

GLADSTONE CAPITAL CORP  
Form 497  
August 22, 2007

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Registration No. 333-143027

**PROSPECTUS SUPPLEMENT**

(To Prospectus dated July 5, 2007)

**GLADSTONE CAPITAL CORPORATION**  
150,000 Shares of Common Stock

We are offering an aggregate of 150,000 shares of our common stock, \$0.001 par value per share. Our common stock is listed on the Nasdaq Global Select Market under the symbol GLAD. We are 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. On August 20, 2007, the last reported sale price of our common stock on the Nasdaq Global Select Market was \$20.80 per share.

We are offering these shares of common stock on a best-efforts basis to institutional investors. We have retained Ferris, Baker Watts, Incorporated to act as placement agent in connection with this offering.

**Investing in our common stock involves risks. See Risk Factors beginning on page 9 of the accompanying prospectus.**

	Per Share	Total
Offering Price	\$ 21.32	\$ 3,198,000
Placement Agent's Fee	\$ 0.6396	\$ 95,940
Proceeds, before expenses, to us	\$ 20.68	\$ 3,102,060

We estimate the total expenses of this offering, excluding the placement agent's fees, will be approximately \$111,000. Because there is no minimum offering amount required as a condition to closing in this offering, the actual offering amount, the placement agent's fees and net proceeds to us, if any, in this offering may be substantially less than the total maximum offering amounts set forth above. We are not required to sell any specific number or dollar amount of shares of common stock in this offering, but the placement agent will use its commercially reasonable efforts to arrange for the sale of all of the shares of common stock offered.

We expect to deliver the shares to the purchasers on or about August 22, 2007.

**Neither the Securities and Exchange Commission, any state securities commission, nor any other regulatory body has approved or disapproved of these securities or determined if this prospectus supplement or the accompanying prospectus is truthful or complete. Any representation to the contrary is a criminal offense.**

**The date of this prospectus supplement is August 21, 2007.**

We have not authorized any dealer, salesman or other person to give any information or to make any representation other than those contained or incorporated by reference in this prospectus or any accompanying supplement to this prospectus. You must not rely upon any information or representation not contained or incorporated by reference in this prospectus or the accompanying prospectus supplement as if we had authorized it. This prospectus and any prospectus supplement do not constitute an offer to sell or a solicitation of any offer to buy any security other than the registered securities to which they relate, nor do they constitute an offer to sell or a solicitation of an offer to buy any securities in any jurisdiction to any person to whom it is unlawful to make such an offer or solicitation in such jurisdiction. The information contained in this prospectus and any prospectus supplement is accurate as of the dates on their respective covers only. Our business, financial condition, results of operations and prospects may have changed since such dates.

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**THE OFFERING**

Common Stock offered by us	150,000 shares
Common Stock outstanding after this offering (1)	14,762,574 shares
Use of proceeds	We expect to use all of the net proceeds of this offering to repay outstanding indebtedness under our line of credit. See Use of Proceeds.
Nasdaq Global Select Market Symbol	GLAD
Risk Factors	See Risk Factors in the accompanying prospectus and other information in this prospectus supplement and the accompanying prospectus for a discussion of factors you should carefully consider before deciding to invest in shares of our common stock.

(1) Based on the number of shares outstanding as of August 20, 2007.

**FEES AND EXPENSES**

The following table is intended to assist you in understanding the costs and expenses that an investor in this offering will bear directly or indirectly. We caution you that some of the percentages indicated in the table below are estimates and may vary. Except where the context suggests otherwise, whenever this prospectus contains a reference to fees or expenses paid by us or Gladstone Capital, or that we will pay fees or expenses, stockholders will indirectly bear such fees or expenses as investors in Gladstone Capital. The following percentages were calculated based on net assets as of June 30, 2007.

	<b>Current</b>
<b>Stockholder Transaction Expenses</b>	
Placement agent fee (as a percentage of offering price)	3 %
Dividend reinvestment plan expenses(1)	None
<b>Estimated annual expenses (as a percentage of net assets attributable to common stock)</b>	
Management fees(2)	3.51 %
Incentive fees payable under investment advisory and management agreement (20% of realized capital gains and 20% of pre-incentive fee net investment income)(3)	2.15 %
Interest Payments on Borrowed Funds(4)	3.03 %
Other expenses	1.00 %
Total annual expenses (estimated)(2)(5)	9.69 %

(1) The expenses of the reinvestment plan are included in stock record expenses, a component of Other expenses. We do not have a cash purchase plan. The participants in the dividend reinvestment plan will bear a pro rata share of brokerage commissions incurred with respect to open market purchases, if any. See Dividend Reinvestment Plan for information on the dividend reinvestment plan.

(2) Our annual base management fee is 2.0% (0.5% quarterly) of our average gross assets, which is defined as total assets of Gladstone Capital, including investments made with proceeds of borrowings, less any uninvested cash or cash equivalents pledged to creditors. See Management Advisory and Administration Agreements and footnote 3 below.

(3) The incentive fee consists of two parts: an income-based fee and a capital gains-based fee. The income-based fee will be payable quarterly in arrears, and will equal 20% of the excess, if any, of our pre-incentive fee net investment income that exceeds a 1.75% quarterly (7.0% annualized) hurdle rate, subject to a catch-up



provision measured as of the end of each calendar quarter. The catch-up provision requires us to pay 100% of our pre-incentive fee net investment income with respect to that portion of such income, if any, that exceeds the hurdle rate but is less than 125% of the quarterly hurdle rate (or 2.1875%) in any calendar quarter (8.75% annualized). The catch-up provision is meant to provide our Adviser with 20% of our pre-incentive fee net investment income as if a hurdle rate did not apply when our pre-incentive fee net investment income exceeds 125% of the quarterly hurdle rate in any calendar quarter (8.75% annualized). The income-based incentive fee will be computed and paid on income that may include interest that is accrued but not yet received in cash. Our pre-incentive fee net investment income used to calculate this part of the income incentive fee is also included in the amount of our gross assets used to calculate the 2% base management fee (see footnote 2 above). The quarter ended December 31, 2006 was the first quarter under our new advisory agreement and, as a result, was the first quarter in which the incentive fee was earned. For purposes of this computation, the aggregate gross amount of the December 31, 2006, March 31, 2007 and June 30, 2007 fees, exclusive of any credits, was annualized to determine the percentage the fee represents of net assets. After giving effect to credits against the incentive fee, the annualized incentive fee was 0.48% of net assets as of June 30, 2007. There can be no assurance that our Adviser will give any credits against the incentive fee in the future. The capital gains-based portion of the fee did not have an effect on the incentive fee for purposes of this calculation since we have not realized overall net capital gains to date.

Examples of how the incentive fee would be calculated (exclusive of any credits) are as follows:

- Assuming pre-incentive fee net investment income of 0.55%, there would be no income-based incentive fee because such income would not exceed the hurdle rate of 1.75%.

- Assuming pre-incentive fee net investment income of 2.00%, the income-based incentive fee would be as follows:

$$= 100\% \times (2.00\% - 1.75\%)$$

$$= 0.25\%$$

- Assuming pre-incentive fee net investment income of 2.30%, the income-based incentive fee would be as follows:

$$= (100\% \times (\text{catch-up} : 2.1875\% - 1.75\%)) + (20\% \times (2.30\% - 2.1875\%))$$

$$= (100\% \times 0.4375\%) + (20\% \times 0.1125\%)$$

$$= 0.4375\% + 0.0225\%$$

$$= 0.46\%$$

- Assuming net realized capital gains of 6% and realized capital losses and unrealized capital depreciation of 1%, the capital gains-based incentive fee would be as follows:

$$= 20\% \times (6\% - 1\%)$$

$$= 20\% \times 5\%$$

$$= 1\%$$

For a more detailed discussion of the calculation of the two-part incentive fee, see Management Advisory and Administration Agreements.

(4) We have entered into a revolving credit facility, under which our borrowing capacity is \$220 million, effective May 29, 2007. We have drawn down on this credit facility and we expect to borrow additional funds in the future up to an amount so that our asset coverage, as defined in the 1940 Act, is at least 200% after each issuance of our senior securities. Assuming that we borrowed \$220 million at an interest rate of 6.10%, interest payments on borrowed funds would have been 6.23% of our net assets as of June 30, 2007.

(5) Includes our overhead expenses, including payments under the administration agreement based on our projected allocable portion of overhead and other expenses incurred by our Administrator in performing its obligations under the administration agreement. See Management Certain Transactions Advisory and Administration Agreements.

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**Example**

The following example demonstrates the projected dollar amount of total cumulative expenses that would be incurred over various periods with respect to a hypothetical investment in our Securities. In calculating the following expense amounts, we have assumed that our annual expenses would remain at the levels set forth in the table above.

	1 Year	3 Years	5 Years	10 Years
You would pay the following expenses on a \$1,000 investment, assuming a 5% annual return	\$ 102	\$ 241	\$ 373	\$ 675

While the example assumes, as required by the Securities and Exchange Commission, which we refer to as the SEC, a 5% annual return, our performance will vary and may result in a return greater or less than 5%. Additionally, we have assumed that the entire amount of such 5% annual return would constitute ordinary income as we have not historically realized positive capital gains (computed net of all realized capital losses and unrealized capital depreciation) on our investments, nor do we expect to realize positive capital gains in the foreseeable future. Because the assumed 5% annual return is significantly below the hurdle rate of 7% (annualized) that we must achieve under the investment advisory and management agreement to trigger the payment of an income-based incentive fee, we have assumed, for purposes of the above example, that no income-based incentive fee would be payable if we realized a 5% annual return on our investments. Additionally, because we have not historically realized positive capital gains (computed net of all realized capital losses and unrealized capital depreciation) on our investments, we have assumed that we will not trigger the payment of any capital gains-based incentive fee in any of the indicated time periods. If we achieve sufficient returns on our investments, including through the realization of capital gains, to trigger an incentive fee of a material amount, our expenses, and returns to our investors after such expenses, would be higher than reflected in the example. In addition, while the example assumes reinvestment of all dividends and distributions at net asset value, participants in our dividend reinvestment plan will receive a number of shares of our common stock, determined by dividing the total dollar amount of the dividend payable to a participant by the market price per share of our common stock at the close of trading on the valuation date for the dividend. See [Dividend Reinvestment Plan](#) for additional information regarding our dividend reinvestment plan.

This example and the expenses in the table above should not be considered a representation of our future expenses, and actual expenses (including the cost of debt and incentive fees, if any, and other expenses) may be greater or less than those shown. As noted in the Fees and Expenses table above, we estimate that annual incentive fees payable under the investment advisory and management agreement will be 2.15% of net assets attributable to common stock.

**USE OF PROCEEDS**

We estimate that the net proceeds of this offering will be approximately \$2,991,060, assuming the sale of an aggregate of 150,000 shares and after deducting estimated placement agent's fees and estimated offering expenses payable by us. We expect to use all of the net proceeds of this offering to repay amounts outstanding under our line of credit, which matures on May 23, 2008 and currently is accruing interest at approximately 6.10% per year.



## CAPITALIZATION

The following table sets forth our actual capitalization at June 30, 2007 on a historical basis, on a pro forma as adjusted basis to reflect the sale of 400,000 shares of common stock at \$20.41 per share on July 24, 2007 and the application of the net proceeds therefrom to repay an aggregate of \$8,149,000 of outstanding borrowings under our line of credit and the cancellation of 37,109 shares of common stock associated with the cancellation of an employee loan, and on a pro forma as further adjusted basis to give effect to:

- the sale of 150,000 shares of common stock in this offering at the offering price of \$21.32 per share; and
- the application of the net proceeds from the offering, after deducting the estimated placement agent's fees and offering expenses payable by us of an aggregate of \$206,940, to repay an aggregate of \$2,991,060 of outstanding borrowings under our line of credit as described in Use of Proceeds.

	As of June 30, 2007		
	Actual	Pro Forma As Adjusted (unaudited)	Pro Forma As Further Adjusted (unaudited)
<b>Assets</b>			
Cash and cash equivalents	\$ 3,491,495	\$ 3,491,495	\$ 3,491,495
<b>Borrowings</b>			
Borrowings under line of credit	161,188,000	153,039,000	150,047,940
<b>Net Assets</b>			
Common stock, \$0.001 par value; 50,000,000 shares authorized; 14,249,683 shares issued and outstanding, actual, 14,612,574 shares issued and outstanding, pro forma as adjusted, and 14,762,574 shares issued and outstanding, pro forma as further adjusted	\$ 14,250	\$ 14,613	\$ 14,763
Capital in excess of par value	225,449,718	232,881,644	235,872,554
Notes receivable-officers	(9,947,366 )	(9,230,655 )	(9,230,655 )
Net unrealized appreciation on investments	(1,026,151 )	(1,026,151 )	(1,026,151 )
Unrealized depreciation on derivative	(279,593 )	(279,593 )	(279,593 )
Realized loss on sale of investments	(780,197 )	(780,197 )	(780,197 )
Realized gain on settlement of derivatives	46,212	46,212	46,212
Accumulated undistributed net investment income	1,776,047	1,776,047	1,776,047
<b>Total Net Assets</b>	<b>\$ 215,252,920</b>	<b>\$ 223,401,920</b>	<b>226,392,980</b>
<b>Total Capitalization</b>	<b>\$ 376,440,920</b>	<b>\$ 376,440,920</b>	<b>376,440,920</b>

### **PLAN OF DISTRIBUTION**

We are offering the shares of our common stock through a placement agent. Subject to the terms and conditions contained in the placement agent agreement dated August 21, 2007, Ferris, Baker Watts, Incorporated agreed to act as the placement agent for the sale of up to 150,000 shares of our common stock. The placement agent is not purchasing or selling any shares by this prospectus, nor is it required to arrange for the purchase or sale of any specific number or dollar amount of shares, but has agreed to use commercially reasonable efforts to arrange for the sale of all 150,000 shares. We will pay the placement agent a fixed fee of 3% of the gross proceeds from common stock issued and sold to the placement agent's accounts and to whom the placement agent confirms a sale of the common stock.

The placement agent agreement provides that the obligations of the placement agent and the investors are subject to certain conditions precedent, including the absence of any material adverse change in our business and the receipt of customary legal opinions, letters and certificates.

We have agreed to indemnify the placement agent against some liabilities, including liabilities under the Securities Act of 1933.

Until the distribution of the common stock is completed, rules of the Securities and Exchange Commission may limit the ability of the placement agent to bid for and purchase shares of the common stock. As an exception to these rules, the placement agent is permitted to engage in certain transactions that stabilize, maintain or otherwise affect the price of the common stock.

The placement agent and its affiliates have from time to time performed and may in the future perform various financial advisory, commercial banking and investment banking services for us in the ordinary course of business, for which they received or will receive customary fees.

The transfer agent for our common stock is The Bank of New York.

Our common stock is traded on the Nasdaq Global Select Market under the symbol GLAD.

### **LEGAL MATTERS**

The validity of the issuance of the common stock offered hereby will be passed upon for us by Cooley Godward Kronish LLP, Reston, Virginia. Bass, Berry & Sims PLC, Memphis, Tennessee, is counsel for the placement agent in connection with this offering.

### **EXPERTS**

The financial statements as of September 30, 2006 and 2005 and for each of the three years in the period ended September 30, 2006 and management's assessment of the effectiveness of internal control over financial reporting (which is included in Management's Report on Internal Control over Financial Reporting) as of September 30, 2006 included in the accompanying prospectus have been so included in reliance on the report of PricewaterhouseCoopers LLP, an independent registered public accounting firm, given on the authority of said firm as experts in auditing and accounting.

### **ADDITIONAL INFORMATION**

We have filed with the SEC a Registration Statement on Form N-2 under the Securities Act of 1933, as amended, with respect to the securities offered by this prospectus supplement. This prospectus supplement and the accompanying prospectus, which are a part of the registration statement, do not contain all of the information in the registration statement, including amendments, exhibits and schedules thereto. Statements in this prospectus supplement and the accompanying prospectus about the contents of any contract or other document are not necessarily complete and in each instance we refer you to the copy of the contract or other document filed, or incorporated by reference, as an exhibit to the registration statement, and each such statement is qualified in all respects by this reference.

We also file reports, proxy statements and other information with the SEC under the Securities Exchange Act of 1934, as amended. Such reports, proxy statements and other information, as well as the registration statement of which this prospectus supplement and the accompanying prospectus are a part and the exhibits and schedules thereto, can be inspected at the public reference facilities maintained by the SEC at 100 F Street, N.E., Washington, D.C. 20549. Information about the operation of the public reference facilities may be obtained by calling the SEC at 1-202-551-8090. The SEC maintains a web site that contains reports, proxy statements and other information regarding registrants, including us, that file such information electronically with the SEC. The address of the SEC's web site is <http://www.sec.gov>. Copies of such material may also be obtained from the Public Reference Section of the SEC at 100 F Street, N.E., Washington, D.C. 20549, at prescribed rates. Our common stock is listed on The Nasdaq Global Select Market and our corporate website is located at <http://www.gladstonecapital.com>. The information contained on, or accessible through, our website is not a part of this prospectus supplement.

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We make available free of charge on our website our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and all amendments to those reports as soon as reasonably practicable after such material is electronically filed with or furnished to the SEC.

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We also furnish to our stockholders annual reports, which include annual financial information that has been examined and reported on, with an opinion expressed, by our independent registered public accounting firm. See **Experts** in the accompanying prospectus for more information.

#### **FORWARD-LOOKING STATEMENTS**

All statements contained herein, other than historical facts, may constitute forward-looking statements. These statements may relate to, among other things, future events or our future performance or financial condition.

These statements may relate to, among other things, future events or our future performance or financial condition. In some cases, you can identify forward-looking statements by terminology such as *may, might, believe, will, provided, anticipate, future, could, growth, expect, should, would, if, seek, possible, potential, likely* or the negative of such terms or comparable terminology. These forward-looking statements involve known and unknown risks, uncertainties and other factors that may cause our actual results, levels of activity, performance or achievements to be materially different from any future results, levels of activity, performance or achievements expressed or implied by such forward-looking statements. Such factors include, among others: (1) adverse changes in interest rates; (2) our failure or inability to establish or maintain referral arrangements with leveraged buyout funds and venture capital funds to generate loan opportunities; (3) the loss of one or more of our executive officers, in particular David Gladstone, Terry Lee Brubaker, or George Stelljes III; (4) our inability to extend, refinance, or maintain our credit facilities on terms reasonably acceptable to us, if at all, in future equity capital resources; (5) our inability to successfully securitize our loan portfolio on terms reasonably acceptable to us, if at all; (6) the decision of our competitors to aggressively seek to make senior and subordinated loans to small and medium-sized businesses on terms more favorable than we intend to provide; and (7) those factors listed under the caption **Risk Factors** in the accompanying prospectus. We caution readers not to place undue reliance on any such forward-looking statements, which speak only as of the date made. 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 prospectus supplement.

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

All statements contained herein, other than historical facts, may constitute forward-looking statements. These statements may relate to, among other things, future events or our future performance or financial condition. In some cases, you can identify forward-looking statements by terminology such as may, might, believe, will, provided, anticipate, future, could, growth, plan, intend, would, if, seek, possible, potential, likely or the negative of such terms or comparable terminology. These forward-looking statements involve known and unknown risks, uncertainties and other factors that may cause our actual results, levels of activity, performance or achievements to be materially different from any future results, levels of activity, performance or achievements expressed or implied by such forward-looking statements. Such factors include, among others: (1) adverse changes in interest rates; (2) our failure or inability to establish or maintain referral arrangements with leveraged buyout funds and venture capital funds to generate loan opportunities; (3) the loss of one or more of our executive officers, in particular David Gladstone, Terry Lee Brubaker, or George Stelljes III; (4) our inability to extend, refinance or maintain our credit facilities on terms reasonably acceptable to us, if at all in future equity capital resources; (5) our inability to successfully securitize our loan portfolio on terms reasonably acceptable to us, if at all; (6) the decision of our competitors to aggressively seek to make senior and subordinated loans to small and medium-sized businesses on terms more favorable than we intend to provide; and (7) those factors listed under the caption Risk Factors of the Annual Report on Form 10-K as filed with the Securities and Exchange Commission on December 6, 2006 and our Quarterly Report on Form 10-Q as filed with the Securities and Exchange Commission on May 2, 2007. We caution readers not to place undue reliance on any such forward-looking statements, which speak only as of the date made. 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 consolidated financial statements and the notes thereto contained elsewhere in this report and our annual report on Form 10-K for the fiscal year ended September 30, 2006.*

**OVERVIEW**

We were incorporated under the General Corporation Laws of the State of Maryland on May 30, 2001. Our investment objectives are to achieve a high level of current income by investing in debt securities, consisting primarily of senior notes, second lien notes, and senior subordinated notes of established private businesses that are backed by leveraged buyout funds, venture capital funds or others, with a particular emphasis on second lien and senior subordinated notes. In addition, we may acquire existing loans, which meet this profile, from leveraged buyout funds, venture capital funds and others. 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 extend 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).

We seek to invest in small and medium-sized businesses that meet certain criteria, including some or all of the following: (1) the potential for growth in cash flow, (2) adequate assets for loan collateral, (3) experienced management teams with a significant ownership interest in the borrower, (4) profitable operations based on the borrower's cash flow, (5) reasonable capitalization of the borrower (usually by buyout funds or venture capital funds) and (6) 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 by the borrower or by exercise of our right to require the borrower to buy back its warrants. We lend to borrowers that need funds to, among other things, effect a change of control, restructure their balance sheets, or finance growth, including acquisitions.

Our loans typically range from \$5 million to \$15 million, although this investment size may vary proportionately as the size of our capital base changes, generally mature in no more than seven years and accrue interest at fixed or variable rates. Some of our loans may contain a provision that calls for some portion of the interest payments to be deferred and added to the principal balance so that the interest is paid, together with the principal, at maturity. This form of deferred interest is often called paid in kind or PIK interest, and, when earned, we record PIK interest as interest income and add the PIK interest to the principal balance of the loans. We seek to avoid PIK interest with all potential investments under review. We currently do not hold any investments with PIK and, therefore, there was no PIK accrued on our balance sheet as of June 30, 2007.

Because the majority of our portfolio loans consist of term debt of private companies who typically cannot or will not expend the resources to have their debt securities rated by a credit rating agency, we expect that most of the debt securities we acquire will be unrated. We cannot accurately predict what ratings these loans might receive if they were in fact rated, and thus cannot determine whether or not they could be considered investment grade quality.

To the extent possible, our loans generally are collateralized by a security interest in the borrower's assets. Interest payments are generally made monthly or quarterly (except to the extent of any PIK interest) with amortization of principal generally being deferred for several years. The principal amount of the loans and any accrued but unpaid interest generally become due at maturity at five to seven years. When we receive a warrant to purchase stock in a borrower in connection with a loan, the warrant will typically have an exercise price equal to the fair value of the portfolio company's common stock at the time of the loan and entitle us to purchase a modest percentage of the borrower's stock.

Original issue discounts (OID) arise when we extend a loan and receive an equity interest in the borrower at the same time. To the extent that the price paid for the equity is not at market value, we must allocate part of the price paid for the loan, to the value of the equity. Then the amount allocated to the equity, the OID, must be amortized over the life of the loan. As with PIK interest, the amortization of OID also produces income that must be recognized for purposes of satisfying the distribution requirements for a regulated investment company (RIC) under Subchapter M of the Internal Revenue Code of 1986, as amended (the Code), whereas the cash is received, if at all, when the equity instrument is sold. We seek to avoid OID and to date do not hold any investments with OID.

In addition, as a business development company under the 1940 Act, we are required to make available significant managerial assistance to our portfolio companies. Our investment adviser, Gladstone Management Corporation (the Adviser) provides these services on our behalf through its officers who are also our officers. In addition, our Adviser provides other services to our portfolio companies, for which it receives fees, in connection with our investments. The fees for these services are generally paid to the Adviser in part at the time a prospective portfolio company signs a non-binding term sheet with us (as further described in the following paragraph), with the remainder paid at the closing of the investment. These fees are generally non-recurring, however in some instances they may have a recurring component which is also paid to the Adviser. Fees for certain of these services are credited 50% against the base management fee payable to the Adviser pursuant to the terms of our advisory agreement, which has the effect of reducing our expenses to the extent of any such credits. The specific other services the Adviser provides vary by portfolio company, but generally include a broad array of services to the portfolio companies such as investment banking services, arranging bank financing, arranging equity financing, structuring financing from multiple lenders and investors, reviewing existing credit facilities, restructuring existing investments, raising equity and debt capital, turnaround management, merger and acquisition services and recruiting new management personnel. To date the Adviser has not charged for managerial assistance services, however, if the Adviser does receive fees for such managerial assistance, the Adviser will credit the managerial assistance fees to the base management fee due from us to the Adviser.

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

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

During the nine months ended June 30, 2007, we extended, directly or through participations or acquisitions, approximately \$253.7 million of new loans to a total of 52 companies. This includes an acquisition of approximately \$63.3 million in senior debt with 16 different borrowers in June 2007. Also, during the nine months ended June 30, 2007, four borrowers repaid their loans ahead of contractual maturity, one borrower refinanced its investment and we sold or were repaid in full on twenty four syndicated loans of approximately \$90.8 million, and we received scheduled contractual principal repayments of approximately \$9.0 million, for total principal repayments of approximately \$99.8 million. Since our initial public offering in August 2001, we have made 227 different loans to, or investments in, 120 companies for a total of approximately \$760.2 million, before giving effect to principal repayments on investments and divestitures.

These prospective loans are subject to, among other things, the satisfactory completion of our due diligence investigation of each borrower, acceptance of terms and structure and attainment of necessary consents. With respect to each prospective loan, we will only agree to provide the loan if, among other things, the results of our due diligence investigations are satisfactory, the terms and conditions of the loan are acceptable and all necessary consents are received. Our management has initiated its due diligence investigations of the potential borrowers, however we cannot assure you that we will not discover facts in the course of completing our due diligence that would render a particular investment imprudent or that any of these loans will actually be made.

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

Our Adviser is led by a management team which has extensive experience in our lines of business. Our Adviser is controlled by David Gladstone, our chairman and chief executive officer. Mr. Gladstone is also the chairman and chief executive officer of our Adviser. Terry Lee Brubaker, our vice chairman, chief operating officer, secretary and director, is a member of the board of directors of our Adviser and its vice chairman and chief operating officer. George Stelljes III, our president, chief investment officer and director, is a member of the board of directors of our Adviser and its president and chief investment officer. Harry Brill, our chief financial officer, is also the chief financial officer of our Adviser. Our Adviser also has a wholly-owned subsidiary, Gladstone Administration, LLC (the Administrator), which employs our chief financial officer, chief compliance officer, controller, treasurer and their respective staffs.

Our Adviser and Administrator also provide investment advisory and administrative services to our affiliates, Gladstone Commercial Corporation, a publicly traded real estate investment trust; Gladstone Investment Corporation, a publicly traded business development company; and Gladstone Land Corporation, an agricultural real estate company owned by Mr. Gladstone. All of our directors and executive officers serve as either directors or executive officers, or both, of Gladstone Commercial Corporation and Gladstone Investment Corporation. In the future, our Adviser may provide investment advisory and administrative services to other funds, both public and private, of which it is the sponsor.

