NESTA

It's Time to Play

A Survey on the impact of a tax credit for cultural video games in the UK development sector

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CONTENTS

Executive Summary

NESTA recently commissioned Games Investor Consulting (GIC) to survey 30 leading British video games developers, publishers and sources of funding with the aim of producing robust evidence to inform future government initiatives to support the UK video games sector. Following the directions set out in Digital Britain, this survey has focused on the potential impact of a tax credit for culturally British video games along the lines of those measures already available for the UK film sector and the French video games sector.

This report acknowledges that a strong video games ecosystem requires a healthy balance between small start-up independent studios, larger established independents and the publishers who often fund their work, or develop games in their large internal studios. Identifying the key challenges and potential impacts of the cultural tax credit on businesses in different positions of the industry's value chain is a crucial task.

To achieve this goal, the survey has targeted senior decision-makers who fulfil different key roles across the sector. They include senior executives in independent and publisher-owned studios, 3rd party development managers (who manage external contracting between publishers and independent studios), and executives at publisher head offices (in charge of the formulation of global investment strategies by publishers). The report also includes external sources of funding, such as project financiers and venture capitalists who already have or might consider funding individual development projects and video games companies.

These are the key findings of the survey:

A world-class sector under pressure

Survey respondents describe a world-class creative industry under increasing pressure. Experience, creativity and quality have been the traditional advantages of UK video games developers, while high costs and skill shortages are their main disadvantages. The availability of government subsidies overseas is making the UK even less competitive as a video games development territory, not only from the point of view of costs, but also of skills- Strong government support in competitor countries (particularly Canada) is attracting key senior staff in a 'brain drain' which intensifies existing skill shortages and threatens the quality of the UK's output.

Original IP development seems to be in decline

Nearly three quarters of respondents claim that original Intellectual Property (IP) development has slowed or stopped in the last 5 years, and more than half think that this the trend will continue in the future, with the potential exception of emerging networked gaming platforms. Risk aversion by publishers is making it harder for UK developers to be creative and innovative, areas where they have excelled in the past.

A slow-down in the UK video games sector

Most respondents report growth of some kind over the past 2 years. This growth is expected to slow down, or halt altogether in the coming 2 years. The survey sample includes some of the UK's most successful video games business. This means that the growth prospects for the rest of the industry could be expected to be significantly worse.

A shift in publisher strategy might benefit some UK developers

Although 3rd party development managers report low levels of investment in UK-based original IP production over the last 2 years, they claim that there will be a steady increase in the funds available for original IP in the years to come. This is a consequence of a shift in some publishers' development resources from internal studios towards external contractors, who are often seen as more efficient. This increased demand will, however, need to be matched by an increased supply of original IP from the UK.

There is optimism about the potential impact of a tax credit for cultural games

Almost all respondents believe that if introduced, the tax credit for cultural games currently under discussion would have a positive impact on the sector, as long as it is designed to take into account the specific requirements of the industry, and administered effectively. The tax credit for cultural games would help to 'level the international playing field', and make it easier for UK studios to retain their talent.

In regards to direct impacts, 89% of studios responding to the survey believe that a tax credit for cultural games would lead to increases in their staff numbers. 70% of publisher and external finance company respondents state that a tax credit could make the difference between investing in and passing on a games development opportunity in the UK.

The tax credit for cultural games would kick-start original IP development and encourage experimentation with new business models

Two thirds of studios claim that a tax credit for cultural games would have a definite, positive impact on original IP development, while 75% of independents believe that the measure would help them to keep hold of the original IP that they produce.

All independent studios state that a tax credit would encourage them to adopt new business models based on digital distribution, with the potential to establish direct relationships with their consumers and generate steadier revenue streams. In order to fund these new ventures, they would be more likely to seek financing from sources outside of the video games industry, such as venture capital or project financing.

The tax credit would boost publisher investment in the UK video games sector

All 3rd party development managers claim that a tax credit would increase their companies' funding of externally contracted development, and could make the difference between investing in and passing on a UK games development opportunity. Similarly, 80% of senior publisher executives claim that tax credits would boost their funding of development by both internal and independent studios in the UK.

The investor perspective

The majority of external finance sources consider the UK video games sector to be an unattractive prospect for investment at the moment. The reasons for this are lack of scale, and an excessive emphasis on traditional, high-risk retail business models instead of network gaming and direct-to-consumer propositions. They are unanimously positive about the impact of a tax credit on the scale and/or number of investments in UK video games projects. Half of respondents would change their attitude towards investing in UK video games companies if the tax credit for cultural games was introduced.

Section 1: Introduction to the survey

Games Investor Consulting (GIC) has been contracted by NESTA to survey 30 leading British video games developers, publishers and investors. The aim of this survey, following the call for evidence in *Digital Britain*[1], is to produce robust evidence for policymaking in support of the activities of the UK video games studio sector, particularly in regards to the potential impact of a tax credit for culturally British games.

In this section we introduce our sample and methodology. In section 2 we present the key findings of the survey, and in section 3, their implications. Appendix 1 identifies our respondents, and Appendix 2 contains a detailed breakdown of the responses according to different categories of respondent and topic.

The interview programme

Between July and August 2009, GIC conducted interviews with 30 leading figures in the games development, publishing and financing sectors. We targeted Managing Directors, Commercial Directors, Chief Executive Officers, 3rd Party Development Managers and senior financial executives working in some of the largest and most important video games companies and external finance companies in the UK. Their companies employ nearly 50% of the UK's entire permanent video games developer headcount. We have classified our respondents into 4 categories depending on their company's position in the sector's value chain and their role within the company (see appendix for a list of respondents' companies):

- **Development studios (14 respondents)**: Development studios design and create video games either for publishers to take to market or, in a slowly growing number of instances, for direct–to- consumer distribution and sale. Development studios are either publisher-owned (also referred to as 'internal'), operating exclusively for their parent company, or independent and mostly reliant on publisher contracts as a source of revenue.

- **3rd party development managers at publishers (5 respondents)**: Publishers perform a range of roles, from funding and project management through to distribution, promotion and commercial exploitation typically via wholesale to retailers. In addition to exploiting games developed by the studios that they own, most publishers make use of independent studios, either funding the development of original video game Intellectual Properties (IPs) or commissioning games

[1] BIS/DCMS June 2009

based on their own or licensed IP using a 'work-for-hire' model. The respondents in this category are responsible for sourcing and managing these third party development projects.

- **Publisher head offices (5 respondents):** This category of respondents comprises senior figures within publishers' global or regional head offices. Their roles typically encompass all development and publishing operations. These respondents have been primarily questioned about their internal development strategies. Their broader company purview and greater seniority sets them apart from 3rd party development managers and the publisher studio respondents.

- **External finance companies (6 respondents):** This category of respondents comprises private equity, project finance, financial advisors and venture capital companies. They were selected according to three main criteria: they had to have a functional understanding of the video games industry (which is uncommon in the finance sector), they had to represent a broad selection of investment methodologies (from project finance to early stage venture capital and buyouts) and had to include both companies that had and had not yet made investments in UK video games. We hope that the inclusion of these respondents in our survey will provide us with a complementary, possibly more nuanced view of the impact of a tax credit in video games development as compared to the video games industry, which we would expect to be mostly favourable to the measure.

The interview data has been anonymised, and permission has been sought for any quoted material. Our respondents were reassured that the interviews were confidential and that individual company opinions would not be published without approval.

Questionnaire content

We designed bespoke questionnaires for each of the 4 respondent types identified above (see appendix 2 for the companies). Each of these questionnaires contains specific questions addressing issues which are unique to the type of respondent and organisation being interviewed, as well as some common questions which are relevant across our survey sample. Most of the questions in the interviews were open.

Analysis

As we have already mentioned, the interviews undertaken in this survey were semi-structured, with open-ended questions addressing the key points included in the questionnaire. We have identified key emerging themes from the responses, highlighting, when relevant, differences in opinion or emphasis between respondents in different categories.

It is important to stress that our survey sample is too small and heterogeneous to produce statistically significant results. Although in Appendix 2 we present some of the results in terms of percentages and average scores, these values should be interpreted as indicative of broad trends, rather than representative of the industry as a whole, or any one games (or finance) company type.

Definition of video game

Throughout this report, we use the term 'video games' to refer to interactive digital games on all technology platforms, including TV-based consoles, handheld consoles, personal computers, interactive television and mobile phones.

Section 2: Key Findings

a) State and trends of the UK video games development sector

The UK video games development sector has advantages in quality, and disadvantages in costs

When asked about the advantages and disadvantages of developing video games in the UK, our respondents indicate two key factors, ‘quality’ and ‘cost’, which have countervailing effects in the attractiveness of the UK as a place to make games.

