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Scaling Up: AI and Creative Tech Submission for the Communications and Digital Committee

Creative Industries Policy and Evidence Centre

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Responses

1. What is the economic potential for improving the UK's scale-up landscape, and what are the consequences of failing to capitalise on this?

From the perspective of creative industries and the creative technology sector, there is substantial scope to improve the scale-up landscape. Many businesses in creative sectors are SMEs, but 73% of creative industries firms desire to grow their businesses (Creative Industries Council 2018).

Improving the scale-up environment for creative businesses could have substantial dividends for addressing regional inequality. Analysis in our report *Growth Finance for the Creative Industries* (Siepel et al 2024) finds that venture capital investment in creative industries tends to be very focused on a limited number of subsectors and regions, with most the vast majority of VC going into businesses in the IT, software and computer services subsector, and in London and the South East of England. Ensuring a more even distribution of growth capital, and addressing the finance and other shortfalls facing innovative businesses outside London and the South East could unlock substantial growth. Creative PEC research found that growth-oriented creative businesses located in creative microclusters (that is, small groupings of 50 or more creative businesses) outside the UK's largest creative clusters were more likely to want to grow but were also more likely to perceive finance as a barrier (Siepel et al 2020).

Another key part of improving the UK's scale-up landscape will involve ensuring that growing creative businesses that receive equity investment will have access to exit opportunities, including on UK stock markets. Our analysis shows that in creative industries in 2021 there were 130 M&A (merger and acquisition) deals involve creative industries businesses, but only four IPOs. Evidence from the US shows that M&A markets in tech sectors serve to reinforce regional inequalities (Ioramashvili et al 2024), so finding ways to address this challenge can help to address regional inequalities by producing more growing businesses in the UK's regions.

2. What specific barriers do SMEs face when seeking to scale in AI, and in creative technology?

In the context of creative technology, there are some specific barriers that companies face. Using analysis from Creative PEC's Creative Radar dataset (Ospina et al 2020), we identify several barriers facing creative technology firms. One is access to finance (see below). Others include late payment, availability of infrastructure, and for some businesses, regulation.

2.1 To what extent are these challenges unique to their respective sectors?

Our analysis in the Siepel et al (2024) report indicates that there are some challenges specific to creative sectors. We find that creative industries businesses are more likely to identify investment opportunities for R&D and new product/service development, but are no more likely to get funding for those investments.

2.2 What role does access to finance play?

Access to finance is an important issue for creative technology firms. As mentioned above, technology-focused creative firms are more likely than creative firms in general to view finance as a barrier. One reason for this is because innovation in creative sectors is more likely to be intangible – whereas other sectors' innovation activities may produce patentable, tangible objects creative businesses are more likely to innovate but these innovations are not picked up as signals of quality by the market (Di Novo et al 2022), meaning that innovative creative firms are more likely to have to rely on injecting personal funds into their businesses.

If innovation is less tangible to investors, this may prove to be a barrier to growth for innovative creative industries businesses. While many creative industries firms say they desire to grow (73% of firms in the survey in Creative Industries Council (2018)) and can identify investment opportunities, they require support to become 'investment ready.' Investment readiness refers to a business's desire to grow, suitability for investment, and ability to communicate to potential investors (Mason and Kwok 2010). Supporting businesses to become investment ready involves a combination of business support and education about funders and what they require.

Another barrier relating to the demand for capital relates to creative businesses' perceptions of investors and investors' understanding of the creative industries. If companies feel they are unlikely to be successful in seeking finance, for example, they may decide not to apply. This phenomenon, known as discouragement, was identified in the creative industries in Fraser and Lomax (2011). This report presents new findings from an analysis of discouragement using the 2017 Creative Industries Council survey data (BDRC 2017) and finds that one key factor associated with discouragement was the perception that financial institutions did not understand creative businesses.

In the context of venture capital and growth capital, our research also shows that investments into creative sectors tend to be heavily concentrated. From a sectoral perspective 85% of VC investment into creative sectors goes into IT, software and computer services businesses, and the share of creative businesses not in that sector has declined as a share of the overall market from 7% in 2013 to 2.5% in 2023. Likewise, these investments are heavily concentrated in London and the South East, which had 62% of VC investments in creative industries, compared to only 11% for the North of England (North East, North West and Yorkshire and Humber).

In the context of growth capital, another issue is availability of a functional 'funding escalator'. Analysis in our forthcoming report (Siepel et al 2024) finds evidence consistent with the presence of an equity gap, with investments available below £500,000 and above £1 million but with limited investments between these.

3. How effectively are existing organisations (such as UKRI), catalyst programmes, industry schemes and other Government initiatives addressing these issues?

There are several interesting initiatives that have helped address some of the issues creative businesses face in scaling up. The AHRC Creative Industries Clusters Programme was a powerful intervention helping innovative businesses to get support and build local connections, strengthening local clusters. Likewise, the Innovate UK Creative Catalyst scheme has helped address issues for creative businesses looking to access funding for their innovative activities.

