

CONVERTIBLE NOTE



INVESTOR:
CO_Capital



**SOCIAL
ENTERPRISE:**
Sistema.bio
(Mexico, Kenya,
India, Colombia)

IMPACT ENTERPRISES LOOKING TO GROW OFTEN STRUGGLE TO RAISE CAPITAL

due to the complexity of establishing an appropriate valuation for the company. The two most frequently used financial instruments for growth-stage companies are equity and convertible notes. In contrast to equity, which requires an established valuation, convertible notes offer access to bridge funding that will convert into equity at a later point in time.

A convertible note is a short-term debt instrument, usually unsecured, that converts into equity upon the occurrence of a triggering event. For example, when the convertible note is used for an initial financing round (seed or post-seed financing), the triggering event is usually the closing of a subsequent equity round of financing (e.g., a Series A).¹

The underlying idea behind a convertible note is to provide an alternative to traditional amortization, offering the investor shares of the company and dividend payments instead of principal and interest payments. After a triggering event, the investor is entitled to convert the outstanding capital into equity during a subsequent financing round at



This case study is part of the Innovative Finance Toolkit. For more information, or to access more case studies, visit www.finanzasinnovadoras.org

¹ Series A is the investment round that follows seed financing. Startups usually raise capital via a Series A when they have already developed a track record that shows the potential for further growth or expansion.



either (i) the price of the financing round after applying the discount rate and/or (ii) the valuation cap, whichever is lower.



Context

CO_Capital is an impact investing fund created as part of the CO_Plataforma initiative to support the social innovation and enterprise ecosystem. The fund seeks to develop sustainable solutions that reduce inequality and improve quality of life in Mexico. It invests in high-impact social and environmental enterprises working to fight poverty, inequality, and climate change in Mexico and Latin America. Co_Capital invests in companies with sustainable and scalable business models that are looking to increase financial and gender inclusion across different sectors, including i) education, workforce, and economic development; ii) access to healthcare; iii) access to basic sustainable infrastructure; and iv) agriculture and ecosystem regeneration.

Created in 2017, CO_Capital invests in early growth-stage impact enterprises that have hit breakeven. In other words, companies that are already profitable and can take on debt to grow their operations and, by extension, their impact.² Exit opportunities for social enterprises in Mexico are limited. As a result, most of CO_Capital's investments are self-liquidating (e.g., debt or revenue-based financing). The rest of the fund's investments are in equity and convertible notes, which require a clear exit strategy to balance the higher level of risk.

Sistema.bio is a manufacturer and distributor of innovative, award-winning, and easy-to-use biodigesters that allow small and medium farmers to transform organic waste into biogas and organic fertilizer, increasing yields and incomes. Founded in 2010, Sistema.bio produces, installs, and finances biodigesters via its teams in Mexico, Colombia, Kenya, and India, and has operations in 30 additional countries via its network



² For more information, visit <http://co.org.mx/es/>



of partners. The company provides access to innovative biodigester technology, training, and flexible financing structures for farmers to implement its modular, robust, and impactful hybrid biodigesters.^{3,4}

To date, more than 36,000 biogas systems have been installed, providing 220,000 people with access to clean and renewable energy. In terms of impact, Sistema.bio has reportedly mitigated 398,000 tons of CO², treated more than 18 million tons of waste, and fertilized more than 582,000 ha/year with biofertilizer.⁵



Opportunity and Deal Terms

In 2018, Sistema.bio started to fundraise for a Series A to support the expansion of its manufacturing capabilities, operations, and product development. The investment would allow the company to cover demand for its biodigester product and positively impact more than 200,000 farmers in Mexico, South America, India, and Kenya.⁶ At this point, Sistema.bio had already demonstrated significant growth potential, with a track record of more than eight years creating technology and value chains and with considerable potential to scale in Africa and Asia to help small farmers become more sustainable and independent while also increasing yields and significantly reducing methane and CO² emissions on livestock and agriculture farms.