Other responses to this question are linked to these two factors. First, there are concerns about the potential impact of skills shortages (including the drain of senior personnel to other development territories) on quality. Second, there is a perception that higher levels of government assistance overseas are making the UK less cost competitive. As a result, UK studio executives often find it difficult to persuade their sources of finance (usually finance directors at the head offices of their global company or 3rd party development managers at their potential publishers) that their creative excellence outweighs higher costs to deliver potential returns on investment. As one senior publisher executive points out when discussing his UK studio:

> “Production costs are far too high and only make sense if the developer/franchise is extremely high quality. Our (UK) studio… (has) to do a very, very good job, otherwise we will move that IP out to one of our studios around the world. The key is if the company guarantees that the game developed there will be AAA and only that developer has the expertise to do it then fine, but if that quality drops it will be moved. If we had government assistance then that studio would be used for other games rather than being shut.” **Anonymous senior publisher executive**

The games industry has historically followed a highly cyclical pattern of growth with the industry’s fortunes largely echoing the parabolic sales curve of the major video games platforms such as Sony’s PlayStation and Microsoft’s Xbox consoles. The industry is currently considered to be mid-cycle. As it advances towards the lowest part of the console cycle around 2010-2011 (when publishers begin to shift resources to development for the next console generation) and government assistance overseas increases, risk aversion and cost consciousness will alter the balance against UK developers.

A brain drain of UK talent

The top two trends identified by our respondents, overseas subsidies and ‘brain drain’, are two sides of the same coin. The brain drain is a relatively recent trend that was not visible when Games Investor Consulting last surveyed the industry for government (*Playing for Keeps*, GIC/DTI/UKTI 2007). In that survey, executives reported that representatives from Canada were approaching them and offering them incentives to relocate but they were not, at that point, tempted to move. The exceptions to this since then have been Eidos (until recently the largest indigenous and independent UK publisher), which shed 75% of its UK development resource and relocated in Montreal, and Babel, which grew faster in Montreal than in the UK.

It is clear from our results that government support is now enabling studios in Canada to attract some of the UK’s most talented and experienced developers, who they target with generous relocation packages. One in three respondents to this survey claim that this brain drain will, over time, have a detrimental impact on the quality of UK video games development.

Trends in original IP generation

Nearly three quarters of our respondents believe that original Intellectual Property (IP) generation in the UK has been in decline or stopped altogether in recent years. 60% of 3rd party development managers confirm that they have not published any new original IP from UK studios in recent years. Executives from publisher head offices acknowledge that this is partly a consequence of increasing risk aversion in parent companies who prefer to focus on well-established franchises over betting on unproven intellectual properties. This trend is particularly worrying for the UK video games sector which has traditionally relied on its creativity and capacity to innovate as a differentiation factor against cheaper development territories.

More than half of our respondents (and 78% of independent studios) expect this trend to continue during the years to come. There are, however, some exceptions to this view. For example, 3rd party development managers are more optimistic about the amount of new original IP that their companies will fund in the next two years. This is possibly linked to a change in the strategy followed by some publishers, who anticipate a shift away from development by internal studios towards the contracting of external developers. However, and as one of our respondents points out, this increased appetite for externally developed IP by publishers will have to be matched by an increase in the supply of original IP from independents which, in his view, has fallen substantially in recent years.

Finally, a quarter of our sample is optimistic about the potential of less expensive networked gaming platforms (such as mobile and online) as new outlets for original IP.

Staff growth halts after some years of boom

84% of our respondents report growth of some kind over the past two years. It is necessary to take into account, however, that our sample includes some of the UK's most successful video games companies. In this regard, our findings could hardly be expected to be representative of broader trends in the UK video games sector. GIC's ongoing monitoring of overall headcount in the UK video games development market, shows, for example, that many UK studios have cut their staff, or gone out of business altogether in the last two years.

Future prospects are modest in the absence of a tax credit, with 76% of respondents anticipating little or no growth. Since the companies in our sample are generally outpacing the rest of the UK video games sector, this result would support the idea that, over the next 2 years, we will witness a decline in the numbers employed by the UK video games sector.

Trends in contracting

3rd party development managers at publishers report a steady growth in outsourced production in recent years. Overall development efficiency is the favourite reason for choosing UK studios over others. These respondents are also optimistic about continued growth in coming years, in part driven by the aforementioned strategic shifts by some major publishers towards third party development. This might improve growth prospects for some UK developers

b) The impacts of a tax credit

It is not surprising that our respondents expect a tax credit for cultural games to have a positive impact. They argue that this measure would, for example, enable UK video games companies to retain their best talent, and increase their cost-competitiveness. This would result, according to 95% of respondents from video games companies, in definitive or potential growth in numbers of staff.

Regarding the potential negative impacts of the tax credit, 87% of respondents declare that in principle there should be none, as long as it is administered properly; our respondents are mainly concerned about how strictly applied will the ‘cultural test’ to qualify for the tax credit be, the time-frames for qualification and payment, and the length of the government’s commitment to it.

The impact of the tax credit according to developers

Two thirds of development studios claim that a tax credit will stimulate growth in staff numbers, while the rest declare that there could be a positive impact.

Two thirds of developers are also optimistic about the impact of a tax credit on the generation of original IP. 75% of independent studios believe that a tax credit would help them retain ownership over the IP they generate. Independents also claim that it would make them significantly more likely to seek external finance (such as venture capital) for their projects.

The positive impact of the tax credit for cultural video games on business model innovation is one of the most striking results of the survey. All independent studios claim that a tax credit would help them to go direct to consumer using new distribution models.

It seems, from our survey, that UK developers would leverage the tax credit for cultural video games in two different ways, depending on their strategic focus. Some would use it to improve the attractiveness of their ‘pitches’ to publishers for original IP funding or contract development work, or when competing for resources with other internal studios owned by their parent publishers. Others, primarily independent studios, would use a tax credit to create video games on networked gaming platforms following novel and possibly more sustainable business models than those prevailing in mainstream console development. This approach might well require (and according to the responses from investors, would be more likely to attract) external financing.

The impact of the tax credit according to 3rd party development managers

The optimism of 3rd party development managers is significant given their key role in the ongoing funding of independent developers in the UK. All respondents in our sample are positive about the potential impact of a tax credit for cultural video games. 80% see potential for an increased number of externally contracted projects, and 75% claim that a tax credit would increase the likelihood of a positive funding decision in favour of UK studios pitching for a project. One reason for this is that 80% of 3rd party development managers at publishers assess the availability of government assistance when deciding which studio to work with.

The impact of the tax credit according to senior publisher managers

80% of senior publisher managers foresee increased investment if the tax credit is introduced. Our survey shows that, on average, senior publisher executives are more sensitive to the costs of video games development in the UK (as well as to the government's inactivity) than respondents in other positions. Executives claim that a tax credit will improve the global competitiveness of the UK video games sector, and help to retain senior staff in the face of increasingly attractive incentives from subsidised territories. Although publishers are more cautious than other respondents in regards to the impact of the tax credit on growth prospects, 80% still expect potential or definite growth in their UK resources if it was to be introduced.

c) The external investor perspective

The barriers to investing in UK video games development

External investors report a diverse range of barriers to investment in UK video games studios. The two most commonly mentioned issues are, first, the scarcity of investment opportunities suitable for their particular investment mandates, and, second, the unattractiveness of the traditional retail-based and hit-driven video games development and publishing model (which is perceived as too risky and unpredictable).

By contrast, some respondents highlight the attractiveness of network gaming businesses, which according to them offer faster and more predictable growth with greater profitability and exit potential. However, they also point out that the UK has very few companies operating in these higher value markets relative to other countries. In addition, very few UK video games companies operate at a scale which is attractive for the larger private equity investment firms.

The impact of a tax credit on investment in UK games

All of the external finance respondents agree that the introduction of a tax credit would result in greater investment in UK games companies and projects by external financiers. However, some of them declare that their own stance towards investing in the video games industry would not be altered by the tax credit. Our sample deliberately includes finance firms that have not invested in UK video games companies, and one of them indicates that the tax credit would not reduce their scepticism about the sector (although, interestingly, that same investor does have investments in video games outside of the UK).

The majority of respondents do nevertheless state that a tax credit for cultural games would either improve their attitude, or help retain an already positive attitude towards investing in games. Several declare that the tax credit would increase the volume of companies seeking funding (which they welcome), including companies with propositions which would be more attractive to them (particularly in network gaming platforms). It would also lead to the development of a range of new investment vehicles to address this increased demand.

Section 3: Implications

A healthy video games development ecosystem needs a balance between independent developers and publisher-owned studios. It simultaneously requires a regular flow of innovative start-ups, and the massive investments in cutting edge technology and content that only confident publishers have the resources to undertake. Some of these publisher investments will focus on internal studios while others will be destined to fund the creation of new blockbuster IPs by highly creative, often more efficient independent studios.

The survey provides important insights into the current state, and future evolution of, the UK video games development sector ecosystem by incorporating views from multiple stakeholders, both within and without the video games sector. It highlights some of the significant challenges faced by the industry, as well as the potential impacts of government support in the shape of a tax credit for cultural video games. The inclusion of sources of finance in our survey sample is unique and particularly important, as it potentially provides a more restrained assessment of the potential impacts of the tax credit, as compared to those video games companies who stand to benefit more directly from its introduction.

