



mind the

*Investment Funding between
start-up and high growth*

gap

Creative Industries

Venture Capital

The Creative Industries are the fastest growing part of the UK economy¹ and yet there is considerable concern from financiers that businesses in this sector are not commercially mature enough to take on investments, whilst creative entrepreneurs are of the opinion that there is insufficient finance to support the development of the sector. If the sector is currently growing this quickly, with such a mismatch between finance and business, how big can the sector become when these two aspects are aligned? This paper explores how it might be possible to diminish this gap through public sector intervention and the use of a Design and Creative Fund.

The last five years have seen a dramatic improvement in the support for Creative Industries start-ups. Furthermore, the breadth and depth of support structures has ensured that financial support has been backed up with entrepreneurship education in Further Education, Higher Education settings, continuing professional development for creative industries entrepreneurs, and financial support with related mentoring and coaching². In the North East alone, the work of organisations such as Codeworks, Digital City, Designed and Made, Northern Film and Media, Northumbria University, Durham University, Sunderland University and Creativitiworks, Teesside University has resulted in a significant growth in creative industries start-ups.

The creative sector in the North East currently stands at around 4,000 businesses and creative businesses employ around 30,000 across the region. This accounts for 2.3%³ of the region's total workforce, making the commercial creative sector the third largest of the nine regional economic priority sectors in terms of employment⁴.

The creative industries in the North East have a particularly youthful profile: 58% of UK SME's are more than 10 years old⁵, as compared with 35% of commercial creative enterprises in the region. In the past 12 months some 180 commercial creative businesses were established in the North East and overall 34% of commercial creative businesses are less than four years old compared with a UK average of 12%.

In parallel with this, the UK has seen a growing interest from the private sector in investing in Creative Industries firms through funds such as those operated by Ingenious Media and Pembridge Partners. The Regional Development Agencies have also established a series of investment funds backed by a combination of European and regional monies, and Scottish Enterprise has gone down the route of public/private partnerships in the Digital Production Fund and the Digital Investment Fund. In the main these funds are looking for investments of £500,000 or more requiring a company with a high degree of commercial acumen and the potential for scale, and yet on the whole these funds find themselves underinvested.

MIND THE GAP

¹ *Staying Ahead: The Economic Performance of the UK's Creative Industries*, Work Foundation, 2007

² *Creative Economy Programme – Access to Finance & Business Support Working Group Report*, DCMS, 2006

³ *Commercial Creative Sector Report (North East Region)*, NMP, 2007

⁴ *Multi Sector Qualitative Analysis Report*, Cardiff Business School, 2006

⁵ *Annual Survey of Small Businesses UK 2004/5*, Small Business Service, 2005

Creative Industries

Venture Capital

The Design & Creative Fund (DCF) has been launched by NStar Limited to support the development and growth of companies in the creative industries in the North East of England. With a maximum of 200,000 Euros to invest per company the fund aims to work with and compliment the approach of business angels who operate with established businesses in the growth sector just below the level where venture capital (VC) investments are viable.

This remit comes with very particular challenges. The NStar DCF aims to have:

- a high number of investments,
- a faster realisation of the investment,
- it cannot sidestep the risk of failure through grant funding or offsetting it against exponential expectations of success as seen in VC's
- a state aid investment limit of 200,000 Euros and there is no ability to follow on with further investments.

This will require the NStar DCF to be very focussed on enabling a process of minimising the cost of failure, through the development of rapid prototypes, early testing of ideas and ensuring that its funds are leveraged to enable the recipient to grow to a point where an early exit (including a commercial return

on the investment for the NStar DCF) can be achieved for NStar DCF without risking the future sustainability of the firm. This requires the fund to focus on sectors of the creative economy and business models that fit this requirement. The key deal structure elements that will support these two factors are elaborated upon in section 2 below.

