

GLADSTONE CAPITAL CORP

Form 10-K

November 14, 2011

[Table of Contents](#)

**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

WASHINGTON, DC 20549

**FORM 10-K**

(Mark One)

**ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

**For the fiscal year ended September 30, 2011**

**OR**

**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

**Commission file number 814-00237**

**GLADSTONE CAPITAL CORPORATION**

(Exact name of registrant as specified in its charter)

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**Maryland**  
(State or other jurisdiction of  
incorporation or organization)

**54-2040781**  
(I.R.S. Employer  
Identification No.)

**1521 Westbranch Drive, Suite 200**

**McLean, Virginia**  
(Address of principal executive offices)

**22102**  
(Zip Code)

**(703) 287-5800**  
(Registrant's telephone number, including area code)

**Securities registered pursuant to Section 12(b) of the Act:**

**Common Stock, \$0.001 par value per share**  
(Title of each Class)

**Nasdaq Global Select Market**  
(Name of exchange on which registered)

**Securities registered pursuant to Section 12(g) of the Act:**

**None**

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. YES  NO

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. YES  NO

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. YES  NO

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). YES  NO

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer, and smaller reporting company in Rule 12 b-2 of the Exchange Act.

Large accelerated filer  Accelerated filer

Non-accelerated filer  Smaller reporting company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12 b-2 of the Exchange Act). YES  NO

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The aggregate market value of the voting stock held by non-affiliates of the Registrant on March 31, 2011, based on the closing price on that date of \$11.31 on the Nasdaq Global Select Market, was \$237,953,827. For the purposes of calculating this amount only, all directors and executive officers of the Registrant have been treated as affiliates. There were 21,039,242 shares of the Registrant's Common Stock, \$0.001 par value per share, outstanding as of November 11, 2011.

**Documents Incorporated by Reference.** Portions of the Registrant's Proxy Statement relating to the Registrant's 2012 Annual Meeting of Stockholders are incorporated by reference into Part III of this Annual Report on Form 10-K as indicated herein.

**Table of Contents**

**GLADSTONE CAPITAL CORPORATION**  
**FORM 10-K FOR THE FISCAL YEAR ENDED**

**SEPTEMBER 30, 2011**

**TABLE OF CONTENTS**

<b><u>PART I</u></b>			
ITEM 1	<u>Business</u>		2
ITEM 1A	<u>Risk Factors</u>		17
ITEM 1B	<u>Unresolved Staff Comments</u>		33
ITEM 2	<u>Properties</u>		33
ITEM 3	<u>Legal Proceedings</u>		33
ITEM 4	<u>Removed and Reserved</u>		33
<b><u>PART II</u></b>			
	<u>Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities</u>		34
ITEM 5	<u>Securities</u>		34
ITEM 6	<u>Selected Financial Data</u>		34
ITEM 7	<u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>		36
ITEM 7A	<u>Quantitative and Qualitative Disclosures About Market Risk</u>		62
ITEM 8	<u>Financial Statements and Supplementary Data</u>		64
ITEM 9	<u>Changes in and Disagreements with Accountants on Accounting and Financial Disclosure</u>		101
ITEM 9A	<u>Controls and Procedures</u>		101
ITEM 9B	<u>Other Information</u>		101
<b><u>PART III</u></b>			
ITEM 10	<u>Directors, Executive Officers and Corporate Governance</u>		101
ITEM 11	<u>Executive Compensation</u>		101
ITEM 12	<u>Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters</u>		101
ITEM 13	<u>Certain Relationships and Related Transactions, and Director Independence</u>		102
ITEM 14	<u>Principal Accountant Fees and Services</u>		102
<b><u>PART IV</u></b>			
ITEM 15	<u>Exhibits and Financial Statement Schedule</u>		102
<b><u>SIGNATURES</u></b>			

---

**Table of Contents**

**FORWARD-LOOKING STATEMENTS**

*All statements contained herein, other than historical facts, may constitute forward-looking statements. These statements may relate to, among other things, future events or our future performance or financial condition. In some cases, you can identify forward-looking statements by terminology such as may, might, believe, will, provided, anticipate, future, could, growth, plan, intend, expect, should, would, if, seek, possible, potential, likely or the negative of such terms or comparable terminology. These forward-looking statements involve known and unknown risks, uncertainties and other factors that may cause our actual results, levels of activity, performance or achievements to be materially different from any future results, levels of activity, performance or achievements expressed or implied by such forward-looking statements. Such factors include, among others: (1) further adverse changes in the economy and the capital markets; (2) risks associated with negotiation and consummation of pending and future transactions; (3) the loss of one or more of our executive officers, in particular David Gladstone, Terry Lee Brubaker, or George Stelljes III (4) changes in our business strategy; (5) availability, terms and deployment of capital; (6) changes in our industry, interest rates, exchange rates or the general economy; (7) the degree and nature of our competition; and (8) those factors described in the Risk Factors section of this Form 10-K. We caution readers not to place undue reliance on any such forward-looking statements. We undertake no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events or otherwise, after the date of this Form 10-K.*

**PART I**

*In this Annual Report on Form 10-K, or Annual Report, the Company, we, us, and our refer to Gladstone Capital Corporation and its wholly-owned subsidiaries unless the context otherwise indicates. Dollar amounts are in thousands unless otherwise indicated.*

**ITEM 1. BUSINESS**

**Overview**

We were incorporated under the General Corporation Laws of the State of Maryland on May 30, 2001 and completed our initial public offering on August 24, 2001. We operate as a closed-end, non-diversified management investment company and we have elected to be treated as a business development company ( BDC ) under the Investment Company Act of 1940, as amended ( the 1940 Act ). For federal income tax purposes, we have elected to be treated as a regulated investment company ( RIC ) under Subchapter M of the Internal Revenue Code of 1986, as amended (the Code ). We currently continue to qualify as a RIC for federal income tax purposes and obtain favorable RIC tax treatment by meeting certain requirements, including certain minimum distribution requirements.

We were established to achieve a high level of current income by investing in debt securities, consisting primarily of senior notes and senior subordinated notes, of established private United States ( U.S. ) businesses that are substantially owned by leveraged buyout funds, individual investors or are family-owned businesses, with a particular focus on senior notes. In addition, we may acquire from others existing loans that meet this profile. We also seek to provide our stockholders with long-term capital growth through appreciation in the value of warrants or other equity instruments that we may receive when we make loans.

We seek to invest in small and medium-sized private U.S. businesses that meet certain criteria, including some but not necessarily all of the following: the potential for growth in cash flow, adequate assets for loan collateral, experienced management teams with a significant ownership interest in the borrower, profitable operations based on the borrower's cash flow, reasonable capitalization of the borrower (usually by leveraged buyout funds or venture capital funds) and the potential to realize appreciation and gain liquidity in our equity positions, if any. We anticipate that liquidity in our equity position will be achieved through a merger or acquisition of the borrower, a public offering of the borrower's stock or by exercising our right to require the borrower to repurchase our warrants. However, there can be no assurance that we will always have these rights. We lend to borrowers that need funds to finance growth, restructure their balance sheets or effect a change of control. We invest either by ourselves or jointly with other funds or management of the borrower, depending on the opportunity. If we are participating in an investment with one or more co-investors, our investment is likely to be smaller than if we were to invest alone. Our loans typically range from \$5 million to \$20 million and generally mature in no more than seven years.

## **Table of Contents**

As of September 30, 2011, our portfolio consisted of loans to 59 companies in 27 states in 23 different industries with an aggregate fair value of \$302.9 million. Since our initial public offering in 2001, we have invested in over 153 different companies, while making over 100 consecutive distributions to stockholders.

We expect that our target portfolio over time will primarily include the following three categories of investments in private U.S. companies:

*Senior Loans.* We seek to invest a portion of our assets in senior notes of borrowers. Using its assets as collateral, the borrower typically uses senior notes to cover a substantial portion of the funding needed to operate. The collateral usually takes the form of first priority liens on the assets of the portfolio company. Senior lenders are exposed to the least risk of all providers of debt because they command a senior position with respect to scheduled interest and principal payments and assets of the borrower. However, unlike senior subordinated lenders, these senior lenders typically do not receive any stock, warrants to purchase stock of the borrowers or other yield enhancements. As such, they generally do not participate in the equity appreciation of the value of the business. Senior notes may include revolving lines of credit, senior term loans, senior syndicated loans and senior last-out tranche loans and generally are at variable interest rates in relation to the London Interbank Offered Rate ( LIBOR ). These loans typically are structured with interest rate floors to protect against declining interest rates.

*Senior Subordinated Loans.* We seek to invest a portion of our assets in senior subordinated notes, which include second lien notes. Holders of senior subordinated notes, which are typically unsecured, are subordinated to the rights of holders of senior debt in their right to receive principal and interest payments or, in the case of last out tranches of senior debt, liquidation proceeds from the borrower. As a result, senior subordinated notes are riskier than senior notes. Although such loans are sometimes secured by significant collateral (assets of the borrower), the lender is largely dependent on the borrower's cash flow for repayment. Additionally, lenders may receive warrants to acquire shares of stock in borrowers or other yield enhancements in connection with these loans. Senior subordinated notes include second lien loans and syndicated second lien loans. We typically structure these senior subordinated loans with variable interest rates in relation to the LIBOR with interest rate floors to protect against declining interest rates.

*Junior Subordinated Loans:* We also seek to invest a small portion of our assets in junior subordinated notes, which include mezzanine notes. Holders of junior subordinated notes are subordinated to the rights of the holders of senior debt and senior subordinated debt in their rights to receive principal and interest payments from the borrower and the assets of the borrower. The risk profile of junior subordinated notes is high, which permits the junior subordinated lender to obtain higher variable interest rates and more equity and equity-like compensation.

*Preferred and Common Equity/Equivalents:* While not a primary focus of our investment portfolio strategy, from time to time we also receive yield enhancements in connection with some of our loans, which include warrants to purchase stock or success fees. A portion of our portfolio consists of equity investments that were part of a larger initial investment in a private company. Additionally, we also have equity investments derived from restructurings on some of our investments.

Because the majority of the loans in our portfolio consist of term debt of private companies that typically cannot or will not expend the resources to have their debt securities rated by a credit rating agency, we expect that most, if not all, of the debt securities we acquire will be unrated. Investors should assume that these loans would be rates below what is today considered investment grade quality. Investments rated below investment grade are often referred to as high yield securities or junk bonds and may be considered high risk as compared to investment-grade debt instruments.

## ***Investment Concentrations***

Year over year, our investment concentration as a percentage of fair value and of cost has remained relatively unchanged. Due to favorable syndicate loan marketplace conditions, we invested in 23 senior syndicated loans during 2011 at an aggregate cost of \$95.7 million. As of September 30, 2011, we held 24 syndicated investments totaling \$92.1 million at cost and \$90.7 million at fair value, or 24.0% and 29.9 %, respectively, of our total aggregate portfolio.



**Table of Contents**

The table below outlines the investment by security type as of September 30, 2011 and 2010:

	September 30, 2011				September 30, 2010			
	Cost		Fair Value		Cost		Fair Value	
Senior term debt	\$ 266,491	69.6%	\$ 200,145	66.1%	\$ 200,041	67.1%	\$ 172,596	67.1%
Senior subordinated term debt	107,140	28.0	92,148	30.4	93,987	31.5	81,899	31.8
Common equity/equivalents	7,999	2.1	10,088	3.3	3,744	1.3	2,227	0.9
Preferred equity	1,185	0.3	566	0.2	444	0.1	387	0.2
<b>Total investments</b>	<b>\$ 382,815</b>	<b>100.0%</b>	<b>\$ 302,947</b>	<b>100.0%</b>	<b>\$ 298,216</b>	<b>100.0%</b>	<b>\$ 257,109</b>	<b>100.0%</b>

The five largest investments at fair value as of September 30, 2011 totaled \$91.2 million, or 30.1% of the total aggregate portfolio, as compared to the five largest investments at fair value as of September 30, 2010 totaling \$101.5 million, or 39.4% of the total aggregate portfolio.

Investments at fair value consisted of the following industry classifications as of September 30, 2011 and 2010:

Industry Classification	September 30, 2011		September 30, 2010	
	Fair Value	Percentage of Total Investments	Fair Value	Percentage of Total Investments
Electronics	\$ 45,752	15.1%	\$ 25,080	9.8%
Healthcare, education & childcare	34,106	11.3	41,098	16.0
Mining, steel, iron & non-precious metals	33,734	11.1	24,343	9.5
Broadcast (TV & radio)	28,194	9.3	44,562	17.3
Automobile	25,768	8.5	9,868	3.8
Retail stores	19,340	6.4	19,620	7.6
Printing & publishing	17,623	5.8	37,705	14.7
Buildings & real estate	10,275	3.4	12,454	4.8
Aerospace & defense	10,003	3.3	400	0.2
Home & office furnishings	9,715	3.2	10,666	4.1
Textiles & leather	9,626	3.2		
Diversified/conglomerate manufacturing	8,790	2.9	2,042	0.8
Machinery	8,696	2.9	8,719	3.4
Personal, food and miscellaneous services	7,635	2.5		
Beverage, food & tobacco	7,332	2.4		
Personal & non-durable consumer products	6,962	2.3	9,230	3.6
Leisure, amusement, movies & entertainment	6,607	2.2	3,994	1.6
Diversified/conglomerate service	3,810	1.3		
Diversified natural resources, precious metals & minerals	3,054	1.0		
Oil & gas	1,916	0.6		
Telecommunications	1,794	0.6		
Chemicals, plastics & rubber	1,225	0.4	7,044	2.7
Insurance	990	0.3		
Farming & agriculture			284	0.1
<b>Total investments</b>	<b>\$ 302,947</b>	<b>100.0%</b>	<b>\$ 257,109</b>	<b>100.0%</b>

During the year ended September 30, 2011, we expanded our industry diversification by investing in eight new industries. As of September 30, 2011, we held investments in 23 industries, as compared to 16 as of September 30, 2010.

The investments at fair value were included in the following U.S. geographic regions at September 30, 2011 and September 30, 2010:



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Geographic Region	September 30, 2011		September 30, 2010	
	Fair Value	Percent of Total Investments	Fair Value	Percentage of Total Investments
Midwest	\$ 144,292	47.6%	\$ 109,299	42.5%
West	70,862	23.4	59,684	23.2
South	52,265	17.3	44,704	17.4
Northeast	28,158	9.3	36,995	14.4
Outside Continental U.S.	7,370	2.4	6,427	2.5
<b>Total Investments</b>	<b>\$ 302,947</b>	<b>100.0%</b>	<b>\$ 257,109</b>	<b>100.0%</b>

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## **Table of Contents**

The geographic region indicates the location of the headquarters of our portfolio companies. A portfolio company may have a number of other business locations in other geographic regions.

### **Our Investment Adviser and Administrator**

Gladstone Management Corporation (our Adviser) is our affiliate, investment adviser, and a privately-held company led by a management team which has extensive experience in our lines of business. Our Adviser's affiliate, a privately-held company, Gladstone Administration, LLC (our Administrator), employs our chief financial officer, chief compliance officer, treasurer, internal legal counsel and their respective staffs. Excluding our chief financial officer, all of our executive officers serve as directors or executive officers, or both, of the following of our affiliates: Gladstone Commercial Corporation (Gladstone Commercial), a publicly-traded real estate investment trust; Gladstone Investment Corporation (Gladstone Investment), a publicly-traded BDC and RIC; our Adviser; and our Administrator. Our treasurer is also an executive officer of another one of our affiliates, Gladstone Securities, LLC (Gladstone Securities), a privately-held broker-dealer registered with the Financial Industry Regulatory Authority (FINRA) and insured by the Securities Investor Protection Corporation. Our chief executive officer also serves on the board of managers of Gladstone Securities.

Our Adviser and Administrator also provide investment advisory and administrative services, respectively, to our affiliates, including Gladstone Commercial; Gladstone Investment; Gladstone Partners Fund, L.P., a private partnership fund formed primarily to co-invest with us and Gladstone Investment; Gladstone Land Corporation, a private agricultural real estate company owned by David Gladstone, our chairman and chief executive officer; and Gladstone Lending Corporation (Gladstone Lending), a private corporation that was formed to primarily invest in first and second lien term loans that has filed a registration statement on Form N-2 with the Securities and Exchange Commission (the SEC), but which has not yet commenced operations. Our Adviser and Administrator may provide investment advisory and administrative services, respectively, to other funds and companies, both public and private.

We have been externally managed by our Adviser pursuant to an investment advisory agreement since October 1, 2004. Our Adviser was organized as a corporation under the laws of the State of Delaware on July 2, 2002, and is a registered investment adviser under the Investment Advisers Act of 1940, as amended. Our Adviser is headquartered in McLean, Virginia, a suburb of Washington, D.C., and also has offices in several other states.

### **Investment Process**

#### ***Overview of Investment and Approval Process***

To originate investments, our Adviser's investment professionals use an extensive referral network comprised primarily of venture capitalists, leveraged buyout funds, investment bankers, attorneys, accountants, commercial bankers and business brokers. Our Adviser's investment professionals review informational packages from these and other sources in search of potential financing opportunities. If a potential opportunity matches our investment objectives, the investment professionals will seek an initial screening of the opportunity from our Adviser's investment committee which is composed of Messrs. Gladstone, Brubaker and Stelljes. If the prospective portfolio company passes this initial screening, the investment professionals conduct a due diligence investigation and create a detailed profile summarizing the prospective portfolio company's historical financial statements, industry and management team and analyzing its conformity to our general investment criteria. The investment professionals then present this profile to our Adviser's investment committee, which must approve each investment. Further, each financing is available for review by the members of our Board of Directors, a majority of whom are not interested persons as defined in Section 2(a)(19) of the 1940 Act.

#### ***Prospective Portfolio Company Characteristics***

We have identified certain characteristics that we believe are important in identifying and investing in prospective portfolio companies. The criteria listed below provide general guidelines for our investment decisions, although not all of these criteria may be met by each portfolio company.

*Value-and-Income Orientation and Positive Cash Flow.* Our investment philosophy places a premium on fundamental analysis from an investor's perspective and has a distinct value-and-income orientation. In seeking value, we focus on companies in which we can invest at relatively low multiples of earnings before interest, taxes, depreciation and amortization (EBITDA), and that have positive operating cash flow at the time of investment. In seeking income, we seek to invest in companies that generate relatively stable and high percentage of sales and cash flow to provide some



## **Table of Contents**

assurance that they will be able to service their debt and pay any required distributions on preferred stock. Typically, we do not expect to invest in start-up companies or companies with speculative business plans.

*Experienced Management.* We generally require that our portfolio companies have experienced management teams. We also require the portfolio companies to have in place proper incentives to induce management to succeed and act in concert with our interests as investors, including having significant equity or other interests in the financial performance of their companies.

*Strong Competitive Position in an Industry.* We seek to invest in target companies that have developed strong market positions within their respective markets and that we believe are well-positioned to capitalize on growth opportunities. We seek companies that demonstrate significant competitive advantages versus their competitors, which we believe will help to protect their market positions and profitability.

*Exit Strategy.* We seek to invest in companies that we believe will provide a stable stream of earnings and cash flow that is sufficient to repay the loans we make to them and to reinvest in their respective businesses. We expect that such internally generated cash flow, which will allow our portfolio companies to pay interest on, and repay the principal of, our investments, will be a key means by which we exit from our investments over time. In addition, we also seek to invest in companies whose business models and expected future cash flows offer attractive possibilities for capital appreciation on any equity interests we may obtain or retain. These capital appreciation possibilities include strategic acquisitions by other industry participants or financial buyers, initial public offerings of common stock, or other capital market transactions.

*Liquidation Value of Assets.* The prospective liquidation value of the assets, if any, collateralizing loans in which we invest is an important factor in our investment analysis. We emphasize both tangible assets, such as accounts receivable, inventory, equipment, and real estate and intangible assets, such as intellectual property, customer lists, networks, databases, although the relative weight we place on these assets will vary by company and industry.

### ***Extensive Due Diligence***

Our Adviser conducts what we believe are extensive due diligence investigations of our prospective portfolio companies and investment opportunities. The due diligence investigation may begin with a review of publicly available information and will generally include some or all of the following:

a review of the prospective portfolio company's historical and projected financial information;

visits to the prospective portfolio company's business site(s);

interviews with the prospective portfolio company's management, employees, customers and vendors;

review of loan documents;

background checks on the prospective portfolio company's management team; and

research on the prospective portfolio company's products, services or particular industry.

Upon completion of a due diligence investigation and a decision to proceed with an investment, our Adviser's investment professionals who have primary responsibility for the investment present the investment opportunity to our Adviser's investment committee. The investment committee determines whether to pursue the potential investment. Additional due diligence of a potential investment may be conducted on our behalf by

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attorneys and independent accountants, as well as other outside advisers, prior to the closing of the investment, as appropriate.

We also rely on the long-term relationships that our Adviser's investment professionals have with venture capitalists, leveraged buyout funds, investment bankers, commercial bankers, private equity sponsors, and business brokers. In addition, the extensive direct experience of our executive officers and managing directors in the operations of and providing debt and equity capital to small and medium-sized private businesses plays a significant role in our investment evaluation and assessment of risk.

