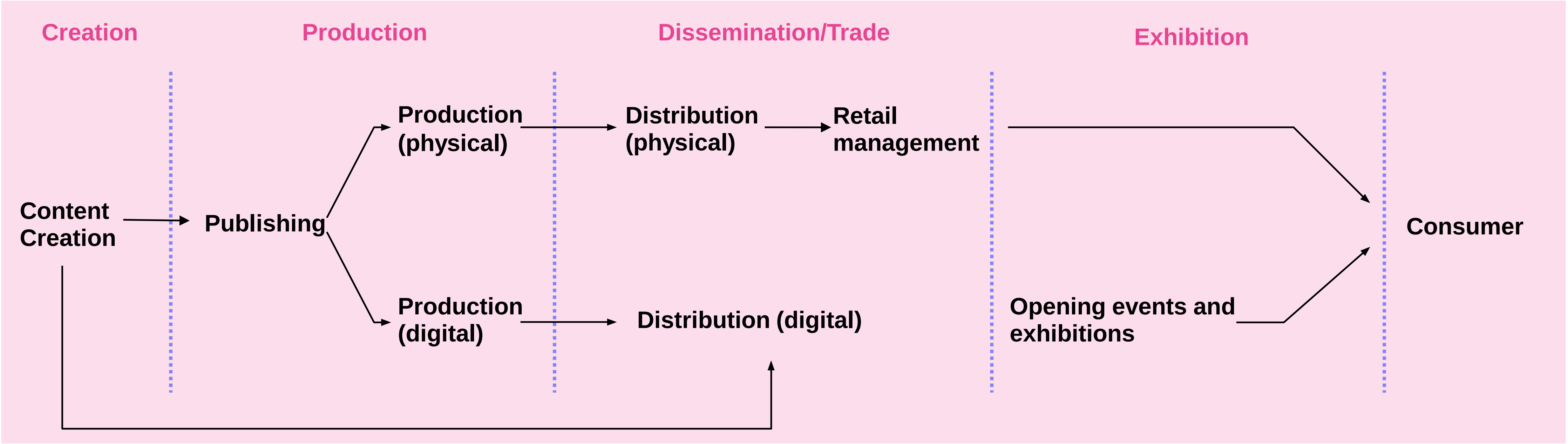
Sub-sectors	Description	Examples
Heritage, Archives and Libraries	• Library and archives activities • Museums activities • Operation of historical sites and buildings	
Books & Press	• Book, newspapers and journals publishing and retail sales in specialised stores	
Visual arts	• Artistic creation • Photographic activities • Specialised design activities	
Architecture	• Architectural activities (advisory, technical consultancy, design and planning)	
Performing arts	• Operation of arts facilities • Performing arts and its support activities	
Audio-Visual & Multimedia	• Production, recording, distribution of motion picture, video and music • Radio and TV broadcasting	
Education & Memberships	• Cultural education • Activities of professional memberships organisations	
Other cultural and creative sectors activities	• Wholesale of other household goods • Retail of second hand goods in stores	

Source: European Commission, Survey on access to finance for CCS (2013)

CCS SPECIFICS AND VALUE CHAIN EXAMPLE

Key features of CCS SMEs are intangible nature of production and value chains often centered around particular project

Typical CCS value chain



Overview

- Each CCS sub-sector has its own specificities in terms of business model and market structure
- However, there are certain **characteristics which are common** for all CCS sub-sectors:
  - Dependence on **intangible assets** and often intangible nature of the projects and production
  - **Value chain** is dominated by a network of agreements with partners, and a large portion of the revenues are based on B2B relationships
  - Complex and evolving **business models subject to external trends** such as technology disruptions and shift in consumer preference (digital distribution channels, impact of social networks, sharing vs. ownership-based consumer consumption, etc.)
  - Importance of **funding by public bodies**, eligibility for grants or tax credits

Source: Mapping the Creative Value Chains - A study on the economy of culture in the digital age, 2017

CCS ACCESS TO FINANCING

Access to third party financing is facilitated by financiers' ability to address a number of risks specific to CCS SMEs

CCS financing overview and opportunities

- CCS SMEs' access to third party financing is hindered by specific risks inherent to their business models and overall perception of riskiness of CCS enterprises by capital providers:
  - Self financing remains the most important source of finance for most small and very small CCS organisations
  - Government funding is a very important funding source for enterprises (particularly SMEs) in CCS (exceeding EUR 71 billion in 2021 or 1.0% of general government expenditure)
  - Government spending in CCS has been decreasing in OECD countries since the financial crisis in 2008
  - Depending on the size of CCS SMEs, banks have been an external source of financing mostly in the form of short term (micro-) credit
  - With some notable exceptions, venture capital (VC) and private equity (PE) investors are less present in the sector
  - Other sources of funding may encompass donations, sponsorships, patronages, etc. Between 2013 and 2017, CCS firms launched more than 75,000 crowdfunding campaigns, for example raising more than EUR 247 million just for audiovisual and music

- While the sector has its specifics, there is no evidence that CCS underperform in terms of profitability and financial health compared to other sectors:
  - Financial health (current ratio: 3.5, solvency ratio: 37.9) in line with the average total business economy
  - Profitability (ROE: 14.3%, EBIT margin: 6.9%)
  - Capital structure (equity: 38%, long term liability: 27%, short term liability: 35%)
  - CCS' contribution to GDP is similar to the sectors of Information and Communications Technology (ICT) and Accommodation and food services*
  - CCS generated a value added of EUR 354 billion in 2020 and employed more than 8 million workers in the EU, Norway and Iceland*
  - The number of companies in the CCS exceeds those in ICT and Accommodation and food services*
  - Whilst the overall sector was significantly impacted by the COVID-19 crisis, certain sub-sectors were relatively unaffected or even experienced a positive impact

* Please refer to the market study document (2023 update)
Sources: European Commission, Survey on access to finance for CCS (2013), Boosting the competitiveness of cultural and creative industries for growth and jobs (2016), Eurostat (2023) Statistics explained: Government expenditure on cultural, broadcasting and publishing services, OECD (2022) Public and private funding for cultural and creative sectors (data from 2019).

LENDING TO CCS AND RISK ASSESSMENT

LENDING TO CCS AND RISK ASSESSMENT

Each step of the lending and risk assessment process needs to be tailored to CCS specificities

Phase	1. Origination	2. Underwriting	3. Closing and monitoring
Key Steps	1.1 CCS awareness development	2.1 Loan products and structuring	*Signing & Closing**
	1.2 Understanding CCS sub-sector value chains	2.2 Understanding of cash flows and funding requirements	3.1 Monitoring
	1.3 CCS strategy & prospecting	2.3 Risk mitigation	3.2 Distressed situations management
Challenge	• Perceived complexity of the business models and associated risks	• Insufficient understanding of the CCS operations	• Lack of operational resources and tools of financial Key Risk Indicators (KRIs) set-up and risk monitoring
Solution	• Defining CCS lending strategy • Partnering with local sector bodies	• SME risk assessment based on CCS specific criteria	• Regular monitoring of targeted CCS sub-sectors and evaluation of CCS SMEs according to defined KRIs

(*) We have included this step in this overview as they are part of a typical lending/risk assessment process. However, there is no specific guidance provided in this document as they do not depend on CCS specifics

I. ORIGINATION PHASE

Phase	1. Origination	2. Underwriting	3. Closing and monitoring
	1.1 CCS awareness development	2.1 Loan products and structuring	*Signing & Closing**
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I. ORIGINATION PHASE

I.I CCS awareness development

Section overview

Key takeaway

- CCS are expanding across Europe
- Digitalisation has a strong impact on traditional CCS value chains

Potential challenges for financial intermediaries

- Perception of higher-than-average riskiness of CCS SMEs
- High uncertainty of customer demand for the project outcome
- Fast evolving business model dominated by B2B relations which varies depending on the CCS sub-sector
- Assessment of the impact of changing customer preferences, technology and digitalisation on the value chain

I. ORIGINATION PHASE

I.I CCS awareness development

Understand the economic potential and attractiveness of CCS SMEs

- Perform research to understand key economic variables related to the CCS market on each sub-sector
- Consult studies and databases:
  - https://ec.europa.eu/eurostat
  - http://ecbnetwork.eu/ – EU level
  - https://culture.ec.europa.eu/resources/document-library? – the European Commission's Culture Document library
  - https://www.bmwi.de/Redaktion/EN/Dossier/cultural-and-creative-industries.html – Germany
- Consult with external service providers to obtain market intelligence tailored to your needs
- Set up an advisory board composed of experts from the targeted CCS sub-sectors that will provide support with the industry understanding and the application of risk assessment
- Liaise with key associations and stakeholders in the targeted CCS sub-sectors

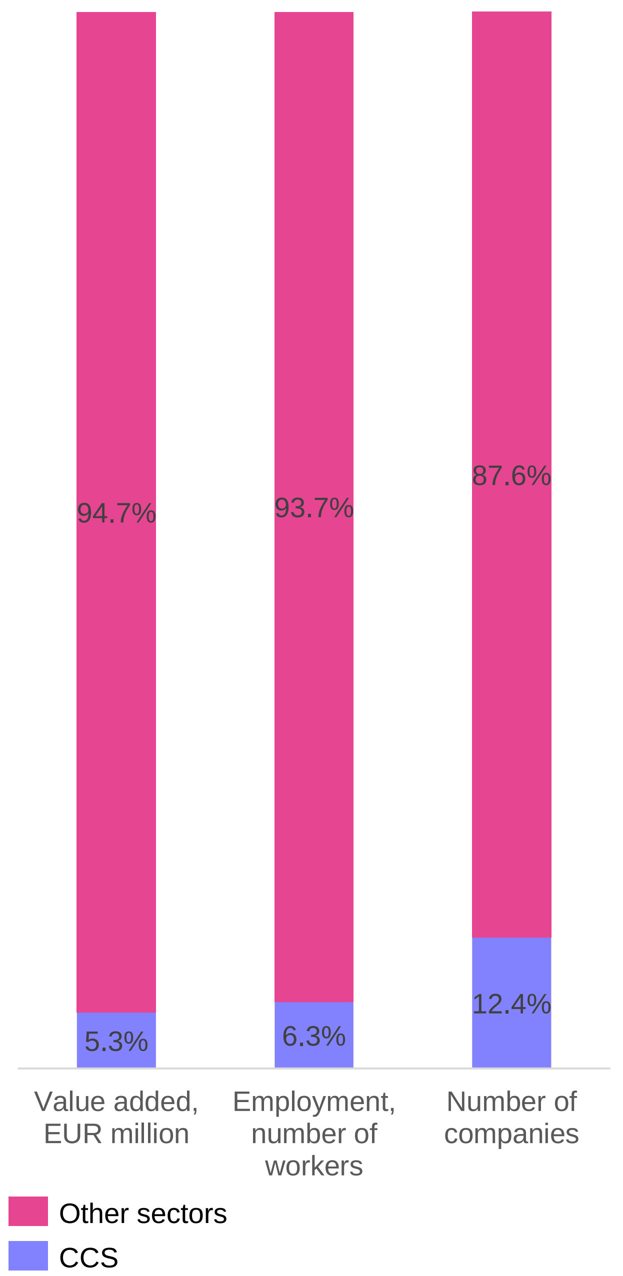
Understand the recent developments affecting the sector

