

GLADSTONE CAPITAL CORP

Form 10-Q

May 03, 2011

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**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549
FORM 10-Q**

**Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934
For the Quarter Ended March 31, 2011**

**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)**

MARYLAND

54-2040781

(State or other jurisdiction of incorporation or organization)

(I.R.S. Employer Identification No.)

**1521 WESTBRANCH DRIVE, SUITE 200
MCLEAN, VIRGINIA 22102**

(Address of principal executive office)

(703) 287-5800

(Registrant's telephone number, including area code)

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 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 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 <input type="checkbox"/> | Accelerated filer <input type="checkbox"/> | Non-accelerated filer <input type="checkbox"/> | Smaller reporting company <input type="checkbox"/> |
| | | (Do not check if a smaller reporting company) | |

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date. The number of shares of the issuer's common stock, \$0.001 par value per share, outstanding as of May 2, 2011 was 21,039,242.

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GLADSTONE CAPITAL CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF ASSETS AND LIABILITIES
(DOLLAR AMOUNTS IN THOUSANDS, EXCEPT PER SHARE AMOUNTS)
(UNAUDITED)

| | March 31, 2011 | September 30, 2010 |
|---|-------------------|--------------------------|
| ASSETS | | |
| Cash | \$ 8,871 | \$ 7,734 |
| Investments at fair value | | |
| Non-Control/Non-Affiliate investments (Cost of \$229,517 and \$244,140, respectively) | 208,461 | 223,737 |
| Control investments (Cost of \$84,718 and \$54,076, respectively) | 48,652 | 33,372 |
| Total investments at fair value (Cost of \$314,235 and \$298,216, respectively) | 257,113 | 257,109 |
| Interest receivable investments in debt securities | 2,379 | 2,648 |
| Interest receivable employees ⁽⁴⁾ | 122 | 104 |
| Due from custodian | 1,279 | 255 |
| Deferred financing fees | 1,361 | 1,266 |
| Prepaid assets | 744 | 799 |
| Other assets | 667 | 603 |
| TOTAL ASSETS | \$ 272,536 | \$ 270,518 |
| LIABILITIES | | |
| Borrowings at fair value (Cost of \$33,200 and \$16,800, respectively) | \$ 33,646 | \$ 17,940 |
| Accounts payable and accrued expenses | 456 | 752 |
| Interest payable | 120 | 693 |
| Fee due to Administrator ⁽¹⁾ | 175 | 267 |
| Fees due to Adviser ⁽¹⁾ | 1,791 | 673 |
| Other liabilities | 1,133 | 947 |
| TOTAL LIABILITIES | 37,321 | 21,272 |
| NET ASSETS | \$ 235,215 | \$ 249,246 |
| ANALYSIS OF NET ASSETS | | |
| Common stock, \$0.001 par value, 50,000,000 shares authorized and 21,039,242 shares issued and outstanding at March 31, 2011 and September 30, 2010 | \$ 21 | \$ 21 |
| Capital in excess of par value | 326,935 | 326,935 |
| Notes receivable employees ⁽⁴⁾ | (6,049) | (7,103) |
| Net unrealized depreciation on investments | (57,121) | (41,108) |
| Net unrealized appreciation on borrowings | (446) | (1,140) |
| Overdistributed net investment income | | (1,103) |
| Accumulated net realized losses | (28,125) | (27,256) |

| | | |
|-----------------------------|-------------------|-------------------|
| TOTAL NET ASSETS | \$ 235,215 | \$ 249,246 |
| NET ASSETS PER SHARE | \$ 11.18 | \$ 11.85 |

(1) Refer to Note 4 *Related Party Transactions* for additional information.

THE ACCOMPANYING NOTES ARE AN INTEGRAL PART OF THESE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS.

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GLADSTONE CAPITAL CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS
(DOLLAR AMOUNTS IN THOUSANDS, EXCEPT PER SHARE AMOUNTS)
(UNAUDITED)

| | Three Months Ended March | | Six Months Ended March | |
|---|---------------------------------|-------------|-------------------------------|-------------|
| | 31, | | 31, | |
| | 2011 | 2010 | 2011 | 2010 |
| INVESTMENT INCOME | | | | |
| Interest income | | | | |
| Non-Control/Non-Affiliate investments | \$ 6,055 | \$ 7,675 | \$ 12,651 | \$ 16,045 |
| Control investments | 1,113 | 709 | 2,240 | 1,477 |
| Notes receivable from employees ⁽¹⁾ | 122 | 108 | 244 | 221 |
| Total interest income | 7,290 | 8,492 | 15,135 | 17,743 |
| Other income | 1,108 | 1,322 | 1,270 | 1,875 |
| Total investment income | 8,398 | 9,814 | 16,405 | 19,618 |
| EXPENSES | | | | |
| Loan servicing fee ⁽¹⁾ | 757 | 852 | 1,599 | 1,781 |
| Base management fee ⁽¹⁾ | 608 | 739 | 1,113 | 1,459 |
| Incentive fee ⁽¹⁾ | 1,102 | 1,072 | 2,261 | 1,447 |
| Administration fee ⁽¹⁾ | 175 | 176 | 361 | 354 |
| Interest expense | 478 | 1,136 | 358 | 2,671 |
| Amortization of deferred financing fees | 368 | 449 | 664 | 943 |
| Professional fees | 201 | 219 | 534 | 1,131 |
| Other expenses | 383 | 703 | 603 | 965 |
| Expenses before credits from Adviser | 4,072 | 5,346 | 7,493 | 10,751 |
| Credits to fees from Adviser ⁽¹⁾ | (102) | (6) | (154) | (35) |
| Total expenses net of credits to fees | 3,970 | 5,340 | 7,339 | 10,716 |
| NET INVESTMENT INCOME | 4,428 | 4,474 | 9,066 | 8,902 |
| REALIZED AND UNREALIZED | | | | |
| (LOSS) GAIN ON: | | | | |
| Net realized gain (loss) on investments | 5 | 892 | 5 | (28) |
| Net unrealized (depreciation) appreciation on investments | (13,069) | 2,483 | (16,014) | 5,082 |
| Net unrealized depreciation on borrowings | 255 | 131 | 693 | 350 |
| Net (loss) gain on investments and borrowings | (12,809) | 3,506 | (15,316) | 5,404 |

| | | | | | | | | |
|---|----|---------|----|-------|----|---------|----|--------|
| NET (DECREASE) INCREASE IN NET ASSETS RESULTING FROM OPERATIONS | \$ | (8,381) | \$ | 7,980 | \$ | (6,250) | \$ | 14,306 |
|---|----|---------|----|-------|----|---------|----|--------|

| | | | | | | | | |
|--|----|--------|----|------|----|--------|----|------|
| NET (DECREASE) INCREASE IN NET ASSETS RESULTING FROM OPERATIONS PER SHARE: | | | | | | | | |
| Basic and Diluted | \$ | (0.40) | \$ | 0.38 | \$ | (0.30) | \$ | 0.68 |

| | | | | | | | | |
|---|--|-------------------|--|------------|--|-------------------|--|------------|
| WEIGHTED AVERAGE SHARES OF COMMON STOCK OUTSTANDING: | | | | | | | | |
| Basic and Diluted | | 21,039,242 | | 21,075,445 | | 21,039,242 | | 21,081,576 |

(1) Refer to Note 4 *Related Party Transactions* for additional information.

*THE ACCOMPANYING NOTES ARE AN INTEGRAL PART OF THESE CONDENSED CONSOLIDATED
FINANCIAL STATEMENTS.*

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GLADSTONE CAPITAL CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF CHANGES IN NET ASSETS
(DOLLAR AMOUNTS IN THOUSANDS)
(UNAUDITED)

| | Six Months Ended March | |
|--|-------------------------------|-------------|
| | 31, | |
| | 2011 | 2010 |
| <i>Operations:</i> | | |
| Net investment income | \$ 9,066 | \$ 8,902 |
| Net realized gain (loss) on investments | 5 | (28) |
| Net unrealized (depreciation) appreciation on investments | (16,014) | 5,082 |
| Net unrealized depreciation on borrowings | 693 | 350 |
| Net (decrease) increase in net assets from operations | (6,250) | 14,306 |
| <i>Distributions:</i> | | |
| Distributions to stockholders | (8,836) | (8,853) |
| <i>Capital transactions:</i> | | |
| Shelf offering costs | | (74) |
| Conversion of former employee stock option loans from recourse to non-recourse | | (420) |
| Repayment of principal on employee notes | 1,055 | |
| Reclassification of principal on employee note | | 514 |
| Net increase in net assets from capital transactions | 1,055 | 20 |
| Total (decrease) increase in net assets | (14,031) | 5,473 |
| Net assets at beginning of period | 249,246 | 249,076 |
| Net assets at end of period | \$ 235,215 | \$ 254,549 |

THE ACCOMPANYING NOTES ARE AN INTEGRAL PART OF THESE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS.

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GLADSTONE CAPITAL CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(DOLLAR AMOUNTS IN THOUSANDS)
(UNAUDITED)

| | Six Months Ended | |
|--|-------------------------|-------------|
| | March 31, | |
| | 2011 | 2010 |
| CASH FLOWS FROM OPERATING ACTIVITIES | | |
| Net (decrease) increase in net assets resulting from operations | \$ (6,250) | \$ 14,306 |
| Adjustments to reconcile net (decrease) increase in net assets resulting from operations to net cash (used in) provided by operating activities: | | |
| Investments in portfolio companies | (52,424) | (6,880) |
| Principal repayments on investments | 35,227 | 38,418 |
| Proceeds from sale of investments | 777 | 3,119 |
| Increase in investment balance due to paid in kind interest | (8) | (60) |
| Repayment of paid in kind interest | | 51 |
| Increase in investment balance due to transferred interest | (204) | (441) |
| Net change in premiums, discounts and amortization | 776 | 63 |
| Net realized (gain) loss on investments | (163) | 28 |
| Net unrealized depreciation (appreciation) on investments | 16,014 | (5,082) |
| Net unrealized depreciation on borrowings | (693) | (349) |
| Amortization of deferred financing fees | 664 | 943 |
| Change in compensation expense from non-recourse notes | | 245 |
| Decrease in interest receivable | 251 | 655 |
| Increase in due from custodian | (1,024) | (7,512) |
| Decrease in prepaid assets | 55 | 53 |
| Decrease in due from Adviser ⁽¹⁾ | | 69 |
| (Increase) decrease in other assets | (64) | 1,158 |
| Decrease in accounts payable and accrued expenses | (296) | (670) |
| Decrease in interest payable | (573) | (134) |
| Increase in fees due to Adviser ⁽¹⁾ | 1,118 | 1,531 |
| Decrease in administration fee due to Administrator ⁽¹⁾ | (92) | (39) |
| Increase (decrease) in other liabilities | 186 | (237) |
| Net cash (used in) provided by operating activities | (6,723) | 39,235 |
| CASH FLOWS FROM FINANCING ACTIVITIES: | | |
| Shelf offering costs | | (74) |
| Proceeds from borrowings | 50,800 | 5,500 |
| Repayments on borrowings | (34,400) | (35,500) |
| Distributions paid | (8,836) | (8,853) |
| Receipt of principal on employee's notes receivable | 1,055 | |
| Deferred financing fees | (759) | (1,323) |
| Net cash provided by (used in) financing activities | 7,860 | (40,250) |

| | | |
|--|-----------------|-----------------|
| NET INCREASE (DECREASE) IN CASH | 1,137 | (1,015) |
| CASH, BEGINNING OF PERIOD | 7,734 | 5,276 |
| CASH, END OF PERIOD | \$ 8,871 | \$ 4,261 |

(1) Refer to Note 4 *Related Party Transactions* for additional information.

THE ACCOMPANYING NOTES ARE AN INTEGRAL PART OF THESE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS.

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GLADSTONE CAPITAL CORPORATION
CONDENSED CONSOLIDATED SCHEDULE OF INVESTMENTS
AS OF MARCH 31, 2011
(DOLLAR AMOUNTS IN THOUSANDS)
(UNAUDITED)

| Company ⁽¹⁾ | Industry | Investment ⁽²⁾ | Cost | Fair Value |
|--|--|---|--|------------|
| NON-CONTROL/NON-AFFILIATE INVESTMENTS | | | | |
| <i>Non-syndicated</i> | | | | |
| <i>Loans:</i> | | | | |
| Access Television Network, Inc. | Service-cable airtime (infomercials) | Senior Term Debt (14.0%, Due 2/2011) ⁽⁴⁾ | \$ 918 | \$ 459 |
| Allison Publications, LLC | Service-publisher of consumer | Senior Term Debt (10.5%, Due 9/2012) ⁽⁴⁾ | 8,786 | 8,282 |
| BAS Broadcasting | Service-radio station operator | Senior Term Debt (11.5%, Due 7/2013) ⁽⁴⁾ | 7,465 | 6,495 |
| Chinese Yellow Pages Company | Service-publisher of Chinese language directories | Line of Credit, \$250 available (7.3%, Due 11/2011) ⁽⁴⁾ | 450 | 383 |
| | | Senior Term Debt (7.3%, Due 11/2011) ⁽⁴⁾ | 243 | 207 |
| CMI Acquisition, LLC | Service-recycling | Senior Subordinated Term Debt (10.3%, Due 11/2012) ⁽⁴⁾ | 5,980 | 5,950 |
| FedCap Partners, LLC | Private equity fund | Class A Membership Units ⁽⁷⁾ Uncalled Capital Commitment (\$1,200) | 800 | 800 |
| GFRC Holdings LLC | Manufacturing-glass-fiber reinforced concrete | Senior Term Debt (11.5%, Due 12/2012) ⁽⁴⁾ | 5,911 | 5,202 |
| | | Senior Subordinated Term Debt (14.0%, Due 12/2012) ⁽³⁾⁽⁴⁾ | 6,632 | 5,836 |
| Global Materials Technologies, Inc. | Manufacturing-steel wool products and metal fibers | Senior Term Debt (13.0%, Due 6/2012) ⁽³⁾⁽⁴⁾ | 3,035 | 2,534 |
| | | Service-radio station operator | Line of Credit, \$0 available (10.0%, Due 3/2013) ⁽⁴⁾ | |
| Heartland Communications Group | | | 100 | 45 |
| | | Line of Credit, \$50 available (10.0%, Due 3/2013) ⁽⁴⁾ | 50 | 23 |
| | | Senior Term Debt (5.0%, Due 3/2013) ⁽⁴⁾ Common Stock Warrants ⁽⁶⁾⁽⁷⁾ | 4,309 | 1,954 |
| International Junior Golf Training Acquisition Company | Service-golf training | Line of Credit, \$0 available (11.0%, Due 5/2012) ⁽⁴⁾ | 1,500 | 1,349 |
| | | Line of Credit, \$0 available (11.0%, Due 6/2011) ⁽⁴⁾ | 200 | 179 |
| | | Senior Term Debt (10.5%, Due 5/2012) ⁽⁴⁾ | 1,226 | 1,103 |
| | | Senior Term Debt (12.5%, Due 5/2012) ⁽³⁾⁽⁴⁾ | 2,500 | 2,250 |
| KMBQ Corporation | Service-AM/FM radio broadcaster | Line of Credit, \$42 available (non-accrual, Due 7/2010) ⁽⁴⁾⁽⁷⁾ | 158 | 13 |
| | | Senior Term Debt (non-accrual, Due 7/2010) ⁽⁴⁾⁽⁷⁾ | 2,020 | 172 |
| Legend Communications of | Service-operator of radio stations | Senior Term Debt (12.0%, Due 6/2013) ⁽⁴⁾ | 9,880 | 5,928 |
| | | Senior Term Debt (14.0%, Due 7/2011) ⁽⁴⁾ | 220 | 132 |

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|--------------------------|---|--|-------|-------|
| Wyoming, LLC | | | | |
| Newhall Holdings, Inc. | Service-distributor of personal care products and supplements | Line of Credit, \$0 available (8.0%, Due 12/2012) ⁽⁴⁾ | 1,985 | 1,878 |
| | | Senior Term Debt Term A (8.5%, Due 12/2012) ⁽⁴⁾ | 1,870 | 1,770 |
| | | Senior Term Debt (3.5%, Due 12/2012) ⁽⁴⁾ | 2,000 | 1,868 |
| | | Senior Term Debt (3.5%, Due 12/2012) ⁽³⁾⁽⁴⁾ | 4,648 | 4,294 |
| | | Preferred Equity ⁽⁶⁾⁽⁷⁾ | | |
| | | Common Stock ⁽⁶⁾⁽⁷⁾ | | |
| Northern Contours, Inc. | Manufacturing-veneer and laminate components | Senior Subordinated Term Debt (13.0%, Due 9/2012) ⁽⁴⁾ | 6,214 | 5,717 |
| Northstar Broadband, LLC | Service-cable TV franchise owner | Senior Term Debt (0.7%, Due 12/2012) ⁽⁴⁾ | 96 | 85 |

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GLADSTONE CAPITAL CORPORATION
CONDENSED CONSOLIDATED SCHEDULE OF INVESTMENTS (Continued)
AS OF MARCH 31, 2011
(DOLLAR AMOUNTS IN THOUSANDS)
(UNAUDITED)

| Company ⁽¹⁾ | Industry | Investment ⁽²⁾ | Cost | Fair Value |
|---|---|--|--|-----------------------------------|
| Precision Acquisition Group Holdings, Inc. | Manufacturing-consumable components for the aluminum industry | Equipment Note (13.0%, Due 11/2011) ⁽⁴⁾ Senior Term Debt (13.0%, Due 11/2011) ⁽⁴⁾ Senior Term Debt (13.0%, Due 11/2011) ⁽³⁾⁽⁴⁾ | \$ 1,000 4,125 4,053 | \$ 943 3,887 3,820 |
| PROFITSystems Acquisition Co. | Service-design and develop ERP software | Line of Credit, \$350 available (4.5%, Due 7/2011) ⁽⁴⁾ Senior Term Debt (8.5%, Due 7/2011) ⁽⁴⁾ Senior Term Debt (10.5%, Due 7/2011) ⁽³⁾⁽⁴⁾ | 500 2,900 | 475 2,737 |
| RCS Management Holding Co. | Service-healthcare supplies | Senior Term Debt (9.5%, Due 1/2013) ⁽⁴⁾ Senior Term Debt (11.5%, Due 1/2013) ⁽³⁾⁽⁴⁾ | 1,687 3,060 | 1,658 3,007 |
| Reliable Biopharmaceutical Holdings, Inc. | Manufacturing-pharmaceutical and biochemical intermediates | Line of Credit, \$2,400 available (9.0%, Due 1/2013) ⁽⁴⁾ Mortgage Note (9.5%, Due 12/2014) ⁽⁴⁾ Senior Term Debt (12.0%, Due 12/2014) ⁽³⁾⁽⁴⁾ Senior Subordinated Term Debt (12.5%, Due 12/2014) ⁽⁴⁾ Common Stock Warrants ⁽⁶⁾⁽⁷⁾ | 1,600 7,210 11,633 6,000 209 | 1,580 7,120 11,284 5,715 |
| Saunders & Associates | Manufacturing-equipment provider for frequency control devices | Line of Credit, \$2,500 available (11.25%, Due 5/2013) ⁽⁴⁾ Senior Term Debt (11.25%, Due 5/2013) ⁽⁴⁾ | 8,947 | 8,958 |
| SCI Cable, Inc. | Service-cable, internet, voice provider | Senior Term Debt (non-accrual, Due 10/2012) ⁽⁴⁾⁽⁷⁾ Senior Term Debt (non-accrual, Due 10/2012) ⁽⁴⁾⁽⁷⁾ | 710 2,931 | 71 147 |
| Sunburst Media Louisiana, LLC Thibaut Acquisition Co. | Service-radio station operator Service-design and distribute wall covering | Senior Term Debt (10.5%, Due 12/2011) ⁽⁴⁾ Line of Credit, \$250 available (9.0%, Due 1/2014) ⁽⁴⁾ Senior Term Debt (8.5%, Due 1/2014) ⁽⁴⁾ Senior Term Debt (12.0%, Due 1/2014) ⁽³⁾⁽⁴⁾ | 6,255 750 812 3,000 | 4,844 728 789 2,895 |
| Viapack, Inc. | Manufacturing-polyethylene film | Senior Real Estate Term Debt (10.0%, Due 3/2014) ⁽⁴⁾ Senior Term Debt (13.0%, Due 3/2014) ⁽³⁾⁽⁴⁾ | 625 3,952 | 619 3,912 |
| Westlake Hardware, Inc. | Retail-hardware and variety | Senior Subordinated Term Debt (12.3%, Due 1/2014) ⁽⁴⁾ Senior Subordinated Term Debt (13.5%, Due 1/2014) ⁽⁴⁾ Senior Term Debt (5.3%, Due 5/2012) ⁽⁴⁾ | 12,000 8,000 1,250 | 11,790 7,780 1,249 |

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|--------------------------------------|---|---|---------|---------|
| Winchester Electronics | Manufacturing-high bandwidth connectors and cables | Senior Term Debt (5.7%, Due 5/2013) ⁽⁴⁾ | 1,682 | 1,675 |
| | | Senior Subordinated Term Debt (14.0%, Due 6/2013) ⁽⁴⁾ | 9,850 | 9,739 |
| <i>Subtotal Non-syndicated loans</i> | | | 184,003 | 162,330 |
| Syndicated Loans: | | | | |
| Airvana Network Solutions, Inc | Service-telecommunications | Senior Term Debt (10.25%, Due 3/2015) ⁽⁵⁾ | 7,840 | 7,990 |
| Allied Security Holdings LLC | Service - contract security officer providers | Senior Subordinated Term Debt (8.5%, Due 2/2018) ⁽⁵⁾ | 990 | 1,010 |
| Allied Specialty Vehicles, Inc | Manufacturing - speciality vehicles | Senior Term Debt (9.5%, Due 2/2016) ⁽⁵⁾ | 9,801 | 9,800 |
| Ameriquial Group, LLC | Manufacturing - production and distribution of food products | Senior Term Debt (9.8%, Due 3/2016) ⁽⁵⁾ | 7,350 | 7,350 |
| Applied Systems, Inc | Service - software for property & casualty insurance industry | Senior Subordinated Term Debt (9.3%, Due 6/2017) ⁽⁵⁾ | 991 | 1,015 |
| Ascend Learning, LLC | Service - technology-based learning solutions | Senior Subordinated Term Debt (12.3%, Due 12/2017) ⁽⁵⁾ | 971 | 1,000 |
| Covad Communications Group, Inc | Service-telecommunications | Senior Term Debt (12.0%, Due 11/2015) ⁽⁵⁾ | 1,912 | 1,984 |

