Nordicity

Directions in New Financing for the Cultural Media Industries

Final Report

Nordicity Group Ltd.
with PricewaterhouseCoopers LLP

January 2010

Acknowledgements and Disclaimer

Nordicity would like to acknowledge that funding for this study was provided by:

Ontario

Ontario Media Development Corporation

Société de développement de l'industrie des médias de l'Ontario

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Introduction

Through a combination of regulation, policies, program support and tax incentives at the provincial and federal government levels, an impressive cultural media sector has developed in Ontario. It is a thriving and resourceful sector that, while facing enormous challenges, has positioned Ontario for vigorous growth in the digital era.

An important component of Ontario's cultural media sector is its collection of indigenous Canadian-owned content producers in the film, television, interactive digital media, music, book publishing and magazine publishing industries. A major challenge for these content producers is financial: a lack of financial capital to sustain the development and exploitation of the intellectual property (IP) necessary to grow and compete in the global digital economy.

Ontario's cultural media industries have support from federal and provincial programs, as well as tax-expenditures for production and, to some extent, for development, marketing and other infrastructure needs. However, industry studies for specific cultural media industries have identified two gaps in the financing environment for cultural media companies in Ontario. First, with some exceptions (e.g., financing of tax credits in film and television production) there is limited access to short-term credit from lending institutions such as banks; and, second, there is a gap in the availability of long-term capital, such as equity financing, to provide for the investment needed to succeed in the rapidly changing digital media marketplace.

An intelligent upgrading of financial mechanisms, including new financing vehicles for indigenous content producers that are focused on better accessing private capital (angel, venture and institutional), could go a long way to supporting the development of a more sustainable environment in which Ontario's cultural media sector can grow. Effective financing vehicles would bring substantial economic benefits from increased profitability, attraction of foreign capital and revenues, and new employment and greater employment security. Ontario would also benefit from a cultural perspective by providing more opportunities for creators and more content with which Ontarians can view, consume and interact.

Project Mandate

The purpose of this study is to examine how content-creating firms might be better positioned to tap into equity investment and credit facilities from the private sector that becomes more accessible to these firms. The study also determines whether there is an appropriate public role for Ontario in providing measures that would leverage private capital at an appropriate risk/return level. Effective solutions to this challenge will help Ontario's cultural media companies develop and produce intellectual property (IP), and to retain the rights to this IP. The Ontario Media Development Corporation (OMDC) commissioned Nordicity Group Ltd. (Nordicity) in association with PricewaterhouseCoopers LLP (PwC) to investigate new *financing vehicles* for the province's cultural media industries.

In developing these new financing vehicles, Nordicity conducted research of financing practices in other jurisdictions. We also consulted with key stakeholders from each of Ontario's cultural media industries and the financial community within Ontario. Nordicity sought to develop financing vehicles that could be cross-industry in application. We also took into account the manner in which digital transformation and convergence are quickly blurring the lines between the six cultural media industries: book publishing, magazine publishing, music, film production, television production and interactive digital media.

The Rationale for Public Financial Support

Most, if not all, industries face challenges in raising or attracting financing. Companies in all industries need financing to start their businesses, fund day-to-day operations and to invest in new business opportunities. While all industries entail risks for investors, the cultural media industries have certain unique characteristics that increase that risk in the perception of the financial markets.

For the most part, the cultural media industries are in the *hits business*. Only some cultural media products created will be commercially successful. This very small group of successful properties is expected to offset the losses incurred by less successful properties. The hits business model is not unlike the model under which some other industries operate. In the pharmaceutical industry, for example, companies must often rely on the development of a small group of highly successful drugs to offset the costs of researching many other drugs that do not pan out in terms of therapeutic value.

Most of the cultural media industries differ from even the pharmaceutical industries in one key respect: *demand uncertainty*. Unlike the pharmaceutical industry—and most other industries—there is no reliable way to gauge or pre-assess the demand for a cultural media product until most or all of its production is complete. For example, if a drug is successful in terms of health value, it can be released in the market with some expectations of sales. But the same cannot be said for a book, a film, a game or a music recording whose success after its release is unpredictable. The uncertain demand in the cultural media industries can lead to problems securing financing as potential investors often face an *all or nothing* bet. They can lose their complete investment in the production if the cultural media product fares badly in the marketplace. It is the same for a television production, even though the production budget can be covered by the market (broadcasters) and public subsidy; the value of rights for subsequent payback on the original investment is often nil or close to it.

The hits business aspect of the cultural media industries combined with the unique degree of demand uncertainty creates a very high degree of business risk. Cultural media companies address this high degree of business risk through scale. Scale can be achieved through multiple products, which lead to a portfolio approach to the spread of risk and reduce the correlation of investment returns. Scale can also be achieved, in part, through vertical integration into the distribution segment of the cultural media value chain, whereby the company can expand into the distribution of its own products, as well as acquire the rights to distribute other companies' products.

Where cultural media companies or industries are unable to attain the scale sufficient to mitigate the sector's unique risk, a proverbial financing gap emerges. This financing gap is the outcome of the market failure that besets the cultural media industries: the supply of financing falls short of the demand for financing that would be consistent with expected consumer demand or the level of cultural media production sought by policy makers. A lack of corporate management expertise in the cultural media sector and the financial community's limited understanding of cultural media business models can exacerbate this financing gap.

Ontario's Cultural Media Sector

Ontario's cultural media companies have to cope with operating in a hits business afflicted by demand uncertainty. However, they also have to grapple with a lack of scale and limited domestic market, limited industry knowledge among the local financial community, and federal foreign-ownership regulations—all of which can dampen the flow of private investment into the sector.

Cultural media companies in Ontario that are too small to achieve the necessary level of scale will often adopt alternative risk-mitigation strategies, so they can continue to create cultural media content and to maintain an ongoing business.

While Toronto is Canada's financial centre, it is not considered a centre for media-industry financing as it does not have the depth of financing professionals with sufficient knowledge of the global cultural media industries. Without a financial community equipped to identify, to assess and to effectively articulate investment opportunities to suppliers of capital, there will be a limit to the flow of financing capital to cultural media companies in the province.

One obvious potential way to overcome the lack of local financial community knowledge would be to seek out financial community assistance outside the country. However, all of the cultural media industries in Ontario, with the exception of the interactive digital media industry, are subject to various types of federal legal requirements that can impede their ability to raise financing (particularly equity) from outside of Canada. In particular, federal foreign-ownership regulations regarding cultural companies (including broadcasters and distribution undertakings), restrict owners from accessing foreign capital and dampen exit opportunities. Other regulations governing non-Canadian investments in cultural media companies and projects, such as prohibiting access to tax credits, complicate and even forestall such outside advice and associated investment.

Key Financing Challenges

Ontario's cultural media sector faces several financing challenges that are inhibiting companies from effectively responding to and capitalizing on the transition to digitization. The key financing challenges are related to scarcity of equity investment, to lack of adequate access to credit and to the need for more effective direct government support measures.

i. Scarcity of Equity Investment

Ontario's cultural media companies appear starved of risk capital at the very time when they need it most. The book publishing and magazine publishing industries, in particular, are afflicted by limited pricing power, low margins and low growth rates; the other cultural media industries lack the scale to be true international competitors. All of the cultural media industries could benefit from financing vehicles that would help them attract risk capital, so that they can invest in response to these global forces. The types of equity investment incentives required appear to be somewhat different for each of the cultural industries.

ii. Lack of Access to Credit

All of the cultural media industries are experiencing cash-flow strains. In some cases, these strains can be tied back to the length of time to receive the proceeds from provincial and federal tax credits; in other cases, they are related to delays in obtaining approved public funding or to the inability to obtain bank financing from receivables. All of the cultural media industries are challenged by the effects of digitization and heightened international competition in some manner. Such technological challenges are forcing them to explore content innovation and new business models—all of which require investment in some form or another.

iii. Uneven Support Across the Value Chain

For the most part, the provincial and federal governments concentrate their support in the production part of the value chain for cultural industries. There is some support for the early and later parts of the value chain, such as content development (early) and marketing and distribution (later). However, established cultural media companies contend that more effective financial support at both ends of the value chain is needed.

Indeed, such support may prove to be an efficient route for addressing the challenges of digitization and international competition. Different types of government support could be an alternative or a complement to measures to improve access to equity investment and credit.

Our research of the financing challenges in Ontario's cultural media industries points to the need to consider some form of incentives for these three areas: private equity investment, credit-support mechanisms and additional forms of directed value-chain support.

Incentives for Private Equity Investment

The overriding goal of incentives for private equity investment is to attract *risk* capital or much more patient capital to cultural media companies. This type of financing plays a crucial role in the development of globally competitive content and sustainable corporate growth. Private equity investment offers cultural media companies the risk tolerance and investment time horizons that afford them the opportunity to experiment and to develop innovative new IP content.

Governments in Canada and elsewhere typically use one or both of two models for facilitating private equity investment: tax incentives for direct equity investment or public-private equity investment managed funds. Tax incentives for direct equity investment offer private investors some type of tax incentive or tax advantage that they can claim when they make certain types of investments. Under the public-private managed fund approach, the government co-mingles its capital with private risk capital. Under the latter approach, the government typically defers to the private investment professionals to make the investment decisions that govern these co-mingled funds.

There are several precedents inside and outside Canada for the use of direct tax incentives to attract private investment to the cultural media industries. For example, Canada's mining and oil exploration industries utilize flow-through shares to attract private investment. Based on the rules governing ordinary flow-through shares in the Canadian mining industry and 2008 income tax rates, the Province would face an upfront cost of 17.4 cents in foregone tax revenue for every dollar of flow-through-share investment in cultural media companies or properties. However, the net cost to the Province could be lower once the cultural media companies issuing the flow-through shares started to earn income. Still, federal government participation is essential to the extension of the flow-through-share scheme to the cultural media industries.

An investment tax credit could be an alternative to flow-through shares. A 30% investment tax credit would cost the Province 16 cents in foregone tax revenue for every dollar of private investment (after taking into account the personal income tax on the value of the tax credit) in cultural media companies or properties. Therefore, for every dollar of investment tax credits provided by the Province, there would be \$6.25 (1.00 ÷ 0.16 = 6.25) of incremental private investment—a leverage rate[1] of approximately 6:1. Both forms of direct tax incentives—flow-through shares and investment tax credits—would provide cultural media entrepreneurs with an additional source of capital to enable them to invest in new initiatives.

The degree to which individual investors will participate in any tax incentive for direct investment is uncertain; as such, the degree to which financing capital will flow to the cultural media industries is also uncertain. It is unclear what rate the incentive would need to be fixed at, although there are useful precedents that can be used as guidelines. Furthermore, the Province would need to develop detailed qualification criteria to determine the sectors that would benefit from the investment tax credits; otherwise, the Province could risk having no control over the distribution of any financing among the cultural media industries.

We expect that much of the new financing would flow to the interactive digital media industry, whose companies could demonstrate the possibility of high growth potential from the exploitation of rights across all platforms or could crack global markets (e.g., for the games sector). Some would flow to a handful of companies consolidating in specific sectors like film and television production, where the effect of scale could be perceived as potentially generating higher returns. If such a measure were introduced in Ontario, the sector's pool of financing capital would be limited to Ontario taxpayers. However, the province does have the highest concentration of high-net-worth investors in Canada, so the potential for increasing access to capital certainly exists.

A public-private managed fund could enable access to a wider pool of capital. The Province has already established its own public-private managed fund by way of the Ontario Emerging Technologies Fund (OETF) co-financing program—for the broader emerging technology sector. There are also a number of public-private managed funds already in place in Europe, which cover the cultural media industries. Belgium's CultuurInvest, Scotland's Digital Media IP Fund and northeast England's North East Content Fund all provide matching funds on a strict 50-50 co-financing basis for investments in the cultural media industries.

Such 50-50 co-financing structures adopted by these public-private managed funds help to ensure that market discipline governs their investments. However, the type of returns required to give such funds the potential to be sustainable (i.e., revolving) are best found in industries where companies are poised for high growth. Since mainstream cultural product is based on the undercapitalized and slower-growing cultural media companies, there is some risk in the creation of a public-private cultural media fund. It would tend to invest only in the situations where high growth was possible. However, since it will be the growth-oriented companies that lead the future development of the sector, a fund of this kind could provide the extra incentive needed to obtain the risk capital required to stimulate this growth.

[1] The "leverage rate" or "leverage factor" refers to ratio of total financing made available to cultural media companies to the level of the Province's financing capital or foregone tax revenues required to attract or initiate this funding.

There are risks with the public-private managed fund concept. It could be derailed by the lack of high calibre investment professionals with a track record and knowledge of the cultural media industries. There is also a risk that the Province's allocation for a fund may not be invested for lack of high-return investment opportunities. The fund's management may not ferret out enough new investment opportunities to compose a diversified portfolio of investments. Until there is more liquidity generally in the sector, management would also face the problem of lack of exit options to reinvest the funds in new situations. In addition, it is not clear how large an investment portfolio would be required to represent enough of a cross-section of content-producing companies to make a discernible difference in provincial employment and gross domestic product (GDP) in this sector.

Aside from investing in companies directly, a public-private managed fund could become a vehicle for channelling equity investments directly into IP projects, such as films, television programs and books. Once again, however, such a fund would be looking for the opportunity for high returns. Since the vast majority of Canadian content production does not provide opportunities for achieving superior returns, any fund would be highly selective. The beneficiaries of the equity investments would likely be the cultural media properties with greater market potential, likely with high potential in foreign markets.

Credit Support Mechanisms

Credit support mechanisms, or cash-flow support mechanisms, permit companies to raise current cash against some type of future income. This future income may be a government tax credit; other forms of government funding; the pre-sale of content to a television broadcaster, magazine subscriber, book distributor or game publisher; or other trade receivables (such as IP rights developed but not exploited). Credit support vehicles will likely increase the level of interaction between cultural media companies and financial institutions, leading to a greater familiarity between the financial and creative sectors. As these financial institutions gain more knowledge of the business and credit conditions in the six cultural media industries, their use could be expanded. For example, they could include longer-duration credit instruments, such as long-term loans, that could be tied to specific IP development projects or to other asset classes beyond current assets. In the short term, however, the two potential credit support mechanisms considered are (i) loan guarantees and (ii) accelerated payments of tax credits.

Loan Guarantees

Government-sponsored loan guarantees are a widely used financing vehicle in Canada and elsewhere. Indeed, the Province operates a loan guarantee program for the forestry sector. The reason for the popularity of loan guarantees is that they enable governments to leverage banks' loan-to-capital ratios to generate additional industry financing that is anywhere from 6.7 to 10 times the amount of the government capital outlay. Loan guarantees can be a very flexible tool. They can be used to provide much-needed cash-flow loans against short-term receivables or longer-term loans associated with business investment or riskier assets classes. A loan guarantee for Ontario's cultural media sector would encourage Canadian financial institutions to gain a better understanding of the business and credit conditions in the sector. Such practices could lead to better banking relationships for the cultural media sector.

Loan guarantees are not cost-free, however. Our cost-benefit analysis indicates that, under conservative assumptions, after five years, approximately 35% of the Province's capital could be eliminated as a result of loan losses, thus reducing the loan capacity of the program. As well, because the Province would have to take on some type of applicant-screening role, it is likely to incur incremental operating costs to administer the program. Indeed, one of the primary downsides of loan guarantees is that they can be cumbersome for government to establish. Loan guarantee programs require collaboration with financial institutions that must be persuaded to move beyond low-risk loans. There is a fine line in judging what the appropriate risk is and what an acceptable loss ratio would be for a loan guarantee program.

Despite the difficulties one can expect in setting up a loan guarantee program with the right balance, it does offer the Province the highest potential rates of leverage on its capital, compared to the alternatives. The leverage factor on tax incentives for direct investment is approximately 3:1 and the leverage factor on a public-private managed fund is 2:1. A loan guarantee program offers the potential for a leverage factor of 6.7:1 or even as high as 10:1.

Accelerated Payments of Tax Credits

If a mechanism can be found to accelerate payment of tax credits, cultural media companies could save an estimated $3.6 million annually in financing charges (and the opportunity cost of lost investment returns). This benefit appears to be tilted to three cultural media industries: film production, television production and interactive digital media. Although a smaller measure than the others contemplated in this study, the industries involved regard the cash saved as a critical component of a return to producers themselves.

One concern associated with the accelerated tax credit is the double-cohort effect. As such, an acceleration of payments would likely have to be phased-in over a period of years. In any event, the relatively modest impact of this credit support mechanism and its relevance for only a portion of cultural media activity suggest that it should be considered in combination with other financing vehicles.

Directed Value-Chain Support

There is a history of support for development activities in the cultural media industries. For the most part, however, this support is for specific projects, while the apparent need is to support the development of a range of IP concepts to make the content production company more viable. For example, instead of single projects, a more effective intervention would be to construct the financial incentive to support the initial development phase of a slate of projects, therefore spreading the risk for the company and developing its leverage in the marketplace.

Thus, the basic design of the development incentive would be to strike an agreement with a qualified content development and production company (i.e., one that has a proven track record). This agreement would provide for the co-financing of a heightened development slate, which would include financing by the content producer or by third-party private investors. To encourage innovation, the development incentive could be made available for some form of business model transformation, whereby the content producer invests into broadband distribution or partners with other entities that can supply some of the functions required by the new generation of revenue sources.

Summary of Policy Options

Based on the alternative financing vehicles discussed above, the following table summarizes these options according to three alternative policy objectives. For each objective, a suggested ranking of choices is provided and rationale described below.

Summary of policy objectives and potential financing vehicles

	Policy Objective A: ***Improve investment capacity***	**Policy Objective B:** ***Promote high growth opportunities***	**Policy Objective C:** ***Improve cash flow***
Choice 1	Loan guarantees	Tax incentives for direct equity investment	Accelerating payment of the tax credit
Choice 2	Directed financing for R&D/development	Directed financing for R&D/development	Loan guarantees
Choice 3	Tax incentives for direct equity investment	Public-private managed fund	Directed financing for distribution and marketing
Choice 4	--	Directed financing for distribution and marketing	--

<u>Policy Objective A</u>: *Improve the investment capacity of established companies in the cultural media sector and position them for digital transformation.*

Policy Objective A could be best met by focusing financing programs on improving the investment capacity of Ontario's established companies, thus helping them to position themselves for digital transformation.

While many of Ontario's established cultural media companies face uncertain futures, their solid track records of historical financial performance provide a good basis for utilizing loan guarantees to obtain short- or long-term bank credit. They can use the short-term credit to improve their cash flow situation, and they can use the long-term credit to make the investments needed to adapt their IP to digital production and distribution models.

Directed financing for development would provide additional support to established companies because it would offer them additional financing resources for developing new content and slates of content, which will further help them to grow and remain competitive.

Ontario's established cultural media companies have some opportunities to securitize the cash flow from content projects or slates of projects. For those cases, some type of tax incentive for direct equity investment (e.g., flow-through shares or investment tax credits) would help them raise the risk capital that may be seeking to finance projects with a high potential return.

<u>Policy Objective B</u>: *Promote high-growth opportunities within the cultural media sector.*

To best meet Policy Objective B, the focus of policy measures and industry could be placed on the financing needs of those companies with high-growth potential. This approach would include considering support for both established and emerging companies. While it might be somewhat biased to the fast-expanding interactive digital media industry, it could encourage scale development in some other sectors. And it could stimulate the development of cross-platforms concepts and rights. As a result, in each of the other five cultural media industries (other than interactive digital media) this policy objective would likely result in some consolidation and vertical integration into distribution, as well as innovative companies with high-growth potential.

A tax incentive for direct equity investment that was available to individuals could allow cultural companies to offer an investment sweetener to potential investors. Present economic circumstances would indicate that individual investors would be cautious, so the financial services industry that would market these securities would need to be encouraged and familiarized with the potential so that investment would flow. The tax incentive for direct investment also gives cultural media companies the opportunity to structure investments directly in companies or in slates of projects that offer revenue streams.

Because innovation and growth in the cultural media sector is underpinned by R&D/development, directed financing for such activities would be an essential pillar of this policy objective. A program that directly supported development would provide a financing counter-balance to the private equity investment incentives: those industries and companies that found it more difficult to attract private investors could turn to some form of directed financing for R&D/development to finance the activities that could lead them into high growth.

A public-private managed fund would be a very efficient financing vehicle for the purpose of matching risk capital with high-growth/high-risk investment opportunities. However, we have ranked it third under Policy Objective B because such a fund might end up being focused only on investments in the interactive digital media industry, and would avoid investment opportunities in content developers with growth plans founded on international markets, corporate consolidation or cross-platform development. A special effort would be necessary to ensure that the public-private managed fund did seek out investment opportunities in companies following these alternative paths to growth.

A fourth approach to supporting cultural media companies' efforts to capitalize on high-growth opportunities would involve directed financing (from government) for distribution and marketing. Ontario's cultural media companies operate in a relatively small domestic market, which is exposed to a steady flow of cultural media content from the U.S. and, to a lesser extent, other countries. The international sale of cultural media content and services is a vital piece of any strategy for high growth among cultural media companies in Ontario.

Directed financing for marketing and distribution facilitates this international growth in two respects. First, it directly supports cultural media companies' international business-development initiatives, which can lead to increased international revenues. Second, the Province can structure directed financing for marketing and distribution, so that it allows cultural media companies to retain more of the distribution rights associated with their content. By retaining more distribution rights, cultural media companies can increase the revenues from the content they develop, and produce and build rights libraries with ongoing income. Cultural media companies can then use these revenues and income streams to finance their growth.

Policy Objective C: ***Improve the cash flow position of established and emerging companies in the cultural media sector.***

If priority were given to pursuing Policy Objective C, the cash flow position of established and emerging companies in the cultural media industries could be improved by focusing on both of the credit support mechanisms considered (i.e., accelerated payments of tax credits and loan guarantees).

Accelerating the tax credit payments would put some cash in the hands of cultural media companies much sooner. While the amount of interim financing savings would not be substantial, it would reduce their cash conversion cycle and convert more of their working capital into cash that they can deploy in new projects. Moreover, accelerating the tax credit will improve the profitability of cultural media companies by directly reducing the financing charges they face. Cultural media companies can also deploy these additional profits to investment opportunities.

Loan guarantees do not reduce cultural media companies' financing charges; in fact, they increase companies' financing charges. However, like the accelerated tax credits, loan guarantees allow cultural media companies to convert a larger portion of their current assets (e.g., trade receivables or government funding) into cash more quickly. Cultural media companies that can identify content development and investment opportunities with expected rates of return that exceed financing interest rates will be in a position to deploy this cash in an economic manner and to grow their businesses.

Summary of Potential Financing Vehicles

A review of the potential financing vehicles for addressing each of the three policy objectives indicates that no single financing vehicle can feasibly address all three policy objectives in an effective manner. However, our research indicates that certain financing vehicles would be effective under at least two policy objectives.

It is also clear from our analysis that there is significant merit in pursuing some form of loan guarantees as a vehicle for short- and long-term access to credit. Loan guarantees can help cultural media companies improve their investment capacity; they can also be an effective tool for improving cultural media companies' cash flow. Loan guarantees may not be effective in promoting high-growth opportunities. With high-growth opportunities comes high risk, and banks may not have a high enough tolerance for extending credit for high-risk opportunities. We believe that loan guarantees require further deliberation with the financial community to ascertain whether and to what extent Ontario could count on the financial services sector as a partner in loan guarantee mechanisms.

Directed financing for R&D/development would help Ontario's cultural media companies increase their investment capacity and, at same time, promote high-growth opportunities. While a co-financing scheme for R&D/development offers the Province much lower financing leverage than loan guarantees, the financing could be directed at the types of corporate activities—namely the development of digital applications and content—that are vital to cultural media companies' growth.

The Province is also very familiar with the provision of investment tax credits. Our research indicates that tax incentives for direct equity investment can be an effective tool for attracting risk capital to established companies seeking to expand their investment capacity, as well as to emerging companies with high growth potential.

1 Introduction and Background

1.1 Introduction

More effective financial vehicles could transform Ontario's content production across cultural media industries.

Through a combination of regulation, policies, program support and tax incentives at the provincial and federal government levels, Ontario has built an impressive cultural media sector. It is a thriving and resourceful sector that, while facing enormous challenges, has positioned Ontario for vigorous growth in the digital era.

An important component of Ontario's cultural media sector is its collection of indigenous Canadian-owned content producers in the film, television, interactive digital media, music, book publishing and magazine publishing industries. A major challenge for these content producers is financial: a lack of financial capital to sustain the development and exploitation of the intellectual property (IP) necessary to grow and compete in the global digital economy.

Ontario's cultural media industries have national and provincial program and tax-expenditure support for production, and, to some extent, for development, marketing and other infrastructure needs. However, industry studies for specific cultural media industries have identified two gaps in the financing environment for cultural media companies in Ontario. First, there is limited access to short-term credit from lending institutions such as banks. Second, there is a gap in the availability of long-term financial capital, such as equity financing, to provide for the investment needed to succeed in the rapidly changing digital media marketplace.

The range of program, tax credit and other initiatives demonstrate that the Ontario Media Development Corporation (OMDC) and the Ontario government support the full range of creative and innovative activity in each of the cultural media industries that it supports.[2] However, it has become apparent that Ontario's indigenous creative-sector enterprises need to be more profitable to attract sufficient capital from private sources to seize Canadian and international opportunities. Ontario needs more companies that can reach a level of operations that generates synergies and efficiencies, and can exercise some leverage in retaining and exploiting their IP content. Ontario also needs an ecosystem of smaller, innovative companies, and a constant infusion of emerging companies to become the next generation of profitable, sustainable and growth-oriented content producers.

A strategic upgrading of financial mechanisms, including new financing vehicles for indigenous content producers, could go a long way to supporting the development of a more sustainable environment in which Ontario's cultural media sector can grow. Effective financing vehicles would bring substantial economic benefits from increased profitability, attraction of foreign capital and revenues, and new employment and greater employment security. Ontario would also benefit from a cultural perspective by

[2] Specifically, OMDC has expressed an interest in exploring the following themes: digital evolution, content development and market access, the need for market intelligence, access to capital, and cross-sector collaboration and communication (See: OMDC, *Ontario Media Development Corporation: Towards a Strategic Plan: Helping Ontario Companies Compete in the Global Creative Media Market*, September 2008, pp 13-15).

providing more opportunities for creators and more content with which Ontarians can view, consume and interact.

1.2 Project Mandate

The project mandate: develop and evaluate new financing vehicles that help Ontario's cultural media companies to develop, produce and retain the rights to intellectual property of global calibre.

Over the past 15 years, the Ontario government has implemented an array of financial support mechanisms for Ontario's cultural media companies through the OMDC. Historically, the Province has provided its financial support through the refundable tax credits available to all of the cultural media industries except for magazine publishing. For the film and television production industries, refundable tax credits have been in place for over a decade and have injected hundreds of millions of dollars into the production of Canadian and foreign films, as well as television programs shot in Ontario. Refundable tax credits have also supported the production of content in the music, book publishing and interactive digital media industries.