### *Investment Structure*

Once we have determined that a prospective acquisition, buyout or recapitalization meets our standards and investment criteria, we work with the management of that company and other capital providers to structure the transaction in a way that

## **Table of Contents**

we believe will provide us with the greatest opportunity to maximize our return on the investment, while appropriately incentivizing company management. As discussed above, the capital classes through which we typically structure a deal include subordinated and mezzanine debt, senior secured debt and preferred and common equity. Through our risk management process, we seek to limit the downside risk of our investments by:

making investments with an expected total return (including both interest and potential equity appreciation) that we believe compensates us for the credit risk of the investment;

seeking collateral or superior positions in the portfolio company's capital structure where possible;

incorporating put rights and call protection into the investment structure where possible; and

negotiating covenants in connection with our investments that afford our portfolio companies as much flexibility as possible in managing their businesses, consistent with the preservation of our capital.

We expect to hold most of our investments in subordinated debt, mezzanine debt or equity interests until maturity or repayment, but may sell our investments earlier if a liquidity event takes place, such as the sale or recapitalization of a portfolio company or, in the case of an equity investment in a company, its initial public offering.

## ***Hedging Strategies***

Although it has not yet happened, nor do we expect it to happen in the near future, if one of our portfolio companies goes public, we may undertake hedging strategies with regard to any equity interests that we may have in that company. We may mitigate risks associated with the volatility of publicly-traded securities by, for example, selling securities short or writing or buying call or put options. Hedging against a decline in the value of such investments in public companies would not eliminate fluctuations in the values of such investments or prevent losses if the values of such investments decline, but would establish or enhance a hedging strategy to seek to protect our investment in such securities. Therefore, by engaging in hedging transactions, we seek to moderate the decline in the value of our hedged investments in public companies. However, such hedging transactions would also limit our opportunity to gain from an increase in the value of our investment in the public company. In the future, we may enter into hedging transactions, such as interest rate cap agreements, in connection with the borrowings that we make under our line of credit. We currently do not hold any interest rate cap agreements, although we have done so in the past. Hedging strategies can pose risks to us and our stockholders; however we believe that such activities are manageable because they will be limited to only a portion of our portfolio.

Section 12(a)(3) of the 1940 Act prohibits us from effecting a short sale of any security in contravention of such rules and regulations or orders as the [SEC] may prescribe as necessary or appropriate in the public interest or for the protection of investors . . . . However, to date, the SEC has not promulgated regulations under this statute, it is possible that such regulations could be promulgated in the future in a way that would require us to change any hedging strategies that we may adopt. In addition, our ability to engage in short sales may be limited by the 1940 Act's leverage limitations. We will only engage in hedging activities in compliance with applicable laws and regulations.

## ***Competitive Advantages***

A large number of entities compete with us and make the types of investments that we seek to make in small and medium-sized privately-owned businesses. Such competitors include private equity funds, leveraged buyout funds, venture capital funds, investment banks and other equity and non-equity based investment funds, and other financing sources, including traditional financial services companies such as commercial banks. Many of our competitors are substantially larger than we are and have considerably greater funding sources that are not available to us. In addition, certain of our competitors may have higher risk tolerances or different risk assessments, which could allow them to consider a wider variety of investments, establish more relationships and build their market shares. Furthermore, many of these competitors are not subject to the regulatory restrictions that the 1940 Act imposes on us as a BDC. However, we believe that we have the following competitive advantages over other providers of financing to small and mid-sized businesses.

## ***Management Expertise***

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David Gladstone, our chairman and chief executive officer, is also the chairman and chief executive officer of our Adviser and its affiliated companies, (the Gladstone Companies ), and has been involved in all aspects of the Gladstone Companies

## **Table of Contents**

investment activities, including serving as a member of our Adviser's investment committee. Terry Lee Brubaker is our vice chairman, chief operating officer and secretary, and has substantial experience in acquisitions and operations of companies. George Stelljes III is our president and chief investment officer and has extensive experience in leveraged finance. Messrs. Gladstone, Brubaker and Stelljes have principal management responsibility for our Adviser constituting the majority of its senior executive officers. These individuals dedicate a significant portion of their time to managing our investment portfolio. Our senior management has extensive experience providing capital to small and mid-sized companies and has worked together for more than 10 years. In addition, we have access to the resources and expertise of our Adviser's investment professionals and supporting staff who possess a broad range of transactional, financial, managerial and investment skills.

### ***Increased Access to Investment Opportunities Developed Through Proprietary Research Capability and an Extensive Network of Contacts***

Our Adviser seeks to identify potential investments both through active origination and due diligence and through its dialogue with numerous management teams, members of the financial community and potential corporate partners with whom our Adviser's investment professionals have long-term relationships. We believe that our Adviser's investment professionals have developed a broad network of contacts within the investment, commercial banking, private equity and investment management communities, and that their reputation in investment management enables us to identify well-positioned prospective portfolio companies which provide attractive investment opportunities. Additionally, our Adviser expects to generate information from its professionals' network of accountants, consultants, lawyers and management teams of portfolio companies and other companies.

### ***Disciplined, Value and Income-Oriented Investment Philosophy with a Focus on Preservation of Capital***

In making its investment decisions, our Adviser focuses on the risk and reward profile of each prospective portfolio company, seeking to minimize the risk of capital loss without foregoing the potential for capital appreciation. We expect our Adviser to use the same value and income-oriented investment philosophy that its professionals use in the management of the other Gladstone Companies and to commit resources to management of downside exposure. Our Adviser's approach seeks to reduce our risk in investments by using some or all of the following approaches:

focusing on companies with good market positions and good cash flow;

investing in businesses with experienced and established management teams;

engaging in extensive due diligence from the perspective of a long-term investor;

investing at low price-to-cash flow multiples; and

adopting flexible transaction structures by drawing on the experience of the investment professionals of our Adviser and its affiliates.

### ***Longer Investment Horizon with Attractive Publicly-traded Model***

Unlike private equity and venture capital funds that are typically organized as finite-life partnerships, we are not subject to standard periodic capital return requirements. The partnership agreements of most private equity and venture capital funds typically provide that these funds may only invest investors' capital once and must return all capital and realized gains to investors within a finite time period, often seven to ten years. These provisions often force private equity and venture capital funds to seek returns on their investments by causing their portfolio companies to pursue mergers, public equity offerings, or other liquidity events more quickly than might otherwise be optimal or desirable, potentially resulting in both a lower overall return to investors and an adverse impact on their portfolio companies. We believe that our flexibility to make investments with a long-term view and without the capital return requirements of traditional private investment vehicles provides us with the opportunity to achieve greater long-term returns on invested capital.

### ***Flexible Transaction Structuring***



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We believe our management team's broad expertise and its ability to draw upon many years of combined experience enables our Adviser to identify, assess, and structure investments successfully across all levels of a company's capital structure and manage potential risk and return at all stages of the economic cycle. We are not subject to many of the regulatory limitations

## **Table of Contents**

that govern traditional lending institutions such as banks. As a result, we are flexible in selecting and structuring investments, adjusting investment criteria and transaction structures, and, in some cases, the types of securities in which we invest. We believe that this approach enables our Adviser to identify attractive investment opportunities that will continue to generate current income and capital gain potential throughout the economic cycle, including during turbulent periods in the capital markets. One example of our flexibility is our ability to exchange our publicly-traded stock for the stock of an acquisition target in a tax-free reorganization under the Code. After completing an acquisition in such an exchange, we can restructure the capital of the small company to include senior and subordinated debt.

### ***Leverage***

For the purpose of making investments and to take advantage of favorable interest rates, we intend to issue senior debt securities (including borrowings under our current line of credit) up to the maximum amount permitted by the 1940 Act. The 1940 Act currently permits us to issue senior debt securities and preferred stock, to which we refer collectively as senior securities, in amounts such that our asset coverage, as defined in the 1940 Act, is at least 200% after each issuance of senior securities. We may also incur such indebtedness to repurchase our common stock. As a result of issuing senior securities, we are exposed to the risks of leverage. Although borrowing money for investments increases the potential for gain, it also increases the risk of a loss. A decrease in the value of our investments will have a greater impact on the value of our common stock to the extent that we have borrowed money to make investments. There is a possibility that the costs of borrowing could exceed the income we receive on the investments we make with such borrowed funds. In addition, our ability to pay distributions or incur additional indebtedness would be restricted if asset coverage is less than twice our indebtedness. If the value of our assets declines, we might be unable to satisfy that test. If this happens, we may be required to liquidate a portion of our loan portfolio and repay a portion of our indebtedness at a time when a sale may be disadvantageous. Furthermore, any amounts that we use to service our indebtedness will not be available for distributions to our stockholders. Our Board of Directors is authorized to provide for the issuance of preferred stock with such preferences, powers, rights and privileges as it deems appropriate, provided that such an issuance adheres to the requirements of the 1940 Act. See *Regulation as a Business Development Company Asset Coverage* for a discussion of our leveraging constraints.

In November 2011, we completed a public offering of 1.4 million shares of 7.125% Series 2016 Term Preferred Stock, par value \$0.001 per share ( Term Preferred Stock ), at a public offering price of \$25.00 per share. The Term Preferred Stock has an aggregate liquidation preference of \$35.0 million, which will be recorded as a liability in accordance with the U.S. generally accepted accounting principles and as such will affect our asset coverage, exposing us to additional leverage risks. In addition, until November 27, 2011, the underwriters for the offering have an option to purchase an additional 210,000 shares of Term Preferred Stock from us solely to cover over-allotments, which would additionally increase the amount of this liability. On November 14, 2011, the underwriters notified us of their intent to exercise their option to purchase an additional 139,882 shares of our Term Preferred Stock. For a further discussion of the terms of our Terms Preferred Stock, see *Management's Discussion and Analysis of Financial Condition and Results of Operations Liquidity and Capital Resources*.

### **Ongoing Relationships with and Monitoring of Portfolio Companies**

Our Adviser's investment professionals actively oversee each investment by continuously evaluating the portfolio company's performance and working collaboratively with the portfolio company's management to identify and incorporate best resources and practices that help us achieve our investment expectations.

#### ***Monitoring***

Our Adviser's investment professionals monitor the financial performance, trends, and changing risks of each portfolio company on an ongoing basis to determine if each company is performing within expectations and to guide the portfolio company's management in taking the appropriate courses of action. Our Adviser employs various methods of evaluating and monitoring the performance of our investments in portfolio companies, which may include the following:

Monthly analysis of financial and operating performance;

Assessment of the portfolio company's performance against its business plan and our investment expectations;

Assessment of the investment's risks;

Participation in the portfolio company's board of directors or management meetings;

Assessment of portfolio company management, sponsor, governance and strategic direction;

## **Table of Contents**

Assessment of the portfolio company's industry and competitive environment; and

Review and assessment of the portfolio company's operating outlook and financial projections.

### ***Relationship Management***

Our Adviser's investment professionals interact with various parties involved with a portfolio company, or investment, by actively engaging with internal and external constituents, including:

Management;

Boards of directors;

Financial sponsors;

Capital partners; and

Advisers and consultants.

### ***Managerial Assistance and Services***

As a BDC, we make available significant managerial assistance to our portfolio companies and provide other services to such portfolio companies. Neither we nor our Adviser currently receives fees in connection with the managerial assistance we make available. At times, our Adviser provides other services to certain of our portfolio companies and it receives fees for these other services with 50% of certain of these fees, and 100% of others, credited against the base management fee that we would otherwise be required to pay to our Adviser.

In April, 2011, Gladstone Securities started providing other services (such as investment banking and due diligence services) to certain of our portfolio companies. The fees the portfolio companies paid to Gladstone Securities do not impact the overall fees we pay to our Adviser or the overall fees credited against the base management fee.

### ***Valuation Process***

The following is a general description of the steps we take each quarter to determine the value of our investment portfolio. We value our investments in accordance with the requirements of the 1940 Act. We value securities for which market quotations are readily available at their market value. We value all other securities and assets at fair value as determined in good faith by our Board of Directors. In determining the value of our investments, our Adviser has established an investment valuation policy (the "Policy"). The Policy has been approved by our Board of Directors and each quarter the Board of Directors reviews whether our Adviser has applied the Policy consistently and votes whether or not to accept the recommended valuation of our investment portfolio. Due to the uncertainty inherent in the valuation process, such estimates of fair value may differ significantly from the values that would have been obtained had a ready market for the securities existed. Investments for which market quotations are readily available are recorded in our financial statements at such market quotations. With respect to any investments for which market quotations are not readily available, we perform the following valuation process each quarter:

Our quarterly valuation process begins with each portfolio company or investment being initially assessed by our Adviser's investment professionals responsible for the investment, using the Policy.

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Preliminary valuation conclusions are then discussed with our management, and documented, along with any independent opinions of value provided by Standard & Poor's Securities Evaluations, Inc. ( SPSE ), for review by our Board of Directors.

Our Board of Directors reviews this documentation and discusses the information provided by our management, and the opinions of value provided by SPSE to arrive at a determination that the Policy has been followed for determining the aggregate fair value of our portfolio of investments.

Our valuation policies, procedures and processes are more fully described under Management's Discussion and Analysis of Financial Condition and Results of Operations Critical Accounting Policies Investment Valuation.

## **Table of Contents**

### **Investment Advisory and Management Agreements**

We are externally managed pursuant to contractual arrangements with our Adviser under which our Adviser and Administrator employ all of our personnel and pay our payroll, benefits and general expenses directly. In 2004, we entered into an investment advisory agreement with our Adviser (as amended, the *Advisory Agreement*), which is controlled by our chairman and chief executive officer. In accordance with the *Advisory Agreement*, we pay the Adviser fees as compensation for its services, consisting of a base management fee and an incentive fee. On July 12, 2011, our Board of Directors approved the renewal of the *Advisory Agreement* through August 31, 2012.

#### ***Base Management Fee***

The base management fee is computed and payable quarterly and is assessed at an annual rate of 2.0% computed on the basis of the value of our average gross assets at the end of the two most recently completed quarters, which are total assets, including investments made with proceeds of borrowings, less any uninvested cash or cash equivalents resulting from borrowings. Overall, the base management fee cannot exceed 2.0% of total assets (as reduced by cash and cash equivalents pledged to creditors) during any given fiscal year. In addition, the following three items are potential adjustments to the base management fee calculation.

#### ***Loan Servicing Fees***

Our Adviser also services the loans held by our wholly-owned subsidiary, Gladstone Business Loan, LLC (*Business Loan*), in return for which our Adviser generally receives a 1.5% annual fee based on the monthly aggregate outstanding balance of loans pledged under our line of credit. Since we own these loans, all loan servicing fees paid to our Adviser are treated as reductions directly against the 2.0% base management fee under the *Advisory Agreement*.

#### ***Portfolio Company Fees***

Under the *Advisory Agreement*, our Adviser has also provided and continues to provide managerial assistance and other services to our portfolio companies and may receive fees for services other than managerial assistance with 50% of certain of these fees, and 100% of others, credited against the base management fee that we would otherwise be required to pay to our Adviser.

#### ***Senior Syndicated Loan Fee Waiver***

Our Board of Directors accepted an unconditional and irrevocable voluntary waiver from the Adviser to reduce the annual 2.0% base management fee on senior syndicated loan participations to 0.5%, to the extent that proceeds resulting from borrowings were used to purchase such syndicated loan participations, for the years ended September 30, 2011 and 2010.

#### ***Incentive Fee***

The incentive fee consists of two parts: an income-based incentive fee and a capital gains-based incentive fee. The income-based incentive fee rewards the Adviser if our quarterly net investment income (before giving effect to any incentive fee) exceeds 1.75% of our net assets (the *hurdle rate*). We will pay the Adviser an income-based incentive fee with respect to our pre-incentive fee net investment income in each calendar quarter as follows:

no incentive fee in any calendar quarter in which our pre-incentive fee net investment income does not exceed the hurdle rate (7% annualized);

100% of our pre-incentive fee net investment income with respect to that portion of such pre-incentive fee net investment income, if any, that exceeds the hurdle rate but is less than 2.1875% in any calendar quarter (8.75% annualized); and

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20% of the amount of our pre-incentive fee net investment income, if any, that exceeds 2.1875% in any calendar quarter (8.75% annualized).

**Table of Contents**

***Quarterly Incentive Fee Based on Net Investment Income***

Pre-incentive fee net investment income

(expressed as a percentage of the value of net assets)

Percentage of pre-incentive fee net investment income

allocated to income-related portion of incentive fee

The second part of the incentive fee is a capital gains-based incentive fee that is determined and payable in arrears as of the end of each fiscal year (or upon termination of the Advisory Agreement, as of the termination date), and equals 20% of our realized capital gains as of the end of the fiscal year. In determining the capital gains-based incentive fee payable to our Adviser, we calculate the cumulative aggregate realized capital gains and cumulative aggregate realized capital losses since our inception, and the aggregate unrealized capital depreciation as of the date of the calculation, as applicable, with respect to each of the investments in our portfolio. For this purpose, cumulative aggregate realized capital gains, if any, equals the sum of the differences between the net sales price of each investment, when sold, and the original cost of such investment since our inception. Cumulative aggregate realized capital losses equals the sum of the amounts by which the net sales price of each investment, when sold, is less than the original cost of such investment since our inception. Aggregate unrealized capital depreciation equals the sum of the difference, if negative, between the valuation of each investment as of the applicable calculation date and the original cost of such investment. At the end of the applicable year, the amount of capital gains that serves as the basis for our calculation of the capital gains-based incentive fee equals the cumulative aggregate realized capital gains less cumulative aggregate realized capital losses, less aggregate unrealized capital depreciation, with respect to our portfolio of investments. If this number is positive at the end of such year, then the capital gains-based incentive fee for such year equals 20% of such amount, less the aggregate amount of any capital gains-based incentive fees paid in respect of our portfolio in all prior years. We have not incurred capital gains-based incentive fees from inception through September 30, 2011, as cumulative unrealized capital depreciation has exceeded cumulative realized capital gains net of cumulative realized capital losses.

Additionally, in accordance with accounting principles generally accepted in the U.S. ( GAAP ), we have not accrued a capital gains-based incentive fee since inception. This GAAP accrual is calculated using the aggregate cumulative realized capital gains and losses and aggregate cumulative unrealized capital depreciation included in the calculation of the capital gains-based incentive fee plus the aggregate cumulative unrealized capital appreciation. If such amount is positive at the end of a period, then GAAP requires us to record a capital gains-based incentive fee equal to 20% of such amount, less the aggregate amount of actual capital gains-based incentive fees paid in all prior years. If such amount is negative, then there is no accrual for such year. GAAP requires that the capital gains-based incentive fee accrual consider the cumulative aggregate unrealized capital appreciation in the calculation, as a capital gains-based incentive fee would be payable if such unrealized capital appreciation were realized. In such instances, however, there could be no assurance that any such unrealized capital appreciation would be realized in the future.

Our Board of Directors accepted an unconditional and irrevocable voluntary waiver from the Adviser to reduce the income-based incentive fee to the extent net investment income did not cover 100% of the distributions to stockholders for the fiscal years ended September 30, 2011 and 2010. For the years ended September 30, 2011 and 2010, these credits totaled \$21 and \$165, respectively.

***Administration Agreement***

In 2004, we entered into an administration agreement with our Administrator (as amended, the Administration Agreement ), whereby we pay separately for administrative services. The Administration Agreement provides for quarterly payments equal to our allocable portion of our Administrator s overhead expenses in performing its obligations under the Administration Agreement, including, but not limited to, rent and salaries and benefits expenses of our chief financial officer, chief compliance officer, treasurer, internal counsel and their respective staffs. Our allocable portion of expenses is generally derived by multiplying our Administrator s total allocable expenses by the percentage of our total assets at the beginning of the quarter in comparison to the total assets at the beginning of the quarter of all companies managed by the Adviser under



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## Table of Contents

similar agreements. On July 12, 2011, our Board of Directors approved the renewal of the Administration Agreement through August 31, 2012.

### **Material U.S. Federal Income Tax Considerations**

#### ***Regulated Investment Company Status***

To maintain the qualification for treatment as a RIC under Subchapter M of the Code, we must distribute to our stockholders, for each taxable year, at least 90% of our investment company taxable income, which is generally our ordinary income plus short-term capital gains. We refer to this as the annual distribution requirement. We must also meet several additional requirements, including:

**Business Development Company status.** At all times during the taxable year, we must maintain our status as a BDC.

**Income source requirements.** At least 90% of our gross income for each taxable year must be from distributions, interest, payments with respect to securities loans, gains from sales or other dispositions of securities or other income derived with respect to our business of investing in securities, and net income derived from an interest in a qualified publicly-traded partnership.

**Asset diversification requirements.** As of the close of each quarter of our taxable year: (1) at least 50% of the value of our assets must consist of cash, cash items, U.S. government securities, the securities of other regulated investment companies and other securities to the extent that (a) we do not hold more than 10% of the outstanding voting securities of an issuer of such other securities and (b) such other securities of any one issuer do not represent more than 5% of our total assets, and (2) no more than 25% of the value of our total assets may be invested in the securities of one issuer (other than U.S. government securities or the securities of other regulated investment companies), or of two or more issuers that are controlled by us and are engaged in the same or similar or related trades or businesses or in the securities of one or more qualified publicly-traded partnerships.