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GLADSTONE CAPITAL CORPORATION
CONDENSED CONSOLIDATED SCHEDULE OF INVESTMENTS (Continued)
AS OF MARCH 31, 2011
(DOLLAR AMOUNTS IN THOUSANDS)
(UNAUDITED)

| Company⁽¹⁾ | Industry | Investment⁽²⁾ | Cost | Fair Value |
|--|--|---|-------------------|-------------------|
| Global Brass and Copper, Inc | Service-telecommunications | Senior Term Debt (10.3%, Due 8/2015) ⁽⁵⁾ | \$ 2,901 | \$ 3,130 |
| HGI Holding, Inc | Service-telecommunications | Senior Term Debt (6.3%, Due 10/2016) ⁽⁵⁾ | 1,830 | 1,885 |
| Keypoint Government Solutions, Inc | Service - security consulting services | Senior Term Debt (10% Due 12/2015) ⁽⁵⁾ | 6,948 | 6,913 |
| National Surgical Hospitals, Inc | Service - physician-partnered surgical fa | Senior Term Debt (8.25%, Due 2/2017) ⁽⁵⁾ | 1,664 | 1,690 |
| WP Evenflo Group Holdings Inc. | Manufacturing-infant and juvenile products | Senior Term Debt (8.0%, Due 2/2013) ⁽⁵⁾ | 1,872 | 1,768 |
| | | Senior Preferred Equity ⁽⁶⁾⁽⁷⁾ | 333 | 399 |
| | | Junior Preferred Equity ⁽⁶⁾⁽⁷⁾ | 111 | 138 |
| | | Common Stock ⁽⁶⁾⁽⁷⁾ | | 59 |
| <i>Subtotal</i> | | | | |
| <i>Syndicated loans</i> | | | 45,514 | 46,131 |
| Total Non-Control/Non-Affiliate Investments (represents 81.1% of total investments at fair value) | | | \$ 229,517 | \$ 208,461 |

CONTROL INVESTMENTS

| | | | | |
|--|---|--|----------|-------|
| BERTL, Inc. | Service-web-based evaluator of digital imaging products | Line of Credit, \$81 available (non-accrual, Due 10/2011) ⁽⁶⁾⁽⁷⁾ | \$ 1,249 | |
| | | Common Stock ⁽⁶⁾⁽⁷⁾ | 424 | |
| Defiance Integrated Technologies, Inc. | Manufacturing-trucking parts | Senior Term Debt (11.0%, Due 4/2013) ⁽³⁾⁽⁴⁾ | 8,165 | 8,165 |
| Lindmark Acquisition, LLC | Service-advertising | Common Stock ⁽⁶⁾⁽⁷⁾ | 1 | 5,515 |
| | | Senior Subordinated Term Debt (non-accrual, Due 10/2012) ⁽⁴⁾⁽⁷⁾ | 10,000 | 3,500 |
| | | Senior Subordinated Term Debt (non-accrual, Due 10/2012) ⁽⁴⁾⁽⁷⁾ | 2,000 | 700 |
| | | Senior Subordinated Term Debt (non-accrual, Due Upon Demand) ⁽⁴⁾⁽⁷⁾ | 1,909 | 668 |
| | | Common Stock ⁽⁶⁾⁽⁷⁾ | 317 | |
| LocalTel, LLC | Service-yellow pages publishing | Line of credit, \$77 available (non-accrual, Due 12/2011) ⁽⁶⁾⁽⁷⁾ | 1,773 | 764 |
| | | Line of Credit, \$1,830 available (non-accrual, Due 6/2011) ⁽⁶⁾⁽⁷⁾ | 1,170 | |
| | | | 325 | |

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| | | | | |
|--|---|--|-------------------|-------------------|
| | | Senior Term Debt (non-accrual, Due 2/2012) (6)(7) | | |
| | | Senior Term Debt (non-accrual, Due 6/2011) (6)(7) | 2,687 | |
| | | Senior Term Debt (non-accrual, Due 6/2011) (3)(6)(7) | 2,750 | |
| | | Common Stock Warrants (6)(7) | | |
| Midwest Metal Distribution, Inc. | Distribution-aluminum sheets and stainless steel | Senior Subordinated Term Debt (12.0%, Due 7/2013) (4) | 18,258 | 16,179 |
| | | Common Stock (6)(7) | 138 | |
| Sunshine Media Holdings (8) | Service-publisher regional B2B trade magazines | Line of credit, \$400 available (10.5%, Due 5/2016) (4) | 1,600 | 719 |
| | | Senior Term Debt (10.5%, Due 5/2012) (4) | 16,948 | 7,627 |
| | | Senior Term Debt (5%, Due 5/2012) (3)(4) | 10,700 | 4,815 |
| | | Preferred Equity (6)(7) | 375 | |
| | | Common Stock (6)(7) | 740 | |
| U.S. Healthcare Communications, Inc. | Service-magazine publisher/operator | Line of credit, \$131 available (non-accrual, Due 12/2010) (6)(7) | 269 | |
| | | Line of credit, \$0 available (non-accrual, Due 12/2010) (6)(7) | 450 | |
| | | Common Stock (6)(7) | 2,470 | |
| Total Control Investments (represents 18.9% of total investments at fair value) | | | \$ 84,718 | \$ 48,652 |
| Total Investments | | | \$ 314,235 | \$ 257,113 |

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- (1) Certain of the listed securities are issued by affiliate(s) of the indicated portfolio company.
- (2) Percentage represents interest rates in effect at March 31, 2011 and due date represents the contractual maturity date.
- (3) Last Out Tranche (LOT) of senior debt, meaning if the portfolio company is liquidated, the holder of the LOT is paid after the senior debt.
- (4) Fair value was primarily based on opinions of value submitted by Standard & Poor's Securities Evaluations, Inc.
- (5) Security valued based on the indicative bid price on or near March 31, 2011, offered by the respective syndication agent's trading desk or secondary desk.
- (6) Fair value was primarily based on the total enterprise value of the portfolio company using a liquidity waterfall approach. Gladstone Capital Corporation (the Company) also considered discounted cash flow methodologies.
- (7) Security is non-income producing.
- (8) During the quarter ended March 31, 2011, the Company purchased a controlling interest in common stock from existing shareholders of Sunshine Media Holdings. This purchase resulted in the Company reclassifying the investment from Non-Control/Non-Affiliate to Control.

THE ACCOMPANYING NOTES ARE AN INTEGRAL PART OF THESE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS.

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GLADSTONE CAPITAL CORPORATION
CONSOLIDATED SCHEDULE OF INVESTMENTS
SEPTEMBER 30, 2010
(DOLLAR AMOUNTS IN THOUSANDS)

| Company ⁽¹⁾ | Industry | Investment ⁽²⁾ | Cost | Fair Value |
|--|--|---|--------|------------|
| NON-CONTROL/NON-AFFILIATE INVESTMENTS | | | | |
| <i>Non-syndicated</i> | | | | |
| <i>Loans:</i> | | | | |
| Access Television Network, Inc. | Service-cable airtime (infomercials) | Senior Term Debt (14.0%, Due 12/2011) ⁽⁵⁾ | \$ 963 | \$ 809 |
| Allison Publications, LLC | Service-publisher of consumer oriented magazines | Senior Term Debt (10.5%, Due 9/2012) ⁽⁵⁾ | 9,094 | 8,543 |
| BAS Broadcasting | Service-radio station operator | Senior Term Debt (13.0%, Due 12/2010) ⁽⁵⁾ Senior Term Debt (11.5%, Due 7/2013) ⁽⁵⁾ | 65 | 64 |
| Chinese Yellow Pages Company | Service-publisher of Chinese language directories | Line of Credit, \$250 available (7.3%, Due 11/2010) ⁽⁵⁾ | 7,465 | 6,644 |
| CMI Acquisition, LLC | Service-recycling | Senior Term Debt (7.3%, Due 11/2010) ⁽⁵⁾ | 450 | 428 |
| FedCap Partners, LLC | Private equity fund | Senior Subordinated Term Debt (10.3%, Due 11/2012) ⁽⁵⁾ | 333 | 317 |
| Finn Corporation | Manufacturing-landscape equipment | Class A Membership Units ⁽⁸⁾ | 5,972 | 5,868 |
| GFRC Holdings LLC | Manufacturing-glass-fiber reinforced concrete | Uncalled Capital Commitment (\$1,600) Common Stock Warrants ⁽⁷⁾⁽⁸⁾ | 400 | 400 |
| Global Materials Technologies, Inc. | Manufacturing-steel wool products and metal fibers | Senior Term Debt (11.5%, Due 12/2012) ⁽⁵⁾ | 37 | 284 |
| Heartland Communications Group | Service-radio station operator | Senior Subordinated Term Debt (14.0%, Due 12/2012) ⁽³⁾⁽⁵⁾ | 6,111 | 6,004 |
| International Junior Golf Training Acquisition Company | Service-golf training | Senior Term Debt (13.0%, Due 6/2012) ⁽³⁾⁽⁵⁾ | 6,632 | 6,450 |
| Interfilm Holdings, Inc. | Service-slit and distributor of plastic films | Line of Credit, \$100 available (8.5%, Due 3/2013) | 3,560 | 2,937 |
| | | Line of Credit, \$100 available (8.5%, Due 3/2013) | | |
| | | Senior Term Debt (8.5%, Due 3/2013) ⁽⁵⁾ | 4,301 | 2,519 |
| | | Common Stock Warrants ⁽⁷⁾⁽⁸⁾ | 66 | |
| | | Senior Term Debt (12.3%, Due 10/2012) ⁽⁵⁾ | 2,400 | 2,382 |
| | | Line of Credit, \$1,500 available (9.0%, Due 5/2011) ⁽⁵⁾ | | |
| | | Senior Term Debt (8.5%, Due 5/2012) ⁽⁵⁾ | 1,557 | 1,537 |
| | | Senior Term Debt (10.5%, Due 5/2012) ⁽³⁾⁽⁵⁾ | 2,500 | 2,456 |

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| | | | | |
|--|---|--|-------|-------|
| KMBQ Corporation | Service-AM/FM radio broadcaster | Line of Credit, \$39 available (non-accrual, Due 7/2010) ⁽⁵⁾⁽⁸⁾⁽¹⁰⁾ | 161 | 16 |
| | | Senior Term Debt (non-accrual, Due 7/2010) ⁽⁵⁾⁽⁸⁾⁽¹⁰⁾ | 1,921 | 192 |
| Legend Communications of Wyoming LLC | Service-operator of radio stations | Senior Term Debt (12.0%, Due 6/2013) ⁽⁵⁾ | 9,880 | 6,422 |
| Newhall Holdings, Inc. | Service-distributor of personal care products and supplements | Line of Credit, \$0 available (5.0%, Due 12/2012) ⁽⁵⁾ | 1,350 | 1,269 |
| | | Senior Term Debt (5) (5.0%, Due 12/2012) ⁽⁵⁾ | 3,870 | 3,638 |
| | | Senior Term Debt (5.0%, Due 12/2012) ⁽³⁾⁽⁵⁾ | 4,648 | 4,323 |
| | | Preferred Equity ⁽⁷⁾⁽⁸⁾ Common Stock ⁽⁷⁾⁽⁸⁾ | | |
| Northern Contours, Inc. | Manufacturing-veneer and laminate components | Senior Subordinated Term Debt (13.0%, Due 9/2012) ⁽⁵⁾ | 6,301 | 5,765 |
| Northstar Broadband, LLC | Service-cable TV franchise owner | Senior Term Debt (0.7%, Due 12/2012) ⁽⁵⁾ | 117 | 102 |
| Pinnacle Treatment Centers, Inc. | Service-Addiction treatment centers | Line of Credit, \$350 available (12.0%, Due 10/2010) ⁽⁵⁾⁽¹²⁾ | 150 | 150 |
| | | Senior Term Debt (10.5%, Due 12/2011) ⁽⁵⁾ | 1,950 | 1,945 |
| | | Senior Term Debt (10.5%, Due 12/2011) ⁽³⁾⁽⁵⁾ | 7,500 | 7,481 |
| Precision Acquisition Group Holdings, Inc. | Manufacturing-consumable components for the aluminum industry | Equipment Note (13.0%, Due 10/2010) ⁽⁵⁾⁽¹³⁾ | 1,000 | 950 |
| | | Senior Term Debt (13.0%, Due 10/2010) ⁽⁵⁾⁽¹³⁾ | 4,125 | 3,919 |
| | | Senior Term Debt (13.0%, Due 10/2010) ⁽³⁾⁽⁵⁾⁽¹³⁾ | 4,053 | 3,850 |

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GLADSTONE CAPITAL CORPORATION
CONSOLIDATED SCHEDULE OF INVESTMENTS
SEPTEMBER 30, 2010
(DOLLAR AMOUNTS IN THOUSANDS)

| Company⁽¹⁾ | Industry | Investment⁽²⁾ | Cost | Fair Value |
|---|--|--|-------------|-------------------|
| PROFITSystems Acquisition Co. | Service-design and develop ERP software | Line of Credit, \$350 available (4.5%, Due 7/2011) | \$ | \$ |
| | | Senior Term Debt (8.5%, Due 7/2011) ⁽⁵⁾ | 1,000 | 940 |
| | | Senior Term Debt (10.5%, Due 7/2011) ⁽³⁾⁽⁵⁾ | 2,900 | 2,697 |
| RCS Management Holding Co. | Service-healthcare supplies | Senior Term Debt (9.5%, Due 1/2011) ⁽³⁾⁽⁵⁾ | 1,937 | 1,918 |
| | | Senior Term Debt (11.5%, Due 1/2011) ⁽⁴⁾⁽⁵⁾ | 3,060 | 3,029 |
| Reliable Biopharmaceutical Holdings, Inc. | Manufacturing-pharmaceutical and biochemical intermediates | Line of Credit, \$3,800 available (9.0%, Due 10/2010) ⁽⁵⁾⁽¹⁴⁾ | 1,200 | 1,188 |
| | | Mortgage Note (9.5%, Due 10/2014) ⁽⁵⁾ | 7,255 | 7,201 |
| | | Senior Term Debt (9.0%, Due 10/2012) ⁽⁵⁾ | 1,080 | 1,069 |
| | | Senior Term Debt (11.0%, Due 10/2012) ⁽³⁾⁽⁵⁾ | 11,693 | 11,386 |
| | | Senior Subordinated Term Debt (12.0%, Due 10/2013) ⁽⁵⁾ | 6,000 | 5,730 |
| Saunders & Associates | Manufacturing-equipment provider for frequency control devices | Common Stock Warrants ⁽⁷⁾⁽⁸⁾ | 209 | |
| | | Senior Term Debt (9.8%, Due 5/2013) ⁽⁵⁾ | 8,947 | 8,935 |
| SCI Cable, Inc. | Service-cable, internet, voice provide | Senior Term Debt (non-accrual, Due 10/2012) ⁽⁵⁾⁽⁸⁾⁽¹⁰⁾ | 450 | 140 |
| | | Senior Term Debt (non-accrual, Due 10/2012) ⁽⁵⁾⁽⁸⁾⁽¹⁰⁾ | 2,931 | 352 |
| Sunburst Media Louisiana, LLC | Service-radio station operator | Senior Term Debt (10.5%, Due 6/2011) ⁽⁵⁾ | 6,391 | 5,100 |
| Sunshine Media Holdings | Service-publisher regional B2B trade magazines | Line of credit, \$401 available (10.5%, Due 2/2011) ⁽⁵⁾ | 1,599 | 1,499 |
| | | Senior Term Debt (10.5%, Due 5/2012) ⁽⁵⁾ | 16,948 | 15,889 |
| | | Senior Term Debt (13.3%, Due 5/2012) ⁽³⁾⁽⁵⁾ | 10,700 | 9,898 |
| Thibaut Acquisition Co. | Service-design and distribute wall covering | Senior Term Debt (8.5%, Due 1/2011) ⁽⁵⁾ | 1,000 | 970 |
| | | Senior Term Debt (8.5%, Due 1/2011) ⁽⁵⁾ | 1,075 | 1,043 |
| | | Senior Term Debt (12.0%, Due 1/2011) ⁽³⁾⁽⁵⁾ | 3,000 | 2,888 |
| Viapack, Inc. | Manufacturing-polyethylene film | Senior Real Estate Term Debt (10.0%, Due 3/2011) ⁽⁵⁾ | 675 | 672 |
| | | Senior Term Debt (13.0%, Due 3/2011) ⁽³⁾⁽⁵⁾ | 4,005 | 3,990 |
| Westlake Hardware, Inc. | Retail-hardware and variety | Senior Subordinated Term Debt (12.3%, Due 1/2014) ⁽⁵⁾ | 12,000 | 11,820 |
| | | Senior Subordinated Term Debt (13.5%, Due 1/2014) ⁽⁵⁾ | 8,000 | 7,800 |
| Winchester Electronics | Manufacturing-high bandwidth connectors and cables | Senior Term Debt (5.3%, Due 5/2012) ⁽⁵⁾ | 1,250 | 1,244 |
| | | Senior Term Debt (6.0%, Due 5/2013) ⁽⁵⁾ | 1,686 | 1,661 |

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| | | |
|--|-------|-------|
| Senior Subordinated Term Debt (14.0%, Due 6/2013) ⁽⁵⁾ | 9,875 | 9,603 |
|--|-------|-------|

*Subtotal
Non-syndicated
loans*

| | |
|---------|---------|
| 225,798 | 206,326 |
|---------|---------|

Syndicated Loans:

| | | | | |
|---|--|---|-------|-------|
| Airvana Network Solutions, Inc | Service-telecommunications | Senior Term Debt (11.0%, Due 8/2014) ⁽⁶⁾ | 8,858 | 8,942 |
| Puerto Rico Cable Acquisition Company, Inc. | Service-telecommunications | Senior Subordinated Term Debt (7.9%, Due 1/2012) ⁽⁶⁾ | 7,159 | 6,427 |
| WP Evenflo Group Holdings Inc. | Manufacturing-infant and juvenile products | Senior Term Debt (8.0%, Due 2/2013) ⁽⁶⁾ | 1,881 | 1,655 |
| | | Senior Preferred Equity ⁽⁷⁾⁽⁸⁾ | 333 | 379 |
| | | Junior Preferred Equity ⁽⁷⁾⁽⁸⁾ | 111 | 8 |
| | | Common Stock ⁽⁷⁾⁽⁸⁾ | | |

*Subtotal
Syndicated loans*

| | |
|--------|--------|
| 18,342 | 17,411 |
|--------|--------|

Total Non-Control/Non-Affiliate Investments (represents 87% of total investments at fair value)

| | |
|-------------------|-------------------|
| \$ 244,140 | \$ 223,737 |
|-------------------|-------------------|

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GLADSTONE CAPITAL CORPORATION
CONSOLIDATED SCHEDULE OF INVESTMENTS
SEPTEMBER 30, 2010
(DOLLAR AMOUNTS IN THOUSANDS)

| Company ⁽¹⁾ | Industry | Investment ⁽²⁾ | Cost | Fair Value |
|--|---|---|---|-----------------------|
| CONTROL INVESTMENTS | | | | |
| BERTL, Inc. | Service-web-based evaluator of digital imaging products | Line of Credit, \$302 available (non-accrual, Due 10/2010) ⁽⁷⁾⁽⁸⁾⁽¹⁰⁾⁽¹¹⁾ Common Stock ⁽⁷⁾⁽⁸⁾ | \$ 1,319 424 | |
| Defiance Integrated Technologies, Inc. | Manufacturing-trucking parts | Senior Term Debt (11.0%, Due 4/2013) ⁽³⁾⁽⁵⁾ Common Stock ⁽⁷⁾⁽⁸⁾ Guaranty (\$250) | 8,325 1 | 8,325 1,543 |
| Lindmark Acquisition, LLC | Service-advertising | Senior Subordinated Term Debt (non-accrual, Due 10/2012) ⁽⁵⁾⁽⁸⁾⁽⁹⁾⁽¹⁰⁾ Senior Subordinated Term Debt (non-accrual, Due 12/2010) ⁽⁵⁾⁽⁸⁾⁽⁹⁾⁽¹⁰⁾ Senior Subordinated Term Debt (non-accrual, Due Upon Demand) ⁽⁵⁾⁽⁸⁾⁽⁹⁾⁽¹⁰⁾ Common Stock ⁽⁷⁾⁽⁸⁾ | 10,000 2,000 1,794 1 | 5,000 1,000 897 |
| LocalTel, LLC | Service-yellow pages publishing | Line of credit, \$152 available (non-accrual, Due 12/2010) ⁽⁷⁾⁽⁸⁾⁽¹⁰⁾ Line of Credit, \$1,830 available (non-accrual, Due 6/2011) ⁽⁷⁾⁽⁸⁾⁽¹⁰⁾ Senior Term Debt (non-accrual, Due 6/2011) ⁽⁷⁾⁽⁸⁾⁽¹⁰⁾ Senior Term Debt (non-accrual, Due 6/2011) ⁽⁷⁾⁽⁸⁾⁽¹⁰⁾ Senior Term Debt (non-accrual, Due 6/2011) ⁽³⁾⁽⁷⁾⁽⁸⁾⁽¹⁰⁾ Common Stock Warrants ⁽⁷⁾⁽⁸⁾ | 1,698 325 1,170 2,688 2,750 | 1,063 |
| Midwest Metal Distribution, Inc. | Distribution-aluminum sheets and stainless steel | Senior Subordinated Term Debt (12.0%, Due 7/2013) ⁽⁵⁾ Common Stock ⁽⁷⁾⁽⁸⁾ | 18,254 138 | 15,539 |
| U.S. Healthcare Communications, Inc. | Service-magazine publisher/operator | Line of credit, \$131 available (non-accrual, Due 12/2010) ⁽⁷⁾⁽⁸⁾⁽¹⁰⁾ Line of credit, \$0 available (non-accrual, Due 12/2010) ⁽⁷⁾⁽⁸⁾⁽¹⁰⁾ Common Stock ⁽⁷⁾⁽⁸⁾ | 269 450 2,470 | 5 |
| Total Control Investments (represents 13% of total investments at fair value) | | | \$ 54,076 | \$ 33,372 |
| Total Investments ⁽¹⁵⁾ | | | \$ 298,216 | \$ 257,109 |

(1) Certain of the listed securities are issued by affiliate(s) of the indicated portfolio company.