These refundable tax credits have been very effective in subsidizing the *production* of content and have helped to create thousands of jobs for Ontarians, particularly in film and television production. However, such incentives are not designed to promote the development of *companies* within the cultural media industries in Ontario. Despite the cultural media sector's many successes, the globally competitive companies that have developed in Ontario often find it difficult to grow and to improve their profitability because of limited access to long-term financing.

The purpose of this study is to examine which new financing mechanisms would help Ontario's cultural media companies develop and produce IP, and to retain the rights to this IP. The OMDC commissioned Nordicity Group Ltd. (Nordicity) in association with PricewaterhouseCoopers LLP (PwC), to further develop one or more new financing *vehicles* for the province's cultural media industries. We have emphasized the word *vehicles* within the description of the study mandate because it best captures the essence of the project—to consider new financing tools that will facilitate access to capital and to provincial funding programs for the cultural media industries.

Mandate:

Develop and recommend one or more new financing vehicles for Ontario's cultural media industries.

- Identify key financing challenges facing Ontario's cultural media industries on an industry-specific, cross-industry and value-chain basis.
- Conduct research of innovative financing mechanisms in place in other jurisdictions.
- Meet with industry stakeholders within Ontario.
- Develop mechanisms that will promote the development of IP and the retention of IP rights, and that complement but do not replace the existing array of expenditure-based tax credits.
- Consider the possibility of public-public or public-private partnerships in examining financing mechanisms.

There is considerable merit to promoting the creation of cultural media content for cultural rather than economic reasons. However, there are already a large number of support mechanisms—provincial and federal—available to meet cultural objectives. This study focuses on developing financing vehicles that will facilitate the marriage of capital and investment opportunities in the cultural media industries, namely the development and distribution of cultural media content. The purpose of these financing vehicles will be to support cultural media projects and to develop strong globally competitive companies.

In developing these new financing vehicles, Nordicity conducted research of financing practices in other jurisdictions. We also consulted with key stakeholders from each of Ontario's cultural media industries and the financial community within Ontario. Nordicity sought to develop financing vehicles that could be cross-industry in application. We also took into account the manner in which digital transformation and convergence are quickly blurring the lines between the six cultural media industries: book publishing, magazine publishing, music, film production, television production and interactive digital media.

New Financing Objectives

OMDC's vision of a cultural media sector in Ontario, where well-capitalized and sustainable companies anchor an ecosystem of content creation, guided the study's analysis and adaptation of new vehicles. Ontario already has hundreds of small- and medium-sized enterprises (SMEs) across the cultural media industries. These SMEs have driven the sectors' growth over the last decade, and they will continue to play a vital role. OMDC would like to ensure that companies operating in the cultural media industries have access to the capital required to develop their companies and to address some of the key challenges they face.

Ontario's cultural media SMEs often lack sufficient capital to realize their full potential. As a result, they struggle to access domestic and international markets, to retain IP and to position themselves to take full advantage of all aspects of digital development. Going forward, OMDC would like to see many of

Ontario's cultural media companies grow into well-capitalized and sustainable companies that can compete in the global marketplace for cultural media content.

Overall Vision:

Well-capitalized, sustainable cultural media companies that can compete on the global stage.

- Improve cultural media companies' balance sheets so they have the working capital to develop IP and to pursue investments.
- Attract private investment to Ontario's cultural media companies.
- Guide both individual companies and the overall cultural media sector through the stages of corporate development, from start-up to a sustainable, self-financing company.
- Be proactive in adapting to new business models in the cultural media industries, but respect different business models while so doing.
- Assist each of the six cultural media industries in their development and evolution while

Since the provincial government's financial resources are limited, sustainable private-sector solutions are likely to be required, and the Province's role might well be to leverage the highest private engagement within limited public incentives. Private investment can provide market discipline to any new financing vehicle. Therefore, Nordicity concentrated on new financing vehicles whose aim is to attract private investment to Ontario's cultural media companies.

To attract private capital, the core objective of any new financing vehicle would be to improve cultural media companies' balance sheets. Achieving strong balance sheets through improved profitability, cash-flow efficiency or external capital will give Ontario's cultural media companies the resources needed to invest in the development and exploitation of new IP. New financing vehicles for the cultural media sector would ideally guide companies through all the stages of corporate development, ranging from start-up to a stage where they can finance their growth in a more sustainable pattern by way of internal capital. These vehicles should be proactive in moving the sector closer to OMDC's vision, while respecting the different needs of each of the industries.

All of the cultural media industries are undergoing a transformation in their business models. This transformation has been brought on by the interaction of digital technology with content production and content distribution. At the same time, the digital revolution is furthering the convergence of many of the cultural media industries. Books, films, music and magazines can no longer rely solely on distinct distribution channels or platforms. Increasingly, all of these forms of media are finding themselves moving towards emerging digital distribution platforms. Online distributors, most notably Apple iTunes, demonstrate how digital convergence can lead to new ways to monetize content. To be effective, any new financing vehicles must take into account the impact that content digitization and digital convergence is having on each stage of the cultural media value chain: from content development through to distribution.

Ultimately, any new financing vehicles implemented now should, five years hence, yield a cultural media sector comprised of many well-capitalized, profitable and sustainable companies anchoring an ecosystem of SMEs, which further drive content creation in Ontario.

1.3 Research Approach

Evidence-based analysis derived from extra-jurisdictional research and industry consultation, in addition to an understanding of the cost-benefit implications, constitutes the research approach.

To develop the new financing vehicles described in this report, Nordicity conducted both secondary and primary research. The secondary research consisted of a literature review and web-based research of financing vehicles that are in place in other jurisdictions or that are available to Ontario companies in other industries. The *References* section of this report lists the documents we reviewed as part of the literature review, as well as the documentation we obtained through web-based research of financing vehicles.

Industry consultation formed another key component of our research approach. In conjunction with OMDC, Nordicity convened and facilitated two Think Tank sessions (workshops) with representatives from all six of the cultural media industries. The industry representatives included entrepreneurs, managers and other industry stakeholders who were exposed to the financing aspects of their cultural media companies. Representatives from Ontario's financial services community also participated in the Think Tank sessions.

Following the development of our preliminary findings report, Nordicity convened and facilitated three consultation meetings (roundtables) with representatives from the five Industry Advisory Committees (IACs) established by OMDC. A list of the Think Tank and IAC participants can be found in Appendix C.

We supplemented the Think Tank sessions and IAC meetings with our own informal interviews with representatives from the financial community in Canada and the United Kingdom (U.K.). In addition, PwC leveraged its network of Canadian tax specialists and financial advisory consultants to provide additional insights on design considerations relevant of new financing vehicles.

On the basis of our primary and secondary research, Nordicity arrived at a short list of six new financing vehicles. For each new vehicle, we outlined the key design considerations, prepared a high-level cost-benefit analysis and assessed its feasibility within the context of Ontario's cultural media sector. The design considerations, cost-benefit analysis and feasibility assessment provided the basis for the development of policy options for the consideration of the Province.

1.4 Outline of Report

The following report presents the outcome of Nordicity's research and analysis of the financing environment in the cultural media sector, as well as potential new financing vehicles for the companies in the sector. The report concludes with a set of policy options for new financing vehicles for Ontario's cultural media sector.

The remainder of this report is divided into five sections. In Section 2, *The Rationale for Public Financial Support*, we review the structure and economic performance of Ontario's cultural media industries and survey the existing array of public financing mechanisms available to cultural media companies in Ontario. Following a brief review of the corporate finance principles relevant to our analysis, we examine the most acute financing gaps and challenges facing Ontario's cultural media industries.

In Sections 3 through 5, we review three distinct types of new financing vehicles. In Section 3, we examine *Incentives for Private Investment*; in Section 4, we examine *Credit Support Mechanisms*; and in Section 5, we examine forms of *Directed Value-Chain Support*. In each of these three sections, we present the results of our research of financing vehicles already available in other jurisdictions or available to other industries in Ontario, along with the information we gathered through our industry consultations. For each financing vehicle, we provide a discussion of the design considerations and a cost-benefit analysis. Section 6, *Summary and Policy Options*, concludes the report with a review of the key findings from our research and assessment, a summary assessment of the new financing vehicles and an outline of the policy options available to the Province for support to the cultural media industries.

2 The Rationale for Public Financial Support

2.1 Introduction

The first stage in our analysis consists of a review of the rationale for the public financial support for the cultural media industries in Ontario. In the current economic environment, many industries in Canada are seeking some type of financial support from federal and provincial governments; the cultural media sector is no exception.
However, unlike other sectors, the cultural media sector displays unique characteristics that often lead to a financing market failure. In this section, we describe these unique characteristics and how they contribute to a market failure in the financing of cultural media companies.

We also outline the particular position of Ontario's cultural media sector, and how its structure generates an even more pronounced degree of financing market failure. In so doing, we review the structure and economic performance of Ontario's cultural media industries, and point out what causes financing issues. We then briefly outline the orientation of the support mechanisms currently in place to mitigate financing challenges in the cultural media sector. Finally, we investigate the financing challenges that stem from the cultural media industries, using three specific analytical filters. In the remainder of the report, we address these financing challenges and put forward several new financing vehicles.

2.2 Financial Challenges in the Cultural Media Industries

The combination of a hits-business characteristic and demand uncertainty accentuates the investment risk for investors in cultural media products.

Most, if not all, industries face challenges in raising or attracting financing. Financial capital is a scarce resource. Companies in all industries must obtain financial capital to form their businesses, fund the day-to-day operations of their businesses and invest in new business opportunities. While all industries present risks for investors, the cultural media industries have certain unique characteristics that increase that risk. In economic terms, it is called a financing market failure—cultural media companies are unable to obtain sufficient private capital on reasonable terms to meet market- or policy-driven demand for cultural media products.

Hits Businesses

Most of the cultural media industries are hits business industries. History shows that there is no reliable model for predicting the success or failure of a book, film, television program or musical artist. Only some cultural media products created will be commercially successful. This very small group of successful properties is expected to offset the losses incurred by less successful properties. The hits business model is not unlike the model under which some other industries operate. In the pharmaceutical industry, for example, companies often must rely on the development of a small group of highly successful drugs to offset the costs of researching many other drugs with limited or no therapeutic value.

Demand Uncertainty

Most of the cultural media industries differ from even the pharmaceutical industries in one key respect: *demand uncertainty*. Unlike the pharmaceutical industry—and most other industries—there is no reliable way to gauge or pre-assess the demand for a cultural media product until most or all of its production is complete. Most industries can develop prototypes and test their demand before investing in the full production of the product. Most of the cultural media industries do not have this option, and this lack of predictability generates additional risk for investors. While concepts can be market tested to some degree, the only way to gauge a potential audience for cultural products is to release the completed product into the marketplace. Content producers try to increase their odds by producing sequels or works by previously successful authors, but the result is far from guaranteed.

This inability to pre-test or test-market differentiates the cultural media industries from many manufacturing industries (e.g., consumer electronics), where buyer demand can be predicted, to an extent, through focus groups, market research and similar methods. The uncertain demand in the cultural media industries can lead to problems securing financing, as potential investors often face an *all or nothing* bet; they can lose their complete investment in the production if the cultural media product fares badly in the marketplace. It is the same for a television production, even though the production budget can be covered by the market (broadcasters) and public subsidy; the value of rights for subsequent payback on the original investment is often nil or close to it.

Demand uncertainty is endemic to the film production and IDM industries.[3] There is no way to effectively gauge audiences' demand for a film until the producer has shot and edited it for cinematic release. Once the film is complete, the producer can use test screenings to gauge audience demand for the film. If the test screenings point to low audience demand, the producer has the option of avoiding additional distribution and marketing expenditures; however, the producer cannot recover the large-scale investment already made in the production of the film. The same is true of video games and other IDM products. There is no way to effectively test-market the product until the game developer and publisher have made a substantial investment in its development.

Aspects of demand uncertainty also emerge in book publishing, television production and music. A book publisher can avoid the printing, marketing and distribution costs of a new book that shows signs of low demand, but the development of the book must still be financed. For the music industry, the production of an artist's album presents a similar situation: the music label cannot avoid the costs associated with creating the master, but it can avoid the costs of distribution, marketing and artist promotion. In the television production industry, the use of pilots is an example of a method for mitigation of demand uncertainty. However, the television producer cannot avoid the cost of development (which may involve investing in a making a pilot), and the broadcaster is still exposed to risk if the production does not draw good audiences. Overall, the development of most cultural media products will always require a significant upfront investment.

Scale and Diversification to Mitigate Investment Risk

The hits-business aspect of the cultural media industries combined with its unique degree of demand uncertainty creates a very high degree of business risk—perhaps more so than many other sectors of the

[3] North East Finance (Nstar), *Mind the Gap: Investment funding between start-up and high growth*, downloaded on July 3, 2005, at < http://www.nstarfinance.com/documents/mind-the-gap.pdf>, p. 5.

economy. Cultural media companies address this high degree of business risk through scale. Scale can be achieved through multiple products, which lead to a portfolio approach to the spread of risk and which reduce the correlation of investment returns. Scale can also be achieved, in part, through vertical integration into the distribution segment of the cultural media value chain, whereby the company can expand into the distribution of its own products, as well as acquire the rights to distribute other companies' products.

Both approaches—multiple products and vertical integration into distribution—provide companies with greater opportunities to manage the very high level of business risk. The tendency to both horizontal and vertical scale often leads to an industry structure characterized by a small group of very large vertically integrated firms, which will act as content gatekeepers. In fact, because they develop strong distribution and marketing arms, they effectively act as content gatekeepers between the content producer and the ultimate customer.

Where cultural media companies or industries are unable to attain the scale sufficient to mitigate the sector's unique risk, a financing gap emerges. A financing gap occurs when a business or industry is unable to obtain the financing it requires to achieve a level of output that is commensurate with demand or with public policy objectives. This financing gap is the outcome of the market failure that besets the cultural media industries: the supply of financing falls short of the demand for financing that would be consistent with expected consumer demand or the level of cultural media production sought by policy makers.

Management Skills and Financier Knowledge

Research indicates two additional factors that contribute to the market failure and financing gap. The first is that there may be lack of strong management skills in the cultural and media sector. The second is that the financial community itself exhibits a limited understanding of cultural media business models.[4] Potential investors point to a lack of high-calibre professional management at cultural media companies as a factor that limits these companies' ability to raise financing. High-calibre professional management is considered a key factor in business success; yet, creative people are often not the most talented business managers.[5] Devoting resources to providing creative people with management training can be an inefficient approach, as it can divert creative people from creating.[6] An alternative approach is to attract high-calibre managers to partner with creative people.[7] Many companies in the cultural media industries experience a dearth of strong management skills, which makes investors more reluctant to invest in cultural media companies.

By the same token, the financial community—the suppliers of financing capital—often lacks a deep enough understanding of the cultural media industries and their business models to make informed assessments of business opportunities. The economics of creating and distributing cultural media products is very different from other industries, owing largely to its demand uncertainty, its intangible (intellectual property) assets and the fact that human capital is the essential input. It takes financial

[4] These observations were made through the focus group sessions held in the course of this study.

[5] Mike Luckwell, "The UK Investment Climate: A Business Angel's View," *Sustainable Investment for the Creative Industries?*, roundtable discussion hosted by Ingenious Media in association with DCMS and DTI, June 2007.

[6] Chris Powell, "A Perspective from NESTA," *Sustainable Investment for the Creative Industries?*, roundtable discussion hosted by Ingenious Media in association with DCMS and DTI, June 2007.

[7] *Ibid*.

professionals who understand the creative process and know how to maximize the performance of creative talent to assess and value financing opportunities in the creative industries.

Government Response

The financing market failure and resulting financing gap prevalent in the cultural media sector has led many Western governments to implement government policies to directly fund cultural media sector production or facilitate the financing of businesses in the sector. The cultural media sector is a source of significant economic spillovers for Western economies, and has become a key pillar in many Western governments' plans for transitioning their economies from manufacturing base to knowledge base.

2.3 Ontario's Cultural Media Industries

Ontario's cultural media industries face their own unique set of economic challenges, which contribute to a financing market failure and lead many to adopt a commissioned business model.

While the cultural media sector, in general, is characterized by unique factors that contribute to a financing market failure, many of Ontario's cultural media industries also face several additional geographic-specific factors that compound the sector-specific financing market failure. Ontario's cultural media companies have to cope with operating in a hits business afflicted by demand uncertainty. However, they also have to grapple with a lack of scale and limited domestic market, limited industry knowledge among the local financial community, and federal foreign-ownership regulations, all of which can dampen the flow of private investment into the sector.

Lack of Scale and Limited Domestic Market

For the most part, companies in Ontario's cultural media sector are exposed to the same high level of risk brought on by the hit-business environment and demand uncertainty in their industries. However, unlike companies in other jurisdictions, Ontario's cultural media companies lack the scale to effectively mitigate and manage the unique risks inherent to the cultural media industries.

Cultural media companies in Ontario that are too small to achieve the necessary level of scale will often adopt alternative risk-mitigation strategies so that they can continue to create cultural media content and to maintain an ongoing business. Ontario's producers of cultural media content (particularly in film and television production or video game development) can secure sufficient financing from a combination of the marketplace and public subsidy to proceed with a project that pays the producer enough to remain in the business. Either there is a very low expectation of profit or much of the potential profit is transferred along with some of the risk to a supplier of finance, such as a downstream gatekeeper, which has the necessary scale to manage the risk.

In film production, the downstream gatekeeper might be a Canadian or foreign distributor; in television production, it is often a Canadian broadcaster; in the IDM industry, it is global video game publishers. Because of the need to rely on a gatekeeper relationship, many cultural media businesses in Ontario are more akin to the commissioned businesses, where the producer delivers a product for set financing. In many cases, whether the product is a hit or a miss does not directly affect the return to the producer, per se. Thus, most of Ontario's content producers can go from project to project without building a sustainable business. The current public support system in Ontario tends to maintain this kind of business model for many of the province's cultural media industries.

The commissioned-businesses model and the reliance on gatekeepers is not entirely unique to Ontario; however, unlike the United States (U.S.) or U.K., Ontario's cultural media companies have operated in a relatively small domestic market, which can further inhibit their ability to achieve necessary scale. While several of Ontario's cultural media industries, including book publishing, music and IDM, have track records of strong export sales, the creation of cultural media products often first requires success in the home market. Ontario is the leading province for the creation and production of cultural media products for Canada's English-language market; however, the size of this market is less than one-half the size of the U.K.'s domestic market and less than one-tenth the size of the U.S. market. A smaller domestic market means fewer potential viewers, readers and listeners with which to experiment with new content and to amortize the costs of developing and producing this new content.

Another characteristic of the cultural media industries in Ontario is that they must all compete with foreign content (mostly U.S.), albeit to differing degrees. The easy and constant access Ontarians have to this foreign content creates a major challenge for Ontario's cultural media companies, whose promotional budgets are often much smaller than their foreign counterparts.

Lack of Industry Knowledge in the Local Financial Community

The lack of in-depth knowledge of the cultural media sector among financial professionals is a problem outside of Ontario, but there are developments in other jurisdictions that indicate that some steps have been taken to remedy this deficiency. For example, in the U.K., two specialist firms, Pembridge Partners and Ingenious Media, have emerged to fill the niche created by this lack of financing expertise.[8] Both firms specialize in developing financing solutions for cultural media companies and in matching investors with investment opportunities in the cultural media sector.

However, the prospect of such a firm emerging in Ontario is unlikely. While Toronto is Canada's financial centre, it is not considered a centre for media-industry financing: it does not have the depth of financing professionals with sufficient knowledge of the global cultural media industries. Without a financial community equipped to identify, assess and effectively articulate investment opportunities to suppliers of capital, there will be a limit to the flow of financing capital to cultural media companies in the province. Ontario-based companies in the cultural media industries are at a disadvantage to their counterparts in the U.K. and the U.S., which can tap into the deep pool of expertise in London, New York and Silicon Valley. Larger Ontario companies can still access the international financing experts; however, smaller Ontario companies may find such access prohibitively expensive.

The gap in financial expertise can be largely related to the relatively small opportunity perceived by the financial community. Some financial institutions do provide specialized service and expertise where the market is of sufficient size (e.g., interim financing of tax credits for film and television production). Of course, investment by financial institutions in acquiring the expertise and creating useful financial products could help create a larger market, but financial institutions in Ontario have generally attributed a low return on investments (ROI) to such initiatives.

[8] North East Finance (Nstar), *Mind the Gap: Investment funding between start-up and high growth*, downloaded on July 3, 2005, at http://www.nstarfinance.com/documents/mind-the-gap.pdf, p. 1.

Foreign Ownership Rules

All of the cultural media industries in Ontario, with the exception of the IDM industry, are subject to some type of federal regulation affecting their ability to raise financing from outside of Canada. One obvious potential way to overcome the lack of local financial community knowledge would be to seek out financial community assistance outside the country. However, the federal foreign-ownership statutes, and other regulations governing non-Canadian investments in cultural media companies and products, complicate and even forestall such outside advice and associated investment. In effect, the province's cultural media sector is largely captive to the Toronto or Canadian financial marketplace. This deficiency not only limits the ability to obtain expert financing advice for small, medium and large companies, but also reduces the pool of financing capital from which the sector can source investment capital.

The Need for Government Intervention in Ontario

Cultural media companies in Ontario experience many of the same financing challenges as cultural media companies around the world because of the hits-business nature of the industries, demand uncertainty, and the lack of business-manager skills and financing-community knowledge. However, Ontario's cultural media companies face an even higher financing hurdle than some of their counterparts in other countries: they lack the scale sufficient to mitigate the risk that comes from a hits business and demand uncertainty. In part, this lack of scale can be tied to the limited size of the domestic market in which Ontario's cultural media companies operate. The limited industry knowledge within the Canadian financial community and the constraints of federal foreign-investment rules introduce another set of Canada-specific or Ontario-specific challenges.

Like other Western governments, the Ontario government recognizes the important economic benefits that flow from a growing cultural media sector. The provincial government has already responded to the unique financing challenges of the cultural media industries in Ontario by implementing numerous fiscal support programs over the years. Despite the challenges they continue to face, the cultural media industries in Ontario are an important part of the province's economy; however, if the industry is to continue to thrive and to be globally competitive, more innovation in incentives or mechanisms for attracting more financing capital may be required. (For more information on the current size of the Ontario cultural media sector in terms of revenues generated, please refer to Appendix A.)

In the next section, we review the existing array of public support mechanisms available to Ontario's cultural media companies.

2.4 Review of Existing Public Financing Mechanisms

Federal and provincial governments' financing mechanisms for the cultural media industries largely support content production, although there are some programs to support other aspects of the value chain, including development, distribution and marketing.

Canada, like many countries, has a strong policy foundation for promoting the creation of cultural-media content. There is a genuine need for enabling Canadian creators to express themselves, and for

Canadians to have access to Canadian voices and stories. This policy foundation has provided the basis for the federal government's financing support for the cultural media industries over the past several decades. Canada's provinces have also taken a very active role in implementing their own systems of financial support for the cultural media industries. Much of this support (e.g., tax credit support) has been based on a rationale that explicitly recognizes the value of the cultural industries as economic drivers, while other support (e.g., Ontario Arts Council grants) has been provided for a variety for social and cultural reasons. Today, as a result of federal and provincial policies, the cultural media industries in Canada have access to a wide array of financing mechanisms. Generally speaking, these mechanisms tend to be either tax credits or direct subsidies.

Ontario Government Support

Ontario's financial support for the cultural media sector is centred on the six tax credits that it currently has in place for five of the six cultural media industries (the exception being the magazine publishing industry). For most of these five industries, tax credits account for the largest share of financial support. The tax credits largely support the *production* of cultural media properties. In effect, the tax credits subsidize the cultural media companies' production expenditures, specifically expenditures on Ontario-resident labour or purchases of goods and services within the province. However, the tax credits for book publishing, sound recording and interactive digital media also provide support for marketing and distribution.

The Province's tax credit support is complemented by *directed value-chain support*. That is, support for specific initiatives at various points along the content value chain. This directed value-chain support is largely in the form of interest-free loans, repayable advances or grants to support specific project-related activities such as development, marketing, distribution or export development. Both the tax credits and the directed value-chain support are tailored to the specific needs of each cultural media industry.

Federal Government Support

Ontario's cultural media companies can also access a wide array of federal support programs specifically tailored to their respective industries. For film and television production, labour-based tax credits represent one of the largest forms of financial support; these tax credits are complemented by direct contributions for all aspects of the film and television value chain. For television, the federal government's parliamentary allocation for CBC/Radio-Canada is the largest single expenditure for a specific cultural sector, namely public broadcasting.

For the other cultural media industries, the federal government delivers most of its financial support through direct grants to support the creation of Canadian content, the distribution of this content and, in some cases, the promotion of this content and the artists who create it. Some of the federal support mechanisms (e.g., the Canada New Media Fund [CNMF] and the Canadian Feature Film Fund [CFFF]) contain components to assist all three major value-chain stages (development, production and marketing/distribution). While some of these mechanisms are called conditionally repayable loans (e.g., the CNMF), the low level of repayment effectively renders them direct grant support programs.

Lack of Support for Building Companies

The financing mechanisms at both the provincial and federal levels are designed to support particular cultural media initiatives or projects; they do not seek to support cultural media companies, per se. What is more, existing financial support is not designed in any manner to attract a significant amount of voluntary or market-driven private investment or to encourage financial institutions to extend additional credit to cultural media companies. While many of the existing financing programs have become essential elements in financing the creation of Canadian cultural media properties, they are not designed with the financial capitalization of cultural media companies at the forefront.

So, while the existing programs have been very effective in promoting the creation and distribution of Canadian content, they have not, arguably, made a significant contribution to corporate development and sustainable growth within Canada's cultural media industries. As such, there appears to be a gap in the financing ecology of Canada's and Ontario's cultural media sector. There is room for new financing vehicles that can help proven and emerging high-potential companies in the cultural media industries to attract the private financing or bank credit they need to create IP, to improve their financial performance and to grow.

