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Patrick McKenna: The Future for Creative Content Businesses in the Digital Age

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Good evening ladies and gentlemen.

I would firstly like to say what an honour it is to have been asked to speak here this evening at the home of BAFTA. It is also a delight to see so many familiar faces in the audience – both clients and friends! But I have to say that this is also a fairly daunting task. This evening I am speaking to a group of very distinguished industry leaders about a set of issues impacting an industry that is truly more yours than mine.

As I look around, I see many experienced and successful people from the world of film and television. I'm asking myself how might I contribute to the debate about the future for creative businesses in the digital age?

It's true that I've spent some thirty years working in this sector and that I've run and been involved with a number of successful creative companies. But it's also the case that my experience has been very much focused on the business and financial side of the industry. So this evening I will be speaking from the perspective of a corporate advisor and investor. I'll be looking at the strategic direction that creative businesses might take and examining some of the business and financial repercussions arising from the transition from analogue and physical to the digital world.

I am lucky to have worked closely with some very creative and commercially minded people. It is through these relationships that I have managed to build an understanding of both the creative process and the challenges that such businesses face. They operate in a difficult and uncertain world, but it's not quite as risky and random as some might think.

They do however have a number of accentuated characteristics that differentiate them from other businesses. At their core, it's simply about people.

It is *individuals* who have ideas and are responsible for the generation of content - and these creative people are a rare asset. Without their full engagement it just isn't possible to build a successful creative business.

I've often thought that it's possible to have a great piece of content and a lousy business plan, and still make money. Conversely, it's also possible to have a great business plan and lousy content, and lose a fortune!

<u>Introduction</u>

This evening I'd like to discuss four interconnected subjects but in no particular order:

First I'll talk about the main challenges and opportunities facing creative businesses in this world of converging media platforms and audience fragmentation.
Secondly I'll comment on the commercial and funding implications arising from the shift from "old" to "new" media.

Thirdly I'll take a look at the likely drivers of commercial success in a world of convergence and suggest what shape successful media companies might take if they are to attract investment and grow in capital value.

And finally I would like to give you a short observation on public policy in this area.

And if all that sounds like a lot to cover then let me assure you that it is! So, here are a few caveats.

Firstly, I don't intend to examine these issues on a sector by sector basis. Most of what I have to say is applicable to all types of creative media companies. However, as the central theme of my talk is about integration, creative convergence and multi platform "monetization", then any sector focus I may have given shouldn't matter too much.

Secondly, it will come as no surprise to you that there is no one single solution to all these challenges. Having said this, I do believe a fundamental change will be necessary in the way we approach content creation, and the way it is exploited.

And lastly, by way of caveats, for the last decade we have all lived in a digital environment, so I am assuming that we all have a reasonably good understanding of the background and recognize that it is the change in consumer behaviour - brought about by technology and deregulation - that is driving the search for new business models, and not the technology itself.

So, my task this evening is to draw together some of the influences that have produced the current media landscape, and try to anticipate what creative companies now need to do to be successful.

This task is not an easy one, but at least the mist that once cloaked the digital media space has started to lift. We now have much greater visibility as to future trends – both in technological terms and in understanding the likely requirements of the consumer. We also have what I call "economic relevance" emanating from a much higher level of consumer adoption, and more extensive digital penetration of consumer markets.

Greater consumer engagement is leading to the emergence of new revenue sources, and this in turn is accelerating investment into the transitional process, thereby creating real momentum.

<u>**Background**</u>

Let me begin by providing some context to the issues facing creative businesses in the digital age.

The first thing to say is that if we define creative businesses as those responsible for the creation and dissemination of artistic and intellectual outputs, then <u>every</u> creative business will be impacted by digital change. Of course, artistic creativity, i.e. the idea or spark of genius itself, will remain a constant factor, but the ways in which an idea is packaged and distributed will change dramatically – in line with the demands and needs of the consumer.

So, whether you are a writer, agent, producer, broadcaster or distributor you will need to re-evaluate your business model to adapt to the changing landscape. This isn't something you can worry about at a later date – you need to do something about it now. The pace of change is accelerating, as is the economic impact on your business.

I believe that UK companies are exceptionally well placed to take advantage of the changing media scene. We were early adopters of the new technology and we have a rich cultural heritage. We are also fortunate to live in a country that is defined, now more than ever, by the depth of its creative talent. We are blessed with a rich inheritance of literary genius, and our civic institutions, headed by the BBC, are the envy of the world. And at last we have the confidence to celebrate our cultural heritage as a national asset.