- (2) Percentage represents interest rates in effect at September 30, 2010 and due date represents the contractual maturity date.
- (3) Last Out Tranche (LOT) of senior debt, meaning if the portfolio company is liquidated, the holder of the LOT is paid after the senior debt.
- (4) LOT of senior debt, meaning if the portfolio company is liquidated, the holder of the LOT is paid after the senior debt, however, the debt is also junior to another LOT.
- (5) Fair value was primarily based on opinions of value submitted by Standard & Poor's Securities Evaluations, Inc.
- (6) Security valued based on the indicative bid price on or near September 30, 2010, offered by the respective syndication agent's trading desk or secondary desk.
- (7) Fair value was primarily based on the total enterprise value of the portfolio company using a liquidity waterfall approach. The Company also considered discounted cash flow methodologies.
- (8) Security is non-income producing.
- (9) Lindmark's loan agreement was amended in March 2009 such that any unpaid current interest accrues as a success fee. The success fee is not recorded until paid (see Note 2, Summary of Significant Accounting Policies *Investment Income Recognition*).
- (10) BERTL, KMBQ, Lindmark, LocalTel, SCI Cable and U.S. Healthcare are currently past due on interest payments and are on non-accrual.
- (11) BERTL's interest includes past due interest transferred to principal (see Note 2, Summary of Significant Accounting Policies *Investment Income Recognition*). Subsequent to September 30, 2010, BERTL's line of credit maturity date was extended to October 2011.
- (12) Subsequent to September 30, 2010, Pinnacle's line of credit maturity date was extended to January 2011.
- (13) Subsequent to September 30, 2010, Precision's equipment note and senior term loan maturity dates were extended to November 2010.
- (14) Subsequent to September 30, 2010, Reliable's line of credit limit was reduced to \$3,500, the interest rate floor was increased to 10.0% and the maturity date was extended to January 2011.
- (15) Aggregate gross unrealized depreciation for federal income tax purposes is \$1,919; aggregate gross unrealized appreciation for federal income tax purposes is \$43,023. Net unrealized depreciation is \$41,104 based on a tax cost of \$298,186.

THE ACCOMPANYING NOTES ARE AN INTEGRAL PART OF THESE CONDENSED CONSOLIDATED FINANCIAL STATEMENTS.

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GLADSTONE CAPITAL CORPORATION
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)
MARCH 31, 2011
(DOLLAR AMOUNTS IN THOUSANDS, EXCEPT PER SHARE DATA AND AS OTHERWISE INDICATED)

NOTE 1. ORGANIZATION

Gladstone Capital Corporation (the Company) was incorporated under the General Corporation Laws of the State of Maryland on May 30, 2001. The Company is a closed-end, non-diversified management investment company that has elected to be treated as a business development company under the Investment Company Act of 1940, as amended (the 1940 Act). In addition, the Company has elected to be treated for tax purposes as a regulated investment company (RIC) under the Internal Revenue Code of 1986, as amended (the Code). The Company's 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 that are substantially owned by leveraged buyout funds, individual investors or are family-owned businesses, with a particular focus on senior notes. In addition, the Company may acquire from others existing loans that meet this profile.

Gladstone Business Loan, LLC (Business Loan), a wholly-owned subsidiary of the Company, was established on February 3, 2003 for the purpose of holding the Company's portfolio of loan investments. Gladstone Capital Advisers, Inc. established on December 30, 2003, is also a wholly-owned subsidiary of the Company.

Northern Virginia SBIC, LP (Northern Virginia SBIC) and Northern Virginia SBIC GP, LLC, the general partner of Northern Virginia SBIC, were established on December 4, 2008 as wholly-owned subsidiaries of the Company for the purpose of applying for and holding a license to enable the Company, through Northern Virginia SBIC, to make investments in accordance with the United States Small Business Administration guidelines for small business investment companies.

Gladstone Financial Corporation (Gladstone Financial), a wholly-owned subsidiary of the Company, was established on November 21, 2006 for the purpose of holding a license to operate as a Specialized Small Business Investment Company. Gladstone Financial (previously known as Gladstone SSBIC Corporation) acquired this license in February 2007. This will enable the Company, through this subsidiary, to make investments in accordance with the United States Small Business Administration guidelines for specialized small business investment companies.

The financial statements of all of the aforementioned subsidiaries are consolidated with those of the Company. The Company is externally managed by Gladstone Management Corporation (the Adviser), an affiliate of the Company.

NOTE 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Unaudited Interim Financial Statements and Basis of Presentation

Interim financial statements of the Company are prepared in accordance with accounting principles generally accepted in the United States of America (GAAP) for interim financial information and pursuant to the requirements for reporting on Form 10-Q and Article 10 of Regulation S-X under the Securities Act of 1933, as amended (the Securities Act).

Accordingly, certain disclosures accompanying annual financial statements prepared in accordance with GAAP are omitted. The accompanying condensed consolidated financial statements include the accounts of the Company and its wholly-owned subsidiaries. All significant intercompany balances and transactions have been eliminated. Under Article 6 of Regulation S-X under the Securities Act, and the authoritative accounting guidance provided by the AICPA Audit and Accounting Guide for Investment Companies, the Company is not permitted to consolidate any portfolio company investments, including those in which the Company has a controlling interest. In the opinion of the Company's management, all adjustments, consisting solely of normal recurring accruals, necessary for the fair statement of financial statements for the interim periods have been included. The results of operations for the six months ended March 31, 2011 are not necessarily indicative of results that ultimately may be achieved for the year. The interim financial statements and notes thereto should be read in conjunction with the financial statements and notes thereto included in the Company's Form 10-K for the fiscal year ended September 30, 2010, as filed with the Securities and Exchange Commission (the SEC) on November 22, 2010.

The year-end *Condensed Consolidated Statement of Assets and Liabilities* contained elsewhere in this report was derived from audited financial statements but does not include all disclosures required by GAAP.

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Reclassifications

Certain amounts in the prior period's financial statements have been reclassified to conform to the presentation for the period ended March 31, 2011 with no effect to net increase in net assets resulting from operations.

Investment Valuation Policy

The Company carries its investments at market value to the extent that market quotations are readily available and reliable, and otherwise at fair value, as determined in good faith by its Board of Directors. In determining the fair value of the Company's investments, the Adviser has established an investment valuation policy (the Policy). The Policy has been approved by the Company's Board of Directors, and each quarter the Board of Directors reviews whether the Adviser has applied the Policy consistently and votes whether or not to accept the recommended valuation of the Company's investment portfolio.

The Company uses generally accepted valuation techniques to value its portfolio unless the Company has specific information about the value of an investment to determine otherwise. From time to time the Company may accept an appraisal of a business in which the Company holds securities. These appraisals are expensive and occur infrequently but provide a third-party valuation opinion that may differ in results, techniques and scopes used to value the Company's investments. When these specific third-party appraisals are sought, the Company uses estimates of value provided by such appraisals and its own assumptions, including estimated remaining life, current market yield and interest rate spreads of similar securities as of the measurement date, to value the investment the Company has in that business.

The Policy, summarized below, applies to publicly-traded securities, securities for which a limited market exists and securities for which no market exists.

Publicly-traded securities: The Company determines the value of publicly-traded securities based on the closing price for the security on the exchange or securities market on which it is listed and primarily traded on the valuation date. To the extent that the Company owns restricted securities that are not freely tradable, but for which a public market otherwise exists, the Company will use the market value of that security adjusted for any decrease in value resulting from the restrictive feature.

Securities for which a limited market exists: The Company values securities that are not traded on an established secondary securities market, but for which a limited market for the security exists, such as certain participations in, or assignments of, syndicated loans, at the quoted bid price. In valuing these assets, the Company assesses trading activity in an asset class and evaluates variances in prices and other market insights to determine if any available quote prices are reliable. If the Company concludes that quotes based on active markets or trading activity may be relied upon, firm bid prices are requested; however, if a firm bid price is unavailable, the Company bases the value of the security upon the indicative bid price (IBP) offered by the respective originating syndication agent's trading desk, or secondary desk, on or near the valuation date. To the extent that the Company uses the IBP as a basis for valuing the security, the Adviser may take further steps to consider additional information to validate that price in accordance with the Policy.

In the event these limited markets become illiquid such that market prices are no longer readily available, the Company will value its syndicated loans using alternative methods, such as estimated net present values of the future cash flows or discounted cash flows (DCF). The use of a DCF methodology follows that prescribed by the Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) 820, Fair Value Measurements and Disclosures, which provides guidance on the use of a reporting entity's own assumptions about future cash flows and risk-adjusted discount rates when relevant observable inputs, such as quotes in active markets, are not available. When relevant observable market data does not exist, the alternative outlined in ASC 820 is the valuation of investments based on DCF. For the purposes of using DCF to provide fair value estimates, the Company considers multiple inputs such as a risk-adjusted discount rate that incorporates adjustments that market participants would make both for nonperformance and liquidity risks. As such, the Company develops a modified discount rate approach that incorporates risk premiums including, among others, increased probability of default, or higher loss given default or increased liquidity risk. The DCF valuations applied to the syndicated loans provide an estimate of what the Company believes a market participant would pay to purchase a syndicated loan in an active market, thereby establishing a fair value. The Company will apply the DCF methodology in illiquid markets until quoted prices are available or are

deemed reliable based on trading activity.

As of March 31, 2011, the Company assessed trading activity in its syndicated loan assets and determined that there continued to be market liquidity and a secondary market for these assets. Thus, firm bid prices, or IBPs, were used to fair value the Company's syndicated loans as of March 31, 2011.

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Securities for which no market exists: The valuation methodology for securities for which no market exists falls into four categories: (1) portfolio investments comprised solely of debt securities; (2) portfolio investments in controlled companies comprised of a bundle of securities, which can include debt and equity securities; (3) portfolio investments in non-controlled companies comprised of a bundle of investments, which can include debt and equity securities; and (4) portfolio investments comprised of non-publicly-traded non-control equity securities of other funds.

(1) Portfolio investments comprised solely of debt securities: Debt securities that are not publicly traded on an established securities market, or for which a limited market does not exist (Non-Public Debt Securities), and that are issued by portfolio companies in which the Company has no equity or equity-like securities, are fair valued in accordance with the terms of the Policy, which utilizes opinions of value submitted to the Company by Standard & Poor's Securities Evaluations, Inc. (SPSE). The Company may also submit paid in kind (PIK) interest to SPSE for its evaluation when it is determined that PIK interest is likely to be received.

(2) Portfolio investments in controlled companies comprised of a bundle of investments, which can include debt and equity securities: The fair value of these investments is determined based on the total enterprise value (TEV) of the portfolio company, or issuer, utilizing a liquidity waterfall approach under ASC 820 for the Company's Non-Public Debt Securities and equity or equity-like securities (e.g. preferred equity, common equity, or other equity-like securities) that are purchased together as part of a package, where the Company has control or could gain control through an option or warrant security; both the debt and equity securities of the portfolio investment would exit in the mergers and acquisition market as the principal market, generally through a sale or recapitalization of the portfolio company. In accordance with ASC 820, the Company applies the in-use premise of value which assumes the debt and equity securities are sold together. Under this liquidity waterfall approach, the Company first calculates the TEV of the issuer by incorporating some or all of the following factors to determine the TEV of the issuer:

the issuer's ability to make payments;

the earnings of the issuer;

recent sales to third parties of similar securities;

the comparison to publicly traded securities; and

DCF or other pertinent factors.

In gathering the sales to third parties of similar securities, the Company may reference industry statistics and use outside experts. Once the Company has estimated the TEV of the issuer, the Company will subtract the value of all the debt securities of the issuer, which are valued at the contractual principal balance. Fair values of these debt securities are discounted for any shortfall of TEV over the total debt outstanding for the issuer. Once the values for all outstanding senior securities (which include the debt securities) have been subtracted from the TEV of the issuer, the remaining amount, if any, is used to determine the value of the issuer's equity or equity-like securities. If, in the Adviser's judgment, the liquidity waterfall approach does not accurately reflect the value of the debt component, the Adviser may recommend that the Company use a valuation by SPSE, or, if that is unavailable, a DCF valuation technique.

(3) Portfolio investments in non-controlled companies comprised of a bundle of investments, which can include debt and equity securities: The Company values Non-Public Debt Securities that are purchased together with equity or equity-like securities from the same portfolio company, or issuer, for which the Company does not control or cannot gain control as of the measurement date, using a hypothetical secondary market as the Company's principal market. In accordance with ASC 820, the Company determines its fair value of these debt securities of non-control investments assuming the sale of an individual debt security using the in-exchange premise of value. As such, the Company estimates the fair value of the debt component using estimates of value provided by SPSE and its own assumptions in the absence of observable market data, including synthetic credit

ratings, estimated remaining life, current market yield and interest rate spreads of similar securities as of the measurement date. Subsequent to June 30, 2009, for equity or equity-like securities of investments for which the Company does not control or cannot gain control as of the measurement date, the Company estimates the fair value of the equity using the in-exchange premise of value based on factors such as the overall value of the issuer, the relative fair value of other units of account including debt, or other relative value approaches. Consideration is also given to capital structure and other contractual obligations that may impact the fair value of the equity. Further, the Company may utilize comparable values of similar companies, recent investments and indices with similar structures and risk characteristics or its own assumptions in the absence of other observable market data and may also employ DCF valuation techniques.

- (4) **Portfolio investments comprised of non-publicly traded non-control equity securities of other funds:** The Company values any uninvested capital of the non-control fund at par value and values any invested capital at the value provided by the non-control fund.

Due to the uncertainty inherent in the valuation process, such estimates of fair value may differ significantly from the values that

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would have been obtained had a ready market for the securities existed, and the differences could be material. Additionally, changes in the market environment and other events that may occur over the life of the investments may cause the gains or losses ultimately realized on these investments to be different than the valuations currently assigned. There is no single standard for determining fair value in good faith, as fair value depends upon circumstances of each individual case. In general, fair value is the amount that the Company might reasonably expect to receive upon the current sale of the security in an arms-length transaction in the security's principal market. Refer to Note 3 below for additional information regarding fair value measurements and the Company's adoption of ASC 820.

Investment Income Recognition

Interest income, adjusted for amortization of premiums and acquisition costs, the accretion of discounts and the amortization of amendment fees, is recorded on the accrual basis to the extent that such amounts are expected to be collected. Generally, when a loan becomes 90 days or more past due, or if the Company's qualitative assessment indicates that the debtor is unable to service its debt or other obligations, the Company will place the loan on non-accrual status and cease recognizing interest income on that loan until the borrower has demonstrated the ability and intent to pay contractual amounts due. However, the Company remains contractually entitled to this interest. Interest payments received on non-accrual loans may be recognized as income or applied to principal depending upon management's judgment. Non-accrual loans are restored to accrual status when past due principal and interest are paid and, in management's judgment, are likely to remain current, or due to a restructuring such that the interest income is deemed to be collectible. As of March 31, 2011, two Non-Control/Non-Affiliate investments and four Control investments were on non-accrual with an aggregate cost basis of approximately \$30.4 million, or 9.7% of the cost basis of all loans in the Company's portfolio. As of September 30, 2010, two Non-Control/Non-Affiliate investments and four Control investments were on non-accrual with an aggregate cost basis of approximately \$29.9 million, or 10.0% of the cost basis of all loans in the Company's portfolio.

As of March 31, 2011, the Company had loans in its portfolio which contain a PIK provision. The PIK interest, computed at the contractual rate specified in each loan agreement, is added to the principal balance of the loan and recorded as income. To maintain the Company's status as a RIC, this non-cash source of income must be paid out to stockholders in the form of distributions, even though the Company has not yet collected the cash. The Company recorded PIK income of \$4 and \$8 for the three and six months ended March 31, 2011, respectively, as compared to \$4 and \$60 for the three and six months ended March 31, 2010, respectively.

The Company also transfers past due interest to the principal balance as stipulated in certain loan amendments with portfolio companies. The Company transferred past due interest to the principal balance of \$0.2 million for both the three and six months ended March 31, 2011, as compared to \$0.3 million and \$0.4 million for the three and six months ended March 31, 2010, respectively.

As of March 31, 2011, the Company had fifteen original issue discount (OID) loans. The Company recorded OID income of \$29 and \$53 for the three and six months ended March 31, 2011, respectively, as compared to \$2 for both the three and six months ended March 31, 2010.

Success fees are recorded upon receipt. Success fees are contractually due upon a change of control in a portfolio company and are recorded in Other income in the accompanying *Condensed Consolidated Statements of Operations*. The Company recorded \$0.6 million of success fees during the six months ended March 31, 2011, which resulted from the exits of Pinnacle Treatment Centers, Inc. and Interfilm Holdings, Inc. During the six months ended March 31, 2010, the Company received \$1.4 million in success fees from the exits of ActivStyle Acquisition Co., Saunders & Associates, Visual Edge Technology, Inc., Tulsa Welding School, and the prepayment of success fees from Doe & Ingalls Management LLC.

NOTE 3. INVESTMENTS

ASC 820 defines fair value, establishes a framework for measuring fair value and expands disclosures about assets and liabilities measured at fair value. ASC 820 provides a consistent definition of fair value that focuses on exit price in the principal, or most advantageous, market and prioritizes, within a measurement of fair value, the use of market-based inputs over entity-specific inputs. ASC 820 also establishes the following three-level hierarchy for fair value measurements based upon the transparency of inputs to the valuation of an asset or liability as of the

measurement date.

Level 1 inputs to the valuation methodology are quoted prices (unadjusted) for identical assets or liabilities in active markets;

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Level 2 inputs to the valuation methodology include quoted prices for similar assets and liabilities in active markets, and inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the financial instrument. Level 2 inputs are in those markets for which there are few transactions, the prices are not current, little public information exists or instances where prices vary substantially over time or among brokered market makers; and

Level 3 inputs to the valuation methodology are unobservable and significant to the fair value measurement. Unobservable inputs are those inputs that reflect the Company's own assumptions that market participants would use to price the asset or liability based upon the best available information.

As of March 31, 2011 and September 30, 2010, all of the Company's investments were valued using Level 3 inputs. The following tables present the financial instruments carried at fair value as of March 31, 2011 and September 30, 2010, by caption on the accompanying *Condensed Consolidated Statements of Assets and Liabilities* for each of the three levels of hierarchy established by ASC 820:

| | Level 3 Investments | |
|---|---|-------------------------------|
| | Total Fair Value Reported in Condensed Consolidated Statements of Assets and Liabilities | |
| | March 31, 2011 | September 30, 2010 |
| Non-Control/Non-Affiliate Investments | | |
| Senior term debt | \$ 151,512 | \$ 163,203 |
| Senior subordinated term debt | 55,552 | 59,463 |
| Preferred equity | 538 | 387 |
| Common equity/equivalents | 859 | 684 |
| Total Non-Control/Non-Affiliate investments at fair value | 208,461 | 223,737 |
| Control Investments | | |
| Senior term debt | \$ 22,090 | \$ 9,393 |
| Senior subordinated term debt | 21,047 | 22,436 |
| Common equity/equivalents | 5,515 | 1,543 |
| Total Control investments at fair value | 48,652 | 33,372 |
| Total investments at fair value | \$ 257,113 | \$ 257,109 |

Changes in Level 3 Fair Value Measurements of Investments

The following tables provide a roll-forward in the changes in fair value during the three-month period from December 31, 2010 to March 31, 2011, and for the six-month period from September 30, 2010 to March 31, 2011, for all investments for which the Company determines fair value using unobservable (Level 3) factors. When a determination is made to classify a financial instrument within Level 3 of the valuation hierarchy, the determination is based upon the significance of the unobservable factors to the overall fair value measurement. However, Level 3 financial instruments typically include, in addition to the unobservable or Level 3 components, observable components (that is, components that are actively quoted and can be validated to external sources). Accordingly, the gains and losses in the tables below include changes in fair value due in part to observable factors that are part of the valuation methodology. Two tables are provided for each period: the first table is broken out by Control and Non-Control/Non-Affiliate investment classification, and the second table is broken out by major security type.

Fair value measurements using unobservable data inputs (Level 3)**Periods ended March 31, 2011:**

| | Non-Control/ Non-Affiliate Investments | Control Investments | Total |
|---|---|--------------------------------|-------------------|
| Three months ended March 31, 2011: | | | |
| Fair value at December 31, 2010 | \$ 216,612 | \$ 35,893 | \$ 252,505 |
| Net realized gain | 163 | | 163 |
| Net unrealized depreciation ⁽¹⁾ | (2,810) | (10,049) | (12,859) |
| Reversal of prior period net appreciation on realization ⁽¹⁾ | (210) | | (210) |
| Issuances/Originations ⁽²⁾ | 38,829 | 2,008 | 40,837 |
| Settlements/Repayments | (21,888) | (695) | (22,583) |
| Sales | | (740) | (740) |
| Transfer ⁽³⁾ | (22,235) | 22,235 | |
| Fair value as of March 31, 2011 | \$ 208,461 | \$ 48,652 | \$ 257,113 |

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| | Non-Control/ Non-Affiliate Investments | Control Investments | Total |
|---|---|--------------------------------|-------------------|
| Six months ended March 31, 2011: | | | |
| Fair value at September 30, 2010 | \$ 223,737 | \$ 33,372 | \$ 257,109 |
| Net realized gain | 163 | | 163 |
| Net unrealized depreciation ⁽¹⁾ | (8,355) | (7,952) | (16,307) |
| Reversal of prior period net depreciation on realization ⁽¹⁾ | 293 | | 293 |
| Issuances/Originations ⁽²⁾ | 50,125 | 2,511 | 52,636 |
| Settlements/Repayments | (35,230) | (774) | (36,004) |
| Sales | (37) | (740) | (777) |
| Transfer ⁽³⁾ | (22,235) | 22,235 | |
| Fair value as of March 31, 2011 | \$ 208,461 | \$ 48,652 | \$ 257,113 |

| | Senior Term Debt | Senior Subordinated Term Debt | Preferred Equity | Common Equity/ Equivalents | Total |
|--|---------------------------------|--|-----------------------------|---|-------------------|
| Three months ended March 31, 2011: | | | | | |
| Fair value at December 31, 2010 | \$ 169,882 | \$ 76,999 | \$ 523 | \$ 5,101 | \$ 252,505 |
| Net realized gain (loss) | 177 | (14) | | | 163 |
| Net unrealized (depreciation) appreciation ⁽¹⁾ | (11,268) | (1,364) | (361) | 134 | (12,859) |
| Reversal of prior period net appreciation on realization ⁽¹⁾ | (210) | | | | (210) |
| Issuances/Originations ⁽²⁾ | 37,544 | 1,038 | 375 | 1,880 | 40,837 |
| Settlements/Repayments | (22,523) | (60) | | | (22,583) |
| Sales | | | | (740) | (740) |
| Fair value as of March 31, 2011 | \$ 173,602 | \$ 76,599 | \$ 537 | \$ 6,375 | \$ 257,113 |

| | Senior Term Debt | Senior Subordinated Term Debt | Preferred Equity | Common Equity/ Equivalents | Total |
|--|---------------------------------|--|-----------------------------|---|--------------|
| Six months ended March 31, 2011: | | | | | |
| Fair value at September 30, 2010 | \$ 172,596 | \$ 81,899 | \$ 386 | \$ 2,228 | \$ 257,109 |
| Net realized gain (loss) | 177 | (14) | | | 163 |
| Net unrealized (depreciation) appreciation ⁽¹⁾ | (17,218) | (1,839) | (224) | 2,974 | (16,307) |
| Reversal of prior period net (appreciation) depreciation on realization ⁽¹⁾ | (191) | 731 | | (247) | 293 |
| Issuances/Originations ⁽²⁾ | 46,942 | 3,122 | 375 | 2,197 | 52,636 |

| | | | | | |
|--|------------------|-----------------|---------------|----------------|------------------|
| Settlements/Repayments | (28,704) | (7,300) | | | (36,004) |
| Sales | | | | (777) | (777) |
| Fair value as of March 31, 2011 | \$173,602 | \$76,599 | \$ 537 | \$6,375 | \$257,113 |