- New digital services and products have unlocked additional revenue generation opportunities for most of the CCS, and new business models are emerging, such as mobile gaming, music streaming, Video on Demand, audiobooks and extended reality
- CCS content is increasingly consumed digitally: the diversification of access points (e.g. internet, social media, mobile apps) and formats (e.g. podcasts) has widened opportunities to reach new customers, especially among the younger population
- While a number of CCS sub-sectors suffered significantly as a result of COVID-19, certain activities such as streaming experienced an increase in demand

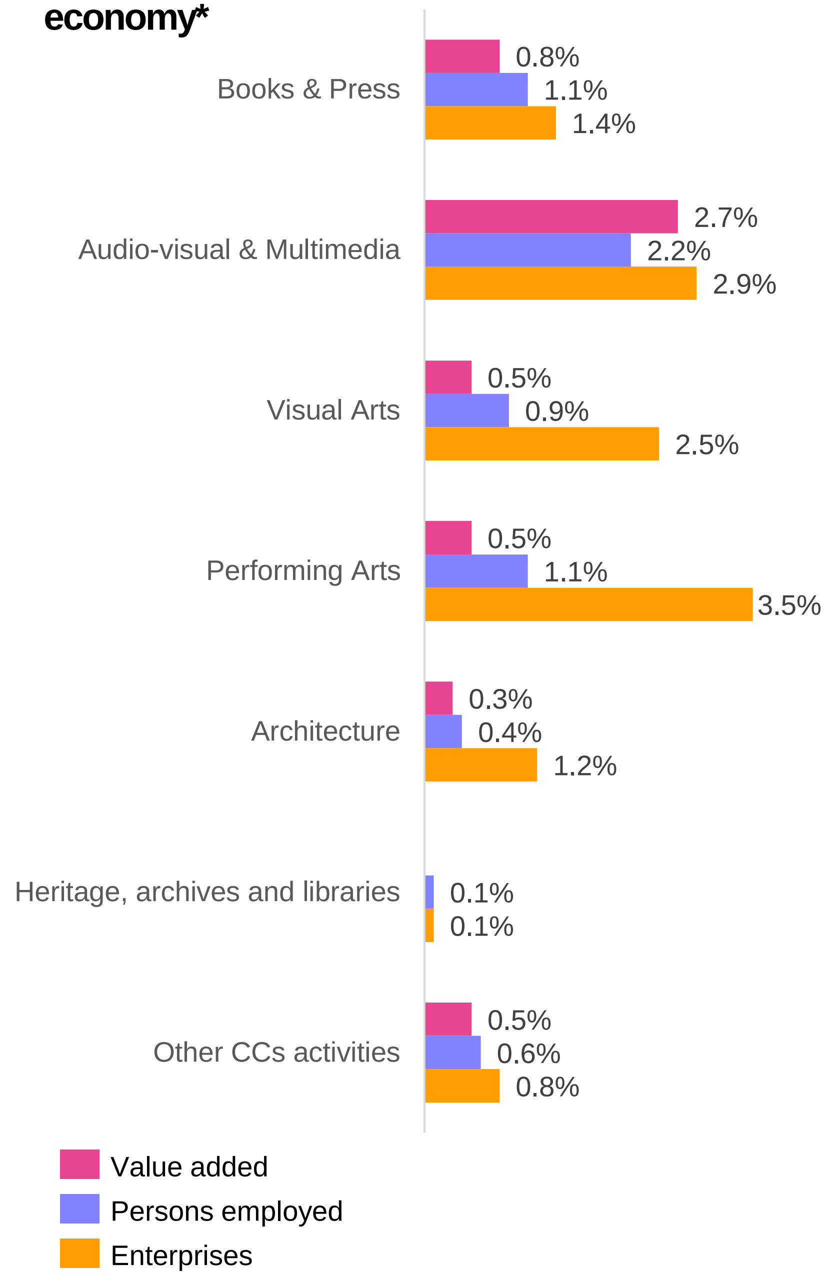
I. ORIGINATION PHASE

I.I CCS awareness development

CCS contribution to the EU economy*



CCS market by sub-sector as a share of the EU economy*



Key observations

- The CCS generate 5.3% of the total European value added
- In total, the CCS make up 12.4% of all private enterprises in Europe

  6.3% of all individuals employed in the European economy work in the CCS

  The CCS are characterised by a high portion of very small firms – 95% of CCS firms are businesses with up to 9 employees
- 95% of the enterprises in CCS engage in a "trade and services" activity, while 5% in a "production" activity
- The biggest sub-sectors within the CCS, in term of economic value added and employment, are the Audio-Visual & Multimedia and the Books & Press sub-sectors
- Some of the main trends shaping the CCS are related to:
  - the digital uptake which increases access to content and gives rise to new business models and revenue streams
  - new forms of collaborations through creative hubs and co-working spaces

*In the calculations of the share of the CCS or of a sub-sector on the overall economy, the NACE code B-N_S95_X_K ("*Total business economy; repair of computers, personal and household goods; except financial and insurance activities*") was used as the proxy for the overall economy. Therefore percentages showing the share out of the EU economy (for value added, employment and number of companies) have been calculated with this proxy. The EU and European economy refers to the countries covered in the market study, i.e. the EU-27, Norway and Iceland. In 2020, aggregate values for the EU-27, Norway and Iceland amount to value added: EUR 6,670,837 million / employment: 129,208,060 / number of enterprises 23,716,655

I. ORIGINATION PHASE

I.I CCS awareness development

Even though digitalisation has had a significant impact on the CCS sub-sectors, the extent of these changes varies among countries, with smaller countries being less affected in case some of the largest players have not entered their geography. Below are just some of the examples of the impact of digitalisation on the CCS:

Product adjustments

- Film: shorter format for new media platforms (mobility), virtual reality, augmented reality
- Live music: live performance became increasingly important for music artists as a revenue source

Impact on contract terms

- Book publishing: in countries where Amazon operates, book publishers often have to accept their contract terms which may include exclusivity clauses in order to gain access to the marketplace
- Music production: digitalisation impacted the way that the end user interacts with the IP with a shift from 'ownership' via download to streaming

New distribution methods

- Book publishing: libraries are catching up on the digital trend and offering more and more e-books (e.g. e-loans vs e-book sales)
- Video games: online sale displacing retail, micro transaction for monetisation

Cash flow impact

- Music production: more revenue predictability with music streaming and increased longevity of the songs due to streaming
- Book publishing: new opportunities are arising thanks to the development of new formats (e-books) and new products (audiobooks). New actors are entering the value chain accordingly altering the timing of the payments

New market creation / market adjustment

- Video games: new online and mobile opportunities with digital platforms
- Book publishing: traditional actors (e.g. active in printing, binding) are replaced by digital production activities

I. ORIGINATION PHASE

I.2 Understanding CCS sub-sector value chains

Section overview

Key takeaway

- Gain an understanding of value chain specificities

Potential challenges for financial institutions

- Little understanding of specific CCS market dynamics per sub-sector
- Significant differences between the value chains of CCS sub-sectors
- Capacity to capture the relevant KPI for each sub-sector in order to align the financing priorities to the risk appetite of the financial institutions

I. ORIGINATION PHASE

I.2 Understanding CCS sub-sector value chains

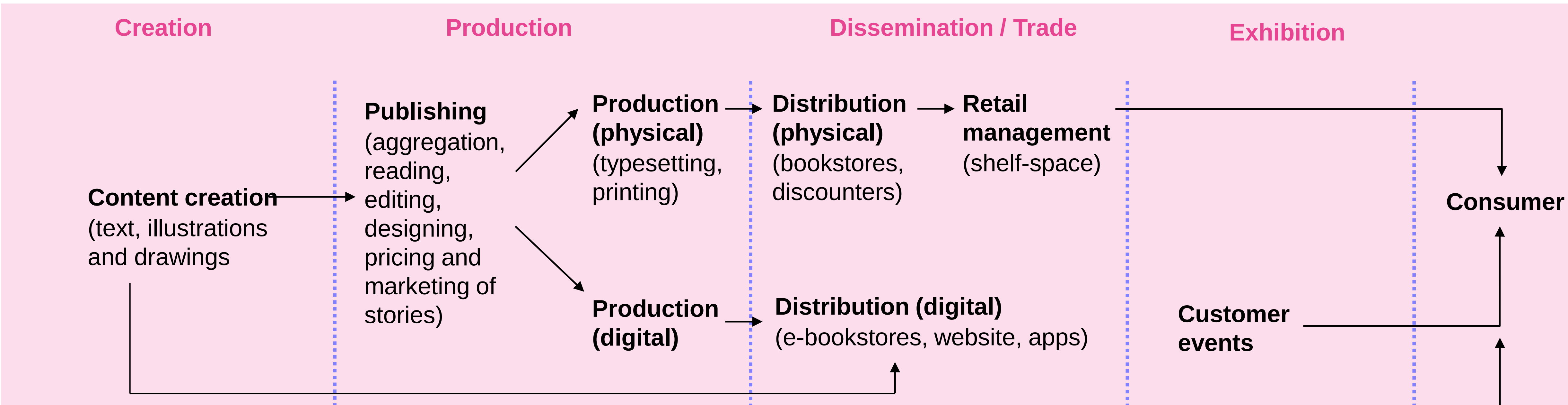
Analyse the functioning of the value chain of the specific sub-sector