But it is the combination of our creative and our entrepreneurial skills that really makes this country such a potent force in the global creative economy. The UK has always been a centre of artistic excellence, and we do of course have a well developed general financial and business infrastructure.

On a less optimistic note, the media industry has never lived through such troubled times. The pace and depth of change is creating massive disruption to long established business models and new revenue models are either still emerging or have yet to emerge.

The turmoil in media may not be as dramatic as that witnessed last week in the financial markets, but it has been going on for some time and it is still claiming casualties, as witnessed by the recent loss of ITV from the FTSE 100. And of course ITV is just one of many examples one could quote. Just look at what has happened to EMI, EMAP and Johnston Press to name but a few! The media giants are faced with having to run businesses with an inappropriate cost base and an environment of reducing revenues. At the same time as they are fighting to make a profit, in a world of tumbling revenues and audiences, they also have to invest in new distribution platforms for migrating audiences.

It is really hard to effectively run two businesses at the same time, and this perhaps accounts for why companies like Google have been so successful in just 10 short years. Change rarely comes from within – it is forced on the incumbents.

Away from big business, it's much easier for creative companies to react to, and embrace change. Although the bulk of revenues still come from "old" media, and this will be the case for some time to come, the new progressive companies will prosper going forward. They have the clearest focus on the current and future needs of the consumer, and are capable of quickly adapting their services and products to changing conditions.

Competition for the attention and wallet of the consumer has been fierce over the last ten years. Media consumption, and revenues, have grown year on year, but despite the rise, in both advertising and consumer media spending, companies in the sector have been suffering. Indeed, apart from a few dominant new media companies the only clear winner to emerge from the digital age so far is the consumer.

The consumer has an ever expanding choice of what is now available anytime and anywhere, and at an ever lower cost – including free, if you include "pirated" and user generated content.

Challenges and Opportunities

So, having set the scene, let me highlight what I see as the major challenges and opportunities facing creative businesses.

The specific challenges will vary across each sub-sector of media. But there is a lot of common ground. In this context we should all observe and learn from the way the music industry dealt with the impact of digital technology. There are many lessons to be learned here, though sadly they are mainly about what <u>not</u> to do!

It is fair to say that music is likely to prove to have been the most badly affected area of media, although newspapers and print might not be too far behind. And the reasons for this are not just because recorded music was the first to encounter the disruptive effects of digital technology. It is also because it has had to cope with the transition from physical distribution to digital delivery, while losing a dominant market position.

It has also had to deal with consumer and commercial piracy on an unprecedented level, as well as an entirely new industry player in the form of Steve Jobs. Overnight he created a dominant new distribution platform whilst the incumbents were burying their heads in the sand and wishing they'd never heard the word "digital".

But the changing and difficult environment in music has also proved beneficial to a new breed of music company. Digital distribution has led to the creators of music being able to form direct relationships with the end consumer, thereby allowing them to advance along the value chain and in the process pick up incremental profits. I believe that similar opportunities will exist for each and every creative business, especially in the context of multi channel exploitation.

Of course, the very challenges that creative businesses now face in the digital age are also a primary source of future opportunity! If there was no change or disruption there would be no opportunities for new entrepreneurial companies, and the larger media companies would continue to dominate the media landscape. As it is, digital technology has unlocked the power of the consumer, allowed new competition to emerge, and put creativity and content centre stage. Indeed, looking back at earlier technological innovation it has always been a driver of growth in media industries, as with the arrival of CDs, DVDs and electronic games consoles. Unfortunately, as regards the impact of the internet, the successful monetisation of new models has not been so quick to emerge.

Digital technology has also led to audience fragmentation, and with this has come the need for companies to develop new skills in identifying and communicating with migrating audiences. It has made us think about how content is created, and how content is formatted, packaged and delivered to new markets. This has impacted on costs and methods of funding. It has also led to the emergence of new business models and revenue sources, such as advertising funded programming and product placement – currently the subject of government consultation. Above all, it has created awareness that the cost of content needs to be amortized across as many different sectors and revenue sources as possible. It has led to the so called 360° approach.

In this multi channel world, where the consumer has almost infinite choice, creative businesses need to compete not just with other media companies, but with other non-media businesses competing for the consumer's discretionary spend. In using the term "multi channel", I'm referring to <u>all</u> of the many and different ways in which a single creative idea can be presented to the consumer. It could be an original idea for television being adapted for the live marketplace, or for on-line delivery, or for exploitation through music or film. New creative projects will require the adoption of a more holistic approach towards commercial exploitation.