It is critical to the success of the Creative Industries that investment sources exist which enable firms both to consolidate their growth to date and to prepare themselves for high growth. By working in this part of the investment market not only does the NStar DCF fulfil a crucial financing need, but also a critical management development role as it is at this stage of a company's development that business models are likely to change to enable growth and scalability^{6,7,8} and that scarce resources must be harnessed to maximize effectiveness and efficiency if the market opportunities are to be met swiftly and profitably.

⁶ *A note on managing the growing venture*, Hamnermesh, Heskett & Roberts, Harvard Business School, 2005

⁷ *Bootstrap Finance: the art of start-ups*, Blide, Harvard Business Review, 1992

⁸ *How Entrepreneurs Craft Strategies that Work*, Blide, Harvard Business Review 1994

NStar Design and Creative Fund (DCF)

Investment Goals

NStar sees its role not only as a financial backer, but also as an advisor and management development facilitator, and developer of the sector. This will ultimately provide a contributor to regional regeneration. This places the NStar DCF into a particular space in the continuum of finance between

start up funding up to £50,000 and seed funding of over £500,000. The implications of this are that we are trying to move unsophisticated businesses to become value creators and those existing value creators to value growers.

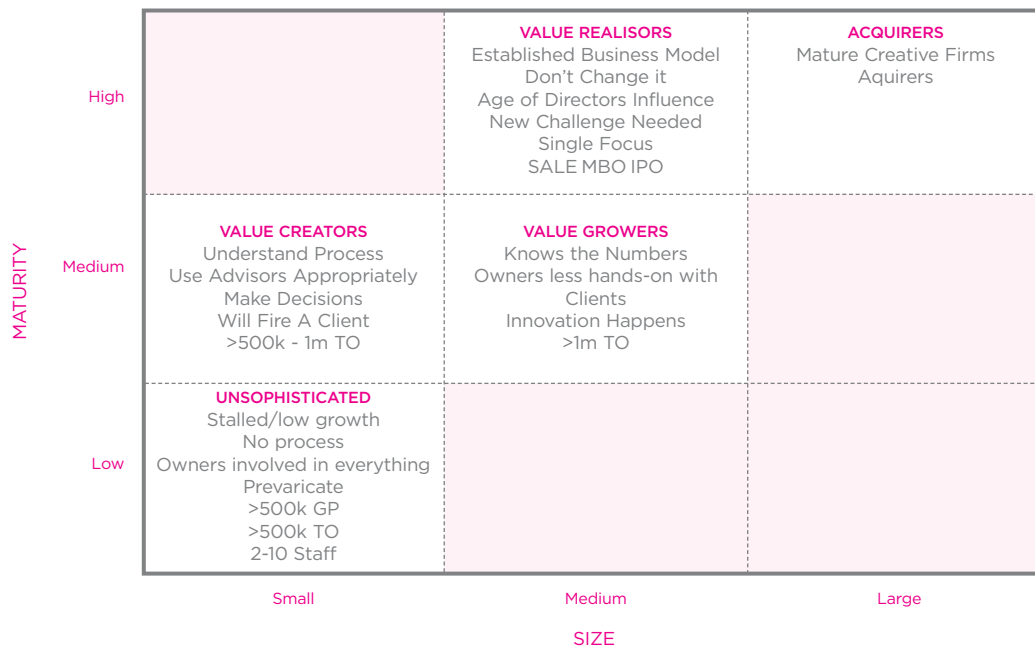


Figure 1 © Pembridge Partners

One North East (ONE) revised Regional Economic Strategy 2006 sets three very challenging targets:

- To increase GVA per capita in the North East to 90% of the national average, up from 80% currently;
- To create between 18,500 and 22,000 new businesses; and
- To provide employment for between 61,00 and 73,000 more people

The DCF is therefore aiming to be part of delivery of this structural change, alongside a requirement for a return on investment.