2.5 Key Financing Challenges

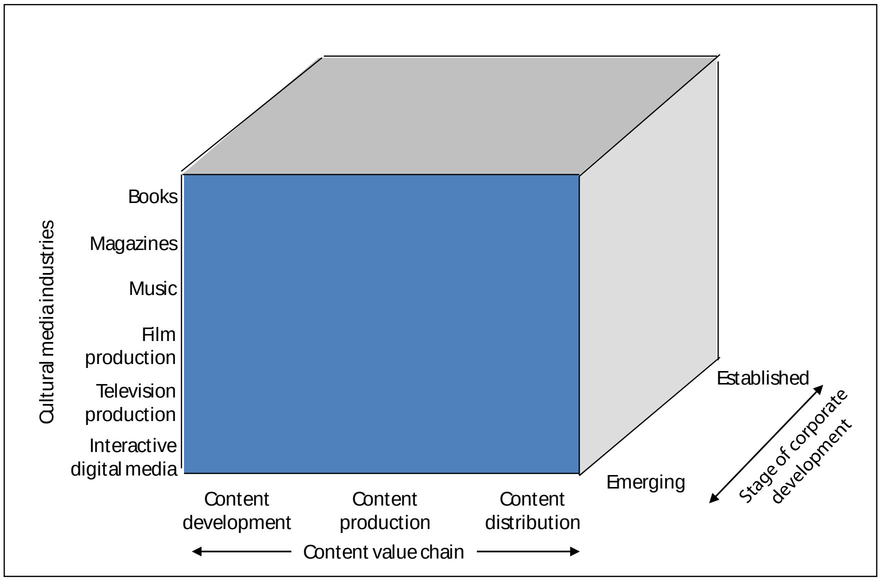
All of Ontario's cultural media industries face financing challenges that are inhibiting them from effectively responding to and capitalizing on the transition to digital.

When analyzing the financing challenges in the cultural media sector, it is important to recognize that these financing needs will vary widely within the sector itself. As a guide to an analysis of the financing needs in the cultural media sector, it is therefore useful to adhere to a three-dimensional framework. This framework, as represented by Figure 1, recognizes that the financing needs vary from industry to industry (e.g., book publishing vs. interactive digital media), vary along the cultural media value chain (content development to content distribution) and vary through various phases of corporate development. Each axis of the below cube represents one of the three key considerations needed when examining a cultural media company: place in the content value chain (x-axis), cultural media industries (y-axis) and stage of corporate development (z-axis).

Financing needs also vary across the content value-chain. Companies engaged in content development require different types of financing from those engaged in content production. Content development typically requires much smaller investment than production, but the conversion rates (i.e., the rate at which development ideas can be converted to production projects) can be as low as 10% to 20%. Meanwhile, the content distribution end of the content value-chain requires financing that facilitates the acquisition and retention of content rights, as well as the marketing of these rights.

Cultural media companies' financing needs also change as they move through various phases of corporate development. An early-stage company with little track record will undoubtedly have a significant financing shortfall: the financing needs warranted by its business plan cannot be met by private sources of capital. Mature companies may be seen as stable, but could be operating in highly competitive industries where low profit margins make it difficult to attract the type of risk capital required to expand into faster-growing industries. For Ontario's cultural media industries, our research indicates that financing needs depend largely on whether a company is *emerging* or *established* in its own market.

Figure 1: Framework for analysis of financing gaps and challenges



While the financing needs of cultural media companies can vary across each of these three axes, the three-dimensional framework also recognizes that there are commonalities across the cultural media industries. Identifying such commonalities can aid in tailoring new financing vehicles to be applied across all six cultural media industries, as digital convergence reduces the clear distinction that has existed between the industries.

It should be noted that the cultural media industries are experiencing tremendous threats to their business models. In some cases, digitization has led to piracy and uprooted many of the traditional business models for cultural media content. Digitization and the Internet have also raised the competitive forces experienced by Canadian content producers. Canadians now have more low-cost options for accessing international content than ever before. For those cultural media industries that have traditionally relied on advertising revenues, fragmentation and the migration of advertising dollars have put tremendous pressure on advertising rates. New financing vehicles cannot ameliorate these business-model pressures, but they can help many of Ontario's cultural media companies to adapt their business models by investing in new methods for distributing content and engaging audiences. In this regard, such companies that can exploit the digital distribution channels might be better positioned to leverage the changing marketplace.

2.5.1 Key Financing Challenges by Industry

While Ontario's **book publishing** industry is established (several publishing companies have been in operation for 30 years or longer), concentration at the retail end of the value chain and intense price competition arising from American publishers and used books are putting tremendous pressure on profit margins. Book publishers are unable to accumulate the retained earnings needed to invest in digitization initiatives or the development of larger slates of titles. What is more, book publishers also experience unpredictable cash flow, particularly because there is always a risk that retailers will return unsold inventory. [9]

Ontario's **music** industry, particularly the sound recording labels, continues to be dogged by illegal downloading that hamper the industry's ability to generate revenue from digital music recording. As Ontario's music industry comes under revenue pressure, the need for expanding international markets is greater than ever. Where Ontario's music companies utilize tax credits or other industry-promotion funding, cash flow can be stressed as music companies have to wait several months to receive disbursements. Music companies in Ontario have also experienced difficulties in attracting and retaining trained business professionals with the necessary skill sets to address the above challenges.[10]

Table 1: Key financing challenges in Ontario by cultural media industry

Industry	Key financing challenges
Book publishing	• Production costs are static or even increasing in some cases. Low margins prevent companies from accumulating sufficient levels of retained earnings to invest in a larger slate of titles or in new business opportunities. • Book publishing is considered a relatively stable industry, but because of its low profit margins, it is also unable to attract risk capital. • Despite the long-term financial stability of the industry, cash flow can be unpredictable in the short-term.
Music	• Illegal downloading is putting pressure on business models. Because of piracy there is a perception that the music industry has a weak revenue base, making it difficult to attract investment. • Delays in the disbursement of industry-promotion grants (e.g., FACTOR grants) and, to a lesser extent, tax credits lead to cash flow challenges. • A lack of financing capital prevents companies from exploiting the full international potential of the IP under their control. • Some companies are underdeveloped with respect to business acumen and training.
Magazine publishing	• A high reliance on advertising sales is putting pressure on revenues, leading to slim profit margins, particularly among SMEs. • Intense advertising-price pressure arising from international and other online competition is also putting pressure on revenues. • Online initiatives can be costly and tend to require significant investment.

[9] These concerns were expressed in both Castledale Inc and Nordicity Group, *A Strategy for the Book Publishing Industry in Ontario,* OMDC, September 2008, and the Organization of Book Publishers of Ontario (OBPO), *Publishing Stabilization: A Discussion Paper*, OMDC, March 2009.
[10] See: Nordicity Group. *A Strategic Study for the Music Industry in Ontario,* OMDC, September 2008.

Industry	Key financing challenges
Television production	• Companies must wait as long as 18 months for disbursement of tax credits; this leads to significant interim financing costs. • Companies lack the financial resources to engage in a broader range of content development. (OMDC's pilot Intellectual Property Development Fund was designed to address this need.) • Companies have been largely operating as "manufacturers" for Canadian broadcasters, who are exacting more rights and longer terms from independent producers. • The limited value of rights libraries for Canadian programming has made it difficult to attract outside capital.
Film production	• Companies must wait as long as 18 months for disbursement of tax credits; this leads to significant interim financing costs. • Companies lack the financial resources to undertake the extensive development (e.g., script writing) required to improve their chances for success. (OMDC's pilot Intellectual Property Development Fund was designed to address this need.) • Access to international distributors can require complex co-production arrangements to mount a project of sufficient production value to be globally successful. • Domestic distribution is a problem for feature film producers in English Canada. Companies struggle to access domestic screens and adequate marketing support. As a result, domestic box-office share is consistently low.
Interactive digital media	• A lack of available patient capital makes it difficult to produce more of the expensive formats (e.g., for consoles). • The games developer-publisher typically means that projects can be financed, but very little, if any, IP can be retained by the developer. • Tax credits and directed value-chain support with completion or other conditional requirements hamper the flexibility of managers to quickly deploy capital where needed in the product development cycle. Currently, the tax credits are only available upon completion of the development cycle and not available if the product, for some reason, is not developed. This inhibits the ability to finance the tax credits.

Source: Nordicity research

At a time when **magazines** in Ontario should be investing in new forms of content distribution, they are under severe economic strain. They have a reliance on advertising revenues, which are both in the midst of a cyclical nadir and secular-trend migration to online sources upon which magazine publishers have limited claim. The Internet has also introduced more international competition to Ontario's magazines. As such, there is an urgent need for external financing to develop new editorial content and to utilize the Internet to defend and expand readership.[11]

Television producers have been increasingly operating as *manufacturers* for Canadian television broadcasters, who try to obtain all programming and non-programming rights for an ever-increasing duration. Producers recover only part of the cost of production through the sale of their television

[11] See: TCI Management Consultants, *A Strategic Study for the Magazine Publishing Industry in Ontario,* OMDC, September 2008.

programs to a Canadian broadcaster. They cover off a substantial portion of their budgets through a variety of public support (mainly tax credits and CTF funding), and increasingly require a foreign pre-sale to complete the financing. Without their own capital base, Canadian producers face key financing challenges: they lack the financing capital to engage in more development; they have to devote a significant part of their financial resources to cover the cost of interim financing of their tax credits; and they have to resort to gap financing or distribution advances rather than to obtaining full distribution revenue benefits if they could finance distribution on their own. Thus, they typically rely mostly on producer fees for their return from the risks they take in mounting a project.[12]

Film producers do have access to an array of public financing (mainly tax credits and the Canadian Feature Film Fund). They also have access to private interim financing for tax credits. However, they do not have access to the same buyer infrastructure as their television counterparts. Canadian distributors guarantee low amounts relative to the production budgets, and the distributors keep the downstream television market (e.g., pay-TV). Foreign distribution and financial advances are very difficult to obtain without quite complex co-production arrangements. Aside from being rare, Canadian feature film hits do not return enough to the producers to pay for the many projects that are *not* hits.

Ontario's **interactive digital media** companies need flexible capital that they can deploy, as needed through the product-development cycle. Because distribution is very concentrated and business models far from certain, they have limited leverage. The games component would benefit from financing sources that permit them to do more self-distribution or give them more negotiation leverage, so that they do not have to relinquish all of their rights to publishers.[13]

2.5.2 Key Financing Challenges by Stage of Content Value-Chain

Despite the several federal and provincial government programs available for **content development** financing, there appears to be a need for more. In most of the cultural media industries, development is undertaken largely through self-financing. Financing models where the risk and reward might be shared between cultural media companies and financing sources might help draw more financing into this aspect of the value chain.

With the availability of tax credits, most of Ontario's cultural media industries have access to sufficient amounts of **content production** financing. However, the precarious position of particular content buyers, such as television broadcasters, which depend on advertising revenues or are threatened by new distribution models, may put pressure on other sources of production financing. Thus, there is a risk that a large production financing gap might emerge in certain cultural media industries. In addition, tax credits have been in existence for many years and were not originally designed for the current multi-platform distribution models that are emerging. Unless addressed, this gap in the regulations surrounding tax credits could negatively impact the ability of new projects to obtain sufficient financing for their projects.

[12] See: PwC/Nordicity Group, *Economic Study for the Film, Television, and Digital Media Sector in Ontario*, OMDC, October 2006.
[13] See (for video games): SECOR Consulting, *Ontario 2012: Stimulating Growth in Ontario's Digital Game Industry,* OMDC, August 2008.

Table 2: Key financing challenges by stage of content value-chain

Stage of content value-chain	Key financing challenges
Content development	• With the exception of the Intellectual Property Development Fund and some other public subsidies, there is very limited external financing available for development of cultural media content. • Low success rates of 10% to 20% can inhibit external investment; cultural media companies have to rely on self-financing in many cases.
Content production	• Companies require solutions that can reduce the financing costs that often accompany the delay between the start of content production and the delivery of final content. • Economic and technological forces are putting pressure on certain buyer groups (e.g., television broadcasters). Threats to media revenues put pressure on prices and on buyers to demand more rights.
Content-distribution	• Most of Ontario's companies lack the scale to compete in the global distribution of their cultural media products. • Companies require financing that will permit them to retain more rights in IP and to build libraries comprised of this IP. • Companies require financing support for marketing and sales development efforts, and to develop distribution activities.

Source: Nordicity/PwC research

Of all points along the cultural media content value-chain, scale is most critical in **content distribution**. Ontario's cultural media companies lack the scale to compete in global distribution. This lack of scale presents challenges in both the international sale and promotion of cultural media products. As a result, they often end up pre-selling international rights to larger companies better able to absorb the risk. Financing vehicles that would assist Ontario's cultural media companies in retaining more of the rights to their content, and in marketing this content on an international basis, would start to address the content-distribution financing challenge. With the exception of the magazine publishing industry, Ontario's cultural media companies increasingly find that they must compete and sell on an international basis. The Canadian market is generally too small to cover all the production costs. Furthermore, Canadian companies are experiencing increasing price pressures in Canada and are losing market share to foreign content.

2.5.3 Key Financing Challenges by Phase of Corporate Development

While there are traditionally four distinct phases to corporate development (early-stage, start-up, fast-growth and mature), Ontario's cultural media industries can be classified into two distinct phases: emerging and established.

Emerging companies are cultural media companies that have only been in operation for a short period of time. They have not yet reached a level of financial performance where they can internally finance their own content development or retain content rights in order to develop their own IP libraries.

The emerging companies that participated in our primary research indicated that patient risk capital that they could deploy as needed through their businesses—in contrast to tax credits tied largely to production expenditures—would offer them the flexibility to capitalize on their fast-changing industries.

Emerging companies also reported experiencing some difficulty in obtaining bank credit on reasonable terms.

Established companies are companies that have been in operation for several years and have significant experience creating and selling their content. They are likely to have proven track records of financial performance. However, such companies might now find themselves in a position where they have to expand into new markets or new products, or to retain more rights, so they can improve their profitability and position themselves for sustainable growth.

Table 3: Key financing challenges by phase of corporate development

Stage of corporate development	Key financing challenges
Emerging companies	• Companies require patient and agnostic financing capital that they can deploy across the content-development cycle, as needed. • Companies would benefit from the ability to obtain bank credit on better terms.
Established companies	• There is a lack of financing capital to pursue the full extent of content development needed to be successful. • Companies often have difficulty attracting financing to pursue new business opportunities (e.g., online distribution). • There is a lack of financing to pursue international marketing efforts and to retain control of international distribution. • Companies need better capitalization, so they are better positioned to retain rights to their own content.

Source: Nordicity/PwC research

The more established cultural media companies that participated in our primary research indicated that they would most benefit from financing support for development and marketing/distribution. Established companies appear to be able to raise financing and utilize tax credits for production; they believe they can best grow their businesses by engaging in more content development and by expanding their markets outside of Canada. At the same time, established companies could also benefit from better cash flow and lower interim financing costs.

2.5.4 Summary and Assessment

Our review of the financing challenges within Ontario's cultural media industries indicates that there are some areas of commonality, particularly when viewed through the lenses of the value chain or two phases of corporate development. Our review also indicates that there are some clear industry-specific challenges that the Province may choose to address by way of new financing vehicles.

All of the cultural media industries are grappling with the effects of digitization and heightened international competition in some manner. This technological challenge is forcing them to explore content innovation and new business models. Ontario's cultural media companies appear to lack sufficient risk capital at the very time when they need it most, so that they can respond and capitalize on digitization. Some cultural media industries' ability to raise risk capital is affected by limited pricing power, low margins and low growth prospects; others lack the scale to be true global competitors. A financing vehicle for attracting private risk capital to the cultural media sector is therefore warranted, so that cultural media companies can invest in response to these global forces. However, such a financing vehicle would serve each industry to a different degree.

All of the cultural media industries are experiencing cash-flow strains. In some cases, these strains are related to the timing of provincial and federal tax credits. In other cases, these cash-flow strains are related to other public funding or general receivables.

While the Province does already provide some support for content development and marketing and distribution, established cultural media companies contend that more financial support at both ends of the value chain would significantly accelerate growth, sustainability and employment. Indeed, such value-chain support may prove to be more efficient than risk capital in addressing the challenges of digitization and international competition.

Our research of the financing challenges in Ontario's cultural media industries suggests that there is a need for cultural media companies to attract equity investments, to have some type of credit-support mechanism and to add additional forms for directed value-chain support. In the remainder of this report, we explore the types of financing vehicles that fit within these three categories.

3 Incentives for Private Equity Investment

Some type of tax incentive would encourage private investors to purchase equity in cultural companies, which are considered relatively high-risk.

In this section, we review two financing vehicles designed to attract private equity investment to the cultural media industries. The overriding goal of equity investment vehicles is to attract *risk* capital, including more patient capital to cultural media companies. This type of financing plays a crucial role in the development of globally competitive content and sustainable corporate growth. Private equity investment offers cultural media companies the risk tolerance and investment time horizon that affords them the opportunity to experiment and to develop innovative new IP content.

Private equity investment is typically unsecured by an asset or income stream, although certain types of equity financing vehicles can be tied to a royalty-based income stream. It is the relatively risky nature of private equity investment that makes it one of the highest-cost forms of financing for the financing recipient. To obtain private equity investment, the recipient must be able to offer the investor a relatively high expected return.

3.1 Tax Incentives for Direct Equity Investment

3.1.1 Overview

Many other jurisdictions provide tax incentives for individuals and corporations to invest in SMEs, both in very high-risk industries and in other under-capitalized segments of the economy.

It is very common for governments to offer some type of tax incentive to attract financing capital to industries or business endeavours that are receiving capital inflows that are less than optimal from a social welfare or policy perspective. Furthermore, tax incentives allow governments to address such market failures and to fill these financing gaps with minimal government influence on the investment-selection process. Private investors make the investment decisions; however, government provides some cushion to any losses that the investor might experience.

Representatives from the industry advisory committees, specifically those representing the film and television production and interactive digital media industries, expressed interest in new financing vehicles that would assist them in attracting direct equity investment to raise the significant upfront capital necessary for development. As previously noted, a tax incentive might motivate investors to become more knowledgeable and would provide a suitable mechanism to encourage private investment that is otherwise hard to obtain due to difficulties in valuing cultural media companies. In addition, a tax incentive would bridge the perceived unattractive risk-reward ratio dominant in the cultural media industries.

Under the direct equity investment model, the Province and the federal government could use a variant of *flow-through* shares (as is currently used in the Canadian energy and mining sectors) or some type of investment tax credit to induce Ontario taxpayers—individual and corporate—to invest directly in cultural media companies. The Province could also design such a direct equity investment model to accommodate investment in projects or slates of projects, which would permit investors to avoid company-specific equity risk and be closer to the IP income stream. The fact that projects in two of the cultural media industries (film and television productions) are actually produced by single-purpose corporations would facilitate a project-investment or project-portfolio-investment approach.

Flow-through Shares

Use of flow-through shares is one form of tax incentive for direct investment. This mechanism is widely used in Canada's mining and energy sectors, and therefore is well-understood in the financial community. Flow-through shares are a type of share where there is an agreement between the corporation and the investor, whereby the Canadian exploration expenditures of the corporation are *renounced* to the investor in exchange for the consideration received by the corporation for the shares. Since the corporation requires a large amount of upfront capital, but does not expect to be profitable in the first few years of operation, it is able to raise capital and transfer the deductible expenditures to its investors. Each investor's net investment is effectively reduced to nil as a result of the allocation of deductible expenditures that reduce his or her taxable income. At a future date, the investor can sell the flow-through shares and have the appreciation in the value of the shares taxed at the more preferable capital gains taxation rate (one-half of the taxpayer's income-tax rate). In this regard, flow-through shares can greatly improve the risk-reward ratio for investors by reducing the net after-tax cost of an equity investment for taxable investors, particularly those at a high marginal tax rate.

A variant of the flow-through share model found in the mining sector could be applied to Ontario's cultural media sector. There are some important similarities between the cultural media companies and junior mining companies in terms of risk and cash flow that could make flow-through shares a very suitable tax incentive for attracting direct equity investment. As in the mining industry, companies in many cultural media industries (in particular, film and television production and interactive digital media) require significant upfront capital, expect little or no taxable income during the creation of the IP (and the early years of the exploitation of the IP) and face a very high degree of risk. Flow-through shares would be ideal for this cash flow pattern.

Still, since corporate tax filing in Ontario is harmonized with federal filings, the provincial legislation required to implement such a tax incentive would be difficult to structure without a corresponding federal change. In other words, a tax credit would have to be designed that would effectively replicate the taxation impact of flow-through shares. Such a tax credit, however, could be complex as it would have to take into account each taxpayer's federal and provincial marginal tax rates and his or her capital gains tax circumstances.

Investment Tax Credits

As an alternative to flow-through shares or an equivalent tax credit, the Province could consider a straightforward investment tax credit to provide an upfront rebate to individuals or companies making equity investments in cultural media companies. The Province is already familiar with the use of investment tax credits as mechanisms for attracting capital to SMEs. Since 1991, Ontario taxpayers have been able to obtain a 30% tax credit rebate (15% federal, 15% provincial) for investing up to $5,000 in one of several labour-sponsored venture capital funds. These funds, in turn, have been making direct investments in Ontario companies in accordance with regulations, which compel the funds to seek investments that promote, among other things, job creation and regional development.

While the Province is phasing out its tax credit for investments in labour-sponsored funds, tax incentives for direct investment in SMEs or specific industries are in place in many other jurisdictions. In the U.K., individual investors can use the Enterprise Investment Scheme (EIS) program to obtain a 20% tax credit and preferential treatment of capital gains for investments in higher-risk trading companies (see the next page). In British Columbia, the B.C. New Media Venture Capital Tax Credit (see next page) offers venture capital corporations a 30% non-refundable tax credit on investments in eligible new media companies. The B.C. New Media Venture Capital Tax Credit is subject to a maximum of $60,000 per investor per taxation year. Ontario could make an investment tax credit available to individuals, to corporations, to venture capital companies or to other investment corporations who invest in cultural media industries. It could operate in a similar fashion to the EIS in the U.K. or to the B.C. New Media Venture Capital Tax Credit.

U.K. Enterprise Investment Scheme (EIS)

The EIS is designed to help smaller, higher-risk companies to raise financing by offering a range of tax relief to investors who purchase shares in these companies. This tax structure offers the following types of benefits to investors:

- **Income tax relief**: If an EIS qualifying investment is held three years from the date of issue or from commencement of trade, an individual with no more than a 30% interest in the company can reduce their income tax liability by an amount equal to 20% of the amount invested. The minimum subscription is £500 per company and the maximum per investor is £500,000 per annum. Where an individual subscribes for qualifying shares before October 6th in a tax year, a claim may be made to carry back one-half of the amount subscribed to the previous tax year, subject to a maximum of £50,000.
- **Capital Gains Tax Freedom**: No Capital Gains Tax is payable on disposal of shares after three years, or three years after commencement of trade, if later, provided the EIS initial income tax relief was given and not withdrawn on those shares.
- **Capital Gains Tax Deferral Relief**: Tax on gains realized on a different asset can be deferred indefinitely, where disposal of that asset was less than 36 months before the EIS investment or less than 12 months after it. Deferral relief is unlimited; in other words, this relief is not limited to investments of £500,000 per annum and can be claimed by investors (individuals or trustees) whose interest in the company exceeds 30%. This can be done on a sequential or serial basis.
- **Loss Relief**: If EIS shares are disposed of at any time at a loss (after taking into account income tax relief), such loss can be set against the investor's capital gains or his income in the year of disposal or the previous year. For gains offset against **income tax**, the net effect is to limit the investment exposure to 48p in the £1 for a 40% tax payer if the shares become totally worthless. Alternatively, the losses can be offset against **Capital Gains Tax** at the prevailing rate—18% from tax year 2008-09.

B.C. New Media Investment Tax Credit

Launched in 2003, the British Columbia government dedicated approximately $5 million under its Equity Capital Program for "seed" or early-stage investment in small interactive digital media companies. The tax credit is intended to lever up to $17 million in private capital for early-stage investment.

The initiative offers a 30% tax credit (refundable for individuals and non-refundable for corporate investors) on investments in eligible companies, and it is ideal for investors who want to be actively involved in the growth of small businesses in this emerging sector.

Investment tax credits can be very potent mechanisms for attracting risk capital. In the U.K. (an economy that is approximately six times the size of Ontario's economy), between 2002-03 and 2006-07, more than 2,000 SMEs utilized the EIS to raise an annual average of $1.2 billion (all historical amounts converted to Canadian dollars at current exchange rate) in equity financing. Since its inception in 1994, the EIS has helped SMEs in the U.K. raise over $11 billion in risk capital.

Table 4: EIS statistics by year

	Number of companies raising funds	Amount of equity investment (£ millions)	Amount of equity investment (C$ millions)*
2002 to 2003	2,455	667	1,200
2003 to 2004	2,172	627	1,129
2004 to 2005	2,184	605	1,088
2005 to 2006	2,126	645	1,161
2006 to 2007*(p)*	2,062	699	1,257
Average	2,200	648	1,167
Five-year total	--**	3,342	5,835
All years total	--**	6,276	11,246

Source: HM Revenue & Customs, "Enterprise investment scheme: Table 8.1 - Companies and amount of investment, number of subscriptions, business angels and amounts invested," *HM Revenue & Customs*, downloaded on June 28, 2009, http://www.hmrc.gov.uk/stats/ent_invest_scheme/menu.htm.

p - Provisional

* All historical amounts converted to Canadian dollars at current exchange rate of C$1.8 per £1.

**The total is not reported because companies may raise financing in more than one year.

Table 5: EIS statistics by industry, 2006-07

	Number of companies raising funds	Amount of equity investment (£ millions)	Amount of equity investment (C$ millions)*	Percentage share of total financing raised
Agriculture, forestry and fishing	15	6	11	1%
Hi-tech companies**	564	177	319	25%
Energy and water supply	24	12	21	2%
Manufacturing	300	67	121	10%
Construction	31	8	14	1%
Distribution, restaurants and catering	372	145	260	21%
Transport and communication	66	31	56	4%
Business services	427	130	234	19%
Other services	263	122	219	17%
Total	2,062	699	1,257	100%

Source: HM Revenue & Customs, "Enterprise investment scheme: Companies and amount of investment, by industry," *HM Revenue & Customs*, downloaded on June 28, 2009, http://www.hmrc.gov.uk/stats/ent_invest_scheme/menu.htm.
Note: all amounts are provisional.
* All historical amounts converted to Canadian dollars at current exchange rate of C$1.8 per £1.
**Includes instrument engineering, some chemicals, R&D, computer consultancy plus others.

In recent years, most investment relating to the EIS has been concentrated in a few sectors: high-technology; distribution, restaurants and catering; and business services. While the published EIS statistics do not break out the financing levels for the cultural media industries, they would fall within the transport and communications industry category, which accounted for only 4% of total financing raised in 2006-07. As such, it would appear that the EIS may not have played as significant a role in the financing of cultural media companies as it did for SMEs in other industries. This outcome may have, in part, been a function of the fact that the provisions of an economy-wide tax incentive such as the EIS have presented some challenges for cultural media companies. For one, the fact that the EIS requires the recipient company to hold the copyright to any intellectual property it sells has precluded many distribution companies from accessing the EIS.[14] This drawback of an economy-wide tax credit underlines the need to design an investment tax credit that is customized to the business models and corporate structures unique to the cultural media sector.