As mentioned previously, our survey sample includes large, renowned and successful companies, that is, those most able to weather the storms of global competition and the console cycle. In this sense, some of the results they report, particularly regarding growth trends and original IP generation and ownership could be expected to be unrepresentative, and significantly outperform those of the broader UK video games sector, which is mostly formed of smaller companies.

A world-class sector under pressure

Our survey shows that the UK video games development industry faces serious and mounting problems, often linked to the availability of government subsidies for video games companies overseas.

These subsidies are perceived to have several negative impacts: they have made independent studios less attractive as external development partners, and diverted investment away from publisher owned studios in the UK (in some cases, such as Eidos, leading to studio closures and major job losses). They also seem to be behind an exodus of senior and talented staff away from the UK, and towards studios in subsidised territories. This ‘brain drain’ has intensified industry-wide skill shortages caused by the limited flow of suitably educated graduates from games degree courses at British universities.

This trend might have harmful implications for the ability of UK video games companies to create the kind of high quality video games for which the UK is globally known, and which attract global companies in spite of higher costs. Whilst some respondents see network gaming as a potential new outlet for original IP developed by UK studios, very few companies have, to date, moved to seize the opportunities in these radically new, thriving markets.

A tax credit could trigger new original British IP from independents

Most respondents to the survey believe that a tax credit for cultural games would benefit the UK video games industry in a number of ways, principally by improving growth, widening investment prospects, and supporting creativity and innovation.

Independent developers are most positive, although some acknowledge that they may well end up passing on the benefits of the credit to their publisher partners. All independents believe that the credit will help them grow their staff, and explore novel direct-to-consumer business models in networked gaming platforms. They also argue that the tax credit will make it easier for them to retain ownership over the original IP they generate.

These impacts might be significant for the future competitiveness of the UK studio sector. As NESTA's *Raise The Game* report in 2008 described in detail, UK video games developers are finding it increasingly difficult to fund and retain ownership over original games IP. This has made them reliant on publishers for day-to-day funding via 'work-for-hire' contracts. Whilst this kind of externally contracted work from publishers provides substantial cash flow value to independents, it is the creation of successful original IP that generates long-term asset value and profitability for video games companies.

Retaining ownership over successful original IP, and the adoption of new direct-to-consumer distribution models, would enable UK video games developers to hold on to the asset and cash flow value generated by their creations. If, as our respondents report, the tax credit encourages innovation in this area, it could play a critical role in reversing the fortunes of some independent developers in the UK, helping them to adopt more sustainable business models, and reducing their reliance on overseas publisher funding sources. It would also contribute to speeding up the UK video games sector's transition towards exploiting booming networked gaming markets in which the UK is currently lagging behind its competitors in the USA, the Nordic countries, South Korea and Germany.

The impact of a tax credit on publishers' investment decisions

The future health of the UK video games sector equally depends on the activities of large scale, publisher-owned studios which comprise nearly half the sector's headcount, and are behind some of the UK's most important and globally successful IP. The survey sheds light on the factors behind global publishers' investment decisions, and on the pressures faced by strong but costly studios located in the UK. The survey finds that the benefits of a tax credit will also significantly benefit publisher-owned studios and the 3rd party development operations of global publishers. Publisher investment would not only benefit their internal studios but also, as 3rd party development managers highlight, those independent studios which they would be more likely to contract.

A tax credit could attract otherwise sceptical external investors

Investors believe that the tax credit could trigger increased investment for the industry overall and, in most instances, would improve their own attitudes towards investing in video games opportunities. This result is aligned with most independent developers' stated goal of seeking external finance if the tax credit is introduced. As we previously highlighted, the tax credit will definitely encourage developers to explore network gaming business models, which are precisely those that external investors are more interested in funding.

The tax credit is no panacea to the problems faced by the UK video games sector

Despite their optimism, most of our respondents do not believe that the tax credit will be the cure to all of the UK video games sector's ills; for example, it will do little to improve the quality of graduates coming from UK universities, a crucial challenge identified by our respondents.

In addition to this, there are concerns about the implementation of the tax credit, particularly in regards to the application of cultural criteria, and the administration of the scheme. For example, most respondents believe that the benefits from the tax credit will be limited if it is managed in an excessively bureaucratic fashion, if the credit is not approved at the concept stage of development, or if it is not paid in a timely manner. Many fear that the scheme will operate over a few years before being withdrawn or substantially modified. These are potentially disastrous scenarios for an industry where a typical project might take between 18 and 30 months to complete. One respondent claims that a poorly implemented scheme that does not take into account the unique funding and production processes for video games could do more harm than good, and possibly even result in company closures.

Appendix 1: List of Respondents

The survey respondents comprised individuals from the following companies:

- **Development studios**: Bizarre Creations, Blitz, Codemasters, DR Studios, Eutechnyx, Frontier, Jagex, Kuju, Rebellion, Reflections, Realtime Worlds, Sports Interactive, Sega Studios and TT Games.
- **Publisher 3rd party development managers**: Activision, Bethesda, Eidos, Sony Computer Entertainment and THQ.
- **Publisher head offices**: Codemasters, Eidos, Microsoft, SCEE and Ubisoft.
- **External finance companies**: 3i, Ariadne Capital, Atlas Venture, Balderton Capital, Carlyle Group and Fund4Games.

Appendix 2: Detailed breakdown of survey results

Developing games in the UK

1. Strengths of the UK games sector

This question asked 24 out of 30 companies' respondents (all but the finance companies) to describe the advantages of developing video games in the UK over other territories. This question is a proxy to the question "why invest in UK games development" that is asked by global games publishers in their decisions about development location as well as externally contracted development partners.

Most respondents cite multiple advantages:

Responses	All respondents	Studios	3rd party development managers	Publisher head offices
Strength of the talent pool	54%	71%	40%	
Strong tradition of video games development	50%	71%		40%
Creativity	42%	57%		40%
Quality of video games produced in the UK	42%	50%		60%
Cultural and language reasons (English, access to Europe and North America)	25%	36%	20%	
Closeness and camaraderie of development sector	13%	7%	20%	
High development efficiency	13%		60%	

The top four results are evidence of the excellent track record of the UK's video games development sector. We have also received a wide range of responses with fewer respondents, the most notable being the advantages derived from the close location of a critical mass of companies, and the development efficiency of independent studios (3 publisher head offices give this response). The cultural and location arguments are largely a legacy of the UK's past track record. The UK was the first large scale games market to develop in Europe in the early 1980s and its emergence was accompanied, uniquely, by a rapid proliferation of development professionals and companies. US publishers established their European headquarters in the UK because it gave them easy access to Europe's biggest games market and developer resource.

3rd party development managers place particular emphasis on the superior efficiency of UK studios, as well as cultural reasons. As one of them points out:

> "The exchange rate is favourable at the moment which has brought costs down. Combined with the greater efficiency of developers over here (the development process is better managed in the UK), British development is more cost effective than US development. The UK also benefits from having a shared culture and language with the USA, it is difficult to envisage being able to work as smoothly with German or French developers because of the difference of culture and language."
> **Anonymous publisher 3rd party development manager**

2. Weaknesses of the UK games sector

We asked 24 out of 30 respondents (as above) to describe the disadvantages of developing games in the UK in comparison to other territories.

Most respondents cite multiple disadvantages.

Responses	All respondents	Studios	Publishers head offices
High development staff costs compared to other comparable territories	50%	79%	40%
Low quality education system	38%	50%	20%
Skills shortages	33%	50%	20%
Limited/no government assistance	25%	36%	20%
Exchange rate fluctuations	21%	29%	
The brain drain to other territories / inability to retain staff	17%	21%	20%

We have received a broader range of answers than we did for the first question although three key, interlinked themes underpin all of the most frequent responses: high development costs, skill shortages and the impact of overseas government subsidies.

High development costs are seen as the UK's biggest disadvantage. They are a consequence of the high costs of living in the UK, as well as the impact of government subsidies for games production in directly comparable and competitive overseas territories, in particular Canada. Such subsidies have helped reduce costs in numerous countries and left the UK as one of the most expensive development territories in the world. Since most independent British studios do a significant proportion of their business with US publishers in US Dollars, adverse exchange rate movements can significantly exacerbate the UK's development cost disadvantage. Respondents' concerns about exchange rate fluctuations are the result of relatively extreme turbulence in the US Dollar: Sterling exchange rate through 2008 and 2009 (when a UK studio could be reasonably priced in the morning, and expensive in the evening).