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

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

On December 2, 2005, our stockholders approved a proposal to enter into an amended and restated investment advisory agreement (the Amended Advisory Agreement) with the Adviser and an administration agreement (the Administration Agreement) between us and our Administrator, both of which became effective on October 1, 2006. The Amended Advisory Agreement replaced the original advisory agreement (the Initial Advisory Agreement), which terminated on September 30, 2006. We will continue to pay our direct expenses including, but not limited to, directors fees, legal and accounting fees, stockholder related expenses, and directors and officers insurance under the Amended Advisory Agreement.

Pursuant to the Initial Advisory Agreement, we paid the Adviser an annual advisory fee of 1.25% of our total assets (as reduced by cash and cash equivalents pledged to creditors), payable in quarterly computed increments of 0.3125%, and an annual administrative fee of 0.75% of our total assets (as reduced by cash and cash equivalents pledged to creditors), payable in quarterly computed increments of 0.1875%, for a total annual base management fee of 2%. This fee was then directly reduced by the amount of loan servicing fees paid to the Adviser and any other fees received by the Adviser from our borrowers and potential borrowers.

Under the Amended Advisory Agreement, we pay the Adviser an annual base management fee of 2% of our average gross assets, which is defined as total assets less cash and cash equivalents pledged to creditors calculated as of the end of the two most recently completed fiscal quarters and also consists of a two-part incentive fee.





The first part of the incentive fee is an income-based incentive fee which rewards the Adviser if our quarterly net investment income (before giving effect to any incentive fee) exceeds 1.75% of our net assets (the hurdle rate). We will pay the Adviser an income incentive fee with respect to our pre-incentive fee net investment income in each calendar quarter as follows:

- no incentive fee in any calendar quarter in which our pre-incentive fee net investment income does not exceed the hurdle rate (7% annualized);
- 100% of our pre-incentive fee net investment income with respect to that portion of such pre-incentive fee net investment income, if any, that exceeds the hurdle rate but is less than 2.1875% in any calendar quarter (8.75% annualized); and
- 20% of the amount of our pre-incentive fee net investment income, if any, that exceeds 2.1875% in any calendar quarter (8.75% annualized).

The second part of the incentive fee is a capital gains incentive fee that will be determined and payable in arrears as of the end of each fiscal year (or upon termination of the Amended Advisory Agreement, as of the termination date), commencing on October 1, 2006, and will equal 20% of our realized capital gains as of the end of the fiscal year. In determining the capital gains incentive fee payable to the Adviser, we will calculate the cumulative aggregate realized capital gains and cumulative aggregate realized capital losses since our inception, and the aggregate unrealized capital depreciation as of the date of the calculation, as applicable, with respect to each of the investments in our portfolio.

The Adviser's board of directors has agreed to voluntarily waive 1.5% of the annual 2.0% base management fee to 0.5% for senior syndicated loans for the three and nine months ended June 30, 2007.

In addition to the base management and incentive fees under the Amended Advisory Agreement, certain fees received by the Adviser from our portfolio companies were credited against the investment advisory fee under the Initial Advisory Agreement, and will continue to be paid to the Adviser and credited under the Amended Advisory Agreement.

The Adviser services our loan portfolio pursuant to a loan servicing agreement with Gladstone Business Loan, LLC (Business Loan) in return for a 1.5% annual fee, based on the monthly aggregate outstanding loan balance of the loans pledged under our credit facility. Effective in April 2006, the Adviser's board of directors voted to reduce the portion of the 1.5% annual fee to 0.5% for senior syndicated loans. This fee directly reduces the amount of fee payable under both the Initial and Amended Advisory Agreements.

#### **Administration Agreement**

Under the Administration Agreement, we pay separately for administrative services. The Administration Agreement provides for payments equal to our allocable portion of the Administrator's overhead expenses in performing its obligations under the Administration Agreement including, but not limited to, rent for employees of the Administrator, and our allocable portion of the salaries and benefits expenses of our chief financial officer, controller, chief compliance officer, treasurer and their respective staffs. Our allocable portion of expenses is derived by multiplying our Administrator's total expenses by the percentage of our average total assets (the total assets at the beginning and end of each quarter) in comparison to the average total assets of all companies managed by our Adviser.

#### **Off-Balance Sheet Arrangements**

We do not have any significant off-balance sheet arrangements as defined in Item 303(a)(4)(ii) of Securities and Exchange Commission (SEC) Regulation S-K as of June 30, 2007.

#### **Recent Accounting Pronouncements**

In May 2005, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards (SFAS) No. 154, *Accounting Changes and Error Corrections*, a replacement of APB Opinion No. 20, *Accounting Changes*, and SFAS No. 3, *Reporting Accounting Changes in Interim Financial Statements* and changes the requirements for the accounting for and reporting of a change in accounting principle. SFAS No. 154 applies to all voluntary changes in accounting principle and also applies to changes required by an accounting pronouncement in the unusual instance that the pronouncement does not include specific transition provisions. SFAS No. 154 requires retrospective application to prior periods' financial statements of changes in accounting principle. SFAS No. 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. We adopted the provisions of SFAS No.

154, as applicable, on October 1, 2006.

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In February 2006, the FASB issued SFAS No. 155, *Accounting for Certain Hybrid Financial Instruments, an amendment of FASB statements No. 133 and 140* ( SFAS No. 155 ). SFAS No. 155 allows financial instruments that have embedded derivatives to be accounted for as a whole (eliminating the need to bifurcate the derivative from its host) as long as the entire instrument is valued on a fair value basis. The statement also resolves and clarifies other specific SFAS No. 133 and SFAS No. 140 related issues. SFAS No. 155 is effective for all financial instruments acquired or issued after the beginning of an entity's first fiscal year that begins after September 15, 2006. We adopted SFAS No. 155 on October 1, 2006 and have not realized a material impact of the financial statements since all investments are valued on a fair value basis.

In June 2006, the FASB issued FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109*, which clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with SFAS No. 109, *Accounting for Income Taxes*. This Statement shall be effective as of the beginning of an entity's first fiscal year that begins after December 15, 2006. We will adopt this Interpretation effective October 1, 2007, and are currently evaluating the impact of this pronouncement on the consolidated financial statements.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements* ( SFAS No. 157 ). SFAS No. 157 defines fair value, establishes a framework for measuring fair value in accordance with GAAP, and expands disclosures about fair value measurements. SFAS No. 157 applies broadly to securities and other types of assets and liabilities. SFAS No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007 and interim periods within that fiscal year. We will be required to adopt SFAS No. 157 on October 1, 2008 and are currently evaluating the impact of this pronouncement on the consolidated financial statements.

In September 2006, the SEC issued Staff Accounting Bulletin No. 108 ( SAB 108 ). SAB 108 addresses how the effects of prior year uncorrected misstatements should be considered when quantifying misstatements in current year financial statements and requires registrants to consider the effect of all carry over and reversing effects of prior year misstatements when quantifying errors in current year financial statements. SAB 108 does not change the SEC's previous guidance in SAB No. 99, *Materiality*, on evaluating the materiality of misstatements. A registrant applying the new guidance for the first time that identifies material errors in existence at the beginning of the first fiscal year ending after November 15, 2006, may correct those errors through a one-time cumulative effect adjustment to beginning-of-year retained earnings. The cumulative effect alternative is available only if the application of the new guidance results in a conclusion that a material error exists as of the beginning of the first fiscal year ending after November 15, 2006, and those misstatements were determined to be immaterial based on a proper application of the registrant's previous method for quantifying misstatements. The adoption of SAB 108 did not have an impact on the consolidated financial statements.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities Including an Amendment of FASB Statement No. 115*, which is effective for fiscal years beginning after November 15, 2007. This pronouncement permits an entity to choose to measure many financial instruments and certain other items at fair value at specified election dates. Subsequent unrealized gains and losses on items for which the fair value option has been elected will be reported in earnings. We are currently evaluating the potential impact of this pronouncement on the consolidated financial statements.

### **Critical Accounting Policies**

The preparation of financial statements and related disclosures in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported consolidated amounts of assets and liabilities, and 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. Our accounting policies are more fully described in the Notes to Consolidated Financial Statements contained elsewhere in this report. 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 consolidated financial statements is the valuation of investments and the related amounts of unrealized appreciation and depreciation of investments recorded.

*General Valuation Policy:* Using procedures established by our Board of Directors, we value our investment portfolio each quarter. We carry our investments at fair value, as determined in good faith by or under the direction of our Board of Directors. Securities that are publicly traded, if any, are valued at the closing price of the exchange or securities market on which they are listed on the valuation date. Securities that are not traded on a public exchange or securities market, but for which a limited market exists and that have been rated by a nationally recognized statistical rating organizations, ( NRSRO ), (such as certain participations in syndicated loans) are valued at the indicative bid price offered by the respective originating syndication agent's desk on or near the valuation date.



Debt and equity securities that are not publicly traded, for which a limited market does not exist, or for which a limited market exists but that have not been rated by a NRSRO (or for which we have various degrees of trading restrictions) are valued at fair value as determined in good faith by or under the direction of our Board of Directors. In making the good faith determination of the value of these securities, we start with the cost basis of the security, which includes the amortized OID and PIK interest, if any. We then apply the methods set out below in *Valuation Methods*. Members of our Adviser's portfolio management team prepare the valuations of our investments in portfolio companies using the most recent portfolio company financial statements and forecasts. These individuals also consult with portfolio company senior management and ownership to obtain further updates on the portfolio company's performance, including information such as industry trends, new product development, and other operational issues. 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.

At June 30, 2007, we engaged Standard & Poor's Securities Evaluations, Inc. ( SPSE ) to submit opinions of value for most of our loan securities. We request that SPSE also evaluate and assign values to success fees (conditional interest included in some loan securities) when we determine that the probability of receiving a success fee on a given loan is above 6-8%, a threshold of significance. We may also submit paid in kind ( PIK ) interest to SPSE for valuation when it is determined the PIK interest is likely to be received. 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. We also add any amortized original issue discount ( OID ) interest to the fair value, unless adverse factors lead to a determination of a lesser valuation. Upon completing our collection of data with respect to the investments (including the information described under *Credit Information*, the risk ratings of the loans described under *Loan Grading and Risk Rating* and the factors described under *Valuation Methods* ), this valuation data is forwarded along 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 value 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 the Board 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 whether to accept the recommended valuation of our investment portfolio. Our Adviser and our management recommended, and the 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 as of June 30, 2007 and September 30, 2006, included in our 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. Because SPSE does not provide values for our equity securities, our Adviser determines the fair value of these investments using valuation policies approved by our Board of Directors.

*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. If we held a controlled or affiliate investment, we and our Adviser would participate in periodic board meetings of such portfolio companies and also require them to provide annual audited and monthly unaudited financial statements. Using these statements and board discussions, our Adviser would calculate and evaluate the credit statistics.

*Loan Grading and Risk Rating:* As part of our valuation procedures we risk rate all of our investments in debt securities. For syndicated loans that have been rated by a 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

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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.

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 a 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 a 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 a 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 from a NRSRO, however, no assurance can be given that a 10 on our scale is equal to a BBB on a NRSRO scale.

**Company s**

ystem	First NRSRO	Second NRSRO	Gladstone Capital s Description(a)
>10			Probability of Default (PD during the next ten years is 4% and the Expected Loss (EL) is 1% or less
10	Baa2	BBB	PD is 5% and the EL is 1% to 2%
9	Baa3	BBB-	PD is 10% and the EL is 2% to 3%
8	Ba1	BB+	PD is 16% and the EL is 3% to 4%
7	Ba2	BB	PD is 17.8% and the EL is 4% to 5%
6	Ba3	BB-	PD is 22% and the EL is 5% to 6.5%
5	B1	B+	PD is 25% and the EL is 6.5% to 8%
4	B2	B	PD is 27% and the EL is 8% to 10%
3	B3	B-	PD is 30% and the EL is 10% to 13.3%
2	Caa1	CCC+	PD is 35% and the EL is 13.3% to 16.7%
1	Caa2	CCC	PD is 65% and the EL is 16.7% to 20%
0	Caa3	CC	PD is 85% or there is a Payment Default: and the EL is greater than 20%
	N/a	D	

(a) *The default rates set here are for a ten year term debt security. If the company s 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. Currently, our investment in MCA Communications LLC is on non-accrual, the investment is currently not accruing interest nor is it paying any past due interest. Additionally, we do not risk rate our equity securities.

The following table lists the risk ratings for all non-syndicated loans in our portfolio at June 30, 2007 and September 30, 2006, representing approximately 76% and 73%, respectively, of all loans in our portfolio:

Rating	June 30, 2007	Sept. 30, 2006
Average	7.1	7.2
Weighted Average	7.0	7.2
Highest	9.0	9.0
Lowest	4.0	6.0





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The following table lists the risk ratings for syndicated loans in our portfolio that are not currently rated by an NRSRO at June 30, 2007 and September 30, 2006, representing approximately 6% and 17%, respectively, of all loans in our portfolio:

Rating	June 30, 2007	Sept. 30, 2006
Average	6.0	6.1
Weighted Average	6.0	6.3
Highest	6.0	8.0
Lowest	6.0	4.0

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 a NRSRO. The following table lists the risk ratings for all syndicated loans in our portfolio that are currently rated by an NRSRO at June 30, 2007 and September 30, 2006, representing approximately 18% and 10%, respectively, of all loans in our portfolio:

Rating	June 30, 2007	Sept. 30, 2006
Average	CCC+/Caa1	CCC+/Caa1
Weighted Average	CCC+/Caa1	CCC+/Caa1
Highest	B/B3	B-/B3
Lowest	CCC/Caa2	CCC/Caa1

*Valuation Methods:* We determine the value of publicly-traded debt securities based on the closing price for the security on the exchange or securities market on which it is listed on the valuation date. We value debt securities that are not publicly traded, but for which a limited market for the security exists, such as certain participations in syndicated loans, at the indicative bid price offered by the respective originating syndication agent's trading desk on or near the valuation date. At June 30, 2007, none of the debt securities in our portfolio were publicly traded and there was a limited market for 31 debt securities in our portfolio. At September 30, 2006, none of the debt securities in our portfolio were publicly traded and there was a limited market for 9 debt securities in our portfolio.

Debt securities that are issued to portfolio companies where we have an equity, or equity-like interest that are not publicly traded, for which there is no market, or for which there is a market but the securities have not been rated by a NRSRO, are valued at cost, if there is adequate total enterprise value determined when valuing our equity holdings in the borrower. Fair values are discounted for any shortfall of total enterprise value over the total debt outstanding for the borrower. At June 30, 2007, for our debt investment in Clinton Aluminum Holdings LLC, where we hold a warrant, we solicited and were provided an opinion of value by SPSE. Prospectively, in accordance with our valuation policies, due to its accompanying equity-like security, the debt securities for this investment will not be assessed by SPSE.

Debt securities that are not publicly traded and that are issued to portfolio companies where we have no equity or equity-like securities, for which there is no market, or for which there is a market but have not been rated by a NRSRO, we begin with the risk rating designation of the security as described above. Using this risk rating designation, we seek to determine the value of the security as if we currently intended to sell the security and consider some or all of the following factors:

- the cost basis and the type of the security;
- the nature and realizable value of the collateral;
- the portfolio company's ability to make payments and discounted cash flow;
- reports from portfolio company senior management and board meetings;
- reported values of similar securities of the portfolio company or comparable companies; and
- changes in the economy affecting the portfolio company.

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We value convertible debt, equity, success or exit fees or other equity-like securities for which there is a market based on the market prices for such securities, even if that market is not robust. At June 30, 2007 and September 30, 2006, there was no market for any of the equity securities we owned. To value equity securities for which no market exists, we use the same information we would use for a debt security valuation described above, except risk-rating, as well as standard valuation techniques used by major valuation firms to value the equity securities of private companies. These valuation techniques also include discounted cash flow of the expected sale price in the future, valuation of the securities based on recent sales to third parties in comparable transactions, or a review of similar companies that are publicly traded and the market multiple of their equity securities. In gathering the sales to third parties of similar securities, we may reference industry statistics and use outside experts. At June 30, 2007 and September 30, 2006, we had \$146,124 and \$37,000, respectively, invested, at cost, in equity securities compared to our debt portfolio with a cost basis of \$369,829,274 and \$216,165,986, respectively.

At June 30, 2007, we had total unrealized depreciation of \$4,288,673, which was mainly comprised of unrealized depreciation of \$1,375,000 on our senior subordinated term debt investment in Visual Edge Technology, Inc., unrealized depreciation of \$1,022,250, on the aggregate of our investments in LocalTel, Inc. and unrealized depreciation of \$282,750 on our senior term debt investment in It's Just Lunch International, LLC. Unrealized appreciation of \$3,262,522 was primarily composed of unrealized appreciation of \$2,935,858 on our warrants in Finn Corporation. In the aggregate, we recorded net unrealized depreciation of \$1,026,151 on our total investment portfolio as of June 30, 2007.

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At September 30, 2006, we had total unrealized appreciation of \$2,015,198, which was mainly comprised of unrealized appreciation of \$672,431 on our warrants of Finn Corporation, unrealized appreciation of \$607,625 on our senior term debt in Mistras Holding Corporation and unrealized appreciation of \$148,287 on our senior subordinated term debt investment in Xspedius Communications, LLC. This unrealized appreciation was offset by unrealized depreciation of \$575,434, most notably composed of unrealized depreciation of \$131,367 on our senior subordinated term debt investment in Consolidated Bedding, Inc. and unrealized depreciation of \$115,750 on our senior term debt in LocalTel Inc. In the aggregate, we recorded net unrealized appreciation of \$1,439,764 on our total investment portfolio as of September 30, 2006.

### ***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 are required to distribute to stockholders at least 90% of our investment company taxable income, as defined by the Code. We have a policy to pay out as a dividend up to 100% of that amount.

In an effort to avoid certain excise taxes imposed on RICs, we currently 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 for preceding years that were not distributed during such years.

#### ***Revenue Recognition***

##### *Interest Income Recognition*

Interest income is recorded on the accrual basis to the extent that such amounts are expected to be collected. We will stop accruing interest on investments and write off any previously accrued and uncollected interest when it is determined that interest is no longer collectible. Conditional interest or a success fee is recorded when earned upon full repayment of a loan investment.

##### *Paid in Kind Interest*

In the future, we may hold loans in our portfolio which contain a PIK interest 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 interest income. To maintain our status as a RIC, this non-cash source of income must be paid out to stockholders in the form of dividends, even though we have not yet collected the cash.

## RESULTS OF OPERATIONS

*Comparison of the Three Months Ended June 30, 2007 to the Three Months Ended June 30, 2006*

### Investment Income

Investment income for the three months ended June 30, 2007 was \$9,201,279, as compared to \$6,522,816 for the three months ended June 30, 2006.

Interest income from our investments in debt securities of private companies was \$8,911,643 for the three months ended June 30, 2007, as compared with \$5,775,522 for the three months ended June 30, 2006. This increase consisted of approximately \$88.5 million of net new investments. As a result of repayments by Allied Extruders LLC, and SCPH Holdings during the three months ended June 2007, we recorded success fees of approximately \$515,000. In June 2007, we purchased a senior debt portfolio of approximately \$63.3 million to 16 different lenders, which is included in the net new investments described above.

The annualized weighted average yield on our portfolio for the three months ended June 30, 2007 was 11.8%; there was no PIK interest accrued during the three months ended June 30, 2007. The annualized weighted average yield on our portfolio for the three months ended June 30, 2006 was 11.7% (with and without giving effect to PIK interest).

Interest income from invested cash and cash equivalents for the three months ended June 30, 2007 was \$109,269, as compared to \$8,178 for the three months ended June 30, 2006. Interest income increased from the prior year due to the amount of cash that was held in interest bearing accounts and the interest earned on our custodial account prior to disbursement.

For the three months ended June 30, 2007 and June 30, 2006, we recorded \$132,795 and \$108,877, respectively, in interest income from loans to our employees in connection with the exercise of employee stock options. The increase is the result of additional loans issued in connection with employee stock option exercises during the fourth quarter of the previous fiscal year.

For the three months ended June 30, 2007, we recorded \$47,572 of prepayment fees and other income, as compared to \$630,239 for the three months ended June 30, 2006. The income for both periods consisted of prepayment penalty fees received upon the full repayment of certain loan investments ahead of contractual maturity and prepayment fees received upon the early unscheduled principal repayments which, in both instances, were based on a percentage of the outstanding principal amount of the loan at the date of prepayment.

### Operating Expenses

Operating expenses, prior to credit from the Adviser for fees earned and voluntary waivers to the base management fees and incentive fees, for the three months ended June 30, 2007 were \$5,205,300, as compared to \$2,277,508 for the three months ended June 30, 2006. Operating expenses for the three months ended June 30, 2007 reflected a significant increase in interest expense and management fees, prior to credits, as well as the addition of the incentive and administration fees, prior to credits, under the Amended Advisory and Administration Agreements.

Loan servicing fees of \$897,634 were incurred for the three months ended June 30, 2007, as compared to \$693,965 for the three months ended June 30, 2006. These fees were incurred in connection with a loan servicing agreement between Business Loan and our Adviser, which is based on the size of the portfolio. These fees were reduced against the amount of the base management fee due to our Adviser.

For the three months ended June 30, 2007, we incurred a base management fee of \$727,259, after reductions for loan servicing fees received by our Adviser of \$897,634, less credits for fees received by our Adviser of \$530,875 and a \$139,261 fee reduction for the waiver of the 2% fee on senior syndicated loans to 0.5%, for a net base management fee of \$57,123 as compared to the three months ended June 30, 2006, in which we incurred a base management fee of \$334,814 after reductions for loan servicing fees received by our Adviser of \$693,965, less credits for fees received by our Adviser of \$539,000 and a \$3,774 fee reduction for the waiver of the 2% fee on senior syndicated loans to 0.5%, for a net base management credit of \$207,960. The base management fee is computed quarterly as described under *Investment Advisory and Management Agreement*. Effective April 1, 2007, the board of our Adviser reduced the amount of credit for fees received by our Adviser from 100% of the fees received to 50% of the fees received, therefore the three months ended June 30, 2007 reflects the reduced credit for fees received by our Adviser. The gross base management fee before the reduction for loan servicing fees for the three months ended June 30, 2007 and June 30, 2006, was \$1,624,893 and \$1,028,779, respectively, increased in the current period due to the growth of the investment portfolio as compared to the same period of the prior year.



Effective October 1, 2006, the income based incentive fee became effective and as such we recorded a gross incentive fee of \$1,166,529, which was reduced by a voluntary waiver issued by our Adviser's board of directors of \$1,038,752, which resulted in a net incentive fee of \$127,777, which is recorded in fees due to Adviser on our consolidated statements of assets and liabilities at June 30, 2007. There was no incentive fee recorded for the three months ended June 30, 2006, as the Amended Advisory Agreement was not in effect.

Effective October 1, 2006, the Administration Agreement became effective in which we provide payments equal to our allocable portion of our Administrator's overhead expenses in performing its obligations under the Administration Agreement including, but not limited to, rent for employees of our Administrator, and our allocable portion of the salaries and benefits expenses of our chief financial officer, chief compliance officer and controller and their respective staffs. We incurred an administration fee of \$186,895 for the three months ended June 30, 2007. There was no administration fee recorded during the three months ended June 30, 2006, as the Administration Agreement was not in effect.

Professional fees, consisting primarily of legal and audit fees, for the three months ended June 30, 2007 were \$148,609, as compared to \$166,405 for the three months ended June 30, 2006. The decrease is due to the reimbursement of certain legal fees at the time of the investment funding.

Amortization of deferred financing costs, in connection with our line of credit, was \$72,133 for the three months ended June 30, 2007 and \$36,036 for the three months ended June 30, 2006. The increase is due to the amortization of additional fees incurred with our line of credit which were not in place during the prior year period.

Interest expense for the three months ended June 30, 2007 was \$1,762,249, as compared to \$702,449 for the three months ended June 30, 2006. This increase is primarily a result of increased borrowings under our line of credit during the three months ended June 30, 2007, which borrowings were partially used to finance our increased investments, borrowings remaining outstanding for longer periods of time and an increase in the interest rates on our borrowings.

Stockholder related costs for the three months ended June 30, 2007 were \$39,434, as compared to \$28,371 for the three months ended June 30, 2006. Stockholder related costs include such recurring items as transfer agent fees, NASDAQ listing fees, SEC filing fees and annual report printing fees. These fees increased during the three months ended June 30, 2007 due to additional filing fees as compared to the prior year.

Directors' fees for the three months ended June 30, 2007 were \$56,250, as compared to \$27,500 for the three months ended June 30, 2006 due to the increase in annual stipend fees and their related monthly amortization.

Insurance expense for the three months ended June 30, 2007 was \$66,246, as compared to \$50,589 for the three months ended June 30, 2006. The increase was primarily the result of an increase in the amortization of our directors and officers insurance policy premiums.

There was no stock option compensation expense recorded for the three months ended June 30, 2007 as there was no longer a stock option plan in effect. Stock option compensation expense for the three months ended June 30, 2006 was \$202,296 and was the result of the adoption of the SFAS No. 123 (revised 2004) *Share-based Payment*.

Other expenses were \$82,062 for the three months ended June 30, 2007, as compared to \$35,083 for the three months ended June 30, 2006. The expenses primarily represent direct expenses such as travel related specifically to our portfolio companies, loan evaluation services for our portfolio companies, press releases and backup servicer expenses.

#### **Net Realized Gain (Loss) on Sale of Investments**

During the three months ended June 30, 2007, we sold or were repaid in full on eleven syndicate loan investments for a net loss of \$5,021, as compared to a realized net loss of \$100,850 as a result of the repayment in full of syndicate investments that contained unamortized premiums during the three months ended June 30, 2006.

#### **Realized Gain on Settlement of Derivative**

During the three months ended June 30, 2007, we received interest rate cap agreement payments of \$8,405 as a result of the one month LIBOR exceeding 5% as compared to \$1,367 during the three months ended June 30, 2006.



### **Net Unrealized Depreciation on Derivative**

During the three months ended June 30, 2007, we recorded net unrealized depreciation of \$264 due to a decrease in the fair market value of our interest rate cap agreement, as compared to unrealized appreciation of \$41,486 during the three months ended June 30, 2006.

### **Net Unrealized Appreciation on Investments**

For the three months ended June 30, 2007, we recorded net unrealized appreciation on investments of \$256,613, as compared to net unrealized appreciation of \$812,991, for the three months ended June 30, 2006. The unrealized appreciation is mainly attributable to the increase in fair value on our portfolio due to the repayment in full of certain underperforming investments, most notably Consolidated Bedding, Inc.

### **Net Increase in Net Assets from Operations**

Overall, we realized a net increase in net assets resulting from operations of \$5,964,600 for the three months ended June 30, 2007. Based on a weighted-average of 13,561,511 basic and diluted shares outstanding, our net increase in net assets from operations per weighted-average common share for the three months ended June 30, 2007 was \$0.44, basic and diluted.

For the three months ended June 30, 2006, we realized a net increase in net assets resulting from operations of \$5,543,076. Based on a weighted-average of 11,337,291 (basic) and 11,570,425 (diluted) shares outstanding, our net increase in net assets from operations per weighted-average common share for the three months ended June 30, 2006 was \$0.49 (basic) and \$0.48 (diluted).