**Failure to Qualify as a RIC.** If we are unable to qualify for treatment as a RIC, we will be subject to tax on all of our taxable income at regular corporate rates. We would not be able to deduct distributions to stockholders, nor would we be required to make such distributions. Distributions would be taxable to our stockholders as dividend income to the extent of our current and accumulated earnings and profits. Subject to certain limitations under the Code, corporate distributees would be eligible for the distributions received deduction. Distributions in excess of our current and accumulated earnings and profits would be treated first as a return of capital to the extent of the stockholder's tax basis, and then as a gain realized from the sale or exchange of property. If we fail to meet the RIC requirements for more than two consecutive years and then seek to requalify as a RIC, we would be required to recognize a gain to the extent of any unrealized appreciation on our assets unless we make a special election to pay corporate-level tax on any such unrealized appreciation recognized during the succeeding 10-year period. Absent such special election, any gain we recognized would be deemed distributed to our stockholders as a taxable distribution.

**Qualification as a RIC.** If we qualify as a RIC and distribute to stockholders each year in a timely manner at least 90% of our investment company taxable income, we will not be subject to federal income tax on the portion of our taxable income and gains we distribute to stockholders. We would, however, be subject to a 4% nondeductible federal excise tax if we do not distribute, actually or on a deemed basis, 98% of our ordinary income and 98.2% of our capital gains.

The excise tax would apply only to the amount by which the required distributions exceed the amount of income we distribute, actually or on a deemed basis, to stockholders. We will be subject to regular corporate income tax, currently at rates up to 35%, on any undistributed income, including both ordinary income and capital gains. We intend to retain some or all of our capital gains, but to treat the retained amount as a deemed distribution. In that case, among other consequences, we will pay tax on the retained amount, each stockholder will be required to include its share of the deemed distribution in income as if it had been actually distributed to the stockholder and the stockholder will be entitled to claim a credit or refund equal to its allocable share of the tax we pay on the retained capital gain. The amount of the deemed distribution net of such tax will be added to the stockholder's cost basis for its common stock. Since we expect to pay tax on any retained capital gains at our regular corporate capital gain tax rate, and since that rate is in excess of the maximum rate currently payable by individuals on long-term capital gains, the amount of tax that individual stockholders will be treated as having paid will

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**Table of Contents**

exceed the tax they owe on the capital gain distribution and such excess may be claimed as a credit or refund against the stockholder's other tax obligations. A stockholder that is not subject to U.S. federal income tax or tax on long-term capital gains would be required to file a U.S. federal income tax return on the appropriate form in order to claim a refund for the taxes we paid. In order to utilize the deemed distribution approach, we must provide written notice to the stockholders prior to the expiration of 60 days after the close of the relevant tax year. We will also be subject to alternative minimum tax, but any tax preference items would be apportioned between us and our stockholders in the same proportion that distributions, other than capital gain distributions, paid to each stockholder bear to our taxable income determined without regard to the distributions paid deduction.

If we acquire debt obligations that were originally issued at a discount, that bear interest at rates that are not either fixed rates or certain qualified variable rates or that are not unconditionally payable at least annually over the life of the obligation, we will be required to include in taxable income each year a portion of the original issue discount (OID) that accrues over the life of the obligation. Such OID will be included in our investment company taxable income even though we receive no cash corresponding to such discount amount. As a result, we may be required to make additional distributions corresponding to such OID amounts in order to satisfy the annual distribution requirement and to continue to qualify as a RIC or to avoid the 4% excise tax. In this event, we may be required to sell investments or other assets to meet the RIC distribution requirements. The number of our OID investments grew from four as of September 30, 2010, to 27 as of September 30, 2011, due to the increased number of syndicated loan investments we made during fiscal 2011. For the year ended September 30, 2011, we incurred \$0.2 million of OID income and the unamortized balance of OID investments as of September 30, 2011 totaled \$1.5 million.

**Taxation of Our U.S. Stockholders**

*Distributions.* For any period during which we qualify for treatment as a RIC for federal income tax purposes, distributions to our stockholders attributable to our investment company taxable income generally will be taxable as ordinary income to stockholders to the extent of our current or accumulated earnings and profits. Any distributions in excess of our earnings and profits will first be treated as a return of capital to the extent of the stockholder's adjusted basis in his or her shares of common stock and thereafter as gain from the sale of shares of our common stock. Distributions of our long-term capital gains, designated by us as such, will be taxable to stockholders as long-term capital gains regardless of the stockholder's holding period for its common stock and whether the distributions are paid in cash or invested in additional common stock. Corporate stockholders are generally eligible for the 70% distributions received deduction with respect to ordinary income, but not to capital gains distributions to the extent such amount designated by us does not exceed the distributions received by us from domestic corporations. Any distribution declared by us in October, November or December of any calendar year, payable to stockholders of record on a specified date in such a month and actually paid during January of the following year, will be treated as if it were paid by us and received by the stockholders on December 31 of the previous year. In addition, we may elect (in accordance with Section 855(a) of the Code) to relate a distribution back to the prior taxable year if we (1) declare such distribution prior to the due date for filing our return for that taxable year, (2) make the election in that return, and (3) distribute the amount in the 12-month period following the close of the taxable year but not later than the first regular distribution payment following the declaration. Any such election will not alter the general rule that a stockholder will be treated as receiving a distribution in the taxable year in which the distribution is made, subject to the October, November, December rule described above.

If a stockholder participates in our dividend reinvestment plan, any distributions reinvested under the plan will be taxable to the stockholder to the same extent, and with the same character, as if the stockholder had received the distribution in cash. The stockholder will have an adjusted basis in the additional common shares purchased through the plan equal to the amount of the reinvested distribution. The additional shares will have a new holding period commencing on the day following the day on which the shares are credited to the stockholder's account.

*Sale of Our Shares.* A U.S. stockholder generally will recognize taxable gain or loss if the U.S. stockholder sells or otherwise disposes of his, her or its shares of our common stock. Any gain arising from such sale or disposition generally will be treated as long-term capital gain or loss if the U.S. stockholder has held his, her or its shares for more than one year. Otherwise, it will be classified as short-term capital gain or loss. However, any capital loss arising from the sale or disposition of shares of our common stock held for six months or less will be treated as long-term capital loss to the extent of the amount of capital gain distributions received, or undistributed capital gain deemed received, with respect to such shares. Under the tax laws in effect as of the date of this filing, individual U.S. stockholders are subject to a maximum federal income tax rate of 15% on their net capital gain (*i.e.* the excess of realized net long-term capital gain over realized net short-term capital loss for a taxable year) including any long-term capital gain derived from an investment in our shares. Such rate is lower than the maximum rate on ordinary income currently payable by individuals. Corporate U.S. stockholders currently

## **Table of Contents**

are subject to federal income tax on net capital gain at the same rates applied to their ordinary income (currently up to a maximum of 35%). Capital losses are subject to limitations on use for both corporate and non-corporate stockholders.

*Backup Withholding.* We may be required to withhold federal income tax, or backup withholding, currently at a rate of 28%, from all taxable distributions to any non-corporate U.S. stockholder (1) who fails to furnish us with a correct taxpayer identification number or a certificate that such stockholder is exempt from backup withholding, or (2) with respect to whom the Internal Revenue Service ( IRS ) notifies us that such stockholder has failed to properly report certain interest and distribution income to the IRS and to respond to notices to that effect. An individual s taxpayer identification number is generally his or her social security number. Any amount withheld under backup withholding is allowed as a credit against the U.S. stockholder s federal income tax liability, provided that proper information is provided to the IRS.

## **Regulation as a Business Development Company**

We are a closed-end, non-diversified management investment company that has elected to be regulated as a BDC under Section 54 of the 1940 Act. As such, we are subject to regulation under the 1940 Act. The 1940 Act contains prohibitions and restrictions relating to transactions between BDCs and their affiliates, principal underwriters and affiliates of those affiliates or underwriters and requires that a majority of the directors be persons other than interested persons, as defined in the 1940 Act. In addition, the 1940 Act provides that we may not change the nature of our business so as to cease to be, or to withdraw our election as, a BDC unless approved by a majority of our outstanding voting securities, as defined in the 1940 Act.

We intend to conduct our business so as to retain our status as a BDC. A BDC may use capital provided by public stockholders and from other sources to invest in long-term private investments in businesses. A BDC provides stockholders the ability to retain the liquidity of a publicly-traded stock while sharing in the possible benefits, if any, of investing in primarily privately owned companies. In general, a BDC must have been organized and have its principal place of business in the U.S. and must be operated for the purpose of making investments in qualifying assets, as described in Section 55(a) (1) (3) of the 1940 Act.

## ***Qualifying Assets***

Under the 1940 Act, a BDC may not acquire any asset other than assets of the type listed in Section 55(a) of the 1940 Act, which are referred to as qualifying assets, unless, at the time the acquisition is made, qualifying assets, other than certain interests in furniture, equipment, real estate, or leasehold improvements ( operating assets ) represent at least 70% of the company s total assets, exclusive of operating assets. The types of qualifying assets in which we may invest under the 1940 Act include, but are not limited to, the following:

- (1) Securities purchased in transactions not involving any public offering from the issuer of such securities, which issuer is an eligible portfolio company. An eligible portfolio company is generally defined in the 1940 Act as any issuer which:
  - (a) is organized under the laws of, and has its principal place of business in, any State or States in the U.S.;
  - (b) is not an investment company (other than a small business investment company wholly owned by the BDC or otherwise excluded from the definition of investment company); and
  - (c) satisfies one of the following:
    - (i) it does not have any class of securities with respect to which a broker or dealer may extend margin credit;
    - (ii) it is controlled by the BDC and for which an affiliate of the BDC serves as a director;

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- (iii) it has total assets of not more than \$4 million and capital and surplus of not less than \$2 million;
  - (iv) it does not have any class of securities listed on a national securities exchange; or
  - (v) it has a class of securities listed on a national securities exchange, with an aggregate market value of outstanding voting and non-voting equity of less than \$250 million.
- (2) Securities received in exchange for or distributed on or with respect to securities described in (1) above, or pursuant to the exercise of options, warrants or rights relating to such securities.
- (3) Cash, cash items, government securities or high quality debt securities maturing in one year or less from the time of investment.

## **Table of Contents**

### ***Asset Coverage***

We are permitted, under specified conditions, to issue multiple classes of indebtedness and one class of stock senior to our common stock if our asset coverage, as defined in the 1940 Act, is at least 200% immediately after each such issuance. In addition, while senior securities are outstanding, we must make provisions to prohibit any distribution to our stockholders or the repurchase of such securities or shares unless we meet the applicable asset coverage ratios at the time of the distribution or repurchase. We may also borrow amounts up to 5% of the value of our total assets for temporary purposes. The 1940 Act requires, among other things, that (1) immediately after issuance and before any dividend or distribution is made with respect to our common stock or before any purchase of our common stock is made, the preferred stock, together with all other senior securities, must not exceed an amount equal to 50% of our total assets after deducting the amount of such dividend, distribution or purchase price, as the case may be, and (2) the holders of shares of preferred stock, if any are issued, must be entitled as a class to elect two directors at all times and to elect a majority of the directors if distributions on the preferred stock are in arrears by two years or more. In November 2011, we issued Term Preferred Stock in accordance with the provisions described above. Our preferred stockholders will elect one director to serve a three year term at our upcoming annual stockholders meeting, currently scheduled for February 16, 2012, and an additional director at the subsequent year's annual stockholders meeting.

### ***Significant Managerial Assistance***

A BDC generally must make available significant managerial assistance to issuers of certain of its portfolio securities that the BDC counts as a qualifying asset for the 70% test described above. Making available significant managerial assistance means, among other things, any arrangement whereby the BDC, through its directors, officers or employees, offers to provide, and, if accepted, does so provide, significant guidance and counsel concerning the management, operations or business objectives and policies of a portfolio company. Significant managerial assistance also includes the exercise of a controlling influence over the management and policies of the portfolio company. However, with respect to certain, but not all such securities, where the BDC purchases such securities in conjunction with one or more other persons acting together, one of the other persons in the group may make available such managerial assistance, or the BDC may exercise such control jointly.

### ***Investment Policies***

We seek to achieve a high level of current income and capital gains through investments in debt securities and preferred and common stock that we acquired in connection with buyout and other recapitalizations. The following investment policies, along with these investment objectives, may not be changed without the approval of our Board of Directors:

We will at all times conduct our business so as to retain our status as a BDC. In order to retain that status, we must be operated for the purpose of investing in certain categories of qualifying assets. In addition, we may not acquire any assets (other than non-investment assets necessary and appropriate to our operations as a BDC or qualifying assets) if, after giving effect to such acquisition, the value of our qualifying assets is less than 70% of the value of our total assets. We anticipate that the securities we seek to acquire will generally be qualifying assets.

We will at all times endeavor to conduct our business so as to retain our status as a RIC under the Code. In order to do so, we must meet income source, asset diversification and annual distribution requirements. We may issue senior securities, such as debt or preferred stock, to the extent permitted by the 1940 Act for the purpose of making investments, to fund share repurchases, or for temporary emergency or other purposes.

With the exception of our policy to conduct our business as a BDC, these policies are not fundamental and may be changed without stockholder approval.

### ***Code of Ethics***

We and our Adviser have each adopted a code of ethics and business conduct applicable to our officers, directors and all employees of our Adviser and our Administrator that complies with the guidelines set forth in Item 406 of Regulation S-K of the Securities Act. As required by the 1940 Act, this code establishes procedures for personal investments, restricts certain transactions by our personnel and requires the reporting of certain transactions and holdings by our personnel. A copy of this code is available for review, free of charge, at our website at [www.GladstoneCapital.com](http://www.GladstoneCapital.com). We intend to provide any required



**Table of Contents**

disclosure of any amendments to or waivers of the provisions of this code by posting information regarding any such amendment or waiver to our website within four days of its effectiveness.

**Compliance Policies and Procedures**

We and our Adviser have adopted and implemented written policies and procedures reasonably designed to prevent violation of the federal securities laws, and our Board of Directors is required to review these compliance policies and procedures annually to assess their adequacy and the effectiveness of their implementation. We have designated a chief compliance officer, John Dellafiora, Jr., who also serves as chief compliance officer for our Adviser.

**Staffing**

We do not currently have any employees and do not expect to have any employees in the foreseeable future. Currently, services necessary for our business are provided by individuals who are employees of our Adviser and our Administrator pursuant to the terms of the Advisory Agreement and the Administration Agreement, respectively. Excluding our chief financial officer, each of our executive officers is an employee or officer, or both, of our Adviser and our Administrator. No employee of our Adviser or our Administrator will dedicate all of his or her time to us. However, we expect that 25-30 full time employees of our Adviser and our Administrator will spend substantial time on our matters during the remainder of calendar year 2011 and all of calendar year 2012. To the extent we acquire more investments, we anticipate that the number of employees of our Adviser and our Administrator who devote time to our matters will increase.

As of November 11, 2011, our Adviser and our Administrator collectively had 53 full-time employees. A breakdown of these employees is summarized by functional area in the table below:

<b>Number of Individuals</b>	<b>Functional Area</b>
9	Executive Management
32	Investment Management, Portfolio Management and Due Diligence
12	Administration, Accounting, Compliance, Human Resources, Legal and Treasury

**Available Information**

Copies of our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and amendments, if any, to those reports filed pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934, as amended (the Exchange Act) are available free of charge through our website at [www.GladstoneCapital.com](http://www.GladstoneCapital.com). A request for any of these reports may also be submitted to us by sending a written request addressed to Investor Relations Manager, Gladstone Capital Corporation, 1521 Westbranch Drive, Suite 200, McLean, VA 22102, or by calling our toll-free investor relations line at 1-866-366-5745. The public may read and copy materials that we file with the SEC at the SEC's Public Reference Room at 100 F Street, NE, Washington, DC 20549. Information on the operation of the Public Reference Room may be obtained by calling the SEC at 1-800-SEC-0330. The SEC also maintains a website that contains reports, proxy and information statements, and other information regarding issuers that file electronically with the SEC at [www.sec.gov](http://www.sec.gov).

**Item 1A. Risk Factors**

*An investment in our securities involves a number of significant risks and other factors relating to our structure and investment objectives. As a result, we cannot assure you that we will achieve our investment objectives. You should consider carefully the following information before making an investment in our securities.*

***Risks Related to the Economy***

*The current state of the economy and the capital markets increases the possibility of adverse effects on our financial position and results of operations. Continued economic adversity could impair our portfolio companies' financial positions and operating results and affect the industries in which we invest, which could, in turn, harm our operating results. Continued adversity in the capital markets could impact our ability to raise capital and reduce our volume of new investments.*

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The U.S. is beginning to recover from the recession that largely began in late 2007. While economic conditions generally appear to be improving, we remain cautious about a long-term economic recovery. The recent recession in general, and the disruptions in the capital markets in particular, have impacted our liquidity options and increased the cost of debt and equity



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## **Table of Contents**

capital. As a result, we do not know if adverse conditions will again intensify, and we are unable to gauge the full extent to which the disruptions will affect us. The longer these uncertain conditions persist, the greater the probability that these factors could continue to increase our costs of, and significantly limit our access to, debt and equity capital and, thus, have an adverse effect on our operations and financial results. Many of our portfolio companies and the companies we may invest in the future are also susceptible to these unstable economic conditions, which may affect the ability of one or more of our portfolio companies to repay our loans or engage in a liquidity event, such as a sale, recapitalization or initial public offering. These unstable economic conditions could also disproportionately impact some of the industries in which we invest, causing us to be more vulnerable to losses in our portfolio, which could cause the number of non-performing assets to increase and the fair value of our portfolio to decrease. The unstable economic conditions may also decrease the value of collateral securing some of our loans as well as the value of our equity investments which would decrease our ability to borrow under our line of credit or raise equity capital, thereby further reducing our ability to make new investments.

In November 2011, we completed an offering of term preferred stock; however, there can be no assurance that we will be able to raise additional equity capital in the near future.

The unstable economic conditions have affected the availability of credit generally. Our current credit facility limits our distributions to stockholders and as a result we decreased our monthly cash distribution rate by 50% starting with the April 2009 distributions through the current period in an effort to more closely align our distributions to our net investment income. We do not know when market conditions will stabilize, if adverse conditions will intensify or the full extent to which the disruptions will continue to affect us. Also, it is possible that persistent instability of the financial markets could have other unforeseen material effects on our business.

*The recent downgrade of the United States credit rating and the ongoing economic crisis in Europe could negatively impact our liquidity, financial condition and earnings.*

Recent U.S. debt ceiling and budget deficit concerns, together with signs of deteriorating sovereign debt conditions in Europe, have increased the possibility of additional credit-rating downgrades and economic slowdowns. Although U.S. lawmakers passed legislation to raise the federal debt ceiling, Standard & Poor's Ratings Services lowered its long-term sovereign credit rating on the U.S. from AAA to AA+ in August 2011. The impact of this or any further downgrades to the U.S. government's sovereign credit rating, or its perceived creditworthiness, and the impact of the current crisis in Europe with respect to the ability of certain European Union countries to continue to service their sovereign debt obligations is inherently unpredictable and could adversely affect the U.S. and global financial markets and economic conditions. There can be no assurance that governmental or other measures to aid economic recovery will be effective. These developments, and the government's credit concerns in general, could cause interest rates and borrowing costs to rise, which may negatively impact our ability to access the debt markets on favorable terms. In addition, the decreased credit rating could create broader financial turmoil and uncertainty, which may weigh heavily on our stock price. Continued adverse economic conditions could have a material adverse effect on our business, financial condition and results of operations.

*We may experience fluctuations in our quarterly and annual results based on the impact of inflation in the United States.*

The majority of our portfolio companies are in industries that are directly impacted by inflation, such as consumer goods and services and manufacturing. Our portfolio companies may not be able to pass on to customers increases in their costs of operations which could greatly affect their operating results, impacting their ability to repay our loans. In addition, any projected future decreases in our portfolio companies' operating results due to inflation could adversely impact the fair value of those investments. Any decreases in the fair value of our investments could result in future unrealized losses and therefore reduce our net assets resulting from operations.

### ***Risks Related to Our External Management***

*We are dependent upon our key management personnel and the key management personnel of our Adviser, particularly David Gladstone, George Stelljes III and Terry Lee Brubaker, and on the continued operations of our Adviser, for our future success.*

We have no employees. Our chief executive officer, president and chief investment officer, chief operating officer, chief financial officer, and the employees of our Adviser, do not spend all of their time managing our activities and our investment portfolio. We are particularly dependent upon David Gladstone, George Stelljes III and Terry Lee Brubaker in this regard. Our executive officers and the employees of our Adviser allocate some, and in some cases a material portion, of their time to

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**Table of Contents**

businesses and activities that are not related to our business. We have no separate facilities and are completely reliant on our Adviser, which has significant discretion as to the implementation and execution of our business strategies and risk management practices. We are subject to the risk of discontinuation of our Adviser's operations or termination of the Advisory Agreement and the risk that, upon such event, no suitable replacement will be found. We believe that our success depends to a significant extent upon our Adviser and that discontinuation of its operations could have a material adverse effect on our ability to achieve our investment objectives.