Periods ended March 31, 2010:

| | Non-Control/ Non-Affiliate Investments | Control Investments | Total |
|---|---|--------------------------------|-------------------|
| Three months ended March 31, 2010: | | | |
| Fair value at December 31, 2009 | \$ 272,380 | \$ 34,258 | \$ 306,638 |
| Net realized gain ⁽²⁾ | 892 | | 892 |
| Net unrealized appreciation (depreciation) ⁽¹⁾ | 1,018 | (566) | 452 |
| Reversal of prior period net depreciation on realization ⁽¹⁾ | 2,031 | | 2,031 |
| Issuances/Originations ⁽²⁾ | 3,308 | 1,832 | 5,140 |
| Settlements/Repayments | (23,065) | | (23,065) |
| Sales | (337) | | (337) |
| Fair value as of March 31, 2010 | \$ 256,227 | \$ 35,524 | \$ 291,751 |

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| | Non-Control/ Non-Affiliate Investments | Control Investments | Total |
|---|---|--------------------------------|-------------------|
| Six months ended March 31, 2010: | | | |
| Fair value at September 30, 2009 | \$ 286,997 | \$ 33,972 | \$ 320,969 |
| Net realized loss ⁽²⁾ | (28) | | (28) |
| Net unrealized appreciation (depreciation) ⁽¹⁾ | 3,211 | (1,566) | 1,645 |
| Reversal of prior period net depreciation on realization ⁽¹⁾ | 3,437 | | 3,437 |
| Issuances/Originations ⁽²⁾ | 4,202 | 3,118 | 7,320 |
| Settlements/Repayments | (38,473) | | (38,473) |
| Sales | (3,119) | | (3,119) |
| Fair value as of March 31, 2010 | \$ 256,227 | \$ 35,524 | \$ 291,751 |

| | Senior Term Debt | Senior Subordinated Term Debt | Preferred Equity | Common Equity/ Equivalents | Total |
|--|---------------------------------|--|-----------------------------|---|-------------------|
| Three months ended March 31, 2010: | | | | | |
| Fair value at December 31, 2009 | \$ 198,577 | \$ 106,609 | \$ | \$ 1,452 | \$ 306,638 |
| Net realized (loss) gain | (312) | (163) | | 1,367 | 892 |
| Net unrealized appreciation (depreciation) ⁽¹⁾ | 414 | 392 | | (354) | 452 |
| Reversal of prior period net depreciation (appreciation) on realization ⁽¹⁾ | 1,066 | 1,212 | | (247) | 2,031 |
| Issuances/Originations ⁽²⁾ | 4,901 | 239 | | | 5,140 |
| Settlements/Repayments | (16,298) | (5,200) | | (1,567) | (23,065) |
| Sales | | (337) | | | (337) |
| Fair value as of March 31, 2010 | \$ 188,348 | \$ 102,752 | \$ | \$ 651 | \$ 291,751 |

| | Senior Term Debt | Senior Subordinated Term Debt | Preferred Equity | Common Equity/ Equivalents | Total |
|--|---------------------------------|--|-----------------------------|---|--------------|
| Six months ended March 31, 2010: | | | | | |
| Fair value at September 30, 2009 | \$ 212,290 | \$ 105,794 | \$ | \$ 2,885 | \$ 320,969 |
| Net realized (loss) gain | (825) | (570) | | 1,367 | (28) |
| Net unrealized appreciation (depreciation) ⁽¹⁾ | 2,065 | 1,619 | | (247) | 3,437 |
| Reversal of prior period net depreciation (appreciation) on realization ⁽¹⁾ | 1,210 | 2,222 | | (1,787) | 1,645 |
| Issuances/Originations ⁽²⁾ | 6,078 | 1,242 | | | 7,320 |

| | | | | |
|--|-------------------|-------------------|-----------|-------------------|
| Settlements/Repayments | (31,545) | (5,361) | (1,567) | (38,473) |
| Sales | (925) | (2,194) | | (3,119) |
| Fair value as of March 31, 2010 | \$ 188,348 | \$ 102,752 | \$ | \$ 651 |
| | | | | \$ 291,751 |

- (1) Included in unrealized appreciation (depreciation) on investments on the accompanying *Condensed Consolidated Statements of Operations* for the three and six months ended March 31, 2011 and 2010.
- (2) Includes PIK, amortization of OID, and other cost basis adjustments.
- (3) Transfer represents the fair value of Sunshine Media Holdings as of December 31, 2010, which was reclassified from a Non-Control/Non-Affiliate investment to a Control investment during the three months ended March 31, 2011.

Non-Control/Non-Affiliate Investments

As of March 31, 2011 and September 30, 2010, the Company held Non-Control/Non-Affiliate investments in the aggregate of approximately \$208.5 million and \$223.7 million, at fair value, respectively. During the three months ended March 31, 2011, the Company added six new Non-Control/Non-Affiliate investments, with an aggregate fair value of \$34.8 million as of March 31, 2011 and exited three Non-Control/Non-Affiliate investments, for which the Company received aggregate payments of \$17.1 million. During the six months ended March 31, 2011, the Company added eleven new Non-Control/Non-Affiliate investments, with an aggregate fair value of \$43.8 million as of March 31, 2011, exited five Non-Control/Non-Affiliate investments, for which the Company received aggregate payments of \$26.6 million, sold one Non-Control/Non-Affiliate investment and partially sold one Control investments for aggregate net proceeds of \$0.8 million. As of March 31, 2011, the Company had a total of 38 Non-Control/Non-Affiliate investments, of which twelve were syndicated loans.

Table of Contents*Control Investments*

As of March 31, 2011 and September 30, 2010, the Company held seven and six Control investments in the aggregate of approximately \$48.7 million and \$33.4 million, at fair value, respectively. During the three months ended March 31, 2011, the Company took control of Sunshine Media Holdings, which is now classified as a Control Investment. Additionally, three Control investments made draws, totaling \$0.2 million, on their respective lines of credit. During the six months ended March 31, 2011, three Control investments made draws, totaling \$0.3 million, on their respective lines of credit. The Company did not exit any Control investments during the six months ended March 31, 2011.

Investment Concentrations

As of March 31, 2011, the Company had aggregate investments in 45 portfolio companies. Approximately 67.5% of the aggregate fair value of such investments at March 31, 2011 was comprised of senior term debt, 29.8% was senior subordinated term debt and 2.7% was in equity securities. The following table outlines the Company's investments by type at March 31, 2011 and September 30, 2010:

| | March 31, 2011 | | September 30, 2010 | |
|-------------------------------|-------------------|-------------------|--------------------|-------------------|
| | Cost | Fair Value | Cost | Fair Value |
| Senior term debt | \$ 218,457 | \$ 173,602 | \$ 200,041 | \$ 172,596 |
| Senior subordinated term debt | 89,794 | 76,599 | 93,987 | 81,899 |
| Preferred equity | 1,185 | 537 | 444 | 387 |
| Common equity/equivalents | 4,799 | 6,375 | 3,744 | 2,227 |
| Total investments | \$ 314,235 | \$ 257,113 | \$ 298,216 | \$ 257,109 |

Investments at fair value consisted of the following industry classifications as of March 31, 2011 and September 30, 2010:

| Industry Classification | March 31, 2011 | | September 30, 2010 | |
|--|----------------|---------------------------------|--------------------|---------------------------------|
| | Fair Value | Percentage of Total Investments | Fair Value | Percentage of Total Investments |
| Broadcast (TV & radio) | \$ 33,226 | 12.9% | \$ 44,562 | 17.3% |
| Healthcare, education & childcare | 33,053 | 12.8 | 41,098 | 16.0 |
| Electronics | 24,833 | 9.7 | 25,080 | 9.8 |
| Mining, steel, iron & non-precious metals | 24,663 | 9.6 | 24,343 | 9.5 |
| Automobile | 23,480 | 9.1 | 9,868 | 3.8 |
| Printing & publishing | 22,796 | 8.9 | 37,705 | 14.7 |
| Retail stores | 19,570 | 7.6 | 19,620 | 7.6 |
| Personal & non-durable consumer products | 11,693 | 4.5 | 9,230 | 3.6 |
| Buildings & real estate | 11,038 | 4.3 | 12,454 | 4.8 |
| Home & office furnishings | 10,130 | 3.9 | 10,666 | 4.1 |
| Machinery | 8,650 | 3.4 | 8,719 | 3.4 |
| Personal, food and miscellaneous services | 7,923 | 3.1 | | |
| Beverage, food & tobacco | 7,350 | 2.9 | | |
| Leisure, amusement, movies & entertainment | 4,883 | 1.9 | 3,994 | 1.6 |
| Chemicals, plastics & rubber | 4,531 | 1.8 | 7,044 | 2.7 |
| | 3,130 | 1.2 | | |

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| | | | | |
|---|-------------------|---------------|------------|--------|
| Diversified natural resources, precious metals & minerals | | | | |
| Diversified/conglomerate manufacturing | 2,365 | 0.9 | 2,042 | 0.8 |
| Telecommunications | 1,984 | 0.8 | | |
| Insurance | 1,015 | 0.4 | | |
| Aerospace & defense | 800 | 0.3 | 400 | 0.2 |
| Farming & agriculture | | | 284 | 0.1 |
| Total investments | \$ 257,113 | 100.0% | \$ 257,109 | 100.0% |

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The investments at fair value were included in the following geographic regions of the United States at March 31, 2011 and September 30, 2010:

| Geographic Region | March 31, 2011 | | September 30, 2010 | |
|--------------------------|-------------------|------------------|--------------------|---------------------|
| | Fair Value | Percent of Total | Fair Value | Percentage of Total |
| | | Investments | | Investments |
| Midwest | \$ 127,790 | 49.7% | \$ 109,299 | 42.5% |
| South | 52,592 | 20.5 | 44,704 | 17.4 |
| West | 49,891 | 19.4 | 59,684 | 23.2 |
| Northeast | 26,840 | 10.4 | 36,995 | 14.4 |
| U.S. Territory | | | 6,427 | 2.5 |
| Total Investments | \$ 257,113 | 100.0% | \$ 257,109 | 100.0% |

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

Investment Principal Repayments

The following table summarizes the contractual principal repayments and maturity of the Company's investment portfolio by fiscal year, assuming no voluntary prepayments, at March 31, 2011:

| | | Amount |
|---|--|-------------------|
| For the remaining six months ending September 30: | 2011 | \$ 18,295 |
| For the fiscal year ending September 30: | 2012 | 76,646 |
| | 2013 | 122,981 |
| | 2014 | 28,863 |
| | 2015 | 32,088 |
| | 2016 and thereafter | 30,926 |
| | Total contractual repayments | \$ 309,799 |
| | Investments in equity securities | 5,984 |
| | Adjustments to cost basis on debt securities | (1,548) |
| | Total cost basis of investments held at March 31, 2011: | \$ 314,235 |

Receivables from Portfolio Companies

Receivables from portfolio companies represent non-recurring costs incurred on behalf of portfolio companies. The Company maintains an allowance for uncollectible receivables from portfolio companies, which is determined based on historical experience and management's expectations of future losses. The Company charges the accounts receivable to the established provision when collection efforts have been exhausted and the receivables are deemed uncollectible. As of March 31, 2011 and September 30, 2010, the Company had gross receivables from portfolio companies of \$0.6 million. The allowance for uncollectible receivables was \$0.3 million for both March 31, 2011 and September 30, 2010.

NOTE 4. RELATED PARTY TRANSACTIONS*Loans to Former Employees*

The Company has outstanding loans to certain employees of the Adviser, each of whom was a joint employee of the Adviser (or the Company's previous adviser, Gladstone Capital Advisers, Inc.) and the Company at the time the loans were originally provided, for the exercise of options under the Amended and Restated 2001 Equity Incentive Plan, which has since been terminated. The loans require the quarterly payment of interest at the market rate in effect at the date of issue, have varying terms not exceeding ten years and have been recorded as a reduction of net assets. The loans are evidenced by full recourse notes that are due upon maturity or 60 days following termination of employment, and the shares of common stock purchased with the proceeds of the loan are posted as collateral. The Company received \$1.1 million and \$0 of principal repayments during the six months ended March 31, 2011 and 2010, respectively. The Company recognized interest income from all employee loans of \$0.1 million and \$0.2 million for the three and six months ended March 31, 2011, respectively, and \$0.1 million and \$0.2 million for the three and six months ended March 31, 2010, respectively.

Table of Contents*Investment Advisory and Management Agreement*

The Company has entered into an investment advisory and management agreement with the Adviser (the Advisory Agreement), which is controlled by the Company's chairman and chief executive officer. In accordance with the Advisory Agreement, the Company pays the Adviser fees as compensation for its services, consisting of a base management fee and an incentive fee. On July 7, 2010, the Company's Board of Directors approved the renewal of the Advisory Agreement through August 31, 2011.

The following table summarizes the management fees, incentive fees and associated credits reflected in the accompanying *Condensed Consolidated Statements of Operations*:

| | Three Months Ended March | | Six Months Ended March | |
|--|--------------------------|-------------|------------------------|-------------|
| | 2011 | 31, 2010 | 2011 | 31, 2010 |
| Average total assets subject to base management fee ⁽¹⁾ | \$ 273,000 | \$ 318,200 | \$ 271,200 | \$ 324,000 |
| Multiplied by pro-rated annual base management fee of 2.0% | 0.5% | 0.5% | 1.0% | 1.0% |
| Unadjusted base management fee | \$ 1,365 | \$ 1,591 | \$ 2,712 | 3,240 |
| Reduction for loan servicing fees ⁽²⁾ | (757) | (852) | (1,599) | (1,781) |
| Base management fee ⁽²⁾ | 608 | 739 | 1,113 | 1,459 |
| Fee reduction for the voluntary, irrevocable waiver of 2.0% fee on senior syndicated loans to 0.5% per annum | (81) | (6) | (133) | (13) |
| Net base management fee | \$ 527 | \$ 733 | \$ 980 | \$ 1,446 |
| Incentive fee ⁽²⁾ | \$ 1,102 | \$ 1,072 | \$ 2,261 | \$ 1,447 |
| Credit from voluntary, irrevocable waiver issued by Adviser's board of directors | (21) | | (21) | (22) |
| Net incentive fee | \$ 1,081 | \$ 1,072 | \$ 2,240 | \$ 1,425 |
| Fee reduction for the voluntary, irrevocable waiver of 2.0% fee on senior syndicated loans to 0.5% per annum | \$ (81) | \$ (6) | \$ (133) | \$ (13) |
| Incentive fee credit | (21) | | (21) | (22) |
| Credit to base management and incentive fees from Adviser ⁽²⁾ | \$ (102) | \$ (6) | \$ (154) | \$ (35) |

(1) 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 and cash equivalents resulting from borrowings, valued at the end of the applicable quarters within the respective periods and appropriately adjusted for any share issuances or repurchases during the periods.

(2) Reflected as a line item on the *Condensed Consolidated Statement of Operations* located elsewhere in this report.

Base Management Fee

The base management fee is payable quarterly and assessed at a rate of 2.0%, computed on the basis of the value of the Company's 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. In addition, the following three items are adjustments to the base management fee calculation:

Loan Servicing Fees

The Adviser also services the loans held by Business Loan, in return for which it receives a 2.0% annual fee based on the monthly aggregate outstanding balance of loans pledged under the Company's line of credit. Since the Company owns these loans, all loan servicing fees paid to the Adviser are treated as reductions directly against the 2.0% base management fee under the Advisory Agreement.

Senior Syndicated Loan Fee Waiver

The Company's 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 six months ended March 31, 2011 and 2010.

Portfolio Company Fees

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

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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 the Company's quarterly net investment income (before giving effect to any incentive fee) exceeds 1.75% of the Company's net assets (the hurdle rate). The Company will pay the Adviser an income-based incentive fee with respect to the Company's pre-incentive fee net investment income in each calendar quarter as follows:

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

100% of the Company's 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

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

The second part of the incentive fee is a capital gains-based incentive fee that will be 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 the Company's realized capital gains as of the end of the fiscal year. In determining the capital gains-based incentive fee payable to the Adviser, the Company will calculate the cumulative aggregate realized capital gains and cumulative aggregate realized capital losses since the Company's inception, and the aggregate unrealized capital depreciation as of the date of the calculation, as applicable, with respect to each of the investments in the Company's 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 the Company's 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 the Company's 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 the Company's 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 the Company's 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 the Company's portfolio in all prior years. No capital gains-based incentive fee has been recorded for the Company from its inception through March 31, 2011, as cumulative unrealized capital depreciation exceeded cumulative realized capital gains net of cumulative realized capital losses.

Administration Agreement

The Company has entered into an administration agreement (the Administration Agreement) with Gladstone Administration, LLC (the Administrator), an affiliate of the Adviser, whereby it pays separately for administrative services. The Administration Agreement provides for payments equal to the Company's allocable portion of its Administrator's overhead expenses in performing its obligations under the Administration Agreement, including, but not limited to, rent and the salaries and benefits expenses of the Company's personnel, including its chief financial officer, chief compliance officer, treasurer, internal counsel and their respective staffs. The Company's allocable portion of administrative expenses is generally derived by multiplying the Administrator's total allocable expenses by the percentage of the Company's 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 similar agreements. On July 7, 2010, the Company's Board of Directors approved the renewal of the Administration Agreement through August 31, 2011.

Related Party Fees Due

Amounts due to related parties in the accompanying *Condensed Consolidated Statements of Assets and Liabilities* were as follows:

| | March 31, 2011 | September 30, 2010 |
|--|---------------------------|-------------------------------|
| Unpaid base management fee to Adviser | \$ 515 | \$ 319 |
| Unpaid incentive fee to Adviser | 1,081 | 158 |
| Unpaid loan servicing fees to Adviser | 195 | 196 |
| Total fees due to Adviser | 1,791 | 673 |
| | | |
| Unpaid administration fee due to Administrator | 175 | 267 |
| Total related party fees due | \$ 1,966 | \$ 940 |

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On March 15, 2010, the Company, through Business Loan, entered into a fourth amended and restated credit agreement which currently provides for a \$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. On November 22, 2010 (the Amendment Date), the Company amended its Credit Facility. Prior to the Amendment Date, advances under the Credit Facility bore interest at LIBOR subject to a minimum rate of 2.0%, plus 4.5% per annum, with a commitment fee of 0.5% per annum on undrawn amounts. As of the Amendment Date, advances under the Credit Facility bear interest at LIBOR subject to a minimum rate of 1.5%, plus 3.75% per annum, with a commitment fee of 0.5% per annum on undrawn amounts when the facility is drawn more than 50% and 1.0% per annum on undrawn amounts when the facility is drawn less than 50%. In addition, effective as of the Amendment Date, the Company is no longer obligated to pay an annual minimum earnings shortfall fee to the committed lenders, which was calculated as the difference between the weighted average of borrowings outstanding under the Credit Facility and 50.0% of the commitment amount of the Credit Facility, multiplied by 4.5% per annum, less commitment fees paid during the year. During the quarter ended December 31, 2010, the Company reversed the projected annual minimum earnings shortfall fee of \$0.6 million that had been accrued as of September 30, 2010. As of the Amendment Date, the Company paid a \$0.7 million fee.

As of March 31, 2011, there was a cost basis of approximately \$33.2 million of borrowings outstanding under the Credit Facility at an average interest rate of 5.25%. Available borrowings are subject to various constraints imposed under the Credit Facility, based on the aggregate loan balance pledged by Business Loan. Interest is payable monthly during the term of the Credit Facility. The Credit Facility matures on March 15, 2012, and, if the facility is not renewed or extended by this date, all unpaid principal and interest will be due and payable on March 15, 2013. In addition, if the Credit Facility is not renewed on or before March 15, 2012, the Company will be required to use all principal collections from its loans to pay outstanding principal on the Credit Facility.

The Credit Facility contains covenants that require Business Loan to maintain its status as a separate entity, prohibit certain significant corporate transactions (such as mergers, consolidations, liquidations or dissolutions), and restrict material changes to the Company's credit and collection policies. The facility requires a minimum of 20 obligors in the borrowing base and also limits payments of distributions. As of March 31, 2011, Business Loan had 30 obligors and the Company was in compliance with all of the facility covenants.

Fair Value

The Company elected to apply ASC 825, Financial Instruments, specifically for the Credit Facility, which was consistent with its application of ASC 820 to its investments. The Company estimated the fair value of the Credit Facility using estimates of value provided by an independent third party and its own assumptions in the absence of observable market data, including estimated remaining life, credit party risk, current market yield and interest rate spreads of similar securities as of the measurement date. The following tables present the Credit Facility carried at fair value as of March 31, 2011 and September 30, 2010, by caption on the accompanying *Condensed Consolidated Statements of Assets and Liabilities* for each of the three levels of hierarchy established by ASC 820 and a roll-forward in the changes in fair value during the three-month period from December 31, 2010 to March 31, 2011 and the six-month period from September 30, 2010 to March 31, 2011, for the Credit Facility for which the Company determines fair value using unobservable (Level 3) factors:

| Borrowings under Credit Facility | |
|---|---|
| Level 3 | Total Fair Value Reported in Condensed Consolidated Statements of Assets and Liabilities |

| | Level 1 | Level 2 | | |
|--------------------|--------------------|--------------------|----------|-----------|
| March 31, 2011 | \$ | \$ | \$33,646 | \$ 33,646 |
| September 30, 2010 | \$ | \$ | \$17,940 | \$ 17,940 |

Fair value measurements using unobservable data inputs (Level 3)

| | Three Months Ended March 31, | |
|---|---|------------------|
| | 2011 | 2010 |
| Fair value as of December 31, 2010 and 2009, respectively | \$ 25,301 | \$ 73,531 |
| Unrealized depreciation ⁽¹⁾ | (255) | (131) |
| Borrowings | 40,800 | 2,600 |
| Repayments | (32,200) | (23,000) |
| Fair value as of March 31, 2011 and 2010, respectively | \$ 33,646 | \$ 53,000 |

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| | Six Months Ended March 31, | |
|---|---------------------------------------|------------------|
| | 2011 | 2010 |
| Fair value as of September 30, 2010 and 2009, respectively | \$ 17,940 | \$ 83,350 |
| Unrealized depreciation ⁽¹⁾ | (694) | (350) |
| Borrowings | 50,800 | 5,500 |
| Repayments | (34,400) | (35,500) |
| Fair value as of March 31, 2011 and 2010, respectively | \$ 33,646 | \$ 53,000 |

⁽¹⁾ Included in unrealized depreciation on borrowings on the accompanying *Condensed Consolidated Statements of Operations* for the three and six months ended March 31, 2011 and 2010.

The fair value of the collateral under the Credit Facility was approximately \$216.1 million and \$212.6 million at March 31, 2011 and September 30, 2010, respectively.