The other initiatives that are important are the DCMS Creative Scale Up programme and DCMS Create Growth Programme. These have helped to build investment readiness for creative businesses by providing business support and knowledge to creative firms with interest in growing. These interventions are particularly interesting.

3.1 What outcomes are being achieved?

We await formal publication of the DCMS Creative Scale Up evaluation, which is complete, and the completion of evaluation of the DCMS Create Growth Programme. We also await details of the evaluation of the Innovate UK Creative Catalyst scheme.

We note with interest the results of the evaluation for the AHRC Creative Industries Clusters Programme (Frontier Economics and BOP Consulting 2024), which suggest promising results for growing businesses in these clusters. However, information and support do not always guarantee that investment barriers will be alleviated. For example, the evaluation of the Creative Industries Clusters Programme (Frontier Economics and BOP Consulting 2024) found that while many participants in the programme said they benefited from new information about finance, there was no change in the number of firms identifying finance as a barrier after participating in the programme. This may potentially indicate an issue with timeframe of the evaluation (that is, companies might have been asked the question but would eventually feel more comfortable seeking finance) but the challenge remains clear that improving investment readiness is a key issue.

4. What further measures (financial and non-financial) are needed to address barriers to scale in AI, and creative technology?

Several measures can help address the challenges for creative technology businesses:

- Many of the issues facing creative businesses relate to demand. Support for businesses to become investment ready is essential to strengthen capacity in these sectors.
- The lack of availability of sector- and investment-level data has previously been identified as a barrier to growth in the creative industries (UKBAA 2023), and only by demonstrating in quantitative terms that creative businesses are solid investments can new investors be attracted to the sector. More and higher quality data collection of investment flows into creative sectors will be very helpful
- There is scope for new forms of innovative finance in these sectors. Recent years have seen financial innovations such as the music rights company Hipgnosis, and other opportunities exist for new financial instruments to help businesses grow. The forthcoming changes to British Business Bank provide some opportunity to support innovation in financial services.

There is also the wider issue of ensuring that R&D tax reliefs work for the creative industries, which would help to further stimulate innovative activity in the CreaTech and AI space. Creative PEC research shows that creative industries firms make an outsized contribution to R&D in the UK economy, accounting for 11.5% of Business Expenditure on Research and Development (BERD) in the economy (Bakhshi 2022). This is higher than the creative industries share in GVA (5.8%) calculated on the same basis using ONS data, meaning that they make a significant contribution to R&D overall. Despite this, there is evidence that some parts of the creative industries are under-served by R&D tax relief, suggesting that these creative industries firms could be incentivised to invest in more R&D.

Adopting the more inclusive definition of R&D set out in the OECD's Frascati Manual for R&D definitions which recognises AHSS R&D, thereby incentivising more R&D investment in the creative industries, could supercharge creative industries innovation and help the Government make good on its mission to generate further economic growth.

The creative industries are R&D intensive and rely extensively on the Arts, Humanities and Social Science disciplines for their innovation. A DCMS survey of R&D in the creative industries from 2020 found that over half of firms reported carrying out R&D according to the OECD Frascati Manual definition, but this dropped to only 14 per cent when using the UK government R&D definition for tax relief (OMB Research 2020). A large part of this disparity is that HMRC's current definition for R&D tax reliefs does not recognise R&D in the AHSS, which contrasts with the best practice outlined in the OECD's Frascati Manual and 23 other peer countries (including France, Italy and South Korea) that include these

disciplines within their own definitions for R&D reliefs (OECD 2015; Bakhshi and Puttick 2022).

Creative PEC researchers have combined the findings from a 2021 survey of 361 R&D active businesses in the creative and high-tech sectors who had received funding from UK Research and Innovation (UKRI) research councils or from Innovate UK with ONS data on Business Enterprise Research and Development (BERD), to estimate that in 2020, creative industries firms may have invested in as much as £321 million in AHSS R&D, or around 9.7% of total creative industries BERD (Siepel and Bakhshi 2023). They would invest considerably more if they benefited from the same tax reliefs that are enjoyed by STEM R&D.

Unpublished HMRC data shared in confidence with DCMS also shows that R&D tax relief currently enjoyed by the creative industries is disproportionately directed to the IT, Software and Computer services sub-sector. Creative content sub-sectors – Music, Publishing and especially the Film, TV, Video, Radio and Photography sub-sectors – which invest in AHSS R&D are underrepresented.

5. What can the UK learn from overseas?

On the topic of R&D tax credits, a comparative study of 23 peer countries highlights how many other countries acknowledge Arts, Humanities and Social Sciences R&D for their tax credit programmes (Bakhshi and Puttick 2022).

About Creative PEC

The Creative Industries Policy and Evidence Centre (Creative PEC) supports the growth of the creative industries in the UK and internationally through the provision of authoritative research and policy advice. Funded by the Arts and Humanities Research Council, and hosted by Newcastle University with the Royal Society of Arts, Creative PEC works with policymakers and industry to enable a thriving sector that plays a central role in generating growth and innovation. Our research is led by consortium partners at Newcastle University, the University of Sheffield, the University of Sussex, and Work Advance.

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