*Our incentive fee may induce our Adviser to make certain investments, including speculative investments.*

The management compensation structure that has been implemented under the Advisory Agreement may cause our Adviser to invest in high-risk investments or take other risks. In addition to its management fee, our Adviser is entitled under the Advisory Agreement to receive incentive compensation based in part upon our achievement of specified levels of income. In evaluating investments and other management strategies, the opportunity to earn incentive compensation based on net income may lead our Adviser to place undue emphasis on the maximization of net income at the expense of other criteria, such as preservation of capital, maintaining sufficient liquidity, or management of credit risk or market risk, in order to achieve higher incentive compensation. Investments with higher yield potential are generally riskier or more speculative. This could result in increased risk to the value of our investment portfolio.

*We may be obligated to pay our Adviser incentive compensation even if we incur a loss.*

The Advisory Agreement entitles our Adviser to incentive compensation for each fiscal quarter in an amount equal to a percentage of the excess of our investment income for that quarter (before deducting incentive compensation, net operating losses and certain other items) above a threshold return for that quarter. When calculating our incentive compensation, our pre-incentive fee net investment income excludes realized and unrealized capital losses that we may incur in the fiscal quarter, even if such capital losses result in a net loss on our statement of operations for that quarter. Thus, we may be required to pay our Adviser incentive compensation for a fiscal quarter even if there is a decline in the value of our portfolio or we incur a net loss for that quarter. For additional information on incentive compensation under the Advisory Agreement with our Adviser, see *Business Investment Advisory and Management Agreements Management services and fees under the Advisory Agreement*.

*Our Adviser's failure to identify and invest in securities that meet our investment criteria or perform its responsibilities under the Advisory Agreement may adversely affect our ability for future growth.*

Our ability to achieve our investment objectives will depend on our ability to grow, which in turn will depend on our Adviser's ability to identify and invest in securities that meet our investment criteria. Accomplishing this result on a cost-effective basis will be largely a function of our Adviser's structuring of the investment process, its ability to provide competent and efficient services to us, and our access to financing on acceptable terms. The senior management team of our Adviser has substantial responsibilities under the Advisory Agreement. In order to grow, our Adviser will need to hire, train, supervise, and manage new employees successfully. Any failure to manage our future growth effectively could have a material adverse effect on our business, financial condition, and results of operations.

*There are significant potential conflicts of interest which could impact our investment returns.*

Our executive officers and directors, and the officers and directors of our Adviser, serve or may serve as officers, directors, or principals of entities that operate in the same or a related line of business as we do or of investment funds managed by our affiliates. Accordingly, they may have obligations to investors in those entities, the fulfillment of which might not be in the best interests of us or our stockholders. For example, Mr. Gladstone, our chairman and chief executive officer, is the chairman of the board and chief executive officer of our Adviser, Gladstone Investment and Gladstone Commercial and the sole stockholder of Gladstone Land. In addition, Mr. Brubaker, our vice chairman, chief operating officer and secretary is the vice chairman, chief operating officer and secretary of our Adviser, Gladstone Investment and Gladstone Commercial. Mr. Stelljes, our president and chief investment officer, is also the president and chief investment officer of our Adviser and Gladstone Commercial and vice chairman and chief investment officer of Gladstone Investment. Moreover, our Adviser may establish or sponsor other investment vehicles which from time to time may have potentially overlapping investment objectives with those of ours and accordingly may invest in, whether principally or secondarily, asset classes similar to those we target. While our Adviser generally has broad authority to make investments on behalf of the investment vehicles that it advises, our Adviser has adopted investment allocation procedures to address these potential conflicts and intends to direct investment opportunities to the Gladstone affiliate with the investment strategy that most closely fits the investment

## Table of Contents

opportunity. Nevertheless, the management of our Adviser may face conflicts in the allocation of investment opportunities to other entities managed by our Adviser. As a result, it is possible that we may not be given the opportunity to participate in certain investments made by other members of the Gladstone Companies or investment funds managed by investment managers affiliated with our Adviser.

In certain circumstances, we may make investments in a portfolio company in which one of our affiliates has or will have an investment, subject to satisfaction of any regulatory restrictions and, where required, to the prior approval of our Board of Directors. As of September 30, 2011, our Board of Directors has approved the following types of co-investment transactions:

Our affiliate, Gladstone Commercial, may lease property to portfolio companies that we do not control under certain circumstances. We may pursue such transactions only if (i) the portfolio company is not controlled by us or any of our affiliates, (ii) the portfolio company satisfies the tenant underwriting criteria of Gladstone Commercial, and (iii) the transaction is approved by a majority of our independent directors and a majority of the independent directors of Gladstone Commercial. We expect that any such negotiations between Gladstone Commercial and our portfolio companies would result in lease terms consistent with the terms that the portfolio companies would be likely to receive were they not portfolio companies of ours.

We may invest simultaneously with our affiliate Gladstone Investment in senior syndicated loans whereby neither we nor any affiliate has the ability to dictate the terms of the loans.

Additionally, pursuant to an exemptive order granted by the SEC, our Adviser may sponsor a private investment fund to co-invest with us or Gladstone Investment in accordance with the terms and conditions of the order.

Certain of our officers, who are also officers of our Adviser, may from time to time serve as directors of certain of our portfolio companies. If an officer serves in such capacity with one of our portfolio companies, such officer will owe fiduciary duties to all stockholders of the portfolio company, which duties may from time to time conflict with the interests of our stockholders.

In the course of our investing activities, we will pay management and incentive fees to our Adviser and will reimburse our Administrator for certain expenses it incurs. As a result, investors in our common stock will invest on a gross basis and receive distributions on a net basis after expenses, resulting in, among other things, a lower rate of return than one might achieve through our investors themselves making direct investments. As a result of this arrangement, there may be times when the management team of our Adviser has interests that differ from those of our stockholders, giving rise to a conflict. In addition, as a BDC, we make available significant managerial assistance to our portfolio companies and provide other services to such portfolio companies. Although, neither we nor our Adviser currently receives fees in connection with managerial assistance, our Adviser provides other services to our portfolio companies and receives fees for these other services. For example, during the year ended September 30, 2011, certain of our portfolio companies contracted directly with our Adviser for the provision of various consulting services and with Gladstone Securities for the provision of investment banking and due diligence services, in each case, in return for fees.

*Our Adviser is not obligated to provide a waiver of the base management fee, which could negatively impact our earnings and our ability to maintain our current level of distributions to our stockholders.*

The Advisory Agreement provides for a base management fee based on our gross assets. Since our 2007 fiscal year, our Board of Directors has accepted on a quarterly basis voluntary, unconditional and irrevocable waivers to reduce the annual 2.0% base management fee on senior syndicated loan participations to 0.5% to the extent that proceeds resulting from borrowings were used to purchase such syndicated loan participations, and any waived fees may not be recouped by our Adviser in the future. However, our Adviser is not required to issue these or other waivers of fees under the Advisory Agreement, and to the extent our investment portfolio grows in the future, we expect these fees will increase. If our Adviser does not issue these waivers in future quarters, it could negatively impact our earnings and may compromise our ability to maintain our current level of distributions to our stockholders, which could have a material adverse impact on our stock price.

*Our business model is dependent upon developing and sustaining strong referral relationships with investment bankers, business brokers and other intermediaries.*

We are dependent upon informal relationships with investment bankers, business brokers and traditional lending institutions to provide us with deal flow. If we fail to maintain our relationship with such funds or institutions, or if we fail to establish



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**Table of Contents**

strong referral relationships with other funds, we will not be able to grow our portfolio of loans and fully execute our business plan.

***Risks Related to Our External Financing***

*In addition to regulatory limitations on our ability to raise capital, our credit facility contains various covenants which, if not complied with, could accelerate our repayment obligations under the facility, thereby materially and adversely affecting our liquidity, financial condition, results of operations and ability to pay distributions.*

In March 2010, we entered into a fourth amended and restated credit agreement, which provided for \$127.0 million revolving line of credit arranged by Key Equipment Finance Inc. as administrative agent (the Credit Facility). Branch Banking and Trust Company (BB&T) and ING Capital LLC (ING) also joined the Credit Facility as committed lenders. Subject to certain terms and conditions, the Credit Facility may be expanded up to \$202.0 million through the addition of other committed lenders to the facility. In August 2011, the Credit Facility was expanded by \$10.0 million, bringing the total committed funding under the Credit Facility to \$137.0 million. However, if additional lenders are unwilling to join the facility on its terms, we will be unable to expand the facility and thus will continue to have limited availability to finance new investments under our line of credit. The Credit Facility matures on March 15, 2012, and, if the facility is not renewed or extended by this date, all principal and interest will be due and payable on March 15, 2013. As of November 11, 2011, we had \$56.7 million of borrowing capacity remaining under the Credit Facility.

We will have a continuing need for capital to finance our loans. The Credit Facility permits us to fund additional loans and investments as long as we are within the conditions set forth in the credit agreement. Pursuant to the terms of the Credit Facility, we are subject to certain limitations on the type of loan investments we make, including restrictions on geographic concentrations, sector concentrations, loan size, dividend payout, payment frequency and status, average life and lien property. The credit agreement also requires us to comply with other financial and operational covenants, which require us to, among other things, maintain certain financial ratios, including asset and interest coverage and a minimum net worth and a minimum number of obligors required in the borrowing base of the credit agreement. As of September 30, 2011, we were in compliance with these covenants; however, our continued compliance depends on many factors, some of which are beyond our control. Current market conditions have forced us to write down the value of a portion of our assets, as required by the 1940 Act and fair value accounting rules. These are not realized losses, but constitute adjustment in asset values for purposes of financial reporting and for collateral value for the Credit Facility. As assets are marked down in value, the amount we can borrow on the Credit Facility decreases. As of September 30, 2011, our net assets were \$213.7 million, down from \$249.2 million as of September 20, 2010, primarily a result of unrealized depreciation over the twelve months. As of September 30, 2011, the cumulative net unrealized depreciation on our investments was \$79.9 million, compared to net unrealized depreciation of \$41.1 million as of September 30, 2010.

The minimum net worth covenant contained in the credit agreement requires our net assets to be at least \$200.0 million plus 50.0% of all equity and subordinated debt raised after May 15, 2009. Given the continued uncertainty in the capital markets, the cumulative unrealized depreciation in our portfolio may increase in future periods and threaten our ability to comply with the minimum net worth covenant and other covenants under the Credit Facility. Under the Credit Facility, we are also required to maintain our status as a BDC under the 1940 Act and as a RIC under the Code. There are no assurances that we will continue to comply with these covenants. Our failure to satisfy these covenants could result in foreclosure by our lenders, which would accelerate our repayment obligations under the facility and thereby have a material adverse effect on our business, liquidity, financial condition, results of operations and ability to pay distributions to our stockholders.

*In recent years, creditors have significantly curtailed their lending to BDCs, including us. Any inability to renew, extend or replace our line of credit on terms favorable to us, or at all, could adversely impact our liquidity and ability to fund new investments or maintain distributions to our stockholders.*

As described earlier, availability under the Credit Facility will terminate on March 15, 2012 and if the facility is not renewed or extended by such date, all principal and interest will be due and payable on March 15, 2013, one year after the date of maturity. Since September 30, 2010, outstanding borrowings under the Credit Facility have increased significantly from \$16.8 million to \$99.4 million as of September 30, 2011. If additional lenders are unwilling to join the facility on its terms, we will be unable to expand the facility and thus will continue to have limited availability to finance new investments under our line of credit. Between the maturity date and March 15, 2013, our lenders have the right to apply all interest income to amounts outstanding under the Credit Facility. As of November 11, 2011, after application of the net proceeds of our offering of term preferred stock to repay a portion of the outstanding borrowings, there was \$64.0 million outstanding on the Credit Facility.

## Table of Contents

There can be no guarantee that we will be able to renew, extend or replace the Credit Facility on terms that are favorable to us, or at all. Our ability to obtain replacement financing will be constrained by current economic conditions affecting the credit markets. Consequently, any renewal, extension or refinancing of the Credit Facility will potentially result in significantly higher interest rates and related charges and may impose significant restrictions on the use of borrowed funds with regard to our ability to fund investments or maintain distributions to stockholders. If we are unable to secure replacement financing, we may be forced to sell certain assets on disadvantageous terms, which may result in realized losses, and such realized losses could materially exceed the amount of any unrealized depreciation on these assets as of our most recent balance sheet date, which would have a material adverse effect on our results of operations. Such circumstances would also increase the likelihood that we would be required to redeem some or all of our outstanding Term Preferred Stock, which would potentially require us to sell even more assets. In addition to selling assets, or as an alternative, we may issue equity to repay amounts outstanding under the line of credit. Based on the recent trading prices of our stock, such an equity offering may have a substantial dilutive impact on our existing stockholders' interest in our earnings and assets and voting interest in us.

*Our business plan is dependent upon external financing, which is constrained by the limitations of the 1940 Act.*

Our business requires a substantial amount of cash to operate and grow. We may acquire such additional capital from the following sources:

*Senior Securities.* We may issue debt securities, other evidences of indebtedness (including borrowings under our line of credit) and possibly senior common stock and preferred stock, up to the maximum amount permitted by the 1940 Act. The 1940 Act currently permits us, as a BDC, to issue debt securities, senior common stock and preferred stock (such as our recently issued Term Preferred Stock), which we refer to collectively as senior securities, in amounts such that our asset coverage, as defined in the 1940 Act, is at least 200% after each issuance of senior securities. As a result of issuing senior securities, we will be exposed to the risks associated with leverage. Although borrowing money for investments increases the potential for gain, it also increases the risk of a loss. A decrease in the value of our investments will have a greater impact on the value of our common stock to the extent that we have borrowed money to make investments. There is a possibility that the costs of borrowing could exceed the income we receive on the investments we make with such borrowed funds. In addition, our ability to pay distributions or incur additional indebtedness would be restricted if asset coverage is not at least twice our indebtedness. If the value of our assets declines, we might be unable to satisfy that test. If this happens, we may be required to liquidate a portion of our loan portfolio and repay a portion of our indebtedness at a time when a sale, to the extent possible given the limited market for many of our investments, may be disadvantageous. Furthermore, any amounts that we use to service our indebtedness will not be available for distributions to our stockholders.

*Common and Convertible Preferred Stock.* Because we are constrained in our ability to issue debt for the reasons given above, we are dependent on the issuance of equity as a financing source. If we raise additional funds by issuing more common stock or senior securities convertible into or exchangeable for our common stock, the percentage ownership of our stockholders at the time of the issuance would decrease and our common stock may experience dilution. In addition, any convertible or exchangeable securities that we issue in the future may have rights, preferences and privileges more favorable than those of our common stock. In addition, under the 1940 Act, we will generally not be able to issue additional shares of our common stock at a price below net asset value per share to purchasers, other than to our existing stockholders through a rights offering, without first obtaining the approval of our stockholders and our independent directors. If we were to sell shares of our common stock below our then current net asset value per share, such sales would result in an immediate dilution to the net asset value per share. This dilution would occur as a result of the sale of shares at a price below the then current net asset value per share of our common stock and a proportionately greater decrease in a stockholder's interest in our earnings and assets and voting interest in us than the increase in our assets resulting from such issuance. For example, if we issue and sell an additional 10% of our common stock at a 5% discount from net asset value, a stockholder who does not participate in that offering for its proportionate interest will suffer net asset value dilution of up to 0.5% or \$5 per \$1,000 of net asset value. This imposes constraints on our ability to raise capital when our common stock is trading at below net asset value, as it has for the last year.

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## **Table of Contents**

*A change in interest rates may adversely affect our profitability.*

We anticipate using a combination of equity and long-term and short-term borrowings to finance our investment activities. As a result, a portion of our income will depend upon the difference between the rate at which we borrow funds and the rate at which we loan these funds. Higher interest rates on our borrowings will decrease the overall return on our portfolio.

Ultimately, we expect approximately 90% of the loans in our portfolio to be at variable rates determined on the basis of LIBOR and approximately 10% to be at fixed rates. As of September 30, 2011, our portfolio had approximately 86% of the total loan cost value at variable rates with floors, approximately 6% of the total of the loan cost value at variable rates without a floor or ceiling and approximately 8% of the total loan portfolio cost basis at fixed rates.

### ***Risks Related to Our Investments***

*We operate in a highly competitive market for investment opportunities.*

A large number of entities compete with us and make the types of investments that we seek to make in small and mid-sized companies. We compete with public and private buyout funds, commercial and investment banks, commercial financing companies, and, to the extent they provide an alternative form of financing, hedge funds. Many of our competitors are substantially larger and have considerably greater financial, technical and marketing resources than we do. For example, some competitors may have a lower cost of funds and access to funding sources that are not available to us. In addition, some of our competitors may have higher risk tolerances or different risk assessments, which would allow them to consider a wider variety of investments and establish more relationships than us. Furthermore, many of our competitors are not subject to the regulatory restrictions that the 1940 Act imposes on us as a BDC. The competitive pressures we face could have a material adverse effect on our business, financial condition and results of operations. Also, as a result of this competition, we may not be able to take advantage of attractive investment opportunities from time to time and we can offer no assurance that we will be able to identify and make investments that are consistent with our investment objective. We do not seek to compete based on the interest rates we offer, and we believe that some of our competitors may make loans with interest rates that will be comparable to or lower than the rates we offer. We may lose investment opportunities if we do not match our competitors' pricing, terms, and structure. However, if we match our competitors' pricing, terms, and structure, we may experience decreased net interest income and increased risk of credit loss.

*Our investments in small and medium-sized portfolio companies are extremely risky and could cause you to lose all or a part of your investment.*

Investments in small and medium-sized portfolio companies are subject to a number of significant risks including the following:

*Small and medium-sized businesses are likely to have greater exposure to economic downturns than larger businesses.* Our portfolio companies may have fewer resources than larger businesses, and thus the recent recession, and any further economic downturns or recessions, are more likely to have a material adverse effect on them. If one of our portfolio companies is adversely impacted by a recession, its ability to repay our loan or engage in a liquidity event, such as a sale, recapitalization or initial public offering would be diminished.

*Small and medium-sized businesses may have limited financial resources and may not be able to repay the loans we make to them.* Our strategy includes providing financing to portfolio companies that typically is not readily available to them. While we believe that this provides an attractive opportunity for us to generate profits, this may make it difficult for the portfolio companies to repay their loans to us upon maturity. A borrower's ability to repay its loan may be adversely affected by numerous factors, including the failure to meet its business plan, a downturn in its industry, or negative economic conditions. A deterioration in a borrower's financial condition and prospects usually will be accompanied by a deterioration in the value of any collateral and a reduction in the likelihood of us realizing on any guaranties we may have obtained from the borrower's management. As of September 30, 2011, eight investments were on non-accrual status, which represented 10.8% of the aggregate cost basis of our portfolio. While we are working with the portfolio companies to improve their profitability and cash flows, there can be no assurance that our efforts will prove successful. Although we will sometimes seek to be the senior, secured lender to a borrower, in most of our loans we expect to be subordinated to a senior lender, and our interest in any collateral would, accordingly, likely be subordinate to another lender's security interest.

## Table of Contents

*Small and medium-sized businesses typically have narrower product lines and smaller market shares than large businesses.* Because our target portfolio companies are smaller businesses, they will tend to be more vulnerable to competitors' actions and market conditions, as well as general economic downturns. In addition, our portfolio companies may face intense competition, including competition from companies with greater financial resources, more extensive development, manufacturing, marketing, and other capabilities and a larger number of qualified managerial, and technical personnel.

*There is generally little or no publicly available information about these businesses.* Because we seek to invest in privately owned businesses, there is generally little or no publicly available operating and financial information about our potential portfolio companies. As a result, we rely on our officers, our Adviser, and its employees and consultants to perform due diligence investigations of these portfolio companies, their operations, and their prospects. We may not learn all of the material information we need to know regarding these businesses through our investigations.

*Small and medium-sized businesses generally have less predictable operating results.* We expect that our portfolio companies may have significant variations in their operating results, may from time to time be parties to litigation, may be engaged in rapidly changing businesses with products subject to a substantial risk of obsolescence, may require substantial additional capital to support their operations, to finance expansion or to maintain their competitive position, may otherwise have a weak financial position, or may be adversely affected by changes in the business cycle. Our portfolio companies may not meet net income, cash flow, and other coverage tests typically imposed by their senior lenders. A borrower's failure to satisfy financial or operating covenants imposed by senior lenders could lead to defaults and, potentially, foreclosure on its senior credit facility, which could additionally trigger cross-defaults in other agreements. If this were to occur, it is possible that the borrower's ability to repay our loan would be jeopardized.

*Small and medium-sized businesses are more likely to be dependent on one or two persons.* Typically, the success of a small or medium-sized business also depends on the management talents and efforts of one or two persons or a small group of persons. The death, disability, or resignation of one or more of these persons could have a material adverse impact on our borrower and, in turn, on us.

*Small and medium-sized businesses may have limited operating histories.* While we intend to target stable companies with proven track records, we may make loans to new companies that meet our other investment criteria. Portfolio companies with limited operating histories will be exposed to all of the operating risks that new businesses face and may be particularly susceptible to, among other risks, market downturns, competitive pressures and the departure of key executive officers.