*Comparison of the Nine months ended June 30, 2007 to the Nine months ended June 30, 2006*

### **Investment Income**

Investment income for the nine months ended June 30, 2007 was \$26,078,775, as compared to \$19,553,835 for the nine months ended June 30, 2006.

Interest income from our investments in debt securities of private companies was \$25,064,702 for the nine months ended June 30, 2007 as compared with \$18,497,893 for the nine months ended June 30, 2006, which included \$63,217 of PIK interest. This increase consisted of net new investments of approximately \$153.9 million for the nine months ended June 30, 2007, as compared to net new investments of approximately \$2.8 million for the nine months ended June 30, 2006. As a result of a refinancing by Badanco Acquisition Corp. and a full repayment by Mistras Holdings Corp., Allied Extruders LLC, and SCPH Holdings we recorded success fees of approximately \$2,250,000 during the nine months ended June 30, 2007. In June 2007, we purchased a senior debt portfolio of approximately \$63.3 million to 16 different lenders, which is included in the net new investments described above.

The annualized weighted average yield on our portfolio for the nine months ended June 30, 2007 was 12.3%; there was no PIK interest accrued during the nine months ended June 30, 2007. The annualized weighted average yield on our portfolio for the nine months ended June 30, 2006 was 12.3% (with and without giving effect to PIK interest).

Interest income from invested cash and cash equivalents for the nine months ended June 30, 2007 was \$178,183, as compared to \$21,714 for the nine months ended June 30, 2006. Interest income increased from the prior year due to the amount of cash that was held interest bearing accounts and the interest earned on our custodial account prior to disbursement.

For the nine months ended June 30, 2007 and June 30, 2006, we recorded \$403,917 and \$323,003, respectively, in interest income from loans to our employees in connection with the exercise of employee stock options. The increase is the result of additional loans issued in connection with employee stock option exercises during the fourth quarter of the previous fiscal year.

For the nine months ended June 30, 2007, we recorded \$431,973 of prepayment fees and other income, as compared to \$711,225 for the nine months ended June 30, 2006. The income for both periods consisted of prepayment penalty fees received upon the full repayment of certain loan investments ahead of contractual maturity and prepayment fees received upon the early unscheduled principal repayments which, in both instances, were based on a percentage of the outstanding principal amount of the loan at the date of prepayment.





## Operating Expenses

Operating expenses, prior to credit from the Adviser for fees earned and voluntary waivers to the base management and incentive fees, for the nine months ended June 30, 2007 were \$14,168,785, as compared to \$6,835,060 for the nine months ended June 30, 2006. Operating expenses for the nine months ended June 30, 2007 reflected a significant increase in interest expense and management fees, prior to credits, as well as the addition of the incentive and administration fees, prior to credits, under the Amended Advisory and Administration Agreements.

Loan servicing fees of \$2,377,409 were incurred for the nine months ended June 30, 2007, as compared to \$2,144,024 for the nine months ended June 30, 2006. These fees were incurred in connection with a loan servicing agreement between Business Loan and our Adviser, which is based on the size of the portfolio. These fees were reduced against the amount of the base management fee due to our Adviser.

For the nine months ended June 30, 2007, we incurred a base management fee of \$1,806,075 after reductions for loan servicing fees received by our Adviser of \$2,377,409, less credits for fees received by our Adviser of \$1,616,875 and a \$369,161 fee reduction for the waiver of the 2% fee on senior syndicated loans to 0.5%, for a net base management fee credit of \$179,961, as compared to the nine months ended June 30, 2006, in which we incurred a base management fee of \$955,894 after reductions for loan servicing fees received by our Adviser of \$2,144,024, less credits for fees received by our Adviser of \$1,762,000 and a \$3,774 fee reduction for the waiver of the 2% fee on senior syndicated loans to 0.5%, for a net base management credit of \$809,880. The base management fee is computed quarterly as described under *Investment Advisory and Management Agreement*. Effective April 1, 2007, the board of our Adviser reduced the amount of credit for fees received by our Adviser from 100% of the fees received to 50% of the fees received, therefore, the three months ended June 30, 2007 reflect the reduced credit for fees received by our Adviser. The gross base management fee before the reduction for loan servicing fees for the nine months ended June 30, 2007 and June 30, 2006, was \$4,183,484 and \$3,099,918, respectively, which increased in the current period due to the growth of the investment portfolio as compared to the same period of the prior year and fewer credits for fees received by our Adviser.

Effective October 1, 2006, the income based incentive fee became effective and as such we recorded a gross incentive fee of \$3,474,007, which was reduced by a voluntary waiver issued by our Adviser's board of directors of \$2,696,124, which resulted in a net incentive fee of \$777,883, which is recorded in fees due to Adviser on our consolidated statements of assets and liabilities at June 30, 2007. There was no incentive fee recorded for the nine months ended June 30, 2006, as the Amended Advisory Agreement was not in effect.

Effective October 1, 2006, the Administration Agreement became effective in which we provide payments equal to our allocable portion of our Administrator's overhead expenses in performing its obligations under the Administration Agreement including, but not limited to, rent for employees of our Administrator, and our allocable portion of the salaries and benefits expenses of our chief financial officer, chief compliance officer and controller and their respective staffs. We incurred an administration fee of \$481,746 for the nine months ended June 30, 2007. There was no administration fee recorded during the nine months ended June 30, 2006, as the Administration Agreement was not in effect.

Professional fees, consisting primarily of legal and audit fees, for the nine months ended June 30, 2007 were \$368,610, as compared to \$399,758 for the nine months ended June 30, 2006. The slight decrease is due to the reimbursement of certain legal fees at the time of investment funding.

Amortization of deferred financing costs, in connection with our line of credit, was \$198,633 for the nine months ended June 30, 2007 and \$94,572 for the nine months ended June 30, 2006. The increase is due to the amortization of additional fees incurred with our line of credit which were not in place during the prior year period.

Interest expense for the nine months ended June 30, 2007 was \$4,693,525, as compared to \$2,302,693 for the nine months ended June 30, 2006. This increase is primarily a result of increased borrowings under our line of credit during the nine months ended June 30, 2007, which borrowings were partially used to finance our increased investments, borrowings remaining outstanding for longer periods of time and an increase in the interest rates on our borrowings.

Stockholder related costs for the nine months ended June 30, 2007 were \$190,450, as compared to \$273,170 for the nine months ended June 30, 2006. Stockholder related costs include such recurring items as transfer agent fees, NASDAQ listing fees, SEC filing fees and annual report printing fees. These fees decreased during the nine months ended June 30, 2007 since there were no special proxy solicitation or stock option termination notices filed as there were during the nine months ended June 30, 2006.

Directors' fees for the nine months ended June 30, 2007 were \$167,470, as compared to \$81,712 for the nine months ended June 30, 2006 due to the increase in annual stipend fees and their related monthly amortization.



Insurance expense for the nine months ended June 30, 2007 was \$191,338, as compared to \$151,956 for the nine months ended June 30, 2006. The increase is primarily the result of an increase in the amortization of our directors and officers insurance policy premiums.

There was no stock option compensation expense recorded for the nine months ended June 30, 2007 as there was no longer a stock option plan in effect. Stock option compensation expense for the nine months ended June 30, 2006 was \$279,618 and was the result of the adoption of the SFAS No. 123 (revised 2004) *Share-based Payment*.

Other expenses were \$219,552 for the nine months ended June 30, 2007, as compared to \$151,663 for the nine months ended June 30, 2006. The expenses primarily represent direct expenses such as travel related specifically to our portfolio companies, loan evaluation services for our portfolio companies, press releases and backup servicer expenses.

#### **Income Tax Expense**

During the nine months ended June 30, 2006, Gladstone Capital Corporation recorded approximately \$50,000 in connection with penalties incurred on misclassified revenue on its fiscal year 2004 corporate tax return.

#### **Net Realized Gain (Loss) on Sale of Investments**

During the nine months ended June 30, 2007, we sold or were repaid in full on 24 syndicate loan investments for a net gain of \$81,498, as compared to an aggregate net loss of \$903,945, which was composed of \$1,180,595 loss from the sale of two investments and a net gain of \$276,650 from the sale and repayments of syndicate investments during the nine months ended June 30, 2006.

#### **Realized Gain on Settlement of Derivative**

During the nine months ended June 30, 2007, we received interest rate cap agreement payments of \$31,198 as a result of the one month LIBOR exceeding 5%, as compared to \$1,367 received during the nine months ended June 30, 2006.

#### **Net Unrealized (Depreciation) Appreciation on Derivative**

During the nine months ended June 30, 2007, we recorded net unrealized depreciation of \$25,877 due to a decrease in the fair market value of our interest rate cap agreement, as compared to unrealized appreciation of \$65,252 during the nine months ended June 30, 2006.

#### **Net Unrealized (Depreciation) Appreciation on Investments**

For the nine months ended June 30, 2007, we recorded net unrealized depreciation on investments of \$2,465,915, as compared to net unrealized appreciation of \$5,769,820, for the nine months ended June 30, 2006. The unrealized depreciation is mainly attributable to the depreciated fair value on certain investments, most notably unrealized depreciation on Its Just Lunch International LLC, LocalTel, Inc. and Visual Edge Technology, Inc., partially offset by appreciation of our warrants in Finn Corporation.

#### **Net Increase in Net Assets from Operations**

Overall, we realized a net increase in net assets resulting from operations of \$14,213,054 for the nine months ended June 30, 2007. Based on a weighted-average of 12,701,845 basic and diluted shares outstanding, our net increase in net assets from operations per weighted-average common share for the nine months ended June 30, 2007 was \$1.12, basic and diluted.

For the nine months ended June 30, 2006, we realized a net increase in net assets resulting from operations of \$19,366,806. Based on a weighted-average of 11,317,437 (basic) and 11,549,054 (diluted) shares outstanding, our net increase in net assets from operations per weighted-average common share for the nine months ended June 30, 2006 was \$1.71 (basic) and \$1.68 (diluted).

**LIQUIDITY AND CAPITAL RESOURCES**

At June 30, 2007, we had investments in debt securities of, or loans to, 59 private companies, totaling approximately \$370.0 million (cost basis) of total assets.

During the nine months ended June 30, 2007 and June 30, 2006, the following investment activity occurred:

<b>Quarter Ended</b>	<b>New Investments</b>	<b>Principal Repayments</b>	<b>Net Gain/(Loss) on Disposal</b>
June 30, 2007	\$ 126,086,654	\$ 37,572,621	\$ (5,021 )
March 31, 2007	75,330,167	38,263,017	84,205
December 31, 2006	52,311,008	23,967,229	2,314
	\$ 253,727,829	\$ 99,802,867	\$ 81,498
June 30, 2006	\$ 39,916,834	\$ 44,358,944	\$ (100,850 )
March 31, 2006	38,471,109	24,815,067	377,500
December 31, 2005	26,688,457	38,702,066	(1,180,595 )
	\$ 105,076,400	\$ 107,876,077	\$ (903,945 )

The following table summarizes the contractual principal amortization and maturity of our investment portfolio by fiscal year:

<b>Fiscal Year Ended September 30,</b>	<b>Amount</b>
2007	\$ 8,358,133
2008	9,922,956
2009	26,109,512
2010	43,759,511
2011	94,200,816
Thereafter	187,624,470
	\$ 369,975,398

Net cash used in operating activities for the nine months ended June 30, 2007, consisting primarily of the items described in *Results of Operations* and the investment activity described above, was approximately \$136.6 million as compared to net cash provided by operating activities of approximately \$17.8 million for the nine months ended June 30, 2006. Net cash provided by investing activities consisted of \$300,941 and \$129,943 for the nine months ended June 30, 2007 and June 30, 2006, respectively, and consisted of the principal repayments of employee loans. Net cash provided by financing activities for the nine months ended June 30, 2007 was approximately \$139.1 million and mainly consisted of an offering of common stock for net proceeds of approximately \$45.7 million, borrowings on our line of credit of approximately \$277.8 million, offset by repayments on line of credit borrowings of approximately \$166.6 million, and approximately \$16.0 million for the payment of dividends. Net cash used in financing activities was approximately \$18.0 million for the nine months ended June 30, 2006 and consisted primarily of net repayments on our line of credit of approximately \$5.2 million and the payment of dividends of approximately \$13.8 million.

During the nine months ended June 30, 2007, cash and cash equivalents increased from approximately \$732,000 to approximately \$3.5 million.

In order to qualify as a RIC and to 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 dividends of \$0.14 per common share for July, August, September, October, November and December 2006 and January, February, March, April, May and June 2007 and \$0.135 per common share for January, February, March, April, May and June 2006, and October, November and December 2005. In July 2007, our Board of Directors declared a monthly dividend of \$0.14 per common share for each of July, August, and September 2007.

We anticipate continuing to borrow funds and, from time to time issuing additional equity securities, to obtain additional capital to make further investments. On May 2, 2007, we completed a public offering of 2,000,000 shares of our common stock, at a price of \$24.25 per share, under a shelf registration statement on Form N-2 (File No. 333-100385), and pursuant to the terms set forth in a prospectus dated April 16, 2007, as supplemented by a final prospectus dated April 27, 2007. Net proceeds of the offering, after underwriting discounts and offering expenses were approximately \$45,669,292 and were used to repay outstanding borrowings under our line of credit. In May 2007, we filed with the SEC a new shelf registration statement on Form N-2 (File No. 333-143027) (the Registration Statement ) which the SEC declared effective on July 5, 2007 that would permit us to issue, through one or more transactions, up to an aggregate of \$300 million in securities, consisting of common stock, preferred stock and/or debt securities. On July 24, 2007, we completed an offering of 400,000 shares of our common stock, at a price of \$20.41 per share, under the Registration Statement, and pursuant to the terms set forth in a prospectus dated July 5, 2007, as supplemented by a final prospectus dated July 24, 2007. Net proceeds from this offering, after offering expenses, were approximately \$8,149,000 and were used to repay outstanding borrowings under our line of credit. After this offering, we have the capacity to issue up to an aggregate of approximately \$291.8 million in securities under the Registration Statement.

### Revolving Credit Facilities

Through our wholly-owned subsidiary, Business Loan, we have a \$220 million revolving credit facility (the DB Facility ) with Deutsche Bank AG, as administrative agent, which is scheduled to mature on May 23, 2008. Pursuant to the DB Facility, Business Loan has pledged the loans it holds to secure future advances by certain institutional lenders. Interest rates charged on the advances under the DB Facility will be based on LIBOR, the Prime Rate or the Federal Funds Rate, depending on market conditions, and will adjust periodically. As of June 30, 2007, our outstanding principal balance under the DB Facility was approximately \$161.2 million at an interest rate of approximately 5.3%. Available borrowings are subject to various constraints imposed by Deutsche Bank AG, based on the aggregate loan balance pledged by Business Loan, which varies as loans are added and repaid, regardless of whether such repayments are early prepayment or are made as contractually required. At June 30, 2007, the remaining borrowing capacity available under the DB Facility was approximately \$58.8 million.

The DB Facility contains covenants that, among other things, 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 DB Facility also restricts some of the terms and provisions (including interest rates, terms to maturity and payments schedules) and limits the borrower and industry concentrations of loans that are eligible to secure advances. As of June 30, 2007, Business Loan was in compliance with all of the DB Facility covenants. We currently intend to securitize all of the loans held by Business Loan and to use the proceeds from the securitization to pay down any amounts then outstanding under the revolving credit facility. However, there can be no assurance that we will be able to successfully securitize any of these loans on terms acceptable to us, if at all.

The administrative agent also requires that any interest or principal payments on pledged loans be remitted directly by the borrower into a lockbox account with the Bank of New York as custodian. Deutsche Bank AG is also the trustee of the account and once a month remits the collected funds to us. For the nine months ended June 30, 2007, the amount due from custodian decreased by \$457,261.

Our Adviser, services the loans pledged under the DB Facility. As a condition to this servicing arrangement, we executed a performance guaranty pursuant to which we guaranteed that our Adviser would comply fully with all of its obligations under the facility. The performance guaranty requires us to maintain a minimum net worth of \$100 million and to maintain asset coverage with respect to senior securities representing indebtedness of at least 200%, in accordance with Section 18 of the 1940 Act. As of June 30, 2007, we were in compliance with our covenants under the performance guaranty.

The DB facility is available for general corporate purposes.

**Contractual Obligations**

As of June 30, 2007, we were a party to signed and non-binding term sheets for two loan originations for an aggregate of \$15.0 million. To date, these investments have not yet funded and we expect to fund these potential investments as follows:

Contractual Obligations	Total	Payment Due by Period			
		Less than 1 Year	1-3 Years	3-5 Years	More than 5 Years
Investments	15,000,000	15,000,000			
Total	\$ 15,000,000	\$ 15,000,000	\$	\$	\$

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## INTERIM CONSOLIDATED FINANCIAL STATEMENTS

**GLADSTONE CAPITAL CORPORATION**  
**CONSOLIDATED STATEMENTS OF ASSETS AND LIABILITIES**  
(Unaudited)

	June 30, 2007	September 30, 2006
<b>ASSETS</b>		
Investments at fair value (Cost 6/30/2007: \$369,975,398; 9/30/2006: \$216,202,986)	\$ 368,949,247	\$ 217,642,750
Cash and cash equivalents	3,491,495	731,744
Interest receivable investments in debt securities	2,221,606	1,394,942
Interest receivable employees	32,739	37,396
Due from custodian	3,129,891	3,587,152
Deferred financing fees	246,333	145,691
Prepaid assets	186,643	226,747
Due from employees		1,803,283
Other assets	352,796	213,510
<b>TOTAL ASSETS</b>	<b>\$ 378,610,750</b>	<b>\$ 225,783,215</b>
<b>LIABILITIES</b>		
Accounts payable	\$ 5,160	\$ 4,072
Interest payable	516,780	247,530
Administration fee due to Administrator	186,895	
Fees due to Adviser (Refer to Notes 4 and 5)	404,240	240,363
Borrowings under line of credit	161,188,000	49,993,000
Withholding taxes payable		1,803,283
Accrued expenses and deferred liabilities	854,322	721,287
Funds held in escrow	202,433	203,193
<b>TOTAL LIABILITIES</b>	<b>163,357,830</b>	<b>53,212,728</b>
<b>NET ASSETS</b>	<b>\$ 215,252,920</b>	<b>\$ 172,570,487</b>
<b>ANALYSIS OF NET ASSETS</b>		
Common stock, \$0.001 par value, 50,000,000 shares authorized and 14,249,683 and 12,305,008 shares issued and outstanding, respectively	\$ 14,250	\$ 12,305
Capital in excess of par value	225,449,718	181,270,565
Notes receivable employees	(9,947,366	) (10,248,308
Net unrealized appreciation on investments	(1,026,151	) 1,439,764
Unrealized depreciation on derivative	(279,593	) (253,716
Realized loss on sale of investments	(780,197	) (861,695
Realized gain on settlement of derivative	46,212	15,014
Accumulated undistributed net investment income	1,776,047	1,196,558
<b>TOTAL NET ASSETS</b>	<b>\$ 215,252,920</b>	<b>\$ 172,570,487</b>
<b>NET ASSETS PER SHARE</b>	<b>\$ 15.11</b>	<b>\$ 14.02</b>

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



**GLADSTONE CAPITAL CORPORATION**  
**CONSOLIDATED SCHEDULE OF INVESTMENTS**  
**AS OF JUNE 30, 2007**  
**(UNAUDITED)**

Company(1)	Industry	Investment(2)	Cost	Fair Value
Access Television Network, Inc. AccessTV PIN Acquisition LLC Product Information Network Venture	Service-cable airtime (infomercials)	Line of Credit (7)(8) (12.3% Due 3/2009) Senior Term Debt (7) (12.3% Due 3/2009)	\$ 2,979,835	\$ 2,948,401
ActivStyle Acquisition Co. ActivStyle, Inc.	Service-medical products distribution	Line of Credit (5) (9) (9.6%, Due 7/2009) Senior Term Debt (5) (9.6%, Due 7/2011) Senior Term Debt (3) (5) (11.8%, Due 7/2011)	450,000 2,960,000 2,500,000	448,313 2,956,300 2,496,875
Advanced Homecare Management, Inc.	Service-home health nursing services	Senior Subordinated Term Debt (5) (6) (11.9%, Due 12/2013)	6,300,000	6,300,000
Allison Publications, LLC D. Magazine Partners, L.P. Allison Media, Inc. City Newspapers, LP City Newspapers, Management, LLC	Service-publisher of consumer oriented magazines	Senior Term Debt (7) (10.3%, Due 12/2011)	8,014,728	7,933,000
Anitox Acquisition Company Anitox Holding, Inc.	Manufacturing-preservatives for animal feed	Senior Real Estate Term Debt (8.8%, Due 1/2012) Line of Credit (10) (9.6%, Due 1/2010) Senior Term Debt (5) (9.6%, Due 1/2012) Senior Term Debt (3) (5) (11.8%, Due 1/2012)	3,412,939 2,750,000 2,750,000	3,360,000 2,746,563 2,746,563
Badanco Acquisition Corp.	Service-luggage design and distribution	Senior Subordinated Term Debt (5) (12.1%, Due 7/2012)	9,701,250	9,701,250
Bresnan Communications, LLC	Service-telecommunications	Senior Term Debt (6) (7.3%, Due 9/2013) Senior Subordinated Term Debt (6) (9.9%, Due 3/2014)	3,001,880 1,510,393	2,992,500 1,505,625
CCS, LLC	Service-cable tv franchise owner	Senior Term Debt (7) (12.3%, Due 7/2007)	3,455,580	3,424,146
CHG Companies, Inc. CHG Medical Staffing, Inc.	Service-healthcare staffing	Letter of Credit (5) (6) (7.9%, Due 12/2012) Senior Term Debt (5) (6) (7.8%, Due 12/2012) Senior Subordinated Term Debt (5) (6) (11.3%, Due 12/2012)	400,000 1,596,000 500,000	404,000 1,605,975 503,125

**GLADSTONE CAPITAL CORPORATION**  
**CONSOLIDATED SCHEDULE OF INVESTMENTS (Continued)**  
**AS OF JUNE 30, 2007**  
**(UNAUDITED)**

Company(1)	Industry	Investment(2)	Cost	Fair Value
Chinese Yellow Pages Company	Service-publisher of Chinese language directories	Line of Credit (7)(11) (12.3%, Due 9/2010) Senior Term Debt (7) (12.3%, Due 9/2010)	\$ 150,071 1,235,008	\$ 150,071 1,222,435
Clinton Holdings, LLC	Distribution-aluminum sheets and stainless steel	Senior Subordinated Term Debt (5) (12.6%, Due 1/2013) Common Stock Warrants	15,500,000 109,124	15,519,375 125,864
Clinton Aluminum Acquisition, LLC Metal Transportation, LLC Clinton Distribution Center, LLC				
CMI Acquisition, LLC (d/b/a Triangle Metal Industries)	Service-recycling	Senior Subordinated Term Debt (7) (12.3%, Due 11/2012)	6,500,000	6,500,000
TMC Acquisition, LLC				
Community Media Corporation	Service-publisher of free weekly newspapers	Senior Term Debt (7) (10.8%, Due 7/2007)	2,572,497	2,547,350
Country Road Communications LLC Country Road Management, Inc.	Service-telecommunications	Senior Subordinated Term Debt (5) (6) (13.2%, Due 7/2013)	5,965,833	6,030,000
Defiance Acquisition Corporation	Manufacturing-trucking parts	Senior Term Debt (3) (5) (13.3%, Due 4/2010)	6,325,000	6,317,094
Doe & Ingalls Management LLC	Distributor-specialty chemicals	Senior Term Debt (5) (8.8%, Due 11/2010)	4,100,000	4,110,250
Doe & Ingalls of North Carolina Operating LLC Doe & Ingalls of Florida Operating LLC Doe & Ingalls of Virginia Operating LLC Doe & Ingalls of Maryland Operating LLC		Senior Term Debt (3) (5) (9.8%, Due 11/2010)	4,466,250	4,471,833
Emdeon Business Services, Inc.	Service-healthcare technology solutions	Senior Term Debt (6) (7.6%, Due 11/2013) Senior Subordinated Term Debt (6) (10.4%, Due 5/2014)	2,440,341 2,013,460	2,450,020 2,020,000
Express Courier International, Inc.	Service-ground delivery and logistics	Line of Credit (12) (9.6%, Due 6/2009) Senior Term Debt (5) (9.6%, Due 6/2011) Senior Term Debt (3) (5) (11.8%, Due 6/2011)	4,347,500 3,950,000	4,347,500 3,950,000

**GLADSTONE CAPITAL CORPORATION**  
**CONSOLIDATED SCHEDULE OF INVESTMENTS (Continued)**  
**AS OF JUNE 30, 2007**  
**(UNAUDITED)**

Company(1)	Industry	Investment(2)	Cost	Fair Value
Finn Corporation	Manufacturing-landscape equipment	Common Stock Warrants	\$ 37,000	\$ 2,972,858
Florida Cable, Inc. Lakepointe Limited Partnership	Service-cable and internet system operator	Senior Term Debt (7) (11.8%, Due 7/2010)	5,906,391	5,849,810
FR X Ohmstede Holdings, LLC FR X Ohmstede Acquisitions Co.	Service & Manufacturing-heat exchangers	Senior Term Debt (6) (7.9%, Due 8/2013) Senior Subordinated Term Debt (6) (12.4%, Due 8/2014)	2,739,130 3,011,190	2,756,250 3,015,000
Global Materials Technologies, Inc.	Manufacturing-steel wool products and metal fibers	Senior Term Debt (3) (5) (14.3%, Due 11/2009)	5,150,000	4,944,000
GTM Holdings, Inc. Gold Toe Investment Corp.	Manufacturing-socks	Senior Term Debt (6) (8.1%, Due 10/2013) Senior Subordinated Term Debt (6) (11.4%, Due 4/2014)	497,500 500,000	499,988 505,000
Greatwide Logistics Services, Inc.	Service - logistics and transportation	Senior Term Debt (6) (8.6%, Due 12/2013) Senior Subordinated Term Debt (6) (11.9%, Due 6/2014)	3,980,000 4,000,000	3,880,500 3,840,000
Harrington Holdings, Inc. Harrington Acquisition Corp.	Service - healthcare products distribution	Senior Term Debt (6) (7.8%, Due 1/2014) Senior Subordinated Term Debt (6) (11.4%, Due 1/2014)	2,493,750 5,000,000	2,506,219 5,025,000
Heartland Communications Group, LLC Heartland Comm. License, LLC Heartland Comm. Houghton License, LLC Tu-Mar Broadcasting, Inc.	Service-radio station operator	Line of Credit (7)(13) (11.8%, Due 5/2008) Senior Term Debt (7) (11.8%, Due 5/2011)	9,856 4,873,531	9,856 4,823,237
International Junior Golf	Service-golf training	Line of Credit (5) (14) (9.6%, Due 5/2010) Senior Term Debt (5) (9.6%, Due 5/2012) Senior Term Debt (3) (5) (11.8%, Due 5/2012)	500,000 2,650,000 2,500,000	499,375 2,646,688 2,493,750
It s Just Lunch International, LLC	Service-dating service	Line of Credit (5) (15) (9.3%, Due 6/2009) Senior Term Debt (5) (9.6%, Due 6/2011) Senior Term Debt (3) (5) (15) (11.8%, Due 6/2011)	550,000 3,300,000 500,000	514,250 3,085,500 467,500