NOTE 6. COMMON STOCK*Registration Statement*

On October 20, 2009, the Company filed a registration statement on Form N-2 (File No. 333-162592) that was declared effective by the SEC on January 28, 2010, and the Company filed a post-effective amendment to such registration statement on April 7, 2011, which has not yet been declared effective. Once the post-effective amendment has been declared effective, such registration statement will permit the Company to issue, through one or more transactions, an aggregate of \$300.0 million in securities, consisting of common stock, senior common stock, preferred stock, subscription rights, debt securities and warrants to purchase common stock, or a combination of these securities.

On May 17, 2010, the Company and the Adviser entered into an equity distribution agreement (the *Agreement*) with BB&T Capital Markets, a division of Scott & Stringfellow, LLC (the *Agent*), under which the Company may, from time to time, issue and sell through the Agent, as sales agent, up to 2.0 million shares (the *Shares*) of the Company's common stock, par value \$0.001 per share, based upon instructions from the Company (including, at a minimum, the number of shares to be offered, the time period during which sales are requested to be made, any limitation on the number of shares that may be sold in any one day and any minimum price below which sales may not be made). Sales of Shares through the Agent, if any, will be executed by means of either ordinary brokers' transactions on the NASDAQ Global Select Market in accordance with Rule 153 under the Securities Act of 1933 or such other sales of the Shares as shall be agreed by the Company and the Agent. The compensation payable to the Agent for sales of Shares with respect to which the Agent acts as sales agent shall be equal to 2.0% of the gross sales price of the Shares for amounts of Shares sold pursuant to the Agreement. To date, the Company has not issued any shares pursuant to this Agreement.

Employee Notes

The following table is a summary of all outstanding notes issued to employees of the Adviser for the exercise of stock options:

| Issue Date | Number of Options Exercised | Strike Price of Options Exercised | Amount of Promissory Note Issued to Employees | Outstanding | | |
|------------|-----------------------------|-----------------------------------|---|--------------------------------------|---------------|-----------------------|
| | | | | Balance of Employee Loans at 3/31/11 | Maturity Date | Interest Rate on Note |
| Aug-01 | 393,334 | 15.00 | \$ 5,900 ⁽¹⁾ | \$ 4,850 | Aug-10 | 4.90% ⁽²⁾ |

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| | | | | | | |
|--------|----------------|-------|--------------------|-----------------|--------|---------------------|
| Aug-01 | 18,334 | 15.00 | 275 ⁽¹⁾ | 251 | Aug-10 | 4.90 ⁽²⁾ |
| Aug-01 | 18,334 | 15.00 | 275 | 275 | Aug-11 | 4.90 |
| Sep-04 | 13,332 | 15.00 | 200 | 198 | Sep-13 | 5.00 |
| Jul-06 | 13,332 | 15.00 | 200 | 200 | Jul-15 | 8.26 |
| Jul-06 | 18,334 | 15.00 | 275 | 275 | Jul-15 | 8.26 |
| | 475,000 | | \$ 7,125 | \$ 6,049 | | |

- (1) On September 7, 2010, the Company entered into redemption agreements (the Redemption Agreements) with David Gladstone, the Company s Chairman and Chief Executive Officer, and Laura Gladstone, the daughter of Mr. Gladstone, in connection with the maturity of secured promissory notes executed by Mr. Gladstone and Ms. Gladstone in favor of the Company on August 23, 2001, in the principal amounts of \$5.9 million and \$0.3 million, respectively (collectively, the Notes). Mr. and Ms. Gladstone executed the Notes in payment of the exercise price of certain stock options (the Options) to acquire shares of the Company s common stock. Concurrently with the execution of the Notes, the Company and Mr. and Ms. Gladstone entered into a stock pledge agreements (collectively, the Pledge Agreements), pursuant to which Mr. and Ms. Gladstone granted to the Company a first priority security interest in the Pledged Collateral (as defined in the respective Pledge Agreements), which includes 393,334 and 18,334 shares, respectively, of the Company s common stock that Mr. and Ms. Gladstone acquired pursuant to the exercise of the Options (collectively, the Pledged Shares). An event of default was

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triggered under the Notes by virtue of Mr. and Ms. Gladstone's failure to repay the amounts outstanding under the Notes within five business days of August 23, 2010. The Redemption Agreements provide that, pursuant to the terms and conditions thereof, the Company will automatically accept and retire the Pledged Shares in partial or full satisfaction, as applicable, of Mr. and Ms. Gladstone's obligations to the Company under the Notes at such time, if ever, that the trading price of the Company's common stock reaches \$15 per share. In entering into the Redemption Agreements, the Company reserved all of its existing rights under the Notes and the Pledge Agreements, including, but not limited to, the ability to foreclose on the Pledged Collateral at any time. On March 30, 2011, Mr. Gladstone paid down \$1.1 million of the principal balance of his Note, leaving a principal balance of \$4.8 million outstanding. In connection with this payment, the Company released its first priority security interest on 70,000 shares of Mr. Gladstone's Pledged Shares, leaving a balance of 323,334 shares in Pledged Collateral from Mr. Gladstone.

- (2) An event of default was triggered under the Note by virtue of the employees' failure to repay the amounts outstanding within five business days of August 23, 2010. As such, the Company charged a default rate of 2% per annum under the Note for periods following the date of default.

In accordance with ASC 505-10-45-2, Equity, receivables from employees for the issuance of capital stock to employees prior to the receipt of cash payment should be reflected in the balance sheet as a reduction to stockholders equity. Therefore, these recourse notes were recorded as loans to employees and are included in the equity section of the accompanying *Condensed Consolidated Statements of Assets and Liabilities*. As of March 31, 2011, the Company determined that these notes were still recourse.

NOTE 7. NET (DECREASE) INCREASE IN NET ASSETS RESULTING FROM OPERATIONS PER SHARE

The following table sets forth the computation of basic and diluted net (decrease) increase in net assets resulting from operations per share for the three and six months ended March 31, 2011 and 2010:

| | Three Months Ended March | | Six Months Ended March 31, | |
|---|--------------------------|------------|----------------------------|------------|
| | 2011 | 2010 | 2011 | 2010 |
| Numerator for basic and diluted net (decrease) increase in net assets resulting from operations per share | \$ (8,381) | \$ 7,980 | \$ (6,250) | \$ 14,306 |
| Denominator for basic and diluted weighted average shares | 21,039,242 | 21,075,445 | 21,039,242 | 21,081,576 |
| Basic and diluted net (decrease) increase in net assets resulting from operations per share | \$ (0.40) | \$ 0.38 | \$ (0.30) | \$ 0.68 |

NOTE 8. DISTRIBUTIONS

The following table lists the per share distributions paid to stockholders for the six months ended March 31, 2011 and 2010:

| Fiscal Year | Record Date | Payment Date | Distribution per Share |
|-------------|-------------------|-------------------|------------------------|
| 2011 | October 21, 2010 | October 29, 2010 | \$ 0.07 |
| | November 19, 2010 | November 30, 2010 | 0.07 |
| | December 23, 2010 | December 31, 2010 | 0.07 |
| | January 21, 2011 | January 31, 2011 | 0.07 |
| | February 21, 2011 | February 28, 2011 | 0.07 |
| | March 21, 2011 | March 31, 2011 | 0.07 |

| | | | | |
|------|-------------------|-------------------|----|-------------|
| | | Total | \$ | 0.42 |
| 2010 | October 22, 2009 | October 30, 2009 | \$ | 0.07 |
| | November 19, 2009 | November 30, 2009 | | 0.07 |
| | December 22, 2009 | December 31, 2009 | | 0.07 |
| | January 21, 2010 | January 29, 2010 | | 0.07 |
| | February 18, 2010 | February 26, 2010 | | 0.07 |
| | March 23, 2010 | March 31, 2010 | | 0.07 |
| | | Total | \$ | 0.42 |

Aggregate distributions declared and paid for the six months ended March 31, 2011 and 2010 were approximately \$8.8 million, and \$8.9 million, respectively, which were declared based on estimates of net investment income for the respective fiscal years. Distributions declared for the fiscal year ended September 30, 2010 were comprised of 95.6% from ordinary income and 4.4% from a return of capital. The characterization of the distributions declared and paid for the fiscal year ending September 30, 2011 will be determined at year end and cannot be determined at this time. The timing and characterization of certain income and capital gains distributions are determined annually in accordance with federal tax regulations which may differ from GAAP. These differences primarily relate to items recognized as income for

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financial statement purposes and realized gains for tax purposes. As a result, net investment income and net realized gain (loss) on investment transactions for a reporting period may differ significantly from distributions during such period. Accordingly, the Company may periodically make reclassifications among certain of its capital accounts without impacting the net asset value of the Company.

NOTE 9. COMMITMENTS AND CONTINGENCIES

As of March 31, 2011, the Company was not party to any signed commitments for potential investments. However, the Company has certain line of credit and capital commitments with its portfolio companies that have not been fully drawn or called, respectively. Since these commitments have expiration dates and the Company expects many will never be fully drawn or called, the total commitment amounts do not necessarily represent future cash requirements. The Company estimates the fair value of these unused and uncalled commitments as of March 31, 2011 and September 30, 2010 to be nominal.

In July 2009, the Company executed a guaranty of a line of credit agreement between Comerica Bank and Defiance Integrated Technologies, Inc. (the Guaranty), one of its Control investments. Pursuant to the Guaranty, if Defiance had a payment default, the guaranty was callable once the bank had reduced its claim by using commercially reasonable efforts to collect through disposition of the Defiance collateral. The Guaranty was limited to \$0.3 million plus interest on that amount accrued from the date demand payment was made under the Guaranty, and all costs incurred by the bank in its collection efforts. On March 1, 2011, the Company and Comerica Bank terminated the Guaranty.

NOTE 10. FINANCIAL HIGHLIGHTS

| | Three Months Ended March | | Six Months Ended March 31 | |
|--|--------------------------|-------------|---------------------------|----------|
| | 2011 | 31, 2010 | 2011 | 2010 |
| Per Share Data ⁽¹⁾ | | | | |
| Net asset value at beginning of period | \$ 11.74 | \$ 11.92 | \$ 11.85 | \$ 11.81 |
| <i>Income from investment operations:</i> | | | | |
| Net investment income ⁽²⁾ | 0.21 | 0.21 | 0.43 | 0.42 |
| Net realized gain on investments ⁽²⁾ | | 0.04 | | |
| Net unrealized (depreciation) appreciation on investments ⁽²⁾ | (0.62) | 0.12 | (0.76) | 0.24 |
| Net unrealized appreciation on borrowings ⁽²⁾ | 0.01 | 0.01 | 0.03 | 0.02 |
| Total from investment operations | (0.40) | 0.38 | (0.30) | 0.68 |
| Distributions to stockholders ⁽³⁾ | (0.21) | (0.21) | (0.42) | (0.42) |
| Conversion of former employee stock option loans from recourse to non-recourse | | (0.02) | | (0.02) |
| Reclassification of principal on employee note | | | | 0.02 |
| Repayment of principal on employee note | 0.05 | | 0.05 | |
| Anti-dilutive effect from retirement of employee loan shares | | 0.03 | | 0.03 |
| Net asset value at end of period | \$ 11.18 | \$ 12.10 | \$ 11.18 | \$ 12.10 |
| | \$ 11.52 | \$ 7.96 | \$ 11.27 | \$ 8.93 |

| | | | | |
|--|-------------------|------------|-------------------|------------|
| Per share market value at beginning of period | | | | |
| Per share market value at end of period | 11.31 | 11.80 | 11.31 | 11.80 |
| Total return ⁽⁴⁾⁽⁵⁾ | 1.86% | 56.94% | 4.12% | 38.77% |
| Shares outstanding at end of period | 21,039,242 | 21,039,242 | 21,039,242 | 21,039,242 |
| Statement of Assets and Liabilities Data: | | | | |
| Net assets at end of period | \$ 235,215 | \$ 254,549 | \$ 235,215 | \$ 254,549 |
| Average net assets ⁽⁶⁾ | 252,457 | 251,111 | 249,985 | 249,993 |
| Senior Securities Data: | | | | |
| Total borrowings | 33,646 | 53,000 | 33,646 | 53,000 |
| Asset coverage ratio ⁽⁷⁾⁽⁸⁾ | 797% | 575% | 797% | 575% |
| Asset coverage per unit ⁽⁸⁾ | \$ 7,966 | \$ 5,754 | \$ 7,966 | \$ 5,754 |
| Ratios/Supplemental Data: | | | | |
| Ratio of expenses to average net assets-annualized ⁽⁹⁾ | 6.43% | 8.52% | 6.00% | 8.60% |
| Ratio of net expenses to average net assets-annualized ⁽¹⁰⁾ | 6.27 | 8.51 | 5.87 | 8.57 |
| Ratio of net investment income to average net assets-annualized | 7.04 | 7.13 | 7.25 | 7.12 |

(1) Based on actual shares outstanding at the end of the corresponding period.

(2) Based on weighted average basic per share data.

(3) Distributions are determined based on taxable income calculated in accordance with income tax regulations which may differ from amounts determined under accounting principles generally accepted in the United States of America.

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- (4) Total return equals the change in the ending market value of the Company's common stock from the beginning of the period taking into account distributions reinvested in accordance with the terms of the Company's dividend reinvestment plan. Total return does not take into account distributions that may be characterized as a return of capital. For further information on the estimated character of the Company's distributions please refer to Note 8.
- (5) Amounts were not annualized.
- (6) Average net assets are computed using the average of the balance of net assets at the end of each month of the reporting period.
- (7) As a business development company, the Company is generally required to maintain a ratio of at least 200% of total assets, less all liabilities and indebtedness not represented by senior securities, to total borrowings and guaranty commitments.
- (8) Asset coverage ratio is the ratio of the carrying value of the Company's total consolidated assets, less all liabilities and indebtedness not represented by senior securities, to the aggregate amount of senior securities representing indebtedness (including interest payable and guarantees). Asset coverage per unit is the asset coverage ratio expressed in terms of dollar amounts per one thousand dollars of indebtedness.
- (9) Ratio of expenses to average net assets is computed using expenses before credits from Adviser to the base management and incentive fees but includes income tax expense.
- (10) Ratio of net expenses to average net assets is computed using total expenses net of credits from Adviser to the base management and incentive fees but includes income tax expense.

NOTE 11. SUBSEQUENT EVENTS*Distributions*

In April 2011, the Company's Board of Directors declared the following monthly cash distributions to stockholders:

| Record Date | Payment Date | Distribution per Share |
|--------------------|---------------------|-------------------------------|
| April 22, 2011 | April 29, 2011 | \$ 0.07 |
| May 20, 2011 | May 31, 2011 | 0.07 |
| June 20, 2011 | June 30, 2011 | 0.07 |
| Total | | \$ 0.21 |

Investment Activity

Subsequent to March 31, 2011, the Company extended an aggregate amount of approximately \$17.3 million in three new investments and \$0.5 million in revolver draws and additional investments to existing portfolio companies. Additionally, the Company received scheduled repayments of \$1.5 million.

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ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS (dollar amounts in thousands, except per share data and as otherwise indicated)

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 estimate, may, might, believe, will, provided, anticipate, future, could, growth, plan, intend, expect, should, 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. 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-Q.

The following analysis of our financial condition and results of operations should be read in conjunction with our condensed consolidated financial statements and the notes thereto contained elsewhere in this report and in our annual report on Form 10-K for the fiscal year ended September 30, 2010.

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 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 business development company 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 regulated investment company (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.

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 decreased liquidity for us and increased our cost of debt and equity capital. The longer these economic 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 the companies in which we have made investments are still susceptible to the 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. 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.

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 our credit facility that further constrain our ability to access the capital

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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 on an annual basis. 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.

Market conditions have also affected the trading price of our common stock and thus our ability to finance new investments through the issuance of equity. When our stock trades below net asset value (NAV) per share, as it has periodically traded for more than two years, our ability to issue equity is constrained by provisions of the 1940 Act which generally prohibit the issuance and sale of our common stock at an issuance price 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 determinations prior to any such sale. On May 2, 2011, the closing market price of our common stock was \$11.29, which price represented a 1% premium to our March 31, 2011 NAV per share.

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 our credit facility. Additionally, our credit facility contains covenants regarding the maintenance of certain minimum net worth covenants, 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 our credit facility. As of March 31, 2011, we were in compliance with all of our credit facility's 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. This was demonstrated on January 20, 2011, when we were informed by the United States Small Business Administration that our Northern Virginia SBIC, LP application to obtain a license as a small business investment company (SBIC) would not be granted. At this time, we do not intend to pursue a SBIC license for the foreseeable future. Despite current market constraints, we believe that our \$127.0 million credit facility with a two-year term increases our ability to make new investments consistent with our strategy of making conservative investments in businesses that we believe will weather the current economic conditions and are likely to produce attractive long-term returns for our stockholders.

Investment Highlights

Purchases: During the six months ended March 31, 2011, we extended \$44.2 million of investments to eleven new portfolio companies and \$8.2 million of investments to existing portfolio companies through revolver draws or the additions of new term notes or equity investments, for total investments of \$52.4 million.

Repayments: During the six months ended March 31, 2011, five borrowers made unscheduled payoffs in the aggregate amount of \$26.6 million, and we experienced contractual amortization, revolver repayments and some principal payments received ahead of schedule in the aggregate amount of \$8.6 million, for total principal repayments of \$35.2 million.

Sales: During the six months ended March 31, 2011, we sold one Non-Control/Non-Affiliate investment and partially sold one of our Control investments for aggregate net proceeds of \$0.8 million.

Since our initial public offering in August 2001, we have made 283 different loans to, or investments in, 139 companies for a total of approximately \$1,021.8 million, before giving effect to principal repayments on investments and divestitures.

Recent Developments

Credit Facility Amendment

On November 22, 2010 (the Amendment Date), we entered into an amendment to our fourth amended and restated credit agreement, which provides for a \$127.0 million revolving line of credit arranged by Key Equipment Finance Inc. as

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administrative agent (the Credit Facility). Prior to the Amendment Date, advances under the Credit Facility bore interest at LIBOR subject to a minimum rate of 2.0%, plus 4.5% per annum, with a commitment fee of 0.5% per annum on undrawn amounts. As of the Amendment Date, advances under the Credit Facility bear interest at LIBOR subject to a minimum rate of 1.5%, plus 3.75% per annum, with a commitment fee of 0.5% per annum on undrawn amounts when the facility is drawn more than 50% and 1.0% per annum on undrawn amounts when the facility is drawn less than 50%. In addition, effective as of the Amendment Date, we are no longer obligated to pay an annual minimum earnings shortfall fee to the committed lenders, which was calculated as the difference between the weighted average of borrowings outstanding under the Credit Facility and 50.0% of the commitment amount of the Credit Facility, multiplied by 4.5% per annum, less commitment fees paid during the year. As of the Amendment Date, we paid a \$0.7 million fee.

We elected to apply ASC 825, Financial Instruments, specifically to our Credit Facility, which requires us to apply a fair value methodology to the Credit Facility each reporting period. As of March 31, 2011, the Credit Facility was fair valued at \$33.6 million.

Table of Contents**RESULTS OF OPERATIONS*****Comparison of the Three Months Ended March 31, 2011 to the Three Months Ended March 31, 2010****A comparison of our operating results for the three months ended March 31, 2011 and 2010 is below:*

| | For the Three Months Ended March 31, | | | |
|--|---|-----------------|--------------------|---------------------|
| | 2011 | 2010 | \$ Change | % Change |
| INVESTMENT INCOME | | | | |
| Interest income | \$ 7,290 | \$ 8,492 | \$ (1,202) | (14.2)% |
| Other income | 1,108 | 1,322 | (214) | (16.2) |
| Total investment income | 8,398 | 9,814 | (1,416) | (14.4) |
| EXPENSES | | | | |
| Loan servicing fee | 757 | 852 | (95) | (11.2) |
| Base management fee | 608 | 739 | (131) | (17.7) |
| Incentive fee | 1,102 | 1,072 | 30 | 2.8 |
| Administration fee | 175 | 176 | (1) | (0.6) |
| Interest expense | 478 | 1,136 | (658) | (57.9) |
| Amortization of deferred financing fees | 368 | 449 | (81) | (18.0) |
| Professional fees | 201 | 219 | (18) | (8.2) |
| Other expenses | 383 | 703 | (320) | (45.5) |
| Expenses before credit from Adviser | 4,072 | 5,346 | (1,274) | (23.8) |
| Credit to base management and incentive fees from Adviser | (102) | (6) | (96) | 1,600.0 |
| Total expenses net of credit to base management and incentive fees | 3,970 | 5,340 | (1,370) | (25.7) |
| NET INVESTMENT INCOME | 4,428 | 4,474 | (46) | (1.0) |
| REALIZED AND UNREALIZED (LOSS) GAIN ON: | | | | |
| Net realized gain on investments | 5 | 892 | (887) | (99.4) |
| Net unrealized (depreciation) appreciation on investments | (13,069) | 2,483 | (15,552) | NM |
| Net unrealized appreciation on borrowings | 255 | 131 | 124 | 94.7 |
| Net (loss) gain on investments and borrowings | (12,809) | 3,506 | (16,315) | NM |
| NET (DECREASE) INCREASE IN NET ASSETS RESULTING FROM OPERATIONS | \$ (8,381) | \$ 7,980 | \$ (16,361) | NM |

*NM = Not Meaningful***Investment Income**

Interest income from our investments in debt securities decreased for the three months ended March 31, 2011, as compared to the three months ended March 31, 2010, for several reasons. The level of interest income from investments is directly related to the balance, at cost, of the interest-bearing investment portfolio outstanding during the period multiplied by the weighted average yield. The weighted average cost basis of our interest-bearing investment portfolio during the quarter ended March 31, 2011 was approximately \$256.9 million, compared to approximately \$309.6 million for the prior year quarter, due primarily to increased principal repayments and limited new investment activity subsequent to March 31, 2010. The annualized weighted average yield on our interest-bearing investment portfolio for the three months ended March 31, 2011 was 11.32%, compared to 10.98% for the prior year period. The weighted average yield varies from period to period based on the current stated interest rate on interest-bearing investments and the amounts of loans for which interest is not accruing. The increase in the weighted average yield on our portfolio for the quarter ended March 31, 2011 resulted primarily from the repayment of loans with lower stated interest rates. During the three months ended March 31, 2011, six investments were on non-accrual, for an aggregate of approximately \$30.4 million at cost, or 9.7% of the aggregate cost of our investment portfolio, and during the prior year period, six investments were on non-accrual, for an aggregate of approximately \$26.4 million at cost, or 8.0% of the aggregate cost of our investment portfolio.