- Review the value chain of the relevant CCS sub-sector
- Value chains generally consist of four core functions: Creation, Production/Publishing, Dissemination/Trade, Exhibition/Reception/Transmission*
- Analyse key local actors, financial flows and revenues generated at each step of the value chain
- Use sector-specific publications and news from sources such as:
  - Europa-cinema.org or the European audiovisual observatory for the film sector
  - Author societies (e.g. GESAC, CISAC)
- Evaluate the impact of digital shift in the CCS sub-sector. Digitalisation and other technology trends are disrupting the traditional value chains (e.g. classical publishing vs emergence of e-books)

Source: European Commission, Mapping the Creative Value Chains - A study on the economy of culture in the digital age (2017)

I. ORIGINATION PHASE

I.2 Understanding CCS sub-sector value chains – book publishing

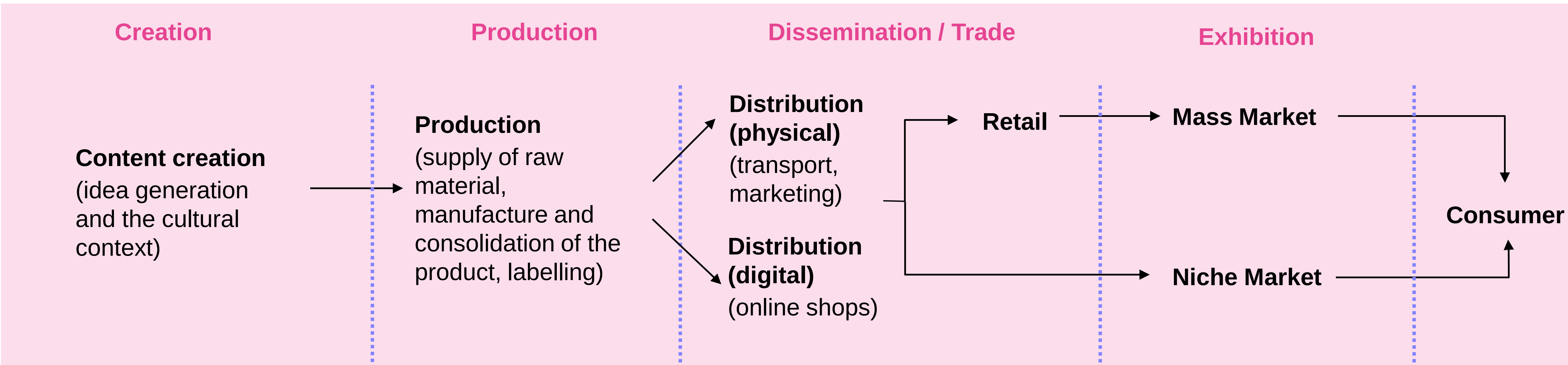


Ancillary goods & services		**Support activities** (software and application development)	**Hardware production** (e-reader)
Typical funding	**Funding Need** Low	**Funding Need** High	**Funding Need** High
Overview of each step in the VCH	**Key actors** Authors, illustrators **Key activity** Content creation	**Key actors** Book publisher **Key activity** Commission/acquisition, copy-editing, proof reading, index making and rights management, physical and digital production (typesetting, layout, design, printing, binding, insurance, shipping)	**Key actors** Book distributor/retailer **Key activity** Distribution (sales and marketing, promotions and management of publicity), physical delivery of books (and digital delivery) to stores (online stores), packaging, transport, ordering process and servicing and management of IT systems and warehouses, handling of returns of unsold books from stores

Source: Mapping the Creative Value Chains - A study on the economy of culture in the digital age, 2017

I. ORIGINATION PHASE

I.2 Understanding CCS sub-sector value chains – fashion



Ancillary goods & services		**Support activities** (raw material suppliers)		
Typical funding	**Funding Need** Low	**Funding Need** High	**Funding Need** High	
Overview of each step in the VCH	**Key actors** Crafters/artisans, associations, universities and schools **Key activity** Content creation, transmission of craft skills through training	**Key actors** Artisan **Key activity** Transform raw material into final product	**Key actors** Fairs, markets, sales representative, online retail and e-commerce **Key activity** Marketing/distribution of product on different market places	**Key actors** Consumer **Key activity** Audience accesses the production and production is affected with consumer behaviour

Source: Mapping the Creative Value Chains - A study on the economy of culture in the digital age, 2017

I. ORIGINATION PHASE

I.2 Understanding CCS sub-sector value chains – film

Creation

Content creation
(script development, rights acquisition)

Production

Financing & Pre-Sales
(studio backing, private & public financing and pre selling)

Production
(shooting and post shooting, film financing, involvement in content production, negotiation of commercial agreements for distribution and post-production)

Sales & Licensing

Dissemination / Trade

Physical distribution
(national/territorial distribution to cinemas as well as retail & sales management)

Marketing
(offline marketing, online marketing, social media)

Online distribution & Exhibition
(digital distribution via Over-The-Top services and subscription-based Video-on-Demand)

Exhibition

Cinemas

Broadcasting & cable retransmission
(via Pay TV, Cable TV Free-to-air)

Consumer

Ancillary goods & services			**Support activities** (filming, location activities, technical crew and software)
Typical funding	**Funding Need** Low	**Funding Need** High	**Funding Need** High
Overview of each step in the VCH	**Key actors** screenwriters, directors, talent **Key activity** Story development	**Key actors** Film producer **Key activity** Financing, casting, distribution deals, production of the movie	**Key actors** Film distributors, theatres, media, sale agents, festivals **Key activity** Promotion, marketing, rights acquisition and sale

Source: Mapping the Creative Value Chains - A study on the economy of culture in the digital age, 2017

I. ORIGINATION PHASE

I.2 Understanding CCS sub-sector value chains – live music / performance

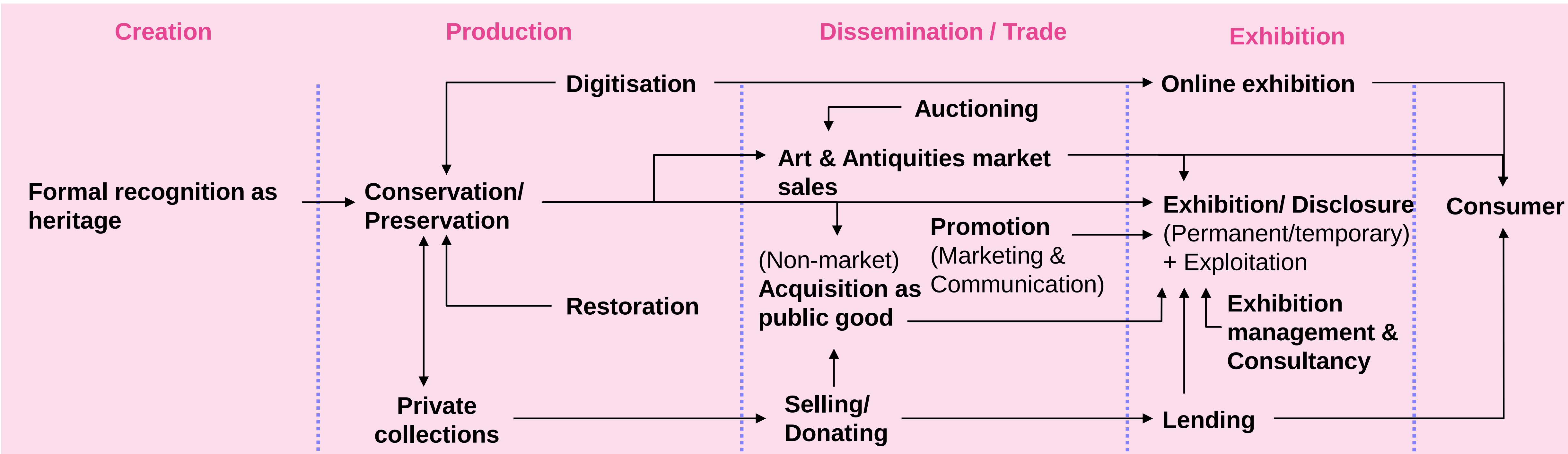
Creation	Production	Dissemination / Trade	Exhibition / Transmission	
Content creation (script, composition, choreography)	**Production** (rehearsals, stage, design, make-up, lights, sounds, choreography) **Technical support** (design, set, lights, backstage, costumes)	**Promotion** (marketing and media communication, programs and touring) **Distribution to stages and venues** (on-site information and communication, hosting and security) **Commercialisation & ticketing** (online and targeted marketing)	**Live Performance** **Broadcasting/ Cable Transmission/ Live Streaming**	**Consumer**

	Creation	Production	Dissemination / Trade	Exhibition / Transmission
Ancillary goods & services		**Technology Providers**		
Typical funding	**Funding Need** Low	**Funding Need** Medium	**Funding Need** High	**Funding Need** High
Overview of each step in the VCH	**Key actors** Authors **Key activity** Conceptualisation of original artworks	**Key actors** Artists, producers, technical crew, designers **Key activity** Rehearsals, stage design, light choreography	**Key actors** Agents, promoters, ticket distributors **Key activity** Distribution of produced events towards stages, promotion, marketing, communicating activities and commercialisation of event	**Key actors** Venues and stages **Key activity** Live performance of the play

Source: Mapping the Creative Value Chains - A study on the economy of culture in the digital age, 2017

I. ORIGINATION PHASE

I.2 Understanding CCS sub-sector value chains – museums



Ancillary goods & services				**Hardware and software** (online platforms, virtual reality equipment)
Typical funding	**Funding Need** Low	**Funding Need** Medium	**Funding Need** Medium	
Overview of each step in the VCH	**Key actors** Public authority **Key activity** Institutionalised process of labelling or certification	**Key actors** Heritage conservators/conservation organisations, restoration experts **Key activity** Heritage management, maintaining and renovating/restoring culture heritage	**Key actors** Market of arts & antiquities, auction houses, public heritage management organisations **Key activity** Trade of heritage objects, financial estimation and marketing	**Key actors** Exhibition facilities (e.g. museums), heritage sites/monuments **Key activity** Present and provide information on tangible heritage to the public

Source: Mapping the Creative Value Chains - A study on the economy of culture in the digital age, 2017