Of course the idea of multi channel exploitation is not in itself new. I was involved with two successful, vertically integrated companies, The Really Useful Group and 19 Entertainment. In both these cases, each and every new project was exploited through a multiplicity of revenue channels. Of course, this strategy did require some knowledge of the market for each opportunity, but it was possible to acquire this through a series of joint ventures or partnerships. The integrated approach adopted in these examples created a virtuous circle as each strand of exploitation promoted and reinforced the others.

In a very noisy, competitive environment the ability to create distinctive, compelling content carries a significant premium, whatever the future revenue models might turn out to be. Incidentally this point has been powerfully argued by Jeff Bewkes, the CEO of Time Warner, in an interview for a recent article in the *New York Times*. As Mr Bewkes recognizes, content is so often the only differentiating factor between one competing channel and another.

And in the changing world of television, with the decline of "linear" viewing, the ability to access distinctive content is what is driving viewers - as evidenced by the success of Sky Plus and the BBC's I-player.

Successful creative companies always find a way of producing distinctive content. The real challenge they now face is how best to <u>deliver</u> that content across as many different channels as possible and how best to monetize it. And this will more often mean looking outside of the silo for which the content was first created. In many cases this is likely to require the development of new in-house skills and/or the creation of new joint ventures or partnerships.

Television producers, who have enjoyed a very benign funding environment in the UK in recent years, will now have to develop the corporate finance skills of their colleagues in the film industry, where the challenge is to piece together project funding from a wide variety of different sources. Luckily, the economics are very different for television so this shouldn't prove to be as difficult as it is for film!

Creative businesses will also need to be far more ambitious. They will have to take greater control over their own destiny and build greater business capacity so that they can truly take advantage of what they own. Though certainly challenging, this isn't as difficult as creating great content. It's about having the experience, relationships and know-how to ensure optimum commercial exploitation.

And, of course, great content has great scalability, across many market-places, as evidenced by the international success of our television shows and formats.

The creative businesses of the future will be agnostic so far as distribution channels are concerned; their creative and commercial activity will no longer be confined to a single "silo". We will see a much greater level of innovation and a more holistic approach to the creation and development of content. Convergence will no longer primarily be about technology platforms, but about the creation of the content itself, <u>and</u> the <u>monetization</u> of that content.

Right now, on-line production, for example, still draws heavily on the skills of specialist companies, but this is changing as on-line becomes more mainline and integrated. And of course, broadcasters and television producers are now learning more of those specialist digital skills themselves. I'm sure we will also see a spate of corporate activity as companies in one sector seek to acquire expertise in related areas through acquisitions. The creative businesses of the future will no longer be defined by any particular sector of media; they will simply be companies with really good creative people working across as many areas as they can. A good creative idea can come from any source and can be made to work in many different ways.

It's interesting to note that the largest media companies in the world already have most of the commercial channels within a single ownership structure, but the people working within those companies rarely demonstrate real creative or commercial collaboration. This must represent a competitive advantage to smaller creative businesses who adopt a more multi-disciplinary approach.

The other good news for future successful media companies is that they no longer have to be big. New creative companies are being created all the time and they don't need large amounts of capital – just the freedom to create. And small companies are usually much better at this than bigger ones, although in this matter – as in many other cases – the BBC is often an exception to the rule.

And this is why I think we are entering a new cycle of reducing scale. I emphasise reducing scale, which is not of course the same as *sub*-scale. In an earlier era of physical distribution, heavy regulation, and fewer channels for consumers to spread themselves across, it was very easy to see how and why the entertainment majors existed. They acted as the gatekeepers to the industry through their dominant position in distribution, and controlled both ends of the pipe. They decided what access suppliers would be given and determined how, when and for what price consumers got access to media.

They still hold important positions but they no longer wield the power they once had. They have significant financial muscle, which will ensure a powerful presence for some time to come, but their dominant position is no longer assured and their success will be more and more dependent upon their ability to acquire or create content.

And whilst the grip of the majors is loosening it is now possible to grow significant value in creative businesses and for them to remain independent. There has been a major shift of negotiating power in favour of content creators and owners: I don't see this trend ending any time soon.

Another change under way is in the area of investment. In the past the only real investors or buyers of content companies were the majors, but there are now more investors around in the sector than ever before. I also believe that given a choice of investment partner most creative companies would choose to stay out of the ownership of the large industry players – even if only during their development and high growth stages. Of course, their choice of partner will also be influenced by what an investor can bring to the party beyond the money.