Recruitment is another important worry for games executives. Several studios highlight the difficulties that they face when attempting to grow their headcount. This can be broken into two issues- the low quality of graduates from British universities and the shortage of experienced development staff due to the continuing brain drain to studios overseas. 2 out of every 5 respondents express strong dissatisfaction with the level of education, training and preparation for professional games development provided by British universities and in particular the specialist games courses. According to the CEO of the largest independent studio in the UK:

> "University graduates are trained to expect employment when they graduate but are not given sufficient skills because the universities are not providing coursework that is relevant to industry. We have to invest 12 months of training in new graduates, even Cambridge computer science degree graduates. We spend 6 months getting them to forget much of what they were taught at university and a further 6 months getting them used to our work culture and our tools and technologies." **Mark Gerhard, Jagex**

The brain drain phenomenon, caused by government subsidies overseas, is a growing source of concern. According to some respondents, the brain drain is not only robbing the UK of its most experienced and valuable developers but is also stifling the creation of new IP, damaging the quality of games production in the UK, and reducing video games start-up rates.

Some respondents believe that these disadvantages are inhibiting growth within the UK, and encourage the relocation of games production overseas:

> "The disadvantages are the limited talent pool and high employment costs. We cannot compete with China on costs but we can on creativity, so it is critical that we nurture this. We have two studios in China which we established to add the necessary scale to our business. They handle art and animation but also programming now too. We chose to expand there because of the difficulties of finding the right skills at the right price in the UK." **Darren Jobling, Eutechnyx**

Other disadvantages mentioned by our respondents include 'fears about the decreasing quality of British studios', 'high levels of taxation and over-regulation of small companies', 'high cost of living' and the 'geographical distance to US publisher partners'.

3. Government policy

We have asked all 30 respondents about whether they consider that the government is acting to address the problems of the UK video games industry.

Responses	All respondents	Studios	Publishers head officer	Investors
No	70%	86%	80%	100%
It has begun to help	17%	29%	20%	
The government has actually created many of the biggest problems	13%	14%		33%
It supports other (media) industries but not games	13%	7%	60%	

Most respondents have a negative opinion of the role of government in supporting the games sector to date. Responses range from "they are listening but not doing anything" to "they are positively working against the industry". There is widespread scepticism about the government's intentions, and its appreciation of the value of the games industry in comparison with film or television. Eidos' Life President expands on these issues:

> "Over the years, the government has failed to support the games industry regarding the problems caused by rising costs and inadequate graduate skills. UK universities in the main continue to churn out games generalists despite the industry's calls for more graduates with core skills in computer science, art and animation. The government has failed to introduce a production tax credit scheme to enable the UK to compete globally on an even playing field whereas many foreign governments have invested heavily in their own games industries. The UK games industry forms a major part of the creative industries. It is bigger than the UK film industry, an industry that has benefited from both a Film Council and production tax credits. That's great for the film industry but why doesn't the government treat games in the same way? The global market for games software is estimated to rise to $60-$80 billion by 2015 but unfortunately the UK games development industry is in decline having slipped from 3rd to 5th in world output rankings. The government is ready to help traditional industries that are hurt by the recession. But for our long term interests it should invest in a digital future rather than prop up a failing past." **Ian Livingstone, Eidos**.

17% of respondents believe that that government has begun to help, but nearly as many claim that government has caused many of the problems faced by UK video games companies such as inadequate education policies and over-regulation of small companies.

4. Key trends

All 30 respondents have been asked for their perception of the key trends affecting the British games development industry.

Responses	All respondents	Studios	Publishers head offices
Government subsidies in overseas territories	37%	71%%	20%
The brain drain to other territories/ inability to retain staff	33%	64%%	20%
Network gaming and the advent of new distribution and business models	17%	7%	40%
Industry consolidation / lack of start-ups	17%	29%	20%
Increasing difficulty of securing publisher funding	10%	21%	
The increasing cost/risk of AAA games development	10%	14%	20%
Diminishing access to non-trade finance	10%	14%	20%
The poor quality of graduates	7%	14%	

Unsurprisingly for such a broad question, the respondents have provided us with an extremely broad range of answers. Subsidies and tax breaks overseas (particularly particular Canada) are mentioned most often. The second most frequent response ('brain drain') is also a consequence of government subsidies overseas.

Publisher head offices and investors highlight the impact of network gaming on the industry. Network gaming (primarily via online platforms and mobile phones) makes it possible to adopt new business models (e.g. subscriptions and micro-transactions, or direct to consumer distribution) and company configurations (e.g. taking on support staff and reducing the proportion of developers as a percentage of total headcount). It also creates its own challenges such as the need to managing their relationships directly with a large numbers of consumers.

Studios are particularly concerned about consolidation and decreasing start-up rates. Nearly a quarter of them report difficulties in securing license or original IP publishing deals. Rising costs, poor access to finance and the poor quality of recruits from universities are also identified as important challenges. Interestingly, studio respondents do not seem to perceive network gaming as a key trend.

Bottlenecks in the generation of original IP are also highlighted by 3rd party development managers. As one of them points out:

> “The UK has not lost its talent or ability to create original, global best-selling games but it has gradually lost the financial and commercial environment that allows it to take risks and this has impacted the flow of new IP. It has trapped many developers in me-too business models that force them into accepting the projects that simply pay the wage bill.” **Anonymous publisher 3rd party development manager**

5. Forecasts for the UK studio sector

The 14 development studio respondents have been asked for their projections for the UK studio sector over the next five years.

Responses	Studios
The brain drain to subsidised overseas territories will continue	50%
The UK development industry will continue to shrink	36%
New distribution and business models will grow/open up new opportunities	14%
Government subsidy competition will continue/increase	14%

Our results show that the loss of key experienced staff to subsidised territories such as Canada is a crucial concern for UK developers. Those studios that have survived and stayed in the UK have been losing some of their best personnel to competitors overseas who are able to offer incentive packages they simply cannot or will not match. One independent developer describes the challenge faced by UK studios:

> “Our best technical guy was offered 2.5 times his UK salary, 100% subsidised relocation costs and a comprehensive support programme not just for him but also his wife and children as well as 2 years' completely free accommodation to move to Canada. We had to let him go, he would have been mad to stay. We even told him that. With the Canadian government paying for one in every three employees in Quebec, the likes of EA and Ubisoft can afford to do this for the best developers. We simply cannot compete with that.” **Anonymous independent studio**

Developers fear that as this 'brain drain' unfolds, the overall health of the UK as a global development hub will decline. Here is one representative opinion:

> "The UK will remain a strong games development territory but will not be as strong as it could be and will suffer from a continuation of the same trends as experienced in the last 5 years, namely the brain drain to Canada, the USA, France, Singapore etc., the closure of UK independent studios as well as publisher owned studios, and the steady decline in the volume of games made in the UK." **Gareth Edmondson, Ubisoft**

Original IP development trends

1. Past evolution of original IP development

19 developer and publisher head office respondents have been asked about their perception of the frequency and quality of original IP development in the UK over the last 5 years.

Responses	All respondents	Studios	Publishers head officer
Major console-based original IP has been in decline	47%	70%	
It is now almost non-existent	26%	50%	
New IP is flourishing online / on mobile	26%	40%	20%
The UK remains excellent at creating original IP	11%		40%
Increased publisher risk aversion is reducing original IP development / increasing franchise and sequel focus	11%		40%

The survey paints a pretty bleak picture of original IP development, a traditional source of competitive advantage for the UK sector. Nearly half of the respondents believe that original console IP production in the UK has declined in the last 5 years, and another quarter believe that such production is now almost non-existent. In contrast, a small number of respondents claim that new IP is enjoying a renaissance in emergent networked gaming markets such as online (both console and PC) and mobile phones (particularly iPhone). According to one of them:

> "Digital distribution has undoubtedly stimulated the creation of new IP and in fact has started something of a gold rush similar to the early days of the games industry." **Darren Jobling, Eutechnyx**

A smaller number of respondents claim that the UK still excels at creating original IP. Some respondents (including people working in publisher companies) blame the decline in original IP generation in the UK on increasing risk aversion amongst publishers who prefer to invest on the development of franchises and sequels.

Publisher 3rd party development managers have also been asked about how often have they published original IP developed in the UK over the last 2 years.

Responses	**3rd Party development managers**
We have not published any	60%
We have published multiple original IP titles	20%
We have published a few original IP titles	20%
We are seeing fewer and fewer original IPs pitched to us	20%

The stark finding is that the majority of respondents have not published any original British-made IP in recent years. One respondent indicates a decline in the number of original IP proposals presented to them. This might suggest that the decrease in demand for original IP is leading to a decrease in the supply of original IP.

2. Future trends in Original IP development

The 19 studio and publisher head office respondents have been asked about their opinion regarding original IP development in the UK over the next few years.

Responses	All respondents	Studios	Publishers head officer
It will decrease	54%	78%	
New IP will continue to flourish online/on mobile	23%	22%	25%
Publisher risk aversion will continue	23%		75%

The majority of respondents are fairly pessimistic about the prospects for original IP development in the UK over the coming years. A smaller group do however believe that original IP created in the UK will find a 'home' in the networked gaming markets mentioned in the discussion above. For example, one of our respondents states the following:

> "If you had asked me this two years ago I would have talked about the increasing risks associated with original IP development and the problems this was creating for games developers. However now there are fertile and new ways of distributing games that are promoting original IP development and allowing developers to try out new game ideas on low cost, lower risk and smaller platform such as Xbox Live Arcade or PSN. If they work, they can then gain increased investment by publishers to take them to full production on console." **Peter Molyneux, Microsoft Games Studios**

3rd party development managers have been asked whether they will increase or decrease the amount of original IP developed in the UK over the next 2 years.