CO_Capital had already established a relationship with Sistema.bio via the CO_Plataforma platform, which the company had used to access consulting services and acceleration support during its early stage.⁷



- 3 For more information, visit: <https://sistema.bio/mx/blog/2020-inversion-com-prensa/>
- 4 The cost of the biogas packages ranges between USD 500 - 2,000, with the systems paying for themselves after approximately 10 months.
- 5 Data as of July 2022 at <https://Sistema.bio/>
- 6 Dinero en Imagen (2021). Sistema Bio va por inversión para cubrir demanda de biodigestores [Sistema Bio Looks to Raise Capital to Cover Demand for Biodigesters]. Retrieved from: <https://www.dineroenimagen.com/empresas/sistema-bio-va-por-inversion-para-cubrir-demanda-de-biodigestores/139042>
- 7 Via CO-Plataforma, Sistema.bio accessed acceleration support from Village Capital, fundraising support from Kaya Impacto, and direct operational and financial management support from CO_. For more information, visit <https://www.ecosistema.latimpacto.org/co-apoya-el-ecosistema>.



TABLE 1 General Information - Sistema.bio	
Year Founded:	> 2010
Headquarters:	> México
Geographic Focus:	> México, Kenia, India, Colombia.
Financing Sources:	> Venture capital, impact capital, debt, donations
Partners and Funders	> KawiSafi, AXA IM Alts, Blink CV, Heifer International, Shell Foundation, Engie RD, Factor(e) Ventures, Ashoka, Chroma Impact, Endeavor, EU ElectriFI, W.K Kellogg Foundation, B Corporation, Kiva, Tere, AlphaMundi, CO_Capital, Lend a Hand, USAID, SNV, AlphaMundi, Beneficial Returns, Dila Capital, and more. ⁸
Website:	> https://Sistema.bio/

During this process, CO_Capital established a close relationship with the Sistema.bio founders and developed an in-depth understanding of the company’s business model.

Towards the end of 2020, Sistema.bio saw the need to raise another round of capital. However, the impacts of the COVID-19 pandemic meant that the company’s results didn’t reflect its true potential and would likely negatively impact its valuation. As a result, Sistema.bio decided to raise a bridge round⁹



⁸ Sistema Bio (nd) Partnerships & Clients. Retrieved from: <https://Sistema.bio/partnerships-and-clients/>

⁹ Traditional bridge loans are short-term loans with an initial maturity of one year or less, put in place to bridge a potential gap until a company can secure permanent financing. See <https://www.whitecase.com/insight-alert/basics-bridge-loans>.





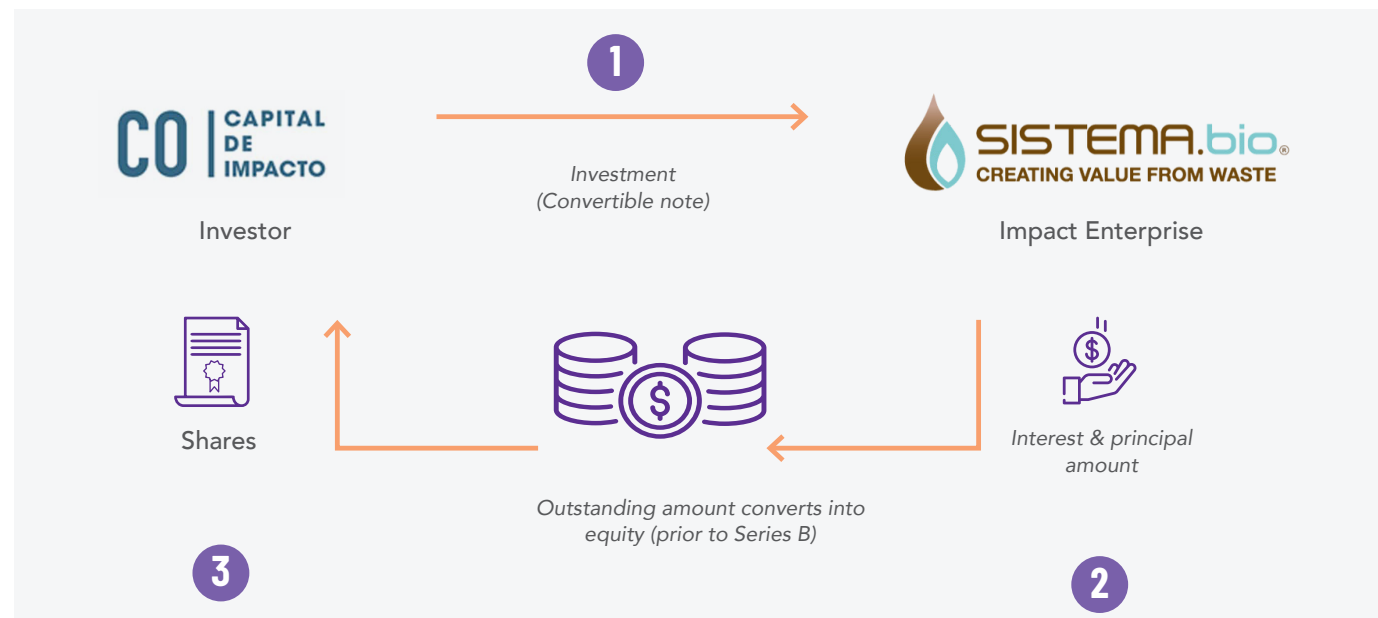
using a convertible note structure. The company invited existing investors from its Series A to participate, as well as some new investors.