I. ORIGINATION PHASE

I.2 Understanding CCS sub-sector value chains – recorded music

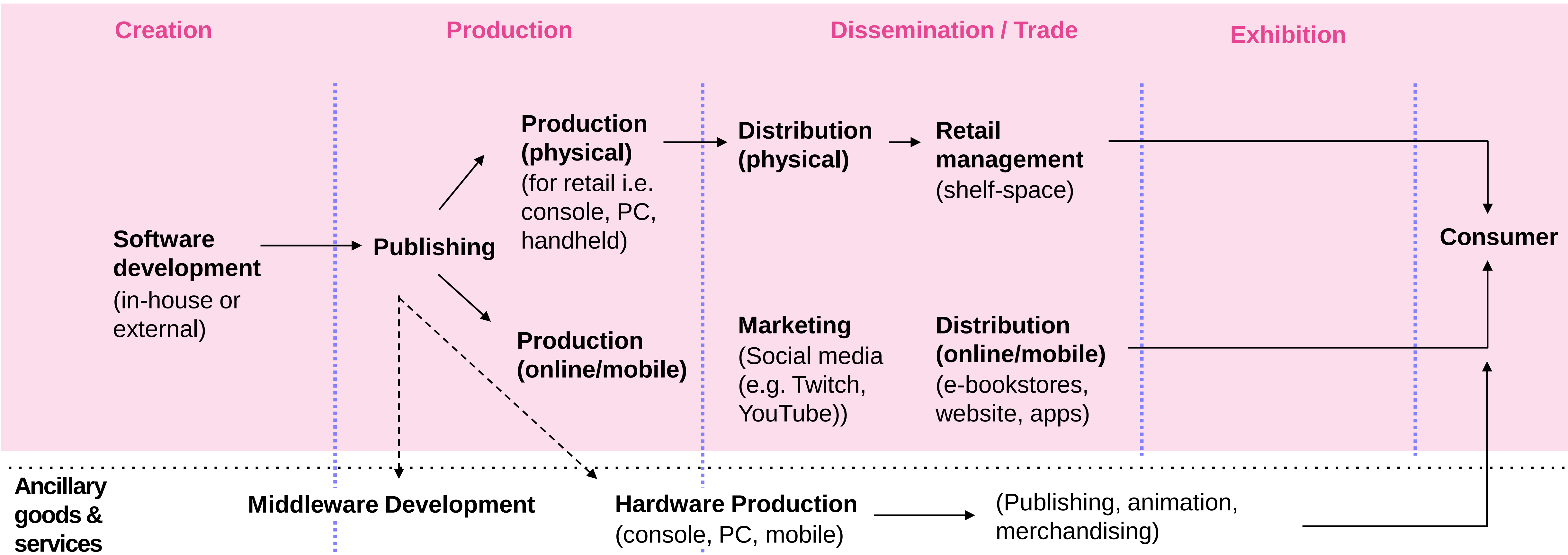
Creation	Production		Dissemination / Trade	Exhibition	
Musical creation & Song-writing	**Publishing** (acquiring copyrights, promoting, authorizing and using in mass media)		**Linear distribution** (TV, Radio as well as marketing and promotion)		
Interpretation performance	**Artists & Repertoire** (scouting and contracting)	**Production** (pitching to recording artists or record labels, manufacturing and PR/marketing)	**Bricks retailers** (packaging, transport & retail management as well as marketing and promotion		**Consumer**
			Non-linear distribution (digital service providers, online promotion and marketing)	**Venues & Festivals**	

Ancillary goods & services	**Support activities** (e.g. music recording software, manufacturing of musical equipment)		
Typical funding	**Funding Need** Medium	**Funding Need** High	**Funding Need** Medium
Overview of each step in the VCH	**Key actors** Composers, writers, performers, musicians **Key activity** Composing music, writing lyrics, interpretation	**Key actors** Music publishers / Record companies, collecting societies **Key activity** Signing new artists for publishing and/or recordings, rights management, manufacturing	**Key actors** Record companies. aggregators, rights collection **Key activity** Promotion/Marketing, distribution deals, touring, artists management

Source: Mapping the Creative Value Chains - A study on the economy of culture in the digital age, 2017

I. ORIGINATION PHASE

I.2 Understanding CCS sub-sector value chains – video games



Typical funding	**Funding Need** (1) High	**Funding Need** High	**Funding Need** Medium
Overview of each step in the VCH	**Key actors** Game developer **Key activity** Content creation	**Key actors** Game producer and publisher **Key activity** Game development and funding, rights management	**Key actors** Game distributor, internet platform, social media, app stores **Key activity** Marketing and promotion, rights acquisition

(1) Low funding need/ revenue for licensed software; High funding need/revenue of in-house software engine development

Source: Mapping the Creative Value Chains - A study on the economy of culture in the digital age, 2017

I. ORIGINATION PHASE

I.3 CCS strategy and prospecting

Section overview

Key takeaway

- Identify member(s) of staff (from sales and/or risk departments) that will specialise in CCS and should take the lead on tasks set out in this document. Alternatively, liaise with local expert(s) to act as an intermediary
- Define specific strategy to target CCS sub-sector(s)
- Adapt product structuring and marketing to CCS

Potential challenges for financial institutions

- Aligning the market understanding and risk appetite for the sector across different bank functions such as credit team, sales team, legal, etc.
- Lack of defined CCS strategy within the bank and difficulty to identify target companies
- Limited experience in tailoring financial products and services to CCS SMEs
- Limited experience in approaching CCS SMEs (mutual misunderstandings/misconceptions)
- CCS SMEs lack information and understanding about the availability of the relevant sources of finance

I. ORIGINATION PHASE

I.3 CCS strategy and prospecting

Define CCS strategy

- Analyse industry data and identify CCS sub-sectors to be targeted based on growth prospects or in house expertise in the sub-sector etc.
- For the selected target sub-sector(s), identify key metrics (e.g. market growth, revenue generated, number of companies and companies of interest)
- Identify reliable data sources to access market / CCS SME data (e.g. IFPI for recorded music industry; European Audiovisual Observatory for audio-visual industry)
- Track market developments
- Discuss the suitability of the existing lending products for CCS
- Align on the approach across the organisation

Identify potential companies per sub-sector

- Based on selected sub-sector(s) and conducted market analysis, perform a mapping of SMEs operating in the selected sub-sectors (e.g. by geography)
- List “target SMEs” by order of priority and identify key stakeholders to contact
- Identify size of client base and potential demand for the product (e.g. is the product restricted to only one market due to a language barrier or will it be relevant for international markets; e.g. music in English vs. music in less internationally known languages)
- The following databases may provide SME market data:
  - Bureau Van Dijk (https://www.bvdinfo.com/en-gb/solutions-for-your-role/corporate-finance-and-ma-research);
  - CB Insights (https://www.cbinsights.com/about)
  - Crunchbase (https://www.crunchbase.com/)

Target marketing in the sector to reach out to CCS audience

- Based on selected sub-sector(s) and list of selected “target SMEs” adapt marketing approach:
  - Identify potential funding gaps within the SMEs’/sub-sectors’ value chains
  - Identify how your financial products may be beneficial for the target SMEs within the context of their specific value chains and financing needs
  - Take into account CCS specific terminologies to tailor your product marketing (e.g. instead of intangible assets refer to catalogue of rights or repertoire)

I. ORIGINATION PHASE

I.3 CCS strategy and prospecting

Network among existing sector investors in the industry

- Liaise and cooperate with incubators dedicated to the CCS
- Identify industry/sub-sector events and profiles of attending companies and investors
- Select and attend relevant events to promote your organisation's interest in the CCS market and financial products
- It is important to get involved with CCS entrepreneurs as early as possible to ensure that both sides fully understand each other and the cooperation can run smoothly

Contact the potential targets identified and understand their financial models

- Arrange initial contact with target SMEs (for instance, in the film industry, large professional events offer networking/meeting opportunities between financiers and CCS) to:
  - Understand the business model, positioning in the value chain of the respective CCS sub-sector, key partners and financial flows
  - Understand SMEs' financing needs (amount, duration, potential terms of pay back etc.)
  - Evaluate whether the financing need can be covered by existing financial instruments offered by your organisation
  - Following the initial feedback, consider adapting the financial offer to meet specific financing needs of CCS

2. UNDERWRITING PHASE

Phase	1. Origination	2. Underwriting	3. Closing and monitoring
	1.1 CC sector awareness development	2.1 Loan products and structuring	*Signing & Closing**
	1.2 Understanding CC sub-sector value chains	2.2 Understanding of cash flows and funding requirements	3.1 Monitoring
	1.3 CCS strategy & prospecting	2.3 Risk mitigation	3.2 Distressed situations management

(*) We have included this step in this overview as they are part of a typical lending/risk assessment process. However, there is no specific guidance provided in this document as they do not depend on CCS specifics

2. UNDERWRITING PHASE

2.1 Loan products and structuring

Section overview

Key takeaway

- Understand the main approaches to structuring loan products and assessing borrowing capacity in the CCS

Potential challenges for financial institutions

- Specific nature of certain sub-sectors
- Existing loan offering may need to be adjusted to fit the needs of the borrowers

2. UNDERWRITING PHASE

2.1 Loan products and structuring

In this section we are just focusing on some distinctive features of each of the sub-sector which differentiate it from the non-CCS SMEs and as such should not be treated as exhaustive.

There are four main ways to structure a facility for a company in a CCS, depending on the funds usage and available collateral. In reality a hybrid structure might be created however for simplicity purposes they are presented separately.