Responses	3rd party development managers
It will definitely rise (we have original IPs in development here)	60%
It might rise (we are looking for original IPs)	40%

It is interesting to highlight the contrast between the responses from 3rd party development managers and the rest of the respondents (including publisher heads offices). This divergence can be attributed to two factors:

First might be an 'aspirational bias' in some responses to this question – positive intentions that may not translate into action. Although most third party development managers are keen to increase the number of original IP deals they do, supply and budgetary limitations combined with head office risk aversion often will limit the number and value of such deals. Second, several of the respondents have highlighted a change in strategy within their companies, with a shift towards external development of both original IP and licence-based titles after several years of internal resource growth at the expense of third party development. As a result, 3rd party development managers in these organisations expect the number of original IPs that are funded and published by their organisations to rise. It should also be noted that one of the respondents is a console manufacturer, for whom ensuring a strong flow of original and often exclusive IP on its proprietary platform is critical to its growth strategy.

3. Independent studios third party licence work vs. own game IP

Independent studios have been asked for the approximate split, over the last three years, between revenues generated from their work on third party owned properties and their own game intellectual property.

Responses	Independent studios
Own IPR	59%
Third party licence	41%

It is important to highlight that this result is probably unrepresentative of the broader population of UK independent developers. Our sample contains a disproportionate number of self-financing studios such as Jagex, Frontier, DR Studios or Realtime Worlds. This kind of studio is the exception to the norm in the UK, where the average developer generates its own IP only occasionally, and focuses mostly on externally contracted work.

When we take this potential distortion into account, exclude these rare studios wholly focused on own-IP exploitation and focus only on those independent studios in our sample which are more representative of the UK population, we find that, in average, they generate 18% of their revenues from their own IPR, whereas 82% come from externally contracted development. This result fits with past data on the subject, such as

TIGA's 2009 survey, which found that well above half of the average independent studio's annual projects are externally contracted[2], and *Playing for Keeps*, which found that around two thirds of independents' revenues were generated through externally contracted work[3].

Staffing trends

1. Past growth of staff numbers

Two thirds of companies have been asked about the growth of their staff numbers over the last 2 years, and by what rough percentage it has changed.

Responses	All respondents	Studios	Publishers head offices
Growth	32%	36%	20%
Substantial growth	26%	36%	
Modest growth	26%	29%	20%
Remain stable	11%		40%
Substantial decline	5%		20%
% average growth of those that reported growth	15%	26%	

The vast majority (84%) of companies (and particularly studios) report growth of some kind. These results should not be extrapolated to the rest of the UK video games sector, because the companies in our sample are all surviving, successful and of a much greater scale than the average UK studio. The average reported growth rate is 15%. Although these results are positive, it is necessary to take into account that the period considered does include 2007, which was a boom year for British games development.

The growth reported by senior publisher executives has been more modest than in the rest of the sample, with 60% remaining stable or declining substantially. This might reflect massive job cuts in one large formerly British-owned publisher (Eidos), and the loss of sales and marketing jobs overseen by some other of our respondents.

[2] On average, 56 per cent of games produced by developers in 2008 were work for hire projects. Wilson, R., State of the UK Video Game Development Sector (TIGA 2009), p. 5.

[3] Playing for Keeps, GIC/UKTI 2007

2. Future trends in staff numbers

Two thirds of companies have been asked about their prospects regarding the growth of their staff numbers over the next 2 years.

Responses	All respondents	Studios	Publishers head offices
Modest growth only	47%	50%	40%
Remain stable	29%	25%	40%
Growth	11%	14%	
Potential for strong growth	11%	7%	20%
Don't know	5%	7%	
Will grow overseas	3%	4%	

Most respondents (76%) state that growth will be modest or non-existent. This represents a major change in the trend observed over the previous 2 years. Only 11% of respondents expect anything more than modest growth over the next 2 years, compared to the 58% of respondents that experienced higher rates of growth over the last 2 years. One respondent claim that his company will be conducting reviews of its cost base with a view to either restructuring or rationalisation. We would expect the staff growth expectations of other smaller, less successful UK video games companies not included in our sample to be more pessimistic.

Publishing and contracting trends

1. Amounts of externally contracted development work outsourced by publishers to UK developers

Publisher 3rd party development managers have been asked to state the number of titles and rough development budgets by UK developers that they fund.

Responses	3rd party development managers
We have a small number of titles in development by UK developers	60%
We have multiple titles in development by UK developers	40%

The UK is often the European location of choice for global publishers' third party development management teams. It is natural therefore that all our respondents in this category have some titles in development, although most of them have only a few.

2. The UK as a location for 3rd party development

Publisher 3rd party development managers have been asked how the UK ranks in terms of other territories to which their company contracts third party development projects.

Responses	3rd party development managers
It is only a small percentage	40%
It is our biggest territory	20%
It is one of our biggest territories	20%
It is reasonable	20%

Although the biggest single category of responses sees the UK as a less frequent recipient of external development contracts, the same proportion claims the UK is large or the largest in their portfolio. Overall, this reflects the UK's status as a major, but far from the largest, location for 3rd party development contracting by publishers.

3. UK studios within the global footprint

Senior executives at publishers have been asked about how the UK ranks in their global studio footprint compared to other territories.

Responses	Publishers head offices
It is a major component	40%
It forms a tiny part	40%
The vast majority	20%

60% of those interviewed see the UK as the main, or at least a major, territory for their companies. Although this shows the relevance of the UK as a global video games production centre, it is necessary to take into account that all the respondents already have a significant presence in the UK, and their views are not necessarily representative of the global video games industry more broadly.

4. Past evolution of externally contracted work

Publisher 3rd party development managers have been asked about the change in the number of contracts with independent UK developers over the last 2 years.

Responses	3rd party development managers
It has grown steadily	40%
It has grown substantially	20%
It has stayed the same	20%
It has decreased as we have moved to internal development	20%

Three out of five respondents indicate growth, either steady or substantial, in recent years. This can be attributed to two factors. First, these last two year's find the video games industry at the mid-point of the current industry cycle, during which the commissioning of third party developed licence projects tends to accelerate. Second, and as we pointed out in 2.2, there has been a recent change in some publishers' third party development strategies, with a shift from development by internal studios towards contracting with external parties. This is linked to the increasing importance of externally contracted development for UK independent studios, which has become their main source of growth over the period.

5. Future trends in externally contracted work

Publisher 3rd party development managers have been asked about the future trends in the number of contracts with independent UK developers over the next 2 years.

Responses	3rd party development managers
It will grow	60%
It will remain stable but our average deal/project sizes are increasing	20%
It will remain stable	20%

There is optimism amongst the majority of respondents, indicating that 3rd party development could see an upswing in the coming years. Again, this is being stimulated by significant strategic shifts at some of the publishers. One respondent explains the changes at his company:

> “We have undergone a major change in development strategy. 6 or 7 years ago 70% of our development was done externally. Since then and under the previous management, this has swapped around and is now 60-70% internal development. The problem with this is that internal studios are generally expensive and inefficient; downtime is expensive when you have major internal teams doing nothing between titles. There isn’t the motivation to complete games on time and budget and to a satisfactory quality, the motivation is to collect the monthly paycheque. We are changing this and are looking to make much more use of external development as are other major publishers. We will be maintaining smaller internal teams and making much more efficient use of outsourcing, bringing in external studios to work on full projects or specific components of projects much like a Hollywood movie production process.”
> **Anonymous publisher 3rd party development manager**

This change in strategy might mean that the moderate or flat growth predicted by independent studios in, for example, 3.2, might be mitigated by a stronger demand by publishers searching anew for the services. However, as we noted in 2.2, 3rd party development managers tend to be much more optimistic on this subject than generally more senior publisher executives.

6. Competitiveness of publisher studios with wider studio portfolio

Publisher-owned studios have been asked how competitive their UK studios were compared to other studios in their parent company’s portfolio.

Responses	Publisher-owned studios
No real internal competition	33%
Don’t know	33%
We are one of the most expensive	17%
N/A	17%

This delicate question receives diplomatic responses from most studios, who state there is little competition between internal studios. However, one respondent points out that his studio is considered as expensive in comparison to other studios owned by his publishers. The NA answer above represents a publisher with no or negligible overseas development resources.

7. Investment drivers for publisher studios' location decisions

Publisher studios and head office executives have been asked to identify the key drivers of decision-making around the location of new studios or the expansion of existing ones. Only 3 publisher head offices have responded to this question, so we only provide percentages for the publisher owned studios.