The overall philosophy for the fund is to:

- Increase deal pipeline activity by allowing companies to fail cheaply (thus allowing DCF to focus on the winners)
- Follow a simple application and funding process;
- Give access to creative and design to support, technical, market, business and investment expertise;
- Moving promising projects rapidly to further funding where appropriate;
- Looking at potential businesses that could contribute to sustainable regional development goals as well as make financial returns for the fund.

NStar Design and Creative Fund (DCF)

Investment Goals

The DCF investment finance faces a tension as it has to have a commercial face in order to satisfy EC state aid rules around unfairly subsidising particular industrial sectors and yet it cannot be a substitute for existing private finance provision. Nor should it be seen as a financier of last resort. It is part of the process of moving entrepreneurs towards a more commercial view of funding and finance sources for their growing enterprises. We believe that the fund has to stimulate the commercial and creative capability of the businesses, transferring them to a position of sustainability and growth which will open the choices for future financial development through revenue generation, debt or venture capital finance.

What is interesting is that there are four approaches to investment happening alongside the space in which NStar is operating:

- Traditional VC funding will not look at investment in businesses which do not have potential of £100 million market. This is truly about scalability and tends to favour technology, science, pharrma, etc
- Funding from individuals traditionally friends and family but also including the frustrated creative trapped in lucrative employment is more likely to favour a social return
- Angel syndicates are looking for a financial return
- Public sector finance is looking for sector development, and regional structural return.

As entrepreneurs gain in experience they learn to put together packages of finance from these different sources and to manage the expectations of these different types of investor⁹.

NStar's Exemplar mentor database, its investment readiness training and the corporate finance advice pilot scheme currently underway are all designed to help provide this specialist and expert support during such changes and growth periods. This is not just a supply of non-executives and mentoring for senior management but also about developing a real understanding of the difference between company management, financial management, and creative development.

NStar Eligibility Criteria

NStar's DCF is focussed upon investments in the Creative Industries and businesses which are utilising design or creative content in the development of new products or services within the North East Region. The fund has been financed by the Regional Development Agency and in practice this means that every investment must meet certain minimum criteria:

- A significant part of the business must be located in the North East
- State aid rules apply: the total invested by NStar and other State Aid compliant investors cannot not exceed 200,000 Euros

Investment Structures

deal makers and breakers

In bridging the gap between start up funding and investment for growth, NStar is focussed both on ensuring that its investments are leveraged to maximum effect, and structuring the deals so that the risks inherent in this stage of investment are mitigated effectively where possible. With this in mind there are six key factors which are deal makers and breakers across all sectors:

- NStar money must reach all the way to market, or be the final gap funding in the business
- Production value fit for market
- Appropriate mix of business function and creative expression
- Appropriate milestones
- Clear place for return
- Exit route within three to five years

Every potential investment will be evaluated on its merits, considered in terms of the sectoral context in which the company operates, and on the management and creative team capabilities. However these factors have particular investment implications which may be unfamiliar to creative industries firms who are in many cases seeking investment finance for the first time. This position paper seeks to clarify and explain these implications so as to increase the ease with which both investor and investee can create deal flow.

Money reaches to Market

Principle - Since NStar requires repayment, businesses must achieve a position that generates cash flow.

Reason - If NStar cannot see how its investment is connected to the payback of these monies, nor can it see how the level of risk is offset by the potential profit from the investment, then it is unlikely that NStar will invest as the risks will be too high and success very difficult to ensure.

What does this mean in reality?

Capability Development - it's not enough just to use NStar DCF money for prototyping, market research, market definition & development etc. There are seed funds and proof of concept funds that can be used to achieve these elements of development and preparation for market. NStar DCF money is more likely to be used for growing or expanding a sales capacity, developing the skills and expertise to understand how to recruit and to expand the quality and capacity of the functional and process side of the business.

Customer Development - in terms of sales, customers and markets, NStar DCF money is more likely to be used for establishing a market and expanding into new geographies or sectors with existing markets but not for identifying markets in the first place.