Type of financing	Description
1. Project financing	• Financing for a specific project where it is expected that the revenue from the commercial release of the project will serve as the source of repayment of the loan
2. Gap financing	• A loan bridging a funding gap resulting from the timing of cash inflows, where the quantum of the inflows is known upfront, also covers receivable financing
3. Slate financing	• Debt capacity is estimated based on the ongoing revenue from some completed titles which provide a portfolio effect and the value of existing intellectual property rights
4. Asset-backed financing	• Similar to more traditional forms of corporate lending based on the tangible assets of the company, secured by real estate, equipment or vehicles

2. UNDERWRITING PHASE

2.1 Loan products and structuring

FUNDING / SUB-SECTOR	PROJET FINANCING	GAP FINANCING	SLATE FINANCING	ASSET-BACKED FINANCING
BOOK PUBLISHING	✓	~	~	~
FASHION	~	✓	~	✗
FILM	~	✓	~	✗
LIVE MUSIC / PERFORMANCE	✓	✓	✗	✗
MUSEUMS	~	✗	✗	~
RECORDED MUSIC	✗	✗	✓	✗
VIDEO GAMES	✓	✓	~	✗

✓ Commonly applicable ~ Situation-specific ✗ Usually not applicable

2. UNDERWRITING PHASE

2.1 Loan products and structuring – book publishing

Type of financing	Application in book publishing sub-sector
1. Project financing	• In case of co-editions, i.e. translations of specific works into local languages which constitute a large portion of sales in non-English speaking jurisdictions, the performance of the book abroad may serve as an indicator of the future performance. The licence with local co-publisher usually lasts 4-7 years • The sales to bookshops are usually done in batches, on a recourse basis, i.e. the bookshop has the right to return unsold copies to the publisher. Whilst the exact figures will vary, on average across the portfolio this may be c.10-15% for the first batch • In jurisdictions where large online retail platform operate, it can also provide data to estimate the sales by competitors and the market size for a particular genre
2. Gap financing	• Applicability depends on the underlying book type, i.e. fiction versus non-fiction • While this may be less relevant for fiction books, in certain jurisdictions the government or other educational institutions may commission and pre-order certain types of academic books which have a low counterparty risk and high degree of certainty
3. Slate financing	• Potential financing in case of books with long shelf life, e.g. classics
4. Asset-backed financing	• May potentially own warehouses or bookstores which can be used as security

2. UNDERWRITING PHASE

2.1 Loan products and structuring – fashion

Type of financing	Application in fashion sub-sector
1. Project financing	• Whilst project financing in the fashion sub-sector is possible, its availability would depend on the certainty level associated with the final demand
2. Gap financing	• Applicability depends on the type of production and types of final outputs – whether we are just looking at production or vertically integrated production with the retail part • Certain types of companies operating in the fashion industry would obtain a contract obliging the customer to a purchase before the items are produced • These usually relate to tailor made solutions both for retail clients (e.g. bridal dresses) as well as B2B either directly with a final purchaser (e.g. costume design for a play, some work uniforms) or a wholesaler • Effectively in most cases, this works as receivable factoring • Source of production needs to be assessed to verify whether the production is feasible in the timeframe
3. Slate financing	• Slate financing is less applicable due to the emergence of fast fashion, however the lenders should reflect the value of the brand in their assessment
4. Asset-backed financing	• Usually not applicable to SMEs in the fashion sub-sector, it is more relevant to fashion manufacturing companies

2. UNDERWRITING PHASE

2.1 Loan products and structuring – film

Type of financing	Application in film sub-sector
1. Project financing	• Gap financing is the financing of the missing budget at the end of the production phase before the revenue from the distribution phase is received • Usually this amount is about 10-15% of the total production budget • Bank will ask for numerous guarantees, e.g. completion bond, production insurances, liability indemnities
2. Gap financing	• Most common type of commercial loans to film production companies • Also called provisional financing, or contract discounting, this is a loan bridging a funding gap resulting from the timing of cash inflows • It is available once financial agreements (such as distribution contracts, pre-sale agreements, subsidy funding contracts, etc.) with other partners are signed • Repayment of the bank loan will occur upon the cash payment stipulated in these contracts • Tax rebates are also common in the film industry and, as they are provided by the government, they offer a high-quality collateral due to limited counter-party risk
3. Slate financing	• Given that generally most of the revenues are concentrated shortly after the release of the film, slate financing is not as common as some of the other approaches • However certain VoD (video on demand) arrangements can provide ongoing revenues from existing titles held by the production company
4. Asset-backed financing	• Often the production companies do not own the studios hence tangible asset availability may be somewhat limited

2. UNDERWRITING PHASE

2.1 Loan products and structuring – live music / performance

Type of financing	Application in live music / performance sub-sector
1. Project financing	• Project funding is intended to finance the costs of planning and organising an event in the phase of development. This includes the creation of the company, initial marketing efforts etc. • Business plans are often constructed using historical data and/or comparable events, however uncertainty about the success of the event remains • In addition, given the trend for festivals to start selling tickets up to a year before the event, presales can help obtain initial feedback on the event and reduce the risks associated with the initial revenue inflow estimation exercise • Statistics should be analysed in the geographical context, genre and format of the event and/or festival
2. Gap financing	• The loan is used to finance down payments and expenses, before the expected cash receipts from the various revenue streams • Main sources of liquidity gaps stem from sponsorships, public grants and tax credits, depending on the jurisdiction
3. Slate financing	• Not applicable
4. Asset-backed financing	• Rarely used as most even organisers are asset light

2. UNDERWRITING PHASE

2.1 Loan products and structuring – museums

Type of financing	Application in museum sub-sector
1. Project financing	• While usually museums primarily rely on public funding for their usual operations, they may require additional financing for the purposes of organising temporary exhibitions, adding a new offering to the visitors (e.g. audio guide, private tours) • Revenue estimates would be based on other past exhibitions at the same entity as well as other venues in case of international exhibition tours
2. Gap financing	• Not applicable
3. Slate financing	• Not applicable
4. Asset-backed financing	• While many entities operating in this sub-sector may seem asset heavy, there may be restrictions on pledging some of the assets which are publicly owned or on private loan

2. UNDERWRITING PHASE

2.1 Loan products and structuring – recorded music

Type of financing	Application in recorded music sub-sector
1. Project financing	• It is rare to obtain financing purely on the basis of one production contract, i.e. pure project financing, proceeds from slate financing can be used for this purpose (see point 3)
2. Gap financing	• Whilst may be applicable based on local public support schemes, similarly to other CCS sub-sectors, it is not the prevalent financing method in the recorded music industry
3. Slate financing	• Most common type of loan financing in the recorded music sub-sector • Thanks to the digitalisation (e.g. Spotify) the existing music catalogue generates recurring and highly predictable revenues thus significantly reducing the risk for the lender • Data for the due diligence purpose is easily obtainable • Clear copyright management with notifications at music societies • Revenues calculated as Net Publisher Share (share of royalties allocated to the publisher after paying writer, performer, etc. royalties) • Funding is often needed to expand the catalogue by acquisition or production
4. Asset-backed financing	• In most cases relatively asset light balance sheet as the cost of the technical equipment has been decreasing over time

2. UNDERWRITING PHASE

2.1 Loan products and structuring – video games

Type of financing	Application in video games sub-sector
1. Project financing	• Assessment of a standalone new game • Risk depends on the stage of development • Favourable statistics from soft launches indicate good revenue potential and serve as indicator to the bank and provide initial revenues • Budget scalable depending on the game expansion
2. Gap financing	• Also called provisional financing, or contract discounting, this is a loan bridging a funding gap resulting from the timing of cash inflows • It is available once financial agreements (such as publishing contracts, product placement agreements, subsidy funding contracts, etc.) with other partners are signed • Repayment of the bank loan will occur upon the cash payment stipulated in these contracts
3. Slate financing	• Some VC-investors are active in the space • If reputable party with industry knowledge is buying an equity stake in the developer, this provides a company valuation • Debt amount would be calculated as a percentage of the purchase price, leaving an equity buffer • If no M&A, it can be done as slate financing i.e. debt capacity is estimated based on the ongoing revenue from some completed titles which provide a portfolio effect
4. Asset-backed financing	• In most cases relatively asset light balance sheet as the cost of the technical equipment has been decreasing over time

2. UNDERWRITING PHASE

2.2 Understanding of cash flows and funding requirements

Section overview

Key takeaway

- Identify the main types of funding sources for CCS and understand their cash flow implications
- Appreciate the types of public support schemes
- Develop a general understanding of the types of intangible assets

Potential challenges for financial institutions

- Legal questions around taking security or quasi-security over certain types of receivable funding and intangibles
- Lack of knowledge of eligible public funding programs, guarantees, support schemes, tax incentives, etc.
- Difficulty with identifying value of the intellectual property

2. UNDERWRITING PHASE

2.2 Understanding of cash flows and funding requirements – book publishing

Type of financing	Description
"Book deal"	A book deal is a contract between the writer and the publishing house in which the publisher agrees to publish a book and in return of royalties and/or an advance. In practice only applicable to the best-selling authors
Commissioned work	Relevant primarily for academic textbook orders by the government or educational institutions in certain jurisdictions
Regional and national grants	"Soft money" obtained from a regional or national government or another institution which does not require repayment
Crowdfunding	Donations collected from the public, mainly for smaller/independent brands
VC providers	Minority investment in the promoter company (applicable to publishing companies)

2. UNDERWRITING PHASE

2.2 Understanding of cash flows and funding requirements – book publishing

Type of financing	Description
Pre-selling	Pre-selling is the commercial practice of asking customers to pay for goods upfront, before a large batch of inventory has been made, thus providing a cash inflow early on. Applicable primarily in case of certain government-ordered academic books and selected bestsellers
Regional and national grants	“Soft money” obtained from a regional or national government or another institution which does not require repayment
Regional and national loan scheme	“Soft money” obtained from a regional or national government or another institution which requires repayment
Crowdfunding	Donations collected from the public, mainly for smaller/independent brands
VC providers	Minority investment in the promoter company

2. UNDERWRITING PHASE

2.2 Understanding of cash flows and funding requirements – film

Type of financing	Description
Pre-sales / minimum guarantee	Agreement with a distributor in relation to the sale of distribution rights in certain regions. About 20% of the price is paid upfront (exact arrangement vary), rest is obtained upon completion of the film
Negative pick-up (commissioned work)	Sale of the film and all attached Intellectual Property (IP) rights to a third party for a pre-agreed fee upon completion. Upside potential is no longer with the producer
Tax and cash rebates	Cash inflow later on in the production process which reimburses part of eligible expenses. In case of production in multiple jurisdictions, multiple incentives may be available
Regional and national grants	"Soft money" obtained from a regional or national government or another institution which does not require repayment
Regional and national loan scheme	"Soft money" obtained from a regional or national government or another institution which requires repayment. However, it is often very flexible and interest free or with a reduced interest rate
Product placement	Producer is rewarded for displaying a particular product in the film. It may be received as a cash payment or specific equipment obtained for free / at a discount. The first option is eligible as security
Co-production	Additional equity contribution (monetary or not) at the cost of waiving the right to a percentage of revenues. May come in later in the process
Crowdfunding	Donations raised from the public, primarily for independent films. Relatively new funding method
Profit participation for key crew members	Rather than being paid a fixed amount, their salary partly depends on the commercial success of the film. May be difficult to convince staff to take on this risk
Payment deferment	Payment deferment to part of the crew and other contributors as means of working capital management