While the EIS appears to have been very effective at helping SMEs in certain industries in the U.K. to attract equity capital, recent research suggests that its impact on even these companies' financial performance and long-term sustainability is somewhat uncertain. A recent Institute for Employment Studies (U.K.) study performed a detailed econometric analysis of the effect of EIS investment in companies. The study revealed a strong association between investments made under EIS and general capacity building (of fixed assets and employment) on the part of the recipients. An expansion in sales was also noted. There was, however, no corresponding rise in the profitability of funded companies. The positive and negative impact of EIS investment seemed to depend largely on the size and age of the company, with lesser impacts observed in larger and older companies, particularly in the case of profitability.[15]

[14] HM Revenue & Customs, "Introduction," *HM Revenue & Customs*, downloaded on June 28, 2009, http://www.hmrc.gov.uk/stats/ent_invest_scheme/menu.htm.
[15] Institute for Employment Studies, *Impact of EIS and VCT on company performance*, University of Exeter, 2008, p. 49.

3.1.2 Design Considerations

Flow-through Shares

There are significant design issues related to flow-through shares. Federal government support would be required for any implementation of a flow-through share scheme for the cultural media industries. The federal government would have to amend the relevant legislation (section 66 of the *Income Tax Act, Canada),* which contains the rules governing the flow-through shares for the mining industry, so that cultural media companies' expenditures could be eligible for renunciation.

Even if issues associated with legislative barriers could be resolved, most cultural media companies in Ontario are privately held. Because most cultural media companies do not trade shares on a public exchange, they are more difficult to value and do not provide investors an easy manner by which to buy and sell shares. The *Income Tax Act, Canada* does contain provisions that allow flow-through shares to take the form of either publicly or privately placed shares. However, the fact that many Canadian mining companies are publicly traded has probably contributed to the popularity of flow-through shares because investors can expect a certain degree of investment liquidity and market valuation. They would not enjoy the same level of liquidity and market valuation in the case of privately held shares in cultural media companies.

Cultural media companies could still choose private placement of their shares; indeed, many Canadian investors are currently using flow-through shares to invest in private companies, and they have developed approaches to address liquidation and valuation issues. That said, many cultural media companies might still need to structure their flow-through share investments to make their shares more attractive to investors. In the film and television production industries, for example, companies interested in raising funds through flow-through shares might have to consider doing it for a slate of projects that could be packaged by investment advisors and sold to investors. To make them attractive to investors, it would be important for cultural media companies to offer investors the opportunity to invest as close as possible to an identifiable cash-flow stream. In other words, to encourage investment, investors would need their repayment schedule to be based on predictable sources of income, like royalty payments. Furthermore, investors would need assurance that they would have favourable positioning within the recoupment schedule. This would allow them to better assess the investment prospects and to gain better access to more immediate returns.

In the Canadian mining industry, where the vast majority of flow-through shares are traded on public markets, investors are not only attracted by the upfront deduction applicable to their taxable earned income, but also to the tax credit and the prospect of selling their shares at a capital gain that would be taxed at 50% of the their marginal tax rate. However, because most cultural media companies in Ontario are not publicly traded, they cannot offer investors the same level of liquidity and ease of valuation. This lack of liquidity and a valuation mechanism could significantly dampen investor interest in flow-through shares for companies in the cultural media industries.

Cultural media companies could, however, offer alternative mechanisms for investors to extract economic value from their investments. Although beyond the scope of the report, it may be possible to look to the mining industry for examples of how this issue has been addressed. For example, partnerships that evolved in the mining industry that own a slate of investments of flow-through shares.

Any tax incentive for investors, flow-through shares included, has the risk of potential misuse. To minimize this risk, the Province could adopt risk mitigation strategies used by the mining sector and the experience gained from other tax incentive programs (e.g., the capital cost allowance film tax shelters). Cultural media companies that subscribe to a flow-through share scheme must also be aware of the risks they face. For example, the issuer of the flow-through shares should have to indemnify investors for losses of tax deductions in the event that the issuer does not live up to its commitment to make and renounce the qualifying development expenditures.

Investment Tax Credits

While an investment tax credit would encourage investment into cultural media companies, there are a few key areas to consider when designing such a program.

First, while equity investments in the corporate entity itself would encourage capacity building, unless properly designed, it is uncertain that such incentives would necessarily lead to the ownership and exploitation of the intellectual property of the company.

Second, from a policy perspective, governments prefer to design tax incentives that prevent doubling up on deductions. In this case, the Province would have to put controls in place to prevent investors from claiming the investment tax credit as well as some portion of the expenditure tax credit. The investment tax credit would need to be on the investment in shares of the cultural media company and would not be linked to underlying costs incurred by the company (e.g., for a particular project or capital investment). The qualification criteria would need to be carefully developed to prevent abuse or doubling up on the incentives. This potential abuse could also be alleviated by ensuring that only direct investments in the company carrying on the business were allowable.

Finally, this approach would necessitate very intricate guidelines to define the type of companies that would be eligible for the investment tax credit, although one option would be to use the company-eligibility guidelines already in place for the expenditure tax credits. However, unlike flow-through shares, there would be no need for the Province to define the types of eligible expenditures for the investment tax credit. The Province would also have to establish restrictions on the holding period of the equity investment to preclude investors seeking quick tax savings. The EIS uses a three-year minimum; the Province's own tax credit for investments in labour-sponsored venture capital funds – to be phased out by 2012 – was eight years.

As noted earlier, the Province would have to consider how it could encourage the investment industry to market the investment tax credit product to potential investors in Ontario without having to pay considerable management or sales fees, which would erode the amount of financing capital ultimately reaching the desired recipients.

3.1.3 Cost-Benefit Analysis

Flow-through Shares

Flow-through shares shift the tax deduction of the costs incurred by a cultural media company from a corporation to an individual. The cost of this shift has two parts: (i) the difference in tax rates between corporations and individuals, and (ii) the difference between income and capital gains tax rates that would apply on any future disposition of the shares of the entity. As a result, flow-through shares may be more cost effective than an investment tax credit since flow-through shares only give rise to a deduction of expense once, if renounced either by the company or the individual. The company would therefore be subject to a higher level of tax on any income earned and not able to obtain a deduction of the expenses that were renounced.

To illustrate the benefit of flow-through shares, we offer an example based on ordinary flow-through shares available to Canada's mining industry. For an Ontario taxpayer in the top marginal tax bracket (federal 29%, Ontario 17.4%), a $1,000 investment in mining industry flow-through shares generates a combined federal and provincial income-tax rebate of $464, once all the renounced expenditures have been passed through to reduce the cost base of the flow-through share investment to zero. The $464 income-tax rebate includes federal income tax savings of $290 and provincial income tax savings of $174. So, the net cost of the investment to the taxpayer is $536 after these income tax deductions ($1,000 – $464 = $536).

As the company issuing the flow-through shares (the "issuing company") can no longer claim an income deduction for the renounced expenditures, the federal and provincial governments have the potential to recover approximately $335 in corporate income tax from the issuing company if and when the issuing company ultimately earns revenues. For an Ontario-based issuing company, the combined corporation tax rate is 33.5% (federal 19.5% and provincial 14%), so the $335 of recovered corporate income tax is comprised of $195 in recovered federal corporate tax and $140 in provincial corporate tax. After taking into account the amount of recovered corporate income taxes, the combined net cost of the flow-through shares to both levels of government is $129 ($464 - $335 = $134). This net cost is essentially the difference between the highest personal marginal income tax rate of 46.4% in Ontario and the combined corporate income tax rate of 33.5% in the province. For the Province, the net cost of the flow-through share is $34 ($174–$140 = $34).

Under a scenario where the issuing company generated profits and the flow-through shares appreciated to their original value, the federal and provincial governments would stand to earn additional capital-gains tax revenues from the investor, given that the cost basis for the flow-through shares was zero. The federal government would recover an additional $145 in capital gains tax ($1,000 × 50% × 29% = $145). The Province would recover an additional $87 in capital gains tax ($1,000 × 50% × 17.4% = $87). Both governments would also be in a position to recover some corporate income tax revenue on the issuing company's future profits.

In order to attract $10 million of equity capital in the form of flow-through shares, the Province would face an upfront cost of $1.74 million in foregone tax revenues; the federal government would face an additional $2.9 million in upfront costs in the form of foregone tax revenues. The Province would stand to recover a portion of its upfront cost through the taxation of the issuing company's corporate income and any future capital gains on the flow-through shares. If one ignores the potential for capital gains tax and only considers the potential for future corporate income tax, the Province's net cost could drop to as low as $340,000 per $10 million of investment.

Table 6: Flow-through shares, cost-benefit analysis, $10 million of investment

	Provincial government	Federal government	Total
Aggregate value of original investment	--	--	$10,000,000
Foregone income tax revenue	$1,740,000	$2,900,000	$4,640,000
Net cost to investors	$2,010,000	$3,670,000	$5,360,000
Potential recovery of corporate income tax by governments [Note 1]	$1,400,000	$1,950,000	$3,350,000
Potential net cost to governments [Note 2]	**$340,000**	**$950,000**	**$1,290,000**

Source: Nordicity analysis
Note 1: The calculation of the potential recovery of corporate income tax by governments assumes that the issuing company earns income in the future that is equivalent to the amount of expenditures renounced to investors.
Note 2: The calculation of the net cost to governments is equal to forgone income tax revenue less potential recovery of corporate income tax by governments.
Please note: Potential net cost does not include dollar values associated with additional staffing and other administrative costs required to run the program.

<u>*Investment Tax Credits*</u>

If we take British Columbia's New Media Investment Tax Credit as a guide, then the Province may consider offering a 30% tax credit to individual and corporate investors. However, given that Ontario already has significant tax incentives in the form of refundable credits, the incentive would not need to be as large to achieve a similar level of increased investment. Consideration should also be given to establishing a maximum tax credit to ensure multiple companies obtain the benefit.

With a 30% tax credit rate, the cost to the Province of attracting additional financing to the cultural media industries would be 16 cents on the dollar after tax, plus any incremental administrative costs associated with ensuring proper compliance with investment guidelines. Some of the Province's upfront cost for the tax credit could be offset by tax on any future capital gains. However, if the Province was to adopt some of the elements of the U.K.'s EIS, then an investment tax credit would also offer some type of exemption-equivalent offset for future capital gains. However, there is some sensitivity to this manner of mechanism in Canada, where governments generally prefer tax incentives wherein the tax credit has a corresponding reduction in costs otherwise incurred (like the cost of the investment in this situation). Ignoring future capital gains, therefore, means that the Province would incur an estimated $1.6 million to attract $10 million to the cultural media industries, plus compliance costs. Alternatively, $10 million designated for an investment tax credit—double the $5 million set aside by the Government of British Columbia—could attract as much as $30 million in financing capital to the cultural media industries.

3.1.4 Summary Assessment

There are several precedents inside and outside Canada for the use of tax incentives for direct equity investment in the cultural media industries and other industries. Flow-through shares in use in the Canadian mining sector and the more general use of investment tax credits are two examples of tax incentives for direct equity investment. However, the degree to which individual and corporate investors will participate in any tax incentive program is uncertain. As such, the degree to which financing capital will flow to the cultural media industries is also uncertain, as is its distribution among the different cultural media industries.

The fact that the creation of cultural media products requires significant upfront investment has a long development period and involves a very high degree of risk that suggests that flow-through shares would be an appropriate type of tax incentive. However, a flow-through-share system would require changes to federal legislation (or a very high provincial tax credit rate to replicate the federal program); as well, flow-through shares are better suited to highly liquid equity investments subject to public-market valuation. As a result, some type of provincial investment tax credit might be a more feasible option to consider for encouraging direct equity investment in cultural media companies.

It should be noted that any investment tax credit for cultural media industries should not be seen as a replacement for the existing array of expenditure tax credits. As well, it would need to be designed to be complementary to the existing tax credits and not lead to double-dipping.

The fact that the majority of Ontario's cultural media companies are privately held probably means that some type of significant investment intermediary infrastructure would be required to match retail investors with investment opportunities. Without effective controls on management fees, the allocation of financing capital to the cultural media industries through some type of fund might be susceptible to such leakage, thus eroding the total amount of financing capital that ultimately reaches cultural media companies.

While flow-through shares and investment tax credits might be compelling options for lowering the hurdle for Ontario's cultural media companies to raise private equity financing, they do come with some significant challenges and drawbacks.

First, flow-through shares would require investment dealers to market them to individual investors. Industry education would be needed and there would be no assurance that investment professionals could effectively market the product.

Second, a provincial investment tax credit would apply only to Ontario taxpayers and the pool of potential investors would be restricted accordingly. In this respect, a tax incentive for direct equity investment ignores the available institutional financing capital within the province, which is not subject to taxation. Obviously, it also creates no incentive for attracting financing capital—venture capital and otherwise—available outside of the province.

A tax incentive for direct equity investment on its own—flow-through shares or an investment tax credit—may not be the most effective vehicle for attracting a large amount of financing capital to the cultural media industries in Ontario. However, it does represent the type of financing vehicle that would complement other vehicles because it would offer an extra incentive for Ontario taxpayers who are considering investments in cultural media companies or projects.

3.2 Public-Private Managed Funds

3.2.1 Overview

A public-private managed fund would allow the province to leverage professional investment expertise and to tap into a wider pool of financing.

A public-private managed fund is an investment fund in which public monies (i.e., the Province's financial capital) are co-mingled or invested alongside private money. Privately managed funds, such as mutual funds, hedge funds, venture capital or private-equity funds, are quite common in the investment industry. Individual and institutional investors contribute capital to these funds; a team of investment professionals then selects the investments for this capital. The fund manager will earn an ongoing fee, equal to some percentage of the assets under management, and will often earn significant performance-based fees.

The use of a professional intermediary to match the supply of financing to the demand for financing can be a very efficient way to allocate capital. In some cases, however, the objectives of investors or fund managers do not correspond with that of policy makers. When this occurs, policy makers may seek to intervene by investing government monies alongside private investors. Private investors and intermediaries gain access to more capital in return for investing that capital in correspondence with the objectives of policy makers.

There are a number of examples of public-private managed funds in place in Canada and elsewhere, where policy makers have intervened.

- Under the third investment round of the Australia Innovation Investment Fund (IIP) program,[16] the Australian Government has committed A$200 million to provide 10 fund managers with up to $20 million in capital, which fund managers must invest on a 1:1 basis with capital from private investors.[17] A$100 million has been committed to a 50-50 partnership with private investors. Fund managers must invest the capital in small early stage Australian companies that are engaged in the commercialization of Australian research and development.[18] As an incentive to private investors, the Australian government permits them to retain 90% of the returns exceeding the long-term bond rate.[19]

[16] The Australian Government launched the first round of financing under the IIF program in 1998; it launched the second round of financing in 2001. The Australian Government invested a total of A$221 million the first two rounds of the IIF program on a 2:1 ration with private capital (Source: Australian Government, "Innovation Investment Fund: Fact sheet," *AusIndustry*, December 2008, downloaded at http://www.ausindustry.gov.au/VentureCapital/InnovationInvestmentFundIIF/Pages/InnovationInvestmentFundProgram>-Factsheet.aspx, September 24, 2009).

[17] Australian Government, "Innovation Investment Fund: Fact sheet," *AusIndustry*, December 2008, downloaded at http://www.ausindustry.gov.au/VentureCapital/InnovationInvestmentFundIIF/Pages/InnovationInvestmentFundProgram>-Factsheet.aspx, September 24, 2009.

[18] *Ibid.*

[19] Australian Government, "Innovation Investment Fund Program (Round Three No.1 of 2007) - Guidelines," *AusIndustry*, downloaded at http://www.ausindustry.gov.au/VentureCapital/InnovationInvestmentFundIIF/Pages/InnovationInvestmentFundProgramRoundThreeNo1of2007-Guidelines.aspx, September 24, 2009, paragraph 89.

- In Belgium, the Flemish government has set up a €21.5 million, 50-50 public-private managed fund called CultuurInvest, which invests in cultural media projects and firms that have the potential to offer high returns.[20] One-half of the capital in CultuurInvest comes from the Participatie Maatschappij Vlaanderen;[21] the other half comes from seven strategic partners in the private sector.[22]
- Within Canada, British Columbia's Renaissance Capital Fund is a 20-80 public-private partnership to which the Government of British Columbia has committed $90 million. The mandate of the Renaissance Capital Fund is to invest in the life sciences, information technology and new media, and clean technology sectors.[23]

The Province is already pursuing a type of public-private managed fund for the technology sector. In July 2009, the Ministry of Research and Innovation established a $250 million co-investment fund (over five years) called the Ontario Emerging Technologies Fund (OETF). The OETF will not seek out its own investments, but will accept co-investment opportunities from a group of pre-qualified investors.[24] Unlike the Australian model, under the OETF, the Province and its co-investors will share any losses and profits. The Province will invest all of its investment proceeds back into the fund. At the end of the initial five-year investment round, the OETF will only continue to make investments on the basis of the remaining net capital and investment profits. Digital media has been designated an eligible sector for OETF investment, among other emerging high-tech industries.

The co-investment model has become a popular tool for facilitating the flow of public and private financing to investment opportunities in the cultural media industries. In June 2009, Scottish Screen (the government development agency for the screen-based industries in Scotland) launched the Digital Media IP Fund.[25] This fund has £1.5 million (for the 2009/10 fiscal year) to invest on a 50-50 co-investment basis with private investors in non-broadcast interactive content.[26] In the northeast of England, the regional agency, Northern Film & Media, recently launched the £1 million co-investment fund, the North East Content Fund, which will invest alongside private investors in the film, television, video games, interactive digital media and music industries.[27]

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[20] France Lebon and Joris Janssens, "Culture Policy Profile: Belgium," *Compendium: Cultural Policies and Trends in Europe*, downloaded at http://www.culturalpolicies.net/web/belgium.php?aid=426 on September 14, 2009.
[21] The Participatie Maatschappij Vlaanderen (Flanders Participation Company) is an independent investment agency set up by the Flemish government to invest in high-risk projects that help fulfil the economic policy of Flanders.
[22] *Ibid.*
[23] See the B.C. Government Website: http://www.tted.gov.bc.ca/TRI/Pages/BCRCF.aspx.
[24] It should be noted that the OETF explicitly excludes applications from content producing companies (with the exception of video game development). That said, it does provide an informative model for a public-private co-investment fund.
[25] The film production, television production and interactive digital media industries are often collectively referred to as the *screen-based* industries.
[26] See Scottish Screen, "Digital Media IP Fund," *Scottish Screen*, http://www.scottishscreen.com/content/sub_page.php?sub_id=207 and Scottish Screen, "Investment Guidelines," *Scottish Screen*, http://www.scottishscreen.com/images/documents/InvestmentGuidelinesJune09final.pdf.
[27] Northern Film & Media, "£1m North East Content Fund Launched by Northern Film & Media," *Northern Film & Media*, August 3, 2009, downloaded at http://www.northernmedia.org/?mod=news&pageid=38&id=548 on August 5, 2009; and Northern Film & Media, North East Content Fund Guidelines, *Northern Film & Media*, downloaded at http://www.northernmedia.org/tpl/uploads/21North_East_Content_Fund_Guidelines.pdf on August 5, 2009.

The public-private managed fund model is an improvement over direct government investment or grants because it allows the competitive market to allocate investment. It can also offer flexibility in investment style: the fund manager can provide equity, debt or other types of financial instruments that may be suitable for the type of financing sought by companies. Indeed, this is, to some extent, the approach followed by Quebec's La financière des entreprises culturelles (FIDEC)—a limited public-private partnership with approximately $45.5 million in capital. FIDEC is a partnership made up of various financial and cultural sector companies (e.g., the Gillette Group and TVA) that makes financing available to segments of the cultural media sector in Quebec.[28]

The public-private managed fund could also tap into financing capital outside of the province, and even outside of Canada. Perhaps most importantly, a public-private managed fund or similar co-investment model leverages the investment principles associated with market-driven capital, as opposed to policy-driven capital.

Under the public-private managed fund model, the Province could encourage the capitalization of companies in the cultural media industries by providing a passive investment to a venture capital fund, another type of professionally managed fund, or under a co-investment program modelled after the OETF. The Province may also enter into a limited liability partnership to form a managed fund with private investors.

So, the Province and the private sector would have to jointly establish a fund explicitly tailored to the cultural media industries. If it establishes a new fund for the cultural media industries (and thus benefit from diversification of its investments), it will still be exposed to considerable sectoral risk. Therefore, it is likely that the Province would have to offer significant incentives to induce private-sector collaboration, by way of preferential recoupment or a greater share of profits (e.g., private investor recoup first and the Province second, or a 75-25 split of profits in favour of the private sector).

3.2.2 Design Considerations

Purpose

During our industry consultations, several representatives from the interactive digital media, film production and television production industries identified public-private managed funds as being most attractive to their financing needs. In either case, the funding would be used to develop work products. While producers would have to give up a share of revenues or profits from the work product, this type of mechanism would improve their ability to maintain control over the IP. They would have less of a need to secure gap financing or exchange rights for distribution advances.

Basic Structure

Fundamentally, this type of vehicle involves matching private money with public money, with the public money accepting an equal share of the downside risk and/or a much smaller share of the upside potential. This type of arrangement makes the investment much more attractive to the private investor and should attract additional private money into the industry. Because of the downside risk, however, such investments would need to target those productions where there was a reasonable expectation of positive

[28] Additional information on FIDEC can be found on page 36 of this report or at http://www.fidecinvest.com/en/creation_fidec/creation_fs.html.

return. It is therefore likely that such investments would target slates, or potentially even "slates of slates" across multiple producers, to reduce some of the risk.

There are two ways that this could be structured.

Option 1: The first option would be for a promoter to bring a project to the fund, which, if found to meet eligibility criteria, would receive matching equity funds for the promoter's investment in the project. Any revenues in excess of production costs would be used to repay both the private and public equity funds, with any profit thereafter split on an unequal basis (for example, 90% to the private investor and 10% to the public investor). This is similar to the approach taken by the Ministry of Research and Innovation (MRI) for the OETF, which does not accept applications from most cultural media companies.

MRI has established a two-stage selection process for this fund. Prospective investors must be certified as "qualified investors" against a defined set of criteria. Qualified investors may then submit specific projects for approval as "eligible investments," which would include a clear set of covenants to protect Ontario's interests. Tracking and monitoring processes for outstanding investments are required to ensure compliance with these covenants until exit. OETF is currently outsourcing certain aspects of the administration of this program to the private sector on a fee for service basis.[29]

Option 2: The second alternative would be for the fund to be managed as a pool by a professional fund manager. Private investors would purchase units in the fund, and this private investment would be matched with government money invested in a second class of shares entitled to receive a lower proportion of profits earned on the underlying projects. Returns to the two different types of units would be determined in a manner similar to Option 1.

Fund Management

Option 2 requires the identification of a fund manager with sufficient experience in the cultural media industries to attract interest from a broad range of institutional investors and/or brokers who would market the fund to retail investors. In addition, this fund manager would be entitled to management fees of 2% to 4% of the fund's net asset value on an ongoing basis, which would result in a corresponding reduction in overall returns to investors.

Under Option 1, a fund manager would not be required; however, outsourcing of certain parts of the program administration, as MRI has done with the OETF, may be required.

Project/Slate Eligibility, Approval and Monitoring

Under either option, to receive the matching funds, an evaluation and approval process would need to be established to ensure that the underlying projects or slates met established eligibility criteria, such as likelihood of success. Likelihood of success is a subjective evaluation, and may require the establishment of an expert panel with appropriate industry expertise.

[29] MRI, "Request for Proposals for Evaluating Co-investor and Investment Applications, and Administering and Monitoring Investments for the Ontario Emerging Technologies Fund," RFP No.: OSS-077903, Issued: June 2, 2009.

A monitoring process would also need to be established to track progress during development and to ensure appropriate return of investor money once the project or slate was completed and commercialized.

The Province will need to determine whether a government ministry or agency or a third-party service provider would be best-suited to undertake these activities. This is similar to the model currently being used by MRI for the OETF.[30]

3.2.3 Cost-Benefit Analysis

A cost-benefit analysis of a public-private managed fund requires assumptions regarding three key parameters: (i) the co-financing rate, (ii) the fund-management fees and (iii) the expected return and return-sharing scheme. The co-financing rate directly determines the financial leverage that the Province could achieve with a public-private managed fund. While British Columbia's Renaissance Fund proposes to adhere to a 20-80 co-financing regime, most of the international examples of public-private funds, as well as the OETF, have adopted a 50-50 co-financing rule. As such, the Province could reasonably expect to achieve financial leverage of two times any provincial capital. Therefore, $10 million in provincial capital invested in a public-private managed fund would generate a total of $20 million of total financing capital.

As noted, this approach entails a fund management fee of 2% to 4%. Taking the midpoint of this range suggests that annual fund management fees would total $300,000. After five years, fund management would therefore account for as much as $1.5 million—a significant portion of the Province's investment of $10 million. Assuming a long-term inflation rate of 2%, the fund would have to generate an annual average return of approximately 5% simply to preserve the real value of its capital.

To attract private capital to co-invest alongside public money, the fund would have to offer a potential rate of return well beyond the capital-preservation rate of 5% and the risk-free investment rate offered by long-term Government of Canada bonds (currently yielding approximately 4%).

The most uncertain and variable parameter in an analysis of the cost-benefit of a public-private managed fund is the expected return. In 2008, Canadian venture capital funds posted an average one-year return of negative 7.4%.[31] Over a ten-year time horizon, the average net return was negative 2.8%.[32] These rates of return demonstrate that there is very little assurance of returns that will cover inflation and fund-management fees, and still offer the potential to earn a return in excess of the risk-free returns on a long-term government bond.

By way of example, Canadian television programs have historically displayed equity-investment recovery rates of 10 cents to 15 cents on the dollar; thus, they lost 90 cents to 85 cents of the investment.[33] The

[30] The OETF is managed by the Ontario Capital Growth Corporation, an agency of MRI.
[31] Canada's Venture Capital & Private Equity Association (CVCA), "Canadian Venture Capital & Private Equity Industry: Performance Data – Private Independent Funds," news release, May 28, 2009.
[32] *Ibid*.
[33] Nordicity Group Ltd., *The Case for Kids Programming: Children's and Youth Audio-Visual Production in Canada*," prepared for the Canadian Film and Television Production Association in association with Shaw Rocket Fund, Alliance for Children and Television and the National Film Board of Canada, February 2007, p. 35. Also see statistics reported for the Canadian Television Fund found in Telefilm Canada, *Annual Report 2005/2006*, pp. 62-63.

fund should, therefore, allow for significant losses, even with a co-financing approach whereby private investors put money at risk alongside the Province's capital. Of course, to attract private equity any structuring of the investment would have to provide a higher recoupment position (i.e., better access to the returns) than what is typical of production investments.