Investment Monies - if the NStar DCF money alone is not sufficient to take the company all the way to market then it is unlikely that any/all the NStar funds will be available for draw down until this security is achieved. NStar monies may be used as leverage to bring in other investment; they may also be the last chunk of money to be put in place. Under some circumstances some of the funds may be used to develop the company to increase its investability.

The development of content is a critical aim for the fund. However, the money reaching to the market principle is skewed towards making content which exclude the use of large scale investment prior to the market testing of an idea. Traditional film and games companies sit in the space where large scale finance is required prior to market testing. The fund will invest in these sectors when unusual business models or approaches to market can be demonstrated, enabling the DCF to satisfy the money reaching to market principle.

Production Value

fit for market

Principle - the ambition of the company to service a particular market must be reflected in the resources required to service the customers needs e.g. the expected production values inherent in a massively multiplayer online role playing game such as World of Warcraft are different from those for a casual game for a mobile phone. The ability to match production values to market values is a strong indicator of a management teams' depth of experience in their sector, the creative process and the production methods.

Reason - over or under-engineering a product or service is an inefficient use of scant resources and will not deliver appropriate levels of profitability. Furthermore, the stages of manufacturing expansion need to be married up to the company's resources and its ability to manage its production or delivery.

What does this mean in reality?

NStar will take a keen interest in the production or delivery decisions, their relationship to the target customer segments, and the profitability of the products and services. The cash flow implications will also be reviewed. The ability to demonstrate experience in fitting production values to market values is a key element considered in investment risk analysis. If a firm is inexperienced in making such decisions, the demonstration of relationships or partnerships with those more expert is a reasonable substitute e.g. production consultants, key manufacturing suppliers, due diligence in production research, or test runs.

Capabilities in this area can also be expected to include knowledge of the stages, scale and change of production methods as demand and orders grow. Examples of the need for careful management of demand and order fulfilment can be seen in the designer fashion sector where the temptation to accept larger orders, and with it substantial cash flow risk, can lead to the bankrupting of small firms if growth rates are not carefully managed.

Shooting the Rapids - the challenge in content businesses. For companies creating content the risk of demand failure is felt particularly keenly as there is little or no value in market testing an incomplete product, thus narrowing the range of tweaks possible in response to market feedback.

This means that any requirement for market testing will require substantial expenditure to take the product to a testable stage, and that certain decisions taken during the pre-testing development and expenditure are essentially irreversible. For many investors this particular risk profile is too high to contemplate, and the mitigation strategies are not straightforward.

Logically, a track record in 'shooting the rapids' is an advantage as it demonstrates the ability to accurately predict market demand and develop content accordingly. However previous track record is not a guarantee of future success in content development, as it is certainly not a given that enormous hits are followed by continuing success. There are many examples of second films flopping and the painful release of a weaker second album.

The irony in this situation is that there are times when a lack of track record is an advantage and that intuition, when effectively harnessed, is capable of positioning a product as effectively as years of experience. The spirit of the digital age is reflected in emerging applications coming from young people working outside traditional business or R+D. Napster, Google, facebook and Last FM were all products of prodigious talent in young people with no track record.

It is here that talent scouts, industry expertise, and a connection with emerging disciplines in a variety of sectors along with well structured developmental experience prior to investment favours the investors. For the investees, creative and novel approaches to market testing at an early stage are vital alongside a realistic view of how much money will be needed to produce the product.

Appropriate mix of Business Function and Creative Expression

Principle - In the development and growth stages of a company's maturation the focus and balance between Business Function and Creative Expression shifts. If a business is to be sustainable it needs to develop the functional operational side and understand how to communicate with the market, collect revenue, and measure returns.

Reason - Function is the monetisable output of Creative Expression. In order for a company to achieve financial sustainability and return on investment, Function must be the focus once the early creative Expression has been achieved (Hamermesh, Heskett, and Roberts).

What does this mean in reality?