2. UNDERWRITING PHASE

2.2 Understanding of cash flows and funding requirements – live music / performance

Type of financing	Description
Sponsorships	Agreement between the sponsor and the beneficiary for the exchange of funding support (or other forms of support) in exchange of rights and/or benefits
Regional and national grants	“Soft money” obtained from a regional or national government or another institution which does not require repayment
Regional and national loan scheme	“Soft money” obtained from a regional or national government or another institution which requires repayment
Tax credit	Cash inflow later on in the process which reimburses part of eligible expenses
Crowdfunding	Donations collected from the public, mainly for independent festivals
VC providers	Minority investment in the promoter company

2. UNDERWRITING PHASE

2.2 Understanding of cash flows and funding requirements – museums

Type of financing	Description
Public funding	Subsidies obtained from a regional or national government or another institution which does not require repayment
Crowdfunding / membership fees	Donations collected from the public
Sponsorships	Agreement between the sponsor and the beneficiary for the exchange of funding support (or other forms of support) in exchange of rights and/or benefits
Endowments	Endowments are defined as funds used to accumulate those assets that have been given to the museum on the condition that the principal of the gift is to be kept intact and that only the investment income it produces can be used to meet the museum's needs. For art museums, these are largely committed to acquiring new works for the collection

2. UNDERWRITING PHASE

2.2 Understanding of cash flows and funding requirements – recorded music

Type of financing	Description
Royalty factoring	Royalty factoring allows musicians and other artists to get immediate cash in exchange for earned royalties
Sponsorships	Agreement between the sponsor and the beneficiary (generally the artist) to receive funding support (or other forms of support) in exchange of rights and/or benefits such use of their image
Regional and national grants	“Soft money” obtained from a regional or national government or another institution which does not require repayment
Regional and national loan scheme	“Soft money” obtained from a regional or national government or another institution which requires repayment
Tax credit	Cash inflow later on in the production process which reimburses part of eligible expenses. In case of production in multiple jurisdictions, multiple incentives may be available
Crowdfunding	Donations collected from the public, mainly for smaller/independent artists
VC providers	Minority investment in the producer company / label

2. UNDERWRITING PHASE

2.2 Understanding of cash flows and funding requirements – video games

Type of financing	Description
Publishing contract	Sale of the video game and all or part of the attached IP rights to a third party
Tax and cash rebates	Cash inflow later on in the production process which reimburses part of eligible expenses. In case of production in multiple jurisdictions, multiple incentives may be available
National and international grants	"Soft money" obtained from a government or another institution which does not require repayment
Product placement contract	Producer is rewarded for displaying a particular product in the game. It may be received as a cash payment or specific equipment obtained for free / at a discount. The first option is eligible as security
Crowdfunding	Donations raised from the public, primarily for independent games
VC providers	Minority investment into the video game development company
Soft launch	Game launch during the development phase in order to obtain funding for further development

2. UNDERWRITING PHASE

2.2 Understanding of cash flows and funding requirements

- In most countries a series of public funding programmes and tax incentives exist to foster the development of specific CCS sub-sectors and to mitigate sector-specific risks. Access to support schemes, where applicable, may be an indicator of the viability of a CCS SME's business model
- Public grants are traditionally a very important source of finance for cultural and arts projects, training activities or support for the mobility of cultural stakeholders. Their aim is to increase the competitiveness of certain sectors and companies*
- Tax incentives are used to encourage CCS to pursue business opportunities but also to stimulate external private investment in CCS SMEs

Type of aid	Description
Loan	Financial support from government or other institutions in the form of a repayable loan with no or limited interest. Depending on the jurisdiction, they usually have a longer maturity and additional bank loan would be repaid first in the ordinary course of business
Cash rebates	The government can also put in place a cash return of all expenses fitting a certain criteria to boost the production of local movies. After an expense is incurred, the producer can ask for a certain percent back in cash
Tax credit	The tax advantage gives the possibility to receive a cash payment on any tax loss up to a certain percentage on the qualifying costs. The qualifying criteria can also depend on the production stage the current project is engaged in
Tax shelter	The investors and the production company benefit from tax exemptions. It gives an incentive for the investor to co-finance the movie project of the producer. However, there are some limitations on the spending budget, the target group, the genre of the movie, etc.
Subsidies (selective schemes)	Type of public funding where a project plan is submitted with an estimate of the costs, from this plan they support the producers financially without the need to repay. The available funds are limited and the movie needs to meet some conditions

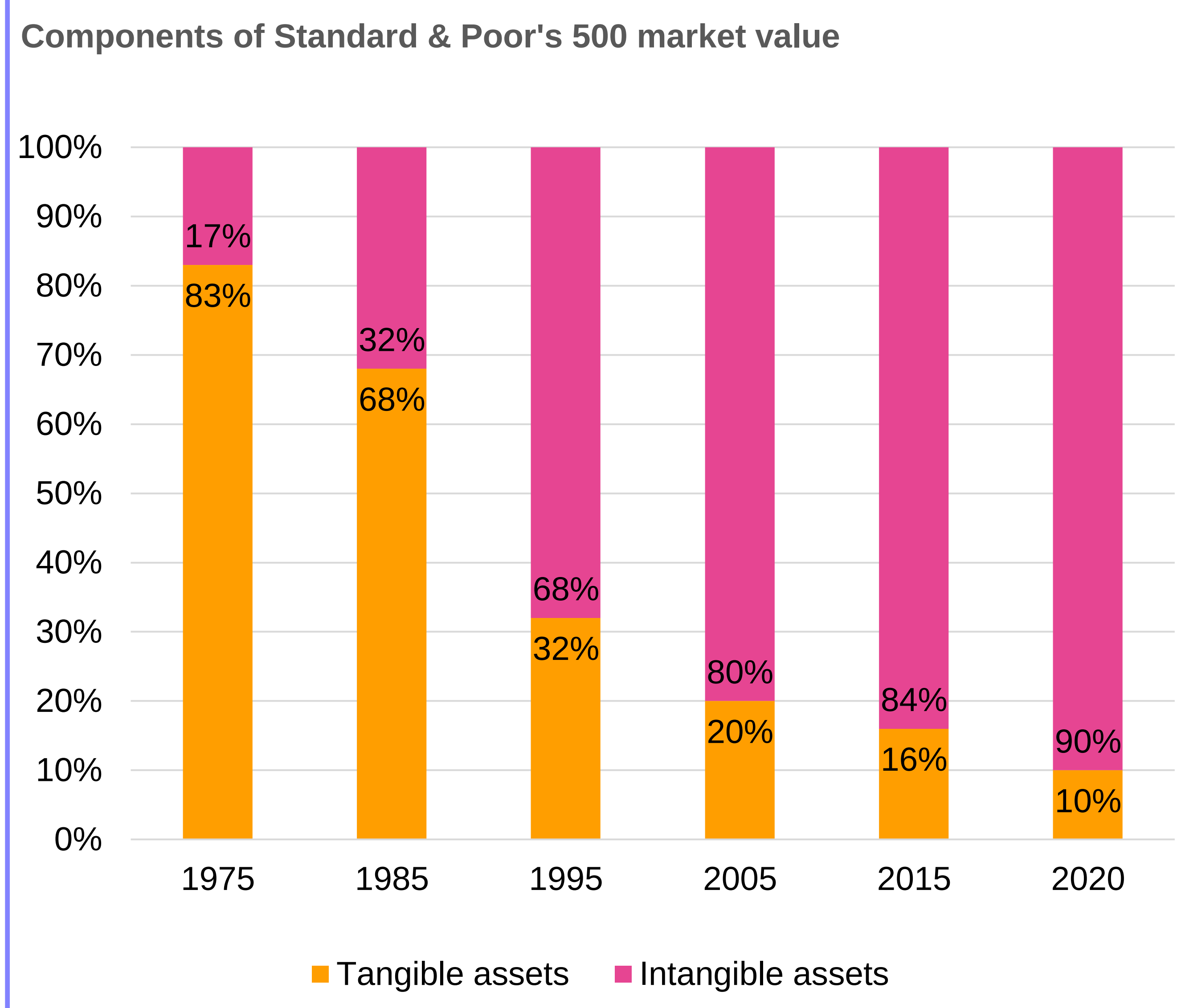
* Source: Towards more efficient financial ecosystems: innovative instruments to facilitate access to finance for the cultural and creative sectors (CCS), Working Group of EU Member State experts (November 2015)

2. UNDERWRITING PHASE

2.2 Understanding of cash flows and funding requirements

Value of intangible assets

- As illustrated by the graph on the right showing the components of Standard & Poor's 500 market value, intangible assets are increasingly important to companies' total value across the spectrum, therefore it is in the lenders' interest to understand it better and include it in their credit analysis
- Nevertheless there are still some obstacles associated with their valuation and the legal treatment of intangibles as loan security in certain jurisdictions
- Unless an intangible asset has been acquired from a 3rd party, most intangible assets are not recognised in the balance sheet under the International Financial Reporting Standard (IFRS)
- As such they need to be identified and valued separately. The key intangible asset for the CCS is intellectual property and more specifically copyright. The main types of intellectual property are listed on the next slide
- There are 3 different methods of valuing intellectual property:
    - Income / economic benefit method;
    - Market value method; and
    - Cost method
- Whilst each of them has their pros and cons, the Income method would be the most relevant to the lender for the purpose of credit analysis
- Further details about the valuation approaches and their implementation can be found in the IP Finance Toolkit issued by the Intellectual Property Office



Source: Towards more efficient financial ecosystems: innovative instruments to facilitate access to finance for the cultural and creative sectors (CCS), Working Group of EU Member State experts Ocean Tomo LLC

2. UNDERWRITING PHASE

2.2 Understanding of cash flows and funding requirements

Right Type	Copyright	Trade marks	Patents	Designs
Usage	Relate to artistic creations, such as books, music, paintings, sculptures, video games and films	Used in trade to identify products	Protect technical inventions in all fields of technology	Specify how products look
Registration	Unregistered	Registered, national, regional or EU level	Registered, national, regional or EU level	May be unregistered or registered, national, regional or EU level
How to check whether protected	No official list available. For music, using YouTube music, for written content, online plagiarism checks	EU registration: eSearch plus / TMview database National databases	EU registration: Espacenet National databases	EU registration: eSearch plus / Designview (registered designs only) National databases
Duration at EU level	Author's life + 70 years after death	10 years but can be renewed indefinitely	20 years	Max 25 years (registered) 3 years (unregistered)
Valuation considerations	• Complexity of the output limits independent creation risk • Existence and terms of licences may impact the value	• Value may change over time depending on underlying brand	• Patents lose value closer to expiry • Other, related patents further down the value chain may limit its value	• Registered designs offer greater protection in case of infringement • Limited protection in case of component parts of complex products