*Because the loans we make and equity securities we receive when we make loans are not publicly-traded, there is uncertainty regarding the value of our privately held securities that could adversely affect our determination of our net asset value.*

Our portfolio investments are, and we expect will continue to be, in the form of securities that are not publicly-traded. The fair value of securities and other investments that are not publicly-traded may not be readily determinable. Our Board of Directors has established an investment valuation policy and consistently applied valuation procedures used to determine the fair value of these securities quarterly. These procedures for the determination of value of many of our debt securities rely on the opinions of value submitted to us by SPSE or the use of internally developed discounted cash flow ( DCF ) methodologies or indicative bid prices ( IBP ) offered by the respective originating syndication agent's trading desk, or secondary desk, specifically for our syndicated loans, or internal methodologies based on the total enterprise value ( TEV ) of the issuer used for certain of our equity investments. SPSE will only evaluate the debt portion of our investments for which we specifically request evaluation, and SPSE may decline to make requested evaluations for any reason in its sole discretion. However, to date, SPSE has accepted each of our requests for evaluation.

Our use of these fair value methods is inherently subjective and is based on estimates and assumptions of each security. In the event that we are required to sell a security, we may ultimately sell for an amount materially less than the estimated fair value calculated by SPSE, or utilizing the TEV, IBP or the DCF methodology.

Our procedures also include provisions whereby our Adviser will establish the fair value of any equity securities we may hold where SPSE or third-party agent banks are unable to provide evaluations. The types of factors that may be considered in determining the fair value of our debt and equity securities include some or all of the following:



the nature and realizable value of any collateral;

the portfolio company's earnings and cash flows and its ability to make payments on its obligations;

the markets in which the portfolio company does business;

## Table of Contents

the comparison to publicly-traded companies; and

discounted cash flow and other relevant factors.

Because such valuations, particularly valuations of private securities and private companies, are not susceptible to precise determination, may fluctuate over short periods of time, and may be based on estimates, our determinations of fair value may differ from the values that might have actually resulted had a readily available market for these securities been available.

A portion of our assets are, and will continue to be, comprised of equity securities that are valued based on internal assessment using our own valuation methods approved by our Board of Directors, without the input of SPSE or any other third-party evaluator. We believe that our equity valuation methods reflect those regularly used as standards by other professionals in our industry who value equity securities. However, determination of fair value for securities that are not publicly-traded, whether or not we use the recommendations of an independent third-party evaluator, necessarily involves the exercise of subjective judgment. Our net asset value could be adversely affected if our determinations regarding the fair value of our investments were materially higher than the values that we ultimately realize upon the disposal of such securities.

*The lack of liquidity of our privately held investments may adversely affect our business.*

We will generally make investments in private companies whose securities are not traded in any public market. Substantially all of the investments we presently hold and the investments we expect to acquire in the future are, and will be, subject to legal and other restrictions on resale and will otherwise be less liquid than publicly-traded securities. The illiquidity of our investments may make it difficult for us to quickly obtain cash equal to the value at which we record our investments if the need arises. This could cause us to miss important investment opportunities. In addition, if we are required to liquidate all or a portion of our portfolio quickly, we may record substantial realized losses upon liquidation. We may also face other restrictions on our ability to liquidate an investment in a portfolio company to the extent that we, our Adviser, or our respective officers, employees or affiliates have material non-public information regarding such portfolio company.

Due to the uncertainty inherent in valuing these securities, our determinations of fair value may differ materially from the values that could be obtained if a ready market for these securities existed. Our net asset value could be materially affected if our determinations regarding the fair value of our investments are materially different from the values that we ultimately realize upon our disposal of such securities.

*Our financial results could be negatively affected if a significant portfolio investment fails to perform as expected.*

Our total investment in companies may be significant individually or in the aggregate. As a result, if a significant investment in one or more companies fails to perform as expected, our financial results could be more negatively affected and the magnitude of the loss could be more significant than if we had made smaller investments in more companies.

*When we are a debt or minority equity investor in a portfolio company, which we expect will generally be the case, we may not be in a position to control the entity, and its management may make decisions that could decrease the value of our investment.*

We anticipate that most of our investments will continue to be either debt or minority equity investments in our portfolio companies. Therefore, we are and will remain subject to risk that a portfolio company may make business decisions with which we disagree, and the shareholders and management of such company may take risks or otherwise act in ways that do not serve our best interests. As a result, a portfolio company may make decisions that could decrease the value of our portfolio holdings. In addition, we will generally not be in a position to control any portfolio company by investing in its debt securities.

During the year ended September 30, 2011, we significantly increased the number of our syndicated loan investments. This type of loan has a larger group of investors and the investment objectives thereof may not be completely aligned with ours.

*Our portfolio companies may incur debt that ranks equally with, or senior to, our investments in such companies.*

We invest primarily in debt securities issued by our portfolio companies. In some cases portfolio companies will be permitted to have other debt that ranks equally with, or senior to, the debt securities in which we invest. By their terms, such debt instruments may provide that the holders thereof are entitled to receive payment of interest and principal on or before the dates on which we are entitled to receive payments in respect of the debt securities in which we invest. Also, in the event of insolvency, liquidation, dissolution, reorganization, or bankruptcy of a portfolio company, holders of debt instruments



## Table of Contents

ranking senior to our investment in that portfolio company would typically be entitled to receive payment in full before we receive any distribution in respect of our investment. After repaying such senior creditors, such portfolio company may not have any remaining assets to use for repaying its obligation to us. In the case of debt ranking equally with debt securities in which we invest, we would have to share on an equal basis any distributions with other creditors holding such debt in the event of an insolvency, liquidation, dissolution, reorganization, or bankruptcy of a portfolio company.

*Prepayments of our investments by our portfolio companies could adversely impact our results of operations and reduce our return on equity.*

In addition to risks associated with delays in investing our capital, we are also subject to the risk that investments that we make in our portfolio companies may be repaid prior to maturity. For the year ended September 30, 2011, we received principal payments prior to maturity of \$17.5 million. We will first use any proceeds from prepayments to repay any borrowings outstanding on the Credit Facility. In the event that funds remain after repayment of our outstanding borrowings, then we will generally reinvest these proceeds in government securities, pending their future investment in new debt and/or equity securities. These government securities will typically have substantially lower yields than the debt securities being prepaid and we could experience significant delays in reinvesting these amounts. As a result, our results of operations could be materially adversely affected if one or more of our portfolio companies elect to prepay amounts owed to us. Additionally, prepayments could negatively impact our return on equity, which could result in a decline in the market price of our common stock.

*Higher taxation of our portfolio companies may impact our quarterly and annual operating results.*

The recession's adverse effect on federal, state, and municipality revenues may induce these government entities to raise various taxes to make up for lost revenues. Additional taxation may have an adverse effect on our portfolio companies' earnings and reduce their ability to repay our loans to them, thus affecting our quarterly and annual operating results.

*Our portfolio is concentrated in a limited number of companies and industries, which subjects us to an increased risk of significant loss if any one of these companies does not repay us or if the industries experience downturns.*

As of September 30, 2011 we had investments in 59 portfolio companies, of which there were five investments that comprised approximately \$91.2 million or 30.1% of our total investment portfolio, at fair value. A consequence of a concentration in a limited number of investments is that the aggregate returns we realize may be substantially adversely affected by the unfavorable performance of a small number of such investments or a substantial write-down of any one investment. Beyond our regulatory and income tax diversification requirements, we do not have fixed guidelines for industry concentration and our investments could potentially be concentrated in relatively few industries. In addition, while we do not intend to invest 25.0% or more of our total assets in a particular industry or group of industries at the time of investment, it is possible that as the values of our portfolio companies change, one industry or a group of industries may comprise in excess of 25.0% of the value of our total assets. As a result, a downturn in an industry in which we have invested a significant portion of our total assets could have a materially adverse effect on us. As of September 30, 2011, 15.1% of our total assets at fair value were invested in electronics companies, 11.3% were invested in healthcare, education and childcare companies, and 11.1% were invested in mining, steel, iron and non-precious metal companies. As a result, we are susceptible to the economic circumstances in these industries, and a downturn in one or more of these industries could have a material adverse effect on our results of operations and financial condition.

*Our investments are typically long term and will require several years to realize liquidation events.*

Since we generally make five to seven year term loans and hold our loans and related warrants or other equity positions until the loans mature, you should not expect realization events, if any, to occur over the near term. In addition, we expect that any warrants or other equity positions that we receive when we make loans may require several years to appreciate in value and we cannot give any assurance that such appreciation will occur.

*The disposition of our investments may result in contingent liabilities.*

Currently, all of our investments involve private securities. In connection with the disposition of an investment in private securities, we may be required to make representations about the business and financial affairs of the underlying portfolio company typical of those made in connection with the sale of a business. We may also be required to indemnify the purchasers of such investment to the extent that any such representations turn out to be inaccurate or with respect to certain

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## **Table of Contents**

potential liabilities. These arrangements may result in contingent liabilities that ultimately yield funding obligations that must be satisfied through our return of certain distributions previously made to us.

*There may be circumstances where our debt investments could be subordinated to claims of other creditors or we could be subject to lender liability claims.*

Even though we have structured some of our investments as senior loans, if one of our portfolio companies were to go bankrupt, depending on the facts and circumstances, including the extent to which we actually provided managerial assistance to that portfolio company, a bankruptcy court might re-characterize our debt investments and subordinate all, or a portion, of our claims to that of other creditors. Holders of debt instruments ranking senior to our investments typically would be entitled to receive payment in full before we receive any distributions. After repaying such senior creditors, such portfolio company may not have any remaining assets to use to repay its obligation to us. We may also be subject to lender liability claims for actions taken by us with respect to a borrower's business or in instances in which we exercised control over the borrower. It is possible that we could become subject to a lender's liability claim, including as a result of actions taken in rendering significant managerial assistance.

*Portfolio company litigation could result in additional costs and the diversion of management time and resources.*

In the course of providing significant managerial assistance to certain of our portfolio companies, our executive officers sometimes serve as directors on the boards of such companies. To the extent that litigation arises out of our investments in these companies, such executive officers may be named as defendants in such litigation, which could result in additional costs and the diversion of management time and resources.

*We may not realize gains from our equity investments and other yield enhancements.*

When we make a subordinated loan, we may receive warrants to purchase stock issued by the borrower or other yield enhancements, such as success fees. Our goal is to ultimately dispose of these equity interests and realize gains upon our disposition of such interests. We expect that, over time, the gains we realize on these warrants and other yield enhancements will offset any losses we experience on loan defaults. However, any warrants we receive may not appreciate in value and, in fact, may decline in value and any other yield enhancements, such as success fees, may not be realized. Accordingly, we may not be able to realize gains from our equity interests or other yield enhancements and any gains we do recognize may not be sufficient to offset losses we experience on our loan portfolio.

*Any unrealized depreciation we experience on our investment portfolio may be an indication of future realized losses, which could reduce our income available for distribution.*

As a BDC we are required to carry our investments at market value or, if no market value is ascertainable, at fair value as determined in good faith by or under the direction of our Board of Directors. Decreases in the market values or fair values of our investments will be recorded as unrealized depreciation. Since our inception, we have, at times, incurred a cumulative net unrealized depreciation of our portfolio. Any unrealized depreciation in our investment portfolio could result in realized losses in the future and ultimately in reductions of our income available for distribution to stockholders in future periods.

### ***Risks Related to Our Regulation and Structure***

*We will be subject to corporate-level tax if we are unable to satisfy Code requirements for RIC qualification.*

To maintain our qualification as a RIC, we must meet income source, asset diversification, and annual distribution requirements. The annual distribution requirement is satisfied if we distribute at least 90% of our ordinary income and short-term capital gains to our stockholders on an annual basis. Because we use leverage, we are subject to certain asset coverage ratio requirements under the 1940 Act and could, under certain circumstances, be restricted from making distributions necessary to qualify as a RIC. Warrants we receive with respect to debt investments will create original issue discount, which we must recognize as ordinary income, increasing the amounts we are required to distribute to maintain RIC status. Because such warrants will not produce distributable cash for us at the same time as we are required to make distributions in respect of the related original issue discount, we will need to use cash from other sources to satisfy such distribution requirements. The asset diversification requirements must be met at the end of each calendar quarter. If we fail to meet these tests, we may need to quickly dispose of certain investments to prevent the loss of RIC status. Since most of our investments will be illiquid, such dispositions, if even possible, may not be made at prices advantageous to us and, in fact, may result in



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## Table of Contents

substantial losses. If we fail to qualify as a RIC for any reason and become fully subject to corporate income tax, the resulting corporate taxes could substantially reduce our net assets, the amount of income available for distribution, and the actual amount distributed. Such a failure would have a material adverse effect on us and our shares. For additional information regarding asset coverage ratio and RIC requirements, see *Business Competitive Advantages Leverage and Business Material U.S. Federal Income Tax Considerations Regulated Investment Company Status*.

From time to time, some of our debt investments may include success fees that would generate payments to us if the business is ultimately sold. Because the satisfaction of these success fees, and the ultimate payment of these fees, is uncertain, we do not recognize them as income until we have received payment. We sought and received approval for a change in accounting method from the IRS related to our tax treatment for success fees. As a result, we, in effect, will continue to account for the recognition of income from the success fees upon receipt, or when the amount becomes fixed. Prior to January 1, 2011, we treated the success fee amount as a capital gain for tax characterization purposes. However, starting January 1, 2011, the tax characterization of the success fee amount was and will be treated as ordinary income. The approved change in accounting method does not require us to retroactively change the capital gains treatment of the success fees received prior to January 1, 2011. As a result, we will be required to distribute such amounts to our stockholders in order to maintain RIC status for success fees we receive after January 1, 2011.

*Changes in laws or regulations governing our operations, or changes in the interpretation thereof, and any failure by us to comply with laws or regulations governing our operations may adversely affect our business.*

We and our portfolio companies are subject to regulation by laws at the local, state and federal levels. These laws and regulations, as well as their interpretation, may be changed from time to time. Accordingly, any change in these laws or regulations, or their interpretation, or any failure by us or our portfolio companies to comply with these laws or regulations may adversely affect our business. For additional information regarding the regulations to which we are subject, see *Business Material U.S. Federal Income Tax Considerations Regulated Investment Company Status and Business Regulation as a Business Development Company*.

*We are subject to restrictions that may discourage a change of control. Certain provisions contained in our articles of incorporation and Maryland law may prohibit or restrict a change of control and adversely impact the price of our shares.*

Our Board of Directors is divided into three classes, with the term of the directors in each class expiring every third year. At each annual meeting of stockholders, the successors to the class of directors whose term expires at such meeting will be elected to hold office for a term expiring at the annual meeting of stockholders held in the third year following the year of their election. After election, a director may only be removed by our stockholders for cause. Election of directors for staggered terms with limited rights to remove directors makes it more difficult for a hostile bidder to acquire control of us. The existence of this provision may negatively impact the price of our securities and may discourage third-party bids to acquire our securities. This provision may reduce any premiums paid to stockholders in a change in control transaction.

Certain provisions of Maryland law applicable to us prohibit business combinations with:

any person who beneficially owns 10% or more of the voting power of our common stock (an interested stockholder );

an affiliate of ours who at any time within the two-year period prior to the date in question was an interested stockholder; or

an affiliate of an interested stockholder.

These prohibitions last for five years after the most recent date on which the interested stockholder became an interested stockholder. Thereafter, any business combination with the interested stockholder must be recommended by our Board of Directors and approved by the affirmative vote of at least 80% of the votes entitled to be cast by holders of our outstanding shares of common stock and two-thirds of the votes entitled to be cast by holders of our common stock other than shares held by the interested stockholder. These requirements could have the effect of inhibiting a change in control even if a change in control were in our stockholders' interest. These provisions of Maryland law do not apply, however, to business combinations that are approved or exempted by our Board of Directors prior to the time that someone becomes an interested stockholder.





## **Table of Contents**

Our articles of incorporation permit our Board of Directors to issue up to 50 million shares of capital stock. In addition, our Board of Directors, without any action by our stockholders, may amend our articles of incorporation from time to time to increase or decrease the aggregate number of shares or the number of shares of any class or series of stock that we have authority to issue. Our Board of Directors may classify or reclassify any unissued common stock or preferred stock and establish the preferences, conversion or other rights, voting powers, restrictions, limitations as to distributions, qualifications and terms or conditions of redemption of any such stock. Thus, our Board of Directors could authorize the issuance of preferred stock with terms and conditions that could have a priority as to distributions and amounts payable upon liquidation over the rights of the holders of our common stock, which it recently did in connection with our issuance in November 2011 of 1.4 million shares of Term Preferred Stock. Preferred stock, including our recently issued Term Preferred Stock, could also have the effect of delaying, deferring or preventing a change in control of us, including an extraordinary transaction (such as a merger, tender offer or sale of all or substantially all of our assets) that might provide a premium price for holders of our common stock.

### ***Risks Related to an Investment in Our Common Stock and Our Preferred Stock***

*We may experience fluctuations in our quarterly and annual operating results.*

We may experience fluctuations in our quarterly and annual operating results due to a number of factors, including, among others, variations in our investment income, the interest rates payable on the debt securities we acquire, the default rates on such securities, the level of our expenses, variations in and the timing of the recognition of realized and unrealized gains or losses, the level of our expenses, the degree to which we encounter competition in our markets, and general economic conditions, including the impacts of inflation. The majority of our portfolio companies are in industries that are directly impacted by inflation, such as manufacturing and consumer goods and services. Our portfolio companies may not be able to pass on to customers increases in their costs of production which could greatly affect their operating results, impacting their ability to repay our loans. In addition, any projected future decreases in our portfolio companies' operating results due to inflation could adversely impact the fair value of those investments. Any decreases in the fair value of our investments could result in future realized and unrealized losses and therefore reduce our net assets resulting from operations. As a result of these factors, results for any period should not be relied upon as being indicative of performance in future periods.

*There is a risk that you may not receive distributions.*

Our current intention is to distribute at least 90% of our ordinary income and short-term capital gains to our stockholders on a quarterly basis by paying monthly distributions. On an annual basis, we intend to distribute net long-term capital gains, after giving effect to any prior year realized losses that are carried forward, by paying a one-time distribution. However, our Board of Directors may determine in certain cases to retain net realized long-term capital gains through a deemed distribution to supplement our equity capital and support the growth of our portfolio. We cannot assure you that we will achieve investment results or maintain a tax status that will allow or require any specified level of cash distributions.

*Distributions by us have included and may in the future include a return of capital.*

Our Board of Directors declares monthly distributions based on estimates of net investment income for each fiscal year, which may differ, and in the past have differed, from actual results. Because our distributions are based on estimates of net investment income that may differ from actual results, future distributions payable to our stockholders may also include a return of capital. Moreover, to the extent that we distribute amounts that exceed our accumulated earnings and profits, these distributions constitute a return of capital. A return of capital represents a return of a stockholder's original investment in shares of our stock and should not be confused with a distribution from earnings and profits. Although return of capital distributions may not be taxable, such distributions may increase an investor's tax liability for capital gains upon the sale of our shares by reducing the investor's tax basis for such shares. Such returns of capital reduce our asset base and also adversely impact our ability to raise debt capital as a result of the leverage restrictions under the 1940 Act, which could have a material adverse impact on our ability to make new investments.

*The market price of our shares may fluctuate significantly.*

The trading price of our common stock and our preferred stock may fluctuate substantially. The extreme volatility and disruption that have affected the capital and credit markets for over a year have reached unprecedented levels in recent months. We have experienced greater than usual stock price volatility.

## **Table of Contents**

The market price and marketability of our shares may from time to time be significantly affected by numerous factors, including many over which we have no control and that may not be directly related to us. These factors include, but are not limited to, the following:

general economic trends and other external factors;

price and volume fluctuations in the stock market from time to time, which are often unrelated to the operating performance of particular companies;

significant volatility in the market price and trading volume of shares of RICs, BDCs or other companies in our sector, which is not necessarily related to the operating performance of these companies;

changes in regulatory policies or tax guidelines, particularly with respect to RICs or BDCs;

loss of BDC or RIC status;

changes in our earnings or variations in our operating results;

changes in the value of our portfolio of investments;

any shortfall in our revenue or net income or any increase in losses from levels expected by securities analysts;

departure of key personnel;

operating performance of companies comparable to us;

short-selling pressure with respect to our shares or BDCs generally;

the announcement of proposed, or completed, offerings of our securities, including a rights offering; and

loss of a major funding source.

Fluctuations in the trading prices of our shares may adversely affect the liquidity of the trading market for our shares and, if we seek to raise capital through future equity financings, our ability to raise such equity capital.

*The issuance of subscription rights to our existing stockholders may dilute the ownership and voting powers by existing stockholders in our common stock, dilute the net asset value of their shares and have a material adverse effect on the trading price of our common stock.*

There are significant capital raising constraints applicable to us under the 1940 Act when our stock is trading below its net asset value per share. In the event that we issue subscription rights to our existing stockholders, there is a significant possibility that the rights offering will dilute the

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ownership interest and voting power of stockholders who do not fully exercise their subscription rights. Stockholders who do not fully exercise their subscription rights should expect that they will, upon completion of the rights offering, own a smaller proportional interest in the Company than would otherwise be the case if they fully exercised their subscription rights. In addition, because the subscription price of the rights offering is likely to be less than our most recently determined net asset value per share, our stockholders are likely to experience an immediate dilution of the per share net asset value of their shares as a result of the offer. As a result of these factors, any future rights offerings of our common stock, or our announcement of our intention to conduct a rights offering, could have a material adverse impact on the trading price of our common stock.