Creative Expression is usually the driver for the establishment of SMEs in the Creative Industries. It is also a dominant element in the skillset of many creative entrepreneurs. The speed and ease with which such entrepreneurs achieve a balance of business function and creative expression skillsets in their business is a key element in the risk assessment for potential investors as it relates to areas such as customer focus, financial literacy, business development and risk management.

In our opinion a model of the balance between Function and Expression should follow the pattern below (Figure 2) as a company grows and develops.

Start-up	Beyond your initial Network	£ Sustainable	Growth
<p>Expression: Usually comes first in CI firms</p>	<p>Restraining the urge to carry on being a creative success above a commercial success.</p>	<p>Making your creativity transferable within the organisation and establishing quality standards and processes to ensure replicability.</p>	<p>Creating new expressive value in a manner which interconnects it to that already in place.</p>
<p>Function: Converting E into F means a business model, route to market and strategies for product development, finance and customer acquisition.</p>	<p>Learning to adopt a long term strategic view of business. Setting financial goals and targets that are not just creative targets</p>	<p>Developing various other functions based on the same piece of expression - the difference between animation with a spin - off into merchandising and developing a piece of intellectual property with multiple incarnations from animation to products and beyond.</p>	<p>Maintaining a greater degree of growth of function than xpression. Achieving self-sufficiency in funding R&D from profits whilst enabling any investors to achieve ROI and exit where appropriate.</p>
<p>Risks: Firms get stuck in the creative act/authorship. Inability to connect with business support.</p>	<p>Not generating enough profit to resource the development of the functional side of the business. Inability to delegate and recruit commercial talent.</p>	<p>Critical role of the creative team. Creative Director and board do not get on. There is a need for mutual respect and collaboration at board level. Inability to manage and communicate with creative side of the company.</p>	<p>Investor and Creative team don't get on. Return of investment gets in the way. Inability to communicate level of risk to potential investors.</p>

Figure 2: Development of Creative Expression & Business Function as an SME grows

Appropriate mix of Business Function and Creative Expression

It is also important to establish a transferable culture for creativity so that the original creative spark can be accommodated and built on by new members who were not part of the initial creation of the business. It is vital to be able to know where you are in this transition and understand the impact that the growth transition and investment will have on the culture of the business.

Appropriate milestones - a key risk mitigation strategy

Principle - The development of appropriate investment milestones is a key risk mitigation strategy.

Reason - One method of managing risk is to establish stages of draw down of investment monies and connect these to go/no-go gateway decisions with mitigation strategies in the development, launch and expansion processes. In markets where venture capital funding has a well established history e.g. pharmaceuticals or film projects, these gateway decision points are fairly standardised. One of the roles of Creative Industries venture capital is to work out the appropriate gateways points or product /service development strategies in the supply chains its investees are operating in.

What does this mean in reality?

Investors are no longer the only financial houses within the Creative Industries. Other parts of the supply chain are willing to invest in the de-risking of product or service developments. Procter & Gamble are beginning to outsource innovation through distributing product briefs in order to gather product development ideas. Distributors and post production

houses in the film business are frequently part of the investment package. Where possible the principles found in user engagement and rapid prototyping pioneered by businesses such as Ideo should be applied in the development of products and services.

Such investors will also play a role in communicating the gateway points; this can be expected to affect the supply chains themselves as they tailor themselves to the risk capacity of the investment funds. Businesses that are not able to identify, understand, articulate, and build strong and long lasting relationships and partnerships with their supply chain will be at a severe disadvantage when seeking investment.

Key milestones are one example of key decision points in a financial strategy. All critical path decisions should be represented in the company's financial strategy and the risk management strategy. In this way, alternative routes will have been sketched out in advance, early warning signals agreed and financial impact planned for. For example, a product development delay is defined as the missing of key development deadlines, the financial impact in terms of additional costs to be incurred has been projected (and where appropriate extra funds raised) and the message to investors and other stakeholders can be managed. Businesses that are not able to identify, describe and build critical milestones into their plans will not receive investment.