Source: Boosting the competitiveness of cultural and creative industries for growth and jobs (2016)

2. UNDERWRITING PHASE

2.3 Risk mitigation

Section overview

Key takeaway

- Appreciate varying risk levels for different categories of projects even within the same sub-sector
- Focus the analysis on cash flow modelling throughout the project life to assess any liquidity gaps
- Understand some of the common contract types in CCS to help you correctly assess the risk level
- Appreciate the key due diligence focus

Potential challenges for financial institutions

- Align the risk appetite and the understanding of CCS risks across your organisation
- Certain projects, despite a diligent assessment of key success factors may not generate the expected returns

2. UNDERWRITING PHASE

2.3 Risk mitigation

CCS-specific risk factors

Intrinsic characteristics

- Value chains dominated by B2B relationships and contract driven cash flows creating liquidity gaps
- Dependence on intangible assets often providing limited capital release as collateral for credit risk
- Long term projects and generation of value over a long period of time
- High uncertainty of market success ("hit-based" business) and project pipeline volatility

Market level risks

- Highly fragmented market (culturally, linguistically)
- Lack of good market intelligence about the sector (i.e. uniform sector definitions and harmonised data)
- Digitalisation and other technology trends disrupting traditional value chains
- Shifts in consumer behavior
- Working capital needs are relatively important and there are typically treasury constraints

Company level risks

- Some SMEs may lack management skills, financial and business planning (especially over a 2 year horizon)
- Potential conflict between the commercial objectives and the artistic focus required in order to obtain public financing
- For some SMEs, insufficient operating track records and cash flow volatility depending on project success
- Business model driven by creative process
- Strong reliance on key people skills and company reputation

Financing CCS requires a specific approach to risk assessment and tailored financing products

2. UNDERWRITING PHASE

2.3 Risk mitigation

It is crucial to understand some of the key terms in the commonly used B2B contracts in the CCS as they impact the certainty level of different income streams. Below are some of the examples of such agreements

Types of contractual arrangements	Description
Conditional on milestones	• Access to additional capital depends on meeting certain development milestones • Common in video game production
Essential element clause	• Contract clause requiring certain artistic outcome as a prerequisite to a payment
Requiring pre-certification	• Primarily relevant for certain tax/cash rebates which require an audit of relevant expenses • Applicable across multiple sub-sectors and depends on the local tax incentives for the CCS
Sales contract with recourse	• Sale of products to a wholesaler or a distributor whereby products not sold by them are returned • Applicable among others to the book publishing
Completion bond	• Specialised film insurance product for the benefit of financing parties • Contract issued by a 3rd party, guaranteeing that a film will be completed
Copyright licence	• Time-specific contract between an owner of copyright and a party who wants to use the IP in exchange for payment • Licence fees are usually fixed amounts while royalties are usage-based

2. UNDERWRITING PHASE

2.3 Risk mitigation

Evaluate the key success factors

- There may be high uncertainty of market success ("hit-based" business) and project pipelines may be volatile in case of a single project
- Identify size of client base and potential demand for the product (e.g. is the product restricted to only one market due to a language barrier or will it be relevant for international markets
- Identify the key criteria (success factors) that need to be met for the venture/project to be a commercial success e.g.: content needs to resonate with customers, marketing needs to ensure that the content will be recognised by potential customers, etc.
  - Usually evaluated with reference to similar past projects or credentials of the key team members
  - Collect historical information regarding the management team (quantity and quality of previous content creation, quantity of production/publications, frequency of content creation, revenue generated from past projects, historical time-to-market, etc.)
  - Verify whether the project/venture owner has a particularly positive (e.g. reception of recognised prizes, awards, public grants) or negative (e.g. negative press) track record of working in the CCS market
  - Does the owner have access to a local or international network to promote the content produced?

Perform financial analysis

- Check that the financial analysis is performed on the right entity (i.e. SMEs may create dedicated SPVs for projects which result in non-existing track records and perceived low financial performance)
- Collect information about projected financial performance from the proposed venture/project e.g.: revenue, profitability, leverage, cash flow, liquidity, financial discipline and asset base. Assess projections. Are they realistic? Do they meet eligibility criteria to receive financing support from your organisation?
- Funding from other investors (e.g. co-financing, grants, equity) can be considered as an indicator of quality
- CCS SMEs which are mainly project driven, may experience cash flow volatility. This is a common feature and should not as such lead to the rejection of a loan but to a further cash flow analysis
- Identify all related partners, clients, investors, subcontractors, counterparties, etc. that are related to the venture/project, especially if they relate to future cash inflows, and perform background checks on them
- Assess whether there are any risks/weaknesses that may lead to failure of the venture, e.g. content creator does not deliver, production company backs out, distribution/retail phase is not clearly planned, contracts have any risky clauses
- Discuss the business model with the person drafting the loan application to fully understand the vision, objectives and strategy of the project

2. UNDERWRITING PHASE

2.3 Risk mitigation

The two case studies below show some of the due diligence analysis for different sub-sectors and funding structures. The first one focuses on bridge financing and looks at the risk-adjusted value of each contract acting as a source of repayment for the bank loan. The second case study looks at ways to help with the assessment of the commercial success of the project based on the example of mobile video games

FILM – Bridge financing

Debt capacity is estimated using contract discounting, which is a similar approach to receivables financing. The exact haircut should be based on due diligence performed on each party. The illustrative advance rates for different contract types are provided in brackets below:

- Distribution contract (100%)
- Minimum sales guarantee (50%)
- Equity investor agreement (100%)
- Subsidy funding contract (100%)
- Facilities deal (50%)

- Tax rebates are also used for this purpose, but it should be noted that their amount is not fixed but rather is calculated as a percentage of the project spending. Depending on the project advancement, there may be different levels of certainty around the quantum of the rebate which may impact the advance rate. Expenses need to be audited and some of them may be rejected, thus decreasing the value of the rebate available

Source: Study on the Role of Banks in the European Film Industry, peacefulfish, European Commission, May 2009

MOBILE VIDEO GAMES – Project financing

Often modelled using historical data and comparable titles however significant uncertainty around the success of the game remains

- Some of the key statistics include:
  - number of downloads,
  - number of active users,
  - ARPPU (average revenue per playing user),
  - ARPDAU (average revenue per daily active user),
  - DAU-MAU ratio (how many monthly users play each day),
  - conversion rate (percentage of users who made a purchase that day),
  - eCPM (amount an advertiser pays another game per 1,000 visitors who see their advert),
  - CPI (cost per install), etc.
- The statistics should be analysed in the context of a distribution platform, genre and revenue model for the game
- A 'soft launch' may help obtain an initial feedback about the game as well as reduce the risk due to observable statistics and initial revenue inflows
- In case of self-publishing, proceeds from the sale via a distribution platform are obtained c. 1 month after the purchase by the customers

Source: Game Analytics: Mobile Gaming Benchmarks

3. CLOSING AND MONITORING PHASE

Phase	1. Origination	2. Underwriting	3. Closing and monitoring
	1.1 CC sector awareness development	2.1 Loan products and structuring	*Signing & Closing**
	1.2 Understanding CC sub-sector value chains	2.2 Understanding of cash flows and funding requirements	3.1 Monitoring
	1.3 CCS strategy & prospecting	2.3 Risk mitigation	3.2 Distressed situations management

(*) We have included this step in this overview as they are part of a typical lending/risk assessment process. However, there is no specific guidance provided in this document as they do not depend on CCS specifics

3. CLOSING AND MONITORING PHASE

3.1 Monitoring

Section overview

Key takeaway

- The monitoring process for CCS loans requires the adaptation of traditional monitoring processes as less quantitative data is available
- A dashboard containing KRIs collected at macro as well as at microeconomic/company level should be established to monitor industry/market trends as well as company related developments
- The dashboard should be regularly updated and used by the relevant departments to ensure the monitoring of CCS loans (e.g. IFRS reporting obligation at the level of the financial intermediary)
- This should have the objective of reducing (or removing) the potential technical and operational hindrance that may arise at the level of the financial intermediary due to specificities of CCS counterparties and projects

Potential challenges for financial institutions

- Most CCS SMEs are not evaluated by analysts and do not have "ratings" to support the monitoring of project risk, requiring more internal attention and modelling
- CCS SMEs' balance sheets are often not structured as those of other corporates in different sectors

3. CLOSING AND MONITORING PHASE

3.1 Monitoring

Monitoring of CCS loans requires a dashboard that allows the collection of KRIs as mentioned below. This dashboard will be used by the relevant departments to monitor the risk associated with CCS loans and prepare required reporting

Credit risk department

- The credit risk department is typically in charge of the preparation of loan dossiers at inception and is involved in the decision-making process. During this phase the CCS company and the overall market environment are evaluated (see previous phases) and KRIs are set up. The challenge is to ensure that risk teams have an unbiased view on credit worthiness of CCS companies and projects
- Specific KRIs relating to project performance can be set up in relation to some sub-sectors with additional data availability, such as film production, video games and music streaming (see some examples on p.52)
- During the life of the loan, the credit risk department needs to monitor the evolution of these KRIs and update them on a regular basis for COREP* purposes and to ensure that any changes in the situation of the SME are detected and if required included in the “watchlist” or set to “default” in case the SME’s performance deteriorates

  Examples of KRIs:
  - Change/deterioration of external ratings (if available)
  - Delays in payments (>30 days, >90 days)

Operations (Back- and Middle-office)

- Ensure the follow-up of covenants related to the loan contracts established with a CCS SME (and potentially the related contractual terms of the EIF CCS financial guarantee)
- Examples of indicators:
  - Maintenance of a certain percentage of revenues in a given CCS sub-sector
  - Maintenance of a dividend payouts ratio below a certain level
  - Maintain a debt-to-equity ratio below a certain percentage
- In case a loan is structured with milestone payments e.g. in video game sub-sector, monitor the performance of the project against the pre-agreed steps to unlock further debt tranches