Responses	Publisher-owned studios
Talent pool	50%
Government support	33%
Staff costs	33%
N/A	17%
Geographical/logistical considerations	17%

These interesting results underscore the importance of talent in determining publisher location decisions. They also show that UK publisher-owned studio managers do not consider government support to be the primary driver behind publishers' decisions. Nevertheless, as the results above have suggested, government support has an impact on both the talent pool (by enabling studios to invest in attracting the best available talent) and staffing costs. The N/A answer above represents publishers with no or negligible overseas development resources.

Senior executives at publishers have been asked how government support compares to other factors such as the skilled labour base, costs of labour, proximity to markets and other factors in determining investment decisions by headquarters. Only three respondents have answered this question. Two of them argue that multiple, interlinked factors played influence publisher's location decisions. According to one of them:

> "Government support and a solid skills base have to be considered together and cannot be considered in isolation. The strength of these two is what makes Canada so attractive as a development territory."
> **Anonymous senior publisher executive**

8. Importance of government support when assessing external contracting

Publisher 3rd party development managers have been asked whether they consider the availability of government assistance in other territories when deciding which studios to work with.

Responses	All respondents
Yes	80%
No	20%

This result suggests that government support is becoming a standard factor when publishers decide which studio to contract with.

9. Publishers' benefit from overseas government assistance

Publisher studio and head office respondents have been asked whether their parent companies benefit from government assistance in other territories (we have adjusted these results for duplication).

Responses	All respondents
Yes	50%
No	50%

Half of the interviewed publishers receive government assistance in other territories, although one publisher describes such support as negligible in impact due to the small size of the team receiving the support. Of the companies that have not received support abroad, two of them are console manufacturers who have made the strategic decision that quality overrides cost. Their internal studios are carefully nurtured for their ability to create strong franchises which show the best potential of their hardware. As such, the quality of their development talent is the key criterion for their survival, outweighing costs and government subsidies. Of the remaining companies, one answers that they have “not yet” received overseas government assistance.

10. Availability and impact of government assistance on sibling studios in other territories

Publisher-owned studios have been asked if their parent company benefits from government assistance in other territories.

Responses	Publisher-owned studios
Yes	50%
No	50%

The even split between those companies that do have studio resources in government subsidised territories does not take into account the scale of resources in those territories nor the extent to which these other studios have actually benefited from such subsidies. One respondent states that such governmental support has been instrumental in the growth of their largest overseas studios.

11. Availability and impact of government assistance for studios in other territories

Senior publisher executives have been asked if their parent company benefits from government assistance in other territories and if so what impact does that support have on studios in that location and their ability to attract investment from the parent.

Responses	Publisher head offices
Yes, most of our growth has been in government supported territories	40%
No	40%
Yes, but it remains a small overseas resource	20%

60% of publishers in this survey have received government support, although only 40% report it as crucial in the formulation of their strategies.

Impacts of a tax credit for cultural games

1. Positive impact of a tax credit for cultural video games

We have informed all our respondents of the government's ongoing consultation about a potential tax credit for games production on titles that pass a cultural test. Afterwards, we ask them what positive impacts they think such a tax credit would have on British video games development.

Responses	All respondents	Studios	Publishers head offices	Investors
Help level the international playing field	57%	79%	40%	33%
Help the UK games sector grow	50%	79%	40%	
Stop the brain drain to other territories/allow us to retain staff more easily	33%	43%	60%	
Result in greater investment in UK studios and raise quality levels	30%	43%	40%	17%
Stimulate innovation, more original IP creation, and new UK studios	13%	14%		
Increase games company funding by external finance sources				33%
Improves the development business model				33%
Will stimulate more companies to seek external finance				17%
It is a strong indication from government that it is taking the industry seriously				17%
Very little positive impact			20%	17%

97% of respondents, from all company types (including investors), are positive about the introduction of a cultural tax credit although a handful question whether it might be too little, too late. Although many respondents recognise that tax breaks in places such as Canada are much more generous that the cultural tax credit being discussed in the UK, they still believe it would contribute to redressing existing distortions in the international games development market. The following respondent argues that the cultural tax credit would enable his company to attract senior staff:

> "[the cultural tax credit] has the potential to make a massive difference to the UK games industry overall, encouraging new studios to form, existing

studios to grow, giving developers an improved opportunity to shine and providing an incentive for key staff to remain in, or return to, the UK. Within the sports games field so many senior staff have left the country to work in studios in Canada and America. We would have loved to employ them but their employers get offered huge personal incentives by the local governments to go there *and those are passed on to the individuals* . This will allow the UK to play catch-up with Canada in particular for us sports specialists." **Miles Jacobson, Sports Interactive**

Some also claim that the tax credit for cultural games would encourage innovation in the UK video games sector:

"It will help the UK industry reclaim its status as a hotbed of original IP development by encouraging greater risk taking and greater investment in innovation. It will help incentivise UK developers to explore new IP development and ultimately create and grow their value." **Anonymous publisher 3rd party development manager**

Although the responses from investors are less enthusiastic than those from companies working in the video games industry, they all expect a beneficial impact. According to one of them:

"There is no question it will have a positive impact on the UK games development industry. It will prove particularly attractive for foreign publishers with development resource here or looking to establish development resources here; it will make less of a difference for independent developers partly because the cost benefits will be claimed by publishers (indirectly if not directly). However the most important positive impact will be that it represents a clear message from government that games are a serious issue for them. They are finally putting their money where their mouth is." **Anonymous external financier**

Naturally, investors put much greater emphasis on the investment and business model angles and the positive impact on external investment in UK games. For example, some suggest that the tax credit for cultural games would lead to the creation of unique games-focused investment vehicles to assist the financing of games projects:

"A tax credit for cultural games productions may stimulate the creation of dedicated games investment vehicles as exist in Germany for film and games. These would have different investment criteria but ultimately will benefit the UK industry just as the German funds have benefitted the German film and games industry." **Anonymous external finance executive**

2. Negative impacts of a tax credit for cultural games

All companies have been asked about the negative impacts that the tax credit could have on British games development.

Responses	All respondents	Studios	Publishers head offices	Investors
None, assuming the system is simple and accessible	23%	14%	20%	50%
None, assuming the credit is approved and paid in a timely fashion	20%	21%		17%
None	20%	14%	40%	33%
None, assuming the cultural test is not too restrictive	17%	29%	20%	
None, assuming the system is not short-term	17%	14%	20%	33%
None, depending on how it is implemented	10%	14%		
Exploitation of the system	10%	14%		
Publishers will/could ultimately be the beneficiaries, not independent studios	7%	14%		

87% of respondents claim that the tax credit should not, in principle, have any negative impacts. Nevertheless, 67% of respondents add that this depends on the administration of the system. Some express concerns about the administrative costs and time-frames. The timing of the credit approval process, and the schedule of payments for the beneficiaries are identified as particularly important factors. According to one 3rd party development manager:

> "I don't really foresee any negative impacts but it cannot be too complex and absolutely has to be applicable (approval at least) at the concept/pitch stage because this is the single point where most independent developers have the most problems." **Anonymous publisher 3rd party development manager**

Many respondents also express concerns about the government's long term commitment to the text credit. Given the long time-frames involved in video games development (18-30 months), uncertainties about the future of the tax credit once approved lead some to suggest that a poorly administered tax credit could do UK video games developers more harm than good. As an anonymous 3rd party development manager at a major international publisher points out:

> "There are several conditions needed for the tax credit to work: we would need to receive approval at concept stage for the tax credit to be able to make our financial product investment decision based on the receipt of the credit or not. It does not have to be paid up-front but we would need to know for sure before we commission full production that the project would qualify. Secondly, the credit needs to be applied as a refundable benefit (i.e. a cash credit) rather than simply used to offset tax liability. It needs to contribute to operating costs rather than reduce taxes payable. If one or both of these are not applied, it will seriously undermine the appeal and effectiveness of the credit." **Anonymous publisher 3rd party development manager**

Investors also emphasise the importance of good implementation in order to avoid negative impacts:

> "There are several critically important requirements that will determine whether this tax credit might have a negative impact. Firstly, the credit has to be received during production to assist with the production costs and not afterwards. The Canadian system sees the credit come through 9 months after the production company's year-end and this has nearly bankrupted companies who have had to build the discount into their development budgets for third party publishers. Secondly, there needs to be an efficient and entirely transparent approval process that allows developers to know, at the concept or prototype phase, whether their product will qualify. The administration for this has to be as light as

possible; we have typically spent 20% of the receipts from R&D tax credits on professional advisors to process the necessary paperwork." **Tim Gatland, Fund4Games**

An outright negative impact identified by a small minority, mostly on the developer side, is that the tax credit will simply be used by publishers to drive down independents' prices even further. Others point out that the measure could be exploited by unscrupulous or desperate companies. Here are the concerns of one independent developer:

> "Publishers will undoubtedly ultimately gain the real financial benefit of the tax credit although they will do so via development price reductions which of course will benefit us by making us more competitive. However my biggest concern is over the policing of the cultural test. Assuming the test is applied at concept stage (if it is only applied at a late stage it will be limited use to the industry), what will happen to games that change between concept and completion and invariably become more commercial and less British? I think that unless it is policed properly, most games will lose some or possibly a great deal of the Britishness that was designed into the concept for the cultural test." **Clive Robert, DR Studios**

One of the publisher studios presents a similar perspective on the potential negative longer-term implications of the tax credit:

> "The definition of 'cultural' is worrying… I can see designers everywhere being forced to shoehorn 'cultural' into their games in order to qualify for the credits, which compromises the creativity and perhaps also the quality of the games. We might end up with some fabulous and lucrative new ideas just not being made, because an ultimately less successful, but also less risky, 'cultural' venture would be financially easier on the company. This leaves the door open for other less shackled countries to capitalise on the new ideas." **Anonymous publisher studio**

3. The impact of a cultural test on studios' ability to create games with global appeal

24 out of 30 companies have been asked if a cultural test will help or hinder their ability to create games with global appeal.