Overall, therefore, the cultural media industries could benefit from an additional $20 million in financing capital as a result of a public-private managed fund model. However, given the fund management fees and the historical returns recently reported by Canadian venture capital funds, it is entirely plausible that the Province could incur net losses totalling $10 million after five years to generate this financing capital for the industry.

3.2.4 Summary Assessment

There are several public-private managed funds in use in other jurisdictions; the Province has established its own public-private managed fund for the technology sector by way of the OETF co-financing program. With the exception of Belgium's CultuurInvest, most of the public-private managed funds are focused on high-growth industries. Indeed, the type of returns required to give such a fund the potential to be sustainable could perhaps only be found in industries where companies are poised for high growth. The interactive digital media industry qualifies as such an industry; however, while most of the cultural media industries are excluded, the video games portion of the interactive digital media industry already falls under the mandate of the OETF. Thus, the more-stable, yet slower-growing cultural media industries are left for a cultural media industries fund.

The public-private managed fund concept is further plagued by the fact that industry stakeholders maintain that Ontario lacks the calibre of investment professionals with enough knowledge of the cultural media industries to make a managed fund effective and sustainable. The market-driven approach that underlies the public-private managed fund model presents a risk that the Province's allocation for a fund may not be invested due to too few investment opportunities from private investors to compose a diversified portfolio of investments.

The public-private managed fund could become a vehicle for channelling equity investments directly into IP projects (e.g., films, television programs and books). However, the vast majority of Canadian content production in film and television production, for example, has up until now posted equity-investment returns equal to 10 cents to 15 cents on the dollar. Any fund's portfolio will, therefore, require a small group of properties with *super-normal* returns to offset the many properties with negative returns.

4 Credit Support Mechanisms

New credit support mechanisms will permit cultural media companies to have quicker access to cash resources. This will enable them to invest in larger slates and, ultimately, help them become stronger companies with healthier balance sheets.

Credit support mechanisms might also be described as cash-flow support mechanisms or short-term financing mechanisms. What these types of mechanisms have in common is that they permit companies to raise current cash against some type of future income. This income may be a government tax credit, other forms of government funding, the pre-sale of content to a broadcaster or game publisher, or other trade receivables.

While credit support is typically associated with these low-risk forms of future income where the probability of payment is high, it can also be extended to riskier forms of future income where the probability of payment might be lower, such as gap financing for film and television production. Over time, as financial institutions gain more knowledge of the business and credit conditions in the cultural media industries, the concept of credit support mechanisms could be expanded to include even longer-duration credit instruments, such as long-term loans, that could be tied to specific IP development projects or other asset classes beyond current assets.

There are a few ways in which credit support mechanisms can improve the profitability and capitalization of cultural media companies and thereby underpin their growth. For those companies that currently utilize interim financing, there is scope for introducing credit support mechanisms that reduce the financing costs that these companies face. Such savings would flow directly into companies' profits and retained earnings, and give them more financial capital to pursue business opportunities.

Credit mechanisms also have the potential to generate financial benefits for those companies that do not currently engage in interim financing. Credit support mechanisms can improve a company's cash conversion cycle, as they reduce the time that elapses between the creation of the inventory and the conversion of this inventory to cash. [34] Shortening the cash conversion cycle increases cash assets on hand; cultural media companies can then use this cash to develop additional inventory or IP. A secondary effect may also come about when a credit mechanism is effective in *smoothing* a company's cash flow. In theory, such smoothing should allow the business owner to avoid devoting financial or human resources to meeting short-term financial obligations, and would thereby free up resources to pursue the development or marketing of new IP or business opportunities.

Also, where credit support mechanisms can be used to facilitate long-term loans for companies, they become a financing vehicle that directly supports the development of new business opportunities.

In this section, we examine two forms of credit support mechanisms: loan guarantees and accelerating the payment of tax credits. Our research suggests that these two forms of credit support would present many of Ontario's cultural media companies with avenues for improved and predictable cash flow, higher

[34] Refer to Appendix B for a detailed explanation of cash conversion cycles and other relevant finance principles.

profitability, and larger amounts of retained earnings and cash resources that could be deployed to value-creating opportunities.

4.1 Loan Guarantees

4.1.1 Overview

Loan guarantees can be an effective and flexible tool for the Province to encourage banks to expand credit for Ontario's cultural media companies, allowing them to improve their cash position and to generate more high-quality content.

Loan guarantees represent a financing vehicle that the Province could use to address several needs articulated by Ontario-based cultural media companies. Loan guarantees are legally binding agreements under which a guarantor (e.g., a public institution) agrees to pay a lender (e.g., a bank) some of or the entire amount due on a loan in the event of non-payment by the borrower (i.e., an Ontario-based cultural media company).[35] That is, the Province would effectively ensure some portion of the loan taken out by cultural media companies for specific activities. This measure would enable the borrowing companies to obtain credit financing that they might not otherwise be able to obtain, or to secure credit financing on more advantageous terms from their lenders.

The Province could also, in theory, use loan guarantees both to ease cash flow difficulties and to help cultural media companies borrow for financing activities that would grow the companies (e.g., investment in research and development, the development of new business opportunities or the development of IP assets). Loan guarantees can be a very flexible tool. Over time, as lending institutions become more familiar with the business and credit environment among Ontario's cultural media companies, there would be scope for the Province to facilitate the expansion of the program to encompass riskier asset classes. Or, the need for loan guarantees could lessen as financial institutions became more comfortable with the business risks involved.

Loan guarantees as a financing vehicle are not new to Canadian governments—provincial or federal. In the mid 1990s, the Province operated a loan guarantee program for the book publishing industry.[36] In 1998, the Department of Canadian Heritage sought to introduce a loan guarantee program for the cultural industries. Before launching the Loan Loss Reserve Fund (LLRF) for all of the cultural industries, the federal government launched a pilot program for the book publishing industry.[37]

Under the Loan Program for Book Publishers (LPBP), the federal government made repayable contributions to the Royal Bank of Canada (RBC) to allow the latter to expand its portfolio of loans to book publishing companies. The total amount of repayable contributions was capped at $2 million for the pilot program with a loan-loss reserve of 10% of outstanding loan volume.[38] Loans were available for

[35] IMF "External Debt Statistics: Guide for Compilers and Users – Appendix III, Glossary," Washington DC, 2003.
[36] Castledale Inc. and Nordicity Group Ltd., *A Strategic Study for the Book Publishing Industry in Ontario,* 2008, p. 44.
[37] Department of Canadian Heritage, *Summative Evaluation of the Loan Loss Reserve Fund*, 2005, p. 2.
[38] *Ibid*, p. 4.

200 to 400 basis points above the prime rate.[39] In case of default, the government would assume 90% of any net losses incurred by RBC.[40] The program only lasted for four years, however. RBC stopped taking applications for the LPBP loans in 2002; in RBC's view, the loan volumes were too low and the risks too high.[41]

According to book publishers participating in the industry consultation for this project, the wind-up of LPBP could largely be attributed to certain flaws in its design. First, the administrative costs associated with the loans often outweighed the savings in interest costs that the program brought about for book publishers. Second, only one financial institution, RBC, participated in the program, and many book publishers were unwilling to switch from their own financial institution to RBC to access the program. The implication is that while a loan guarantee program, in principle, can be an effective vehicle for expanding the financing available to cultural media companies, the ultimate effectiveness of the program will depend largely on the specific design of the program and, potentially, the number of participating financial institutions.

In Quebec, FIDEC offers loan guarantees to Quebec companies in the cultural media industries. FIDEC will guarantee bank loans representing up to 40% of the total budget of a film or television production (see below). These guarantees are commonly issued for film and television projects, and so are based on expected foreign sales revenues. Alberta has a Cultural Industries Guarantee Fund, which is a $2 million loan guarantee program for that province's arts community. It was created with seed money from the Alberta Foundation for the Arts and the Department of Canadian Heritage.[42] Outside Canada, the Berlin and Brandenburg state-run investment banks have begun to provide loan guarantees (in addition to loans themselves) to financing film productions in those jurisdictions. And in Austin, Texas, a similar mechanism is in place to support cultural initiatives.

[39] *Ibid*, p. 5.
[40] *Ibid*, p. 4.
[41] *Ibid*, p.1.
[42] Alberta Cultural Industries Association, "Cultural Industries Fund," *Alberta Music Industry Association*, downloaded at http://www.amia.ca/cms/Portals/amia.ca/pdf/ACIA%20guidelines%20.pdf on June 19, 2009.

FIDEC—Loan guarantees and other investments

La Financière des entreprises culturelles (FIDEC) is a limited public-private partnership with approximately $45.5 million in capital. The partnership, made up of various financial and cultural sector companies (e.g., the Gillette Group and TVA), makes financing available to segments of the cultural media sector in Quebec.

FIDEC offers three types of investment:

1. **Gap financing**: a bank loan guarantee based on the value of the sales potential of a product on the international market. FIDEC guarantees up to 40% of the financial structure of a project up to $4 million.
2. **Investment in projects:** FIDEC can invest in a project in return for a share of future profits to be generated by that project and/or its sales on the international market. FIDEC will finance up to $2 million.
3. **Investment in equity, quasi-equity or debt:** FIDEC, at the request of *La Fonds d'investissement de la culture et des communications* (FICC—a public sector equity investment corporation), can take a direct holding in the capital stock of a cultural media

Loan guarantee programs are also quite common outside of the cultural media industries. At the federal level, Western Economic Diversification Canada (WED) has had its own Loan Investment Fund Program (LIFP) in place since 1995. It has operated the program in partnership with several financial institutions, and targets SMEs in the biotechnology, health, tourism and environmental technology industries. Through repayable contributions, WED's LIFP has been able to generate loan volumes in the hundreds of millions of dollars for cultural SMEs.

At the provincial level, the Ontario Ministry of Natural Resources (MNR) currently administers a loan guarantee program for the province's forestry sector. The Loan Guarantee Program (LGP) has the capacity to provide up to $350 million in loans over five years for new capital investment projects in the forestry sector. Under the LGP, the Province provides a 100% guarantee, but collects a guarantee fee of 0.5% to 1.0% from the loan recipient.

Initially, the loan guarantee program could be used to encourage banks to provide interim financing of the tax credits in industries such as interactive digital media, music and book publishing, where banks do not yet provide tax credit interim financing on a widespread basis. The program could then be expanded to include trade receivables and other forms of government funding.

The wider group of receivables that would fall under such an interim financing solution might include other public monies or grants available to cultural media companies. Ontario music companies, for example, can receive grants for industry promotion through FACTOR; however, they have to make the industry promotion expenditures several months before the disbursement of FACTOR funds. Interim financing facilitated by a loan guarantee could help companies bridge this gap and obtain cash resources to invest in other business opportunities. In this regard, a loan guarantee could also help companies in certain cultural media industries address delays in the disbursement of other public monies or grants.

Table 7: Range of cultural media assets

Risk	Time horizon*	Cost to Province	Asset class
Low	Immediate	Low	Short-term trade receivables
			Medium-term tax credits
			Medium-term government funding (e.g., FACTOR)
			Loans for project/artist/author development
			Loans for research and development
			Loans for development of new business opportunities
High	Long-term	High	Loans to finance the creation of IP

* Refers to the time horizon for implementation. In the early years of the loan guarantee program, banks may only engage in lending against low-risk, short-term receivables. As banks expand their relationships and knowledge of the business and credit environment, a loan guarantee program could encourage them to expand their lending to riskier asset classes.

After time, as the banks gained a more in-depth understanding of the business and credit conditions in the cultural media industries, the banks, working with the Province, could further expand the program to riskier asset classes. Indeed, Alberta's Cultural Industries Guarantee Fund is specifically designed to provide loans to assist Albertan companies in the cultural industries for the purposes of corporate development including "improvement of human and/or technological resources in order to achieve sustainable company growth and/or better fiscal performance."[43]

Many of the established companies operating in Ontario's book publishing, television production and magazine publishing industries have stable sources of revenue. However, they operate with low margins, which prevent them from accumulating surplus capital to invest in new authors, projects or titles. It also means they do not have much capital to invest in new business opportunities around digital convergence. With a loan guarantee from the Province, these companies could secure long-term debt financing from Canadian banks and then make such investments to grow their businesses.

To decrease the risk associated with these riskier asset classes, loans could be tied to specific IP or slates of projects. Notwithstanding these controls, the Province would still have to be prepared to cover a higher rate of losses than might be experienced by a loan guarantee program confined to current assets with identifiable sources of future cash flow. Therefore, if the Province set up such a loan guarantee program, it would also require authorization of some budgeted amount to pay for the losses on the loans.

[43] Alberta Cultural Industries Association, "Cultural Industries Fund," *Alberta Music Industry Association*, downloaded at http://www.ampia.org/pdfs/ACIAFundguidelinesJune2007.pdf, June 19, 2009, p.1.

Cash-flow support example: Creative Industries Loan (CIL) Guarantee Program (Austin, TX)

The Creative Industries Loan (CIL) Guarantee Program is designed to encourage private lenders to provide financing for creative industries, non-profits related to those creative industries and individuals involved in those creative industries in Austin. The primary intent of this program is to foster the creation of cultural media industry employment in Austin. Indeed, guaranteed loans must create one full-time or two part-time jobs for every $15,000 guaranteed.

The City of Austin will guarantee up to 50% of the private loan, or $75,000 (whichever is less).

In general, the CIL Guarantee proceeds may be used for the following purposes:

1. **Real estate improvements**: such as the building of extensions to existing buildings or production facilities;
2. **Business personal property**: such as the purchase of furniture, fixtures, machinery and related equipment; or

The use of loan guarantee programs in other jurisdictions and sectors suggests that they might be a feasible option in Ontario. However, it must be recognized that such a program will come with cash costs to the Province, which may have to extend cash resources to participating banks, and would have to absorb a disproportionate share of the credit losses Effective structuring, monitoring and management would be required to maintain such costs within a defined target range. This situation will arise because of the higher risk nature of the loans to be guaranteed (otherwise, there would not be a need for loan guarantees). The Province would have to set specific restrictions on the loans and plan an authorized expenditure reserve to cover the losses. The challenge will be to balance the desired impact of the loan guarantee (getting the loans out the door to credit-worthy companies) with the aim of keeping losses to a planned minimum. Without effective monitoring and management, a loan guarantee program that tolerated high risk could quickly turn into an annual contribution program.

4.1.2 Design Considerations

Role of the Loan Guarantee Program

Loan guarantees will provide the greatest benefit if focused on the following industry needs:

- Bridging receipt of revenues for magazine publishers who are not eligible for any of the existing tax credit programs and for the non-tax credit revenues of other industry sectors;
- As an alternative to advancing the tax credits for film and television production, music, book publishing and interactive digital media;
- As a lower-cost alternative to existing interim financing mechanisms through financial institutions, for those established companies that have a sufficiently established track record to meet bank underwriting criteria; and
- As a tool for encouraging banks to extend long-term loans for investment in IP development and other new business initiatives.

Program Costs

Loan guarantees should be focused on projects and companies where there is a reasonable expectation that the project or company is otherwise commercially viable, and the borrower will therefore be able to repay the loan without recourse to the guarantor. The primary need being addressed by this type of program is the mismatched timing of expenditures and revenues, not a fundamental shortfall in revenues. These latter situations are better addressed through other mechanisms, such as outright grants in cases where a policy decision is made to support a project for its cultural value rather than for its economic value. That being said, the loan guarantee could also be extended to provide loans for longer-term investment projects where the future is much less certain, but equity investment is inaccessible by cultural media companies.

All loan programs carry an element of risk, and the Province would have to budget for some level of loss, particularly where loans are provided against riskier asset classes. These losses could be partially or fully offset through a guarantee fee to be charged by the Province. However, this guarantee fee and any other administrative costs incurred by the borrower for participation in the program will also reduce the overall benefits of, and participation in, the program. Other mechanisms available to government to control loan losses include:

- Establishment of maximum exposure under the loan guarantee program; and
- Development of eligibility criteria related both to the types of revenues that would qualify and to the financial strength of the borrower, which are designed to result in a specified level of loan losses on a percentage basis.

In the LPBP, the federal government established a cap of $5 million to cover any loses. The maximum exposure multiplied by the expected loan-loss rate is therefore the expected direct cost of the program to the government. This maximum exposure is essentially a policy decision to be made by the Province. Once the policy decision has been made, the program structure will need to be designed to result in loan losses that do not exceed the targeted amount.

Most government-sponsored loan guarantee programs also involve an extensive applicant screening program, which adds another layer of due diligence beyond the banks' own credit analyses. The Province would need to pre-screen all applicants to the LGP before they could approach a financial institution regarding a loan under the program.

Program Eligibility

A key design factor will be borrower eligibility. If the eligibility criteria are set too tight, many potentially deserving borrowers will not be able to benefit from the program. The program will be undersubscribed and loan losses are likely to be less than the maximum acceptable amount; however, the expected industry benefits will not be fully realized. On the other hand, if the eligibility criteria are set too loose, the program's loan losses are likely to quickly approach any pre-set program cap.

To entice participation of commercial lenders, it will likely be necessary to establish eligibility requirements (in terms of the financial strength of the borrower) that are reasonably consistent with normal commercial lending criteria. This type of eligibility requirement would mean that claims against the guarantee would be expected to be consistent with, or perhaps only marginally higher than, loan-loss rates experienced by private sector commercial lenders. The value in structuring it this way is that it will focus the program on commercially viable projects and companies that could not otherwise qualify for normal bank financing because of the lack of acceptable security from the lender's perspective. It also allows for a broader application of the program, while maintaining overall loan losses (and therefore cost to the provincial treasury) within acceptable levels.

In terms of eligible revenues that would qualify in establishing the guarantee amount, the following items could be considered:

- Expected tax credits;[44]
- For film and television production, domestic and export presales;
- For book publishing, pre-sales net of expected returns;
- For interactive digital media, distributor pre-sales or publisher financing commitment;
- For magazines, advertising receivables and pre-booked advertising; and
- For music, expected revenues from FACTOR and other government grants, and pre-booked concert tours.

This list may be expanded or contracted, but the key issue to consider for each revenue source is the relative level of risk that the revenue will not be collected. It follows that the higher the risk associated with the revenue source, the higher the risk that the debtor will default on the loan and the guarantee will be called upon.

Risk Sharing

Although the Province could assume up to 100% of the risk under the LGP, there is ample precedent for sharing of risk between government and lenders in loan guarantee programs. Typically, government accepts the greatest share of the risk (80% to 90% of net losses), with the lender accepting a much smaller share. The benefit of this arrangement is twofold:

- It allows for a broader application of the program within a defined cost to the government envelope; and
- It motivates lenders to exercise appropriate due diligence in approving borrowers, and in monitoring and following up for repayment.

It should also be pointed out that private sector lending institutions are not likely to participate in a loan guarantee program with a risk sharing component unless the eligibility criteria (in terms of financial strength of the borrower and the reliability of the revenue source) are similar to the criteria the institution would expect in non-guaranteed loans. While the guarantee would protect lenders from direct financial loss, any program structured in a way that resulted in an unusually high default rate would be unattractive to lenders. This is due to the high administrative burden associated with monitoring and follow-up efforts with borrowers, as well as processing claims that were submitted to the government for reimbursement.

After having established an overall program budget, the Province may therefore wish to enter into discussions with lenders to negotiate an overall structure that will be acceptable to both sides. This

[44] While tax credits do provide a relatively predictable level of future income, there are administrative and privacy challenges that could arise should tax credits be considered a qualifying revenue.

discussion may involve the need to factor different types of current asset sources (e.g., receivables and inventory) at different rates, depending on risk.

Delivery Considerations—Administrative Costs

For financial institutions to participate in this type of program, there will need to be a reasonable prospect that the program will be profitable for them. In addition to potential sharing of loan losses, the Province and the participating lending institutions will need to consider the costs to administer the program. From the lender perspective, this burden normally includes the due diligence associated with evaluating and approving the borrower, and the costs of monitoring and following-up on delinquent accounts. In a loan guarantee program, there will be additional administrative overhead in terms of submitting claims and complying with any reporting requirements defined by the guarantor. If such additional requirements are onerous or costly to comply with, small borrowers may be squeezed out of the program as the administrative costs would exceed the expected revenue on the loan. The objective therefore should be to minimize these requirements and associated costs.

From the borrower perspective, if the work involved to prepare the application is onerous, or requires them to incur legal or audit costs that would not otherwise be incurred, participation in the program will be discouraged.

The need to minimize administrative costs therefore needs to be balanced against the legitimate need for adequate information and evidence to support a sound approval and due diligence process that ensures prospective borrowers meet eligibility requirements.

This approach impacts the Province's liabilities and its borrowing capacity. Co-ordination with Treasury Board and the Ontario Financing Authority would be required.

4.1.3 Cost-Benefit Analysis

Modelling the benefits and costs of a loan guarantee program requires several assumptions regarding banks' credit practices and the likelihood of impaired loans. The three key assumptions in our model were related to the following: (i) the loan-to-capital ratio, (ii) loan-loss reserve/rates and (iii) the rate of risk sharing between the Province and participating banks.

Loan-to-capital ratio: The most crucial assumption is the loan-to-capital ratio. This ratio dictates the financial leverage that the Province could achieve by supplying capital to Canadian banks. To establish a loan-to-capital ratio, we examined the performance of government loan guarantee programs and Canadian banks' past and current loan practices.

- When the federal government developed the LLRF, it expected that the loan-to-capital ratio would range from 5:1 to 20:1.[45] The LPBP pilot program, which focused on the book publishing industry, realized a loan-to-capital ratio of 10:1.[46]

[45] Department of Canadian Heritage, *Summative Evaluation of the Loan Loss Reserve Fund,* prepared by Etude Economique Conseil Inc., June 2005, p. 3.
[46] Department of Canadian Heritage, p. 18.

- Statistics indicate that WED's LIFP had a loan-to-capital ratio of 6.9:1. In 2002, the total volume of approved LIFP loans totalled $145 million, with WED's share of the loan-loss reserve standing at $21 million ($145 million ÷ $21 million = 6.9).[47]
- A Canada Economic Development (CED) loan guarantee program introduced in 1995 could only achieve a loan-to-capital ratio of 1.25:1.[48]
- Treasury Board of Canada regulations require the Business Development Bank of Canada (BDC) to maintain a loan-to-capital ratio of 10:1. However, in 2009, the BDC operated with an actual loan-to-capital ratio that was closer to 5:1.[49]
- Canadian banks have typically targeted for a loan-to-capital ratio of 10:1.[50] In the current credit environment, the loan-to-capital ratio is in the range of 6.7:1 to 8:1.[51]

Based on the range of realized loan-to-capital ratios for the LPBP and LFIP, BDC's current credit practices and Canadian banks' current credit practices, we have modelled the loan guarantee program on the basis of a relatively conservative loan-to-capital ratio of 6.7:1. This loan-to-capital ratio is at the lower end of Canadian banks' current practices.

Loan-loss reserve/rates: The Business Development Bank of Canada, which provides credit financing to Canadian SMEs, maintained loan-loss allowance equal to 5.6% of its outstanding portfolio in 2007-08. This rate provides a suitable benchmark for estimating the level of reserves required for the loan guarantee program. However, it is reasonable to assume that long-term loans to the cultural media industries would require an even higher loan-loss rate, particularly where loans are made against higher-risk asset classes. For the cost-benefit model, we divided the loan portfolio into three risk categories: low, medium and high. For the low-risk portfolio, we used a 3% loan-loss allowance rate; for the medium-risk portfolio, we used a 6% loan-loss allowance rate; and for the high-risk portfolio, we used a 12% loan-loss allowance rate. We also assumed that 50% of the loan-loss allowance would convert to realized losses each year.

Risk-sharing: We assumed that each risk category had different loss-sharing rates between the Province and banks. For the low-risk category, the Province assumed 85% of losses; for the medium-risk category, the Province assumed 95%; and for the high-risk category, the Province assumed 100% of the losses.

On the basis of these assumptions, we prepared a five-year model of the cost and benefits of a loan guarantee program for which the Province sets aside a cap of $10 million on losses over the period. The following tables summarize the results of the cost-benefit analysis. Additional detail is contained in Appendix D.

[47] Department of Canadian Heritage, p. 18.
[48] Department of Canadian Heritage, pp. 14 and 18.
[49] Business Development Bank of Canada, Annual Report 2009, p. 67. The ratio of 5:1 refers to the ratio of all of BDC's business financing, including its loan portfolio, subordinate financing and venture capital. The latter have financing-to-capital ratios of 4:1 and 1:1, respectively; however, they only account for 5% of BDC's total financing portfolio.
[50] Colin Henderson, "Canadian banks will require more capital to remain within targets," *Bankwatch,* May 25, 2009, downloaded at http://thebankwatch.com/2009/05/25/3529/ on July 28, 2009.
[51] *Ibid*.

Table 8: Loan guarantee program, cost-benefit analysis

	Year 1	Year 2	Year 3	Year 4	Year 5
Available capital (net of losses)	10,000,000	9,648,250	9,072,521	7,809,694	6,652,915
Loan-to-capital ratio	6.7:1	6.7:1	6.7:1	6.7:1	6.7:1
Outstanding loans	67,000,000	64,643,275	60,785,890	54,157,644	46,524,543
Loan-loss fund	2,010,000	2,424,123	3,008,902	2,904,035	2,674,472
Realized loan losses	1,005,000	1,212,061	1,504,451	1,452,017	1,337,236
Province's share of losses	854,250	1,060,554	1,354,006	1,324,966	1,230,257
Banks' share of losses	150,750	151,508	150,445	127,052	106,979
Interest charges	3,685,000	3,555,380	3,343,224	2,877,872	2,451,599

Source: Nordicity analysis

Notes and Assumptions to Table 8:

Available capital (net of losses): The amount of capital available in each year following deduction of the banks' share of realized losses.

Loan-to-capital ratio: The ratio that determines the amount of loan credit banks will provide for each dollar of equity capital.

Outstanding loans: The maximum amount of loan credit available to cultural media companies in each year, based on the annual level of capital.

Loan-loss fund: The notional amount of funds set aside to cover potential losses from impaired loans.

Realized loan losses: The amount of impaired loans converted to losses each year; this amount is equal to 50% of the loan-loss fund.

The Province's share of losses: The Province's share of realized loan losses (85% of low-risk loans, 95% of medium-risk loans, 100% of high-risk loans).

Banks' share of losses: The banks' share of realized losses. It is equal to realized loan losses minus the Province's share of losses.

Interest charges: The amount of interest charged by banks. It is equal to a prime rate of 2.5% plus 300 basis points, for an overall interest rate of 5.5%.

Table 9: Loan guarantee program, industry benefit

	Year 1	Year 2	Year 3	Year 4	Year 5
Outstanding loans	67,000,000	64,643,275	60,785,890	52,324,950	44,574,534
Interest charges	3,685,000	3,555,380	3,343,224	2,877,872	2,451,599
Bank set-up fees	335,000	323,216	60,786	112,125	111,436
Provincial guarantee fees	502,500	484,825	91,179	168,187	167,155
Net industry benefit	**62,477,500**	**60,279,854**	**57,290,701**	**49,166,765**	**41,844,344**

Source: Nordicity analysis

Notes and Assumptions to Table 9:

Bank set-up fees: A one-time set-up fee equal to 0.5% of the value of a loan.