Clear Place for return

Principle - Funding and Finance have different roles at each of the development and growth stages of a firm. NStar's monies are investment finance and therefore the potential for profit needs to be visible, clearly defined and a route for achieving it demonstrable and realistic with the key risks articulated and mitigation strategies in place.

Reason - Given that the risk and return profiles vary considerably at each stage it is critical that expectations are realistic, written into the funding/finance contracts and that SMEs are valued accordingly. Key risks which would lead to profit being reduced, or being at risk need to be articulated and mitigated.

Phase	Start-up	To Market	£ Sustainable	Growth
Type of funding/finance	Grant or loan. Up to £30,000	Convertible loan or Specific grants. Up to £50,000	Convertible loan or equity. Up to £150k	Equity investment. Up to £5m
Role of Funding and Finance:	To get the product/service good enough to go to market and pay for the filling of key skills gaps such as marketing and sales	Keeping the company going through negative cashflow involved in manufacture and launch	Preparing the company for growth	Meeting the costs of significant expansion in capabilities and capacity
Key Goals:	Customer focussed R&D. Refining the business model.	Launching first products/services; achieving positive cashflow; developing a clients and repeat sales	Achieving financial sustainability. Consolidating capabilities prior to growth.	Achieving significant ROI. Enabling investor exit.
Key Risks to Investors:	Sunk costs which deliver no long term value. Too few barriers to competition; too many barriers to entry.	Insufficient funds to get to market or acquire enough clients.	Insufficiently stable base line business. Business model not scalable. Team not ready for growth.	Being overtaken by market, technology or competition before achieve ROI and exit. Team not up to it.
ROI:	Grants - measured in terms of jobs created and turnover/profit growth. Loans - repaid with interest.	Grants - may connect to KTP from HEI's, otherwise measured as before. C. Loans - paid back with 2-10x profit.	C. Loans - paid back with profit. Wquity - bought out by next round investor and delivers profit.	Shares sold via trade sale or market listing.

Table 2: The Varying Roles of Funding & Finance in Supporting SME Growth

The DCF's areas of interest are the middle two sections of a company's development (Table 2). It is at these points that NStar can offer the greatest

value in terms of fast-tracking a company's growth and development.

Exit Route

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Principle - NStar requires a clearly defined mechanism of realisation of an investment that is a process for repayments of original capital. In addition, a timescale for this payout and its route must be articulated e.g. an exit after three years, when agreed milestones have been achieved the payout will be by trade sale (other possibilities include being bought out by management or other investors).

Reason - Public sector investors increasingly require the development of sustainable projects. As NStar operate investment finance and not grant funding, they require not only a profit on their investment, but also a mechanism for realising it. There is no value to the fund manager if an investment cannot be realised within a reasonable time-scale. Nor is there any advantage in an investee simply trading and distributing or accumulating profit without providing an exit route for investors at agreed points. The NStar DCF fund is not able to follow additional investments with further finance. In this situation any equity investment is likely to be diluted. The fund therefore favours an early conversion or immediate equity investment and an early exit at the point of the second round.

What does this mean in reality?

The need for an exit route for investors means that the timeframe and profitability need to meet a set of minimum requirements in order for investors to be interested in an opportunity. These vary according to the remit of different funds but for NStar this means an exit with a commercial yield on the investment (in line with industry standards). Clearly not all investments deliver this in reality. However, if the potential for this type of return is not visible and on the table at the point of application the opportunity is unlikely to be deemed attractive.

Providing stages of support for Entrepreneurs

As the NStar DCF is the first of its kind in the North East region it is unsurprising that other forms of support are required in order to prepare entrepreneurs for venture capital investments. There are two areas where NStar can make a contribution which will increase the number of investment opportunities.

NStar expects to come into contact with a number of firms who are not yet ready for venture capital investment but who could be fast-tracked to investment readiness with the assistance of experts and consultants. In these cases, NStar can offer both capital and contacts – the deal being that the monies come with recommendations of the best use of the funds and the people to work with to this.