**GLADSTONE CAPITAL CORPORATION**  
**CONSOLIDATED SCHEDULE OF INVESTMENTS (Continued)**  
**AS OF JUNE 30, 2007**  
**(UNAUDITED)**

Company(1)	Industry	Investment(2)	Cost	Fair Value
John Henry Holdings, Inc. Multi Packaging Solutions, Inc.	Manufacturing-packaging products	Senior Subordinated Term Debt (6) (12.3%, Due 6/2011)	\$ 8,000,000	\$ 8,000,000
Kinetek Acquisition Corp.	Manufacturing-custom engineered motors & controls	Senior Term Debt (6) (7.8%, Due 11/2013) Senior Subordinated Term Debt (6) (10.8%, Due 5/2014)	1,498,218 1,509,209	1,492,500 1,507,500
KMBQ Corporation	Service-AM/FM radio broadcaster	Line of Credit (7) (16) (13.3%, Due 3/2010) Senior Term Debt (7) (13.3%, Due 3/2010)	150,000 1,825,404	150,000 1,806,543
LocalTel, Inc.	Service-yellow pages publishing	Line of Credit (5) (17) (9.8%, Due 6/2009) Senior Term Debt (5) (9.8%, Due 6/2011) Senior Term Debt (3) (5) (12.3%, Due 6/2011)	1,275,000 2,687,500 2,750,000	1,096,500 2,311,250 2,282,500
Macfadden Performing Arts Media, LLC	Service-magazine publisher	Line of Credit (7) (11.3%, Due 6/2009) Senior Term Debt (7) (11.3%, Due 6/2009)	515,979 6,775,441	515,979 6,700,000
MCA Communications, LLC MCA Internet, LLC	Service-internet-based data publisher	Line of Credit (7) (non-accrual, Due 9/2006)	798,349	792,063
Meteor Holding Corporation Metrologic Instruments, Inc.	Manufacturing-bar code scanning and data capture	Senior Term Debt (6) (8.3%, Due 12/2013) Senior Subordinated Term Debt (6) (11.6%, Due 12/2013)	2,354,100 1,500,000	2,364,281 1,509,375
Multi-Ag Media LLC HFW Communications, Inc. Dairy Radio, LLC DPW Publishing, Inc. Phoenix Data Processing, LLC	Service-dairy magazine publisher/ information database	Senior Term Debt (7) (12.3%, Due 12/2009)	2,643,911	2,618,764
Newhall Holdings, Inc. (d/b/a Newhall Laboratories) Golden Sun, Inc.	Service-distributor of personal care products and supplements	Line of Credit (7) (20) (8.8%, Due 5/2010) Senior Term Debt (3) (7) (9.1%, Due 5/2012) Senior Term Debt (3) (7) (11.3%, Due 5/2012)	4,500,000 4,500,000	4,500,000 4,500,000

**GLADSTONE CAPITAL CORPORATION**  
**CONSOLIDATED SCHEDULE OF INVESTMENTS (Continued)**  
**AS OF JUNE 30, 2007**  
**(UNAUDITED)**

Company(1)	Industry	Investment(2)	Cost	Fair Value
Northern Contours Northern Contours of Kentucky, Inc. Norcon Holding LLC Norcon Lewis LLC	Manufacturing-veneer and laminated components	Senior Subordinated Term Debt (5) (12.3%, Due 5/2010)	\$ 7,000,000	\$ 7,008,750
Pinnacle Treatment Centers, Inc.	Service-Addiction treatment centers	Line of Credit (21) (9.6%, Due 12/2009) Senior Term Debt (5) (9.6%, Due 12/2011) Senior Term Debt (3)(5) (12.3%, Due 12/2011)	2,500,000 4,500,000	2,496,875 4,494,375
Precision Acquisition Group Holdings, Inc. Precision Asset Acquisition Company, LLC	Manufacturing-consumable components for the aluminum industry	Equipment Note (5) (22) (9.8%, Due 10/2011) Senior Term Debt (5) (9.8%, Due 10/2010) Senior Term Debt (3)(5) (11.8%, Due 10/2010)	591,228 5,000,000 4,200,000	591,228 5,012,500 4,210,500
PROFITSystems Acquisition Co. PROFITSystems, Inc.	Service-design and develop ERP software	Line of Credit (23) (9.6%, Due 7/2009) Senior Term Debt (5) (9.6%, Due 7/2011) Senior Term Debt (3)(5) (11.8%, Due 7/201)	2,875,000 2,900,000	2,878,594 2,903,625
Puerto Rico Cable Acquisition Company, Inc.	Service-telecommunications	Senior Subordinated Term Debt (5)(6) (11.6%, Due 1/2012)	7,802,222	7,755,841
Reading Broadcasting, Inc.	Service-television station operator	Senior Term Debt (7) (12.8%, Due 12/2011)	7,087,084	7,017,930
RCS Management Holding Co.	Service-healthcare supplies	Senior Term Debt (3) (5) (9.8%, Due 1/2011) Senior Term Debt (4) (5) (12.3%, Due 1/2011)	3,000,000 3,000,000	2,910,000 2,895,000
RedPrairie Holding, Inc. RedPrairie Corporation Blue Cube Software, Inc.	Service-design and develop supply chain software	Senior Term Debt (6) (8.4%, Due 7/2012) Senior Subordinated Term Debt (6) (11.9%, Due 1/2013)	4,457,500 3,000,000	4,457,500 3,000,000
RiskMetrics Group Holdings, LLC	Service - develop risk and wealth management solutions	Senior Term Debt (6) (7.6%, Due 1/2014) Senior Subordinated Term Debt (6) (10.9%, Due 7/2014)	1,995,000 500,000	1,999,988 505,000
SCI Cable, Inc.	Service-cable, internet, voice provider	Senior Term Debt (7) (14.3%, Due 10/2008)	2,485,032	2,459,885

**GLADSTONE CAPITAL CORPORATION**  
**CONSOLIDATED SCHEDULE OF INVESTMENTS (Continued)**  
**AS OF JUNE 30, 2007**  
**(UNAUDITED)**

Company(1)	Industry	Investment(2)	Cost	Fair Value
SCS Acquisition Corp. (d/b/a Specialty Coatings Systems)	Service-chemically treated equipment distribution	Senior Term Debt (5) (17) (9.3%, Due 12/2011)	\$ 5,442,311	\$ 5,442,311
		Senior Term Debt (3) (5) (17) (11.3%, Due 12/2011)	6,531,250	6,531,250
Sunburst Media - Louisiana, LLC	Service-radio station operator	Senior Term Debt (7) (12.0%, Due 6/2011)	7,875,441	7,800,000
Sunshine Media Holdings	Service-publisher regional B2B trade magazines	Credit Facility (5) (24) (9.3%, Due 5/2010)	600,000	598,500
		Senior Term Debt (5) (9.3%, Due 5/2012)	17,000,000	16,978,750
		Senior Term Debt (3) (5) (11.8%, Due 5/2012)	10,000,000	9,975,000
Thibaut Acquisition Co.	Service-design and disribute wall covering	Credit Facility (5) (25) (9.8%, Due 1/2011)	500,000	499,375
		Senior Term Debt (5) (9.8%, Due 1/2011)	2,887,500	2,887,500
		Senior Term Debt (3) (5) (12.3%, Due 1/2011)	3,000,000	3,000,000
U.S. HealthCare Communications, LLC	Service-magazine publisher/operator	Senior Term Debt (7) (11.3%, Due 4/2011)	2,244,182	2,219,035
Viapack, Inc.	Manufacturing-polyethylene	Senior Real Estate Term Debt (9.8%, Due 3/2011)	975,000	975,000
P&O Packaging Acquisition LLC	film	Senior Term Debt (3) (5) (19) (11.3%, Due 3/2011)	4,223,438	4,202,320
Visual Edge Technology, Inc. Graphic Enterprises, Inc. Copeco, Inc.	Service-office equipment distribution	Senior Subordinated Term Debt (5) (13.3%, Due 8/2011)	5,000,000	3,625,000
Wesco Holdings, Inc. Wesco Aircraft Hardware Corp.	Service-aerospace parts and distribution	Senior Term Debt (6) (7.6%, Due 9/2013)	2,478,317	2,466,436
		Senior Subordinated Term Debt (6) (11.1%, Due 3/2014)	2,271,494	2,289,375
West Coast Yellow Pages, Inc.	Service-directory publisher	Senior Term Debt (7) (13.8%, Due 8/2010)	1,624,251	1,605,390
Westlake Hardware, Inc. WHI Holding Corp.	Retail-hardware and variety	Senior Subordinated Term Debt (5) (12.6%, Due 1/2011)	15,000,000	14,925,000
Winchester Electronics	Manufacturing-high bandwidth connectors and cables	Senior Term Debt (5) (9.1%, Due 6/2012)	2,000,000	2,002,500
		Senior Subordinated Term Debt (5) (12.3%, Due 6/2012)	10,000,000	10,012,500

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WP Evenflo Group Holdings Inc.	Manufacturing-infant and juvenile products	Senior Term Debt (6) (7.8%, Due 2/2013)	1,990,000	1,999,950
WP Evenflo Acquisition, Inc.		Senior Subordinated Term Debt (6) (11.3%, Due 2/2014)	2,000,000	2,000,000
<b>Total:</b>			<b>\$ 369,975,398</b>	<b>\$ 368,949,247</b>

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- (1) We do not Control, and are not an Affiliate of, any of our portfolio companies, each as defined in the Investment Company Act of 1940, as amended (the 1940 Act ). In general, under the 1940 Act, we would Control a portfolio company if we owned 25% or more of its voting securities and would be an Affiliate of a portfolio company if we owned 5% or more of its voting securities.
- (2) Percentage represents interest rates in effect at June 30, 2007 and due date represents the contractual maturity date.
- (3) Last Out Tranche of senior debt, meaning if the company is liquidated then the holder of the Last Out Tranche is paid after the senior debt.
- (4) Last Out Tranche of senior debt, meaning if the company is liquidated then the holder of the Last Out Tranche is paid after the senior debt, however the debt is junior to another Last Out Tranche.
- (5) Fair value was based on opinions of value submitted by Standard & Poor's Securities Evaluations, Inc.
- (6) Marketable securities, such as syndicated loans, are valued based on the indicative bid price, as of June 29, 2007, from the respective originating syndication agent's trading desk.
- (7) Investment valued at cost due to recent acquisition.
- (8) Availability under the Access TV credit facility totals \$500,000. There were no borrowings outstanding as of June 30, 2007.
- (9) Availability under the ActivStyle credit facility totals \$1,500,000. Borrowings of \$450,000 were outstanding at June 30, 2007.
- (10) Availability under the Anitox credit facility totals \$3,000,000. There were no borrowings outstanding at June 30, 2007.
- (11) Availability under the Chinese Yellow Pages credit facility totals \$950,000. Borrowings of \$150,071 were outstanding at June 30, 2007.
- (12) Availability under the Express Courier credit facility totals \$1,500,000. There were no borrowings outstanding at June 30, 2007.
- (13) Availability under the Heartland credit facility totals \$500,000. Borrowings of \$9,856 were outstanding at June 30, 2007.
- (14) Availability under the International Junior Golf credit facility totals \$1,000,000. Borrowings of \$500,000 were outstanding at June 30, 2007.
- (15) Remaining availability under the It's Just Lunch revolving credit facility totals \$200,000, borrowings of \$550,000 were outstanding at June 30, 2007. The company may borrow an additional \$1,750,000 of the senior term debt facility, subject to certain conditions including Gladstone Capital's approval, borrowings of \$500,000 were outstanding at June 30, 2007.
- (16) Availability under the KMBQ credit facility totals \$200,000. Borrowings of \$150,000 were outstanding at June 30, 2007.



- (17) Availability under the LocalTel credit facility totals \$3,000,000. Borrowings of \$1,275,000 were outstanding at June 30, 2007.
- (18) Availability under the MacFadden credit facility totals \$1,400,000. Borrowings of \$515,979 were outstanding at June 30, 2007.
- (19) The MCA credit facility was matured as of June 30, 2007. The investment is currently not income producing.
- (20) Availability under the Newhall credit facility totals \$4,000,000. There were no borrowings outstanding as of June 30, 2007.
- (21) Availability under the Pinnacle credit facility totals \$500,000. There were no borrowings outstanding at June 30, 2007.
- (22) Precision may borrow up to \$1,000,000 for purposes of acquiring equipment. Borrowings of \$591,228 were outstanding at June 30, 2007.
- (23) Availability under the ProfitSystems credit facility totals \$1,250,000. There were no borrowings outstanding at June 30, 2007.
- (24) Availability under the Sunshine credit facility totals \$3,000,000. Borrowings of \$600,000 were outstanding at June 30, 2007.
- (25) Availability under the Thibaut credit facility totals \$500,000. Borrowings of \$500,000 were outstanding at June 30, 2007.

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

## GLADSTONE CAPITAL CORPORATION

## CONSOLIDATED SCHEDULE OF INVESTMENTS

AS OF SEPTEMBER 30, 2007

Company (1)	Industry	Investment (2)	Cost	Fair Value
ActivStyle Acquisition Co. ActivStyle, Inc.	Service-medical products distribution	Line of Credit (16) (9.6%, Due 7/2009) Senior Term Debt (5) (9.6%, Due 7/2011) Senior Term Debt (3) (5) (11.8%, Due 7/2011)	\$  3,200,000 2,500,000	\$  3,200,000 2,500,000
Advanced Homecare Management, Inc.	Service-home health nursing services	Senior Subordinated Term Debt(5)(6) (11.33%, Due 12/2013)	5,000,000	5,000,000
Allied Extruders, LLC P&O Packaging Acquisition LLC	Manufacturing-polyethylene  film	Senior Real Estate Term Debt (9.8%, Due 3/2011) Senior Term Debt (3) (5) (11.3%, Due 3/2011)	1,000,000 8,000,000	1,000,000 8,030,000
Badanco Acquisition Corp.	Manufacturing-luggage	Senior Term Debt (5) (10.8%, Due 2/2010) Senior Term Debt (3)(5) (13.8%, Due 2/2010)	5,145,019 8,585,125	5,157,881 8,628,051
Benetech, Inc.	Service & Manufacturing- dust management systems for the coal and electric  utility industries	Senior Term Debt (5) (10.3%, Due 5/2009) Senior Term Debt (3) (5)  (13.3%, Due 5/2009)	2,112,500 3,046,875	2,144,187 3,107,813
Bresnan Communications, LLC	Service-telecommunications	Senior Term Debt (6) (7.2%, Due 9/2013) Senior Subordinated Term Debt (9.9%, Due 3/2014)	1,002,115 1,511,554	997,500 1,533,750
Consolidated Bedding, Inc.	Manufacturing-mattresses	Senior Subordinated Term Debt (5) (14.4%, Due 3/2009)	2,438,359	2,306,991
Country Road Communications LLC Country Road Management, Inc.	Service-telecommunications	Senior Subordinated Term Debt (5) (6) (13.3%, Due 7/2013)	5,961,594	6,015,000
Defiance Stamping Company	Manufacturing-trucking parts	Senior Term Debt (3) (5) (13.3%, Due 4/2010)	6,325,000	6,332,906
Doe & Ingalls Management LLC Doe & Ingalls of North Carolina Operating LLC Doe & Ingalls of Florida Operating LLC Doe & Ingalls of Virginia Operating LLC	Distributor-specialty chemicals	Senior Term Debt (5) (9.8%, Due 11/2010) Senior Term Debt (3) (5) (13.3%, Due 11/2010)	4,700,000 4,500,000	4,723,500 4,516,875
Express Courier International, Inc.	Service-ground delivery and logistics	Line of Credit (7) (9.6%, Due 6/2009) Senior Term Debt (5) (9.6%, Due 6/2011) Senior Term Debt (3) (5) (11.8%, Due 6/2011)	4,700,000 3,950,000	4,700,000 3,950,000
Finn Corporation	Manufacturing-landscape equipment	Common Stock Warrants	37,000	709,431



## GLADSTONE CAPITAL CORPORATION

## CONSOLIDATED SCHEDULE OF INVESTMENTS (Continued)

AS OF SEPTEMBER 30, 2007

Company (1)	Industry	Investment (2)	Cost	Fair Value
FR X Ohmstede Holdings, LLC FR X Ohmstede Acquisitions Co.	Service & Manufacturing-heat exchangers	Senior Term Debt (6) (8.5%, Due 8/2013) Senior Subordinated Term Debt (6) (12.5%, Due 8/2014)	3,000,000  3,012,369	3,026,250  3,030,000
Global Materials Technologies, Inc.	Manufacturing-steel wool products and metal fibers	Senior Term Debt (3) (5) (14.3%, Due 11/2009)	5,300,000	5,233,750
It's Just Lunch International, LLC	Service-dating service	Line of Credit (12) (5) (9.2%, Due 6/2009) Senior Term Debt (13) (5) (9.6%, Due 6/2011) Senior Term Debt (3) (14) (11.8%, Due 6/2011)	200,000  3,300,000	199,500  3,291,750
John Henry Holdings, Inc. Multi Packaging Solutions, Inc. LocalTel, Inc.	Manufacturing-packaging products Service-yellow pages publishing	Senior Subordinated Term Debt (6) (12.5%, Due 6/2011) Line of Credit (5) (15) (9.8%, Due 6/2009) Senior Term Debt (5) (9.8%, Due 6/2011) Senior Term Debt (3) (5) (12.3%, Due 6/2011)	8,000,000  350,000  2,687,500  2,750,000	8,000,000  343,000  2,633,750  2,695,000
Mistras Holdings Corp.	Service & Manufacturing nondestructive testing instruments, systems and services	Senior Term Debt (3) (5) (11.5%, Due 8/2008) Senior Term Debt (4) (5) (18) (12.5%, Due 8/2008)	9,499,999  5,250,001	9,737,499  5,620,124
Network Solutions LLC	Service-internet domain registry and host	Senior Term Debt (6) (10.4%, Due 1/2012)	4,464,358	4,499,747
Northern Contours Northern Contours of Kentucky, Inc. Norcon Holding LLC Norcon Lewis LLC	Manufacturing-veneer and laminated components	Senior Subordinated Term Debt (5) (12.3%, Due 5/2010)	7,000,000	7,017,500
PROFITSystems Acquisition Co. PROFITSystems, Inc.	Service-design and develop ERP software	Line of Credit (17) (9.6%, Due 7/2009) Senior Term Debt (5) (9.6%, Due 7/2011) Senior Term Debt (5) (11.8%, Due 7/201) (3)	  3,100,000  2,900,000	  3,100,000  2,900,000
Puerto Rico Cable Acquisition Company, Inc.	Service-telecommunications	Senior Subordinated Term Debt (5)(6) (11.6%, Due 1/2012)	7,813,274	7,775,183
QCE, LLC (d/b/a Quiznos Corp.)	Service-restaurant franchisor	Senior Term Debt (6) (7.6%, Due 5/2013) Senior Term Debt (3) (6) (11.1%, Due 11/2013)	3,010,713  3,045,560	2,977,538  3,033,750

## GLADSTONE CAPITAL CORPORATION

## CONSOLIDATED SCHEDULE OF INVESTMENTS (Continued)

AS OF SEPTEMBER 30, 2007

Company (1)	Industry	Investment (2)	Cost	Fair Value
RCS Management Holding Co.	Service-healthcare supplies	Senior Term Debt (3) (5) (9.8%, Due 1/2011)	3,000,000	3,003,750
		Senior Term Debt (4) (5) (12.3%, Due 1/2011)	3,000,000	3,003,750
RedPrairie Holding, Inc. RedPrairie Corporation Blue Cube Software, Inc.	Service-design and develop supply chain software	Senior Term Debt (6) (8.4%, Due 7/2012)	3,990,000	3,990,000
		Senior Subordinated Term Debt (6) (11.9%, Due 1/2013)	2,000,000	2,005,000
SCPH Holdings, Inc. Sea Con Phoenix, Inc. Phoenix Optix, Inc.	Manufacturing-underwater and harsh environment components	Credit Facility (8) (9.8%, Due 2/2007)		
		Senior Term Debt (5) (10.3%, Due 2/2010)	2,625,000	2,631,563
		Senior Term Debt (3) (5) (13.3%, Due 2/2010)	2,887,500	2,898,328
SCS Acquisition Corp.	Service-chemically treated equipment distribution	Senior Term Debt (3) (5) (9) (9.3%, Due 12/2011)	6,250,000	6,257,812
		Senior Term Debt (3) (5) (10) (11.3%, Due 12/2011)	6,568,750	6,576,961
Thibaut Acquisition Co.	Design and Disbtribution-wall coverings	Credit Facility (11) (9.8%, Due 1/2011)		
		Senior Term Debt (5) (9.8%, Due 1/2011)	3,325,000	3,325,000
		Senior Term Debt (3) (5) (12.3%, Due 1/2011)	3,000,000	3,000,000
Visual Edge Technology, Inc. Graphic Enterprises, Inc. Copeco, Inc.	Service-office equipment distribution	Senior Subordinated Term Debt (5) (13.3%, Due 8/2011)	5,000,000	4,987,500
Westlake Hardware, Inc. WHI Holding Corp.	Retail-hardware and variety	Senior Subordinated Term Debt (5) (12.6%, Due 1/2011)	15,000,000	14,981,250
Winchester Electronics	Manufacturing-high bandwidth connectors and cables	Senior Term Debt (3) (5) (12.3%, Due 6/2012)	6,000,000	6,007,500
Xspedius Communications LLC	Service-telecommunications	Senior Subordinated Term Debt (5) (15.8%, Due 3/2010)	5,157,821	5,306,110
<b>Total:</b>			<b>\$ 216,202,986</b>	<b>\$ 217,642,750</b>

(1) We do not Control, and are not an Affiliate of, any of our portfolio companies, each as defined in the Investment Company Act of 1940, as amended (the 1940 Act). In general, under the 1940 Act, we would Control a portfolio company if we owned 25% or more of its voting securities and would be an Affiliate of a portfolio company if we owned 5% or more of its voting securities.

(2) Percentage represents interest rates in effect at September 30, 2006 and due date represents the contractual maturity date.

(3) Last Out Tranche of senior debt, meaning if the company is liquidated then the holder of the Last Out Tranche is paid after the senior debt.

(4) Last Out Tranche of senior debt, meaning if the company is liquidated then the holder of the Last Out Tranche is paid after the senior debt, however the debt is junior to another Last Out Tranche.

(5) Fair value was based on opinions of value submitted by Standard & Poor's Securities Evaluations, Inc.

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- (6) Marketable securities, such as syndicated loans, are valued based on the indicative bid price, as of September 30, 2006 from the respective originating syndication agent's trading desk.
- (7) Availability under the credit facility totals \$1,500,000. There were no borrowings outstanding at September 30, 2006.
- (8) Availability under the credit facility totals \$500,000. There were no borrowings outstanding at September 30, 2006.
- (9) Availability under the debt facility totals \$7,500,000. The outstanding balance of the debt facility was \$6,250,000 at September 30, 2006.
- (10) Availability under the debt facility totals \$7,500,000. The outstanding balance of the debt facility was \$6,568,750 at September 30, 2006.
- (11) Availability under the credit facility totals \$1,000,000. There were no borrowings outstanding at September 30, 2006.
- (12) Availability under the credit facility totals \$750,000. Borrowings of \$200,000 were outstanding at September 30, 2006.

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- (13) The company may borrow an additional \$500,000 under the senior term debt facility, subject to certain conditions including Gladstone Capital's approval.
- (14) The company may borrow an additional \$2,250,000 under the senior term debt facility, subject to certain conditions including Gladstone Capital's approval.
- (15) Availability under the credit facility totals \$3,000,000. Borrowings of \$350,000 were outstanding at September 30, 2006.
- (16) Availability under the credit facility totals \$1,500,000. There were no borrowings outstanding at September 30, 2006
- (17) Availability under the credit facility totals \$1,250,000. There were no borrowings outstanding at September 30, 2006
- (18) Includes a success fee with a fair value of \$742,000 and no cost basis.

