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Unlocking Value in Special Situations Through ESG Integration

by BSP Responsible Investment

Environmental, Social and Governance ("ESG") considerations are increasingly central to institutional investment decision making. For Special Situations strategies - characterised by complexity, stress, and transition - ESG integration is not an overlay but a core component of disciplined underwriting, risk management, and value creation.

Contrary to the perception that ESG considerations are difficult to apply in distressed or complex scenarios, ESG factors are frequently drivers of dislocation, and therefore entry points for attractive investments. Weak governance, environmental liabilities, social controversies or regulatory breaches often contribute directly to operational underperformance, constrained access to capital, or loss of stakeholder confidence. Where these issues are identifiable, measurable, and remediable, they can be addressed through active ownership and structured influence.

Special Situations investors are uniquely positioned to influence outcomes.

Concentrated exposures, control-oriented investment structures, and engagement at moments of corporate transition enable the implementation of targeted ESG improvements that support stabilisation, recovery, and ultimately value realisation.

In many cases, addressing ESG shortcomings is closely linked to restoring financial resilience.

This paper outlines BSP Ltd's perspective on ESG integration in Special Situations investing. It explains how ESG risks are assessed, how influence is embedded at entry, how improvements are driven during the investment period, and how ESG progress contributes to downside protection and exit optionality. Our approach is pragmatic, proportionate, and grounded in financial materiality, with a clear focus on protecting capital while supporting sustainable outcomes for stakeholders.

Whitepaper Thesis

1 ESG in the Context of Special Situations Investing

ESG factors can underpin distress and, when effectively addressed, become a source of value in Special Situations

1.1 The Nature of Special Situations

Special Situations investing involves deploying capital into companies experiencing stress, dislocation or transition. These situations typically arise from balance-sheet pressure, operational underperformance, regulatory intervention, governance failures, shareholder disruption or broader macroeconomic shocks. Empirical studies show that **60–75% of distress events stem from leverage, operational weaknesses or governance failures**, rather than external shocks alone.

Compared with traditional buy-and-hold strategies, Special Situations are characterised by:

- Elevated financial and operational risk;
- Compressed decision-making timelines;
- Complex capital structures;
- Limited or unreliable disclosure; and
- Legacy issues that obscure forward-looking performance.

In this environment, ESG considerations are rarely pristine at entry. Large-sample studies show that ESG controversies - especially governance failures - are strongly associated with higher distress risk, lower profitability and greater volatility. At the same time, firms with stronger ESG performance exhibit lower distress probabilities and more stable cash-flow profiles, reinforcing that ESG factors influence both the onset of dislocation and the potential for recovery. **Assessing which issues are structural versus remediable is critical to underwriting and value creation.**

1.2 ESG Weaknesses as Drivers of Dislocation

ESG shortcomings often play a material role in corporate stress:

- **Environmental** issues such as contamination, remediation obligations, or regulatory non-compliance can generate unanticipated cash demands, constrain operations, or limit access to financing;
- **Social** failures - including safety incidents, labour disputes, or loss of customer trust - can undermine productivity, revenues, and stakeholder confidence at critical moments;
- **Governance** breakdowns - weak boards, misaligned incentives, inadequate controls, or dominant shareholders - are frequently precursors to capital misallocation, strategic drift, or regulatory intervention; excessive risk-taking, capital misallocation, and regulatory intervention are empirically linked to **weak oversight and incentive structures**, often preceding distress events.

In many cases, these ESG factors are inadequately disclosed, poorly managed, or underestimated by markets, leading to mispricing and reduced availability of capital. **As a result, ESG risks are not peripheral considerations but are often central to understanding the root causes of distress.**

1.3 Reframing ESG Integration in Special Situations

Given these dynamics, ESG integration in Special Situations must be approached differently from strategies focused on stable, well-performing issuers. Rather than relying on static exclusions or backward-looking scoring frameworks, ESG analysis should be intended as:

- A **risk identification and triage tool**, focused on capital preservation;
- A **lens on decision-making quality and incentives**; and
- A **forward-looking assessment of recovery potential**, rather than historical performance.

Crucially, the presence of ESG risk at entry does not automatically preclude investment. Instead**, the key question is whether identified risks are structural or remediable, and whether they can be addressed within the expected investment horizon.**

Assessing Remediability and Investment Viability

A central element of ESG underwriting in Special Situations is distinguishing between ESG risks that are:

Legacy and containable	Quantifiable and budgetable	Behavioral or governance-driven	Compatible with future trends
vs. ongoing and open-ended	*vs. uncertain and unbounded*	*therefore, potentially fixable*	*vs. exposed to structural headwinds*

Where ESG risks are judged to be irremediable, or to create unacceptable tail risks to capital preservation or reputation, investments are declined irrespective of valuation. Conversely, where ESG shortcomings are identifiable, addressable, and adequately priced, they may represent opportunities for both risk mitigation and value creation.