As companies develop through the stages of growth and consolidation the management team need to continue to improve their risk management skills and the processes for communicating risk to their stakeholders. In this way both expectations and outcomes can be managed efficiently.

Pay to Play - a £5,000 'placeholder' loan

Part of NStar's role is to contribute to the growth in number of scalable Creative Industries firms. Whilst venture capital investment is the main route to achieving this goal, the creation of a pay to play 'placeholder' loan will both increase deal-flow overall, and create a reason to maintain contact with potential investees. Additionally it will allow NStar to inject expert resources to help prepare firms for investment without requiring a large team within NStar itself.

In return for providing the loan and access to appropriate experts, NStar will start to build a relationship and understanding of the business and the management team. The fund will require a contractual first refusal option on any further loan or investment opportunities for a period of twelve months.

Recipients of these placeholder loans will be required to demonstrate the following:

- Articulation of the business model and demonstration of profitability (either currently, or the route to achieving it)

- Building turnover to a point where the firm is financially sustainable
- Articulation of the risk profile of the sector, firm and products/services along with activities which mitigate key risks

Risk management skills development

The ability not only to identify and manage risks to the business, but also to articulate and contextualise them for the benefit of investors and other stakeholders is a key skill for the management team when a company acquires investment capital – be it debt, convertible loans or equity based^{10 11}.

In particular the following types of risk management are appropriate to many of the NStar DCF potential investments:

Appropriate milestones – identifying gateway points in the product or market development process where go/no-go decisions can be made

Limitation of cost of failure – working out the lowest cost and earliest gateway decision appropriate to the investment and opportunity

Investor focussed articulation of risk and its mitigation and management – investees need to become fluent not only in risk mitigation & management but also in articulating this in terms of investment risk (risk to the investor) as well as business risk (potential impact on the business)

The approaches and structures for risk management vary considerably between content and services businesses. However both case studies and industry norms exist in most sectors.

Through the provision of a combination of training and specific support by experienced individuals the NStar DCF will be working with potential investees to articulate the risks pertaining to their specific market sector as well as increasing the risk management skills within the firm.

¹⁰ Knowledge Capital: barriers to investment in the Creative Industries, Bates & Rivers, 2007

¹¹ Creative Business – Crafting the Value Narrative, Higson, Rivers & Deboo, 2007

Conclusions

The NStar Design & Creative Fund has been positioned to bridge that crucial gap between start-up funding and high growth. The fund aims to take people into the value creators and value growers zones.

In doing so, its goal is to enable a higher proportion of Creative Industries firms to achieve the full commercial potential of their creative outputs. For those on a high-growth route beyond the investment capacity of the DCF, this will mean preparing the firm for the next round of expansion and development. For those firms who achieve their full potential with the aid of the DCF this will mean an exit for the DCF which allows the firm to continue to trade – a management buy-out, or trade sale.

This paper has described not only the aspirations and challenges faced by the fund, but also six key factors which NStar examines in each investment opportunity it evaluates. Clearly each of these elements must be seen within the specific context of the market and supply chain within which a firm operates. Nonetheless, it is important to articulate the criteria against which an investment opportunity will be measured irrespective of sector, as it is these

criteria which will define why some businesses are more attractive than others, overall. It is also important to articulate the value and limitations that this stage of finance is prepared to add to the business. As with all areas of the UK, no one region can hope to support each sector of the creative industries equally – the history of the further education and higher education specialities, availability of key resources (both fixed and variable) and any critical mass already developed in the region will lead to the selection of priority sectors. With this in mind it may be expected that in the early days of the fund all sectors and investment opportunities will be considered on their individual ability to meet the above criteria. However as the fund develops over time it may be expected that areas of focus and sectors/sub-sectors of particular interest will be identified.

The Design and Creative Fund bridges a critical gap in the development of the Creative Industries in the North East and in the UK – a role that NStar and ONE are proud to fulfil.