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

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**GLADSTONE CAPITAL CORPORATION**  
**CONSOLIDATED STATEMENTS OF OPERATIONS**  
**(UNAUDITED)**

	<b>Three Months Ended June 30,</b>	
	<b>2007</b>	<b>2006</b>
<b>INVESTMENT INCOME</b>		
Interest income investments	\$ 8,911,643	\$ 5,775,522
Interest income cash and cash equivalents	109,269	8,178
Interest income notes receivable from employees	132,795	108,877
Prepayment fees and other income	47,572	630,239
Total investment income	9,201,279	6,522,816
<b>EXPENSES</b>		
Interest expense	1,762,249	702,449
Loan servicing (Refer to Notes 4 and 5)	897,634	693,965
Base management fee (Refer to Note 4)	727,259	334,814
Incentive fee (Refer to Note 4)	1,166,529	
Administration fee (Refer to Note 4)	186,895	
Professional fees	148,609	166,405
Amortization of deferred financing fees	72,133	36,036
Stockholder related costs	39,434	28,371
Directors fees	56,250	27,500
Insurance expense	66,246	50,589
Stock option compensation		202,296
Other expenses	82,062	35,083
Expenses before credit from Adviser	5,205,300	2,277,508
Credit to base management and incentive fees from Adviser (Refer to Note 4)	(1,708,888 )	(542,774 )
Total expenses net of credits to base management and incentive fees	3,496,412	1,734,734
<b>NET INVESTMENT INCOME</b>	<b>5,704,867</b>	<b>4,788,082</b>
<b>REALIZED AND UNREALIZED GAIN (LOSS) ON INVESTMENTS:</b>		
Realized loss on sale of investments	(5,021 )	(100,850 )
Realized gain on settlement of derivative	8,405	1,367
Unrealized (depreciation) appreciation on derivative	(264 )	41,486
Net unrealized appreciation on investments	256,613	812,991
Net gain on investments	259,733	754,994
<b>NET INCREASE IN NET ASSETS RESULTING FROM OPERATIONS</b>	<b>\$ 5,964,600</b>	<b>\$ 5,543,076</b>
<b>NET INCREASE IN NET ASSETS RESULTING FROM OPERATIONS PER COMMON SHARE:</b>		
Basic	\$ 0.44	\$ 0.49
Diluted	\$ 0.44	\$ 0.48
<b>WEIGHTED AVERAGE SHARES OF COMMON STOCK OUTSTANDING:</b>		
Basic	13,561,511	11,337,291
Diluted	13,561,511	11,570,425

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



**GLADSTONE CAPITAL CORPORATION**  
**CONSOLIDATED STATEMENTS OF OPERATIONS**  
**(UNAUDITED)**

	<b>Nine Months Ended June 30,</b>	
	<b>2007</b>	<b>2006</b>
<b>INVESTMENT INCOME</b>		
Interest income investments	\$ 25,064,702	\$ 18,497,893
Interest income cash and cash equivalents	178,183	21,714
Interest income notes receivable from employees	403,917	323,003
Prepayment fees and other income	431,973	711,225
Total investment income	26,078,775	19,553,835
<b>EXPENSES</b>		
Interest expense	4,693,525	2,302,693
Loan servicing (Refer to Notes 4 and 5)	2,377,409	2,144,024
Base management fee (Refer to Note 4)	1,806,075	955,894
Incentive fee (Refer to Note 4)	3,474,007	
Administration fee (Refer to Note 4)	481,746	
Professional fees	368,610	399,758
Amortization of deferred financing fees	198,633	94,572
Stockholder related costs	190,450	273,170
Directors fees	167,470	81,712
Insurance expense	191,338	151,956
Stock option compensation		279,618
Other expenses	219,522	151,663
Expenses before credit from Adviser	14,168,785	6,835,060
Credit to base management and incentive fees from Adviser (Refer to Note 4)	(4,682,160 )	(1,765,774 )
Total expenses net of credits to base management and incentive fees	9,486,625	5,069,286
<b>NET INVESTMENT INCOME BEFORE INCOME TAXES</b>	<b>16,592,150</b>	<b>14,484,549</b>
Income tax expense		50,237
<b>NET INVESTMENT INCOME</b>	<b>16,592,150</b>	<b>14,434,312</b>
<b>REALIZED AND UNREALIZED GAIN (LOSS) ON INVESTMENTS:</b>		
Net realized gain (loss) on sale of investments	81,498	(903,945 )
Realized gain on settlement of derivative	31,198	1,367
Unrealized (depreciation) appreciation on derivative	(25,877 )	65,252
Net unrealized (depreciation) appreciation on investments	(2,465,915 )	5,769,820
Net (loss) gain on investments	(2,379,096 )	4,932,494
<b>NET INCREASE IN NET ASSETS RESULTING FROM OPERATIONS</b>	<b>\$ 14,213,054</b>	<b>\$ 19,366,806</b>
<b>NET INCREASE IN NET ASSETS RESULTING FROM OPERATIONS PER COMMON SHARE:</b>		
Basic	\$ 1.12	\$ 1.71
Diluted	\$ 1.12	\$ 1.68
<b>WEIGHTED AVERAGE SHARES OF COMMON STOCK OUTSTANDING:</b>		
Basic	12,701,845	11,317,437
Diluted	12,701,845	11,549,054

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

**GLADSTONE CAPITAL CORPORATION**  
**CONSOLIDATED STATEMENTS OF CHANGES IN NET ASSETS**  
**(UNAUDITED)**

	<b>Nine Months Ended June 30,</b>	
	<b>2007</b>	<b>2006</b>
<i>Operations:</i>		
Net investment income	\$ 16,592,150	\$ 14,434,312
Net realized gain (loss) on sale of investments	81,498	(903,945 )
Realized gain on settlement of derivative	31,198	1,367
Unrealized (depreciation) appreciation on derivatives	(25,877 )	65,252
Net unrealized (depreciation) appreciation on investments	(2,465,915 )	5,769,820
Net increase in net assets from operations	14,213,054	19,366,806
<i>Capital transactions:</i>		
Issuance of common stock under shelf offering	46,075,000	
Distributions to stockholders	(16,012,661 )	(13,751,539 )
Shelf offering costs	(405,708 )	
Repayment of principal on employee notes	300,941	129,943
Stock option compensation		279,618
Issuance of common stock under stock option plan		1,150,245
Stock surrendered in settlement of withholding tax	(1,488,193 )	
Increase (decrease) in net assets from capital share transactions	28,469,379	(12,191,733 )
Total increase in net assets	42,682,433	7,175,073
Net assets at beginning of year	172,570,487	151,610,683
Net assets at end of period	\$ 215,252,920	\$ 158,785,756

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

**GLADSTONE CAPITAL CORPORATION**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
**(UNAUDITED)**

	Nine Months Ended June 30,	
	2007	2006
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>		
Net increase in net assets resulting from operations	\$ 14,213,054	\$ 19,366,806
Adjustments to reconcile net increase in net assets resulting from operations to net cash (used in) provided by operating activities:		
Purchase of investments	(253,727,829 )	(105,076,400 )
Principal repayments on investments	99,802,867	107,876,077
Net amortization of premiums and discounts	29,872	(144,501 )
Amortization of deferred financing fees	198,633	94,572
Stock compensation expense		279,618
Realized loss on investments	122,680	1,329,458
Unrealized depreciation (appreciation) on derivative	25,877	(65,252 )
Change in net unrealized depreciation (appreciation) on investments	2,465,915	(5,769,820 )
(Increase) decrease in interest receivable	(822,007 )	276,230
Decrease in funds due from custodian	457,261	130,150
Decrease in prepaid assets	40,102	105,902
Increase in due from affiliate		(207,960 )
Increase in other assets	(165,163 )	(27,845 )
Increase in accounts payable	1,088	23,449
Increase in interest payable	269,250	4,685
Increase (decrease) in accrued expenses and deferred liabilities	133,035	(125,298 )
Increase (decrease) in fees due to affiliate	163,877	(209,924 )
Increase in administration fee due to Gladstone Administration	186,895	
(Decrease) increase in funds held in escrow	(760 )	40
Increase in investment balance due to payment in kind interest		(74,701 )
Net cash (used in) provided by operating activities	(136,605,353 )	17,785,286
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>		
Receipt of principal on notes receivable - employees	300,941	129,943
Net cash provided by investing activities	300,941	129,943
<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>		
Net proceeds from issuance of common shares	45,669,292	
Borrowings from the lines of credit	277,800,000	113,090,000
Repayments on the lines of credit	(166,605,000 )	(118,278,064 )
Distributions paid	(16,012,661 )	(13,751,539 )
Exercise of employee stock options		1,150,245
Deferred financing fees	(299,275 )	(173,333 )
Withholding tax obligation settlement	(1,488,193 )	
Net cash provided by (used in) financing activities	139,064,163	(17,962,691 )
<b>NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS(1)</b>	2,759,751	(47,462 )
<b>CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD</b>	731,744	503,776
<b>CASH AND CASH EQUIVALENTS, END OF PERIOD</b>	\$ 3,491,495	\$ 456,314
<b>CASH PAID DURING PERIOD FOR INTEREST</b>	\$ 4,424,275	\$ 2,298,008
<b>NON-CASH FINANCING ACTIVITIES</b>		
Notes receivable issued in exchange for common stock associated with the exercise of employee stock options	\$	\$ 199,980

(1) Cash and cash equivalents consist of demand deposits and highly liquid investments with original maturities of three months or less when purchased.

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

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**GLADSTONE CAPITAL CORPORATION**  
**FINANCIAL HIGHLIGHTS**  
**(UNAUDITED)**

	<b>Three Months Ended June 30,</b>	
	<b>2007</b>	<b>2006</b>
<b>Per Share Data(1)</b>		
Net asset value at beginning of period	\$ 13.82	\$ 13.84
<i>Income from investment operations:</i>		
Net investment income(2)	0.42	0.42
Realized gain (loss) on sale of investments(2)		(0.01 )
Net unrealized (loss) gain on investments(2)	0.02	0.07
Net unrealized gain on derivatives(2)		0.01
Total from investment operations	0.44	0.49
<i>Less distributions:</i>		
Distributions from net investment income	(0.42 )	(0.41 )
Total distributions	(0.42 )	(0.41 )
Issuance of common stock under shelf offering	1.50	
Offering costs and underwriting discount	(0.23 )	
Issuance of common stock under stock option plan		0.10
Repayment of principal on notes receivable		0.01
Dilutive effect of share issuance		(0.08 )
Net asset value at end of period	\$ 15.11	\$ 13.95
Per share market value at beginning of period	\$ 23.68	\$ 21.55
Per share market value at end of period	21.46	21.39
Total return(3)(4)	-7.69	% 1.11 %
Shares outstanding at end of period	14,249,683	11,384,363
<b>Ratios/Supplemental Data</b>		
Net assets at end of period	\$ 215,252,920	\$ 158,785,756
Average net assets(5)	\$ 197,994,217	\$ 156,053,816
Ratio of expenses to average net assets-annualized(6)	10.52	% 5.83 %
Ratio of net expenses to average net assets-annualized(7)	7.06	% 4.45 %
Ratio of net investment income to average net assets-annualized	11.53	% 12.27 %

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

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

(3) Total return equals the increase or decrease of the ending market value over the beginning market value plus monthly dividends divided by the monthly beginning market value, assuming monthly dividend reinvestment.

(4) Amounts were not annualized.

(5) Average net assets are computed using the average of the balance of net assets at the end of each month of the reporting period.

(6) Ratio of expenses to average net assets is computed using expenses before credits from Adviser to the base management and incentive fees and including income tax expense.

(7) 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 and including income tax expense.

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



**GLADSTONE CAPITAL CORPORATION**  
**FINANCIAL HIGHLIGHTS**  
**(UNAUDITED)**

	Nine Months Ended June 30,	
	2007	2006
<b>Per Share Data(1)</b>		
Net asset value at beginning of period	\$ 14.02	\$ 13.41
<i>Income from investment operations:</i>		
Net investment income(2)	1.31	1.28
Realized loss on sale of investments(2)		(0.08 )
Net unrealized (loss) gain on investments(2)	(0.19 )	0.51
Total from investment operations	1.12	1.71
Less distributions:		
Distributions from net investment income	(1.26 )	(1.22 )
Total distributions	(1.26 )	(1.22 )
Issuance of common stock under shelf offering	1.50	
Offering costs and underwriting discount	(0.23 )	
Issuance of common stock under stock option plan		0.10
Repayment of principal on notes receivable	0.02	0.01
Stock surrendered to settle withholding tax obligation	(0.06 )	
Dilutive effect of share issuance		(0.06 )
Net asset value at end of period	\$ 15.11	\$ 13.95
Per share market value at beginning of period	\$ 22.01	\$ 22.55
Per share market value at end of period	21.46	21.39
Total return(3)(4)	2.92 %	0.35 %
Shares outstanding at end of period	14,249,683	11,384,363
<b>Ratios/Supplemental Data</b>		
Net assets at end of period	\$ 215,252,920	\$ 158,785,756
Average net assets(5)	\$ 179,127,176	\$ 153,804,303
Ratio of expenses to average net assets-annualized(6)	10.55 %	5.97 %
Ratio of net expenses to average net assets-annualized(7)	7.06 %	4.44 %
Ratio of net investment income to average net assets-annualized	12.35 %	12.51 %

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

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

(3) Total return equals the increase or decrease of the ending market value over the beginning market value plus monthly dividends divided by the monthly beginning market value, assuming monthly dividend reinvestment.

(4) Amounts were not annualized.

(5) Average net assets are computed using the average of the balance of net assets at the end of each month of the reporting period.

(6) Ratio of expenses to average net assets is computed using expenses before credits from Adviser to the base management and incentive fees and including income tax expense.

(7) 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 and including income tax expense.

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





**GLADSTONE CAPITAL CORPORATION**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**JUNE 30, 2007**  
**(UNAUDITED)**

**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, or BDC, 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 objectives are to achieve a high level of current income by investing in debt and equity securities of established private businesses.

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. is also a wholly-owned subsidiary.

Gladstone SSBIC Corporation (*Gladstone SSBIC*), 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 SSBIC 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 the subsidiaries are consolidated with those of the *Company*.

The *Company* is externally managed by Gladstone Management Corporation (the *Adviser*), an unconsolidated affiliate of the *Company*.

**NOTE 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

*Unaudited Interim Financial Statements*

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. Accordingly, certain disclosures accompanying annual financial statements prepared in accordance with *GAAP* are omitted. In the opinion of 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 current period's results of operations 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, 2006, as filed with the Securities and Exchange Commission (the *SEC*) on December 6, 2006.

*Use of Estimates*

The preparation of financial statements in conformity with *GAAP* requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

*Reclassifications*

Certain amounts in the prior year's financial statements have been reclassified to conform to the current year presentation with no effect to net increase in net assets resulting from operations.

### *Investment Valuation*

The Company carries its investments at fair value, as determined by its Board of Directors. Securities that are publicly traded are valued at the closing price on the valuation date. Securities for which a limited market exists, such as certain participations in syndicated loans, are valued at the indicative bid price on or near the valuation date from the respective originating syndication agent's trading desk. Debt and equity securities that are not publicly traded, or for which a limited market does not exist, are valued at fair value. The Company's Board of Directors has established a valuation policy and consistently applied valuation procedures used to determine the fair value of these securities quarterly.

The procedures for the determination of value of the Company's debt securities that are not publicly traded and that are issued to portfolio companies where the Company has no equity, or equity-like securities, rely on the opinions of value submitted to us by Standard & Poor's Securities Evaluations, Inc. ( "SPSE" ). The Company may also submit paid in kind ( "PIK" ) interest to SPSE for valuation when it is determined the PIK interest is likely to be received. SPSE will only evaluate the debt portion of the Company's investments for which the Company specifically requests evaluation, and may decline to make requested evaluations for any reason at its sole discretion. SPSE opinions of value are submitted to the Board of Directors along with the Adviser's supplemental assessment and recommendation regarding valuation of each of these investments. Lastly, the Company adds any amortized original issue discount ( "OID" ) interest to the fair value, unless adverse factors lead to a determination of a lesser valuation.

The fair value of convertible debt, equity, success or exit fees or other equity-like securities is determined based on the collateral, the enterprise value 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, discounted cash flow or other pertinent factors. In gathering the sales to third parties of similar securities, the Company may reference industry statistics and use outside experts.

Debt securities that are issued to portfolio companies where the Company has equity, or equity-like securities are valued at cost, if there is adequate total enterprise value determined when valuing the Company's equity securities of the portfolio company. Fair values are discounted for any shortfall of total enterprise value over the total debt outstanding for the borrower.

The Board of Directors then reviews whether the Adviser has followed its established procedures for determinations of fair value, and votes whether or not to accept the recommended valuation of the Company's investment portfolio.

Due to the uncertainty inherent in the valuation process, such estimates of fair value may differ significantly from the values that would have resulted 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 valuation currently assigned. Because there is a delay between when the Company closes an investment and when the investment can be evaluated by SPSE, new investments are not valued immediately by SPSE; rather, the Adviser makes its own determination about the recommended value of these investments in accordance with the Company's valuation policy without the input of SPSE during the specific quarter in which the investment is made. Because SPSE does not currently perform independent valuations of mortgage loans or equity securities for the Company, the Adviser also determines a recommendation for the fair value of these investments, if any, without the input of SPSE. The Adviser considers a number of qualitative and quantitative factors in current market conditions when performing valuations. The Board of Directors then determines whether or not to accept the Adviser's recommendations for the aggregate valuation of the Company's portfolio of investments. The Board of Directors is ultimately responsible for setting the fair value and disclosure of investments in the financial statements.

### *Interest Income Recognition*

Interest income, adjusted for amortization of premiums and accretion of discounts, is recorded on the accrual basis to the extent that such amounts are expected to be collected. The Company stops accruing interest on its investments when it is determined that interest is no longer collectible. At June 30, 2007, one investment was on non-accrual. Conditional interest or a success fee is recorded when earned upon full repayment of a loan investment.

### *Paid in Kind Interest*

The Company seeks to avoid PIK interest, however, the Company had one loan in its portfolio that contained a PIK provision during the six months ended March 31, 2006 and no loans with PIK provisions for the remainder of fiscal year 2006. A PIK provision requires the borrower to accrue a payment to the Company but the borrower does not have to pay that interest until the loan is paid in full. The PIK interest is added to the principal balance of the loan and recorded as income to the Company even though the cash has not been received. To maintain the Company's status as a RIC (as discussed in Note 10), this non-cash source of income must be paid out to stockholders in the form of cash dividends, even though the Company has not yet collected the cash. The Company recorded no PIK interest income for the three and nine

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months ended June 30, 2007 and \$63,217, respectively, for the nine months ended June 30, 2006, there were no PIK loans in the Company's portfolio during the three months ended June 30, 2006.

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*Services Provided to Portfolio Companies*

The 1940 Act requires that a business development company make available managerial assistance to its portfolio companies by providing significant guidance and counsel concerning the management, operations, or business objectives and policies of the respective portfolio company. The Company provides these and other services to its portfolio companies through its Adviser. Currently, neither the Company nor the Adviser charges a fee for managerial assistance.

The Adviser receives fees for other services it provides to portfolio companies. These other fees are typically non-recurring, are recognized as revenue when earned and are generally paid directly to the Adviser by the borrower or potential borrower upon closing of the investment. The services the Adviser provides to portfolio companies vary by investment, but generally include a broad array of services, such as investment banking services, arranging bank and equity financing, structuring financing from multiple lenders and investors, reviewing existing credit facilities, restructuring existing investments, raising equity and debt capital, turnaround management, merger and acquisition services and recruiting new management personnel. When the Adviser receives fees for these services, fifty percent of certain of those fees are credited to the base management fees due to the Adviser from the Company. Any services of this nature subsequent to the closing would typically generate a separate fee at the time of completion.

The Adviser also receives fees for monitoring and reviewing portfolio company investments. These fees are recurring and are generally paid annually or quarterly in advance to the Adviser throughout the life of the investment. Fees of this nature are recorded as revenue by the Adviser when earned and are not credited against the base management fees.

While the Adviser receives all fees in connection with the Company's investments, such fees received by the Adviser, with the exception of monitoring and review fees, are credited to the Company as a reduction of the advisory fee payable under the advisory agreement between the Company and the Adviser. Prior to April 1, 2007, these fees were entirely credited against the advisory fee payable and starting on April 1, 2007, these fees were credited at 50% against the advisory fee payable. For the three and nine months ended June 30, 2007, the Adviser received \$1,061,750 and \$2,147,750, respectively, of such fees, of which \$530,875 and \$1,616,875, respectively, were credited against the base management fee payable for the three and nine months ended June 30, 2007, as compared to \$539,000 and \$1,762,000, respectively, for the three and nine months ended June 30, 2006 and the advisory fee payable by the Company to the Adviser was reduced by these amounts. None of these fees were for managerial assistance even though the Adviser provided managerial assistance to many of the Company's portfolio companies.

*Cash and Cash Equivalents*

Cash and cash equivalents consist of demand deposits and highly liquid investments with original maturities of three months or less when purchased. Cash and cash equivalents are carried at cost which approximates fair value as of June 30, 2007 and September 30, 2006.

*Realized Gain or Loss and Unrealized Appreciation or Depreciation of Portfolio Investments*

Realized gain or loss is recognized when an investment is disposed of and is computed as the difference between the Company's cost basis in the investment at the disposition date and the net proceeds received from such disposition. Unrealized appreciation or depreciation displays the difference between the fair market value of the investment and the cost basis of such investment.

*Federal and State Income Taxes*

The Company intends to continue to qualify for treatment as a RIC under Subchapter M of the Code. As a RIC, the Company is not subject to federal or state income tax on the portion of its taxable income and gains distributed to stockholders. To qualify as a RIC, the Company is required to distribute to its stockholders at least 90% of its investment company taxable income, as defined by the Code and, as such, no income tax provisions have been recorded for the individual companies of Gladstone Capital Corporation and Gladstone Business Loan LLC.

During the nine months ended June 30, 2006, Gladstone Capital Corporation recorded approximately \$50,000 in connection with penalties incurred on misclassified revenue on its fiscal year 2004 corporate tax return.

*Recent Accounting Pronouncements*

In May 2005, the Financial Accounting Standards Board ( FASB ) issued Statement of Financial Accounting Standards ( SFAS ) No. 154, *Accounting Changes and Error Corrections*, a replacement of APB Opinion No. 20, *Accounting Changes*, and SFAS No. 3, *Reporting Accounting Changes in Interim Financial Statements* and changed the requirements for the accounting for and reporting of a change in accounting principle. SFAS No. 154 applies to all voluntary changes in accounting principle and also applies to changes required by an accounting pronouncement in the unusual instance that the pronouncement does not include specific transition provisions. SFAS No. 154 requires retrospective application to prior periods' financial statements of changes in accounting principle. SFAS No. 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. The Company adopted the provisions of SFAS No. 154, as applicable, on October 1, 2006.

In February 2006, the FASB issued SFAS No. 155, *Accounting for Certain Hybrid Financial Instruments, an amendment of FASB statements No. 133 and 140* ( SFAS No. 155 ). SFAS No. 155 allows financial instruments that have embedded derivatives to be accounted for as a whole (eliminating the need to bifurcate the derivative from its host) as long as the entire instrument is valued on a fair value basis. The statement also resolves and clarifies other specific SFAS No. 133 and SFAS No. 140 related issues. SFAS No. 155 is effective for all financial instruments acquired or issued after the beginning of an entity's first fiscal year that begins after September 15, 2006. The Company adopted SFAS No. 155 on October 1, 2006 and has not realized a material impact of the financial statements since all investments are valued on a fair value basis.

In June 2006, the FASB issued FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes - an interpretation of FASB Statement No. 109*, which clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with SFAS No. 109, *Accounting for Income Taxes*. This Statement shall be effective as of the beginning of an entity's first fiscal year that begins after December 15, 2006. The Company will adopt this Interpretation effective October 1, 2007. The Company is currently evaluating the impact of this pronouncement on its consolidated financial statements.

In September 2006, the FASB issued SFAS No. 157, *Fair Value Measurements* ( SFAS No. 157 ). SFAS No. 157 defines fair value, establishes a framework for measuring fair value in accordance with GAAP, and expands disclosures about fair value measurements. SFAS No. 157 applies broadly to securities and other types of assets and liabilities. SFAS No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007 and interim periods within that fiscal year. The Company will be required to adopt SFAS No. 157 on October 1, 2008 and is currently evaluating the impact of this pronouncement on its consolidated financial statements.

In September 2006, the SEC issued Staff Accounting Bulletin No. 108 ( SAB 108 ). SAB 108 addresses how the effects of prior year uncorrected misstatements should be considered when quantifying misstatements in current year financial statements and requires registrants to consider the effect of all carry over and reversing effects of prior year misstatements when quantifying errors in current year financial statements. SAB 108 does not change the SEC's previous guidance in SAB No. 99, *Materiality*, on evaluating the materiality of misstatements. A registrant applying the new guidance for the first time that identifies material errors in existence at the beginning of the first fiscal year ending after November 15, 2006, may correct those errors through a one-time cumulative effect adjustment to beginning-of-year retained earnings. The cumulative effect alternative is available only if the application of the new guidance results in a conclusion that a material error exists as of the beginning of the first fiscal year ending after November 15, 2006, and those misstatements were determined to be immaterial based on a proper application of the registrant's previous method for quantifying misstatements. The adoption of SAB 108 did not have an impact on the Company's consolidated financial statements.

In February 2007, the FASB issued SFAS No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities - Including an Amendment of FASB Statement No. 115* which is effective for fiscal years beginning after November 15, 2007. This pronouncement permits an entity to choose to measure many financial instruments and certain other items at fair value at specified election dates. Subsequent unrealized gains and losses on items for which the fair value option has been elected will be reported in earnings. The Company is currently evaluating the potential impact of this pronouncement on its consolidated financial statements.

## NOTE 3. INVESTMENTS

Investments at fair value consisted of the following industry classifications as of June 30, 2007 and September 30, 2006:

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Industry Classification	June 30, 2007			September 30, 2006		
	Fair Value	% of Total Investments	% of Net Assets	Fair Value	% of Total Investments	% of Net Assets
Aerospace & Defense	\$ 4,755,812	1.3 %	2.2 %	\$ 5,529,891	2.5 %	3.2 %
Automobile	6,442,958	1.8 %	3.0 %	6,332,906	2.9 %	3.7 %
Broadcasting (TV, Radio & Cable)	36,289,808	9.8 %	16.9 %			
Cargo Transport	16,018,000	4.3 %	7.4 %	8,650,000	4.0 %	5.0 %
Chemicals, Plastics & Rubber	25,732,964	7.0 %	12.0 %	31,105,148	14.3 %	18.0 %
Diversified/Conglomerate						
Manufacturing	3,999,950	1.1 %	1.9 %			
Electronics	32,128,375	8.7 %	14.9 %	33,360,123	15.4 %	19.3 %
Entertainment				3,491,250	1.6 %	2.0 %
Farming & Agriculture	11,825,984	3.2 %	5.5 %	709,431	0.3 %	0.4 %
Finance	2,504,988	0.7 %	1.2 %			
Healthcare, Education & Childcare	39,512,077	10.7 %	18.4 %	16,707,500	7.7 %	9.7 %
Home & Office Furnishings	17,020,625	4.6 %	7.9 %	20,636,991	9.5 %	12.0 %
Leisure, Amusement & Movies	9,707,063	2.6 %	4.5 %			
Machinery	9,814,228	2.7 %	4.6 %			
Mining, Steel, Iron & Non-precious Metals	26,963,375	7.3 %	12.5 %	5,233,750	2.4 %	3.0 %
Oil & Gas	5,771,250	1.6 %	2.7 %	6,056,250	2.8 %	3.5 %
Personal, Food and Miscellaneous Services				6,011,288	2.8 %	3.5 %
Personal & Nondurable						
Consumer Products	9,000,000	2.4 %	4.2 %			
Printing, Publishing & Broadcasting	85,830,553	23.3 %	39.9 %	16,203,000	7.4 %	9.4 %
Retail Stores	14,925,000	4.0 %	6.9 %	14,981,250	6.9 %	8.7 %
Telecommunications				23,596,040	10.8 %	13.7 %
Textiles & Leather	10,706,237	2.9 %	5.0 %	13,785,932	6.3 %	8.0 %
Utilities				5,252,000	2.4 %	3.0 %
<b>Total</b>	<b>\$ 368,949,247</b>	<b>100.0 %</b>	<b>%</b>	<b>\$ 217,642,750</b>	<b>100.0 %</b>	<b>%</b>

The investments at fair value consisted of the following geographic regions of the United States at June 30, 2007 and September 30, 2006:

Geographic Region	June 30, 2007		September 30, 2006	
	Fair Value	% of Total Investments	Fair Value	% of Total Investments
Midwest	\$ 163,405,522	44.3 %	\$ 99,413,970	45.7 %
West	72,358,060	19.6 %	15,502,538	7.1 %
Mid-Atlantic	57,231,151	15.5 %	53,044,805	24.4 %
Southeast	50,493,423	13.7 %	24,697,113	11.3 %
Northeast	17,705,250	4.8 %	17,209,141	7.9 %
US Territory	7,755,841	2.1 %	7,775,183	3.6 %
	<b>\$ 368,949,247</b>	<b>100.0 %</b>	<b>\$ 217,642,750</b>	<b>100.0 %</b>

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

NOTE 4. RELATED PARTY TRANSACTIONS

*Loans to Employees*

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The Company provided loans to employees of the Adviser for the exercise of options under the Amended and Restated 2001 Equity Incentive Plan (the "2001 Plan"), which has since been terminated and is no longer in operation. 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. No new loans were issued during the three and nine months ended June 30, 2007 and the Company received \$300,941 of principal repayments during the nine months ended June 30, 2007. During the nine months ended June 30, 2006, the Company issued one loan to an employee for \$199,980 and received principal repayments of \$129,943 in connection with the full repayment of one loan and a partial

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repayment on another loan. The Company recognized interest income from all employee stock option loans of \$132,795 and \$403,917, respectively, for the three and nine months ended June 30, 2007, as compared to \$108,877 and \$323,003, respectively, for the three and nine months ended June 30, 2006.