Other income decreased for the three months ended March 31, 2011, as compared to the prior year period, primarily due to success fees earned in aggregate of \$0.9 million from exits in ActivStyle Acquisition Co. (ActivStyle), Saunders & Associates (Saunders) and Visual Edge Technologies, Inc. (Visual Edge), and prepayment fees in aggregate of \$0.3 million from

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ActiveStyle and ACE Expeditors, Inc. (ACE) during the three months ended March 31, 2010, partially offset by the receipt of \$0.6 million in a settlement related, in part, to US Healthcare Communications, Inc. (US Healthcare) and \$0.5 million in success fees earned from our exit in Pinnacle Treatment Centers, Inc. (Pinnacle) during the current year period.

The following tables list the interest income from investments for our five largest portfolio company investments during the respective periods:

| Company | As of March 31, 2011 | | Three Months Ended March 31, 2011 | |
|---|----------------------|----------------|-----------------------------------|---------------------|
| | Fair Value | % of Portfolio | Interest Income | % of Total Revenues |
| Reliable Biopharmaceutical Holding Inc. | \$ 25,699 | 10.0% | \$ 755 | 10.4% |
| Westlake Hardware, Inc. | 19,570 | 7.6 | 638 | 8.7 |
| Midwest Metal Distribution, Inc. (formerly Clinton Holdings, LLC) | 16,179 | 6.3 | 548 | 7.5 |
| Defiance Integrated Technologies, Inc. | 13,680 | 5.3 | 225 | 3.1 |
| Sunshine Media Holdings | 13,161 | 5.1 | 704 | 9.7 |
| Subtotal five largest investments | 88,289 | 34.3 | 2,870 | 39.4 |
| Other portfolio companies | 168,824 | 65.7 | 4,298 | 58.9 |
| Other non-portfolio company revenue | | | 122 | 1.7 |
| Total | \$257,113 | 100.0% | \$ 7,290 | 100.0% |

| Company | As of March 31, 2010 | | Three Months Ended March 31, 2010 | |
|--|----------------------|----------------|-----------------------------------|---------------------|
| | Fair Value | % of Portfolio | Interest Income | % of Total Revenues |
| Reliable Biopharmaceutical Holding Inc. | \$ 26,792 | 9.2% | \$ 738 | 8.7% |
| Sunshine Media Holdings | 26,580 | 9.1 | 693 | 8.1 |
| Westlake Hardware, Inc. | 24,400 | 8.4 | 672 | 7.9 |
| VantaCore | 13,590 | 4.7 | 408 | 4.8 |
| Midwest Metal Distribution, Inc. | 12,855 | 4.4 | 514 | 6.1 |
| Subtotal five largest investments | 104,217 | 35.8 | 3,025 | 35.6 |
| Other portfolio companies | 187,534 | 64.2 | 5,359 | 63.1 |
| Other non-portfolio company revenue | | | 108 | 1.3 |
| Total | \$291,751 | 100.0% | \$ 8,492 | 100.0% |

Operating Expenses

Operating expenses, net of credits from our Adviser for fees earned and voluntary and irrevocable waivers applied to the base management and incentive fees, decreased for the three months ended March 31, 2011, as compared to the prior year period. This reduction was primarily due to a decrease in interest expense, other expenses and the base management fee.

Interest expense decreased for the three months ended March 31, 2011, as compared to the prior year period, due primarily to decreased borrowings under the Credit Facility during the three months ended March 31, 2011. The weighted average balance outstanding on the Credit Facility during the quarter ended March 31, 2011 was approximately \$14.5 million, as compared to \$61.0 million in the prior year period, a decrease of 76.3%. On November 22, 2010, we amended the Credit Facility such that advances bear interest at LIBOR, subject to a minimum rate of 1.5%, plus 3.75% per annum. For the three months ended March 31, 2010, under our prior credit facility and our pre-amended Credit Facility, advances generally bore interest at LIBOR, subject to a minimum rate of 2.0%, plus 4.0% to 4.5% per annum. In addition to the lower interest rate, the amendment removed the annual minimum earnings shortfall fee to the committed lenders.

Amortization of deferred financing fees decreased for the three months ended March 31, 2011, as compared to the prior year period, due to significant one-time costs related to the termination of our prior credit facility and transition to the Credit Facility, resulting in increased amortization of deferred financing fees during the quarter ended March 31, 2010 when compared to the quarter ended March 31, 2011.

Other expenses decreased for the three months ended March 31, 2011, as compared to the prior year period due primarily to higher compensation expense, legal fees incurred in connection with troubled loans and the provision for uncollectible receivables from portfolio companies during the three months ended March 31, 2010. The increase in compensation expense was due to the conversion of stock option loans of two former employees of the Adviser from recourse to non-recourse loans. The conversions were non-cash transactions and were accounted for as repurchases of the shares previously received by the employees of the

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Adviser 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 \$0.4 million. Since the value of the stock option loans totaled \$0.7 million, we recorded compensation expense of \$0.2 million. No compensation expense was incurred during the three months ended March 31, 2011.

The base management fee decreased for the three months ended March 31, 2011, as compared to the prior year period, which is reflective of holding fewer assets subject to the base management fee compared to the prior year period. An incentive fee was earned by the Adviser during the three months ended March 31, 2011, due primarily to continued other income and a decrease in operating expenses, partially offset by a decrease in interest income. The incentive fee earned during the prior year period was due in part to other income generated from multiple exits. The base management and incentive fees are computed quarterly, as described under *Investment Advisory and Management Agreement* in Note 4 of the notes to the accompanying *Condensed Consolidated Financial Statements* and are summarized in the following table:

| | Three Months Ended March 31, | |
|--|---|-------------|
| | 2011 | 2010 |
| Average total assets subject to base management fee ⁽¹⁾ | \$ 273,000 | \$ 318,200 |
| Multiplied by pro-rated annual base management fee of 2.0% | 0.5% | 0.5% |
| Unadjusted base management fee | \$ 1,365 | \$ 1,591 |
| Reduction for loan servicing fees ⁽²⁾ | (757) | (852) |
| Base management fee ⁽²⁾ | 608 | 739 |
| Fee reduction for the voluntary, irrevocable waiver of 2.0% fee on senior syndicated loans to 0.5% per annum | (81) | (6) |
| Net base management fee | \$ 527 | \$ 733 |
| Incentive fee ⁽²⁾ | \$ 1,102 | \$ 1,072 |
| Credit from voluntary, irrevocable waiver issued by Adviser's board of directors | (21) | |
| Net incentive fee | \$ 1,081 | \$ 1,072 |
| Fee reduction for the voluntary, irrevocable waiver of 2.0% fee on senior syndicated loans to 0.5% per annum | \$ (81) | (6) |
| Incentive fee credit | (21) | |
| Credit to base management and incentive fees from Adviser ⁽²⁾ | \$ (102) | \$ (6) |

(1) 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 and cash equivalents resulting from borrowings, valued at the end of the applicable quarters within the respective periods and appropriately adjusted for any share issuances or repurchases during the periods.

(2) Reflected as a line item on the *Condensed Consolidated Statement of Operations* located elsewhere in this report.

Net Realized Gain on Investments

There were \$5 in net realized gains for the three months ended March 31, 2011, primarily due to realized gains from unamortized discounts on exits during the quarter, partially offset by realized losses in connection with workout expenditures related to the Sunshine Media Holdings restructure. Net realized gains on investments for the three months ended March 31, 2010 were \$0.9 million, which consisted of a realized gain of \$1.4 million from our exit of ACE, partially offset by an aggregate of \$0.5 million of realized losses from our exits of CCS, LLC and Gold Toe Investment Corp.

Net Unrealized (Depreciation) Appreciation on Investments

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. During the quarter ended March 31, 2011, we recorded net unrealized depreciation on investments in the aggregate amount of \$13.1 million. During the prior year period, we recorded net unrealized appreciation on investments in the aggregate amount of \$2.5 million, which included the reversal of \$2.0 million in unrealized depreciation related to the payoff of Visual Edge and the sale of CCS, LLC. Excluding reversals, we had \$0.5 million in net unrealized appreciation for the three months ended March 31, 2010. The net unrealized (depreciation) appreciation across our investments for the three months ended March 31, 2011 was as follows:

Table of Contents**Three Months Ended March 31, 2011**

| Portfolio Company | Investment Classification | Net Unrealized Appreciation (Depreciation) |
|--|----------------------------------|---|
| Defiance Integrated Technologies, Inc. | Control | \$ 1,003 |
| Midwest Metal Distribution, Inc. | Non-Control / Non-Affiliate | 364 |
| Sunshine Media Holdings | Control | (9,790) |
| Lindmark Acquisition, LLC | Control | (1,410) |
| GFRC Holdings LLC | Non-Control / Non-Affiliate | (810) |
| Heartland Communications Group | Non-Control / Non-Affiliate | (598) |
| Legend Communications of Wyoming, LLC | Non-Control / Non-Affiliate | (434) |
| International Junior Golf Training Acquisition Company | Non-Control / Non-Affiliate | (408) |
| LocalTel, LLC | Control | (361) |
| Reliable Biopharmaceutical Holdings, Inc. | Non-Control / Non-Affiliate | (340) |
| SCI Cable, Inc. | Non-Control / Non-Affiliate | (316) |
| Other, net (<\$250) | | 31 |
| | Total: | \$ (13,069) |

The primary driver in our net unrealized depreciation for the quarter ended March 31, 2011 was notable depreciation in Sunshine Media Holdings (Sunshine), which was primarily due to portfolio company performance and the restructure, and certain comparable multiples. During the quarter ended March 31, 2011, as part of the Sunshine restructure, we acquired a controlling equity position, restructured certain of the debt terms, and infused additional equity capital in the form of preferred equity.

The unrealized appreciation (depreciation) across our investments for the three months ended March 31, 2010 was as follows:

Three Months Ended March 31, 2010

| Portfolio Company | Investment Classification | Net Unrealized Appreciation (Depreciation) |
|------------------------------|----------------------------------|---|
| Visual Edge Technology, Inc. | Non-Control / Non-Affiliate | \$ 1,662 ⁽¹⁾ |
| Northern Contours, Inc. | Non-Control / Non-Affiliate | 429 |
| CCS, LLC | Non-Control / Non-Affiliate | 312 ⁽²⁾ |

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| | | |
|---|--------------------------------|-----------------|
| Puerto Rico Cable Acquisition Company, Inc. | Non-Control / Non-Affiliate | 289 |
| Midwest Metal Distribution, Inc. | Control | (857) |
| Sunshine Media Holdings | Non-Control / Non-Affiliate | (447) |
| Finn Corporation | Non-Control / Non-Affiliate | (354) |
| Other, net (<\$250) | | 1,449 |
| | Total: | \$ 2,483 |

- (1) Reflects 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.
- (2) Reflects the reversal of the unrealized depreciation in connection with the \$0.3 million realized loss on the sale of CCS, LLC.

Excluding reversals, the general increase in our net unrealized appreciation for the quarter ended March 31, 2010 was experienced throughout the majority of our entire portfolio of debt holdings based on increases in market comparables and portfolio company performance.

Over our entire investment portfolio, we recorded an aggregate of approximately \$12.9 million and \$0.2 million of net unrealized depreciation on our debt and equity positions, respectively, for the quarter ended March 31, 2011. At March 31, 2011, the fair value of our investment portfolio was less than its cost basis by approximately \$57.1 million, or 81.8 million as compared to \$44.0 million at December 31, 2010, representing net unrealized depreciation of \$13.1 million for the period. We believe that our aggregate investment portfolio was valued at a depreciated value due primarily to reduced performance by certain portfolio companies and the general instability of the loan markets and resulting decrease in market multiples relative to where multiples were when we originated such investments in our portfolio. Our entire portfolio was fair valued at 81.8% of cost as of March 31, 2011. The 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 to stockholders.

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Net Unrealized Appreciation on Borrowings

Net unrealized appreciation on borrowings is the net change in the fair value of our line of credit borrowings during the reporting period, including the reversal of previously recorded unrealized appreciation or depreciation when gains and losses are realized. We elected to apply ASC 825, Financial Instruments, which requires us to apply a fair value methodology to the Credit Facility. We estimated the fair value of the Credit Facility using a combination of estimates of value provided by an independent third party and our own assumptions in the absence of observable market data, including estimated remaining life, credit party risk, current market yield and interest rate spreads of similar securities as of the measurement date. The Credit Facility was fair valued at \$33.6 million as of March 31, 2011.

Net Decrease (Increase) in Net Assets Resulting from Operations

For the three months ended March 31, 2011, we realized a net decrease in net assets resulting from operations of \$8.4 million as a result of the factors discussed above. For the three months ended March 31, 2010, we realized a net increase in net assets resulting from operations of \$8.0 million. Our net (decrease) increase in net assets resulting from operations per basic and diluted weighted average common share for the three months ended March 31, 2011 and March 31, 2010 were \$(0.40) and \$0.38, respectively.

Table of Contents**Comparison of the Six Months Ended March 31, 2011 to the Six Months Ended March 31, 2010**

A comparison of our operating results for the six months ended March 31, 2011 and 2010 is below:

| | For the Six Months Ended March 31, | | | % |
|--|---|------------------|--------------------|---------------|
| | 2011 | 2010 | \$ Change | Change |
| INVESTMENT INCOME | | | | |
| Interest income | \$ 15,135 | \$ 17,743 | \$ (2,608) | (14.7)% |
| Other income | 1,270 | 1,875 | (605) | (32.3) |
| Total investment income | 16,405 | 19,618 | (3,213) | (16.4) |
| EXPENSES | | | | |
| Loan servicing fee | 1,599 | 1,781 | (182) | (10.2) |
| Base management fee | 1,113 | 1,459 | (346) | (23.7) |
| Incentive fee | 2,261 | 1,447 | 814 | 56.3 |
| Administration fee | 361 | 354 | 7 | 2.0 |
| Interest expense | 358 | 2,671 | (2,313) | (86.6) |
| Amortization of deferred financing fees | 664 | 943 | (279) | (29.6) |
| Professional fees | 534 | 1,131 | (597) | (52.8) |
| Other expenses | 603 | 965 | (362) | (37.5) |
| Expenses before credit from Adviser | 7,493 | 10,751 | (3,258) | (30.3) |
| Credit to base management and incentive fees from Adviser | (154) | (35) | (119) | 340.0 |
| Total expenses net of credit to base management and incentive fees | 7,339 | 10,716 | (3,377) | (31.5) |
| NET INVESTMENT INCOME | 9,066 | 8,902 | 164 | 1.8 |
| REALIZED AND UNREALIZED (LOSS) GAIN ON: | | | | |
| Net realized gain (loss) on investments | 5 | (28) | 33 | NM |
| Net unrealized (depreciation) appreciation on investments | (16,014) | 5,082 | (21,096) | NM |
| Net unrealized appreciation on borrowings | 693 | 350 | 343 | 98.0 |
| Net (loss) gain on investments and borrowings | (15,316) | 5,404 | (20,720) | NM |
| NET (DECREASE) INCREASE IN NET ASSETS RESULTING FROM OPERATIONS | \$ (6,250) | \$ 14,306 | \$ (20,556) | NM |

NM = Not Meaningful

Investment Income

Interest income from our investments in debt securities decreased for the six months ended March 31, 2011, as compared to the six months ended March 31, 2010, for several reasons. The level of interest income from investments is directly related to the balance, at cost, of the interest-bearing investment portfolio outstanding during the period multiplied by the weighted average yield. The weighted average cost basis of our interest-bearing investment portfolio during the six months ended March 31, 2011 was approximately \$262.7 million, compared to approximately \$311.2 million for the prior year period, due primarily to increased principal repayments and limited new investment activity subsequent to March 31, 2010. The annualized weighted average yield on our interest-bearing investment portfolio for the six months ended March 31, 2011 was 11.37%, compared to 11.29% for the prior year period. The weighted average yield varies from period to period based on the current stated interest rate on interest-bearing investments and the amounts of loans for which interest is not accruing. The increase in the weighted average yield on our portfolio for the six months ended March 31, 2011 resulted primarily from the repayment of loans with lower stated interest rates. During the six months ended March 31, 2011, six investments were on non-accrual, for an aggregate of approximately \$30.4 million at cost, or 9.7% of the aggregate cost of our investment portfolio, and during the prior year period, six investments were on non-accrual, for an aggregate of approximately \$26.4 million at cost, or 8.0% of the aggregate cost of our investment portfolio.

Other income decreased for the six months ended March 31, 2011, as compared to the prior year period, primarily due to success fees earned in aggregate of \$1.4 million from exits in Doe & Ingalls Management LLC, Tulsa Welding School, ActivStyle, Saunders and Visual Edge, and prepayment fees in aggregate of \$0.3 million from ActiveStyle and ACE during the six months

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ended March 31, 2010, partially offset by the receipt of \$0.6 million in a settlement related, in part, to US Healthcare and success fees in aggregate of \$0.6 million in success fees earned from our exits in Pinnacle and Interfilm Holdings, Inc during the current year period.

The following tables list the interest income from investments for our five largest portfolio company investments during the respective periods:

| Company | As of March 31, 2011 | | Six Months Ended March 31, 2011 | |
|---|----------------------|----------------|---------------------------------|---------------------|
| | Fair Value | % of Portfolio | Interest Income | % of Total Revenues |
| Reliable Biopharmaceutical Holdings, Inc. | \$ 25,699 | 10.0% | \$ 1,508 | 10.0% |
| Westlake Hardware, Inc. | 19,570 | 7.6 | 1,289 | 8.5 |
| Midwest Metal Distribution, Inc. | 16,179 | 6.3 | 1,109 | 7.3 |
| Defiance Acquisition Corp. | 13,680 | 5.3 | 457 | 3.0 |
| Sunshine Media Holdings | 13,161 | 5.1 | 1,568 | 10.4 |
| Subtotal five largest investments | 88,289 | 34.3 | 5,931 | 39.2 |
| Other portfolio companies | 168,824 | 65.7 | 8,960 | 59.2 |
| Other non-portfolio company revenue | | | 244 | 1.6 |
| Total | \$257,113 | 100.0% | \$ 15,135 | 100.0% |

| Company | As of March 31, 2010 | | Six Months Ended March 31, 2010 | |
|---|----------------------|----------------|---------------------------------|---------------------|
| | Fair Value | % of Portfolio | Interest Income | % of Total Revenues |
| Reliable Biopharmaceutical Holdings, Inc. | \$ 26,792 | 9.2% | \$ 1,497 | 8.5% |
| Sunshine Media Holdings | 26,580 | 9.1 | 1,539 | 8.7 |
| Westlake Hardware, Inc. | 24,400 | 8.4 | 1,596 | 9.0 |
| VantaCore | 13,590 | 4.7 | 827 | 4.7 |
| Midwest Metal Distribution, Inc. | 12,855 | 4.4 | 1,037 | 5.8 |
| Subtotal five largest investments | 104,217 | 35.8 | 6,496 | 36.7 |
| Other portfolio companies | 187,534 | 64.2 | 11,026 | 62.1 |
| Other non-portfolio company revenue | | | 221 | 1.2 |
| Total | \$291,751 | 100.0% | \$ 17,743 | 100.0% |

Operating Expenses

Operating expenses, net of credits from our Adviser for fees earned and voluntary and irrevocable waivers applied to the base management and incentive fees, decreased for the six months ended March 31, 2011, as compared to the prior year period. This reduction was primarily due to a decrease in interest expense subsequent to March 31, 2010 and the amortization of deferred financing fees incurred in connection with the Credit Facility during the six months ended March 31, 2010, and a decrease in the base management fee and professional fees, which were partially offset by an increase in the incentive fee during the six months ended March 31, 2011.

Interest expense decreased for the six months ended March 31, 2011, as compared to the prior year period, due primarily to decreased borrowings under the Credit Facility and the reversal of \$0.6 million minimum earnings shortfall fee during the six months ended March 31, 2011. The weighted average balance outstanding on the Credit Facility during the six months ended March 31, 2011 was approximately \$17.2 million, as compared to \$70.0 million in the prior year period, a decrease of 75.4%. On November 22, 2010, we amended the Credit Facility such that advances bear interest at LIBOR subject to a minimum rate of 1.5%, plus 3.75% per annum. For the six months ended March 31, 2010, under our prior credit facility and our pre-amended Credit Facility, advances generally bore interest at LIBOR subject to a minimum rate of 2.0%, plus 4.0% to 4.5% per annum. In addition to the lower interest rate, the amendment removed the annual minimum earnings shortfall fee to the committed lenders. Consequently, we reversed \$0.6 million during the six months ended March 31, 2011 that we had accrued through September 30, 2010 for a projected minimum earnings shortfall fee, as it was no longer applicable.

Amortization of deferred financing fees decreased for the six months ended March 31, 2011, as compared to the prior year period due to significant one-time costs related to the termination of our prior credit facility and transition to the Credit Facility, resulting in increased amortization of deferred financing fees during the six months ended March 31, 2010 when compared to the six months ended March 31, 2011.

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Professional fees decreased for the six months ended March 31, 2011, as compared to the prior period, primarily due to legal fees incurred in connection with troubled loans during the six months ended March 31, 2010.

The base management fee decreased for the six months ended March 31, 2011, as compared to the prior year period, which is reflective of holding fewer assets subject to the base management fee, compared to the prior year period. An incentive fee was earned by our Adviser during the six months ended March 31, 2011, due primarily to decreased interest expense. The incentive fee earned during the prior year period was due in part to other income generated from multiple exits. The base management and incentive fees are computed quarterly, as described under *Investment Advisory and Management Agreement* in Note 4 of the notes to the accompanying *Condensed Consolidated Financial Statements* and are summarized in the following table:

| | Six Months Ended March 31, | |
|--|-----------------------------------|-------------|
| | 2011 | 2010 |
| Average total assets subject to base management fee ⁽¹⁾ | \$ 271,200 | \$ 324,000 |
| Multiplied by pro-rated annual base management fee of 2.0% | 1.0% | 1.0% |
| Unadjusted base management fee | \$ 2,712 | \$ 3,240 |
| Reduction for loan servicing fees ⁽²⁾ | (1,599) | (1,781) |
| Base management fee ⁽²⁾ | 1,113 | 1,459 |
| Credit for fees received by Adviser from the portfolio companies | | |
| Fee reduction for the voluntary, irrevocable waiver of 2.0% fee on senior syndicated loans to 0.5% per annum | (133) | (13) |
| Net base management fee | \$ 980 | \$ 1,446 |
| Incentive fee ⁽²⁾ | \$ 2,261 | \$ 1,447 |
| Credit from voluntary, irrevocable waiver issued by Adviser's board of directors | (21) | (22) |
| Net incentive fee | \$ 2,240 | \$ 1,425 |
| Fee reduction for the voluntary, irrevocable waiver of 2.0% fee on senior syndicated loans to 0.5% per annum | \$ (133) | \$ (13) |
| Incentive fee credit | (21) | (22) |
| Credit to base management and incentive fees from Adviser ⁽²⁾ | \$ (154) | \$ (35) |

(1) 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 and cash equivalents resulting from borrowings, valued at the end of the applicable quarters within the respective periods and appropriately adjusted for any share issuances or repurchases during the periods.

(2) Reflected as a line item on the *Condensed Consolidated Statement of Operations* located elsewhere in this report.