2 Why Special Situations Strategies are Well Positioned to Achieve Effective ESG Integration

How ESG integration in Special Situations creates value for investors and borrowers

Special Situations strategies are characterised by structural features that make effective ESG integration both feasible and impactful. These characteristics support improved outcomes not only for investors, but also for borrowers operating through periods of stress, transition, or transformation.

2.1 Special Situations opportunity channels where ESG integration can create value for both investors and borrowers

Strategy key features	Why this matters for Investors	Why this matters for Borrowers
Investment at moments of transition	Investors deploy capital at inflection points where ESG risks have, in most cases, already crystallised and are priced into valuations, enabling targeted interventions that directly address sources of financial distress and downside risk.	Borrowers are often more open to change during restructurings, recapitalisations or strategic resets, making it easier to address legacy ESG issues that may have constrained operational performance or access to capital.
Structural influence and governance access	Board representation, enhanced information rights, and consent or veto rights allow investors to influence governance, risk management, and strategic priorities - areas where ESG failures frequently originate.	Improved governance, clearer accountability, and strengthened decision making frameworks can stabilise the business, support better execution, and rebuild trust with stakeholders such as regulators, customers, and employees.
Alignment of ESG and financial recovery	ESG improvements can support capital protection and value preservation when remediation enables refinancing, operational continuity or reduced uncertainty.	ESG-driven actions can unlock concrete benefits such as reduced regulatory risk, stronger operating resilience and improved access to financing.
Concentrated exposure and active stewardship	More concentrated portfolios allow increased senior attention and deeper engagement with individual situations where ESG risk is material.	Borrowers may benefit from hands-on support on governance, risk controls and sustainable operational practices during complex transitions.
Influence designed at entry	ESG priorities can be embedded through covenants, reporting requirements, milestones and incentive structures, ensuring ESG considerations are enforceable rather than aspirational.	Borrowers with legacy ESG issues are not automatically excluded from capital, provided there is a credible path to improvement, allowing them to stabilise and reposition the business.
Focus on remediation rather than exclusion	Investors can differentiate between irremediable risks and fixable ESG shortcomings, avoiding value traps while capturing opportunities where change is achievable and financially material.	Borrowers with legacy ESG issues are not automatically excluded from capital, provided there is a credible path to improvement, allowing them to stabilise and reposition the business.

3 BSP Ltd.'s Approach to Embedding ESG in Special Situations Investing

How BSP Ltd applies ESG as a structured risk-management and recovery tool

BSP Ltd integrates Environmental, Social and Governance considerations throughout the lifecycle of its Special Situations strategy. ESG is embedded as a core component of underwriting, structuring, stewardship, and exit planning, reflecting the firm's conviction that ESG risks and opportunities are frequently inseparable from financial outcomes in stressed or transitional situations. The approach is pragmatic, proportionate, and grounded in financial materiality. It is designed to support capital protection and sustainable recovery while recognising the operational, informational, and time bound realities of Special Situations investing.

3.1 ESG Integration Across the Investment Lifecycle

Pre Investment Assessment

Each borrower is reviewed using our proprietary ESG & Climate Checklist, which scores Environmental, Social, Governance and Climate factors to identify material risks, remediation potential and implications for structuring and pricing. ESG insights feed into downside scenarios and recovery assumptions, ensuring they influence investment decisions rather than sit as a parallel overlay. Transactions where risks are judged incompatible with sustainable recovery are not pursued.

Structuring for Influence

Where appropriate, ESG considerations are built into investment terms from the outset. This may include enhanced information rights, governance access or other mechanisms that support oversight of material ESG issues. Priorities identified during due diligence are translated into clear expectations for management, creating accountability and enabling consistent monitoring throughout the investment period.

Active Stewardship & Monitoring

Post-investment, stewardship is targeted and proportionate to the risks identified at entry. The internal ESG score guides engagement intensity, with a focus on areas most relevant to stabilisation and recovery, such as governance effectiveness, regulatory compliance, operational resilience and management of environmental or social liabilities. Progress is monitored over time and incorporated into ongoing portfolio reviews.

Exit Considerations and Value Realisation

ESG integration continues through to exit, where strengthened governance, improved risk management and better handling of environmental or social issues can reduce uncertainty, support refinancing, broaden the buyer universe and reinforce confidence in the durability of cash flows. Where relevant, ESG progress is documented for prospective investors or lenders, demonstrating how sustainability improvements contribute to long-term value creation.