Convertible financing offered Sistema.bio the opportunity to quickly capitalize its expansion and prepare for its next investment round with low execution costs and without having to establish a valuation for the business. Already deeply familiar with Sistema.bio and committed to its potential for impact, CO_Capital decided to invest through the convertible instrument, welcoming two new investors to further fuel the company's growth.



How was the convertible note of Sistema.bio structured?

FIGURE 1 Convertible Note Structure



SOURCE: Created by authors.



ASSUMPTIONS

- Biogas provides access to a clean and affordable energy source for low-income households and livestock farmers, displacing other sources that emit greenhouse gases, such as biomass or fossil fuels. Biowaste (bio/organic fertilizer) increases agricultural yields, replaces nitrogen fertilizers, and increases nutrients in agricultural products.
- Access to innovative biodigestion technology, training, and financing helps farmers address social and environmental challenges, such as poverty, food insecurity, and climate change.

- 1 Using a convertible note structure, three Sistema.bio investors provided USD 1 million in capital to support the company's operations for a limited time until the next successful fundraising round. The note included a discount rate of 20% and a valuation cap of USD 16.8 million.
- 2 The convertible note established a maturity date of 12 months and an interest rate of 8%. Upon reaching the maturity date, the total interest was calculated and added to the amount to be converted into equity.
- 3 Investors could elect to convert the total amount of the convertible note (plus accrued interest) if any of the following triggering events occurred: (i) a subsequent qualified financing round, (ii) a subsequent non-qualified financing round if the investors decided to convert, (iii) a liquidity event if the investors decided to convert, or (iv) the maturity date.



TABLE 2 Terms and Conditions a Convertible Note

Can Replace:	> Equity, SAFE, conventional debt/loan financing
Enterprise Lifecycle:	> Early stage
Risk/Return Profile:	> High risk / High return
Maturity	> 2021

Triggering Event

The investment was used to provide the impact enterprise with working capital, finance its technology and micro-loans, and to prepare it to raise additional capital in a subsequent Series B. The investment totaled USD 1 million (representing 15% of capital raised in the company's Series A) and was paid out in a single disbursement.

Discount Rate and Valuation Cap

The convertible note established both a discount rate and a valuation cap in the event that the maturity date was reached before one of the other triggering events occurred. The pre-agreed discount rate was 20% of the existing valuation, and the valuation cap was USD 16.8 million. The note would convert into equity at the price determined by the triggering event.

Interest Rate and Maturity

The convertible promissory notes bore interest at 8% with an established term of 12 months (with the option to extend for an additional 24 months) or the conversion into shares upon a triggering event, whichever occurred first. In this specific case, instead of being paid out in cash, the interest accrued on the invested capital, thus increasing the number of shares issued at the time of conversion during the Series B round in 2021.





When to Use this Instrument

- › Investors are not immediately compensated for the early-stage risk they take on via a convertible note. As a result, the impact enterprise must demonstrate a track record of financial performance and impact and **prove that it will be able to raise capital in the short to medium term** so that the investor is paid once the company has raised additional funds.
- › In situations where an impact enterprise cannot obtain a favorable valuation, a convertible note can allow it to **raise capital simply and quickly** while also deferring the valuation to a later investment round when it can obtain a favorable valuation for both the company and its investors.
- › Convertible notes issued with a discount rate that is too high or a valuation cap that is too low can **limit the company's ability to raise capital in the future**, as new investors might perceive that the convertible note investors received better terms and disproportionate benefits. It is important to adjust the discount rate and/or valuation ceiling (or floor) appropriately to facilitate the inflow of new capital.
- › For a convertible note to be an appropriate investment structure, the impact enterprise must have a **clear need for capital** (e.g., cash flow injections), in addition to demonstrated growth, healthy financial statements, and clear exit options to mitigate the risks of the investment.