Net Realized Gain (Loss) on Investments

There were \$5 in net realized gains for the six months ended March 31, 2011, primarily due to realized gains from unamortized discounts on exits during the period, partially offset by realized losses in connection with workout expenditures related to the Sunshine Media Holdings restructure. Net realized losses on investments for the six months ended March 31, 2010 were \$28, which consisted of an aggregate of \$1.4 million of realized losses from our exits in CCS, LLC, Gold Toe Investment Corp., Kinetek Acquisition Corporation and Wesco Holdings, Inc., offset by a

realized gain of \$1.4 million from our exit of ACE.

Net Unrealized (Depreciation) Appreciation on Investments

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. During the six months ended March 31, 2011, we recorded net unrealized depreciation on investments in the aggregate amount of \$16.0 million. During the prior year period, we recorded net unrealized appreciation on investments in the aggregate amount of \$5.1 million, which included the reversal of \$2.0 million in unrealized depreciation related to the payoff of Visual Edge and the sale of CCS, LLC. Excluding reversals, we had \$3.1 million in net unrealized appreciation for the six months ended March 31, 2010. The net unrealized (depreciation) appreciation across our investments for the six months ended March 31, 2011 was as follows:

Table of Contents**Six Months Ended March 31, 2011**

| Portfolio Company | Investment Classification | Net Unrealized Appreciation (Depreciation) |
|--|----------------------------------|---|
| Defiance Integrated Technologies, Inc. | Control | \$ 3,972 |
| Puerto Rico Cable Acquisition Company, Inc. | Non-Control / Non-Affiliate | 732 |
| Midwest Metal Distribution, Inc. | Control | 636 |
| WP Evenflo Group Holdings, Inc. | Non-Control / Non-Affiliate | 333 |
| Sunshine Media Holdings | Non-Control / Non-Affiliate | (15,240) |
| Lindmark Acquisition, LLC | Control | (2,461) |
| GFRC Holdings LLC | Non-Control / Non-Affiliate | (1,216) |
| Heartland Communications Group | Non-Control / Non-Affiliate | (654) |
| Legend Communications of Wyoming LLC | Non-Control / Non-Affiliate | (582) |
| SCI Cable, Inc. | Non-Control / Non-Affiliate | (533) |
| International Junior Golf Training Acquisition Company | Non-Control / Non-Affiliate | (479) |
| LocalTel, LLC | Control | (374) |
| Access Television Network, Inc. | Non-Control / Non-Affiliate | (305) |
| Other, net (<\$250) | | 157 |
| | Total: | \$ (16,014) |

The primary driver to our net unrealized depreciation for the six months ended March 31, 2011 was notable depreciation in Sunshine, which was primarily due to portfolio company performance and the restructure and certain comparable multiples, partially offset by appreciation in Defiance Integrated Technologies, Inc., which was due to an improvement in portfolio company performance and in certain comparable multiples.

The unrealized appreciation (depreciation) across our investments for the six months ended March 31, 2010 was as follows:

Six Months Ended March 31, 2010

| Portfolio Company | Investment Classification | Net Unrealized Appreciation (Depreciation) |
|---|----------------------------------|---|
| Visual Edge Technology, Inc. | Non-Control / Non-Affiliate | \$ 1,716 ⁽¹⁾ |
| BAS Broadcasting | Non-Control / Non-Affiliate | 1,266 |
| Westlake Hardware, Inc. | Non-Control / Non-Affiliate | 731 |
| Puerto Rico Cable Acquisition Company, Inc. | Non-Control / Non-Affiliate | 579 |
| Northern Contours, Inc. | Non-Control / Non-Affiliate | 542 |
| Kinetek Acquisition Corp. | Non-Control / Non-Affiliate | 513 |
| CCS, LLC | Non-Control / Non-Affiliate | 505 ⁽¹⁾ |
| Wesco Holdings, Inc. | Non-Control / Non-Affiliate | 408 |
| Pinnacle Treatment Centers, Inc. | Non-Control / Non-Affiliate | 399 |
| WP Evenflo Group Holdings, Inc. | Non-Control / Non-Affiliate | 353 |
| Allison Publications, LLC | Non-Control / Non-Affiliate | 353 |
| Gold Toe Investment Corp | Non-Control / Non-Affiliate | 280 |
| Defiance Integrated Technologies, Inc. | Control | (816) |
| Midwest Metal Distribution, Inc. (formerly Clinton Holdings, LLC) | Control | (654) |

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| | | |
|--------------------------------------|-----------------------------|-----------------|
| KMBQ Corporation | Non-Control / Non-Affiliate | (598) |
| Finn Corporation | Non-Control / Non-Affiliate | (573) |
| Heartland Communications Group | Non-Control / Non-Affiliate | (447) |
| Legend Communications of Wyoming LLC | Non-Control / Non-Affiliate | (395) |
| LocalTel, LLC | Control | (357) |
| SCI Cable, Inc. | Non-Control / Non-Affiliate | (346) |
| Other, net (<\$250) | | 1,623 |
| | Total: | \$ 5,082 |

- (1) Reflects 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.
- (2) Reflects the reversal of the unrealized depreciation in connection with the \$0.3 million realized loss on the sale of CCS, LLC.

Excluding reversals, general increase in our net unrealized appreciation for the six months ended March 31, 2010 was experienced throughout the majority of our entire portfolio of debt holdings, based on increases in market comparables and

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portfolio company performance.

Over our entire investment portfolio, we recorded an aggregate of approximately \$18.5 million of net unrealized depreciation on our debt positions for the six months ended March 31, 2011, while our equity holdings experienced an aggregate of approximately \$2.5 million of net unrealized appreciation. At March 31, 2011, the fair value of our investment portfolio was less than its cost basis by approximately \$57.1 million, or 81.8% of cost, as compared to \$41.1 million at September 30, 2010, representing net unrealized depreciation of \$16.0 million for the period. We believe that our aggregate investment portfolio was valued at a depreciated value due primarily to certain reduced performance by portfolio companies and the general instability of the loan markets and resulting decrease in market multiples relative to where multiples were when we originated such investments in our portfolio. The 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 to stockholders.

Net Unrealized Appreciation on Borrowings

Net unrealized appreciation on borrowings is the net change in the fair value of our line of credit borrowings during the reporting period, including the reversal of previously recorded unrealized appreciation or depreciation when gains and losses are realized. We elected to apply ASC 825, Financial Instruments, which requires us to apply a fair value methodology to the Credit Facility. We estimated the fair value of the Credit Facility using a combination of estimates of value provided by an independent third party and our own assumptions in the absence of observable market data, including estimated remaining life, credit party risk, current market yield and interest rate spreads of similar securities as of the measurement date. The Credit Facility was fair valued at \$33.6 million as of March 31, 2011.

Net (Decrease) Increase in Net Assets Resulting from Operations

For the six months ended March 31, 2011, we realized a net decrease in net assets resulting from operations of \$6.3 million as a result of the factors discussed above. For the six months ended March 31, 2010, we realized a net increase in net assets resulting from operations of \$14.3 million. Our net (decrease) increase in net assets resulting from operations per basic and diluted weighted average common share for the six months ended March 31, 2011 and March 31, 2010 were \$(0.30) and \$0.68, respectively.

LIQUIDITY AND CAPITAL RESOURCES (dollar amounts in thousands, unless otherwise indicated)**Operating Activities**

Net cash used in operating activities for the six months ended March 31, 2011 was \$6.7 million and consisted primarily of disbursements of \$44.2 million in new investments, partially offset by principal repayments of \$35.2 million and net unrealized depreciation of \$16.0 million. Net cash provided by operating activities for the six months ended March 31, 2010 was \$39.2 million and consisted primarily of principal repayments of \$38.4 million. At March 31, 2011, we had investments in equity of, loans to, or syndicated participations in, 45 private companies with an aggregate cost basis of approximately \$314.2 million. At March 31, 2010, we had investments in equity of, loans to, or syndicated participations in, 41 private companies with an aggregate cost basis of approximately \$330.1 million. The following table summarizes our total portfolio investment activity during the six months ended March 31, 2011 and 2010:

| | Six Months Ended March 31, | |
|--|---------------------------------------|-------------|
| | 2011 | 2010 |
| Beginning investment portfolio at fair value | \$ 257,109 | \$ 320,969 |
| New investments | 44,203 | 180 |
| Disbursements to existing portfolio companies | 8,220 | 6,700 |
| Principal repayments | (35,227) | (38,471) |
| Proceeds from sales | (777) | (3,119) |
| Increase in investment balance due to PIK | 8 | 60 |
| Increase in investment balance due to transferred interest | 204 | 441 |
| Unrealized (depreciation) appreciation | (16,014) | 1,645 |

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| | | |
|--|-------------------|-------------------|
| Reversal of prior period depreciation on realization | | 3,437 |
| Net realized gain (loss) | 163 | (28) |
| Net change in premiums, discounts and amortization | (776) | (63) |
| Ending investment portfolio at fair value | \$ 257,113 | \$ 291,751 |

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The following table summarizes the contractual principal repayments and maturity of our investment portfolio by fiscal year, assuming no voluntary prepayments, at March 31, 2011.

| | | Amount |
|---|--|-------------------|
| For the remaining six months ending September 30: | 2011 | \$ 18,295 |
| For the fiscal year ending September 30: | 2012 | 76,646 |
| | 2013 | 122,981 |
| | 2014 | 28,863 |
| | 2015 | 32,088 |
| | 2016 and thereafter | 30,926 |
| | Total contractual repayments | \$ 309,799 |
| | Investments in equity securities | 5,984 |
| | Adjustments to cost basis on debt securities | (1,548) |
| | Total cost basis of investments held at March 31, 2011: | \$ 314,235 |

Financing Activities

Net cash provided by financing activities for the six months ended March 31, 2011 was \$7.9 million and consisted primarily of net borrowings from the Credit Facility of \$16.4 million, partially offset by distributions to stockholders of \$8.8 million. Net cash used in financing activities for the six months ended March 31, 2010 was \$40.3 million and primarily consisted of net payments on the Credit Facility of \$30.0 million and distributions to stockholders of \$8.9 million.

Distributions

To qualify as a RIC and, therefore, avoid corporate level tax on the income we distribute to our stockholders, we are required, under Subchapter M of the Code, to distribute at least 90% of our ordinary income and short-term capital gains to our stockholders on an annual basis. In accordance with these requirements, we declared and paid monthly cash distributions of \$0.07 per common share for January, February and March 2011. In April 2011, our Board of Directors declared a monthly distribution of \$0.07 per common share for each of April, May and June 2011. We declared these distributions based on our estimates of net taxable income for the fiscal year.

For the quarter ended March 31, 2011, please refer to *Section 19(a) Disclosure* below for estimated tax characterization. For the fiscal year ended September 30, 2010, which includes the three months ended March 31, 2010, our distribution payments were approximately \$17.7 million. We declared these distributions based on our estimates of net taxable income for the fiscal year. Our investment pace was slower than expected and, consequently, our net taxable income was lower than our original estimates. A portion of the distributions declared during fiscal 2010 is expected to be treated as a return of capital to our stockholders.

Section 19(a) Disclosure

Our Board of Directors estimates the source of the distributions at the time of their declaration, as required by Section 19(a) of the 1940 Act. On a monthly basis, if required under Section 19(a), we post a Section 19(a) notice through the Depository Trust Company's Legal Notice System and also send to our registered stockholders a written Section 19(a) notice along with the payment of distributions for any payment which includes a distribution estimated to be paid from any source other than accumulative net investment income during the fiscal year. The estimates of the source of the distribution are interim estimates based on accounting principles generally accepted in the United States (GAAP) that are subject to revision, and the exact character of the distributions for tax purposes cannot be determined until our books and records are finalized for the calendar year. Following the calendar year end, after we have determined definitive information, if we have made distributions of taxable income (or return of capital), we will deliver a Form 1099-DIV to our stockholders specifying such amount and the tax characterization of such amount. Therefore, these estimates are made solely to comply with the requirements of Section 19(a) of the 1940 Act and should not be relied

upon for tax reporting or any other purposes and could differ significantly from the actual character of distributions for tax purposes.

Issuance of Equity

On October 20, 2009, we filed a registration statement on Form N-2 (File No. 333-162592), that was declared effective by the SEC on January 28, 2010, and the Company filed a post-effective amendment to such registration statement on April 7, 2011,

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which has not yet been declared effective. Once the post-effective amendment has been declared effective, such registration statement will permit us to issue, through one or more transactions, an aggregate of \$300.0 million in securities, consisting of common stock, senior common stock, preferred stock, subscription rights, debt securities and warrants to purchase common stock, or a combination of these securities.

We anticipate issuing equity securities to obtain additional capital in the future. However, we cannot determine the terms of any future equity issuances or whether we will be able to issue equity on terms favorable to us, or at all. Additionally, when our common stock is trading below NAV per share, as it has consistently traded for the last two years, we will have regulatory constraints under the 1940 Act on our ability to obtain additional capital in this manner. Generally, the 1940 Act provides that we may not issue and sell our common stock at a price below our NAV per share, other than to our then existing stockholders pursuant to a rights offering, without first obtaining approval from our stockholders and our independent directors. As of March 31, 2011, our NAV per share was \$11.18 and as of May 2, 2011 our closing market price was \$11.29 per share. To the extent that our common stock trades at a market price below our NAV per share, we will generally be precluded from raising equity capital through public offerings of our common stock, other than pursuant to stockholder approval or a rights offering. The asset coverage requirement of a business development company under the 1940 Act effectively limits our ratio of debt to equity to 1:1. To the extent that we are unable to raise capital through the issuance of equity, our ability to raise capital through the issuance of debt may also be inhibited to the extent of our regulatory debt to equity ratio limits.

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 determinations prior to any such sale. We have not issued any common stock since February 2008.

On May 17, 2010, we and the Adviser entered into an Equity Distribution Agreement (the "Agreement") with BB&T Capital Markets, a division of Scott & Stringfellow, LLC (the "Agent"), under which we may, from time to time, issue and sell through the Agent up to 2.0 million shares (the "Shares") of our common stock, par value \$0.001 per share based upon instructions from us (including, at a minimum, the number of Shares to be offered, the time period during which sales are requested to be made, any limitation on the number of Shares that may be sold in any one day and any minimum price below which sales may not be made). Sales of Shares through the Agent, if any, will be executed by means of either ordinary brokers' transactions on the NASDAQ Global Select Market in accordance with Rule 153 under the Securities Act of 1933, as amended, or such other sales of the Shares as shall be agreed by us and the Agent. The compensation payable to the Agent for sales of Shares with respect to which the Agent acts as sales agent shall be equal to 2.0% of the gross sales price of the Shares for amounts of Shares sold pursuant to the Agreement. To date, we have not issued any shares pursuant to this Agreement.

Revolving Credit Facility

On March 15, 2010, we entered into the Credit Facility. Branch Banking and Trust Company and ING Capital LLC 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. On the Amendment Date, we amended the Credit Facility. Prior to the Amendment Date, advances under the Credit Facility bore interest at LIBOR, subject to a minimum rate of 2.0%, plus 4.5% per annum, with a commitment fee of 0.5% per annum on undrawn amounts. Effective as of the Amendment Date, advances under the Credit Facility bear interest at LIBOR, subject to a minimum rate of 1.5%, plus 3.75% per annum, with a commitment fee of 0.5% per annum on undrawn amounts when the facility is drawn more than 50% and 1.0% per annum on undrawn amounts when the facility is drawn less than 50%. In addition, effective as of the Amendment Date, we are no longer obligated to pay an annual minimum earnings shortfall fee to the committed lenders, which was calculated as the difference between the weighted average of borrowings outstanding under the Credit Facility and 50.0% of the commitment amount of the Credit Facility, multiplied by 4.5% per annum, less commitment fees paid during the year. As of the Amendment Date, we paid a \$0.7 million fee.

As of March 31, 2011, there was a cost basis of approximately \$33.2 million of borrowings outstanding under the Credit Facility at an average interest rate of 5.25%. As of May 2, 2011, there was a cost basis of approximately \$47.2 million of borrowings outstanding. We expect that the Credit Facility will allow us to increase the rate of our investment activity and grow the size of our investment portfolio. Available borrowings are subject to various constraints imposed under the Credit Facility, based on the aggregate loan balance pledged by us. Interest is payable monthly during the term of the Credit Facility. The Credit Facility matures on March 15, 2012, and, if the facility is not renewed or extended by this date, all unpaid principal and interest will be due and payable on March 15, 2013. In addition, if the Credit Facility is not renewed on or before March 15, 2012, we will be required to use all principal collections from the pledged loans to pay outstanding principal on the Credit Facility.

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The Credit Facility contains covenants that require Business Loan to maintain its status as a separate entity, prohibit certain significant corporate transactions (such as mergers, consolidations, liquidations or dissolutions), and restrict material changes to our credit and collection policies. The facility requires a minimum of 20 obligors in the borrowing base and also limits payments of distributions. As of March 31, 2011, Business Loan had 30 obligors and we were in compliance with all of the Credit Facility covenants.

Contractual Obligations and Off-Balance Sheet Arrangements

As of March 31, 2011, we were not party to any signed term sheets for potential investments. However, we have certain line of credit and capital commitments with our portfolio companies that have not been fully drawn or called, respectively. Since these commitments have expiration dates, and we expect many will never be fully drawn or called, the total commitment amounts do not necessarily represent future cash requirements. We estimate the fair value of these unused and uncalled commitments as of March 31, 2011 and September 30, 2010 to be nominal.

In July 2009, we executed a guaranty of a line of credit agreement between Comerica Bank and Defiance Integrated Technologies, Inc. (the Guaranty), one of our Control investments. Pursuant to the Guaranty, if Defiance had a payment default, the guaranty was callable once the bank had reduced its claim by using commercially reasonable efforts to collect through disposition of the Defiance collateral. The Guaranty was limited to \$0.3 million plus interest on that amount accrued from the date demand payment is made under the Guaranty, and all costs incurred by the bank in its collection efforts. On March 1, 2011, the Guaranty was terminated.

In accordance with GAAP, the unused and uncalled portions of these commitments are not recorded on the accompanying *Condensed Consolidated Statements of Assets and Liabilities*. The following table summarizes the nominal dollar balance of unused line of credit commitments, uncalled capital commitments and guarantees as of March 31, 2011 and September 30, 2010:

| | As of March 31, 2011 | As of September 30, 2010 |
|-----------------------------------|-------------------------------------|---|
| Unused line of credit commitments | \$ 7,361 | \$ 9,304 |
| Uncalled capital commitment | 1,200 | 1,600 |
| Guarantees | | 250 |

The following table shows our contractual obligations as of March 31, 2011:

| | Payments Due by Period | | | | Total |
|--|---------------------------------|----------------------|----------------------|--------------------------|--------------|
| | Less than 1 Year | 1-3 Years | 4-5 Years | After 5 Years | |
| Contractual Obligations⁽¹⁾ | | | | | |
| Credit Facility ⁽²⁾ | \$ 33,200 | \$ | \$ | \$ | \$ 33,200 |

(1) Excludes the unused commitments to extend credit or capital to our portfolio companies for an aggregate amount of \$8.6 million, as discussed above.

(2) Principal balance of borrowings under the Credit Facility, based on the contractual maturity due to the revolving nature of the facility.

Critical Accounting Policies

The preparation of financial statements and related disclosures in conformity with GAAP requires management to make estimates and assumptions that affect the reported consolidated amounts of assets and liabilities, including disclosure of contingent assets and liabilities at the date of the financial statements, and revenues and expenses during the period reported. Actual results could differ materially from those estimates. We have identified our investment valuation process as our most critical accounting policy.

Investment Valuation

The most significant estimate inherent in the preparation of our accompanying *Condensed Consolidated Financial Statements* is the valuation of investments and the related amounts of unrealized appreciation and depreciation on investments recorded.

General Valuation Policy: We value our investments in accordance with the requirements of the 1940 Act. As discussed more fully below, we value securities for which market quotations are readily available and reliable at their market value. We value all other securities and assets at fair value as determined in good faith by our Board of Directors.

ASC 820 defines fair value, establishes a framework for measuring fair value and expands disclosures about assets and liabilities measured at fair value. ASC 820 provides a consistent definition of fair value that focuses on exit price in the principal, or most

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advantageous, market and prioritizes, within a measurement of fair value, the use of market-based inputs over entity-specific inputs. ASC 820 also establishes the following three-level hierarchy for fair value measurements based upon the transparency of inputs to the valuation of an asset or liability as of the measurement date.

Level 1 inputs to the valuation methodology are quoted prices (unadjusted) for identical assets or liabilities in active markets;

Level 2 inputs to the valuation methodology include quoted prices for similar assets and liabilities in active markets, and inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the financial instrument. Level 2 inputs are in those markets for which there are few transactions, the prices are not current, little public information exists or instances where prices vary substantially over time or among brokered market makers; and

Level 3 inputs to the valuation methodology are unobservable and significant to the fair value measurement. Unobservable inputs are those inputs that reflect our own assumptions that market participants would use to price the asset or liability based upon the best available information.

See Note 3, *Investments* in the accompanying notes to our condensed consolidated financial statements included elsewhere in this report for additional information regarding fair value measurements and our adoption of ASC 820. We use generally accepted valuation techniques to value our portfolio unless we have specific information about the value of an investment to determine otherwise. From time to time we may accept an appraisal of a business in which we hold securities. These appraisals are expensive and occur infrequently but provide a third-party valuation opinion that may differ in results, techniques and scopes used to value our investments. When these specific third-party appraisals are engaged or accepted, we would use estimates of value provided by such appraisals and our own assumptions including estimated remaining life, current market yield and interest rate spreads of similar securities as of the measurement date to value the investment we have in that business.

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 our 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.

The *Policy*, which is summarized below, applies to the following categories of securities:

Publicly-traded securities;

Securities for which a limited market exists; and

Securities for which no market exists.

Valuation Methods:

Publicly-traded securities: We determine the value of publicly-traded securities based on the closing price for the security on the exchange or securities market on which it is listed and primarily traded on the valuation date. To the extent that we own restricted securities that are not freely tradable, but for which a public market otherwise exists, we will use the market value of that security adjusted for any decrease in value resulting from the restrictive feature.

Securities for which a limited market exists: We value securities that are not traded on an established secondary securities market, but for which a limited market for the security exists, such as certain participations in, or assignments of, syndicated loans, at the quoted bid price. In valuing these assets, we assess trading activity in an asset class, evaluate variances in prices and other market insights to determine if any available quote prices are reliable. If we conclude that quotes based on active markets or trading activity may be relied upon, firm bid prices are requested; however, if a firm bid price is unavailable, we base the value of the security upon the indicative bid price (*IBP*) offered by the respective originating syndication agent's trading desk, or secondary desk, on or near the valuation date. To the extent that we use the *IBP* as a basis for valuing the security, our Adviser may take further steps to consider additional information to validate that price in accordance with the *Policy*.