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

The Company is externally managed by the Adviser, which is controlled by our chairman and chief executive officer, under a contractual investment advisory agreement. On October 1, 2006, the Company entered into an amended and restated investment advisory agreement (the Amended Advisory Agreement). Prior to October 1, 2006, the relationship was governed by the initial advisory agreement (the Initial Advisory Agreement).

#### *Terms of the Amended Advisory Agreement*

Under the Amended Advisory Agreement, the Company pays the Adviser an annual base management fee of 2% of its average gross assets, which is defined as total assets less cash and cash equivalents pledged to creditors calculated as of the end of the two most recently completed fiscal quarters and also consists of a two-part incentive fee.

The first part of the incentive fee is an income-based incentive fee which 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 pays the Adviser an income incentive fee with respect to its pre-incentive fee net investment income in each calendar quarter as follows:

- no incentive fee in any calendar quarter in which its pre-incentive fee net investment income does not exceed the hurdle rate (7% annualized);
- 100% of 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 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 incentive fee that is determined and payable in arrears as of the end of each fiscal year (or upon termination of the Amended 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 incentive fee payable to the Adviser, the Company calculates 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 its portfolio.

The Adviser's board of directors voluntarily waived, for the fiscal quarter ended June 30, 2007, the annual 2.0% base management fee to 0.5% for senior syndicated loan participations and also waived a portion of the incentive fee due.

In addition to the base management and incentive fees under the Amended Advisory Agreement, certain fees received by the Adviser from the Company's portfolio companies were credited against the investment advisory fee under the Initial Advisory Agreement, and will continue to be paid to the Adviser and credited under the Amended Advisory Agreement. Effective April 1, 2007, 50% of certain of the fees received by the Adviser are credited against the base management fee. In addition, the Company will continue to pay its direct expenses including, but not limited to, directors' fees, legal and accounting fees, stockholder related expenses, and directors and officers insurance under the Amended Advisory Agreement.

For the three months ended June 30, 2007, the Company recorded a base management fee of \$727,259, after reductions for loan servicing fees paid to the Adviser of \$897,634, less a 50% credit of \$530,875 for fees received by the Adviser and a \$139,261 fee reduction for the waiver of the 2% fee on senior syndicated loans to 0.5%, for a net base management fee of \$57,123 as compared to a base management fee of \$334,814, after reductions for loan servicing fees paid to the Adviser of \$693,965, less a credit of \$539,000 for fees received by the Adviser and a \$3,774 fee reduction for the waiver of the 2% fee on senior syndicated loans to 0.5%, for a net base management fee credit of \$207,960 for the three months ended June 30, 2006. For the nine months ended June 30, 2007, the Company recorded a base management fee of \$1,806,075, after reductions for loan servicing fees paid to the Adviser of \$2,377,409, less a credit of \$1,616,875 for fees received by the Adviser and a \$369,161 fee reduction for the waiver of the 2% fee on senior syndicated loans to 0.5%, for a net base management fee credit of \$179,961 as compared to



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a base management fee of \$955,894, after reductions for loan servicing fees paid to the Adviser of \$2,144,024, less a credit of \$1,762,000 for fees received by the Adviser and a \$3,774 fee reduction for the waiver of the 2% fee on senior syndicated loans to 0.5%, for a net base management fee credit of \$809,880 for the nine months ended June 30, 2006. The Company also recorded a gross incentive fee of \$1,166,529 and \$3,474,007,

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for the three and nine months ended June 30, 2007, respectively, offset by a credit from a voluntary waiver issued by the Adviser's board of directors of \$1,038,752 and \$2,696,124, for the three and nine months ended June 30, 2007, respectively, for a net incentive fee of \$127,777 and \$777,883, for the three and nine months ended June 30, 2007, respectively. There was no incentive fee in effect at June 30, 2006. As of June 30, 2007, the Company owed \$57,123 of unpaid base management fee due to the Adviser and owed \$127,777 of unpaid incentive fees to the Adviser, presented in the net fees due to Adviser in the accompanying consolidated statements of assets and liabilities. The credits to the base management fee and incentive fee are reflected on the consolidated statement of operations as credits to base management and incentive fees. Overall, the base management fee due to the Adviser cannot exceed 2% of total assets (as reduced by cash and cash equivalents pledged to creditors) during any given fiscal year.

#### *Terms of the Initial Advisory Agreement*

As compensation for its services, under the Initial Advisory Agreement, the Company paid the Adviser an annual advisory fee of 1.25% of total assets (as reduced by cash and cash equivalents pledged to creditors), payable in quarterly computed increments of 0.3125%, and an annual administrative fee of 0.75% of total assets (as reduced by cash and cash equivalents pledged to creditors), payable in quarterly computed increments of 0.1875%, for a total annual management fee of 2.0% (0.50% quarterly) of total assets (as reduced by cash and cash equivalents pledged to creditors). The Company also paid all of its direct expenses including, but not limited to, directors' fees, legal and accounting fees, stockholder related expenses, and directors and officers insurance.

#### *Loan Servicing and Portfolio Company Fees*

The Adviser also services the loans held by Business Loan, in return for which it receives a 1.5% annual fee based on the monthly aggregate outstanding balance of the loans pledged under the Company's line of credit. Since the Company owns these loans, all loan servicing fees paid to the Adviser have been and continue to be treated as reductions directly against the 2% management fee, under both the Initial and Amended Advisory Agreements. Effective in April 2006, the Adviser's board of directors voluntarily agreed to a waiver of the annual servicing fee rate for senior syndicated loans that, on a temporary basis, reduced the annual servicing fee rate on these loans to 0.5%. For the three and nine months ended June 30, 2007, these loan servicing fees totaled \$897,634 and \$2,377,409, respectively, as compared to the loan servicing fees for the three and nine months ended June 30, 2006 of \$693,965 and \$2,144,024, respectively, all of which were deducted against the 2% base management fee in order to derive the base management fee which is presented as the line item base management fee in the consolidated statements of operations. At June 30, 2007, the Company owed \$219,339 of unpaid loan servicing fees to the Adviser, which are netted and recorded in fees due to Adviser. At September 30, 2006, the Company owed \$214,608 in loan servicing fees to the Adviser, recorded in fees due to Adviser in the consolidated statements of assets and liabilities. Under the Initial and Amended Advisory Agreements, 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 services.

#### *Administration Agreement*

On October 1, 2006, the Company entered into an administration agreement (the Administration Agreement) with Gladstone Administration, LLC (the Administrator), a wholly-owned subsidiary of the Adviser. Under the Administration Agreement, the Company pays separately for administrative services. The Administration Agreement provides for payments equal to the Company's allocable portion of the Administrator's overhead expenses in performing its obligations under the Administration Agreement, including, but not limited to, rent for employees of the Administrator, and the allocable portion of salaries and benefits expenses of the Company's chief financial officer, controller, chief compliance officer, treasurer and their respective staffs. The Company recorded an administration fee of \$186,895 and \$481,746, respectively, for the three and nine months ended June 30, 2007. The administration fee was not in effect during the three and nine months ended June 30, 2006.

#### *Sale of Investments to Affiliate*

During the three and nine months ended June 30, 2007, the Company sold to its affiliate, Gladstone Investment Corporation (Gladstone Investment), certain of its investments in syndicated loan participations at market value totaling approximately \$9.7 million and approximately \$22.1 million, respectively. An independent broker was engaged to execute these transactions between the Company and Gladstone Investment. The independent broker accepted the quotes from the respective agent bank for each syndicated loan and then executed these transactions between the Company and Gladstone Investment. The cumulative effect of these transactions, net of any unamortized premiums or discounts associated with the loans, resulted in a realized net gain of \$26,965 and \$83,182, respectively, for the three and nine months ended June 30, 2007. The sales that occurred during the three months ended June 30, 2007 were all initiated during the three months ended March 31, 2007.



NOTE 5. LINE OF CREDIT

Through Business Loan, the Company has a \$220 million revolving credit facility (the DB Facility) with Deutsche Bank AG, as administrative agent, pursuant to which Business Loan pledges the loans it holds to secure future advances by certain institutional lenders. The interest rate charged on the advances under the DB Facility is based on the London Interbank Offered Rate (LIBOR), the Prime Rate or the Federal Funds Rate, depending on market conditions, and adjusts periodically. The DB Facility is in effect through May 23, 2008. As of June 30, 2007, the outstanding principal balance under the DB Facility was \$161,188,000 at an interest rate of approximately 5.3%. Available borrowings are subject to various constraints imposed under the credit agreement, based on the aggregate loan balance pledged by Business Loan, which varies as loans are added and repaid, regardless of whether such repayments are early prepayment or are made as contractually required. At June 30, 2007, the remaining borrowing capacity available under the DB Facility was approximately \$58.8 million.

The DB 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 DB Facility also restricts some of the terms and provisions (including interest rates, terms to maturity and payments schedules) and limits the borrower and industry concentrations of loans that are eligible to secure advances. As of June 30, 2007, Business Loan was in compliance with all of the facility covenants.

The administrative agent also requires that any interest or principal payments on pledged loans be remitted directly by the borrower into a lockbox account with the Bank of New York as custodian. Deutsche Bank AG is also the trustee of the account and once a month remits the collected funds to the Company. At June 30, 2007, the amount due from custodian was \$3,129,891 and at September 30, 2006, the amount due from custodian was \$3,587,152.

The Adviser also services the loans pledged under the DB Facility. As a condition to this servicing arrangement, the Company executed a performance guaranty pursuant to which it guaranteed that the Adviser would comply fully with all of its obligations under the DB Facility. The performance guaranty requires that the Company maintain a minimum net worth of \$100 million and maintain asset coverage with respect to senior securities representing indebtedness of at least 200%, in accordance with Section 18 of the 1940 Act. As of June 30, 2007, the Company was in compliance with all covenants under the performance guaranty.

NOTE 6. INTEREST RATE CAP AGREEMENT

Pursuant to the DB Facility, the Company has an interest rate cap agreement that effectively limits the interest rate on a portion of the borrowings under the line of credit.

The use of a cap involves risks that are different from those associated with ordinary portfolio securities transactions. Cap agreements may be considered to be illiquid. Although the Company will not enter into any such agreements unless it believes that the other party to the transaction is creditworthy, the Company does bear the risk of loss of the amount expected to be received under such agreements in the event of default or bankruptcy of the agreement counterparty.

In February 2004, the Company entered into an interest rate cap agreement with a notional amount of \$35.0 million at a cost of \$304,000. The interest rate cap agreement's current notional amount is \$8.8 million and it has a current fair value of \$24,407 which is recorded in other assets on the Company's consolidated balance sheet at June 30, 2007. At September 30, 2006, the interest rate cap agreement had a fair market value of \$50,284. The Company records changes in the fair market value of the interest rate cap agreement monthly based on the current market valuation at month end as unrealized depreciation or appreciation on derivative on the Company's consolidated statement of operations. The interest rate cap agreement expires in February 2009. The agreement provides that the Company's floating interest rate or cost of funds on a portion of the portfolio's borrowings will be capped at 5% when the LIBOR rate is in excess of 5%. During the three and nine months ended June 30, 2007, the Company recorded \$8,405 and \$31,198, respectively, as compared to \$1,367 for the three and nine months ended June 30, 2006 of income from the interest rate cap agreement recorded as a realized gain on the settlement of derivative on the Company's consolidated statements of operations.

## NOTE 7. COMMON STOCK TRANSACTIONS

As of June 30, 2006 and June 30, 2007, 50,000,000 shares of \$0.001 par value common stock were authorized and 11,384,363 and 14,249,683 shares were outstanding, respectively.

Transactions in common stock were as follows:

	Common Stock Shares	Amount
Balance at September 30, 2005	11,303,510	\$ 11,304
Issuance of Common Stock Under Stock Option Plan	80,853	81
Balance at June 30, 2006	11,384,363	\$ 11,385
Balance at September 30, 2006	12,305,008	\$ 12,305
Issuance of Common Stock Under Shelf Offering	2,000,000	2,000
Issuance of Common Stock Under Stock Option Plan	5,000	5
Stock surrendered for settlement of withholding tax	(60,325 )	(60 )
Balance at June 30, 2007	14,249,683	\$ 14,250

In May 2007, the Company completed a public offering of 2,000,000 shares of its common stock at \$24.25 per share, less an underwriting discount of \$1.21 per share or 5%. In October 2006, 5,000 shares of common stock were issued as a result of an option exercise which took place on the last business day of the prior fiscal year. These shares were issued by the transfer agent at the start of the current fiscal year and during the nine months ended June 30, 2007, 60,325 shares of stock were surrendered to the Company from certain optionees who exercised non-qualified stock options during the third and fourth quarters of fiscal year 2006 in order to satisfy settlement of withholding taxes that were paid by the Company with respect to the shares underlying the exercise of such options.

## NOTE 8. STOCK OPTIONS

There were no stock options outstanding at June 30, 2007. Prior to its termination on September 30, 2006, the Company had authorized 2,000,000 shares of capital stock for the issuance of options under the 2001 Plan to employees and directors. Options granted under the 2001 Plan originally could have been exercised during a term not to exceed ten years from the date of grant. Only employees of the Company and its affiliates were eligible to receive incentive stock options and both employees and non-employee directors were eligible to receive nonstatutory stock options under the 2001 Plan. Options granted under the 2001 Plan were either incentive stock options or nonstatutory stock options. The option exercise price was equal to the market price on the date of the grant. In connection with the externalization of the Company's management, all of the Company's officers and employees became direct employees of the Adviser, as of October 1, 2004. However, these individuals continued to be eligible to receive stock options under the 2001 Plan. Effective October 1, 2004, the Company accounted for any options granted to employees of the Adviser, who qualify as leased employees of the Company under FASB Interpretation No. 44, *Accounting for Certain Transactions Involving Stock Compensation, an Interpretation of APB Opinion No. 25*.

On October 1, 2005, the Company adopted SFAS No. 123 (revised 2004) *Share-based Payment* (SFAS No. 123(R)) using the modified prospective approach. Under the modified prospective approach, stock-based compensation expense was recorded for the unvested portion of previously issued awards that remained outstanding at October 1, 2005 using the same estimate of the grant date fair value and the same attribution method previously used to determine the pro forma disclosure under SFAS No. 123. SFAS No. 123(R) also requires that all share-based payments to employees after October 1, 2005, including employee stock options, be recognized in the financial statements as stock-based compensation expense based on the fair value on the date of grant.

For the three and nine months ended June 30, 2006, the Company recorded stock option compensation expense for the cost of stock options issued under the 2001 Plan of \$202,296 and \$279,618, respectively. The Company's expensing of stock options decreased both basic and diluted net increase to net assets resulting from operations per share by \$0.02 for the three and nine months ended June 30, 2006, respectively. Additionally, SFAS No. 123(R) states that any potential tax benefits associated with incentive stock options should be recognized only at the time of settlement if those options settle through a disqualifying disposition. Thus, the related stock-based compensation expense must be treated as a permanent difference until that time which, in turn, results in an increase to the Company's effective tax rate. The Company did not record tax benefits associated with the expensing of stock options since the Company intends to qualify as a RIC under Subchapter M of the Code and as such the Company is not subject to federal income tax on the portion of its taxable income and gains distributed to stockholders, provided that at least 90% of the taxable income is distributed.



## NOTE 9. INCREASE IN NET ASSETS PER SHARE RESULTING FROM OPERATIONS

The following table sets forth the computation of basic and diluted net increase in net assets per share resulting from operations for the three and nine months ended June 30, 2007 and June 30, 2006:

	Three Months Ended June 30,		Nine Months Ended June 30,	
	2007	2006	2007	2006
Numerator for basic and diluted net increase in net assets resulting from operations per share	\$ 5,964,600	\$ 5,543,076	\$ 14,213,054	\$ 19,366,806
Denominator for basic weighted average shares	13,561,511	11,337,291	12,701,845	11,317,437
Dilutive effect of stock options		233,134		231,617
Denominator for diluted weighted average shares	13,561,511	11,570,425	12,701,845	11,549,054
Basic net increase in net assets resulting from operations per share	\$ 0.44	\$ 0.49	\$ 1.12	\$ 1.71
Diluted net increase in net assets resulting from operations per share	\$ 0.44	\$ 0.48	\$ 1.12	\$ 1.68

There were no stock options outstanding at June 30, 2007. There were 1,224,645 options outstanding to purchase common stock at June 30, 2006. Of these, 336,000 options were not included in the computation of diluted earnings per share for the three and nine months ended June 30, 2006, because the options' exercise prices were greater than the average market price of the common shares for the period and, therefore, were anti-dilutive.

## NOTE 10. DIVIDENDS

The Company is required to pay out as a dividend 90% of its ordinary income and short-term capital gains for each taxable year in order to maintain its status as a RIC under Subtitle A, Chapter 1 of Subchapter M of the Code. It is the policy of the Company to pay out as a dividend up to 100% of those amounts. The amount to be paid out as a dividend is determined by the Board of Directors each quarter and is based on the annual earnings estimated by the management of the Company. Based on that estimate, three monthly dividends are declared each quarter. At year-end the Company may pay a bonus dividend, in addition to the monthly dividends, to ensure that it has paid out at least 90% of its ordinary income and realized net short-term capital gains for the year. Long-term capital gains are composed of success fees, prepayment fees and gains from the sale of securities held for one year or more. The Company intends to retain long-term capital gains from the sale of securities, if any, and not pay them out as dividends, however, the Board of Directors may decide to declare and pay out capital gains during any fiscal year. If the Company decides to retain long-term capital gains, the portion of the retained capital gains will be subject to 35% tax. The tax characteristics of all dividends will be reported to stockholders on Form 1099 at the end of each calendar year. The following table lists the per share dividends paid for the nine months ended June 30, 2007 and 2006:

Fiscal Year	Record Date	Payment Date	Dividend per Share
2007	June 21, 2007	June 29, 2007	\$ 0.14
	May 22, 2007	May 31, 2007	\$ 0.14
	April 20, 2007	April 30, 2007	\$ 0.14
	March 22, 2007	March 30, 2007	\$ 0.14
	February 20, 2007	February 28, 2007	\$ 0.14
	January 23, 2007	January 31, 2007	\$ 0.14
	December 20, 2006	December 29, 2006	\$ 0.14
	November 21, 2006	November 30, 2006	\$ 0.14
	October 23, 2006	October 31, 2006	\$ 0.14
		Total	\$ 1.26
2006	June 22, 2006	June 30, 2006	\$ 0.135
	May 22, 2006	May 31, 2006	\$ 0.135
	April 20, 2006	April 28, 2006	\$ 0.135
	March 23, 2006	March 31, 2006	\$ 0.135
	February 20, 2006	February 28, 2006	\$ 0.135
	January 19, 2006	January 31, 2006	\$ 0.135
	December 21, 2005	December 30, 2005	\$ 0.135
	November 21, 2005	November 30, 2005	\$ 0.135
	October 21, 2005	October 31, 2005	\$ 0.135
		Total	\$ 1.215

## NOTE 11. CONTRACTUAL OBLIGATIONS

As of June 30, 2007, the Company was a party to signed and non-binding term sheets for two loan originations for an aggregate of \$15.0 million. The Company expects to fund these potential investments as follows:

Contractual Obligations	Total	Payment Due by Period			
		Less than 1 Year	1-3 Years	3-5 Years	More than 5 Years
Investments	15,000,000	15,000,000			
Total	\$ 15,000,000	\$ 15,000,000	\$	\$	\$

All prospective investments are subject to, among other things, the satisfactory completion of the Company's due diligence investigation of each borrower, acceptance of terms and structure and receipt of necessary consents. With respect to each prospective loan, the Company will only agree to provide the loan if, among other things, the results of its due diligence investigations are satisfactory, the terms and conditions of the loan are acceptable and all necessary consents are received. The Company has initiated its due diligence investigations of the potential borrowers, however there can be no guarantee that facts will not be discovered in the course of completing the due diligence that would render a particular investment imprudent or that any of these investments will actually be made.

As of July 31, 2007, the above mentioned investments had not yet funded.



## NOTE 12. SUBSEQUENT EVENTS

In July 2007, the Company's Board of Directors declared the following monthly cash dividends:

Fiscal Year	Record Date	Payment Date	Dividend per Share
2007	July 23, 2007	July 31, 2007	\$0.14
	August 23, 2007	August 31, 2007	\$0.14
	September 20, 2007	September 28, 2007	\$0.14

On July 24, 2007, the Company completed an offering of 400,000 shares of its common stock, at a price of \$20.41 per share, under a shelf registration statement on Form N-2 (File No. 333-143027), and pursuant to the terms set forth in a prospectus dated July 5, 2007, as supplemented by a final prospectus dated July 24, 2007. Net proceeds of the offering, after offering expenses, were approximately \$8,149,000 and were used to repay outstanding borrowings under the Company's line of credit.

On July 26, 2007, a loan to an employee, and the shares pledged as collateral under the loan under a separate pledge agreement, were cancelled due to an event of default which was triggered by a stop loss provision in the employee's promissory note and pledge agreement. The provision specified that in the event that the aggregate value of the shares pledged under the note, as determined by the intra-day price of the shares on Nasdaq, became less than or equal to the aggregate outstanding principal amount of the note, the note would become immediately due and collectible through cancellation of the shares under the terms of the pledge agreement. The Company cancelled 37,109 shares which, in turn, cancelled via a non-cash transaction the remaining outstanding principal of the note of approximately \$716,711.

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PROSPECTUS

## GLADSTONE CAPITAL CORPORATION

**\$300,000,000**

### COMMON STOCK DEBT SECURITIES

We may offer, from time to time, up to \$300 million aggregate initial offering price of our common stock, \$0.001 par value per share, or debt securities, which we refer to in this prospectus collectively as our Securities, in one or more offerings. The Securities may be offered at prices and on terms to be set forth in one or more supplements to this prospectus. In the case of our common stock, the offering price per share, less any underwriting commissions or discounts, will not be less than the net asset value per share of our common stock at the time we make the offering. You should read this prospectus and the applicable prospectus supplement carefully before you invest in our Securities.

Our Securities may be offered directly to one or more purchasers, including existing stockholders in a rights offering, through agents designated from time to time by us, or to or through underwriters or dealers. The prospectus supplement relating to the offering will identify any agents or underwriters involved in the sale of our Securities, and will disclose any applicable purchase price, fee, commission or discount arrangement between us and our agents or underwriters or among our underwriters or the basis upon which such amount may be calculated. See Plan of Distribution. We may not sell any of our Securities through agents, underwriters or dealers without delivery of a prospectus supplement describing the method and terms of the offering of such Securities. Our common stock is traded on The Nasdaq Global Select Market under the symbol GLAD. As of July 3, 2007, the last reported sales price for our common stock was \$21.24.

This prospectus contains information you should know before investing, including information about risks. Please read it before you invest and keep it for future reference. This prospectus may not be used to consummate sales of securities unless accompanied by a prospectus supplement.

**An investment in our Securities involves certain risks, including, among other things, risks relating to investments in securities of small, private and developing businesses. We describe some of these risks in the section entitled Risk Factors, which begins on page 9. Shares of closed-end investment companies frequently trade at a discount to their net asset value and this may increase the risk of loss of purchasers of our Securities. You should carefully consider these risks together with all of the other information contained in this prospectus and any prospectus supplement before making a decision to purchase our Securities.**

**The Securities being offered have not been approved or disapproved by the Securities and Exchange Commission or any state securities commission nor has the Securities and Exchange Commission or any state securities commission passed upon the accuracy or adequacy of this prospectus. Any representation to the contrary is a criminal offense.**

July 5, 2007

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**We have not authorized any dealer, salesman or other person to give any information or to make any representation other than those contained or incorporated by reference in this prospectus or any accompanying supplement to this prospectus. You must not rely upon any information or representation not contained or incorporated by reference in this prospectus or the accompanying prospectus supplement as if we had authorized it. This prospectus and any prospectus supplement do not constitute an offer to sell or a solicitation of any offer to buy any security other than the registered securities to which they relate, nor do they constitute an offer to sell or a solicitation of an offer to buy any securities in any jurisdiction to any person to whom it is unlawful to make such an offer or solicitation in such jurisdiction. The information contained in this prospectus and any prospectus supplement is accurate as of the dates on their respective covers only. Our business, financial condition, results of operations and prospects may have changed since such dates.**

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## PROSPECTUS SUMMARY

The following summary contains basic information about this offering. It likely does not contain all the information that is important to an investor. For a more complete understanding of this offering, we encourage you to read this entire document and the documents to which we have referred. Except where the context suggests otherwise, the terms we, us, our, the Company and Gladstone Capital refer to Gladstone Capital Corporation; Adviser refers to Gladstone Management Corporation; Administrator refers to Gladstone Administration, LLC; Gladstone Commercial refers to Gladstone Commercial Corporation, Gladstone Investment refers to Gladstone Investment Corporation; and Gladstone Companies refers to our Adviser and its affiliated companies.

## GLADSTONE CAPITAL CORPORATION

### General

We were incorporated under the General Corporation Laws of the State of Maryland on May 30, 2001. Our investment objectives are to achieve a high level of current income by investing in debt securities, consisting primarily of senior notes, second lien notes, and senior subordinated notes of established private businesses that are backed by leveraged buyout funds, venture capital funds or others, with a particular emphasis on second lien and senior subordinated notes. In addition, we may acquire existing loans, which meet this profile, from leveraged buyout funds, venture capital funds and others. 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 extend 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, which we refer to in this prospectus as the 1940 Act.

We seek to invest in small and medium-sized businesses that meet certain criteria, including some or all of the following: (1) the potential for growth in cash flow, (2) adequate assets for loan collateral, (3) experienced management teams with a significant ownership interest in the borrower, (4) profitable operations based on the borrower's cash flow, (5) reasonable capitalization of the borrower (usually by buyout funds or venture capital funds) and (6) 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 by the borrower or by exercise of our right to require the borrower to buy back its warrants. We lend to borrowers that need funds to, among other things, effect a change of control, restructure their balance sheets, or finance growth, including acquisitions. Our loans typically range from \$5 million to \$15 million, although this investment size may vary proportionately as the size of our capital base changes, generally mature in no more than seven years and accrue interest at fixed or variable rates.

### Our Investment Adviser and Administrator

Our Adviser, is our affiliate and investment adviser and is led by a management team which has extensive experience in our lines of business. All of our directors and executive officers serve as either directors or executive officers, or both, of Gladstone Commercial, a publicly traded real estate investment trust; Gladstone Investment, a publicly traded business development company; our Adviser; and our Administrator. Our Adviser also has a wholly-owned subsidiary, our Administrator, which employs our chief financial officer, chief compliance officer, controller, treasurer and their respective staffs.

Our Adviser and our Administrator also provide investment advisory and administrative services to our affiliates Gladstone Commercial, Gladstone Investment and Gladstone Land Corporation, an agricultural real estate company owned by Mr. Gladstone. In the future, our Adviser may provide

investment advisory and administrative services to other funds, both public and private, of which it is the sponsor.