Provincial guarantee fees: A one-time fee of 0.75% of the value of a loan collected by the Province from loan applicants.

Net industry benefit: The net amount additional loan capital provided by banks to the cultural media industries after deducting the industries' interest charges and fees to obtain this loan capital.

Table 10: Loan guarantee program, cost to Province and benefit to banks

	Year 1	Year 2	Year 3	Year 4	Year 5	Five-year total
Cost to Province						
Province's share of losses	854,250	1,060,554	1,354,006	1,324,966	1,230,257	5,824,032
Provincial guarantee fees	502,500	484,825	91,179	168,187	167,155	1,413,845
Total cost to province	**351,750**	**575,729**	**1,262,827**	**1,156,778**	**1,063,103**	**4,410,187**
Cost to Banks						
Interest charges	3,685,000	3,555,380	3,343,224	2,877,872	2,451,599	15,913,076
Bank set-up fees	335,000	323,216	60,786	112,125	111,436	942,563
Banks' share of losses	150,750	151,508	150,445	127,052	106,979	686,733
Total benefit to banks	**3,869,250**	**3,727,089**	**3,253,565**	**2,862,946**	**2,456,057**	**16,168,906**

Source: Nordicity analysis

Notes and Assumptions to Table 10:

Total cost to Province: The net cost to the Province after the guarantee fee collected by the Province is deducted from the Province's share of losses.

Total cost to banks: The net income earned by the banks after deducting their share of loan losses from the interest charges and set-up fees collected by banks.

Please note: Total cost to province does not include dollar values associated with additional staffing and other administrative costs required to run the program.

If the Province were to provide a repayable contribution of $10 million to banks in Ontario, the resulting increase in the banks' capital base should yield a loan portfolio of $67 million. After taking into account the loan losses that might occur, the Province's capital base would be reduced to $6.7 million at the end of five years. The outstanding loans based on this capital would be $44.6 million in Year 5, unless the banks raised their loan-to-capital ratio.

After taking into account cultural media companies' interest expenses (prime + 300 basis points), and fees for the banks (0.5% of loan principal, one-time fee) and the Province's own loan guarantee fee (0.75% of loan principal, one-time fee), the industry should experience an increase in financing capital of $62.5 million in Year 1, decreasing to $41.8 million in Year 5 as a result of losses on the loan portfolio.

Based on our model's distribution of loans and risk sharing between the Province and banks, the value of the banks' share of impaired loans would be in the range from $100,000 to $150,000 per annum. However, the banks' interest income of $2.5 million to $3.7 million per annum would more than cover the losses generated by impaired loans and would generate significant income f or the banks.

The Province's share of the losses from impaired loans would, however, exceed $1 million from Year 2 onwards. And while these losses would be partially offset by the loan-guarantee fee charged by the Province, the net losses to the Province (i.e., the net cost of the program to the Province) would range from approximately $350,000 in Year 1 to $1.1 million in Year 5.

4.1.4 Summary Assessment

Government-sponsored loan guarantees are a widely used financing vehicle in Canada and elsewhere. They are likely popular because they allow governments to leverage banks' loan-to-capital ratios to generate additional industry financing that is anywhere from 6.7 to 10 times the amount of the Province's capital outlay. Furthermore, loan guarantees can be a very flexible tool. They can be used to provide much-needed cash flow loans against short-term receivables or long-term loans associated with business investment.

Loan guarantees are not cost-free, however. Our cost-benefit modelling demonstrates that, under conservative assumptions, after five years, approximately 35% of the Province's capital could be eliminated as a result of losses, thus reducing the loan capacity of the program. As well, because the Province would have to take on some type of applicant-screening role, it is likely to incur incremental operating costs to administer the program.

There is likely to be a very high rate of take-up of a loan guarantee program among Ontario's cultural media industries, at least once companies understand how it might work. Companies across all of the cultural media industries will, at times, have the need for bank credit, whether it is for short-term cash-flow management or for long-term investment in IP development. Still, the combination of the Province's pre-screening and banks' regular credit due diligence would mean that participation in the program would likely be confined to established companies. In this regard, a loan guarantee program is unlikely to help emerging companies to attract financing capital. However, should the Province wish to assist established companies in their transition to digital business models, then a loan guarantee program might be very suitable. It could offer loans to assist cultural media companies in exploiting digital distribution technologies or designing multi-platform digital content.

4.2 Accelerating Payment of Tax Credits

4.2.1 Overview

Earlier payment of the tax credit would greatly reduce financing costs in the film and television production industries and would reduce the opportunity cost of the tax credits in other cultural media industries.

Five of the six cultural media industries—the exception being magazine publishing—can obtain some type of refundable tax credit from the Province. While the tax credits provide much-needed financing capital to complete the creation of cultural content, they do come with costs. To receive the disbursement of the tax credit from the Province, the recipient faces requirements, such as the completion of the project and, in all cases, a corporate tax return must be filed in addition to the Certificate of Eligibility before a tax credit is paid. These requirements can lead to a delay in the disbursement of the tax credit. In the case of the film and television production industries, the producer often does not receive the tax credit until 18 months after the actual production costs have been incurred. In the interactive digital media sector, this delay can be even longer as projects can take multiple years to create, but the tax credit claim can only be made in the year that the eligible project was completed. Tax credit recipients in the book publishing and music industries also must wait 12 months or more for disbursement of their tax credit. This tax credit lag generates either a direct financing cost for recipients or an opportunity cost if the recipient's own funds are used to finance the time lag. This opportunity cost is significant as it limits the recipient's ability to develop and to produce slates that would allow them to grow their businesses more quickly.

Ideally, the payment of tax credits to qualified companies would be more closely linked to the costs as they are incurred to eliminate this timing gap and the resulting non-production costs. However, this would be difficult and costly, if not impossible, to administer. Other potential approaches for achieving early payment of the tax credits include:

- For approved companies with a demonstrated track record, payment of an amount equal to some percentage of the expected tax credit when costs are first incurred, with final adjustment upon completion via the established tax credit approval mechanisms. To manage risks, the Province could adopt a model similar to that already successfully used by lending institutions to provide interim financing of film and television tax credits.
- Alternatively, these expenditure-related payments could be made in stages as key project milestones are reached. This approach would further mitigate risks, but would have higher administrative costs than a single upfront payment. These higher administrative costs would likely be lower than the administrative costs associated with trying to perfectly match the release of funding to the timing of project costs.

When referring to "early payment of tax credits" throughout the remainder of this document, we mean either one of the two approaches described above.

Film and television production companies are most susceptible to the direct financing or indirect opportunity costs associated with the tax credit. However, established film and television producers in Ontario can generally obtain interim financing secured by tax credit from one of two Canadian banks or a single independent financial services firm. This interim financing is typically available to producers at one or two percentage points above the prime lending rate, with a loan duration of 18 months. A financing solution that accelerated the tax credit would clearly yield direct savings in financing costs for production companies, which is significant as such financing costs do not qualify for the tax credits in Ontario. Indeed, the Province did at one time disburse up to 85% of the tax credit, six weeks after receiving a completed income tax return from a company that received a Certificate of Eligibility. However, the flowing of this partial advance became impossible when the Canada Revenue Agency took over the administration of Ontario corporate tax returns.[52]

In other cultural media industries where Canadian financial institutions do not currently provide interim financing of Ontario tax credits, there would be no direct savings in financing charges; however, there would be a reduction in opportunity cost associated with the tax credit and an improvement in recipients' cash conversion cycle. Cultural media companies that cannot access interim financing for tax credits have had to find financing in other ways (e.g., factoring of their other receivables or through a line of credit to meet the expenses that they have incurred on the basis of the future income represented by the tax credit). In effect, they are incurring indirect financing charges as a result of the lag in the disbursement of the tax credit.

[52] The Province issued partial payments to OFTTC and OPSTC recipients for applications made for fiscal years ending prior to 2009. No such payments have been issued by the CRA for applications pertaining to fiscal years ending in 2009, nor will they be issued in the future.

Cash-flow support example: SODEC interim financing of tax credits

In Québec, the *Société de développent des entreprises culturelles* (SODEC) offers two kinds of interim financing support for its book publishing and audiovisual production tax credits: loan guarantees to support private financing and, in exceptional cases, direct disbursement of a loan.

In most cases, SODEC helps companies acquire interim financing by providing loan guarantees of 100% of the capital and interest of a bank loan against forthcoming tax credit reimbursement. SODEC will not guarantee loans of less than $10,000, owing to the costs of administration, and the loans must not exceed 75% of the value of the tax credit.

In exceptional cases, such as in the case of first-time content producers, SODEC will advance a direct loan of 75% (for book projects) or 90% (for film and television projects) of the expected tax credit value.

Even where a cultural media company does not need to obtain interim financing, it is losing the opportunity to invest the tax credit proceeds in productive activities that could yield a financial return. This foregone financial return represents the opportunity cost. At the minimum, this financial return may be comprised of the yield on short-term cash securities, in which the tax credit recipient could invest its tax credit proceeds while searching for the next content-development opportunity. At the other end of the spectrum, the forgone return may be higher if the cultural media company has opportunities to invest in the development of additional new content or content slates. As such, the economic cost of waiting for the tax credit is real and can, under certain conditions, stymie the research and development process that lies at the heart of IP content.

Some type of program for faster disbursement of the tax credit would go a long way to improving many cultural media companies' cash position and their ability to produce more high-quality content that will ultimately drive growth, profitability and stronger balance sheets.

4.2.2 Design Considerations

On a long-term basis, the acceleration of tax credit payments would involve a minimal net cost increase to the Province. Rather, it changes the timing of when payments are made. However, the challenge with this approach has, in the past, been based in part on concerns over the double-cohort effect on the provincial treasury. The double-cohort effect refers to the temporary doubling-up of government expenditures, as tax credits are paid out under both the old regime (due to the time lag) and new regime (due to reduced time lag). Once all the old-regime tax credits have worked their way through the system, government expenditures would return to the pre-existing levels.

To mitigate the impact of this double-cohort effect on the provincial treasury, a phased-in approach could be adopted, which could be accomplished through either of the following two approaches:

- Phasing in the acceleration equally for all sectors over an extended period (e.g., five to seven years); or
- Phasing in by industry, based on relative need and impact; some of the issues to be considered with this approach are described below.

In 2007-08, the film and television production industry received $171 million in tax credits from the Province, 94% of the Province's total tax credit payments to cultural media industries.[53] Interim financing of tax credits through financial institutions is already a well-established practice in the film and television production industry for two reasons: the larger average size of the tax credits and the practice of obtaining financing commitments from Canadian or foreign broadcasters or distributors called "pre-sales,"[54] which give assurance of repayment to the lender. This predictability allows producers to obtain interim financing as early as 18 months in advance of actual receipt of the tax credit. However, this interim financing is regularly available only to the more-established producers with a proven track record, and often not to the less-established but emerging producers with high potential for future success.

Cultural media industries other than film and television production share additional challenges when trying to secure interim financing of tax credits. Indeed, tax credits earned by the music and book publishing industries are typically too small to make interim financing viable for banks due to the significant upfront administrative costs.

The total amount of tax credits paid to music, books and interactive digital media in 2007-08 was approximately $10.3 million. The total double-cohort effect of accelerating the tax credits for this group is therefore less than 6% of the impact of the corresponding double cohort effect for the film and television production industry. However, we note that the size of the tax credits relative to eligible expenditures is lowest for music and book publishers, and the beneficial impact for them is smaller than in other sectors of the industry.

How an Accelerated Tax Credit Program Could Work

Current legislation requires that some provincial tax credits (the book publishing, sound recording and interactive digital media tax credits) are paid on a completion basis. This means that for these tax credits, the claim can only be submitted once the work on the product has been completed and a Certificate of Eligibility is issued. To accelerate the tax credit payment, the certification rules would need to be amended to allow for a portion of all tax credits to be paid on an accelerated schedule. Additionally, multi-year projects, such as those eligible for the OIDMTC, should be able to file claims on a yearly basis and/or at given benchmarks during the project. In the event that it was deemed impossible to issue a tax credit prior to completion, yearly claims disbursements would be preferable to the existing schedule.

Eligibility

In addition to the existing tax credit eligibility requirements, to mitigate against potential abuse the accelerated tax-credit payment program could be structured such that it was only available to companies that could demonstrate some sort of proven track record. For instance, in cases where tax credits have completion requirements, applicants to the accelerated payment program could be required to demonstrate a history of completing projects. In such a case, if a claimant under the accelerated process failed to complete the work product, that claimant would no longer be eligible for the accelerated program until a satisfactory track record of completion of work products was re-established. Additionally, the claimant would be obliged to return the advance to the Province.

[53] OMDC, "Tax Credit Applications Received and Certificates Issued in 2007-08" http://www.omdc.on.ca/Page5230.aspx

[54] Pre-sales have the effect of giving assurance to bankers that the project will be completed and, therefore, the tax credit will be earned.

All other aspects of the existing tax credit programs, including the definition of eligible claimants and eligible expenditures, would otherwise not change from what is currently in place.

Impact on Government

The level of due diligence required of OMDC with respect to its review of tax credit claims would increase somewhat due to the additional eligibility criteria for the accelerated program. The specific impacts on the operations of the provincial Ministry of Finance and the federal Canada Revenue Agency have not been determined. The current structure of tax credit legislation and regulations may need to be restructured, as the Corporation's tax function does not provide for routine advances on tax credit amounts until the statutory obligations of the claimant under the tax credit have been shown to have been met.

4.2.3 Cost-Benefit Analysis

Accelerating payment of the tax credit provides a benefit to five of the six cultural media industries in Ontario by way of savings in their direct interim financing charges, indirect cash-flow financing costs or the opportunity cost associated with waiting for the tax credit. However, the acceleration of the tax credit requires additional financial resources to be committed on an upfront basis to the early payment of tax credits.

In Appendix D, we model the benefits and costs of the acceleration of the tax credit under a scenario of a five-year phase-in. The cost-benefit model also assumes that only established companies or emerging companies with a proven track record in each of the cultural media industries will be eligible for the tax credit advancement. As well, we model a scenario under which the Province will accelerate 85% of the value of the tax credit claims for eligible companies. Our model assumes that the accelerated payment of tax credits means that film and television production companies would receive their tax credit payment, on average, ten months earlier than they would in the absence of the program. For the purposes of modelling, we assume that the accelerated payments for all other industries would be received six months earlier than the companies would have received them in the absence of the program.

Early payment of the tax credit does introduce the risk of unrecoverable overpayments, where the early payment could exceed the final amount of the assessed tax credit due to the tax credit recipient. A cap of 85% of the estimated tax credit claim should substantially mitigate the risk overpayment as the tax credit claim would have to be more than 15% below the initial assessment for an overpayment to exist. As such, the cost-benefit modelling does not reflect any losses to the Province arising from overpayment risk.

As displayed in Table 11, we estimate that by Year 5 the cost to the Province would have to accelerate $109.9 million of tax credit payments, or approximately 60% of total tax credit claims. The acceleration of the tax credit would save the cultural media industries $3.6 million on an annual basis in financing charges by Year 5.

Approximately 95% of this savings would accrue to the film and television production industries[55] since they account for 86% of total tax credit claims, but also have the longest loan duration. Therefore, it would accrue the vast majority of the benefits.

Table 11: Accelerated payment of tax credits, cost-benefit analysis

	Year 1	Year 2	Year 3	Year 4	Year 5
Value of tax credits	181,000,000	181,000,000	181,000,000	181,000,000	181,000,000
Cost to Province, value of accelerated tax credits	21,368,150	43,044,000	65,027,550	87,318,800	109,917,750
Savings in financing charges	698,173	1,402,500	2,112,981	2,829,616	3,552,405

Source: Nordicity analysis

Please note: Cost to Province does not include dollar values associated with additional staffing and other administrative costs required to run the program.

Overall, accelerating the payment tax credit would require the Province to increase its cash commitment to the tax credit programs by approximately $21 million to $22 million per year. The benefit to the industry, which would be in the form of savings in interest charges, would amount to $3.6 million per annum by Year 5.

4.2.4 Summary Assessment

Accelerating the payment of the tax credit is a practice that is available in Quebec on an exceptional basis. Furthermore, at one time the Province did disburse up to 85% of the film and television tax credits — pending final review and acceptance of the corporate tax return and Certificate of Eligibility — six weeks after receiving a completed income tax return from a company that had received a certificate of eligibility. With accelerated payment of the tax credit, cultural media companies could save an estimated $3.6 million annually in financing charges (and the opportunity cost of lost investment returns).

The benefits of accelerating the tax credit would, however, be concentrated in the film and television production industries and, furthermore, only among established companies. While $3.4 million of additional capital for the film and television production industry would certainly be beneficial, there is no guarantee that producers would be able to invest this savings into content development, or digital distribution of cross-industry initiatives. As such, there might only be a tenuous connection between this capital for the film and television production industry and the overall development of Ontario’s cultural media sector. Nevertheless, the savings are real to producers who may only earn a 7% to 8% producer’s fee (the rest being invested in the project). Indeed, during our industry consultation film and television producers were quite vocal that some type of accelerated payment of the tax credit would be beneficial to their businesses.

[55] It should, nonetheless, be noted that OIDMTC claims have increased over the last five years and are expected to grow in the future. However, it is likely that film and television production will continue to account for the vast majority of tax credit claims in the foreseeable future.

5 Directed Value-Chain Support

While credit support mechanisms and incentives for private equity investment can attract financing capital directly to cultural media companies, there are other types of financial incentive initiatives that could indirectly assist cultural media companies in attracting financing capital to specific value- chain activities. For example, support in the production of film and television projects has enabled some companies to generate working capital internally from producer fees and other services that can be put back into development. Or, savings from postal distribution expenditures engendered by the federal Publishers Assistance Program (PAP) has helped periodicals retain more capital for financing subsequent issues and even in introducing new titles in the market. Both of these examples exhibit ways in which support for certain elements of the cultural media industry can indirectly contribute to profitability and to the accumulation of capital.

In this way, if certain financial incentives have high leverage, they can lead to healthier content production companies. For example, B.C. Film's Slate Development Fund provides recipient film producers early-stage capital that has led to substantial production by companies. These companies manage to convert this upfront investment in development to projects that flow through the full value chain of development to distribution. Thus, financial support improves volume, adds to company earnings, improves relationships with lending institutions and distributors, and contributes to profitable growth.

To a large extent, this type of financial vehicle is similar to programs currently supporting the cultural media industries.[56] That is, they support particular business operations, such as development, production, supply chain, distribution, marketing and sales activities. However, the major difference between existing programs and those outlined in this section is the new focus on the attraction of co-investment by the recipient companies or outside investors. This focus is akin to the requirement of some government funding programs that require the recipient to commit a level of investment before they become eligible for public support. The difference is that the vehicles examined in this section are geared to promote increased corporate profitability and/or the attraction of outside capital. We expect that this type of mechanism would encourage content production companies to take more risk, to develop more innovative IP and to retain this IP.

Feedback from companies in the six cultural media industries has led to the consideration of incentives that are most important (i.e., at the development stage and the need to strike more global business on new platforms at the international marketing stage). However, some flexibility is warranted in designing programs for different industries: there may be different *pain points* in the value chain depending on the industry and the state of the evolution of the content producer.

5.1 Directed Financing for R&D/Development

5.1.1 Overview

[56] This type of support is also similar to the forthcoming $10 million pilot program that would refund a portion of the costs associated with intellectual property development to Ontario-based companies in the screen-based industries. (See *Ontario Budget 2009*, p. 29.)

Incentives for the cultural sector's R&D would inject more creative concepts into the market and provide that up-front support essential to the development of a sustainable industry.

In most modern economies, research and development (R&D) is considered critical to growth in many industries, such as manufacturing and information and communications technology (ICT). The prevailing wisdom and international practice is for state support for R&D because the economic benefits are greater for the economy as a whole than for the individual or company engaging in the R&D effort. In the cultural industries, R&D is considered to be the development of new concepts for music, interactive digital media content, magazines, books, and new feature films and television programs. It is the initial process of creation that can be carried out by a single person or a team that works on a concept until a decision is made to produce, publish or otherwise exploit the creative concept.

Another aspect of R&D that bridges the classic definition of *innovation* is to undertake the creation process in a new way, or to exploit it differently from the traditional commercial practices. In fact, in the digital era, the most important innovation potential is the development of new business models to generate and capture new revenue streams for the creative work. Thus, R&D for the cultural sector can be the development of initial steps that may lead to innovation or to the full commercialization of the product or stream of cultural products.

From our research, it is clear that all six cultural industries would benefit from increased support for the R&D stage of the product life cycle, albeit in different ways:

1. Book publishers could invest in more advances to authors and invest in the further digitization of the book distribution process;
2. Television producers could engage in a broader range of development and even commit more to the production of demos and pilots;
3. Film producers could spend a more lengthy period of time developing scripts and screenplays;
4. Digital games developers could get further along in the development cycle—potentially even produce finished products—to gain more leverage in negotiating the retention of rights with the games publishers;
5. Magazine publishers could develop the often costly incursions into other platforms of content creation (e.g., video or online content), which readers increasingly expect; and
6. Music recording labels and artist managers could develop artists to a more production-ready state.

There is a history of support for development activities in the cultural media industries. For example, the Canadian Feature Film Policy instituted a value-chain approach whereby support is provided to scriptwriting and to project development for the production company. Furthermore, the Canada New Media Fund's (CNMF) product assistance component focuses to a great extent on the financing of development activities in the interactive digital media space.

For the most part, support for the screen-based industries (i.e., interactive digital media, film production and television production) is for specific projects, while the apparent need is to support the development of a range of IP concepts to make the content production company more viable. For example, in addition to single projects, it would be extremely helpful if the financial incentive were constructed to support the initial development phase of a slate of projects, therefore spreading the risk for the company and developing its leverage in the marketplace. In introducing a slate-based funding mechanism for all six industry sectors, the Province would recognize the common needs of all cultural media industries to invest heavily in developing new, innovative forms of content. OMDC's pilot Intellectual Property Development Fund was designed to address this need in the screen-based industries. Results from this pilot should be taken into account in the design of any new R&D incentives that are developed.

The basic design of the R&D incentive—common to all six sectors—would be to strike an agreement with a qualified (experienced and with a proven track record) content-development company. This agreement would provide for the co-financing of a heightened development slate, which could include financing by the content producer or by third-party private investors.

One design option is for the public investment to be repaid through a revenue stream from the successful projects—likely with the public repayment taking a back seat to the repayment of private investors, should it be structured that way. This structure would allow cultural media industries with smaller-sized projects, such as music and most interactive digital media companies, to "bundle" projects together into a larger unit that would be more attractive to potential investors. It is also likely that this sort of mechanism would reduce the perceived risk associated with investment in a company's projects, as one hit among the slate would likely offset the rest of the slate's losses.

Directed value-chain support example – development support: Online Service Development Fund (France)

Since 2004, the French Ministry of Culture and Communications has offered the Online Services Development Fund (*le fonds d'aide au development des services en ligne des entreprises de presse)* with the intention of mitigating the often imposing cost of developing online content.

This fund supports registered magazines and newspapers (and press agencies) by issuing conditionally re-payable loans for 50% of eligible expenses (up to a limit of €300,000 per enterprise per year). For this fund, eligible expenses include project expenditure in equipment, studies, research or other development activities related to the creation of online, digital content.

To encourage innovation, the R&D incentive could be made available for some form of business model transformation whereby, for example, the content producer becomes a broadband distributor or partner where other companies supply some of the functions required by the new generation of revenue sources. In this case, the R&D incentive would not be attached to a specific project, but to the launch of a service that encouraged the exploitation of rights in a form that enabled the content production company to retain IP rights. France's Online Services Development Fund (see box above) illustrates how a co-financing model can be employed to help companies shift their business model to reflect changing market conditions (in this case, the importance of a digital presence for magazines or newspapers).

5.1.2 Design Considerations

Type of Financing Instrument

A key consideration in the design of directed value-chain support for R&D/development is the type of financing instrument. Governments often use investment tax credits to stimulate R&D activity. Several of the cultural media industries can already include part of their development cost in the calculation of their provincial tax credit.

Another option is a development advance that would be repayable if a development project or corporate improvement was produced, completed, distributed or commercialized (as appropriate to each cultural media industry). With such a financing instrument, the Province would need some type of monitoring infrastructure to track its investments, given that the development-to-delivery timeframe will vary between industries. In some cases, as with some video games, it could be several years before commercialization takes place, while in others (e.g., the music industry) development can occur simultaneously with production. The development-to-delivery process, however, may fit all of the cultural media industries, and repayment upon delivery of the product or corporate improvement would ensure that public funds were used to create innovative products or to improve the profitability of the cultural media company.

Co-financing Model

Another key design consideration is the co-financing model. In the OMDC's pilot Screen-Based Content Initiative, the Province funded up to 75% of the development costs. France's Online Services Development Fund uses a lower co-financing rate of 50%. The lower the co-financing rate, the more likely, in theory, that other investors see a strong likelihood of commercialization.

Eligibility Requirements

The eligibility requirements for a program of directed financing for R&D/development will be dependent on the mandate of the program. The program could easily be designed to support slate development by requiring applicants to have a track record of content development and production, as well as multiple projects ready to proceed into R&D/development.

It is through the eligibility requirements that the Province could also design the program to promote the transformation to digital content production and distribution. The Province could require that eligible development projects lead to the creation of content in digital format and have reasonable scope for distribution over one or more digital platforms.

Project Selection

The 50-50 co-financing rate will help ensure that the projects that come forward for direct R&D/development financing will likely be market driven. However, some allocation process will be required should there be oversubscription to the program. If companies with the better track records are selected, that would be a way to improve the returns from these investments.

5.1.3 Cost-Benefit Analysis

To model the costs and benefits of a program for directed financing of R&D, we adopted the following assumptions:

- The Province provides 20 x $100,000 in repayable co-financing advances.
- The Province contributes up to 50% of the development financing.
- One out of 10 projects proceeds to production or commercialization.
- Development costs are equal to 5% of content production costs.
- The content producer earns an operating profit of 10% on the production; out of this operating profit, the content producer must repay the Province and other co-financiers.

Based on these assumptions, $2 million in directed financing for R&D/development would lead to $8 million of content production, and $800,000 in operating profit for content producers (content rights holders). From this profit, the content producer can repay the Province and co-financiers and still be left with $400,000 in profit.