*COREP: Common solvency ratio reporting

3. CLOSING AND MONITORING PHASE

3.1 Monitoring

Monitoring of CCS loans requires a dashboard that allows the collection of KRIs as mentioned below. This dashboard will be used by the relevant departments to monitor the risk associated with CCS loans and prepare required reporting

Finance department

- The finance department needs to evaluate at least on a quarterly basis the Expected Credit Losses (ECL) as part of its financial reporting (FINREP) obligations. The challenge is to ensure that teams have no specific concern about the specificities of CCS companies and that there are few (or no) obstacles for implementing ECL models. Under IFRS 9 this will require:
  - Forward-looking reporting based on parameters calculated/estimated for a given time horizon (e.g. 12 months or until maturity of the loan)
  - Reporting based on macro-economic indicators allowing to evaluate the potential default probability of CCS SMEs (e.g. indicators for specific sub-sectors such as evolution of: sales of music (CDs and streaming), sales of cinema tickets, revenues stemming from sales of videogames, etc.)
  - Reporting based on the most probable scenarios (i.e. with neither positive nor negative bias)
  - The collection of “Back-stop” indicators as defined in the bank’s “Staging Policy” (e.g. delay in payments, changes in ratings, etc.)
  - The collection of parameters allowing an evaluation of potential collateral (e.g. patents, IP, assets held by the CCS SME, which most of the time are intangible)

3. CLOSING AND MONITORING PHASE

3.2 Distressed situations management

Section overview

Key takeaways

- The InvestEU Cultural and Creative Sectors Portfolio Guarantee Product is enhancing access to finance for SMEs and Small Public Enterprises operating in CCS through
    - portfolio credit risk transfer via (counter-) guarantees to financial intermediaries and
    - provision of Capacity Building e.g. technical assistance, knowledge transfer and networking measures in the CCS field to financial intermediaries
- The InvestEU Cultural and Creative Sectors Portfolio Guarantee Product provides capped and uncapped portfolio (counter-) guarantees for partial credit risk coverage of expected losses of loan portfolios of financial intermediaries with low guarantee fees
- Financial intermediaries could increase their lending volumes to CCS SMEs*, Small Mid-Caps and Small Public Enterprises**

*As per the EU definition
**Entities that do not fall under the scope of SME definition exclusively due to detention of shares of the SME by public bodies

CLOSING AND MONITORING PHASE

InvestEU Cultural and Creative Sectors Portfolio Guarantee Product – What it is and what it covers

- Dedicated action managed by the EIF on behalf of the European Commission as part of the InvestEU Programme
- In the form of financial instrument enhancing access to finance for SMEs, Small Mid-Caps and Small Public Enterprises in CCS through:
  - **Capped Portfolio Guarantee** (up to 25%). The cap amount is the maximum amount that can be covered by the portfolio guarantee
  - **Uncapped Portfolio Guarantee**
- The portfolio guarantee provided is meant to be a "final loss" guarantee i.e. on each covered loan**, EIF will cover 70%-80% of outstanding final loss** after recovery procedures are terminated
- The Guarantee Product is implemented through financial intermediaries like guarantee institutions and banks

Thanks to the InvestEU Cultural and Creative Sectors Portfolio Guarantee Product, financial intermediaries would increase their lending volumes to CCS SMEs*, Small Mid-Caps and Small Public Enterprises active in:**

Heritage, Archives and Libraries

Books & Press

Visual arts

Performing arts

Audio-Visual & Multimedia

Architecture

Education & Memberships

Other cultural and creative sectors activities

* As per the EU definition
** Entities that do not fall under the scope of SME definition exclusively due to detention of shares of the SME by public bodies

CLOSING AND MONITORING PHASE

InvestEU Cultural and Creative Sectors Portfolio Guarantee Product – Key features

Capped Guarantee

Risk retained by the Financial Intermediary at least **20%** of the original portfolio

Guarantee Rate on a loan-by-loan basis: **up to 70%** and up to 80% for just transition or Cohesion regions

(Counter-) Guarantee Cap Rate up to: **25%** based on EIF's professional judgement

- **Structured in the form of guarantees or counter-guarantees**
- Guarantee fees of **0.2%** per annum
- (Counter-) Guarantee rate typically set at **max. 70%** and up to 80% for just transition of Cohesion Regions
- (Counter-) Guarantee cap rate up to **25%**
- Minimum maturity level of the Final Recipient Transactions shall be 12 months, no maximum scheduled maturity of the Final Recipient Transaction is required**

Uncapped Guarantee

Risk retained by the Financial Intermediary at least **20%** of the original portfolio

Guarantee Rate on a loan-by-loan basis: **up to 70%** and up to 80% for just transition or Cohesion regions

- **Structured in the form of guarantees or counter-guarantees**
- Guarantee fees between **0.75%** and **1.2%** per annum*
- (Counter-) Guarantee rate typically set at **max. 70%** and up to 80% for just transition of Cohesion Regions
- Minimum maturity level of the Final Recipient Transactions shall be 12 months, no maximum scheduled maturity of the Final Recipient Transaction is required**

* The fee of 1.2% per annum refers to sub debt transactions
** The EIF may set a maximum scheduled maturity for the Final Recipient Transactions in the relevant Individual (Counter-) Guarantee Agreement

CLOSING AND MONITORING PHASE

InvestEU Cultural and Creative Sectors Portfolio Guarantee Product – Eligible entities and Debt Financing

SMEs*, Small Mid-Caps and Small Public Enterprises** that:

- **Have a CCS NACE code*;** or
- Intend to develop a **CCS project** with the debt financing; or
- In the **last 36 months** before the transaction approval:
  - Have been **operating in the field of CCS**; or
  - **Have received debt financing for a CCS project** by European or national CCS institution/association; or
  - Have been awarded a **CCS prize**; or
  - Have filed **copyrights, trademarks, distribution rights, etc. in the CCS field**; or
  - Have benefitted **from tax credit/exemption related to** development of intellectual property rights or **CCS activities**

Debt Financing where:

- **Max loan amount**
  - EUR 7.5m (EUR 2m where financial (sub-) intermediary is NPBI)
- **Min Maturity**
  - 12 months
- **Purpose**
  - Investment
  - Business Transfer
  - Working Capital
- **Max Collateral Requirements**
  - Assets used for the business activity
  - Personal guarantee from the owner(s)

* For the NACE codes please refer to the Appendix

CONCLUSION

CONCLUSION

The CCS market offers investment opportunities across the EU

The CCS represent an **attractive market** in Europe that accounts for a significant amount of job and wealth creation

While the CCS offer growth potential, business models, value chains and risk assumptions are very different from other sectors and require **specific expertise** from financial intermediaries

This document is meant as a **guide to help** financial intermediaries build the required expertise to **assess loan applications received from CCS SMEs**

The risk stemming from low levels of standard collateral and lack of tangible assets needs to be mitigated by **a thorough risk analysis of CCS SMEs, their business plans and track record** of staff and management team in the sub-sector

InvestEU Cultural and Creative Sectors Portfolio Guarantee Product helps financial intermediaries to **share the risk** stemming from these elements turning CCS ventures into bankable projects

APPENDIX

APPENDIX – GLOSSARY OF ABBREVIATIONS

AV producer • Audio-visual producer
B2B • Business to business
CCS • Cultural and Creative Sectors
CoRep • Common solvency ratio reporting
ECL • Expected Credit Loss
GAFA • Google, Amazon, Facebook, Apple
IP • Intellectual Property
IFPI • International Federation of the Phonographic Industry
KPI • Key Performance Indicator
KRI • Key Risk Indicator
PE • Private equity
SMEs • Small and medium-sized Enterprises
SPV • Special Purpose Vehicle
VC • Venture capital
VCH • Value Chain
(S) VOD • Subscription-based Video-on-Demand

APPENDIX – CCS NACE CODES

Cultural Domain of CCS GF	Nace Code (NACE Rev. 2)
Heritage, Archives and Libraries	R91.01 • Library and archives activities R91.02 • Museums activities R91.03 • Operation of historical sites and buildings and similar visitor attractions
Books & Press	C18.11 • Printing of newspapers C18.12 • Other printing C18.13 • Pre-press and pre-media services C18.14 • Binding and related services J58.11 • Book publishing J58.13 • Publishing of newspapers J58.14 • Publishing of journals and periodicals J63.91 • News agency activities G47.61 • Retail sale of books in specialised stores G47.62 • Retail sale of newspapers and stationery in specialised stores M74.30 • Translation and interpretation activities
Visual Arts	G47.78 • Other retail sale of new goods in specialised stores J58.19 • Other publishing activities M74.10 • Specialised design activities M74.20 • Photographic activities R90.03 • Artistic creation

APPENDIX – CCS NACE CODES

Cultural Domain of CCS GF	Nace Code (NACE Rev. 2)
Performing Arts	M74.90 • Other professional, scientific and technical activities n.e.c. N78.10 • Activities of employment placement agencies R90.01 • Performing arts R90.02 • Support activities to performing arts R90.04 • Operation of arts facilities
Audio-Visual & Multimedia	C18.20 • Reproduction of recorded media C32.20 • Manufacture of musical instruments C33.19 • Repair of other equipment G47.63 • Retail sale of music and video recordings in specialised stores J59.11 • Motion picture, video and television programme production activities J59.12 • Motion picture, video and television programme post-production activities J59.13 • Motion picture, video and television programme distribution activities J59.14 • Motion picture projection activities J58.21 • Publishing of computer games J59.20 • Sound recording and music publishing activities J60.10 • Radio broadcasting J60.20 • Television programming and broadcasting activities G47.41 • Retail sale of computers, peripheral units and software in specialised stores J62.01 • Computer programming activities J63.11 • Data processing, hosting and related activities

APPENDIX – CCS NACE CODES

Cultural Domain of CCS GF	Nace Code (NACE Rev. 2)
Architecture	M71.11 • Architectural activities
Education & Memberships	P85.42 • Tertiary education P85.52 • Cultural education S94.12 • Activities of professional membership organisations S94.99 • Activities of other membership organisations n.e.c.
Other cultural and creative sectors activities	G46.49 • Wholesale of other household goods G47.79 • Retail sale of second-hand goods in stores N77.29 • Renting and leasing of other personal and household goods S95.29 • Repair of other personal and household goods

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