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

### **Our Investment Objectives and Our Strategy**

We seek 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 backed by leveraged buyout funds, venture capital funds or others. 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. There can be no assurance that we will realize our investment objectives. We seek to invest primarily in three categories of debt of private companies:

- *Senior Subordinated Notes.* We seek to invest a portion of our assets in senior subordinated notes. Holders of senior subordinated notes are subordinated to the rights of holders of senior debt in their right to receive principal and interest payments or, in the case of last out tranches of senior debt, liquidation proceeds from the borrower. As a result, senior subordinated notes are riskier than senior notes. Although such loans are sometimes secured by significant collateral, the lender is largely dependent on the borrower's cash flow for repayment. Additionally, lenders may receive warrants to acquire shares of stock in borrowers or other yield enhancements in connection with these loans. Senior subordinated notes include second lien loans and syndicated second lien loans.
- *Senior Notes.* We seek to invest a portion of our assets in senior notes of borrowers. Using its assets and cash flow as collateral, the borrower typically uses senior notes to cover a substantial portion of the funding needed to operate. Senior lenders are exposed to the least risk of all providers of debt because they command a senior position with respect to scheduled interest and principal payments. However, unlike senior subordinated and junior subordinated lenders, these senior lenders typically do not receive any stock, warrants to purchase stock of the borrowers or other yield enhancements. As such, they generally do not participate in the equity appreciation of the value of the business. Senior notes may include revolving lines of credit, senior term loans, senior syndicated loans and senior last-out tranche loans.
- *Junior Subordinated Notes.* We also seek to invest a small portion of our assets in junior subordinated notes. Holders of junior subordinated notes are subordinated to the rights of the holders of senior debt and senior subordinated debt in their rights to receive principal and interest payments from the borrower. The risk profile of junior subordinated notes is high, which permits the junior subordinated lender to obtain higher interest rates and more equity and equity-like compensation.

### **THE OFFERING**

We may offer, from time to time, up to \$300,000,000 of our Securities, on terms to be determined at the time of the offering. Our Securities may be offered at prices and on terms to be disclosed in one or more prospectus supplements. In the case of the offering of our common stock, the offering price per share less any underwriting commissions or discounts will not be less than the net asset value per share of our common stock at the time of the offering.

Our Securities may be offered directly to one or more purchasers, including existing stockholders in a rights offering, by us or through agents designated from time to time by us, or to or through underwriters or dealers. The prospectus supplement relating to the offering will disclose the terms of the offering, including the name or names of any agents or underwriters involved in the sale of our Securities by us, the purchase price, and any fee, commission or discount arrangement between us and our agents or underwriters or among our underwriters or the basis upon which such amount may be calculated. See Plan of Distribution. We may not sell any of our Securities through agents, underwriters or dealers without delivery of a prospectus supplement describing the method and terms of the offering of our Securities.

Set forth below is additional information regarding the offering of our Securities:

The Nasdaq Global Select Market

Symbol

GLAD

Use of Proceeds

Unless otherwise specified in a prospectus supplement, we intend to use the net proceeds from the sale of our Securities for general corporate purposes. We expect the proceeds to be used first to pay down existing short-term debt, then to make investments in small and medium sized businesses in accordance with our investment objectives, and any remaining proceeds to be used for other general corporate purposes. See Use of Proceeds.

Dividends and Distributions

We have paid monthly dividends to the holders of our common stock and generally intend to continue to do so. The amount of the monthly dividends is determined by our Board of Directors on a quarterly basis and is based on our estimate of our annual investment company taxable income and net short-term taxable capital gains. See Price Range of Common Stock and Distributions. Certain additional amounts may be deemed as distributed to stockholders for income tax purposes. Other types of securities will likely pay distributions in accordance with their terms.

Taxation

We intend to continue to elect to be treated for federal income tax purposes as a regulated investment company, which we refer to as a RIC. Accordingly, we generally will pay no corporate-level federal income taxes on any ordinary income or capital gains that we distribute to our stockholders. To maintain our RIC status, we must meet specified source-of-income and asset diversification requirements and distribute annually at least 90% of our taxable ordinary income and realized net short-term capital gains in excess of realized net long-term capital losses, if any, out of assets legally available for distribution. See Price Range of Common Stock and Distributions.

Trading at a Discount

Shares of closed-end investment companies frequently trade at a discount to their net asset value. The possibility that our shares may trade at a discount to our net asset value is separate and distinct from the risk that our net asset value per share may decline. We cannot predict whether our shares will trade above, at or below net asset value.

Certain Anti-Takeover Provisions	Our Board of Directors is divided into three classes of directors serving staggered three-year terms. This structure is intended to provide us with a greater likelihood of continuity of management, which may be necessary for us to realize the full value of our investments. A staggered board of directors also may serve to deter hostile takeovers or proxy contests, as may certain provisions of Maryland law and other measures we have adopted. See Certain Provisions of Maryland Law and of Our Articles of Incorporation and Bylaws.
Dividend Reinvestment Plan	We have a dividend reinvestment plan for our stockholders. This is an opt in dividend reinvestment plan, meaning that stockholders may elect to have their cash dividends automatically reinvested in additional shares of our common stock. Stockholders who do not so elect will receive their dividends in cash. Stockholders who receive distributions in the form of stock will be subject to the same federal, state and local tax consequences as stockholders who elect to receive their distributions in cash. See Dividend Reinvestment Plan.
Management Arrangements	Gladstone Management Corporation serves as our investment adviser, and Gladstone Administration, LLC serves as our administrator. We have entered into a license agreement with our Adviser, pursuant to which our Adviser has agreed to grant us a non-exclusive license to use the name Gladstone and the Diamond G logo. For a description of our Adviser, our Administrator, the Gladstone Companies and our contractual arrangements with these companies, see Management Certain Transactions Advisory and Administration Agreements, and Management Certain Transactions License Agreement.

#### Fees and Expenses

The following table is intended to assist you in understanding the costs and expenses that an investor in this offering will bear directly or indirectly. We caution you that some of the percentages indicated in the table below are estimates and may vary. Except where the context suggests otherwise, whenever this prospectus contains a reference to fees or expenses paid by us or Gladstone Capital, or that we will pay fees or expenses, stockholders will indirectly bear such fees or expenses as investors in Gladstone Capital. The following percentages were calculated based on net assets as of March 31, 2007.

	<b>Current</b>	
<b>Stockholder Transaction Expenses</b>		
Sales load (as a percentage of offering price)		%
Dividend reinvestment plan expenses(1)		None
<b>Estimated annual expenses (as a percentage of net assets attributable to common stock)</b>		
Management fees(2)	3.44	%
Incentive fees payable under investment advisory and management agreement (20% of realized capital gains and 20% of pre-incentive fee net investment income)(3)	2.74	%
Interest Payments on Borrowed Funds(4)	4.44	%
Other expenses	1.26	%
Total annual expenses (estimated)(2)(5)	11.88	%





(1) The expenses of the reinvestment plan are included in stock record expenses, a component of Other expenses. We do not have a cash purchase plan. The participants in the dividend reinvestment plan will bear a pro rata share of brokerage commissions incurred with respect to open market purchases, if any. See Dividend Reinvestment Plan for information on the dividend reinvestment plan.

(2) Our annual base management fee is 2.0% (0.5% quarterly) of our average gross assets, which is defined as total assets of Gladstone Capital, including investments made with proceeds of borrowings, less any uninvested cash or cash equivalents pledged to creditors. See Management Advisory and Administration Agreements and footnote 3 below.

(3) The incentive fee consists of two parts: an income-based fee and a capital gains-based fee. The income-based fee will be payable quarterly in arrears, and will equal 20% of the excess, if any, of our pre-incentive fee net investment income that exceeds a 1.75% quarterly (7.0% annualized) hurdle rate, subject to a catch-up provision measured as of the end of each calendar quarter. The catch-up provision requires us to pay 100% of our pre-incentive fee net investment income with respect to that portion of such income, if any, that exceeds the hurdle rate but is less than 125% of the quarterly hurdle rate (or 2.1875%) in any calendar quarter (8.75% annualized). The catch-up provision is meant to provide our Adviser with 20% of our pre-incentive fee net investment income as if a hurdle rate did not apply when our pre-incentive fee net investment income exceeds 125% of the quarterly hurdle rate in any calendar quarter (8.75% annualized). The income-based incentive fee will be computed and paid on income that may include interest that is accrued but not yet received in cash. Our pre-incentive fee net investment income used to calculate this part of the income incentive fee is also included in the amount of our gross assets used to calculate the 2% base management fee (see footnote 2 above). The quarter ended December 31, 2006 was the first quarter under our new advisory agreement and, as a result, was the first quarter in which the incentive fee was earned. For purposes of this computation, the aggregate gross amount of the December 31, 2006 and March 31, 2007 fees, exclusive of any credits, was annualized to determine the percentage the fee represents of net assets. After giving effect to credits against the incentive fee, the annualized incentive fee was 0.17% of net assets as of March 31, 2007. There can be no assurance that our Adviser will give any credits against the incentive fee in the future. The capital gains-based portion of the fee did not have an effect on the incentive fee for purposes of this calculation since we have not realized overall net capital gains to date.

Examples of how the incentive fee would be calculated (exclusive of any credits) are as follows:

- Assuming pre-incentive fee net investment income of 0.55%, there would be no income-based incentive fee because such income would not exceed the hurdle rate of 1.75%.

- Assuming pre-incentive fee net investment income of 2.00%, the income-based incentive fee would be as follows:

$$= 100\% \times (2.00\% - 1.75\%)$$

$$= 0.25\%$$

- Assuming pre-incentive fee net investment income of 2.30%, the income-based incentive fee would be as follows:

$$= (100\% \times (\text{catch-up} : 2.1875\% - 1.75\%)) + (20\% \times (2.30\% - 2.1875\%))$$

$$= (100\% \times 0.4375\%) + (20\% \times 0.1125\%)$$

$$= 0.4375\% + 0.0225\%$$

$$= 0.46\%$$



- Assuming net realized capital gains of 6% and realized capital losses and unrealized capital depreciation of 1%, the capital gains-based incentive fee would be as follows:

$$= 20\% \times (6\% - 1\%)$$

$$= 20\% \times 5\%$$

$$= 1\%$$

For a more detailed discussion of the calculation of the two-part incentive fee, see Management Advisory and Administration Agreements.

(4) We have entered into a revolving credit facility, under which our borrowing capacity is \$220 million, effective May 29, 2007. We have drawn down on this credit facility and we expect to borrow additional funds in the future up to an amount so that our asset coverage, as defined in the 1940 Act, is at least 200% after each issuance of our senior securities. Assuming that we borrowed \$220 million at an interest rate of 6.07%, interest payments on borrowed funds would have been 7.89% of our net assets as of March 31, 2007.

(5) Includes our overhead expenses, including payments under the administration agreement based on our projected allocable portion of overhead and other expenses incurred by our Administrator in performing its obligations under the administration agreement. See Management Certain Transactions Advisory and Administration Agreements.

#### Example

The following example demonstrates the projected dollar amount of total cumulative expenses that would be incurred over various periods with respect to a hypothetical investment in our Securities. In calculating the following expense amounts, we have assumed we would have no leverage and that our annual operating expenses would remain at the levels set forth in the table above. In the event that Securities to which this prospectus relates are sold to or through underwriters, a corresponding prospectus supplement will restate this example to reflect the applicable sales load.

	1 Year	3 Years	5 Years	10 Years
You would pay the following expenses on a \$1,000 investment, assuming a 5% annual return	\$ 89	\$ 257	\$ 412	\$ 745

While the example assumes, as required by the Securities and Exchange Commission, which we refer to as the SEC, a 5% annual return, our performance will vary and may result in a return greater or less than 5%. Additionally, we have assumed that the entire amount of such 5% annual return would constitute ordinary income as we have not historically realized positive capital gains (computed net of all realized capital losses and unrealized capital depreciation) on our investments, nor do we expect to realize positive capital gains in the foreseeable future. Because the assumed 5% annual return is significantly below the hurdle rate of 7% (annualized) that we must achieve under the investment advisory and management agreement to trigger the payment of an income-based incentive fee, we have assumed, for purposes of the above example, that no income-based incentive fee would be payable if we realized a 5% annual return on our investments. Additionally, because we have not historically realized positive capital gains (computed net of all realized capital losses and unrealized capital depreciation) on our investments, we have assumed that we will not trigger the payment of any capital gains-based incentive fee in any of the indicated time periods. If we achieve sufficient returns on our investments, including through the realization of capital gains, to trigger an incentive fee of a material amount, our expenses, and returns to our investors after such expenses, would be higher than reflected in the example. In addition, while the example assumes reinvestment of all dividends and distributions at net asset value, participants in our dividend reinvestment

plan will receive a number of shares of our common stock, determined by dividing the total dollar amount of the dividend payable to a participant by the market price per share of our common stock at the close of trading on the valuation date for the dividend. See [Dividend Reinvestment Plan](#) for additional information regarding our dividend reinvestment plan.

This example and the expenses in the table above should not be considered a representation of our future expenses, and actual expenses (including the cost of debt and incentive fees, if any, and other expenses) may be greater or less than those shown. As noted in the Fees and Expenses table above, we estimate that annual incentive fees payable under the investment advisory and management agreement will be 2.74% of net assets attributable to common stock.

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**CONSOLIDATED SUMMARY FINANCIAL DATA**  
(in thousands, except per share data)

The following table summarizes our consolidated financial data. The summary financial data as of and for the years ended September 30, 2006, 2005 and 2004 is derived from our audited consolidated financial statements included in this prospectus. The summary financial data as of and for the years ended September 30, 2003 and 2002 is derived from our audited consolidated financial statements that are not included in this prospectus. The summary financial data as of and for the six months ended March 31, 2007 and 2006 is derived from our unaudited consolidated financial statements included in this prospectus. You should read this data together with our consolidated financial statements and notes thereto presented elsewhere in this prospectus and the information under Consolidated Selected Financial Data and Management's Discussion and Analysis of Financial Condition and Results of Operations for more information.

	Year Ended September 30, 2006	Year Ended September 30, 2005	Year Ended September 30, 2004	Year Ended September 30, 2003	Year Ended September 30, 2002	Six Months Ended March 31, 2007 (unaudited)	Six Months Ended March 31, 2006 (unaudited)
Total Investment Income	\$ 26,899,846	\$ 23,949,759	\$ 20,395,968	\$ 15,154,874	\$ 10,455,703	\$ 16,877,496	\$ 13,031,019
Total Net Expenses	\$ 7,549,266	\$ 6,663,614	\$ 7,103,193	\$ 3,858,953	\$ 2,839,102	\$ 5,990,213	\$ 3,384,789
Net Investment Income	\$ 19,350,580	\$ 17,286,145	\$ 13,292,775	\$ 11,295,921	\$ 7,616,601	\$ 10,887,283	\$ 9,646,230
Net Increase in Net Assets Resulting from Operations	\$ 24,430,235	\$ 15,490,682	\$ 10,570,290	\$ 11,073,581	\$ 7,616,601	\$ 8,248,454	\$ 13,823,730
Per Share Data:							
Net Increase in Net Assets Resulting from Operations:							
Basic	\$ 2.15	\$ 1.37	\$ 1.05	\$ 1.10	\$ 0.76	\$ 0.67	\$ 1.22
Diluted	\$ 2.10	\$ 1.33	\$ 1.02	\$ 1.09	\$ 0.75	\$ 0.67	\$ 1.20
Cash Distributions							
Declared per Share	\$ 1.635	\$ 1.515	\$ 1.365	\$ 1.10	\$ 0.81	\$ 0.84	\$ 0.81
Statement of Assets and Liabilities Data:							
Total Assets	\$ 225,783,215	\$ 205,793,094	\$ 215,333,727	\$ 214,566,663	\$ 172,922,039	\$ 291,015,954	\$ 217,725,319
Net Assets	\$ 172,570,487	\$ 151,610,683	\$ 152,226,655	\$ 130,802,382	\$ 130,663,273	\$ 169,323,895	\$ 156,461,511
Other Data:							
Number of Portfolio Companies at Period End	32	28	16	11	7	51	28
Principal Amount of Loan Originations	\$ 135,954,879	\$ 143,794,006	\$ 86,267,500	\$ 47,011,278	\$ 97,705,054	\$ 127,641,175	\$ 65,159,566
Principal Amount of Loan Repayments	\$ 124,009,929	\$ 88,019,136	\$ 47,158,995	\$ 18,005,827	\$ 18,387,191	\$ 62,230,246	\$ 63,517,133
Total Return(1)	5.21	% 5.93	% 24.40	% 21.74	% 9.60	% 11.50	%(0.75)%
Weighted Average Yield on Investments(2):							
With PIK Interest(3)	12.74	% 12.36	% 13.78	% 13.86	% 14.79	% n/a	12.56%
Without PIK Interest(3)	12.74	% 12.23	% 13.44	% 13.14	% 13.82	% 12.58	% 12.56%

(1) For the fiscal years ended September 30, 2006, 2005 and 2004, the total return equals the increase of the ending market value over the beginning market value plus monthly dividends divided by the monthly beginning market value. For the fiscal years ended September 30, 2003 and 2002, total return equals the increase of the ending market value over the beginning market value, plus distributions, dividend by the beginning market value.

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

(3) Refer to Note 2 of the Notes to Consolidated Financial Statements for an explanation of PIK, or Paid-in-Kind, interest.

## ADDITIONAL INFORMATION

We have filed with the SEC a registration statement on Form N-2 under the Securities Act of 1933, as amended, which we refer to as the Securities Act, with respect to the Securities offered by this prospectus. This prospectus, which is a part of the registration statement, does not contain all of the information set forth in the registration statement or exhibits and schedules thereto. For further information with respect to our business and our Securities, reference is made to the registration statement, including the amendments, exhibits and schedules thereto, contained in the registration statement.

We also file reports, proxy statements and other information with the SEC under the Securities Exchange Act of 1934, as amended, which we refer to as the Exchange Act. Such reports, proxy statements and other information, as well as the registration statement and the amendments, exhibits and schedules thereto, can be inspected at the public reference facilities maintained by the SEC at 100 F Street, N.E., Washington, D.C. 20549. Information about the operation of the public reference facilities may be obtained by calling the SEC at 1-202-551-8090. The SEC maintains a web site that contains reports, proxy statements and other information regarding registrants, including us, that file such information electronically with the SEC. The address of the SEC's web site is <http://www.sec.gov>. Copies of such material may also be obtained from the Public Reference Section of the SEC at 100 F Street, N.E., Washington, D.C. 20549, at prescribed rates. Our common stock is listed on The Nasdaq Global Select Market and our corporate website is located at <http://www.gladstonecapital.com>. The information contained on, or accessible through, our website is not a part of this prospectus.

We make available free of charge on our website our annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and all amendments to those reports as soon as reasonably practicable after such material is electronically filed with or furnished to the SEC.

We also furnish to our stockholders annual reports, which include annual financial information that has been examined and reported on, with an opinion expressed, by our independent registered public accounting firm. See Experts.

## RISK FACTORS

You should carefully consider the risks described below and all other information provided and incorporated by reference in this prospectus (or any prospectus supplement) before making a decision to purchase our Securities. The risks and uncertainties described below are not the only ones facing us. Additional risks and uncertainties not presently known to us, or not presently deemed material by us, may also impair our operations and performance.

If any of the following risks actually occur, our business, financial condition or results of operations could be materially adversely affected. If that happens, the trading price of our Securities could decline, and you may lose all or part of your investment.

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

We have no employees. Our chief executive officer, chief operating officer, chief investment officer and chief financial officer, and the employees of our Adviser, do not spend all of their time managing our activities and our investment portfolio. We are particularly dependent upon David Gladstone, George Stelljes III and Terry Lee Brubaker in this regard. Our executive officers and the employees of our Adviser allocate some, and in some cases a material portion, of their time to businesses and activities that are not related to our business. We have no separate facilities and are completely reliant on our Adviser, which has significant discretion as to the implementation and execution of our business strategies and risk

management practices. We are subject to the risk of discontinuation of our Adviser's operations or termination of the investment advisory agreement and the risk that, upon such event, no suitable replacement will be found. We believe that our success depends to a significant extent upon our Adviser and that discontinuation of its operations could have a material adverse effect on our ability to achieve our investment objectives.

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

On December 2, 2005, our stockholders approved a proposal to enter into an amended and restated investment advisory agreement with our Adviser, which we refer to as the Amended Advisory Agreement. On October 1, 2006, the Amended Advisory Agreement became effective. The Amended Advisory Agreement entitles our Adviser to incentive compensation for each fiscal quarter in an amount equal to a percentage of the excess of our investment income for that quarter (before deducting incentive compensation, net operating losses and certain other items) above a threshold return for that quarter. Our pre-incentive fee net investment income for incentive compensation purposes excludes realized and unrealized capital losses that we may incur in the fiscal quarter, even if such capital losses result in a net loss on our statement of operations for that quarter. Thus, we may be required to pay our Adviser incentive compensation for a fiscal quarter even if there is a decline in the value of our portfolio or we incur a net loss for that quarter. For additional information on incentive compensation under the Amended Advisory Agreement with our Adviser, see Business Investment Advisory and Administration Agreements Management services and fees under the amended and restated investment advisory agreement.

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

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

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

A large number of entities compete with us and make the types of investments that we seek to make in small and medium-sized privately owned businesses. We compete with a large number of private equity funds, leveraged buyout funds and venture capital funds, investment banks and other equity and non-equity based investment funds, and other sources of financing, including traditional financial services companies such as commercial banks. Many of our competitors are substantially larger and have considerably greater financial, technical and marketing resources than we do. For example, some competitors may have a lower cost of funds and access to funding sources that are not available to us. In addition, certain of our competitors may have higher risk tolerances or different risk assessments, which could allow them to consider a wider variety of investments and establish more relationships and build their market shares. Furthermore, many of our potential competitors are not subject to the regulatory restrictions that the 1940 Act imposes on us as a business development company. We cannot assure you that the competitive pressures we face will not have a material adverse effect on our business, financial

condition and results of operations. Also, as a result of this competition, we may not be able to take advantage of attractive investment opportunities from time to time and there can be no assurance that we will be able to identify and make investments that satisfy our investment objectives or that we will be able to fully invest our available capital.

**Our business model is dependent upon developing and sustaining strong referral relationships with leveraged buyout funds and venture capital funds.**

We are dependent upon informal relationships with leveraged buyout funds, venture capital funds, and traditional lending institutions to provide us with deal flow. If we fail to maintain our relationship with such funds or institutions, or if we fail to establish strong referral relationships with other funds, we will not be able to grow our portfolio of loans and fully execute our business plan.

**Our loans to small and medium-sized borrowers are extremely risky and you could lose all or a part of your investment.**

Loans to small and medium-sized borrowers are subject to a number of significant risks including the following:

- **Small and medium-sized businesses may have limited financial resources and may not be able to repay the loans we make to them.** Our strategy includes providing financing to borrowers that typically is not readily available to them. While we believe that this provides an attractive opportunity for us to generate profits, this may make it difficult for the borrowers to repay their loans to us upon maturity. A borrower's ability to repay its loan may be adversely affected by numerous factors, including the failure to meet its business plan, a downturn in its industry or negative economic conditions. Deterioration in a borrower's financial condition and prospects usually will be accompanied by deterioration in the value of any collateral and a reduction in the likelihood of us realizing on any guarantees we may have obtained from the borrower's management. Although we will sometimes seek to be the senior, secured lender to a borrower, in most of our loans we expect to be subordinated to a senior lender, and our interest in any collateral would, accordingly, likely be subordinate to another lender's security interest.
- **Small and medium-sized businesses typically have narrower product lines and smaller market shares than large businesses.** Because our target borrowers are smaller businesses, they will tend to be more vulnerable to competitors' actions and market conditions, as well as general economic downturns. In addition, our portfolio companies may face intense competition, including competition from companies with greater financial resources, more extensive development, manufacturing, marketing and other capabilities and a larger number of qualified managerial and technical personnel.
- **There is generally little or no publicly available information about these businesses.** Because we seek to make loans to privately owned businesses, there is generally little or no publicly available operating and financial information about our potential borrowers. As a result, we rely on our officers, our Adviser and its employees and consultants to perform due diligence investigations of these borrowers, their operations and their prospects. We may not learn all of the material information we need to know regarding these businesses through our investigations.
- **Small and medium-sized businesses generally have less predictable operating results.** We expect that our borrowers may have significant variations in their operating results, may from time to time be parties to litigation, may be engaged in rapidly changing businesses with products subject to a substantial risk of obsolescence, may require substantial additional capital to support their operations, to finance expansion or to maintain their competitive position, may otherwise have a weak financial position or may be adversely affected by changes in the business cycle. Our portfolio



companies may not meet net income, cash flow and other coverage tests typically imposed by their senior lenders. A borrower's failure to satisfy financial or operating covenants imposed by senior lenders could lead to defaults and, potentially, foreclosure on its senior credit facility, which could additionally trigger cross-defaults in other agreements. If this were to occur, it is possible that the borrower's ability to repay our loan would be jeopardized.

- **Small and medium-sized businesses are more likely to be dependent on one or two persons.** Typically, the success of a small or medium-sized business also depends on the management talents and efforts of one or two persons or a small group of persons. The death, disability or resignation of one or more of these persons could have a material adverse impact on our borrower and, in turn, on us.
- **Small and medium-sized businesses are likely to have greater exposure to economic downturns than larger businesses.** We expect that our borrowers will have fewer resources than larger businesses and an economic downturn is more likely to have a material adverse effect on them. If one of our borrowers is adversely impacted by an economic downturn, its ability to repay our loan would be diminished.
- **Small and medium-sized businesses may have limited operating histories.** While we intend to target stable companies with proven track records, we may make loans to new companies that meet our other investment criteria. Borrowers with limited operating histories will be exposed to all of the operating risks that new businesses face and may be particularly susceptible to, among other risks, market downturns, competitive pressures and the departure of key executive officers.

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

When we make a subordinated loan, we may receive warrants to purchase stock issued by the borrower or other yield enhancements, such as success fees (conditional interest). Our goal is to ultimately dispose of these equity interests and realize gains upon our disposition of such interests. We expect that, over time, the gains we realize on these warrants and other yield enhancements will offset any losses we experience on loan defaults. However, any warrants we receive may not appreciate in value and, in fact, may decline in value and any other yield enhancements, such as success fees, may not be realized. Accordingly, we may not be able to realize gains from our equity interests or other yield enhancements and any gains we do recognize may not be sufficient to offset losses we experience on our loan portfolio. Because the loans we make and equity securities we receive when we make loans are not publicly traded, there will be uncertainty regarding the value of our privately held securities that could adversely affect our determination of our net asset value.

A large percentage of our portfolio investments are, and will continue to be, in the form of securities that are not publicly traded. The fair value of securities and other investments that are not publicly traded may not be readily determinable. Our Board of Directors has established a valuation policy and consistently applied valuation procedures used to determine the fair value of these securities quarterly. These procedures for the determination of value of many of our debt securities rely on the opinions of value submitted to us by Standard & Poor's Securities Evaluations, Inc., which we refer to as SPSE. SPSE will only evaluate the debt portion of our investments for which we specifically request evaluation, and SPSE may decline to make requested evaluations for any reason in its sole discretion. However, to date, SPSE has accepted each of our requests for evaluation.