Responses	All respondents	Studios	Publishers head offices
It depends on how the cultural test is implemented	55%	54%	80%
It would hinder it	23%	31%	
It would help	14%	15%	20%

Half of the respondents point out that this depends on the implementation of the cultural test, while one quarter state that it would reduce their ability to create global hits. Other respondents state that it is perfectly possible to develop 'culturally British', globally appealing video games:

> "The two are not mutually exclusive. It is perfectly possible to create major international games IPs that are inherently British such as LittleBigPlanet or Tomb Raider." **Michael Denny, SCE Worldwide Studios|Europe**

Nevertheless, with little information on how the cultural test would be implemented in practice, this question (along with the earlier assessment of potential negative impacts) indicates some natural concerns regarding the actual constitution of the cultural test.

Publisher 3rd party development managers have also been asked whether the cultural test (which must be passed in order to benefit from a tax credit) would help or hinder their ability to work with external partners, or fund the development of games with global appeal. Their comments are too few and varied to be representative or significant, for example:

> "For the industry in general, it would not be a significant problem if only sub PEGI 18 games were eligible. However for us, it would be a major problem. The majority of our games released to date have been 18 rated and 75% of our products over the next few years are likely to be 18 rated. They are not sexually explicit but do feature swearing and violence." **Anonymous publisher 3rd party development manager**

4. Company-specific impacts of the tax credit

Studio executives (19/30 respondents) have been asked how a tax credit would impact their company.

Responses	All respondents	Studios	Publishers head offices
We would consider growing our UK resources	68%	79%	60%
It would result in increased games production / more investment in our games or facilities	21%	14%	40%
It would lead us to design cultural games	16%	21%	
It would allow us to pay higher salaries / attract better staff	11%		
It would probably not make a difference			20%

All studio respondents claim that the tax credit for cultural games will have a positive impact on their companies. Two thirds of respondents think that the measure will trigger headcount growth. One in five claim that even if their headcount does not grow, investment in games and staff quality or development facilities will increase and result in longer-term benefits. Here is one such example from the Senior Vice President of Sony's European internal development studios:

> "It might assist us to create better development facilities, a world class development environment and genuinely world class studios that are capable of attracting the best development talent from all over the world. This would ultimately lead to higher quality and more commercially successful games." **Michael Denny, SCE Worldwide Studios|Europe**

A smaller group of respondents state that a tax credit for the production of cultural games would change their focus towards more cultural games.

5. Impact of a tax credit for cultural games on staff numbers

Two-thirds of companies (those within studios) have been asked about the effect of a tax credit on their staff numbers, over the next 2 years, giving a growth percentage if possible.

Responses	All respondents	Studios	Publishers head offices
Definite growth	53%	64%	20%
Potential growth	42%	36%	60%
No, not materially	5%		20%
Projected average growth		17%	

Half of the respondents are confident that a tax credit will have a positive impact on staff growth, even though such measure will not benefit every firm. Most of the remainder are cautiously optimistic, stating that tax credits in specific productions might lead to hiring more staff.

There is one exception to this trend: one publisher executive, already a beneficiary of incentive schemes in multiple territories, is deeply pessimistic about the impact of a tax credit for cultural games on its UK staff. He argues that it would be “too little, too late” although he agrees that it might benefit other UK companies.

6. Distribution of benefits of the tax credit between publishers and developers

Publishers (representing 10 respondents) have been asked whether they would seek to claim third party developers' tax credits.

Responses	Publisher 3rd party development managers and head offices	3rd Party development managers
Yes, via development budget reductions	50%	20%
It depends/some will, some won't	25%	20%
Shared by publisher and developer	13%	
No	13%	20%

The majority of respondents believe that publishers will ultimately benefit from the tax credit, primarily via development budget reductions, an outcome envisaged in comments made by some of the developer respondents (who have not been asked this question directly) in response to other questions. Whilst such a practice could be perceived to exclude developers from the benefit of the tax credit, it might still make them more cost-competitive, and thus increase the chance of their project being funded, or successfully securing a work-for-hire contract. It might also lower their break-even point for overages (royalty payments after the development advance has been recouped). Only one respondent thinks that publishers would not seek to claim the tax credit either directly or indirectly. Here is one assessment of the situation:

> "This will depend on how the deal is done. For independently developed original IP the tax credit benefits may well remain with the developer. For internal and work for hire development, the benefits are likely to be absorbed by the publisher." **Chris Deering, Codemasters**

7. Impact on specific games projects

Ten of the publisher and finance company respondents have been asked whether a tax credit would make a difference when deciding whether to invest in a games development opportunity in the UK.

Responses	**All respondents**	**3rd Party development managers**
Possibly	40%	
Yes	30%	75%
No/probably not	20%	25%
Probably not, we already invest heavily in innovative new IP	10%	

Almost all the respondents are positive about the impact of the tax credit on their decision to undertake a project. For example, one respondent points out that:

> "Yes, it will make a difference. 16% (20% of 80%) is significant enough to make a difference in such circumstances" **Anonymous senior publisher executive**

Only a small handful suggests that the tax credit will have no impact. One of them points out that, in the case of his organisation, the reason for this is that they already have a very positive stance towards innovative original IP.

The majority of the finance companies that we have interviewed either have not invested in games projects before, or make investments based on the primary criteria of proposition and prospects, management team, and exit window. In their case, a cultural tax credit would tend not to sway their primary investment decision, although some respondents declared that it could effectively sweeten the deal.

8. Impact of a tax credit for cultural games on original IP development

Developers have been asked whether a cultural tax credit would have an impact on their ability to produce original IP.

Responses	Studios
It would definitely help	64%
We only do original IP	27%
It might help	9%

Most developers, both publisher-owned and independent, claim that the tax credit would have a strongly beneficial impact. Some make the same provisos about eligibility as reported before, highlighting their own strategic issues. Several respondents work in studios that already focus only on original IP, and therefore the tax credit will have no impact on their commitment to original IP development. Where a reason is stated as to why the respondents believe it would have a positive impact, all of them indicate that the tax credit would help reduce the costs and risks of development (which are higher for original IP development). Here are some examples of the kinds of responses to this question:

> “Yes, it would have a very significant impact on our potential future contract negotiations as we may well be able to spend more on our projects before approaching publisher partners. This would allow us to invest more in original IP, which is the core of our business.” **David Braben, Frontier**

> “It would be very advantageous as it may make us more willing to experiment, it gives us greater financial freedom and reduces our original IP investment risk.” **Anonymous independent studio**

> "Yes, it would make us more comfortable about investing in new technology and new games intellectual property." **Anonymous publisher studio**

9. Impact of a tax credit for cultural games on independents' ability to retain IPR ownership

Independent studios have been asked if a tax credit for cultural games would have a significant impact on their companies' ability to retain ownership over the original IP they develop.

Responses	Studios
Yes, definitely	50%
It would help a bit	25%
We already retain all of our IPR	25%

For independent studios, this is often an issue of critical importance. Over the last decade, publishers have become more demanding about ownership over the IP generated in all the projects they fund. They argue this helps them mitigate the ever-rising financial risk of publishing independently- developed original IP.

These results indicate the link between development costs and risks, and control over intellectual property rights. Half of the respondents believe that the tax credit would improve their ability to retain control over the IP they generate, while the rest are either less convinced, or already retain all of their IP (because they self-finance their development). The benefits to potential retaining of ownership over IP are illustrated by the following response:

> "It could well do and could act as a potentially valuable bargaining chip. If we can self-fund 33% and claim 16% from the tax credit, it means that the publisher only has to fund around 50% which gives us strong control over the IPR ownership." **Jason Kingsley, Rebellion**

10. Impact of a tax credit for cultural games on independents' seeking external finance

Independent studios have been asked if a tax credit for cultural games would significantly increase the likelihood of their studios seeking external finance, such as, for example, venture capital.