Table 12: Directed financing for R&D/development, cost-benefit analysis

	Amount
Province's R&D financing (20 x $100,000)	$2,000,000
Value of co-financing	$2,000,000
Total value of R&D financing	$4,000,000
Total value of commercial production	$8,000,000
Content producers' profit margin	$800,000
Repayment of Province's financing	$200,000
Repayment of co-financiers	$200,000
Content producers' net benefit	**$400,000**

Source: Nordicity analysis

Please note: Province's total costs do not include dollar values associated with additional staffing costs and other administrative costs required to run the program.

The cost-benefit model indicates that an annual net investment of $1,800,000 by the Province—after taking into account the repayment of R&D/development funding—would generate total development spending of $4,000,000, total commercial production of $8,000,000 and $400,000 in net operating profits for content producers (after repayment of development funding).

Table 13: Directed financing for R&D/development, cost to Province

	Amount
Province's R&D financing (20 x $100,000)	$2,000,000
Repayment of Province's financing	$200,000
Net financing costs	$1,800,000
Province's total costs	**$1,800,000**

Source: Nordicity analysis

Please note: Province's total costs do not include dollar values associated with additional staffing costs and other administrative costs required to run the program.

5.1.4 Summary Assessment

While directed financing for R&D/development may appear to resemble existing public funding programs, an initiative in this area could be designed to be more like a market-driven fund by adopting a co-financing approach where the Province's contribution is in the form of a repayable advance. The program could also be designed so that the directed financing for R&D/development takes the form of slate-development funding or support for digital transformation.

The co-financing approach does mean that this financing vehicle will, in part, be market driven. However, the payoffs from commercialization must be high enough that the content producer will have sufficient incentive to see their R&D/development through to commercialization or production. Our cost-benefit modelling indicates that under reasonable assumptions, an annual investment of $1.8 million by the Province should yield $8 million in future production spending and a net benefit to content producers totalling $400,000 million in operating profit after repayment of development loans.

Directed value-chain support example – development support: Ontario's Pilot Intellectual Property Development Fund

In the period since the initial research and industry consultations were conducted for this report, Ontario introduced a major program to support the early-stage development of high-potential creative projects. The Intellectual Property (IP) Development Fund is a $10 million initiative that will rebate 30 per cent of the costs incurred by content producers in Ontario to conceive, research and develop new products. The program will be delivered by the OMDC beginning in the current (2009-10) fiscal year.

As a pilot program, in its initial form the IP Fund will operate as a grant (without obligation for repayment on the part of participating companies), which will rebate eligible labour and direct costs already incurred (including the time of in-house staff and a limited share of company overhead) in direct support of research and early stage development activities.

The reimbursement is subject to a $150,000 cap per company and will be paid out while the available funds last. To ensure reasonable access to the limited funds, company may apply up to twice per year to receive a rebate (once at their fiscal year-end and once at a time of their choosing).

The goal of the program is to provide a significant share of the costs required — without the burden of repayment or dilution of ownership in the product — to more intensively develop and refine projects for success in the marketplace, while positioning cultural media companies to retain a greater share of their own intellectual property.

5.2 Directed Financing for Distribution and Marketing

5.2.1 Overview

Incentives to invest in ways to exploit multi-platforms in foreign markets would help Ontario's cultural media companies to transition into a more export-driven culture in the creative sector.

Broadband technology and the new fixed and wireless distribution platforms mean that distribution to foreign markets is now more feasible for Canadian content producers. It is also more feasible for foreign content to penetrate Canadian markets. The search for monetization of all platforms inevitably pushes most Canadian cultural sectors to pursue foreign markets more vigorously than before. In fact, some platforms are not yet available in Canada, or at least aggregators and broadband distribution models like Hulu cannot be accessed from a Canadian IP address.

The music industry, with declining traditional market CD sales, is an example of a cultural industry for which the export markets are more important than ever. Game developers and other interactive content suppliers operate in a more global market, never having been much of a beneficiary of program support, let alone regulation. Books have been successful in international markets, mainly through licensing abroad, but will eventually be distributed on various forms of digital to consumer devices like the Sony Reader and Amazon's Kindle. The expanding broadband distribution options open to film and television production open up global markets more readily than when there were clear market boundaries that followed geographic borders. Even the magazine industry, which has traditionally been a domestically focused cultural media industry, has to face the threats arising from the international ubiquity of digital publications—and possibly turn their own domestic franchises into international properties.

The history of support for international marketing and sales in a number of the cultural industries is quite recent, while in others there has long been program and policy support. Film and, to a lesser extent, television production, have benefitted from official co-production treaties with other nations.[57] Most cultural media industries have earned support through supporting travelling artists or exporting development (in the case of PMDE at the federal level). FACTOR, though originally created to support music recording for Canadian songwriters and artists, provides some financial support for marketing and exploiting foreign markets. The federal government supports the Association for the Export of Canadian Books, designed to assist book publishers to assess markets and establish contacts with local authors. OMDC has long provided direct marketing and export-related financing to Ontario cultural media companies, first through its Market Access Program and currently through the OMDC Export Fund. OMDC has also provided indirect support for export activities (e.g., support for the Canadian Pavilion at MIPCOM-TV in Cannes, France). Furthermore, the CNMF and CFFF both have marketing and distribution assistance initiatives.

Recent changes to federal cultural support mechanisms in 2008 included the conclusion of Trade Routes, which had been established by the Department of Canadian Heritage, in part to support cultural

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[57] In 2008, Canadian film and TV producers conducted 58 co-production projects with 15 different countries with budgets totaling almost $300 million. Most of this activity is film production. (Telefilm Canada website, http://www.telefilm.gc.ca/document/en/04/statistics2008.pdf.)

industries. At the same time, the Department of Foreign Affairs and International Trade Canada (DFAIT) concluded the Cultural Sector Grant Program (known as ProMart) as of March 31, 2009. This program offered $4.7 million for artists, musicians and filmmakers to travel abroad to promote their works. Together, these changes have reduced the level of support available for Ontario cultural media companies to market their product internationally.

For the most part, this federal government support was geared to outbound marketing activities, such as attending trade shows and travelling abroad to meet customers or suppliers. The programs were not production-project specific, but rather supported the content producer companies to attend events (i.e., an international book fair in Berlin; a music festival in Austin, Texas; the International Game Developers conference in San Francisco; or MIPCOM or Cannes for television and feature films). Attendance at these trade shows is critical for building the relationships and engaging in direct contact with buyers. Furthermore, these now-concluded programs were contingent on some form of cost sharing between public support and recipient company.

Directed value-chain support example – export and distribution support: bureau export

The Government of France has established offices in key worldwide locations to support the export and distribution of French music on the global market. These offices, funded by a €2.5 million annual budget, offer financial aid by supporting risk-taking activities related to international touring and promotional operations.

Additionally, the worldwide offices provide consulting services, such as strategic monitoring of priority markets, match-making between French and international professionals, and hosting events to promote French music. These support activities significantly reduce the costs and risk associated with international promotion and export.

While such programs could always be more fully resourced at the federal and provincial levels, the specific incentive envisaged for consideration in this instance is for breaking new ground in international marketing. Such activities could be to establish international sales offices (see box above), foreign distribution arms, or some broadband marketing and content distribution service or system. The purpose would be to encourage Ontario content developers to exploit their product in foreign markets. In so doing, it would not be necessary to sell off their IP to foreign distributors (as is common in the book publishing, film production and interactive digital media industries), thus forgoing opportunities for superior returns related to the IP’s international exploitation. For instance, if a digital game developer was able to “shop” a completed game around to a host of potential publishers, they would be in a more advantageous bargaining position. Similarly, this type of marketing initiative may prove to be fundamental to direct-to-consumer sales initiatives being considered as part of emerging music, book publishing, film, magazine and interactive digital media business models (e.g., online music sales, digital magazine and ebooks).

In British Columbia, the provincial government has attempted one potential solution to improving the return on doing business internationally. The Government of British Columbia (along with Quebec) provides an exemption of certain foreign source income from tax, which has the potential to confer a significant savings on corporate taxes. This would be especially true for those cultural media industries that rely almost exclusively on foreign sales (e.g., music, film and digital media). While this incentive does provide a backend benefit, it does not directly help cultural media companies at the front end to build their export or distribution capacity. Additionally, this approach is limited to international sales, which presumes the pre-existence of international sales channels. For this reason, directed co-financing or risk-sharing approaches are likely more appropriate for the cultural media industries in Ontario.

5.2.2 Summary Assessment

The evidence from other jurisdictions indicates that it is very difficult to design financing vehicles that target the market/distribution end of the content value chain. Most government support for this segment of the value chain has taken the form of direct grants for promotion or business development initiatives, or export office support. And while these programs have involved elements of cost sharing with funding recipients, they have not involved a manner of co-financing whereby the recipient has scope to attract external financing with the promise on the claim to any future returns.

The promotion of marketing and distribution is probably best addressed through other types of financing vehicles. Cultural media companies can use loan guarantees for new distribution initiatives, or even gap financing of foreign sales in the case of film and television production. Better overall company capitalization through equity investments would likely give cultural media companies the resources they require to retain more rights to their content and thereby to improve their distribution revenues. Better capitalization would also be a route for expanding international marketing if companies believe this is the best allocation of their financing resources.

6 Summary and Policy Options

6.1 Summary of Research and Key Findings

Financing Challenges in the Cultural Media Sector

Ontario's cultural media sector faces several financing challenges that are inhibiting companies across the value chain from effectively responding to and capitalizing on the transition to digitization. Our research indicates that companies within Ontario's cultural media sector are experiencing cash-flow strains and difficulty in accessing risk capital. Many cultural media companies also lack the financial resources needed for content development, and marketing and distribution.

All of the cultural media industries are experiencing cash-flow strains. In some cases, these strains can be tied to the payment schedule of the provincial and federal tax credits. All of the cultural media industries are grappling with the effects of digitization and heightened international competition in some manner. This technological challenge is forcing them to explore content innovation and new business models.

Nonetheless, Ontario's cultural media companies appear starved of risk capital at the very time when they need it most. The book publishing and magazine publishing industries, in particular, are afflicted by limited pricing power, low margins and low growth rates; the other cultural media industries lack the scale to be true global competitors. All of the cultural media industries could benefit from a financing vehicle that would help them attract risk capital, so that they can invest in response to these global forces. Each cultural media industry, however, would utilize some type of equity investment vehicle to a different degree.

While the Province does already provide some support for content development, and marketing and distribution, established cultural media companies contend that more financial support at both ends of the value chain is needed. Indeed, such value-chain support may prove to be an efficient alternate route for addressing the challenges of digitization and international competition than strictly risk capital.

Our research of the financing challenges in the Ontario's cultural media industries, therefore, points to the need for some form of incentives for private equity investment, credit-support mechanisms and additional forms of directed value-chain support.

Incentives for Private Equity Investment

The overriding goal of incentives for private equity investment is to attract *risk* capital or much more patient capital to cultural media companies. This type of financing plays a crucial role in the development of globally competitive content and sustainable corporate growth. Private equity investment offers cultural media companies the risk tolerance and investment time horizon that affords them the opportunity to experiment and develop innovative new IP content.

Governments in Canada and elsewhere typically use one or both of two models for facilitating private equity investment: tax incentives for direct equity investment or public-private managed funds. Tax incentives for direct equity investment offer private investors some type of tax incentive or tax advantage that they can claim when they make certain types of investments. Under the public-private managed fund approach, the government co-mingles its capital with private risk capital. Under the latter, the government typically defers to the private investment professionals to make the investment decisions that govern these co-mingled funds.

There are several precedents inside and outside of Canada for the use of direct tax incentives to attract private investment to the cultural media industries. For example, Canada's mining and oil exploration industries utilize flow-through shares to attract private investment. Based on the rules governing ordinary flow-through shares in the Canadian mining industry and 2008 income tax rates, the Province would face an upfront cost of 17.4 cents in foregone tax revenue for every dollar of flow-through investment. However, the net cost to the Province could be lower once the cultural media company issuing the flow-through shares started to earn income. Still, federal government participation is essential to the extension of the flow-through-share scheme to the cultural media industries.

An alternative to flow-through shares could be an investment tax credit. A 30% investment tax credit would cost the Province 16 cents in foregone tax revenue for every dollar of private investment (after taking into account the personal income tax on the value of the tax credit) for cultural media companies or properties. Therefore, for every dollar of investment tax credits provided by the Province, there would be $6.25 (1.00 ÷ 0.16 = 6.25) of incremental private investment—a leverage rate of approximately 6:1.[58] Both forms of direct tax incentives—flow-through shares and investment tax credits—would provide cultural media entrepreneurs with an additional source of capital to enable them to invest in new initiatives.

The degree to which individual investors will participate in any tax incentive for direct investment is uncertain; as such, the degree to which financing capital will flow to the cultural media industries is also uncertain. It is unclear what rate the incentive would need to be fixed at, though there are useful precedents as guidelines. Furthermore, the Province would need to develop detailed qualification criteria to determine the sectors that would benefit from the investment tax credits; otherwise, it could risk having no control over the distribution of any financing among the cultural media industries. We expect that the new financing would flow to the interactive digital media industry, to companies with high growth potential from the exploitation of rights across all platforms, and to a handful of companies consolidating in specific sectors like film and television production. While the sector's pool of financing capital would be limited to Ontario taxpayers, the province does have the highest concentration of high-net-worth investors in Canada.

To potentially access a wider pool of financing capital, a public-private managed fund model could be adopted, which could be similar in structure to the OETF established by the Province for the broader emerging technology sector. There are already a number of public-private managed funds geared to the cultural media industries in place in Europe, which cover the cultural media industries. Belgium's CultuurInvest, Scotland's Digital Media IP Fund and northeast England's North East Content Fund all provide matching funds on a strict 50-50 co-financing basis for investments in the cultural media industries. While the 50-50 co-financing structure adopted by these public-private managed funds will help ensure that market discipline governs their investments, the type of returns required to give such funds the potential to be sustainable (i.e., revolving) could perhaps best be found in industries where companies are poised for high growth.

[58] The "leverage rate" or "leverage factor" refers to ratio of total financing made available to cultural media companies to the level of the Province's financing capital or foregone tax revenues required to attract or initiate this funding.

Since the mainstream of cultural product is based on the undercapitalized and slower-growing cultural media companies, there is some risk in the creation of a cultural media fund. However, it will take the growth-oriented companies to lead the future development of the sector, and a fund could provide the extra incentive needed to obtain the risk capital required.

The public-private managed fund concept could be derailed by the lack of high calibre investment professionals with a track record and knowledge of the cultural media industries. Also, the market-driven approach that underlies the public-private managed fund model means that there is a risk that the Province's allocation for a fund may not be invested for lack of high-return investment opportunities. The fund's management may not ferret out enough new investment opportunities to compose a diversified portfolio of investments.

The public-private managed fund could become a vehicle for channelling equity investments directly into IP projects (e.g., films, television programs and books). However, one must recognize that the vast majority of Canadian content production in film and television production, for example, does not provide opportunities for achieving superior returns. Any fund's portfolio will, therefore, require a small group of properties with *super-normal* returns to offset the many properties with negative returns.

Credit Support Mechanisms

Credit support mechanisms, or cash-flow support mechanisms, permit companies to raise current cash against some type of future income. This future income may be a government tax credit; other forms of government funding; the pre-sale of content to a television broadcaster, magazine subscriber, book distributor or game publisher; or other trade receivables (such as FACTOR grants). Credit support vehicles will likely increase the level of interaction between cultural media companies and financial institutions, leading to a greater familiarity between the two broad sectors. As these financial institutions gain more knowledge of the business and credit conditions in the six cultural media industries, the concept of credit support mechanisms could be expanded. They could include even longer-duration credit instruments, such as long-term loans, that could be tied to specific IP development projects or to other asset classes beyond current assets. In the short term, however, the two potential credit support mechanisms are (i) loan guarantees and (ii) accelerating the payment of tax credits.

Government-sponsored loan guarantees are a widely used financing vehicle in Canada and elsewhere. Indeed, the Province operates a loan guarantee program for the forestry sector. The popularity of loan guarantees stems from the fact that they allow governments to leverage banks' loan-to-capital ratios to generate additional industry financing that is anywhere from 6.7 to 10 times the amount of the government capital outlay. Loan guarantees can be a very flexible tool. They can be used to provide much-needed cash-flow loans against short-term receivables or longer-term loans associated with business investment or riskier assets classes. A loan guarantee for Ontario's cultural media sector would permit Canadian financial institutions to gain a better understanding of the business and credit conditions in the sector, which could lead to better banking relationships in the future.

Loan guarantees are not cost-free, however. Our cost-benefit analysis indicates that, under conservative assumptions, after five years, approximately 35% of the Province's capital could be eliminated as a result of loan losses, thus reducing the loan capacity of the program. As well, because the Province would have to take on some type of applicant-screening role, it is likely to incur incremental operating costs to administer the program. Indeed, one of the primary downsides of loan guarantees is that they can be very cumbersome for government to set up. Loan guarantee programs require collaboration with financial institutions; what is more, governments can often have a difficult time persuading banks to move beyond low-risk loans. Nevertheless, a loan guarantee does offer the Province the highest potential rates of leverage on its capital. Whereas a loan guarantee program offers the potential for a leverage factor of 6.7:1 or even as high as 10:1, the leverage factor on tax incentives for direct investment is a little lower at approximately 6:1, and only 2:1 for a public-private managed fund.

An accelerated payment of the tax credit could help cultural media companies save an estimated $3.6 million annually in financing charges (and the opportunity cost of lost investment returns). This gain appears small and benefits only two of the six cultural industries (film production and television production). One concern associated with the accelerated tax credit is the double-cohort effect. As such, an acceleration of payments would likely have to be phased-in over a period of years. In any event, the relatively modest impact of this credit support mechanism and its relevance for only a portion of cultural media activity suggest that it should be considered in combination with other financing vehicles.

Directed Value-Chain Support

There is a history of support for development activities in the cultural media industries. For the most part, however, this support is for specific projects, while the apparent need is to support the development of a range of IP concepts to make the content-production company more viable. For example, instead of single projects, it would be extremely helpful if the financial incentive were constructed to support the initial development phase of a slate of projects, therefore spreading the risk for the company and developing its leverage in the marketplace.

The basic design of the R&D incentive would be to strike an agreement with a qualified (experienced and with a proven track record) content-development company. This agreement would provide for the co-financing of a heightened development slate, which would include financing by the content producer or by third-party private investors. To encourage innovation, the R&D incentive could be made available for some form of business model transformation, whereby the content producer becomes a broadband distributor or partners with other entities that can supply some of the functions required by the new generation of revenue sources.

6.2 Ranking Process

During the Think Tank workshops and Industry Advisory Committee roundtables we asked the participants what options they would choose among those presented. While we obtained much valuable insight into their experiences with these and other financing mechanisms, especially as it related to their particular industry, this process was designed as an indicative tool rather than a deterministic mechanism. Furthermore, we believe that a mechanistic ranking process may have been a useful analytical tool, but not one to translate into recommendations of the best options.

Accordingly, we developed some basic questions around a few key issues that helped focus our thinking:

- **Objectives:** Does the financing vehicle meet the intended objectives of increased sustainability, industry growth, and build-up of IP assets and attraction of private investment? Will the incentives produce the desired effect? Could there be unintended (and negative) consequences, for example, fraud?

- **Precedent:** Are there other jurisdictions (or other industries) that have established these financing vehicles? Has there been reasonable take-up of the financing vehicles by firms? Do the financing vehicles seem to be working?
- **Take-up:** Will the financing vehicles address the needs of enough of the target company group to make it worthwhile (e.g., across several sectors or target firms in each sector—a target that can be narrow if the objective is to appeal to the handful of firms positioned to soar or broad if the objective is to encourage that next stage in development for many firms)?
- **Feasibility:** Does the proposed financing vehicle appear to be aligned with the Ontario government's public authorities and practices (as understood by the authors of this report)?

At the conclusion of the descriptions of each of the candidate vehicles in prior sections, we put forward a reasoned assessment of the merits of the key incentives. We have concluded that that certain mechanisms may be better matched with different policy objectives. While these are only three of the myriad of possible policy directions available to the Province, they do provide a good indication of the relationship between objectives and associated financing mechanisms.

For each of the three policy options, we offer a ranking of the financing vehicles that our research and analysis indicates will offer the best likelihood of achieving the particular choice of policy objective. Again, it should be noted that these suggested financing vehicles are not meant to exclude any mechanisms not examined in this study.

6.3 Policy Options

Policy Objective A: Improve the investment capacity of established companies in the cultural media sector and position them for digital transformation.

1. Loan guarantees
2. Directed financing for R&D/development
3. Tax incentives for direct equity investment

If the Province and industry stakeholders elected to pursue Policy Objective A, the focus of their joint activities should be on measures that increase the working capital available to established companies, which would allow them to invest in transformative activities and to compete in the new digital environment.

While many of Ontario's established cultural media companies face uncertain futures, their solid track records of historical financial performance provide a good basis for utilizing loan guarantees to obtain short- or long-term bank credit. They can use the short-term credit to improve their cash flow situation, and they can use the long-term credit to make the investments needed to adapt their IP to digital production and distribution models.

Directed financing for R&D/development would provide additional support to established companies because it would offer them additional financing resources for developing new content and slates of content, which will further help them to remain competitive and grow.

Where Ontario's established cultural media companies have opportunities to secure the cash flow from content projects or slates of projects, some type of tax incentive for direct equity investment (e.g., flow-through shares or investment tax credits) would help them raise the risk capital that may be seeking such high-risk cash flows.

Policy Objective B: Promote high-growth opportunities within the cultural media sector.

1. Tax incentives for direct equity investment
2. Directed financing for R&D/development
3. Public-private managed fund
4. Directed financing for distribution and marketing

In this scenario the approach would be to focus on the financing needs of those companies with high-growth potential. This may include both established and emerging companies. While it might be somewhat biased to the fast-expanding interactive digital media industry, it could encourage consolidation in some other sectors and could stimulate the development of cross-platform concepts and rights. As a result, in each of the other five cultural media industries (other than interactive digital media), this policy option would likely serve smaller groups of companies with high-growth potential.

A tax incentive for direct equity investment that was available to individuals could allow these companies to immediately offer an investment sweetener to potential investors. While the tax incentive could take effect in short order, the cultural media sector might have to wait for the domestic venture capital industry and capital markets to recover before the take-up of the tax incentive would be substantial. The tax incentive for direct investment also gives cultural media companies the opportunity to structure investments directly in companies or in slates of projects that offer revenue streams.

Because innovation and growth in the cultural media sector is underpinned by R&D/development, directed financing for R&D/development would be an essential pillar of this policy option. It would offer a financing counter-balance: those industries and companies that found it more difficult to attract private investors could turn to some form of directed financing for R&D/development to finance the activities that could lead them into a high-growth phase of corporate development.

A public-private managed fund would be a very efficient financing vehicle for the purpose of matching risk capital with high-growth/high-risk investment opportunities. However, we have ranked it as a third tool under this objective because there is a risk that such a fund might end up being too focused on investments in the interactive digital media industry, and would avoid investment opportunities for content developers with growth plans founded on international markets, corporate consolidation or cross-platform development. A special effort would be necessary to ensure that the public-private managed fund did seek out investment opportunities in companies following these alternative paths to growth.

A fourth approach to supporting cultural media companies' efforts to capitalize on high-growth opportunities would involve directed financing for distribution and marketing. Ontario's cultural media companies operate in a relatively small domestic market that is exposed to a steady flow of cultural media content from the U.S. and, to a lesser extent, other countries. The international sale of cultural media content and services is a vital piece of any strategy for high growth among cultural media companies in Ontario. Directed financing for marketing and distribution facilitates this international growth in two respects: it directly supports cultural media companies' international business-development initiatives, which can lead to increased international revenues; as well, the Province can structure directed financing for marketing and distribution, so that it allows cultural media companies to retain more of the distribution rights associated with their content. By retaining more distribution rights, cultural media companies can increase the revenues from the content they develop and produce and build rights libraries with ongoing income. Cultural media companies can use these revenues and income streams to finance their growth.

Policy Objective C: Improve the cash flow position of established and emerging companies in the cultural media sector.

1. Accelerating payment of the tax credit
2. Loan guarantees
3. Directed financing for distribution and marketing

The priorities set out under this Policy Objective focus on improving the cash-flow position of established and emerging companies in the cultural media industries by considering both of the credit support mechanisms: accelerating the payment of the tax credit and loan guarantees.

Accelerating the tax-credit payment would put cash in the hands of cultural media companies much sooner, thus reducing their cash conversion cycle and converting more of their working capital into cash that they can deploy in new projects. Moreover, accelerating the tax credit would improve the profitability of cultural media companies by directly reducing the financing charges they face. Cultural media companies can also deploy these additional profits to investment opportunities.

Loan guarantees do not reduce cultural media companies' financing charges; in fact, they increase companies financing charges. However, like the accelerated tax credits, loan guarantees allow cultural media companies to convert a larger portion of their current assets (e.g., trade receivables or government funding) into cash more quickly. Cultural media companies that can identify content development and investment opportunities with expected rates of return that exceed financing interest rates will, therefore, be in a position to deploy this cash in an economic manner and to grow their businesses.

6.4 Summary of Potential Financing Vehicles

Table 14: Summary of policy objectives and potential financing vehicles

	Policy Objective A ***Improve investment capacity***	**Policy Objective B** ***Promote high-growth opportunities***	**Policy Objective C** ***Improve cash flow***
Choice 1	Loan guarantees	Tax incentives for direct equity investment	Accelerating payment of the tax credit
Choice 2	Directed financing for R&D/development	Directed financing for R&D/development	Loan guarantees
Choice 3	Tax incentives for direct equity investment	Public-private managed fund	Directed financing for distribution and marketing
Choice 4	--	Directed financing for distribution and marketing	--

A review of the potential financing vehicles for addressing each of the three policy objectives indicates that no single financing vehicle can feasibly address all three policy objectives in an effective manner. However, our research indicates that certain financing vehicles would be effective for at least two policy objectives.

It is also clear from our analysis that there is significant merit in pursuing some form of loan guarantees as a vehicle for short- and long-term access to credit. Loan guarantees can help cultural media companies to improve their investment capacity; they can also be an effective tool for improving cultural media companies' cash flow. Loan guarantees may not be effective in promoting high growth opportunities. With high-growth opportunities comes high risk; banks may not have a high enough tolerance for extending credit for high-risk opportunities. We believe that loan guarantees require further deliberation with the financial community to ascertain whether and to what extent Ontario could count on the financial services sector as a partner in loan guarantee mechanisms.

Directed financing for R&D/development would help Ontario's cultural media companies increase their investment capacity and, at the same time, promote high-growth opportunities. While a co-financing scheme for R&D/development offers the Province much lower financing leverage than loan guarantees, the financing could be directed at the types of corporate activities—namely the development of digital applications and content—that are vital to cultural media companies' growth.

The Province is also familiar with the provision of investment tax credits. Our research indicates that tax incentives for direct equity investment can be an effective tool for attracting risk capital to established companies seeking to expand their investment capacity, as well as emerging companies on the verge of high growth.