3.2 Article 8 Alignment and ESG Reporting

In 2025, BSP Ltd classified its latest Special Situations vintage fund as Article 8, elevating its ESG ambition by promoting defined E/S characteristics - underpinned by governance as a core pillar - within an established underwriting framework.

ESG factors are assessed using defined indicators, with a strong emphasis on **governance**. BSP Ltd considers robust corporate governance essential to managing ESG risks and advancing the Fund's E/S characteristics, systematically evaluating areas such as board structure and oversight, conduct, controls, transparency and regulatory compliance, alongside relevant environmental and social factors.

These characteristics are backed by binding elements such as internal **ESG scoring** thresholds, minimum **engagement** expectations, **exclusions** for very high-risk borrowers and adherence to BSP Ltd's firm-wide exclusion policy.

As an Article 8 fund, it also provides enhanced **SFDR reporting**, including relevant **PAI indicators** where data is available. This will be complemented by BSP Ltd's **biannual ESG report**, giving LPs a clear view of portfolio ESG risk distribution, engagement activity, progress on priority E/S risks and developments in ESG integration across the portfolio.

Implications for ESG integration in BSP Ltd's Special Situations Strategy

BSP Ltd's approach shows that ESG integration can be both credible and practical in Special Situations. ESG analysis is embedded into underwriting, internal scoring guides stewardship intensity, and reporting combines regulatory requirements with investor-focused insights. ESG is therefore a risk-management and recovery tool, not a compliance exercise.

For LPs, this provides confidence that ESG risks are systematically assessed, prioritised and acted upon - while remaining grounded in the realities of investing at moments of corporate stress and transition.

4 Case Study and Conclusions

Targeted ESG engagement strengthens resilience, protects value and unlocks recovery pathways in Special Situations

4.1 Case Study: A thematic engagement focused on strengthening resilience through improved governance

In Q1 2026, we engaged borrowers in sectors with structurally elevated cyber, operational-resilience and physical-safety risks, recognising their direct implications for governance quality, stakeholder protection and long-term value preservation. These risks are particularly acute for businesses with significant digital exposure, physical estates or operational assets, where incidents can disrupt operations, expose stakeholders to harm and trigger regulatory or reputational consequences. Our engagement therefore focused on whether audit committees and senior management had the right oversight, controls and investment decisions in place to manage these risks effectively.

Discussions were held at audit-committee level across retail, industrial and transport-linked business models, centred on cybersecurity strategy, resilience planning and the sufficiency of investment to protect against external threats. We reviewed policies, internal controls and incident preparedness, and worked with management to update risk registers so that material ESG-related risks - including safety and operational continuity - were clearly captured, regularly monitored and subject to appropriate governance oversight.

This engagement translated into tangible actions. A retail borrower with a large physical estate accelerated a comprehensive fire-safety inspection programme, reflecting the materiality of physical-safety risks and the importance of preventative controls. Another borrower with a significant operational asset base expanded its use of telematics to monitor asset condition in real time, enabling predictive maintenance and improving operational reliability. These interventions strengthened governance oversight, reduced exposure to disruption and data-related incidents, improved safety outcomes and supported more efficient asset utilisation.

For Special Situations, these improvements directly support value preservation and recovery: fewer operational shocks, lower regulatory and reputational liabilities, better asset reliability and clearer governance accountability. The case demonstrates how targeted ESG engagement can materially enhance resilience and stability in stressed or transitional contexts - reinforcing ESG as a practical risk-management lever rather than a compliance exercise.

4.2 Outcomes & Value Creation

- **Reduced disruption and downtime** - stronger cyber and operational controls lower the probability and impact of shocks, supporting financial stabilisation.
- **Lower regulatory and reputational exposure** - proactive safety and governance improvements mitigate tail risks that often drive distress.
- **Improved safety and stakeholder protection** - fewer incidents, stronger compliance and enhanced trust with employees, customers and regulators.
- **More reliable assets and better utilisation** - predictive maintenance reduces failures, improves efficiency and supports cash-flow resilience.
- **Clearer governance accountability** - enhanced oversight improves decision-making quality, a critical determinant of recovery in Special Sits.
- **Enhanced exit optionality** - stronger controls, safer operations and reduced ESG liabilities broaden buyer appetite and support refinancing.

Conclusion

In Special Situations investing, ESG integration is inseparable from prudent risk management and value creation. Far from being an abstract or reputational exercise, ESG analysis informs investment selection, structuring, stewardship, and exit strategy.

Special Situations investors, by virtue of their positioning at moments of corporate transition, can act as catalysts for meaningful improvement. By aligning capital protection with sustainable outcomes, ESG integration contributes to resilient portfolios and long-term value for both investors and stakeholders.

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