*Shares of closed-end investment companies frequently trade at a discount from net asset value.*

Shares of closed-end investment companies frequently trade at a discount from net asset value. Since our inception, our common stock has at times traded above net asset value, and at times traded below net asset value. During the past year, our common stock has traded consistently, and at times significantly, below net asset value. Subsequent to September 30, 2011,

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**Table of Contents**

our stock has traded at discounts of up to 36.4% of our net asset value as of September 30, 2011. This characteristic of shares of closed-end investment companies is separate and distinct from the risk that our net asset value per share will decline. As with any stock, the price of our shares will fluctuate with market conditions and other factors. If shares are sold, the price received may be more or less than the original investment. Whether investors will realize gains or losses upon the sale of our shares will not depend directly upon our net asset value, but will depend upon the market price of the shares at the time of sale. Since the market price of our shares will be affected by such factors as the relative demand for and supply of the shares in the market, general market and economic conditions and other factors beyond our control, we cannot predict whether the shares will trade at, below or above our net asset value. Under the 1940 Act, we are generally not able to issue additional shares of our common stock at a price below net asset value per share to purchasers other than our existing stockholders through a rights offering without first obtaining the approval of our stockholders and our independent directors. Additionally, at times when our stock is trading below its net asset value per share, our dividend yield may exceed the weighted average returns that we would expect to realize on new investments that would be made with the proceeds from the sale of such stock, making it unlikely that we would determine to issue additional shares in such circumstances. Thus, for as long as our common stock trades below net asset value we will be subject to significant constraints on our ability to raise capital through the issuance of common stock. Additionally, an extended period of time in which we are unable to raise capital may restrict our ability to grow and adversely impact our ability to increase or maintain our distributions.

*Stockholders may incur dilution if we sell shares of our common stock in one or more offerings at prices below the then current net asset value per share of our common stock.*

At our most recent annual meeting, our stockholders approved a proposal designed to allow us to access the capital markets in a way that we were previously unable to as a result of restrictions that, absent stockholder approval, apply to BDCs under the 1940 Act. Specifically, our stockholders approved a proposal that authorizes us to sell shares of our common stock below the then current net asset value per share of our common stock in one or more offerings for a period of one year. At the upcoming annual stockholders meeting scheduled for February 16, 2012, our stockholders will again be asked to vote in favor of renewing this proposal for another year. During the past year, our common stock has traded consistently, and at times significantly, below net asset value. Any decision to sell shares of our common stock below the then current net asset value per share of our common stock would be subject to the determination by our Board of Directors that such issuance is in our and our stockholders' best interests.

If we were to sell shares of our common stock below net asset value per share, such sales would result in an immediate dilution to the net asset value per share. This dilution would occur as a result of the sale of shares at a price below the then current net asset value per share of our common stock and a proportionately greater decrease in a stockholder's interest in our earnings and assets and voting interest in us than the increase in our assets resulting from such issuance. The greater the difference between the sale price and the net asset value per share at the time of the offering, the more significant the dilutive impact would be. Because the number of shares of common stock that could be so issued and the timing of any issuance is not currently known, the actual dilutive effect, if any, cannot be currently predicted. However, if for example, we sold an additional 10% of our common stock at a 5% discount from net asset value, a stockholder who did not participate in that offering for its proportionate interest would suffer net asset value dilution of up to 0.5% or \$5 per \$1,000 of net asset value.

*If we fail to pay dividends on our Term Preferred Stock dividends for two years, the holders of our Term Preferred Stock will be entitled to elect a majority of our directors.*

The terms of our Term Preferred Stock provide for annual dividends in the amount of \$1.7813 per outstanding share of Term Preferred Stock. In accordance with the terms of our Term Preferred Stock, if dividends on the Term Preferred Stock are unpaid in an amount equal to at least two years of dividends, the holders of Term Preferred Stock will be entitled to elect a majority of our Board of Directors.

*Our Term Preferred Stock magnifies the potential for gain or loss for our holders of common stock and the risks of investing in our common stock in the same way as our borrowings.*

Preferred stock, which is another form of leverage, has the same risks to our common stockholders as borrowings because the dividends on any preferred stock we issue must be cumulative. Payment of such dividends and repayment of the liquidation preference of such preferred stock must take preference over any dividends or other payments to our common stockholders, and preferred stockholders are less subject to our expenses or losses and are not entitled to participate in any income or appreciation in excess of their stated preference.

## **Table of Contents**

*An investment in Term Preferred Stock with a fixed interest rate bears interest rate risk.*

Our Term Preferred Stock, in general, pays dividends at a fixed dividend rate of 7.125% per year. Prices of fixed income investments generally vary inversely with changes in market yields. The market yields on securities comparable to the Term Preferred Stock may increase, which would likely result in a decline in the secondary market price of the Term Preferred Stock prior to the term redemption date. This risk may be even more significant in light of the low nature of the currently prevailing market interest rates.

*A liquid secondary trading market for our Term Preferred Stock may not develop.*

Because we have no prior trading history for exchange-listed preferred stock, we cannot predict the trading patterns of the Term Preferred Stock, including the effective costs of trading the stock. Although our Term Preferred Stock is listed for trading on the New York Stock Exchange, there is a risk that such shares may be thinly traded, and the market for such shares may be relatively illiquid compared to the market for other types of securities, with the spread between the bid and asked prices considerably greater than the spreads of other securities with comparable terms and features.

*The Series 2016 Term Preferred Stock is not rated.*

We have not had the Term Preferred Stock rated by any rating agency. Unrated securities usually trade at a discount to similar, rated securities. As a result, there is a risk that the shares of our Term Preferred Stock may trade at a price that is lower than they might otherwise trade if they were rated by a rating agency.

*The Term Preferred Stock will bear a risk of early redemption by us.*

We may voluntarily redeem some or all of the Term Preferred Stock on or after December 31, 2012, and we may be forced to redeem some or all of the Term Preferred Stock to meet regulatory requirements and the asset coverage requirements of such shares. Any such redemption may occur at a time that is unfavorable to holders of the Term Preferred Stock. We may have an incentive to redeem the Term Preferred Stock voluntarily before the term redemption date if market conditions allow us to issue other preferred stock or debt securities at a rate that is lower than the fixed dividend rate on the Term Preferred Stock.

*Claims of holders of our Term Preferred Stock are subject to a risk of subordination relative to holders of our debt instruments.*

Rights of holders of our Term Preferred Stock are subordinated to the rights of holders of our indebtedness. Therefore, dividends, distributions and other payments to holders of Term Preferred Stock in liquidation or otherwise may be subject to prior payments due to the holders of our indebtedness. In addition, under some circumstances the 1940 Act may provide debt holders with voting rights that are superior to the voting rights of holders of the Term Preferred Stock.

*Holders of our Term Preferred Stock will be subject to inflation risk.*

Inflation is the reduction in the purchasing power of money resulting from the increase in the price of goods and services. Inflation risk is the risk that the inflation-adjusted, or real, value of an investment in Term Preferred Stock or the income from that investment will be worth less in the future. As inflation occurs, the real value of the Term Preferred Stock and dividends payable on such shares declines.

*Holders of our Term Preferred Stock will bear reinvestment risk.*

Given the five-year term and potential for early redemption of the Term Preferred Stock, holders of such shares may face an increased reinvestment risk, which is the risk that the return on an investment purchased with proceeds from the sale or redemption of the Term Preferred Stock may be lower than the return previously obtained from the investment in such shares.

*Holders of our Term Preferred Stock will bear dividend risk.*

We may be unable to pay dividends on the Term Preferred Stock under some circumstances. The terms of our indebtedness preclude the payment of dividends in respect of equity securities, including the Term Preferred Stock, under certain conditions.



## **Table of Contents**

*There is a risk of delay in our redemption of our Term Preferred Stock, and we may fail to redeem such securities as required by their terms.*

We will generally make investments in private companies whose securities are not traded in any public market. Substantially all of the investments we presently hold and the investments we expect to acquire in the future are, and will be, subject to legal and other restrictions on resale and will otherwise be less liquid than publicly-traded securities. The illiquidity of our investments may make it difficult for us to obtain cash equal to the value at which we record our investments quickly if a need arises. If we are unable to obtain sufficient liquidity prior to the term redemption date, we may be forced to engage in a partial redemption or to delay a required redemption. If such a partial redemption or delay were to occur, the market price of the Term Preferred Stock might be adversely affected.

### ***Other Risks***

*We could face losses and potential liability if intrusion, viruses or similar disruptions to our technology jeopardize our confidential information, whether through breach of our network security or otherwise.*

Maintaining our network security is of critical importance because our systems store highly confidential financial models and portfolio company information. Although we have implemented, and will continue to implement, security measures, our technology platform is and will continue to be vulnerable to intrusion, computer viruses or similar disruptive problems caused by transmission from unauthorized users. The misappropriation of proprietary information could expose us to a risk of loss or litigation.

*Terrorist attacks, acts of war, or national disasters may affect any market for our common stock, impact the businesses in which we invest, and harm our business, operating results, and financial conditions.*

Terrorist acts, acts of war, or national disasters have created, and continue to create, economic and political uncertainties and have contributed to global economic instability. Future terrorist activities, military or security operations, or national disasters could further weaken the domestic/global economies and create additional uncertainties, which may negatively impact the businesses in which we invest directly or indirectly and, in turn, could have a material adverse impact on our business, operating results, and financial condition. Losses from terrorist attacks and national disasters are generally uninsurable.

### **ITEM 1B. UNRESOLVED STAFF COMMENTS**

None.

### **ITEM 2. PROPERTIES**

We do not own any real estate or other physical properties materially important to our operations. Our Adviser is the current leaseholder of all properties in which we operate. We occupy these premises pursuant to our Advisory and Administration Agreements with our Adviser and Administrator, respectively. Our Adviser and Administrator are both headquartered in McLean, Virginia and our Adviser also has offices in several other states.

### **ITEM 3. LEGAL PROCEEDINGS**

We are not currently subject to any material legal proceedings, nor, to our knowledge, is any material legal proceeding threatened against us.

### **ITEM 4. REMOVED AND RESERVED**

**Table of Contents****PART II****ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES**

Our common stock is traded on the Nasdaq Global Select Market under the symbol GLAD. The following table reflects, by quarter, the high and low closing prices per share of our common stock on the Nasdaq Global Select Market, the closing sale price as a percentage of net asset value (NAV) and quarterly distributions declared per share for each fiscal quarter during the last two fiscal years. Amounts presented for each fiscal quarter of 2011 and 2010 represent the cumulative amount of the distributions declared for the months composing such quarter.

	Quarter Ended	NAV (A)	Closing Sales Price		(Discount)	Discount of Low to NAV(B)	Declared Distributions
			High	Low	Premium of High to NAV(B)		
<b>FY 2011</b>	<b>09/30/11</b>	<b>\$ 10.16</b>	<b>\$ 9.69</b>	<b>\$ 6.86</b>	<b>(5)%</b>	<b>(32)%</b>	<b>\$ 0.210</b>
	<b>06/30/11</b>	<b>10.34</b>	<b>11.59</b>	<b>9.24</b>	<b>12</b>	<b>(11)</b>	<b>0.210</b>
	<b>03/31/11</b>	<b>11.18</b>	<b>12.05</b>	<b>10.54</b>	<b>8</b>	<b>(6)</b>	<b>0.210</b>
	<b>12/31/10</b>	<b>11.74</b>	<b>12.00</b>	<b>10.91</b>	<b>2</b>	<b>(7)</b>	<b>0.210</b>
FY 2010	09/30/10	11.85	12.34	10.30	4	(13)	0.210
	06/30/10	11.81	13.94	10.09	18	(15)	0.210
	03/31/10	12.10	12.19	7.19	1	(41)	0.210
	12/31/09	11.92	9.49	7.50	(20)	(37)	0.210

(A) NAV per share is determined as of the last day in the relevant quarter and therefore may not reflect the NAV per share on the date of the high and low sales prices. The NAVs shown are based on outstanding shares at the end of each period.

(B) The (discounts) premiums set forth in these columns represent the high or low, as applicable, closing price per share for the relevant quarter minus the NAV per share as of the end of such quarter, and therefore may not reflect the (discount) premium to NAV per share on the date of the high and low closing prices.

As of November 11, 2011, there were approximately 65 stockholders of record of our common stock.

**Distributions**

We currently intend to distribute in the form of cash distributions a minimum of 90% of our ordinary income and short-term capital gains, if any, on a quarterly basis to our stockholders in the form of monthly distributions. We intend to retain some or all of our long-term capital gains, but to designate the retained amount as a deemed distribution, after giving effect to any prior year realized losses that are carried forward, to supplement our equity capital and support the growth of our portfolio. However, in certain cases, our Board of Directors may choose to distribute our net realized long-term capital gains by paying a one-time special distribution.

**Recent Sales of Unregistered Securities and Purchases of Equity Securities**

We did not sell any unregistered shares of common stock or repurchase any shares of our common stock during the fiscal year ended September 30, 2011.

**ITEM 6. SELECTED FINANCIAL DATA**

The consolidated selected financial data for the fiscal years ended September 30, 2011, 2010, 2009, 2008 and 2007 are derived from our audited consolidated financial statements. The other data included in the second table below is unaudited. The data should be read in conjunction with our *Consolidated Financial Statements* and notes thereto and *Management's Discussion and Analysis of Financial Condition and Results of Operations* included elsewhere in this report.





Table of Contents

## GLADSTONE CAPITAL CORPORATION

## CONSOLIDATED SELECTED FINANCIAL AND OTHER DATA

(DOLLAR AMOUNTS IN THOUSANDS, EXCEPT PER SHARE AND PER UNIT DATA)

	\$00,000,000	\$00,000,000	\$00,000,000	\$00,000,000	\$00,000,000
	2011	As of and for the Year Ended September 30,			2007
	2011	2010	2009	2008	2007
<u>Statement of Operations Data:</u>					
Total Investment Income	\$ 35,211	\$ 35,539	\$ 42,618	\$ 45,725	\$ 36,687
Total Expenses, Net of Credits from Adviser	16,799	17,780	21,587	19,172	14,426
Net Investment Income	18,412	17,759	21,031	26,553	22,261
Net Realized and Unrealized Loss on Investments, Derivative and Borrowings	(39,511)	(1,365)	(17,248)	(47,815)	(7,309)
Net (Decrease) Increase in Net Assets Resulting from Operations	\$ (21,099)	\$ 16,394	\$ 3,783	\$ (21,262)	\$ 14,952
<u>Per Share Data <sup>(A)</sup>:</u>					
Net (Decrease) Increase in Net Assets Resulting from Operations per Common Share Basic and Diluted	\$ (1.00)	\$ 0.78	\$ 0.18	\$ (1.08)	\$ 1.13
Net Investment Income per Common Share Basic and Diluted	0.88	0.84	1.00	1.35	1.69
Cash Distributions Declared Per Common Share	0.84	0.84	1.26	1.68	1.68
<u>Statement of Assets and Liabilities Data:</u>					
Total Assets	\$ 317,624	\$ 270,518	\$ 335,910	\$ 425,698	\$ 367,729
Net Assets	213,721	249,246	249,076	271,748	220,959
Net Asset Value Per Common Share	10.16	11.85	11.81	12.89	14.97
Common Shares Outstanding	21,039,242	21,039,242	21,087,574	21,087,574	14,762,574
Weighted Common Shares Outstanding Basic and Diluted	21,039,242	21,060,351	21,087,574	19,699,796	13,173,822
<u>Senior Securities Data:</u>					
Borrowings <sup>(B)</sup>	\$ 100,012	\$ 17,940	\$ 83,350	\$ 151,030	\$ 144,440
Asset coverage ratio <sup>(C)</sup>	314%	1,419%	396%	279%	252%
Asset coverage per unit <sup>(D)</sup>	\$ 3,144	\$ 14,187	\$ 3,963	\$ 2,792	\$ 2,524

(A) Per share data for net (decrease) increase in net assets resulting from operations is based on the weighted average common stock outstanding for both basic and diluted.

(B) See *Management's Discussion and Analysis of Financial Condition and Results of Operations* for more information regarding our level of indebtedness.

(C) As a BDC, we are generally required to maintain an asset coverage ratio of 200% of total consolidated assets, less all liabilities and indebtedness not represented by senior securities, to total borrowings and guaranty commitments. Asset coverage ratio is the ratio of the

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carrying value of our total consolidated assets, less all liabilities and indebtedness not represented by senior securities, to the aggregate amount of senior securities representing indebtedness.

(D) Asset coverage per unit is the asset coverage ratio expressed in terms of dollar amounts per one thousand dollars of indebtedness.

	\$00,000,000	\$00,000,000	\$00,000,000	\$00,000,000	\$00,000,000
	Year Ended September 30,				
	2011	2010	2009	2008	2007
<b>Other Unaudited Data:</b>					
Number of Portfolio Companies at Year End	<b>59</b>	39	48	63	56
Average Size of Portfolio Company Investment at Cost	<b>\$ 6,488</b>	\$ 7,654	\$ 7,592	\$ 7,315	\$ 6,353
Principal Amount of New Investments	<b>110,903</b>	23,245	24,911	176,550	261,700
Proceeds from Loan Repayments and Investments Sold	<b>50,002</b>	85,634	96,693	70,482	121,818
Weighted Average Yield on Investments <sup>(A)</sup>	<b>11.16%</b>	10.85%	10.07%	10.38%	12.39%
Total Return <sup>(B)</sup>	<b>(33.77)</b>	37.46	(30.94)	(13.90)	(4.40)

(A) Weighted average yield on investments equals interest income on investments divided by the weighted average investment balance throughout the year.

(B) Total return equals the (decrease) increase of the ending market value over the beginning market value plus monthly distributions divided by the monthly beginning market value.

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**Table of Contents**

**ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

*The following analysis of our financial condition and results of operations should be read in conjunction with our financial statements and the notes thereto contained elsewhere in this Form 10-K. Except per share amounts, dollar amounts are in thousands unless otherwise indicated.*

**OVERVIEW**

**General**

We were incorporated under the General Corporation Laws of the State of Maryland on May 30, 2001. Our investment objective is to achieve a high level of current income by investing in debt securities, consisting primarily of senior notes, senior subordinated notes and junior subordinated notes, of established private businesses in the United States that are substantially owned by leveraged buyout funds, individual investors or are family-owned businesses, with a particular focus on senior notes. In addition, we may acquire from other funds existing loans that meet this profile. We also seek to provide our stockholders with long-term capital growth through the appreciation in the value of warrants or other equity instruments that we may receive when we make loans. We operate as a closed-end, non-diversified management investment company, and have elected to be treated as a BDC under the Investment Company Act of 1940, as amended (the "1940 Act"). In addition, for tax purposes we have elected to be treated as a RIC under the Internal Revenue Code of 1986, as amended (the "Code").

We seek to invest in small and medium-sized private U.S. businesses that meet certain criteria, including some but not all of the following: the potential for growth in cash flow, adequate assets for loan collateral, experienced management teams with a significant ownership interest in the borrower, profitable operations based on the borrower's cash flow, reasonable capitalization of the borrower (usually by leveraged buyout funds or venture capital funds) and the potential to realize appreciation and gain liquidity in our equity position, if any. We anticipate that liquidity in our equity position will be achieved through a merger or acquisition of the borrower, a public offering of the borrower's stock or by exercising our right to require the borrower to repurchase our warrants, though there can be no assurance that we will always have these rights. We lend to borrowers that need funds to finance growth, restructure their balance sheets or effect a change of control. We invest either by ourselves or jointly with other funds and/or management of the portfolio company, depending on the opportunity. If we are participating in an investment with one or more co-investors, our investment is likely to be smaller than if we were investing alone.

**Business Environment**

While economic conditions generally appear to be improving, we remain cautious about a long-term economic recovery. The recent recession in general, and the disruptions in the capital markets in particular, have impacted our liquidity options and increased the cost of debt and equity capital. Many of the companies in which we have made investments, as well as those that we evaluate for investment, are impacted by these economic conditions, and if these conditions persist, it may affect their ability to repay our loans or engage in a liquidity event, such as a sale, recapitalization or initial public offering. The economic conditions could also disproportionately impact some of the industries in which we have invested, causing us to be more vulnerable to losses in our portfolio, which could cause the number of our non-performing assets to increase and the fair market value of our portfolio to decrease. We do not know when market conditions will continue to improve again or if adverse conditions will again intensify, and we do not know the full extent to which the economic downturn will affect us. If market instability persists or intensifies, we may experience difficulty in raising capital.

Market conditions have affected the trading price of our common stock and our ability to finance new investments through the issuance of equity. On November 11, 2011, the closing market price of our common stock was \$8.44, a 16.9% discount to our September 30, 2011 NAV per share of \$10.16. When our stock trades below NAV, as it has periodically traded for more than three years, our ability to issue equity is constrained by provisions of the 1940 Act, which generally prohibits the issuance and sale of our common stock below NAV per share without stockholder approval other than through sales to our then-existing stockholders pursuant to a rights offering. At our annual meeting of stockholders held on February 17, 2011, stockholders approved a proposal which authorizes us to sell shares of our common stock at a price below our then current NAV per share subject to certain limitations (including, but not limited to, that the cumulative number of shares issued and sold pursuant to such authority does not exceed 25% of our then outstanding common stock immediately prior to each such sale) for a period of one year from the date of approval, provided that our Board of Directors makes certain

## **Table of Contents**

determinations prior to any such sale. At the upcoming annual stockholders meeting scheduled for February 17, 2012, our stockholders will again be asked to vote in favor of renewing this proposal for another year.