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Appendix A - Revenues Generated by the Creative Industries in Ontario

While Ontario's cultural media sector as a whole is not as large as Ontario's leading industries (such as financial services, auto manufacturing, and health and biotechnology), it does generate almost $5.4 billion in annual revenues (Table 15). Book publishing and magazine publishing are the largest of Ontario's cultural media industries when measured on the basis of revenues. Ontario's book publishers earned just under $1.4 billion in revenues in 2007.[59] In the magazine publishing industry, revenues were just under $1.3 billion.[60]

Ontario's interactive digital media industry—when measured in broad terms—has also had a very large impact within the province. The creators of digital media content and the enablers of the creation and distribution of digital media content (e.g., application and website designers) earned an estimated $1.3 billion of revenues in 2007.[61] The music recording and publishing industries combined to earn $635 million in 2007.[62] Meanwhile, the television production and film production industries earned revenues of $490 million and $300 million, respectively, in 2007.[63]

Table 15: Revenues of Ontario's cultural media industries (2007 figures)

Industry	Revenues (in 000s)
Book publishing	$1,360,000[a]
Interactive digital media	$1,300,000
Magazine publishing	$1,250,000[a]
Music (sound recording and music publishing only)	$635,600
Television production (foreign and domestic)	$490,500[b]
Film production (foreign and domestic)	$300,600[b]
Total	**$5,336,700[64]**

Source: OMDC, *2008 Canadian Interactive Industry Profile*, Statistics Canada (87F0004X and 87F008X), Wilkosfy Gruen estimates generated for the Ontario Ministry of Culture.
[a] Includes printing revenues. The actual revenues generated by content are less than this amount.
[b] Represents the direct production spending left in Ontario
Note:
The tally of revenues presented in the table is an imperfect one. For instance, book and magazine publishing figures include parts of the distribution end of the business (e.g., printing), while film, television and interactive digital media deal only with the production element. Similarly, the music industry data includes only the sound recording and music publishing segments of the value chain, and excludes the revenues generated by live performances, artist management and other music-related activities. The reason for this particular inconsistency stems from the manner by which data are collected about the cultural media industries, for instance, by Statistics Canada.

[59] Statistics Canada, "Book Publishers 2007," Catalogue no. 87F0004X, Table 1, April 2009.
[60] Wilkofsky Gruen, Data prepared for the Ontario Ministry of Culture.
[61] Canadian Interactive Alliance (CIAIC), 2008 Canadian Interactive Industry Profile Prepared by Nordicity, February 2009, pp. 9, 97
[62] Statistics Canada, "CANSIM Results: Sound recording and music publishing, 2007," Table 361-0005, April 6, 2009. Note that there are other aspects of the music industry (e.g., promotion, artist management) that are not measured by Statistics Canada.
[63] OMDC, "Ontario Film and Television Production in the calendar years 2005-2007 sorted by format," http://www.omdc.on.ca/Page5052.aspx.
[64] This total of $5.3 billion accounts for the approximate annual revenue of the cultural media industries in Ontario. The Ontario Ministry of Finance has previously published a figure of $12.2 billion (see *Ontario Budget 2008*). This larger figure measures the direct and indirect impacts of the cultural media industries on Ontario's GDP. Furthermore, this larger number includes media industries not within the OMDC's mandate, such as newspaper publishing.

Appendix B – A Guide to Corporate Growth

Introduction

To better understand the relationship between corporate finance and corporate growth, it may be useful to briefly review some basic corporate finance principles. In this section, we review three concepts. First, we examine the basic capital structure of a firm and the different sources of financing that it might use to construct its capital structure. Second, we examine the relationship between types of financing and phases of corporate development. Finally, we review the concept of the *cash conversion cycle* that plays a key role in a firm's management of working capital. This cycle also has implications for certain new financing vehicles identified and evaluated in this study.

Types of Company Financing

Cultural media firms can access a wide variety of different types of financing. These various types of financing—be they public or private—present potential investors with different costs, incentives, durations, and levels of risk. Table 16 lists some of the more common forms of company financing and their key characteristics.

In any given company, the types of financing currently being used (i.e., its financing structure) are summarized on the right-hand side of its balance sheet, which is typically found in annual reports. This part of the balance sheet also depicts a firm's liabilities and shareholders' equity. In general, as one moves down the balance sheet, the types of financing increase in duration (time outstanding), cost to the recipient (the firm) and risk to the investor.

At the top of the balance sheet are the accounts payables, a form of interest-free loan from a company's suppliers (e.g., equipment vendors, printers). At the bottom of the balance sheet are various forms of equity financing that a company may obtain from private investors or by selling shares on public markets. Equity investors will expect a rate of return (i.e., expected return on investment) that will be much higher than the cost of short-term credit, such as an on-demand line of credit or other forms of secured debt because of the higher risk equity entails.

Self-financing, through paid-in capital (owner investment) or earnings retained from previous profits, probably affords the business owner the greatest degree of financing flexibility. Firms may invest this type of financing in initiatives or projects with short- or long-time horizons and varying degrees of risk. The cost of self-financing to business owners is the loss of interest (or other income) that could have been earned from lending or investing this capital outside of the firm (e.g., in short-term Treasury Bills). On the other hand, companies with a high degree of external financing—debt or equity—often have much less discretion over their use of their retained earnings as they often must be paid back to existing investors.

Different forms of financing have different tax implications. In general, the cost of debt financing is a pre-tax expense and therefore comes at a lower cost to a profitable firm than equity financing, so long as the level of debt does not appreciably increase a firm's default risk. Debt financing also permits owners to maintain control over much of their company's decision-making, although certain types of debt can come with covenants that limit a business owner's discretion and decision making. In general, debt is well suited to companies that have the steady future income sources needed to meet interest expense and principal repayments.

Table 16: Types of company financing

Type of financing	Duration	Recipient cost	Investor risk	Description
Accounts payables	Short	Low	Low	Essentially a loan from suppliers. Firm receives product or service before having to pay supplier; this is equivalent to an interest-free loan.
Current debt: Short-term debt Revolving line of credit (demand basis)	Short	Low	Low	Includes any loans or credit lines due within 12 months. Revolving lines of credit are typically considered short term since they are usually repayable "on demand" and are subject to review at least annually.
Long-term debt Revolving line of credit (committed) Leases Term loans Bonds	Medium to long	Medium	Medium to high	A firm's long-term liabilities can consist of long-term debt such as leases, term loans and bonds. In rare cases, very large and established borrowers are able to obtain "committed" lines of credit that have a term of greater than 12 months and are not repayable on demand so long as the borrower is not in default. Most forms of long-term debt require some type of security in the form of a lien on company assets.
Quasi-equity Subordinated debt - Mezzanine financing Convertible debt Venture loans	Medium	High	High	Quasi-equity is fundamentally a debt instrument with characteristics of equity. It is often unsecured and comes with flexible payment options, but demands a higher interest rate than more conventional forms of short- or long-term debt.
Self financing Retained earnings/ Paid-in capital	Medium to high	*	Medium to high	A company's accumulated profits lead to retained earnings over which it often has considerable discretion. * The cost of capital for retained earnings is equal to the next best investment that the firm could make with its retained earnings (for example, the yield on short-term Treasury Bills)

Type of financing	Duration	Recipient cost	Investor risk	Description
Preferred shares	Long	Medium	Medium	Companies with sufficient free cash flow to make dividend payments can issue preferred shares, which hold a preferred position over common equity with respect to dividend payments.
Public equity	Long	Medium to high	High	Public-traded shares are more liquid than private equity, and therefore require (all else being equal) a lower expected rate of return than private equity, but still higher than debt holders.
Private equity Venture capital Angel investor capital	Long	High	High	Private equity firms, venture capitalists or angel investors may purchase shares in a private company. Private equity investors will often demand a higher expected rate of return to compensate for the high risk and lack of liquidity associated with their equity position.

Source: Nordicity/PwC research

Ultimately, financing decisions for any company involve designing a financing structure where the cost of borrowing capital is lower than the returns the company can earn on the capital borrowed. The underlying purpose of any company is to create shareholder value, whether it is a sole proprietorship with only one shareholder or a large publicly held company with thousands. To create shareholder value, a company's managers must deploy its capital so that profits, dividends or assets sales exceed the cost of the capital in the first place. While a company may have very good access to lower-cost forms of financing (e.g., current debt) and may see this form of financing as cost efficient, this type of short-term financing may not offer the duration needed for longer projects or a risk level that matches a company's best opportunity to create shareholder value. The task, therefore, of managers and financing intermediaries is to match the availability of financial capital to companies' prospects for creating shareholder value in a manner that will maximize shareholder value.

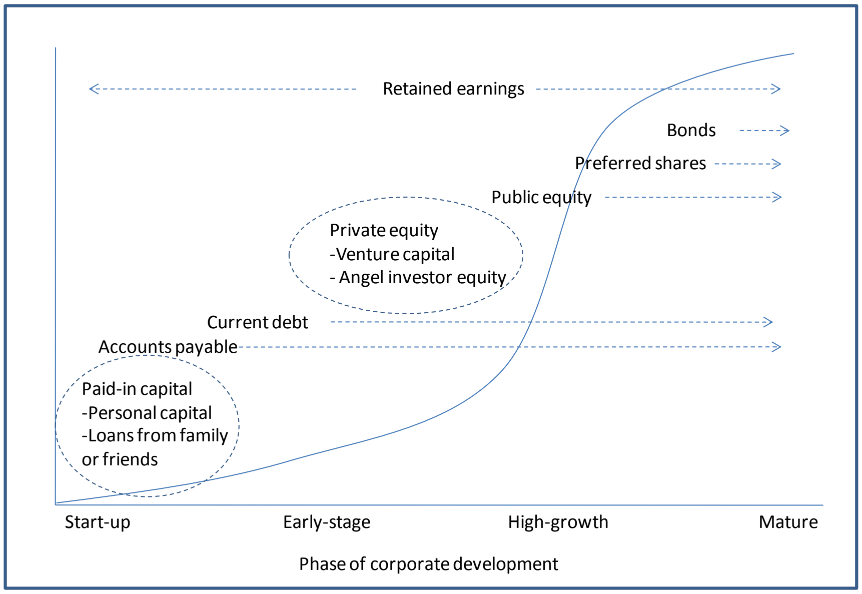
Financing and Phases of Corporate Development

As companies move through stages of corporate development, the types of financing that they require and the types of financing that they can access vary.

Figure 2: Financing types and stage of corporate development, depicts how the various types of financing change as a firm moves from start-up phase to early stage to high-growth and, finally, to the mature-firm phase.

At the start-up phase, the business owners have to rely on self-financing, such as their own personal capital (cash and personal loans) and loans or equity investments from family and friends. As the firm builds up supplier credit, it can obtain financing in the form of accounts payable, which leads to various forms of current debt.

Figure 2: Financing types and stage of corporate development



A firm that is nearing the tail end of its early-stage phase and that might be poised for high growth can attract private equity, such as venture capital or angel-investor capital, in order to finance this growth. Once a firm reaches the mature phase of corporate development, it can expand its sources of financing to include preferred shares, public equity and long-term debt, such as bonds. Retained earnings remain an important source of internal financing through all phases of corporate development.

The fact is that many companies in Ontario's cultural media industries are SMEs and are not in fact poised for high-growth. Some interactive digital media companies, particularly game developers, have been exceptions, and some firms in the other sectors have experienced reasonable growth. However, the nature of the cultural media industries has been that most companies (e.g., small magazine publishers and independent music recording labels) often remain in what resembles the early-stage phase, or even the start-up phase. While many cultural companies (e.g., Ontario-owned book publishers) might be considered mature companies, their relatively small size and limited pricing power would suggest that they have more in common with an early-stage company with very limited, if any, potential for high growth.

To develop a cultural media sector poised for growth, new financing vehicles will be required that help Ontario's cultural media companies to transition from early-stage companies to stronger, more sustainable companies. For companies with high-growth potential, this transition will see them move into the high-growth phase of corporate development. For companies with more stable-growth prospects, the transition should see them take on financing characteristics of mature-phase companies. In both instances, Ontario's cultural media companies must be able to attract new forms of current debt, equity and quasi-equity.

Working Capital and the Cash Conversion Cycle

Working capital plays an important role in the day-to-day operations of a firm. Working capital is defined as current assets minus current liabilities, and so provides a measure of a firm's liquidity position at any given time. Without liquid assets (i.e., cash or credit-worthy receivables) a firm cannot meet its short-term obligations (e.g., paying its employees). In fact, a shortfall of working capital can lead to a company ceasing to exist, let alone planning for the future or investing in the development of new business opportunities.

The *cash conversion cycle* refers to the amount of time that a firm requires to convert its inventory or product (e.g., a film, record, magazine or book) into cash. One can calculate the cash conversion cycle using the following formula:

$$\text{Cash Conversion Cycle} = \text{Inventory Days} + \text{Receivables Days} - \text{Payables Days}$$

Assuming that a company cannot influence its payables terms, it must lower the average duration of its inventory turnover or the average duration of its receivables. Any reduction in the duration of inventory turnover or receivables lowers the cash conversion cycle and thereby increases a firm's cash assets for a given level of revenues. As such, there can be real business impacts arising from effective management (i.e., reduction) of the cash conversion cycle.

The concept of the cash conversion cycle and its role in the management of working capital plays an important role in our analysis as we seek to identify new financing vehicles that allow cultural media companies to obtain cash in a faster and more consistent manner. By improving the predictability of their cash flow and their ability to meet short-term financial obligations, we believe cultural media companies will be in a stronger position to deploy their working capital to increase levels of content development and other business opportunities that offer the potential for increasing shareholder value.

Appendix C – List of Industry Participants

The below table shows the members of the Ontario cultural media industries that participated in workshops or roundtable (i.e., discussions during the course of this study).

Table 17: List of industry participants

Name	Organization	Industry	Method of participation
David Caron	ECW Press Ltd.	B	Workshop Session
Susan Renouf	OBPO, McClelland & Stewart	B	Workshop Session
Jini Stolk	Creative Trust	B	Workshop Session
Karen Boersma	Kids Can Press	B	Workshop Session
David Zitzerman	Goodmans LLP	F/TV	Workshop Session
Charlene Paling	National Bank	F/TV	Workshop Session
Dan McMullen	Royal Bank	F/TV	Workshop Session
Jim Laird	Bedlam Games	IDM	Workshop Session
Bob Shoniker	Courage Capital	IDM	Workshop Session
Robert Montgomery	Achilles Media	IDM	Workshop Session
Nathon Gunn	Bitcasters Inc.	IDM	Workshop Session
Simon Foster	Glassbox	IDM	Workshop Session
D.B. Scott	Impresa	Ma	Workshop Session
Kirby Miller	Canadian House & Home	Ma	Workshop Session
Michael Fox	Rogers Publishing	Ma	Workshop Session
Mark Jamison	Magazines Canada	Ma	Workshop Session
Al Mair	MHL Communications	Mu	Workshop Session
Aubrey Winfield	Orange Lounge Recordings/Starcana Entertainment Inc.	Mu	Workshop Session
Jeff Remedios	Arts & Crafts	Mu	Workshop Session
Trevor Guy	Last Gang Records	Mu	Workshop Session
Kathy Lowinger	Tundra Books	B	Industry Advisory Committee Roundtable
Jack Wayne	Canadian Scholars' Press Inc.	B	Industry Advisory Committee Roundtable
Carolyn Wood	Association of Canadian Publishers	B	Industry Advisory Committee Roundtable
Margie Wolfe	Second Story Press	B	Industry Advisory Committee Roundtable
Matt Hornburg	marblemedia	F/TV	Industry Advisory Committee Roundtable
Brian Topp	ACTRA	F/TV	Industry Advisory Committee Roundtable
Jennifer Jonas	New Real Films	F/TV	Industry Advisory Committee Roundtable
Steve Hoban	Copperheart Entertainment	F/TV	Industry Advisory Committee Roundtable
Anna Stratton	Triptych Media Inc.	F/TV	Industry Advisory Committee Roundtable
Karla Bobadilla	CFTPA	F/TV	Industry Advisory Committee Roundtable
Diane Williamson	marblemedia (digital wizards)	IDM	Industry Advisory Committee Roundtable
Robert Lang	Kensington Communications	IDM	Industry Advisory Committee

Name	Organization	Industry	Method of participation
	Inc.		Roundtable
Philippa King	marblemedia	IDM	Industry Advisory Committee Roundtable
Mike Schmalz	Digital Extremes	IDM	Industry Advisory Committee Roundtable
Wojtek Kawczynski	Transgaming	IDM	Industry Advisory Committee Roundtable
Neil Hiscox	CLB Media Inc.	Ma	Industry Advisory Committee Roundtable
James O. Hall	Keith Communications	Ma	Industry Advisory Committee Roundtable
Brian Heatherman	Curve Music Inc.	Mu	Industry Advisory Committee Roundtable
Shauna de Cartier	Six Shooter Records	Mu	Industry Advisory Committee Roundtable
Larry Wanagas	Bumstead Productions	Mu	Industry Advisory Committee Roundtable
Catherine Saxburg	Canadian Music Publishers Association	Mu	Industry Advisory Committee Roundtable

Appendix D – Cost-Benefit Analysis Calculations

Table 18: Accelerating payment of the tax credit, cost-benefit analysis

7	Year 1	Year 2	Year 3	Year 4	Year 5
Value of tax credits ($)					
Film and television	159,300,000	159,300,000	159,300,000	159,300,000	159,300,000
Book publishing	2,000,000	2,000,000	2,000,000	2,000,000	2,000,000
Music	1,600,000	1,600,000	1,600,000	1,600,000	1,600,000
Interactive digital media	18,100,000	18,100,000	18,100,000	18,100,000	18,100,000
Total	181,000,000	181,000,000	181,000,000	181,000,000	181,000,000
Financing rates					
Prime rate	2.5%	2.5%	2.5%	2.5%	2.5%
Loan premium	1.5%	1.5%	1.5%	1.5%	1.5%
Interim financing rate	4.0%	4.0%	4.0%	4.0%	4.0%
Average loan duration (months)					
Film and television	10	10	10	10	10
Book publishing	6	6	6	6	6
Music	6	6	6	6	6
Interactive digital media	6	6	6	6	6
Direct financing costs ($)					
Film and television	5,310,000	5,310,000	5,310,000	5,310,000	5,310,000
Book publishing	40,000	40,000	40,000	40,000	40,000
Music	32,000	32,000	32,000	32,000	32,000
Interactive digital media	362,000	362,000	362,000	362,000	362,000
Total	5,744,000	5,744,000	5,744,000	5,744,000	5,744,000
Established-company share of tax credits					
Film and television	75%	75%	75%	75%	75%
Book publishing	90%	90%	90%	90%	90%
Music	50%	50%	50%	50%	50%
Interactive digital media	20%	25%	30%	35%	40%
Phase-in rate	20%	40%	60%	80%	100%
Value of accelerated tax credit					
Film and television	20,310,750	40,621,500	60,932,250	81,243,000	101,553,750
Book publishing	306,000	612,000	918,000	1,224,000	1,530,000
Music	136,000	272,000	408,000	544,000	680,000
Interactive digital media	615,400	1,538,500	2,769,300	4,307,800	6,154,000
Total	21,368,150	43,044,000	65,027,550	87,318,800	109,917,750
Total industry benefit					
Film and television	677,025	1,354,050	2,031,075	2,708,100	3,385,125
Book publishing	6,120	12,240	18,360	24,480	30,600
Music	2,720	5,440	8,160	10,880	13,600
Interactive digital media	12,308	30,770	55,386	86,156	123,080
Total industry benefit	**698,173**	**1,402,500**	**2,112,981**	**2,829,616**	**3,552,405**

Source: Nordicity calculations

Notes and Assumptions to Table 18:

Value of tax credits: The amounts are estimates based on statistics published by OMDC for the estimated value of tax credits in 2007-08 (film and television [OFTTC + OPSTC], $159,336,821; book publishing, $2,018,146; music, $1,552,493; interactive digital media [OCASETC+ OIDMTC], $18,139,723).

Financing rates: The prime rate assumption is based on the prime rate prevailing in summer 2009. The analysis assumes a loan premium of 150 basis points. This assumption is based on research of rates charged to Ontario cultural media companies for interim financing.
Average loan duration: The assumptions for loan duration are based on research of the typical period that cultural media companies wait for receipt of their tax credits. The analysis assumes that film and television production companies face a longer loan duration period because of the long production cycle associated with many film and television projects.
Direct financing costs: These amounts are equal to the interest expense associated with the interim financing for the value of the tax credits over the period of the average loan duration.
Established-company share of tax credits: The analysis assumes that companies with an established financial track record account for 75% of tax credits in the film and television production industries, 90% in the book publishing industry, 50% in the music industry and 20% in the interactive digital media industry.
Phase-in rate: The analysis assumes the Province will phase in the program for accelerating the tax credit over a period of five years, 20% per year.
Value of accelerated tax credit: Equal to: value of tax credit × share of established companies × phase-in rate.
Total industry benefit: Equal to: direct financing costs × share of established companies × phase-in rate.

Table 19: Loan guarantees, cost-benefit analysis

8	Year 1	Year 2	Year 3	Year 4	Year 5
Loan Activity					
Capital ($)	10,000,000	9,648,250	9,072,521	8,083,230	6,943,962
Loan-to-capital ratio	6.7:1	6.7:1	6.7:1	6.7:1	6.7:1
Gross loans ($)	67,000,000	64,643,275	60,785,890	54,157,644	46,524,543
Loan turnover ($)	0	64,643,275	48,628,712	30,947,225	23,262,271
New loans ($)	67,000,000	64,643,275	48,628,712	30,947,225	23,262,271
Loan-loss rates					
Low-risk	3%	3%	3%	3%	3%
Medium-risk	6%	6%	6%	6%	6%
High-risk	12%	12%	12%	12%	12%
Share of loans					
Low-risk	100%	75%	55%	45%	40%
Medium-risk	0%	25%	35%	40%	40%
High-risk	0%	0%	10%	15%	20%
Total	100%	100%	100%	100%	100%
Loan-loss fund ($)	2,010,000	2,424,123	3,008,902	3,005,749	2,791,473
Risk sharing rates (Province’s share)					
Low-risk	85%	85%	85%	85%	85%
Medium-risk	95%	95%	95%	95%	95%
High-risk	100%	100%	100%	100%	100%
Realized losses ($)	1,005,000	1,212,061	1,504,451	1,502,875	1,395,736
Province's share of losses ($)	854,250	1,060,554	1,354,006	1,371,373	1,284,077
Banks’ losses ($)	150,750	151,508	150,445	131,502	111,659
Prime rate	2.5%	2.5%	2.5%	2.5%	2.5%
Average loan rate	5.5%	5.5%	5.5%	5.5%	5.5%
Interest expenses ($)	3,685,000	3,555,380	3,343,224	2,978,670	2,558,850
Set-up fees					
Bank set-up fees	0.5%	0.5%	0.5%	0.5%	0.5%
Provincial guarantee fee	0.75%	0.75%	0.75%	0.75%	0.75%
Bank fees ($)	335,000	323,216	243,144	154,736	116,311
Provincial fees ($)	502,500	484,825	364,715	232,104	174,467
Province's net losses/Cost to	**351,750**	**575,729**	**1,262,827**	**1,156,778**	**1,063,103**

8	Year 1	Year 2	Year 3	Year 4	Year 5
Province ($)					
Five-year cost to Province ($)	--	--	--	--	4,410,187
Net industry benefit ($)	**62,477,500**	**60,279,854**	**56,834,807**	**50,792,133**	**43,674,914**
Loan duration (years)					
Low	1	1	1	1	1
Medium	2	2	2	2	2
High	5	5	5	5	5
Average	**8.1.1** 1.0	**8.1.2** 1.3	**8.1.3** 1.8	**8.1.4** 2.0	**8.1.5** 2.2
8.1.6 Turnover rate	**8.1.7** 100.0%	**8.1.8** 80.0%	**8.1.9** 57.1%	**8.1.10** 50.0%	**8.1.11** 45.5%

Source: Nordicity calculations

Notes and Assumptions to Table 19:
Capital: This is the total amount of capital made available by the Province to banks for the provisioning of loans. The available capital is reduced each year by the magnitude of the Province's net losses from the previous year. The analysis assumes that the Province does not replenish the capital.
Loan-to-capital ratio: The analysis assumes a loan-to-capital ratio of 6.7:1. This assumption is based on industry research (see Section 4.1.3.
Gross loans: The total value of outstanding loans. Equal to: capital × loan-to-capital ratio.
Loan turnover: Gross loans × turnover rate in the previous period.
New loans: The value of new loans is equal to gross loans less loan turnover (except in Years 1 and 2, where the analysis assumes that new loans represent 100% of outstanding loans).
Loan-loss rates: The analysis assumes that the loss rates on loans are 3% for low-risk loans, 6% on medium-risk loans and 12% on high-risk loans (see Section 4.1.3).
Share of loans: The analysis assumes that low-, medium- and high-risk loans comprise varying shares of the overall loan portfolio each year.
Loan-loss fund: This is equal to the weighted average of the loan-loss rates (weighted by the share of loans) multiplied by the total value of gross loans.
Risk-sharing rate (Province's share): The analysis assumes that the Province will assume 85% of banks' losses from low-risk loans, 95% of banks' losses from medium-risk loans and 100% of banks' losses from high-risk loans.
Realized losses: The analysis assumes that 50% of impaired loans are converted to realized losses.
Province's losses/Cost to Province: This is the sum of the Province's share of realized loan losses.
Banks' losses: Equal to: direct financing costs × share of established companies × phase-in rate.
Prime rate: The prime rate assumption is based on the prime rate prevailing in summer 2009.
Average loan rate: The average interest rate charged by banks to borrowers of loans guaranteed by the Province under the loan guarantee program (prime + 300 basis points).
Interest expenses: Equal to: gross loans × average loan rate.
Bank set-up fees: The analysis assumes that banks charge borrowers a one-time set-up fee equal to 0.5% of the principal value of a new loan.
Provincial guarantee fee: The analysis assumes that the Province charges borrowers a one-time fee of 0.75% of the principal value of a new loan.
Bank fees: Equal to: bank set up fees rate × new loans.
Provincial guarantee fee: Equal to: provincial guarantee fee rate × new loans.
Province's net losses: Equal to: Province's share of losses − provincial fees.
Net industry benefit: Equal to: gross loans − interest expenses − bank fees − provincial fees.
Loan duration: The analysis assumes that low-risk loans are outstanding for one year, medium-risk loans are outstanding for two years and high-risk loans are outstanding for five years.
Average loan duration: Equal to: the weighted average of the loan durations. The weightings are found under "share of loans."
Turnover rate: Equal to: 1/average loan duration.
Please note: Total cost to Province does not include dollar values associated with FTEs and other administrative costs required to run the program.