A better understanding of media by the investment community - which includes developing a proper appreciation of the risks - should lead to more non-industry investment. This will give greater freedom and control to new creative businesses and should result in only the better companies and ideas finding their way to market. This will, in turn, create a more sustainable funding environment for a new breed of creative company.

The City has always had a difficult relationship with the media industry, and the level of understanding of the sector has generally been poor, although I think that is now starting to change. The poor performance of quoted media stocks against FTSE general averages over the last 10 years reveals how little the City as a whole has understood media companies. However higher quality commentary from the analyst community is likely to lead to better judgment calls by everyone involved.

Whilst on the subject of quoted media stocks, my own belief is that the pendulum has swung too far and that the sector is now oversold. There is greater visibility on future trends in the sector and most companies are now starting to understand what changes need to be implemented to ensure survival and growth in a digital environment. It is also the case that in recessionary times a lot of media companies do better than other sectors of the economy, mainly because the various forms of entertainment are comparatively low ticket items which consumers are reluctant to cut.

In the unquoted marketplace there are some savvy private investors who understand the opportunity very well. Have a look at what Alan Patricof is doing in New York with his new fund, Greycroft Partners. Patricof founded Apax Partners in 1969 before the term "venture capital" had ever been invented. Over the years he successfully backed companies like Apple Computer, America Online and NTL. Now he is backing young, high growth media content businesses with relatively small investments in the range of $500,000 to $3m.

There have also been a number of examples of investors backing creative companies closer to home. We have seen a wave of activity in the independent television sector over the last few years. Today's top "indies" are more mature and more sophisticated than ever before, though of course relatively tiny from a financial perspective. They are, however, the companies where most compelling content gets made, and crucially, these companies are an optimal springboard for launching content in multi-platform environments. I therefore believe that they are ideally placed to widen their approach and become the type of creative businesses I described earlier. They have a number of important characteristics which are attractive for investors including the programme funding environment, easy access to distribution, the change in the rights settlement, and of course the opportunity for scalability and explosive growth through international exploitation.

A word on the film industry

This is the British Academy of *Film* and Television Arts, and I have spoken so far mainly about television, so a word about the UK film industry. I am optimistic about the prospects for the UK TV industry, but less so about the film industry.

It has been five years since the House of Commons Select Committee produced its landmark report on *The British Film Industry*. The report cited a devastating critique of the industry that submitted by the UK Film Council. This is worth quoting in full:

> "The scattered and fragmentary nature of the (British) financing model contrasts sharply with the integrated model which forms the basis of US studio financing. The 'cottage industry' approach of the UK production sector, comprising scores of film companies, is remarkably successful at delivering excellent, culturally significant but ultimately unprofitable British films. This industrial structure (also) fails to deliver a consistent flow of films such that risk can be spread across a slate of projects. This inability to run a portfolio of films to mitigate financial risk acts as a very strong disincentive to private investment into the production sector. Obviously this approach (also) does nothing to build the significant corporate structures which are essential to achieve a sustainable industry."

I can only observe, with some sadness, that nothing has changed. Film and television are in very different places from a business perspective. In film we have buckets of creative talent but scarcely any business capacity. In television we have both. The oft-quoted film inward investment statistics disguise the continuing lack of business capacity and the full extent of market failure in the UK's independent film sector.

On a more positive note in the long term the impact of digital technology on film will lead to lower production and distribution costs. Combined with the effect of changing release windows, this *may* open up new possibilities for the future.

Concluding thought on public policy

Finally**,** I would like to make a brief observation about public policy and the creative economy.

A recent OECD study showed that, proportional to the total economy, our creative industry sector is bigger than any other country in the OECD family. A large part of that strength is down to our reputation for creativity and innovation.

As incomes and aspirations rise in developing countries, there should be a host of opportunities for British creative economy businesses to work abroad, make profits and contribute valuable export earnings to the Exchequer. However we have to maintain that advantage amidst growing international competition from some very ambitious countries – countries like China, Malaysia and India – in addition to more traditional competitors in the USA and continental Europe.

The creative economy has moved centre stage in our political discourse. The attention of politicians is of course welcome, but not always entirely intelligent. There has been a tendency to boastfulness, or hubris, which is not at all the same as self-confidence. There is a tendency to talk about "the creative industries" as if they are all equally successful, which they are not.

There is also a tendency to gloss over the fact that we are generally poor at building business capacity in the creative sector, and that in consequence, all too frequently, the commercial upside that flows from the efforts of our talented artists, actors, producers and directors ends up in some other place – usually America.

Does that matter? I think it does. But that is the subject for another lecture on another occasion.

Thank you for listening!