Challenges in the current market are intensified for us by certain regulatory limitations under the Code and the 1940 Act, as well as contractual restrictions under the agreement governing the Credit Facility that further constrain our ability to access the capital markets. To maintain our qualification as a RIC, we must satisfy, among other requirements, an annual distribution requirement to pay out at least 90% of our ordinary income and short-term capital gains to our stockholders. Because we are required to distribute our income in this manner, and because the illiquidity of many of our investments makes it difficult for us to finance new investments through the sale of current investments, our ability to make new investments is highly dependent upon external financing. Our external financing sources include the issuance of equity securities, debt securities or other leverage such as borrowings under our line of credit. Our ability to seek external debt financing, to the extent that it is available under current market conditions, is further subject to the asset coverage limitations of the 1940 Act, which require us to have at least a 200% asset coverage ratio, meaning generally that for every dollar of debt, we must have two dollars of assets.

The unstable economic conditions may also continue to decrease the value of collateral securing some of our loans, as well as the value of our equity investments, which has impacted and may continue to impact our ability to borrow under the Credit Facility. Additionally, the Credit Facility contains covenants regarding the maintenance of certain minimum net worth requirements, which are affected by the decrease in value of our portfolio. Failure to meet these requirements would result in a default which, if we are unable to obtain a waiver from our lenders, would result in the acceleration of our repayment obligations under the Credit Facility. As of September 30, 2011, we were in compliance with all of the Credit Facility covenants.

We expect that, given these regulatory and contractual constraints in combination with current market conditions, debt and equity capital may be costly or difficult for us to access in the near term. However, we believe that our recent public offering of Term Preferred Stock (discussed in detail further below in *Equity Activity*) increases our ability to make conservative investments in businesses that we believe will weather the current economic conditions and will be likely to produce attractive long-term returns for our stockholders.

## **Investment Highlights**

During the fiscal year ended September 30, 2011, we extended \$110.9 million in new debt and equity investments to 25 new portfolio companies, and we extended \$25.4 million of investments to existing portfolio companies through revolver draws or additions to term notes. Also, during the fiscal year ended September 30, 2011, we exited five portfolio companies for aggregate proceeds of approximately \$25.8 million, and we received scheduled and unscheduled contractual principal repayments of approximately \$20.0 million from existing portfolio companies. Since our initial public offering in August 2001, we have made 306 different loans to, or investments in, 153 companies for a total of approximately \$1.1 billion, before giving effect to principal repayments on investments and divestitures.

### *Investment Activity*

During the fiscal year ended September 30, 2011, we executed the following transactions with certain of our portfolio companies:

### Purchases

During the year ended September 30, 2011, we extended \$95.7 million of senior term or senior subordinated syndicated loan investments to 23 new portfolio companies and \$15.2 million of investments to two new proprietary portfolio companies (North American Aircraft Services LLC and Westland Technologies, Inc.). In monitoring the market activity during the year ended September 30, 2011, we noted favorable syndicate loan marketplace conditions and consequently increased our investment in such loans. The majority of our senior syndicated loan investments occurred during the quarters ended March 31 and June 30, 2011.

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## **Table of Contents**

### **Repayments and Exits**

During the year ended September 30, 2011, 36 borrowers made principal repayments totaling \$45.8 million in the aggregate, consisting of \$16.6 million in unscheduled payoffs as well as \$29.2 million in contractual amortization, revolver repayments and principal payments. Included in the principal payments were payoffs of four portfolio companies at par, Interfilm Holdings, Inc., Puerto Rico Cable Acquisition Company, Inc., Pinnacle Treatment Centers, Inc. and Airvana Network Solutions, Inc. Additionally, we sold one portfolio company, Finn Corporation, for \$37 in net proceeds.

### **Workouts**

In January 2011, we purchased common stock for \$1.5 million from existing shareholders of Sunshine Media Holdings ( Sunshine Media ), a publisher of regional B2B trade magazines, which gave us a controlling interest in the company and resulted in the reclassification of the investment from Non-Control/Non-Affiliate to Control during the quarter ended March 31, 2011. Additionally, we have extended \$1.3 million to Sunshine Media through revolver draws since January 2011.

In July 2011, we increased our investment in Viapack, Inc. ( Viapack ), a manufacturer of polyethylene film, by adding a line of credit facility and purchasing preferred equity; which gave us a controlling interest in the company and resulted in the reclassification of the investment from Non-Control/Non-Affiliate to Control during the quarter ended September 30, 2011. The facility had \$1.6 million drawn as of September 30, 2011.

In August 2011, we restructured our loan to SCI Cable, Inc. ( SCI ), a cable, internet and voice services provider, through a UCC Article 9 sale. This resulted in a new control entity, Kansas Cable Holdings, Inc., obtaining certain of the assets of SCI and we recognized a realized loss of \$1.3 million during the quarter ended September 30, 2011. Kansas Cable Holdings, Inc. replaced SCI on the *Schedule of Investments* and remains on non-accrual status as of September 30, 2011.

Refer to Note 14, *Subsequent Events* in the *Consolidated Financial Statements* included elsewhere in this Form 10-K for investment activity occurring subsequent to September 30, 2011.

### **Equity Activity**

#### *Term Preferred Stock Offering*

On November 4, 2011, we completed an offering of 1.4 million shares of 7.125% Series 2016 Term Preferred Stock, par value \$0.001 per share ( Term Preferred Stock ), at a public offering price of \$25.00 per share under a shelf registration statement on Form N-2 (File No. 333-162592), and pursuant to a prospectus dated July 15, 2011, as supplemented by a final prospectus supplement dated October 28, 2011, which was filed with the SEC on October 31, 2011. Net proceeds of the offering, after deducting underwriting discounts and estimated offering expenses borne by us were approximately \$33.1 million and were used to repay a portion of outstanding borrowings under our line of credit. In connection with the offering, we also granted the underwriters an option, exercisable on or before November 27, 2011, to purchase an additional 210,000 shares of Term Preferred Stock from us on the same terms solely to cover over-allotments, if any. On November 14, 2011, the underwriters notified us of their intent to exercise their option to purchase an additional 139,882 shares of our Term Preferred Stock. Refer to Note 14, *Subsequent Events* in the *Consolidated Financial Statements* included elsewhere in this Form 10-K for discussion of the Term Preferred Stock offering.

### **Investment Strategy**

Our strategy is to make loans at favorable interest rates to small and medium-sized U.S. businesses. Our loans typically range from \$5 million to \$20 million, although this investment size may vary proportionately as the size of our capital base changes, generally mature in no more than seven years and accrue interest at variable rates and to a lesser extent fixed rates. Because the majority of our portfolio loans consist of term debt of private companies that typically cannot or will not expend the resources to have their debt securities rated by a credit rating agency, we expect that most, if not all, of the debt securities we acquire will be unrated. Accordingly, we cannot accurately predict what ratings these loans might receive if they were rated, and thus cannot determine whether or not they could be considered investment grade quality.



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**Table of Contents**

To the extent possible, our loans generally are collateralized by a security interest in the borrower's assets. Interest payments are generally made monthly or quarterly with amortization of principal generally being deferred for several years. The principal amount of the loans and any accrued but unpaid interest generally become due in no more than seven years.

Original issue discount (OID) arises when we extend a loan and receive an equity interest in the borrower at the same time, or purchase a loan at a discount to par. To the extent that the price paid for the equity is not at market value, we must allocate part of the price paid for the loan, to the value of the equity. Then the amount allocated to the equity, the OID, must be amortized over the life of the loan. The amortization of OID also produces income that must be recognized for purposes of satisfying the distribution requirements for a RIC under Subchapter M of the Code, whereas the cash is received, if at all, when the equity instrument is sold. As of September 30, 2011, we had 27 loans with OID income, as compared to four OID loans as of September 30, 2010. We increased the number of syndicated loan investments in our portfolio during 2011, which generally have an OID component. We recorded OID income of \$0.2 million for the year ended September 30, 2011, as compared to \$21 for the year ended September 30, 2010. The unamortized balance of OID investments as of September 30, 2011 and 2010 totaled \$1.5 million and \$0.3 million, respectively.

Some of our loans may contain a provision that calls for some portion of the interest payments to be deferred and added to the principal balance so that the interest is paid, together with the principal, at maturity. This form of deferred interest is often called "paid in kind" (PIK) interest and, when earned, we record PIK interest as interest income and add the PIK interest to the principal balance of the loans. We seek to avoid PIK interest with all potential investments under review. During the quarter ended June 30, 2011, our sole PIK investment was restructured and the PIK interest component was eliminated, therefore as of September 30, 2011, we had no investments that bore PIK interest, as compared to one investments with PIK interest as of September 30, 2010.

In addition, as a BDC under the 1940 Act, we are required to make available significant managerial assistance to our portfolio companies. Our investment adviser, Gladstone Management Corporation (the Adviser) provides these services on our behalf through its officers who are also our officers. Currently, neither we nor our Adviser charges a fee for managerial assistance; however, if our Adviser does receive fees for managerial assistance, our Adviser will credit the managerial assistance fees to the base management fee due from us to our Adviser.

Our Adviser and Gladstone Securities, LLP (Gladstone Securities) a broker-dealer registered with the FINRA, each an affiliate of ours, receive fees for certain services they separately provide to certain of our portfolio companies. Such fees are generally paid directly to our Adviser or Gladstone Securities, as applicable. When our Adviser receives such fees, 50% of certain of those fees and 100% of others are credited against the base management fee that we pay to our Adviser. Gladstone Securities provides certain of our portfolio companies with investment banking and due diligence services; these fees do not impact the overall fees that we pay the Adviser.

Our Adviser also receives fees for monitoring and reviewing portfolio company investments. These fees are recurring and are generally paid annually or quarterly in advance to our Adviser throughout the life of the investment. Fees of this nature are recorded as revenue by our Adviser when earned and are not credited against the base management fee. We may receive fees for the origination and closing services we provide to portfolio companies through our Adviser. These fees are paid directly to us and are recognized as other income upon closing of the originated investment.

Prior to making an investment, we ordinarily enter into a non-binding term sheet with the potential borrower. These non-binding term sheets are generally subject to a number of conditions, including, but not limited to, the satisfactory completion of our due diligence investigations of the potential borrower's business, reaching agreement on the legal documentation for the loan, and the receipt of all necessary consents. Upon execution of the non-binding term sheet, the potential borrower generally pays the Adviser a non-refundable fee for services rendered by the Adviser through the date of the non-binding term sheet. These fees are received by the Adviser and are offset against the base management fee payable to the Adviser, which has the effect of reducing our expenses to the extent of any such fees received by the Adviser.

In the event that we expend significant effort in considering and negotiating a potential investment that ultimately is not consummated, we generally will seek reimbursement from the proposed borrower for our reasonable expenses incurred in connection with the transaction, including legal fees. Any amounts collected for expenses incurred by the Adviser in connection with unconsummated investments will be reimbursed to the Adviser. Amounts collected for these expenses incurred by us will be reimbursed to us and will be recognized in the period in which such reimbursement is received, however, there can be no guarantee that we will be successful in collecting any such reimbursements.



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## **Table of Contents**

### **Our Adviser and Administrator**

Our Adviser is led by a management team which has extensive experience in our lines of business. Our Adviser is controlled by David Gladstone, our chairman and chief executive officer. Mr. Gladstone is also the chairman and chief executive officer of our Adviser. Terry Lee Brubaker, our vice chairman, chief operating officer, secretary and director, is a member of the board of directors of our Adviser and its vice chairman and chief operating officer and has substantial experience in acquisitions and operations of companies., George Stelljes III, our president, chief investment officer and director, is a member of the board of directors of our Adviser and its president and chief investment officer and has extensive experience in leveraged finance. Gladstone Administration, LLC (the Administrator), an affiliate of our Adviser, employs our chief financial officer, chief compliance officer, internal counsel, treasurer and their respective staffs.

Our Adviser and Administrator also provide investment advisory and administrative services to our affiliates, Gladstone Commercial Corporation ( Gladstone Commercial ), a publicly-traded real estate investment trust; Gladstone Investment Corporation ( Gladstone Investment ), a publicly-traded BDC and RIC; Gladstone Lending Corporation ( Gladstone Lending ), a private corporation that was formed to primarily invest in first and second lien term loans that has filed a registration statement on Form N-2 with the SEC, but which has not yet commenced operations; Gladstone Partners Fund, L.P., a private partnership fund formed primarily to co-invest with us and Gladstone Investment and Gladstone Land Corporation, a private agricultural real estate company. Excluding our chief financial officer, all of our executive officers serve as either directors or executive officers, or both, of our Adviser, our Administrator, Gladstone Commercial and Gladstone Investment. In the future, our Adviser and Administrator may provide investment advisory and administrative services, respectively, to other funds, both public and private.

### **Investment Advisory and Management Agreement**

Under the amended and restated investment advisory agreement ( Advisory Agreement ), we pay our Adviser an annual base management fee of 2% of our average gross assets, which is defined as total assets, including investments made with proceeds of borrowings, less any uninvested cash or cash equivalents resulting from borrowings, valued at the end of the two most recently completed calendar quarters and appropriately adjusted for any share issuances or repurchases during the current calendar quarter.

We also pay our Adviser a two-part incentive fee under the Advisory Agreement. The first part of the incentive fee is an income-based incentive fee which rewards our Adviser if our quarterly net investment income (before giving effect to any incentive fee) exceeds 1.75% of our net assets (the hurdle rate ). The second part of the incentive fee is a capital gains-based incentive fee that is determined and payable in arrears as of the end of each fiscal year (or upon termination of the Advisory Agreement, as of the termination date), and equals 20% of our realized capital gains as of the end of the fiscal year. In determining the capital gains-based incentive fee payable to our Adviser, we will calculate the cumulative aggregate realized capital gains and cumulative aggregate realized capital losses since our inception, and the aggregate unrealized capital depreciation as of the date of the calculation, as applicable, with respect to each of the investments in our portfolio. The Adviser has not earned the capital gains-based portion of the incentive fee since our inception.

We pay our direct expenses including, but not limited to, directors fees, legal and accounting fees, stockholder related expenses, and directors and officers insurance under the Advisory Agreement.

Beginning in April 2006, our Board of Directors has accepted from the Adviser, unconditional and irrevocable voluntarily waivers on a quarterly basis to reduce the annual 2.0% base management fee on senior syndicated loans to 0.5% to the extent that proceeds resulting from borrowings were used to purchase such syndicated loan participations. In addition to the base management and incentive fees under the Advisory Agreement, 50% of certain fees and 100% of others received by the Adviser from our portfolio companies are credited against the investment advisory fee and paid to the Adviser.

The Adviser services our loan portfolio, pursuant to a loan servicing agreement with our wholly-owned subsidiary Business Loan, in return for a 1.5% annual fee, based on the monthly aggregate outstanding loan balance of the loans pledged under the Credit Facility.

On July 12, 2011, our Board of Directors approved the renewal of the Advisory Agreement with our Adviser through August 31, 2012. We expect that our Board of Directors will approve a further one year renewal in July 2012.

**Table of Contents**

**Administration Agreement**

We entered into an administration agreement with our Administrator (the Administration Agreement ), whereby we pay separately for administrative services. The Administration Agreement provides for payments equal to our allocable portion of the Administrator's overhead expenses in performing its obligations under the Administration Agreement including, but not limited to, rent and our allocable portion of the salaries and benefits expenses of our chief financial officer, chief compliance officer, internal counsel, treasurer and their respective staffs. Our allocable portion of expenses is derived by multiplying our Administrator's total expenses by the percentage of our average assets (the total assets at the beginning of each quarter) in comparison to the average total assets of all companies managed by our Adviser under similar agreements. On July 12, 2011, our Board of Directors approved the renewal of this Administration Agreement through August 31, 2012. We expect that our Board of Directors will consider a further one year renewal in July 2012.

**Table of Contents****RESULTS OF OPERATIONS***Comparison of the Fiscal Year Ended September 30, 2011 to the Fiscal Year Ended September 30, 2010*

	For the year ended September 30,			
	2011	2010	\$ Change	% Change
<b>INVESTMENT INCOME</b>				
Interest income				
Portfolio	\$ 32,636	\$ 32,583	\$ 53	0.2%
Cash	1	1		
Notes receivable from employees	431	437	(6)	(1.4)
Total interest income	33,068	33,021	47	0.1
Other income	2,143	2,518	(375)	(14.9)
Total investment income	35,211	35,539	(328)	(0.9)
<b>EXPENSES</b>				
Loan servicing fee	3,355	3,412	(57)	(1.7)
Base management fee	2,376	2,673	(297)	(11.1)
Incentive fee	4,598	1,823	2,775	152.2
Administration fee	729	807	(78)	(9.7)
Interest expense	2,676	4,390	(1,714)	(39.0)
Amortization of deferred financing fees	1,420	1,490	(70)	(4.7)
Professional fees	1,118	2,101	(983)	(46.8)
Compensation expense		245	(245)	NM
Other expenses	1,170	1,259	(89)	(7.1)
Expenses before credit from Adviser	17,442	18,200	(758)	(4.2)
Credit to fees from Adviser	(643)	(420)	(223)	53.1
Total expenses net of credit to fees	16,799	17,780	(981)	(5.5)
NET INVESTMENT INCOME	18,412	17,759	653	3.7
<b>REALIZED AND UNREALIZED (LOSS) GAIN</b>				
Net realized loss on investments	(1,280)	(2,893)	1,613	(55.8)
Net unrealized (depreciation) appreciation on investments	(38,759)	2,317	(41,076)	NM
Net unrealized depreciation (appreciation) on borrowings	528	(789)	1,317	NM
Net loss on investments and borrowings	(39,511)	(1,365)	(38,146)	2,794.6
NET (DECREASE) INCREASE IN NET ASSETS RESULTING FROM OPERATIONS	\$ (21,099)	\$ 16,394	\$ (37,493)	NM

NM = Not Meaningful

**Investment Income**

Investment income for the year ended September 30, 2011 was \$35.2 million as compared to \$35.5 million for the year ended September 30, 2010. Interest income from our aggregate investment portfolio remained relatively unchanged year over year, although the last half of 2011

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showed significant increases in interest income over the first half of 2011 due to the large number of new investments we made in the second half of fiscal 2011. The level of interest income from investments is directly related to the balance, at cost, of the interest-bearing investment portfolio outstanding during the year multiplied by the weighted average yield. The weighted average cost basis of our interest-bearing investment portfolio during the year ended September 30, 2011 was approximately \$292.9 million, compared to approximately \$300.5 million for the prior year. We had a net increase of two portfolio companies with investments on non-accrual status as of September 30, 2011, as compared to September 30, 2010. As of September 30, 2011, eight investments were on non-accrual, for an aggregate of approximately \$41.1 million at cost, or 10.8% of the aggregate cost of our investment portfolio. As of September 30, 2010, six investments were on non-accrual, for an aggregate of approximately \$29.9 million at cost, or 10.0% of the aggregate cost of our investment portfolio.

**Table of Contents**

The weighted average yield varies from year to year based on the current stated interest rate of interest-bearing investments. The weighted average yield was 11.2% for the year ended September 30, 2011 as compared to 10.9% for the prior year. The increase in the weighted average yield on our portfolio for the year ended September 30, 2011 resulted primarily from the repayment of loans with lower stated interest rates and the restructuring of certain loans into higher interest rate loans, partially offset by the purchase of syndicated loans, which generally bear lower interest rates than our existing proprietary debt investments.

Interest income from loans to certain employees of our Adviser, in connection with the exercise of employee stock options, decreased slightly, primarily as a result of significant repayments on the principal amounts in 2011. These decreases were offset almost entirely by increases in the interest rates on the loans due to the fact that certain significant loans were in default, triggering penalty interest provisions for all of fiscal 2011.

Other income decreased for the year ended September 30, 2011 as compared to the prior year, mainly due to decreases in success fees, which we recognize when payment is received. Success fees earned during the year ended September 30, 2011 totaled \$1.0 million, which we received primarily from Interfilm Holdings, Inc. and Pinnacle Treatment Centers, Inc. for actual exits in 2011, and also from Westlake Hardware, Inc. as a prepaid success fee. In addition, we received \$0.6 million from US Healthcare Communications, Inc. as a legal settlement in March 2011 that was recorded in other income. Success fees earned during the year ended September 30, 2010 totaled \$1.9 million, which we received from ActivStyle Acquisition Co., Anitox Acquisition Co., Doe & Ingalls Management LLC, Tulsa Welding School and Visual Edge Technology, Inc. for actual exits and from Saunders & Associates and Northern Contours, Inc. as prepayments.