In the event these limited markets become illiquid such that market prices are no longer readily available, we will value our syndicated loans using alternative methods, such as estimated net present values of the future cash flows or discounted cash flows (DCF). The use of a DCF methodology follows that prescribed by ASC 820, which provides guidance on the use of a reporting entity s own assumptions about future cash flows and risk-adjusted discount rates when relevant observable inputs, such as quotes in active markets, are not available. When relevant observable market data does not exist, the alternative outlined in ASC 820 is the valuation of investments based on DCF. For the purposes of using DCF to provide fair value estimates, we consider multiple inputs such as a risk-adjusted discount rate that incorporates adjustments that market participants would make both for

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nonperformance and liquidity risks. As such, we developed a modified discount rate approach that incorporates risk premiums including, among others, increased probability of default, or higher loss given default, or increased liquidity risk. The DCF valuations applied to the syndicated loans provide an estimate of what we believe a market participant would pay to purchase a syndicated loan in an active market, thereby establishing a fair value. We apply the DCF methodology in illiquid markets until quoted prices are available or are deemed reliable based on trading activity. As of March 31, 2011, we assessed trading activity in syndicated loan assets and determined that there continued to be market liquidity and a secondary market for these assets. Thus, firm bid prices, or IBPs, were used to fair value our syndicated loans at March 31, 2011.

Securities for which no market exists: The valuation methodology for securities for which no market exists falls into three categories: (1) portfolio investments comprised solely of debt securities; (2) portfolio investments in controlled companies comprised of a bundle of securities, which can include debt and equity securities; and (3) portfolio investments in non-controlled companies comprised of a bundle of investments, which can include debt and equity securities; and (4) portfolio investments comprised of non-publicly-traded non-control equity securities of other funds.

(1) Portfolio investments comprised solely of debt securities: Debt securities that are not publicly traded on an established securities market, or for which a limited market does not exist (Non-Public Debt Securities), and that are issued by portfolio companies in which we have no equity, or equity-like securities, are fair valued in accordance with the terms of the policy, which utilizes opinions of value submitted to us by Standard & Poor's Securities Evaluations, Inc (SPSE). We may also submit paid in kind (PIK) interest to SPSE for its evaluation when it is determined that PIK interest is likely to be received.

In the case of Non-Public Debt Securities, we have engaged SPSE to submit opinions of value for our debt securities that are issued by portfolio companies in which we own no equity, or equity-like securities. SPSE's opinions of value are based on the valuations prepared by our portfolio management team, as described below. We request that SPSE also evaluate and assign values to success fees when we determine that there is a reasonable probability of receiving a success fee on a given loan. SPSE will only evaluate the debt portion of our investments for which we specifically request evaluation, and may decline to make requested evaluations for any reason, at its sole discretion. Upon completing our collection of data with respect to the investments (which may include the information described below under Credit Information, the risk ratings of the loans described below under Loan Grading and Risk Rating and the factors described hereunder), this valuation data is forwarded to SPSE for review and analysis. SPSE makes its independent assessment of the data that we have assembled and assesses its independent data to form an opinion as to what they consider to be the market values for the securities. With regard to its work, SPSE has issued the following paragraph:

SPSE provides evaluated price opinions which are reflective of what SPSE believes the bid side of the market would be for each loan after careful review and analysis of descriptive, market and credit information. Each price reflects SPSE's best judgment based upon careful examination of a variety of market factors. Because of fluctuation in the market and in other factors beyond its control, SPSE cannot guarantee these evaluations. The evaluations reflect the market prices, or estimates thereof, on the date specified. The prices are based on comparable market prices for similar securities. Market information has been obtained from reputable secondary market sources. Although these sources are considered reliable, SPSE cannot guarantee their accuracy.

SPSE opinions of the value of our debt securities that are issued by portfolio companies in which we do not own equity or equity-like securities are submitted to our Board of Directors along with our Adviser's supplemental assessment and recommendation regarding valuation of each of these investments. Our Adviser generally accepts the opinion of value given by SPSE; however, in certain limited circumstances, such as when our Adviser may learn new information regarding an investment between the time of submission to SPSE and the date of our Board of Directors' assessment, our Adviser's conclusions as to value may differ from the opinion of value delivered by SPSE. Our Board of Directors then reviews whether our Adviser has followed its established procedures for determinations of fair value, and votes to accept or reject the recommended valuation of our investment portfolio. Our Adviser and our management recommended, and our Board of Directors voted to accept, the opinions of value delivered by SPSE on the loans in our portfolio as denoted on the Schedule of Investments included in our

accompanying *Condensed Consolidated Financial Statements*.

Because there is a delay between when we close an investment and when the investment can be evaluated by SPSE, new loans are not valued immediately by SPSE; rather, management makes its own determination about the value of these investments in accordance with our valuation policy using the methods described herein.

- (2) **Portfolio investments in controlled companies comprised of a bundle of investments, which can include debt and equity securities:** The fair value of these investments is determined based on the total enterprise value (TEV) of the portfolio company, or issuer, utilizing a liquidity waterfall approach under ASC 820. For Non-Public Debt Securities and

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equity or equity-like securities (e.g. preferred equity, common equity, or other equity-like securities) that are purchased together as part of a package, where we have control or could gain control through an option or warrant security, both the debt and equity securities of the portfolio investment would exit in the mergers and acquisitions market as the principal market, generally through a sale or recapitalization of the portfolio company. In accordance with ASC 820, we apply the in-use premise of value which assumes the debt and equity securities are sold together. Under this liquidity waterfall approach, we continue to use the enterprise value methodology utilizing a liquidity waterfall approach to determine the fair value of these investments under ASC 820 if we have the ability to initiate a sale of a portfolio company as of the measurement date. Under this approach, we first calculate the TEV of the issuer by incorporating some or all of the following factors:

the issuer's ability to make payments;

the earnings of the issuer;

recent sales to third parties of similar securities;

the comparison to publicly traded securities; and

DCF or other pertinent factors.

In gathering the sales to third parties of similar securities, we may gather and analyze industry statistics and use outside experts. Once we have estimated the TEV of the issuer, we subtract the value of all the debt securities of the issuer, which are valued at the contractual principal balance. Fair values of these debt securities are discounted for any shortfall of TEV over the total debt outstanding for the issuer. Once the values for all outstanding senior securities (which include the debt securities) have been subtracted from the TEV of the issuer, the remaining amount, if any, is used to determine the value of the issuer's equity or equity like securities. If, in our Adviser's judgment, the liquidity waterfall approach does not accurately reflect the value of the debt component, our Adviser may recommend that we use a valuation by SPSE, or if that is unavailable, a DCF valuation technique.

- (3) **Portfolio investments in non-controlled companies comprised of a bundle of investments, which can include debt and equity securities:** We value Non-Public Debt Securities that are purchased together with equity or equity-like securities from the same portfolio company, or issuer, for which we do not control or cannot gain control as of the measurement date, using a hypothetical secondary market as our principal market. In accordance with ASC 820, we determine the fair value of these debt securities of non-control investments assuming the sale of an individual debt security using the in-exchange premise of value (as defined in ASC 820). As such, we estimate the fair value of the debt component using estimates of value provided by SPSE and our own assumptions in the absence of observable market data, including synthetic credit ratings, estimated remaining life, current market yield and interest rate spreads of similar securities as of the measurement date. Subsequent to June 30, 2009, for equity or equity-like securities of investments that we do not control or cannot gain control as of the measurement date, we estimate the fair value of the equity using the in-exchange premise of value based on factors such as the overall value of the issuer, the relative fair value of other units of account, including debt, or other relative value approaches. Consideration also is given to capital structure and other contractual obligations that may impact the fair value of the equity. Further, we may utilize comparable values of similar companies, recent investments and indices with similar structures and risk characteristics or our own assumptions in the absence of other observable market data, and may also employ DCF valuation techniques.
- (4) **Portfolio investments comprised of non-publicly traded non-control equity securities of other funds:** We value any uninvested capital of the non-control fund at par value and value any invested capital at the value provided by the non-control fund.

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, and the differences could be material. Additionally, changes in the market environment and other events that may occur over the life of the investments may cause the gains or losses ultimately realized on these investments to be different than the valuations

currently assigned. There is no single standard for determining fair value in good faith, as fair value depends upon circumstances of each individual case. In general, fair value is the amount that we might reasonably expect to receive upon the current sale of the security in an arms-length transaction in the security's principal market.

Valuation Considerations: From time to time, depending on certain circumstances, the Adviser may use the following valuation considerations, including, but not limited to:

the nature and realizable value of the 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;

the comparison to publicly traded companies; and

DCF and other relevant factors.

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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.

Credit Information: Our Adviser monitors a wide variety of key credit statistics that provide information regarding our portfolio companies to help us assess credit quality and portfolio performance. We and our Adviser participate in the periodic board meetings of our portfolio companies in which we hold Control and Affiliate investments and also require them to provide annual audited and monthly unaudited financial statements. Using these statements or comparable information and board discussions, our Adviser calculates and evaluates the credit statistics.

Loan Grading and Risk Rating: As part of our valuation procedures above, we risk rate all of our investments in debt securities. For syndicated loans that have been rated by an NRSRO (as defined in Rule 2a-7 under the 1940 Act), we use the NRSRO's risk rating for such security. For all other debt securities, we use a proprietary risk rating system. Our risk rating system uses a scale of 0 to 10, with 10 being the lowest probability of default. This system is used to estimate the probability of default on debt securities and the probability of loss if there is a default. These types of systems are referred to as risk rating systems and are used by banks and rating agencies. The risk rating system covers both qualitative and quantitative aspects of the business and the securities we hold. During the three months ended March 31, 2010, we modified our risk rating model to incorporate additional factors in our qualitative and quantitative analysis. While the overall process did not change, we believe the additional factors enhance the quality of the risk ratings of our investments. No adjustments were made to prior periods as a result of this modification.

For the debt securities for which we do not use a third-party NRSRO risk rating, we seek to have our risk rating system mirror the risk rating systems of major risk rating organizations, such as those provided by an NRSRO. While we seek to mirror the NRSRO systems, we cannot provide any assurance that our risk rating system will provide the same risk rating as an NRSRO for these securities. The following chart is an estimate of the relationship of our risk rating system to the designations used by two NRSROs as they risk rate debt securities of major companies. Because our system rates debt securities of companies that are unrated by any NRSRO, there can be no assurance that the correlation to the NRSRO set out below is accurate. We believe our risk rating would be significantly higher than a typical NRSRO risk rating because the risk rating of the typical NRSRO is designed for larger businesses. However, our risk rating has been designed to risk rate the securities of smaller businesses that are not rated by a typical NRSRO. Therefore, when we use our risk rating on larger business securities, the risk rating is higher than a typical NRSRO rating. The primary difference between our risk rating and the rating of a typical NRSRO is that our risk rating uses more quantitative determinants and includes qualitative determinants that we believe are not used in the NRSRO rating. It is our understanding that most debt securities of medium-sized companies do not exceed the grade of BBB on an NRSRO scale, so there would be no debt securities in the middle market that would meet the definition of AAA, AA or A. Therefore, our scale begins with the designation 10 as the best risk rating which may be equivalent to a BBB- or Baa3 from an NRSRO, however, no assurance can be given that a 10 on our scale is equal to a BBB- or Baa3 on an NRSRO scale.

| Company's System | First NRSRO | Second NRSRO | Gladstone Capital's Description ⁽¹⁾ |
|------------------|-------------|--------------|--|
| >10 | Baa2 | BBB | Probability of Default (PD) during the next ten years is 4% and the Expected Loss (EL) is 1% or less |
| 10 | Baa3 | BBB- | PD is 5% and the EL is 1% to 2% |
| 9 | Ba1 | BB+ | PD is 10% and the EL is 2% to 3% |
| 8 | Ba2 | BB | PD is 16% and the EL is 3% to 4% |
| 7 | Ba3 | BB- | PD is 17.8% and the EL is 4% to 5% |
| 6 | B1 | B+ | PD is 22% and the EL is 5% to 6.5% |
| 5 | B2 | B | PD is 25% and the EL is 6.5% to 8% |
| 4 | B3 | B- | PD is 27% and the EL is 8% to 10% |
| 3 | Caa1 | CCC+ | PD is 30% and the EL is 10% to 13.3% |
| 2 | Caa2 | CCC | PD is 35% and the EL is 13.3% to 16.7% |

| | | | |
|----------|------|----|--|
| 1 | Caa3 | CC | PD is 65% and the EL is 16.7% to 20% |
| 0 | N/A | D | PD is 85% or there is a payment default and the EL is greater than 20% |

- (1) The default rates set forth are for a ten year term debt security. If a debt security is less than ten years, then the probability of default is adjusted to a lower percentage for the shorter period, which may move the security higher on our risk rating scale.

The above scale gives an indication of the probability of default and the magnitude of the loss if there is a default. Our policy is to stop accruing interest on an investment if we determine that interest is no longer collectible. As of March 31, 2011 and September 30, 2010, two Non-Control/Non-Affiliate investments and four Control investments were on non-accrual. Additionally, we do not risk rate our equity securities.

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The following table lists the risk ratings for all non-syndicated loans in our portfolio at March 31, 2011 and September 30, 2010, representing approximately 82.1% and 93.2%, respectively, at fair value of all loans in our portfolio at the end of each period:

| Rating | March 31, 2011 | September 30, 2010 |
|------------------|---------------------------|-------------------------------|
| Highest | 10.0 | 10.0 |
| Average | 5.9 | 6.1 |
| Weighted Average | 5.7 | 5.9 |
| Lowest | 1.0 | 1.0 |

For syndicated loans that are currently rated by an NRSRO, we risk rate such loans in accordance with the risk rating systems of major risk rating organizations, such as those provided by an NRSRO. The following table lists the risk ratings for all syndicated loans in our portfolio that were rated by an NRSRO at March 31, 2011 and September 30, 2010, representing approximately 15.2% and 4.3%, respectively, at fair value of all loans in our portfolio at the end of each period:

| Rating | March 31, 2011 | September 30, 2010 |
|------------------|-----------------------|---------------------------|
| Highest | B+/B2 | B+/B2 |
| Average | B/B2 | B+/B2 |
| Weighted Average | B/B1 | B+/B2 |
| Lowest | Caa1/B- | B2 |

As of March 31, 2011 and September 30, 2010, we had one syndicated loan representing 2.7% and 2.5%, respectively, at fair value of all loans in our portfolio that was not rated by an NRSRO. Based on our model, it had a risk rating of 7.0 as of March 31, 2011 and September 30, 2010.

Tax Status*Federal Income Taxes*

We intend to continue to qualify for treatment as a RIC under Subtitle A, Chapter 1 of Subchapter M of the Code. As a RIC, we are not subject to federal income tax on the portion of our taxable income and gains distributed to stockholders. To qualify as a RIC, we must meet certain source-of-income, asset diversification and annual distribution requirements. Under the annual distribution requirements, we are required to distribute to stockholders at least 90% of our investment company taxable income, as defined by the Code. Our policy is to pay out as distributions up to 100% of that amount.

In an effort to avoid certain excise taxes to which RICs are subject, we intend to distribute, during each calendar year, an amount at least equal to the sum of: (1) 98% of our ordinary income for the calendar year, (2) 98% of our capital gains in excess of capital losses for the one-year period ending on October 31 of the calendar year, and (3) any ordinary income and net capital gains from preceding years that were not distributed during such years.

We sought and received a private letter ruling from the Internal Revenue Service (IRS) related to our tax treatment for success fees. In the ruling, executed by our consent on January 3, 2011, we, in effect, will continue to account for the recognition of income from the success fees upon receipt, or when the amount becomes fixed. However, starting January 1, 2011, the tax characterization of the success fee amount will be treated as ordinary income. Previously, we had treated the success fee amount as a capital gain for tax characterization purposes. The private letter ruling does not require us to retroactively change the capital gains treatment of the success fees received prior to January 1, 2011.

Investment Income Recognition

Interest income, adjusted for amortization of premiums and acquisition costs and for the accretion of discounts, is recorded on an accrual basis to the extent that such amounts are expected to be collected. Generally, when a loan becomes 90 days or more past due or if our qualitative assessment indicates that the debtor is unable to service its debt or other obligations, we will place the loan on non-accrual status and cease recognizing interest income on that loan until the borrower has demonstrated the ability and intent to pay contractual amounts due. However, we remain contractually entitled to this interest. Interest payments received on non-accrual loans may be recognized as income or

applied to principal depending upon management's judgment. Non-accrual loans are restored to accrual status when past due principal and interest is paid and in management's judgment, are likely to remain current. As of March 31, 2011, two Non-Control/Non-Affiliate investments and four Control investments were on non-accrual with an aggregate cost basis of approximately \$30.4 million, or 9.7% of the cost basis of all loans in our portfolio. As of September 30, 2010, two Non-Control/Non-Affiliate investments and four Control investments were on non-accrual with an

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aggregate cost basis of approximately \$29.9 million, or 10.0% of the cost basis of all loans in our portfolio.

As of March 31, 2011, we had loans in our portfolio which contain a PIK provision. The PIK interest, computed at the contractual rate specified in each loan agreement, is added to the principal balance of the loan and recorded as income. To maintain our status as a RIC, this non-cash source of income must be paid out to stockholders in the form of distributions, even though we have not yet collected the cash. We recorded PIK income of \$4 and \$8 for the three and six months ended March 31, 2011, respectively, as compared to \$4 and \$60 for the three and six months ended March 31 2010, respectively.

We also transfer past due interest to the principal balance as stipulated in certain loan amendments with portfolio companies. We transferred past due interest to the principal balance of \$204 for the three and six months ended March 31, 2011, as compared to \$338 and \$441 for the three and six months ended March, 31 2010, respectively. As of March 31, 2011, we had fifteen original issue discount (OID) loans. We recorded OID income of \$29 and \$53 for the three and six months ended March 31, 2011, respectively, as compared to \$2 for the three and six months ended March 31, 2010.

Success fees are recorded upon receipt. Success fees are contractually due upon a change of control in a portfolio company and are recorded in Other income in the accompanying *Condensed Consolidated Statements of Operations*. We recorded \$0.6 million of success fees during the six months ended March 31, 2011, which resulted from the exits of Pinnacle Treatment Centers, Inc. and Interfilm Holdings, Inc. During the six months ended March 31, 2010, we received \$1.4 million in success fees from the exits of ActivStyle Acquisition Co., Saunders & Associates, Visual Edge Technology, Inc., Tulsa Welding School, and the prepayment of success fees from Doe & Ingalls Management LLC.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK.

Market risk includes risks that arise from changes in interest rates, foreign currency exchange rates, commodity prices, equity prices and other market changes that affect market sensitive instruments. The primary risk we believe we are exposed to is interest rate risk. While we expect that ultimately approximately 20% of the loans in our portfolio will be made at fixed rates, with approximately 80% made at variable rates or variables rates with a floor mechanism, all of our variable-rate loans have rates associated with either the current LIBOR or Prime Rate. At March 31, 2011, our portfolio, at cost, consisted of the following breakdown in relation to all outstanding debt investments:

| | |
|-------|---|
| 85.4% | variable rates with a floor |
| 5.2% | variable rates without a floor or ceiling |
| 9.4% | fixed rate |

100.0% total

Our Credit Facility has a variable rate based on LIBOR with a 1.5% floor. If LIBOR increases, we could be subject to increased borrowing costs. There have been no material changes in the quantitative and qualitative market risk disclosures for the six months ended March 31, 2011 from that disclosed in our Annual Report on Form 10-K for the fiscal year ended September 30, 2010, as filed with the SEC on November 22, 2010.

ITEM 4. CONTROLS AND PROCEDURES.**a) Evaluation of Disclosure Controls and Procedures**

As of March 31, 2011, we, including our Chief Executive Officer and Chief Financial Officer, evaluated the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)). Based on that evaluation, our management, including our Chief Executive Officer and Chief Financial Officer, concluded that our disclosure controls and procedures were effective at a reasonable assurance level in timely alerting management, including our Chief Executive Officer and Chief Financial Officer, of material information about us required to be included in periodic Securities and Exchange Commission filings. However, in evaluating the disclosure controls and procedures, management recognized that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives, and management necessarily was required to apply its judgment in evaluating the cost-benefit

relationship of possible controls and procedures.

b) Changes in Internal Control over Financial Reporting

There have been no changes in our internal control over financial reporting that occurred during the quarter ended March 31, 2011, that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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PART II OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS.

Neither we nor any of our subsidiaries are currently subject to any material legal proceeding, nor, to our knowledge, is any material legal proceeding threatened against us or any of our subsidiaries.

ITEM 1A. RISK FACTORS.

Our business is subject to certain risks and events that, if they occur, could adversely affect our financial condition and results of operations and the trading price of our common stock. For a discussion of these risks, please refer to the Risk Factors section of the post-effective amendment of our registration statement on Form N-2 (File No. 333-162592), filed by us with the SEC on April 7, 2011.

ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS.

Not applicable.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES.

Not applicable.

ITEM 4. (REMOVED AND RESERVED).

ITEM 5. OTHER INFORMATION.

Not applicable

ITEM 6. EXHIBITS

See the exhibit index.

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SIGNATURE

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

**GLADSTONE CAPITAL
CORPORATION**

By: */s/ David Watson*
David Watson
Chief Financial Officer

Date: May 3, 2011

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EXHIBIT INDEX

| Exhibit | Description |
|----------------|--|
| 3.1 | Articles of Amendment and Restatement of the Articles of Incorporation, incorporated by reference to Exhibit a.2 to Pre-Effective Amendment No. 1 to the Registration Statement on Form N-2 (File No. 333-63700), filed July 27, 2001. |
| 3.2 | By-laws, incorporated by reference to Exhibit b to Pre-Effective Amendment No. 1 to the Registration Statement on Form N-2 (File No. 333-63700), filed July 27, 2001. |
| 3.3 | Amendment to By-laws, incorporated by reference to Exhibit 3.3 to the Company's Quarterly Report on Form 10-Q for the quarter ended December 31, 2003 (File No. 814-00237), filed February 17, 2004. |
| 3.4 | Second amendment to By-laws, incorporated by reference to Exhibit 99.1 to the Company's Current Report on Form 8-K (File No. 814-00237), filed July 10, 2007. |
| 11 | Computation of Per Share Earnings (included in the notes to the unaudited condensed consolidated financial statements contained in this report). |
| 31.1 | Certification of Chief Executive Officer pursuant to section 302 of the Sarbanes-Oxley Act of 2002. |
| 31.2 | Certification of Chief Financial Officer pursuant to section 302 of the Sarbanes-Oxley Act of 2002. |
| 32.1 | Certification of Chief Executive Officer pursuant to section 906 of the Sarbanes-Oxley Act of 2002. |
| 32.2 | Certification of Chief Financial Officer pursuant to section 906 of the Sarbanes-Oxley Act of 2002. |

All other exhibits for which provision is made in the applicable regulations of the Securities and Exchange Commission are not required under the related instruction or are inapplicable and therefore have been omitted.