Responses	Studios
Yes	63%
We are already sufficiently well financed	13%
It would help a bit	13%
No	13%

The majority declare that the cultural tax credit make them significantly more likely to seek external finance as an alternative to publisher finance. The rationale for doing this is the following:

> "Yes, we will want to create cultural games which will be self-financed and in which we can retain the IPR and this will necessitate us seeking external finance." **Philip Oliver, Blitz Games Studios Ltd**

Needless to say, an increase in demand for external finance need not be accompanied by an increase in its supply. However, it should be noted that several external finance respondents (see section 6 of this appendix) suggest that one of the effects of the tax credit could be an increased volume of investment opportunities for them, which would ultimately lead to an increase in external investment in UK video games developers overall.

11. Impact of a tax credit for cultural games on independents' ability to go direct to consumer

Independent studios have been asked if a tax credit for cultural games would allow their companies to experiment more with direct-to-consumer business models. In one of the most striking results of the survey, independents unanimously agree that such a tax credit would lead them to adopt more innovative distribution strategies and business models. The proliferation of more accessible and commercially viable networked games platforms, and increasing consumer acceptance of digital distribution over recent years, are increasingly making it possible for independent developers to establish direct relationships with their consumers, bypassing publishers. Stimulating commercial experimentation by independent studios may well be one of the most important benefits of the tax credit's introduction, as it will enable them to retain ownership over the original IP they develop. According to one of our respondents:

> "Undoubtedly yes. The tax credit reduces our financial and risk exposure, grants us greater control over our IP's destiny and allows us to simply shift the risk to other aspects of the business such as experimenting with direct to consumer models." **Clive Robert, DR Studios**

NESTA's *Raise the Game* report, as well as *Digital Britain,* have emphasised the importance of innovation in business models in order to improve the sustainability and competitiveness of the UK video games sector. Our respondents (particularly those that have already begun experimenting with new routes to market) strongly agree with this view.

12. Impact of the tax credit on externally contracted development for UK studios

Publisher 3rd party development managers have been asked whether a tax credit for cultural games would have an effect on the number and/or value of UK-based independent development projects (original or licence-based) they fund over the next 2 years.

Responses	3rd Party development managers
Yes, it may well increase it	80%
Yes, it would make working with a UK company more attractive	20%

This seems to suggest that a cultural tax credit would result in an increase in the amount of externally contracted development funded by publishers. As a senior development manager at a large global games publisher explains:

> "I would love to increase the amount of independent and original IP projects we fund but the UK does not seem to have, at present, a plethora of spin-outs set up to work on new or innovative projects where 5 years ago there were plenty. The tax credit will hopefully provide the catalyst needed to stimulate this level of innovation again and we will have more projects to choose from. We are already intending to increase the number of independent and original IP projects we fund and this will help us achieve that aim and make us more likely to invest." **Anonymous publisher 3rd party development manager**

13. Impact of tax credit for cultural games on levels of publisher funding for 1^{st} and 3^{rd} UK party studios

Senior executives at publishers have been asked what impact they think such a tax credit would have on the level of funding made available by publishers for 1st party and 3rd party studios based in the UK.

Responses	3^{rd} Party development managers
It will increase it	80%
It might increase it	20%

80% of respondents believe that the tax credit will increase publisher funding for British games. However, one publisher sounds a note of caution:

> "It might make a difference but our development partner decisions are based on quality and specific publishing needs. I see UK developers as being highly specialised, useful for smaller development projects and specific components of development." **Anonymous senior publisher executive**

The investor perspective

1. Past experience with the video games sector

Half of the external finance sample has, to date, made investments in a wide variety of video games projects and companies. For the equity investors, the rationale for their investments was a combination of innovation and the overall potential for return on investment in the investee companies.

For the project financiers the rationale was equally pragmatic, largely because they are games production financing specialists with a model that works. For the remaining external finance companies that have yet to invest, the failure to find the right opportunity is cited as the reason why they have not made any investments to date.

2. Other UK creative industry investments and rationale

The external finance companies have also been asked whether they have invested in any other British creative businesses or projects.

67% indicate that they had done so, with most suggesting the rationale for investment was simply the high potential of the investment opportunities in question. One respondent points out that his company has invested in a creative business but not in a video games business so far because the creative business it invested on was of a scale that greatly mitigated the risks inherently posed by hits-driven creative industries. This respondent still has not found video games company that has reached a similar stage of maturity.

3. Barriers to UK games investment

The external finance companies were asked what they perceived to be the biggest barriers to investing in the UK video games development sector.

Responses	Investors
Traditional business model not attractive to investors	33%
Not enough opportunities in our target size range	17%
Not enough opportunities outside of the traditional model	17%
Not enough opportunities of the right quality (management, product etc.)	17%
High development staff costs compared to other comparable territories	17%
Comparatively high level of taxation	17%
Over-regulation of small companies	17%
Current economic weakness	17%

Respondents have given multiple answers that are broadly split between the unappealing nature of the traditional video games business model, the paucity of suitable investment opportunities, environmental problems such as the high costs of development, taxation and regulation in the UK, and the current unwillingness of banks to lend to smaller businesses. The following quotes illustrate the diversity of investor views about the barriers to investing in UK video games developers:

> “Developers and technical creatives are simply too expensive in the UK. We actively encourage our investees to locate their engineers and development resources in cheaper places like Canada and the USA where

costs are a fraction of the UK and the standard of living is good." **Anonymous external financier**

> "There are probably only 10-15 games businesses within Europe in our target size range and, of those, few have the sort of infrastructure we are looking for. We are looking for multiple product companies with diversified asset bases and broad revenue streams. Many of the companies we have seen are very successful but with single products only. Games production is also highly cash consumptive and has a very long lead time before revenues are generated. However, this can be managed if properly understood and games do fundamentally represent a very attractive market for us and for investors in general. It has proven very resilient to the economic downturn and is the only media business to experience strong growth during the last two years." **Anonymous external financier**

The vast majority of investments in privately held games companies in the last 5 years have been in the network gaming businesses. As NESTA's *Raise the Game* report highlighted, the UK is lagging behind other development territories in the transition to these new and fast growing markets. According to one investment executive:

> "Traditional games development is not attractive to invest in. It is a high risk, hits-driven business model that is highly unpredictable whilst the track record of even the larger publishing companies in the UK is not attractive. The big problem for the UK games development industry is that it, with a few notable exceptions, appears to be stuck with these traditional models and is being left behind whilst the global industry moves on to new distribution methodologies and business models. The most innovative companies currently tend to be US or Korean rather than British and this is contributing to the UK industry standing still." **Paul Flanagan, Ariadne Capital**

4. UK games investment prospects without a tax credit

The external finance companies have been asked for their outlook for investment in the video games sector in the coming years without the introduction of a tax credit for cultural games. Only three companies give responses to this question, with two offering a positive opinion for some types of investment (mainly network gaming businesses and later-stage games companies), and one suggesting that investments will suffer as a result of the shrinking video games development market in the UK.

5. UK games investment prospects with a tax credit

The external finance companies have been asked for their outlook for investment in the games sector in the coming years if a tax credit for cultural games is introduced. In contrast to the responses above, the external finance companies are unanimously positive in regards to the potential impact of the tax credit on the level of business/project funding by VCs, private equity companies and high net worth/angel investors. According to one of them:

> *"It will undoubtedly benefit the investors (as well as the production companies) on a feed-through basis i.e. they stand to gain from a more profitable business."* ***Anonymous external financier***

6. The impact of the tax credit on deal terms

External finance companies have been asked whether they think investment deal terms would change in any perceptible way if a tax credit was introduced.

Responses	Investors
Potentially change the debt : equity ratio for certain projects	40%
Improve deal terms for the games companies	20%
Stimulate the creation of dedicated games funding vehicles	20%
No	20%

Most of the external finance companies indicate that the tax credit would change the types of investment deals that would be done with games companies. Two of the respondents to this question highlight that they would expect a greater use of debt financing, because those projects or companies that qualified for the tax credit would have a reduced risk profile.

7. The impact of the tax credit on games investment intent

The external finance companies have been asked whether the introduction of the tax credit would change their attitude to investing in games companies in the UK.

Responses	Investors
It would improve it	50%
No change, we will remain positive/investors	33%
Probably not, we will remain sceptical	17%

Only one respondent has given a negative response, claiming that it is unlikely that the tax credit will improve investment in the UK video games development sector. The rest of the respondents are more optimistic. For the equity investors, the key factor is an improvement in the investees' business model. For the project financier, the impact would be somewhat different:

> "Yes. It would make projects more viable, it would increase the attractiveness of UK developed titles to foreign publishers which for us will result in a greater choice of projects for us to finance. It will also allow us to become more innovative in what we fund and how we fund it; it will give us an opportunity to experiment." **Tim Gatland, Fund4Games**

We subsequently ask positive respondents about potential changes in their investment strategy brought forward by the tax credit. Of the three companies that have responded, two indicate that it would increase the volume of deals they do whilst the other suggests that it would increase their risk appetite. Here is one explanation of the changes the tax credit might deliver:

> "The impact it would have would be to increase the volume of opportunities for investors, producing not only more companies but also more interesting companies for investors. This would probably lead to a rise in the number of games companies that get financed rather than an increase in the proportion of companies that get seek finance getting finance. This would mean more business for us." **Anonymous external financier**