The following table lists the investment income for our five largest portfolio company investments at fair value during the respective periods:

Company	As of September 30, 2011		Year Ended September 30, 2011	
	Fair Value	% of Portfolio	Investment Income	% of Total Investment Income
Reliable Biopharmaceutical Holdings, Inc.	\$ 25,295	8.3%	\$ 3,090	8.8%
Westlake Hardware, Inc.	19,340	6.4	2,935	8.3
Midwest Metal Distribution, Inc.	17,184	5.7	2,242	6.4
Defiance Integrated Technologies, Inc.	15,039	5.0	888	2.5
CMI Acquisition, LLC	14,336	4.7	1,038	3.0
<b>Subtotal five largest investments</b>	<b>91,194</b>	<b>30.1</b>	<b>10,193</b>	<b>29.0</b>
Other portfolio companies	211,753	69.9	24,586	69.8
Other non-portfolio company revenue			432	1.2
<b>Total investment portfolio</b>	<b>\$ 302,947</b>	<b>100.0%</b>	<b>\$ 35,211</b>	<b>100.0%</b>

Company	As of September 30, 2010		Year Ended September 30, 2010	
	Fair Value	% of Portfolio	Investment Income	% of Total Investment Income
Sunshine Media, Inc.	\$ 27,286	10.6%	\$ 3,254	9.1%
Reliable Biopharmaceutical Holdings, Inc.	26,574	10.3	3,003	8.4
Westlake Hardware, Inc.	19,620	7.6	2,940	8.3
Midwest Metal Distribution, Inc.	15,539	6.0	2,127	6.0
Winchester Electronics Co.	12,508	4.9	1,589	4.5
<b>Subtotal five largest investments</b>	<b>101,527</b>	<b>39.4</b>	<b>12,913</b>	<b>36.3</b>
Other portfolio companies	155,582	60.6	22,036	62.0
Other non-portfolio company revenue			590	1.7
<b>Total investment portfolio</b>	<b>\$ 257,109</b>	<b>100.0%</b>	<b>\$ 35,539</b>	<b>100.0%</b>

**Operating Expenses**

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Operating expenses, net of credits from the Adviser for fees earned and voluntary irrevocable and unconditional waivers to the base management and incentive fees, decreased for the year ended September 30, 2011 as compared to the prior year. This reduction was primarily due to a decrease in interest expense incurred in connection with the Credit Facility and a decrease in professional fees, which were partially offset by an increase in the incentive fee.

**Table of Contents**

The net base management fee decreased for the year ended September 30, 2011, as compared to the prior year, due to a decreased gross base management fee resulting from maintaining a smaller investment portfolio on average at fair value and from an increase in the credit we received against the base management fee for investments in senior syndicated loans, which increased in the year ended September 30, 2011. The base management fee is computed quarterly, as described under *Investment Advisory and Management Agreement* in Note 4 of the notes to the accompanying *Consolidated Financial Statements*, and is summarized in the table below. Incentive fees increased for the year ended September 30, 2011, as compared to the prior year, primarily due to increased pre-incentive fee net investment income. The board of directors of our Adviser voluntarily, irrevocably and unconditionally waived a portion of the incentive fee for each of the years ended September 30, 2011 and 2010.

The base management fee, incentive fee and associated credits are computed quarterly and are summarized in the table below:

	Year Ended September 30,	
	2011	2010
<b>Average total assets subject to base management fee<sup>(A)</sup></b>	<b>\$ 286,550</b>	<b>\$ 304,250</b>
Multiplied by annual base management fee of 2%	<b>2.0%</b>	<b>2.0%</b>
<b>Gross base management fee</b>	<b>5,731</b>	<b>6,085</b>
Reduction for loan servicing fees <sup>(B)</sup>	<b>(3,355)</b>	<b>(3,412)</b>
<b>Base management fee<sup>(B)</sup></b>	<b>\$ 2,376</b>	<b>\$ 2,673</b>
<i>Credits to base management fee from Adviser:</i>		
Fee reduction for the waiver of 2.0% fee on senior syndicated loans to 0.5%	<b>(383)</b>	<b>(42)</b>
Credit for fees received by Adviser from the portfolio companies	<b>(239)</b>	<b>(213)</b>
<b>Credit to base management fee from Adviser</b>	<b>(622)</b>	<b>(255)</b>
<b>Net base management fee</b>	<b>\$ 1,754</b>	<b>\$ 2,418</b>
<b>Incentive fee<sup>(B)</sup></b>	<b>\$ 4,598</b>	<b>\$ 1,823</b>
Credit from voluntary, irrevocable waiver issued by Adviser's board of directors	<b>(21)</b>	<b>(165)</b>
<b>Net incentive fee</b>	<b>\$ 4,577</b>	<b>\$ 1,658</b>
<b>Total credits to fees:</b>		
Fee reduction for the voluntary, irrevocable waiver of 2.0% fee on senior syndicated loans to 0.5%	<b>\$ (383)</b>	<b>\$ (42)</b>
Credit for fees received by Adviser from portfolio companies	<b>(239)</b>	<b>(213)</b>
Incentive fee credit	<b>(21)</b>	<b>(165)</b>
<b>Credit to base management and incentive fees from Adviser<sup>(B)</sup></b>	<b>\$ (643)</b>	<b>\$ (420)</b>

<sup>(A)</sup> Average total assets subject to the base management fee is defined as total assets, including investments made with proceeds of borrowings, less any uninvested cash or cash equivalents resulting from borrowings, valued at the end of the four most recently completed quarters and appropriately adjusted for any share issuances or repurchases during the applicable year.

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<sup>(B)</sup> Reflected, in total, as a line item on the *Consolidated Statement of Operations* located elsewhere in this report. Interest expense decreased for the year ended September 30, 2011, as compared to the prior year, due primarily to decreased borrowing costs under the Credit Facility during the year ended September 30, 2011. The effective interest rate during the year ended September 30, 2011 was 6.0%, compared to an effective interest rate of 7.0% for the year ended September 30, 2010. The weighted average balance outstanding on the Credit Facility increased only slightly year over year from approximately \$47.9 million during the year ended September 30, 2010, to approximately \$49.2 million during the year ended September 30, 2011. On November 22, 2010, we amended the Credit Facility, resulting in a reduced interest rate on outstanding borrowings. In addition to the lower interest rate, the amendment removed the annual minimum earnings shortfall fee to the committed lenders. During 2011 we reversed \$0.6 million of a minimum earnings shortfall fee which was recorded as a credit to interest expense.

Professional fees decreased by \$1.0 million for the year ended September 30, 2011, as compared to the prior year, due primarily to a larger amount of legal fees incurred during the year ended September 30, 2010 in connection with the restructuring of certain troubled loans.



**Table of Contents**

Compensation expense decreased for the year ended September 30, 2011 as compared to the prior year due to the conversion of stock option loans of two former employees of our Adviser from recourse to non-recourse loans during the year ended September 30, 2010. The conversions were non-cash transactions and were accounted for as repurchases of the shares previously received by the employees upon exercise of the stock options in exchange for the non-recourse notes. The repurchases were accounted for as treasury stock transactions at the fair value of the shares, totaling \$420. Since the value of the stock option loans totaled \$665, we recorded compensation expense of \$245 in fiscal 2010.

**Realized Loss and Unrealized (Depreciation) Appreciation on Investments***Realized Losses*

For the year ended September 30, 2011, we recorded a net realized loss on investments of \$1.3 million, which resulted from a restructuring of one of our portfolio companies, SCI. For the year ended September 30, 2010, we recorded a net realized loss on investments of \$2.9 million, which consisted of \$4.3 million of losses from the sale of several syndicated loans, Gold Toe Investment Corp., Kinetek Acquisition Corp and Wesco Holdings, Inc., the Western Directories, Inc. write-off, and the CCS, LLC payoff, partially offset by a \$1.4 million gain from the ACE Expeditors Inc. payoff.

*Unrealized (Depreciation) Appreciation*

Net unrealized (depreciation) appreciation on investments is the net change in the fair value of our investment portfolio during the reporting period, including the reversal of previously recorded unrealized appreciation or depreciation when gains and losses are actually realized. The net unrealized appreciation (depreciation) across our investments for the year ended September 30, 2011 was as follows:

	Year Ended September 30, 2011	Net Unrealized Appreciation (Depreciation)
Portfolio Company	Investment Classification	
Defiance Integrated Technologies, Inc.	Control	\$ 5,992
Midwest Metal Distribution, Inc.	Control	1,637
KMBQ Corporation	Non-Control / Non-Affiliate	738
Puerto Rico Cable Acquisition Company, Inc.	Non-Control / Non-Affiliate	732 <sup>(A)</sup>
WP Evenflo Group Holdings, Inc.	Non-Control / Non-Affiliate	485
Sunshine Media Holdings	Control	(21,237) <sup>(B)</sup>
Newhall Holdings, Inc.	Non-Control / Non-Affiliate	(9,339)
Viapack, Inc.	Control	(4,882) <sup>(B)</sup>
Lindmark Acquisition, LLC	Control	(4,547)
GFRC Holdings LLC	Non-Control / Non-Affiliate	(1,668)
Legend Communications of Wyoming LLC	Non-Control / Non-Affiliate	(975)
Heartland Communications Group	Non-Control / Non-Affiliate	(871)
Sunburst Media Louisiana, LLC	Non-Control / Non-Affiliate	(847)
Access Television Network, Inc.	Non-Control / Non-Affiliate	(704)
International Junior Golf Training Acquisition Company	Non-Control / Non-Affiliate	(666)
Mood Media Corporation	Non-Control / Non-Affiliate	(553)
LocalTel, LLC	Control	(479)
BAS Broadcasting	Non-Control / Non-Affiliate	(411)
Vision Solutions, Inc.	Non-Control / Non-Affiliate	(355)
Westlake Hardware, Inc.	Non-Control / Non-Affiliate	(280)
Other, net (<\$250)		(529)
	<b>Total:</b>	<b>\$ (38,759)</b>

<sup>(A)</sup> Includes the reversal of \$0.7 million in unrealized depreciation in connection with the payoff of the investment.

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<sup>(B)</sup> Reclassified from Non-Control/Non-Affiliate to Control investment during the year ended September 30, 2011 in connection with follow-on equity investments.

The largest driver of our net unrealized depreciation for the year ended September 30, 2011 was the depreciation in each of Sunshine Media Holdings and Newhall Holdings Inc., primarily due to diminished portfolio company performance and a decrease in certain comparable multiples, partially offset by appreciation in Defiance Integrated Technologies, Inc., which resulted from an improvement in portfolio company performance and in certain comparable multiples.

**Table of Contents**

The net unrealized appreciation (depreciation) across our investments for the year ended September 30, 2010 was as follows:

Year Ended September 30, 2010		Net Unrealized Appreciation (Depreciation)
Portfolio Company	Investment Classification	
Western Directories, Inc.	Control	\$ 2,819 <sup>(A)</sup>
Visual Edge Technology, Inc.	Non-Control / Non-Affiliate	1,716 <sup>(B)</sup>
BAS Broadcasting	Non-Control / Non-Affiliate	1,114
Westlake Hardware, Inc.	Non-Control / Non-Affiliate	951
Clinton Holdings, LLC	Control	888
WP Evenflo Group Holdings, Inc.	Non-Control / Non-Affiliate	826
Puerto Rico Cable Acquisition Company, Inc.	Non-Control / Non-Affiliate	729
Defiance Integrated Technologies, Inc.	Control	727
Northern Contours, Inc.	Non-Control / Non-Affiliate	613
Pinnacle Treatment Centers, Inc.	Non-Control / Non-Affiliate	534
Kinetek Acquisition Corp.	Non-Control / Non-Affiliate	513
CCS, LLC	Non-Control / Non-Affiliate	505 <sup>(C)</sup>
Allison Publications, LLC	Non-Control / Non-Affiliate	426
Wesco Holdings, Inc.	Non-Control / Non-Affiliate	408
Gold Toe Investment Corp.	Non-Control / Non-Affiliate	280
Global Materials Technologies, Inc.	Non-Control / Non-Affiliate	259
Lindmark Acquisition, LLC	Control	(4,803)
Legend Communications of Wyoming LLC	Non-Control / Non-Affiliate	(2,520)
LocalTel, LLC	Control	(1,381)
Finn Corporation	Non-Control / Non-Affiliate	(939)
KMBQ Corporation	Non-Control / Non-Affiliate	(807)
Sunburst Media Louisiana, LLC	Non-Control / Non-Affiliate	(696)
SCI Cable, Inc.	Non-Control / Non-Affiliate	(585)
BERTL, Inc.	Control	(390)
Precision Acquisitions Group Holdings, Inc.	Non-Control / Non-Affiliate	(337)
Sunshine Media Holdings	Non-Control / Non-Affiliate	(265)
Other, net (<\$250)		1,732
<b>Total:</b>		<b>\$ 2,317</b>

<sup>(A)</sup> Includes the reversal of \$2.9 million in unrealized depreciation in connection with the write-off of the investment.

<sup>(B)</sup> Includes the reversal of \$1.7 million in unrealized depreciation in connection with payoff of the line of credit and senior subordinated term loan of Visual Edge Technology, Inc.

<sup>(C)</sup> Includes the reversal of the unrealized depreciation in connection with the \$0.3 million realized loss on the sale of CCS, LLC. Excluding reversals, a general increase in our net unrealized depreciation for the year ended September 30, 2010 was experienced by our Control investments, partially offset by increased unrealized appreciation in our Non-Control/Non-Affiliate portfolio of debt holdings, based on increases in market comparables and improved portfolio company performance.

Our investment portfolio depreciated during the year ended September 30, 2011, generally due to a decrease in certain comparable multiples and the performance of some of our portfolio companies used to estimate the fair value of our investments. Our entire portfolio was fair valued at 79.1% of cost as of September 30, 2011 and 86.2% of cost as of September 30, 2010. The cumulative unrealized depreciation of our investments does not have an impact on our current ability to pay distributions to stockholders; however, it may be an indication of future realized losses,

which could ultimately reduce our income available for distribution.

**Net Unrealized Depreciation (Appreciation) on Borrowings**

We elected to apply the Financial Accounting Standards Board ( FASB ) Accounting Standards Codification ( ASC ) No. 825, Financial Instruments, which requires that we apply a fair value methodology to the Credit Facility. We estimated the fair value of the Credit Facility using estimates of value provided by an independent third party and our own assumptions in the absence of observable market data, including estimated remaining life, current market yield and interest rate spreads of similar securities as of the measurement date. The Credit Facility was fair valued at \$100.0 million and \$17.9 million as of September 30, 2011 and 2010, respectively. As a result, we recorded net unrealized depreciation (appreciation) of \$0.5 million and (\$0.8) million for the years ended September 30, 2011 and 2010, respectively.

**Table of Contents****Net (Decrease) Increase in Net Assets from Operations**

For the year ended September 30, 2011, we realized a net decrease in net assets resulting from operations of \$21.1 million as a result of the factors discussed above. For the year ended September 30, 2010, we realized a net increase in net assets resulting from operations of \$16.4 million. Our net (decrease) increase in net assets resulting from operations per basic and diluted weighted average common share for the years ended September 30, 2011 and 2010 were (\$1.00) and \$0.78, respectively.

**Comparison of the Fiscal Year Ended September 30, 2010 to the Fiscal Year Ended September 30, 2009**

	For the year ended September 30,			
	2010	2009	\$ Change	% Change
<b>INVESTMENT INCOME</b>				
Interest income				
Portfolio	\$ 32,583	\$ 41,680	\$ (9,097)	(21.8)%
Cash	1	11	(10)	(90.9)
Notes receivable from employees	437	468	(31)	(6.6)
Total interest income	33,021	42,159	(9,138)	(21.7)
Other income	2,518	459	2,059	448.6
Total investment income	35,539	42,618	(7,079)	(16.6)
<b>EXPENSES</b>				
Loan servicing fee	3,412	5,620	(2,208)	(39.3)
Base management fee	2,673	2,005	668	33.3
Incentive fee	1,823	3,326	(1,503)	(45.2)
Administration fee	807	872	(65)	(7.5)
Interest expense	4,390	7,949	(3,559)	(44.8)
Amortization of deferred financing fees	1,490	2,778	(1,288)	(46.4)
Professional fees	2,101	1,586	515	32.5
Compensation expense	245		245	NM
Other expenses	1,259	1,131	128	11.3
Expenses before credit from Adviser	18,200	25,267	(7,067)	(28.0)
Credit to fees from Adviser	(420)	(3,680)	3,260	(88.6)
Total expenses net of credit to fees	17,780	21,587	(3,807)	(17.6)
NET INVESTMENT INCOME	17,759	21,031	(3,272)	(15.6)
<b>REALIZED AND UNREALIZED (LOSS) GAIN</b>				
Net realized loss on investments	(2,893)	(26,411)	23,518	(89.0)
Net unrealized appreciation on investments	2,317	9,513	(7,196)	(75.6)
Realized loss on settlement of derivative		(304)	304	(100.0)
Net unrealized appreciation on derivative		304	(304)	(100.0)
Net unrealized appreciation on borrowings	(789)	(350)	(439)	125.4
Net loss on investments, derivative and borrowings	(1,365)	(17,248)	15,883	(92.1)
NET INCREASE IN NET ASSETS RESULTING FROM OPERATIONS	\$ 16,394	\$ 3,783	\$ 12,611	333.4%

NM = Not Meaningful

**Investment Income**

Investment income for the year ended September 30, 2010 was \$35.5 million as compared to \$42.6 million for the year ended September 30, 2009. Interest income from our aggregate investment portfolio decreased for the year ended September 30, 2010 as compared to the prior year. The level of interest income from investments is directly related to the balance, at cost, of the interest-bearing investment portfolio outstanding during the year multiplied by the weighted average yield. The weighted average cost basis of our interest-bearing investment portfolio during the year ended September 30, 2010 was

**Table of Contents**

approximately \$300.5 million, compared to approximately \$413.9 million for the year ended September 30, 2009. The weighted average yield varies from year to year based on the current stated interest rate on interest-bearing investments and the amounts of loans for which interest is not accruing. Interest income from our investments decreased primarily due to the overall reduction in the cost basis of our investments, resulting primarily from the exit of 12 investments during the year ended September 30, 2010. The weighted average yield on our portfolio was 10.8% for the year ended September 30, 2010 as compared to 10.1% for the prior year. As of September 30, 2010, six investments were on non-accrual, for an aggregate of approximately \$29.9 million at cost, or 10.0% of the aggregate cost of our investment portfolio, and as of September 30, 2009, five investments were on non-accrual, for an aggregate of approximately \$10.0 million at cost, or 2.8% of the aggregate cost of our investment portfolio.

Interest income from loans to employees, in connection with the exercise of employee stock options, decreased slightly for the year ended September 30, 2010 as compared to the prior year due to principal payments on the employee loans during the year ended September 30, 2010. In addition, during the year ended September 30, 2010, \$0.5 million of an employee stock option loan to a former employee of the Adviser was transferred from notes receivable employees to other assets in connection with the termination of her employment with the Adviser and the later amendment of the loan. The interest on the loan from the time the employee stopped working for the Adviser is included in other income on the accompanying *Consolidated Statement of Operations*.

Other income increased for the year ended September 30, 2010 as compared to the prior year. Other income includes success fees as well as prepayment fees received upon the full repayment of certain loan investments ahead of contractual maturity and prepayment fees received upon the early unscheduled principal repayments, which was based on a percentage of the outstanding principal amount of the loan at the date of prepayment. Success fees earned during the year ended September 30, 2010 totaled \$1.9 million, which we received from ActivStyle Acquisition Co., Anitox Acquisition Co., Doe & Ingalls Management LLC, Saunders & Associates, Northern Contours, Inc., Tulsa Welding School and Visual Edge Technology, Inc. Success fees earned during the year ended September 30, 2009 totaled \$0.4 million, which we received from ActivStyle Acquisition Co., Interfilm Holdings, Inc. and It's Just Lunch.

The following table lists the investment income for our five largest portfolio company investments at fair value during the respective periods:

Company	As of September 30, 2010		Year Ended September 30, 2010	
	Fair Value	% of Portfolio	Investment Income	% of Total Investment Income
Sunshine Media, Inc.	\$ 27,286	10.6%	\$ 3,254	9.1
Reliable Biopharmaceutical Holdings, Inc.	26,574	10.3	3,003	8.4
Westlake Hardware, Inc.	19,620	7.6	2,940	8.3
Midwest Metal Distribution, Inc.	15,539	6.0	2,127	6.0
Winchester Electronics Co.	12,508	4.9	1,589	4.5
<b>Subtotal five largest investments</b>	<b>101,527</b>	<b>39.4</b>	<b>12,913</b>	<b>36.3</b>
Other portfolio companies	155,582	60.6	22,036	62.0
Other non-portfolio company revenue			590	1.7
<b>Total investment portfolio</b>	<b>\$ 257,109</b>	<b>100.0%</b>	<b>\$ 35,539</b>	<b>100.0%</b>

Company	As of September 30, 2009		Year Ended September 30, 2009	
	Fair Value	% of Portfolio	Investment income	% of Total Investment Income
Reliable Biopharmaceutical Holdings, Inc.	\$ 26,996	8.4%	\$ 3,073	7.2%
Sunshine Media, Inc.	25,951	8.1	3,352	7.9
Westlake Hardware, Inc.	23,669	7.3	2,417	5.7
VantaCore	13,589	4.2	1,696	4.0

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GFRC Holdings LLC	12,882	4.0	1,417	3.3
<b>Subtotal five largest investments</b>	<b>103,087</b>	<b>32.0</b>	<b>11,955</b>	<b>28.1</b>
Other portfolio companies	217,882	68.0	30,184	70.8
Other non-portfolio company revenue			479	1.1
<b>Total investment portfolio</b>	<b>\$ 320,969</b>	<b>100.0%</b>	<b>\$ 42,618</b>	<b>100.0%</b>