Our procedures also include provisions whereby our Adviser will establish the fair value of any equity securities we may hold where SPSE is unable to provide evaluations. The types of factors that may be considered in determining the fair value of our debt and equity investments include some or all of the following: the nature and realizable value of any collateral, the portfolio company's earnings and cash flows and its ability to make payments on its obligations, the markets in which the portfolio company does

business, comparison to publicly traded companies, discounted cash flow, and other relevant factors. Because such valuations, particularly valuations of private securities and private companies, are inherently uncertain, may fluctuate over short periods of time, and may be based on estimates, our determinations of fair value may differ materially from the values that might have resulted from a readily available market for these securities.

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

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

Most of our investments presently consist of, and will continue to consist of, loans and warrants acquired in private transactions directly from borrowers or from the originators of loans to such borrowers. Substantially all of the investments we presently hold are, and the investments we expect to acquire in the future will be, subject to restrictions on resale, including, in some instances, legal restrictions, or will otherwise be less liquid than publicly traded securities. The illiquidity of our investments may make it difficult for us to quickly obtain cash equal to the value at which we record our investments if the need arises. This could cause us to miss important business opportunities. In addition, if we are required to quickly liquidate all or a portion of our portfolio, we may realize significantly less than the value at which we have previously recorded our investments. In addition, we may face other restrictions on our ability to liquidate an investment in a portfolio company to the extent that we, our Adviser, or our respective officers, employees or affiliates have material non-public information regarding such portfolio company.

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

**Our business plan is dependent upon external financing which may expose us to risks associated with leverage.**

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

- **Senior Securities.** We intend to issue debt securities, other evidences of indebtedness (including borrowings under our line of credit) and possibly preferred stock, up to the maximum amount permitted by the 1940 Act. The 1940 Act currently permits us, as a business development company, to issue debt securities and preferred stock, to which we refer collectively as senior securities, in amounts such that our asset coverage, as defined in the 1940 Act, is at least 200% after each issuance of senior securities. As a result of issuing senior securities, we will be exposed to the risks associated with leverage. Although borrowing money for investments increases the potential for gain, it also increases the risk of a loss. A decrease in the value of our investments will have a greater impact on the value of our common stock to the extent that we have borrowed money to make investments. There is a possibility that the costs of borrowing could exceed the income we receive on the investments we make with such borrowed funds. In addition, our ability to pay

dividends or incur additional indebtedness would be restricted if asset coverage is not at least twice our indebtedness. If the value of our assets declines, we might be unable to satisfy that test. If this happens, we may be required to liquidate a portion of our loan portfolio and repay a portion of our indebtedness at a time when a sale may be disadvantageous. Furthermore, any amounts that we use to service our indebtedness will not be available for distributions to our stockholders.

- **Common Stock.** Because we are constrained in our ability to issue debt for the reasons given above, we are dependent on the issuance of equity as a financing source. If we raise additional funds by issuing more common stock or debt securities convertible into or exchangeable for our common stock, the percentage ownership of our stockholders at the time of the issuance would decrease and they may experience dilution. In addition, any convertible or exchangeable securities that we issue in the future may have rights, preferences and privileges more favorable than those of our common stock.
- **Securitization.** In addition to issuing securities to raise capital as described above, we anticipate that in the future we will securitize our loans to generate cash for funding new investments. An inability to successfully securitize our loan portfolio could limit our ability to grow our business, fully execute our business strategy and impact our profitability. Moreover, successful securitization of our loan portfolio might expose us to losses as the loans in which we do not plan to sell interests will be those that are riskier and more apt to generate losses.

**A change in interest rates may adversely affect our profitability and our hedging strategy may expose us to additional risks.**

We anticipate using a combination of equity and long-term and short-term borrowings to finance our lending activities. As a result, a portion of our income will depend upon the difference between the rate at which we borrow funds and the rate at which we loan these funds. Certain of our borrowings may be at fixed rates and others at variable rates. Ultimately, we expect approximately 20% of the loans in our portfolio to be at fixed rates and approximately 80% to be at variable rates determined on the basis of a benchmark prime rate. As of March 31, 2007, our portfolio had approximately 56% of the total of the loan cost value at variable rates with a floor, approximately 2% of the total loan cost value at variable rates with a floor and ceiling, 40% at variable rates without a floor or ceiling and approximately 1% of the total loan portfolio cost basis at a fixed rate. Pursuant to our initial line of credit, we agreed to enter into hedging transactions such as interest rate cap agreements, futures, options and forward contracts. To date, we hold only one interest rate cap agreement. In the event that we securitize a portion of our loan portfolio in the future, we believe that we will likely be required to enter into similar arrangements with respect to the securitized loans. While hedging activities may insulate us against adverse fluctuations in interest rates, they may also limit our ability to participate in the benefits of lower interest rates with respect to the hedged portfolio. Adverse developments resulting from changes in interest rates or hedging transactions could have a material adverse effect on our business, financial condition and results of operations.

**Our credit facility imposes certain limitations on us.**

We will have a continuing need for capital to finance our loans. In order to maintain RIC status, we will be required to distribute to our stockholders at least 90% of our ordinary income and short-term capital gains on an annual basis. Accordingly, such earnings will not be available to fund additional loans. Therefore, we are party to a credit agreement arranged by Deutsche Bank AG as the structuring agent. The agreement provides us with a revolving credit line facility of \$220 million. In the future, borrowings outstanding on the credit line facility may be repaid with the proceeds we may receive from securitizing some or all of the loans in our portfolio for long-term funding. The line of credit facility will permit us to fund additional loans and investments as long as we are within the conditions set out in the credit agreement.

As a result of the line of credit facility, we are subject to certain limitations on the type of loan investments we make, including restrictions on geographic concentrations, sector concentrations, loan size, payment frequency and status, and average life. Our failure to satisfy these limitations could result in foreclosure by our lenders which would have a material adverse effect on our business, financial condition and results of operations.

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

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

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

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

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

To maintain our qualification as a RIC, we must meet income source, asset diversification and annual distribution requirements. The annual distribution requirement is satisfied if we distribute at least 90% of our ordinary income and short-term capital gains to our stockholders on an annual basis. Because we use leverage, we are subject to certain asset coverage ratio requirements under the 1940 Act and could, under certain circumstances, be restricted from making distributions necessary to qualify as a RIC. Warrants we receive with respect to debt investments will create original issue discount, which we must recognize as ordinary income, increasing the amounts we are required to distribute to maintain RIC status. Because such warrants will not produce distributable cash for us at the same time as we are required to make distributions in respect of the related original issue discount, we will need to use cash from other sources to satisfy such distribution requirements. The asset diversification requirements must be met at the end of each calendar quarter. If we fail to meet these tests, we may need to quickly dispose of certain investments to prevent the loss of RIC status. Since most of our investments will be illiquid, such dispositions, if even possible, may not be made at prices advantageous to us and, in fact, may result in substantial losses. If we fail to qualify as a RIC for any reason and become fully subject to corporate income tax, the resulting corporate taxes could substantially reduce our net assets, the amount of income available for distribution, and the actual amount distributed. Such a failure would have a material adverse effect on us and our shares. For additional information regarding asset coverage ratio and RIC requirements, see [Business Leverage](#) and [Material U.S. Federal Income Tax Considerations](#).

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

Our executive officers and directors, and the officers and directors of our Adviser and our Administrator serve or may serve as officers, directors or principals of entities that operate in the same or a related line of business as we do or of investment funds managed by our affiliates. Accordingly, they may have obligations to investors in those entities, the fulfillment of which might not be in the best interests of us or our stockholders. In addition, all of our directors and executive officers serve as either directors or executive officers, or both, of Gladstone Commercial and Gladstone Investment and our Adviser and Administrator also provide investment advisory and administrative services to these affiliates as well as Gladstone Land. In the future, our Adviser and our Administrator may provide investment advisory and administrative services, as applicable, to other funds, both public and private, of which it is the sponsor. Moreover, our Adviser may establish or sponsor other investment vehicles which from time to time may have potentially overlapping investment objectives with those of ours and accordingly may invest in, whether principally or secondarily, asset classes similar to those we targeted. While our Adviser generally has broad authority to make investments on behalf of the investment vehicles that it advises, our Adviser has adopted investment allocation procedures to address these potential conflicts and intends to direct investment opportunities to the Gladstone affiliate with the investment strategy that most closely fits the investment opportunity to ensure the fair and equitable treatment of all the funds it manages. Nevertheless, the management of our Adviser may face conflicts in the allocation of investment opportunities to other entities managed by our Adviser. As a result, it is possible that we may not be given the opportunity to participate in certain investments made by other members of the Gladstone Companies or investment funds managed by investment managers affiliated with our Adviser.

In certain circumstances, we may make investments in a portfolio company in which one of our affiliates has or will have an investment, subject to satisfaction of any regulatory restrictions and, where required, to the prior approval of our Board of Directors. As of March 31, 2007, our Board of Directors has approved the following types of co-investment transactions:

- Our affiliate, Gladstone Commercial, may lease property to portfolio companies that we do not control under certain circumstances. We may pursue such transactions only if (i) the portfolio company is not controlled by us or any of our affiliates, (ii) the portfolio company satisfies the tenant underwriting criteria of Gladstone Commercial, and (iii) the transaction is approved by a majority of our independent directors and a majority of the independent directors of Gladstone Commercial. We expect that any such negotiations between Gladstone Commercial and our portfolio companies would result in lease terms consistent with the terms that the portfolio companies would be likely to receive were they not portfolio companies of ours.
- We may invest simultaneously with our affiliate Gladstone Investment in senior syndicated loans whereby neither we nor any affiliate has the ability to dictate the terms of the loans.

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

In the course of our investing activities, we will pay management and incentive fees to our Adviser and will reimburse our Administrator for certain expenses it incurs. As a result, investors in our common stock will invest on a gross basis and receive distributions on a net basis after expenses, resulting in, among other things, a lower rate of return than one might achieve through our investors themselves making direct investments. As a result of this arrangement, there may be times when the management team of our Adviser or our Administrator has interests that differ from those of our stockholders, giving rise to a conflict.

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

On October 1, 2006, we implemented the Amended Advisory Agreement with our Adviser. In addition to providing for a base management fee based on our total assets, this agreement contemplates a quarterly incentive fee based on our pre-incentive fee net investment income and an annual incentive fee based on our capital gains, if any. Our Adviser has the ability to issue a full or partial waiver of the incentive fee for current and future periods, however our Adviser is not required to issue this waiver. If our Adviser does not issue this waiver in future quarters, it could negatively impact our earnings and may compromise our ability to maintain our current level of, or increase, distributions to our stockholders, which could have a material adverse impact on our stock price.

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

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

**We may experience fluctuation in our quarterly results.**

We could experience fluctuations in our quarterly operating results due to a number of factors including, among others, the interest rates payable on our debt securities, variations in and the timing of the recognition of realized and unrealized gains or losses, the level of our expenses, the degree to which we encounter competition in our markets and general economic conditions. As a result of these factors, results for any period should not be relied upon as being indicative of performance in future periods.

**There is a risk that you may not receive dividends or that our dividends may not grow over time.**

Our current intention is to distribute at least 90% of our ordinary income and short-term capital gains to our stockholders on a quarterly basis. We expect to retain net realized long-term capital gains to supplement our equity capital and support the growth of our portfolio, although our Board of Directors may determine in certain cases to distribute these gains. We cannot assure you that we will achieve investment results or maintain a tax status that will allow or require any specified level of cash distributions or year-to-year increases in cash distributions. Provisions of our articles of incorporation and bylaws could deter takeover attempts and adversely impact the price of our shares.

Our articles of incorporation and bylaws and the Maryland General Corporation Law contain provisions that may have the effect of discouraging, delaying or making more difficult a change in control and preventing the removal of incumbent directors. The existence of these provisions may negatively impact the price of our shares and may discourage third-party bids. These provisions may reduce any premiums paid to you for our shares. Furthermore, we are subject to Section 3-602 of the Maryland General Corporation Law which governs business combinations with interested stockholders and could delay or prevent a change in control. In addition, our Board of Directors is elected in staggered terms which makes it more difficult for a hostile bidder to acquire control of us.

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

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

- price and volume fluctuations in the stock market from time to time, which are often unrelated to the operating performance of particular companies;
- significant volatility in the market price and trading volume of shares of RICs, business development companies or other companies in our sector, which is not necessarily related to the operating performance of these companies;
- changes in regulatory policies or tax guidelines, particularly with respect to RICs or business development companies;
- loss of business development company status;
- loss of RIC status;
- changes in our earnings or variations in our operating results;
- changes in the value of our portfolio of investments;
- any shortfall in our revenue or net income or any increase in losses from levels expected by securities analysts;
- departure of key personnel;
- operating performance of companies comparable to us;
- short-selling pressure with respect to our shares or business development companies generally;
- general economic trends and other external factors; and
- loss of a major funding source.

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

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

Shares of closed-end investment companies frequently trade at a discount from net asset value. This characteristic of shares of closed-end investment companies is separate and distinct from the risk that our net asset value per share will decline. Although shares of our common stock have historically traded at a premium to net asset value, there can be no guarantee that they will continue to do so.

**We could face losses and potential liability if intrusion, viruses or similar disruptions to our technology jeopardize our confidential information or that of users of our technology.**

Although we have implemented, and will continue to implement, security measures, our technology platform is and will continue to be vulnerable to intrusion, computer viruses or similar disruptive problems caused by transmission from unauthorized users. The misappropriation of proprietary information could expose us to a risk of loss or litigation.





## **SPECIAL NOTE REGARDING FORWARD-LOOKING STATEMENTS**

All statements contained or incorporated by reference in this prospectus or any accompanying prospectus summary, other than historical facts, may constitute forward-looking statements. These statements may relate to, among other things, future events or our future performance or financial condition. In some cases, you can identify forward-looking statements by terminology such as may, might, believe, will, provided, anticipate, future, could, growth, plan, intend, expect, should, would, if, seek, possible, potential, likely or the negative comparable terminology. These forward-looking statements involve known and unknown risks, uncertainties and other factors that may cause our actual results, levels of activity, performance or achievements to be materially different from any future results, levels of activity, performance or achievements expressed or implied by such forward-looking statements. Such factors include, among others: (1) adverse changes in interest rates; (2) our failure or inability to establish or maintain referral arrangements with leveraged buyout funds and venture capital funds to generate loan opportunities; (3) the loss of one or more of our executive officers, in particular David Gladstone, Terry Lee Brubaker, or George Stelljes III; (4) our inability to extend, refinance, or maintain our credit facilities on terms reasonably acceptable to us, if at all, in future equity capital resources; (5) our inability to successfully securitize our loan portfolio on terms reasonably acceptable to us, if at all; (6) the decision of our competitors to aggressively seek to make senior and subordinated loans to small and medium-sized businesses on terms more favorable than we intend to provide; and (7) those factors described in the Risk Factors section of this prospectus. We caution readers not to place undue reliance on any such forward-looking statements, which speak only as of the date made. 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 prospectus.

## **USE OF PROCEEDS**

Unless otherwise specified in any prospectus supplement accompanying this prospectus, we intend to use the net proceeds from the sale of the Securities for general corporate purposes. We expect the proceeds to be used first to pay down existing short-term debt, then to make investments in small and medium sized businesses in accordance with our investment objectives, and any remaining proceeds to be used for other general corporate purposes. Indebtedness under our credit line facility currently accrues interest at the rate of approximately 6.07% and matures on May 23, 2008. We anticipate that substantially all of the net proceeds of any offering of Securities will be utilized in the manner described above within three months of the completion of such offering. Pending such utilization, we intend to invest the net proceeds of any offering of Securities primarily in cash, cash equivalents, U.S. government securities, and other high-quality debt investments that mature in one year or less from the date of investment, consistent with the requirements for continued qualification as a RIC for federal income tax purposes.

**PRICE RANGE OF COMMON STOCK AND DISTRIBUTIONS**

We have distributed and currently intend to distribute in the form of cash dividends, a minimum of 90% of our ordinary income and short-term capital gains, if any, on a quarterly basis to our stockholders in the form of monthly dividends. We intend to retain long-term capital gains and treat them as deemed distributions for tax purposes. We report the estimated tax characteristics of each dividend when declared while the actual tax characteristics of dividends are reported annually to each stockholder on Form 1099 DIV. There is no assurance that we will achieve investment results or maintain a tax status that will permit any specified level of cash distributions or year-to-year increases in cash distributions. At the option of a holder of record of common stock, all cash distributions can be reinvested automatically under our Dividend Reinvestment Plan in additional whole and fractional shares. A stockholder whose shares are held in the name of a broker or other nominee should contact the broker or nominee regarding participation in our Dividend Reinvestment Plan on the stockholder's behalf. See Risk Factors We will be subject to corporate level tax if we are unable to satisfy Internal Revenue Code requirements for RIC qualification; Dividend Reinvestment Plan; and Material U.S. Federal Income Tax Considerations.

Our common stock is quoted on The Nasdaq Global Select Market under the symbol GLAD. Our common stock has historically traded at prices above its net asset value. There can be no assurance, however, that any premium to net asset value will be maintained. As of June 15, 2007, we had 80 stockholders of record. The following table sets forth the range of high and low sales prices of our common stock as reported on The Nasdaq Global Select Market (for periods prior to July 1, 2006, The Nasdaq National Market) and the dividends declared by us for the last two completed fiscal years and the current fiscal year through July 3, 2007.

	Net Asset Value Per Share (1)	Closing Price		Premium of High to Net Asset Value(2)	Premium of Low to Net Asset Value(2)	Dividends Declared
		High	Low			
<b>FY 2005</b>						
First Quarter	\$ 13.58	\$ 25.35	\$ 22.61	\$ 11.77	\$ 9.03	\$ 0.360
Second Quarter	\$ 13.64	\$ 24.80	\$ 20.94	\$ 11.16	\$ 7.30	\$ 0.360
Third Quarter	\$ 13.61	\$ 23.96	\$ 21.18	\$ 10.35	\$ 7.57	\$ 0.390
Fourth Quarter	\$ 13.41	\$ 26.00	\$ 22.55	\$ 12.59	\$ 9.14	\$ 0.405
<b>FY 2006</b>						
First Quarter	\$ 13.74	\$ 23.68	\$ 20.36	\$ 9.94	\$ 6.62	\$ 0.405
Second Quarter	\$ 13.84	\$ 22.42	\$ 19.96	\$ 8.58	\$ 6.12	\$ 0.405
Third Quarter	\$ 13.95	\$ 23.50	\$ 20.79	\$ 9.55	\$ 6.84	\$ 0.405
Fourth Quarter	\$ 14.02	\$ 23.08	\$ 21.10	\$ 9.06	\$ 7.08	\$ 0.420
<b>FY 2007</b>						
First Quarter	\$ 13.88	\$ 25.21	\$ 21.96	\$ 11.33	\$ 8.08	\$ 0.420
Second Quarter	\$ 13.82	\$ 24.24	\$ 21.24	\$ 10.42	\$ 7.42	\$ 0.420
Third Quarter	*	\$ 24.60	\$ 21.44	*	*	\$ 0.420
Fourth Quarter (through July 3, 2007)	*	\$ 21.39	\$ 21.24	*	*	*

(1) Net asset value per share is determined as of the last day in the relevant quarter and therefore may not reflect the net asset value per share on the date of the high and low sale price. The net asset values shown are based on outstanding shares at the end of each period.

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

\* Not available.

**CONSOLIDATED SELECTED FINANCIAL DATA**  
**(in thousands, except per share data)**

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The following consolidated selected financial data as of and for the years ended September 30, 2006, 2005 and 2004 is derived from our audited consolidated financial statements included in this prospectus. The consolidated selected financial data as of and for the years ended September 30, 2003 and 2002 is derived from our audited consolidated financial statements that are not included in this prospectus. The consolidated selected financial data as of and for the six months ended March 31, 2007 and 2006 is derived from our unaudited consolidated financial statements included in this prospectus. You should read this data together with our consolidated financial statements and notes thereto presented elsewhere in this prospectus and the information under Management's Discussion and Analysis of Financial Condition and Results of Operations for more information.

	Year Ended September 30, 2006	Year Ended September 30, 2005	Year Ended September 30, 2004	Year Ended September 30, 2003	Year Ended September 30, 2002	Six Months Ended March 31, 2007 (unaudited)	Six Months Ended March 31, 2006 (unaudited)
Total Investment Income	\$ 26,899,846	\$ 23,949,759	\$ 20,395,968	\$ 15,154,874	\$ 10,455,703	\$ 16,877,496	\$ 13,031,019
Total Net Expenses	\$ 7,549,266	\$ 6,663,614	\$ 7,103,193	\$ 3,858,953	\$ 2,839,102	\$ 5,990,213	\$ 3,384,789
Net Investment Income	\$ 19,350,580	\$ 17,286,145	\$ 13,292,775	\$ 11,295,921	\$ 7,616,601	\$ 10,887,283	\$ 9,646,230
Net Increase in Net Assets Resulting from Operations	\$ 24,430,235	\$ 15,490,682	\$ 10,570,290	\$ 11,073,581	\$ 7,616,601	\$ 8,248,454	\$ 13,823,730
<b>Per Share Data:</b>							
Net Increase in Net Assets Resulting from Operations:							
Basic	\$ 2.15	\$ 1.37	\$ 1.05	\$ 1.10	\$ 0.76	\$ 0.67	\$ 1.22
Diluted	\$ 2.10	\$ 1.33	\$ 1.02	\$ 1.09	\$ 0.75	\$ 0.67	\$ 1.20
<b>Cash Distributions</b>							
Declared per Share	\$ 1.635	\$ 1.515	\$ 1.365	\$ 1.10	\$ 0.81	\$ 0.84	\$ 0.81
<b>Statement of Assets and Liabilities Data:</b>							
Total Assets	\$ 225,783,215	\$ 205,793,094	\$ 215,333,727	\$ 214,566,663	\$ 172,922,039	\$ 291,015,954	\$ 217,725,319
Net Assets	\$ 172,570,487	\$ 151,610,683	\$ 152,226,655	\$ 130,802,382	\$ 130,663,273	\$ 169,323,895	\$ 156,461,511
<b>Other Data:</b>							
Number of Portfolio Companies at Period End	32	28	16	11	7	51	28
Principal Amount of Loan Originations	\$ 135,954,879	\$ 143,794,006	\$ 86,267,500	\$ 47,011,278	\$ 97,705,054	\$ 127,641,175	\$ 65,159,566
Principal Amount of Loan Repayments	\$ 124,009,929	\$ 88,019,136	\$ 47,158,995	\$ 18,005,827	\$ 18,387,191	\$ 62,230,246	\$ 63,517,133
Total Return(1)	5.21	% 5.93	% 24.40	% 21.74	% 9.60	% 11.50	% (0.75)%
<b>Weighted Average Yield on Investments (2):</b>							
With PIK Interest(3)	12.74	% 12.36	% 13.78	% 13.86	% 14.79	% n/a	12.56%
Without PIK Interest(3)	12.74	% 12.23	% 13.44	% 13.14	% 13.82	% 12.58	% 12.56%

(1) For the fiscal years ended September 30, 2006, 2005 and 2004, the total return equals the increase of the ending market value over the beginning market value plus monthly dividends divided by the monthly beginning market value. For the fiscal years ended September 30, 2003 and 2002, total return equals the increase of the ending market value over the beginning market value, plus distributions, dividend by the beginning market value.

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

(3) Refer to Note 2 of the Notes to Consolidated Financial Statements for an explanation of PIK, or Paid-in-Kind, interest.

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

**OVERVIEW**

We were incorporated under the General Corporation Laws of the State of Maryland on May 30, 2001. Our investment objectives are to achieve a high level of current income by investing in debt securities, consisting primarily of senior notes, second lien notes, and senior subordinated notes of established private businesses that are backed by leveraged buyout funds, venture capital funds or others, with a particular emphasis on second lien and senior subordinated notes. In addition, we may acquire existing loans, which meet this profile, from leveraged buyout funds, venture capital funds and others. 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 extend 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 1940 Act.

We seek to invest in small and medium-sized businesses that meet certain criteria, including some or all of the following: (1) the potential for growth in cash flow, (2) adequate assets for loan collateral, (3) experienced management teams with a significant ownership interest in the borrower, (4) profitable operations based on the borrower's cash flow, (5) reasonable capitalization of the borrower (usually by buyout funds or venture capital funds) and (6) 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 by the borrower or by exercise of our right to require the borrower to buy back its warrants. We lend to borrowers that need funds to, among other things, effect a change of control, restructure their balance sheets, or finance growth, including acquisitions.

Our loans typically range from \$5 million to \$15 million, although this investment size may vary proportionately as the size of our capital base changes, generally mature in no more than seven years and accrue interest at fixed or variable rates. Some of our loans may contain a provision that calls for some portion of the interest payments to be deferred and added to the principal balance so that the interest is paid, together with the principal, at maturity. This form of deferred interest is often called "paid in kind" or PIK interest, and, when earned, we record PIK interest as interest income and add the PIK interest to the principal balance of the loans. We seek to avoid PIK interest with all potential investments under review. We currently do not hold any investments with PIK and, therefore, there was no PIK accrued on our balance sheet as of March 31, 2007.

Because the majority of our portfolio loans consist of term debt of private companies who typically cannot or will not expend the resources to have their debt securities rated by a credit rating agency, we expect that most of the debt securities we acquire will be unrated. We cannot accurately predict what ratings these loans might receive if they were in fact rated, and thus cannot determine whether or not they could be considered investment grade quality.

To the extent possible, our loans generally are collateralized by a security interest in the borrower's assets. Interest payments are generally made monthly or quarterly (except to the extent of any PIK interest) with amortization of principal generally being deferred for several years. The principal amount of the loans and any accrued but unpaid interest generally become due at maturity at five to seven years. When we receive a warrant to purchase stock in a borrower in connection with a loan, the warrant will typically have an exercise price equal to the fair value of the portfolio company's common stock at the time of the loan and entitle us to purchase a modest percentage of the borrower's stock.

Original issue discount, or OID, arises when we extend a loan and receive an equity interest in the borrower at the same time. To the extent that the price paid for the equity is not at market value, we must

allocate part of the price paid for the loan to the value of the equity. Then the amount allocated to the equity, the OID, must be amortized over the life of the loan. As with PIK interest, the amortization of OID also produces income that must be recognized for purposes of satisfying the distribution requirements for a RIC under Subchapter M of the Internal Revenue Code, which we refer to as the Code, whereas the cash is received, if at all, when the equity instrument is sold. We seek to avoid OID and to date do not hold any investments with OID.

In addition, as a business development company under the 1940 Act, we are required to make available significant managerial assistance to our portfolio companies. We provide these services through our Adviser, who provides these services on our behalf through its officers who are also our officers. In addition, our Adviser provides other services to our portfolio companies, for which it receives fees, in connection with our investments. The fees for these services are generally paid to our Adviser in part at the time a prospective portfolio company signs a non-binding term sheet with us (as further described in the following paragraph), with the remainder paid at the closing of the investment. These fees are generally non-recurring, however in some instances they may have a recurring component which is also paid to our Adviser. Any fees received for other services, with the exception of recurring monitoring and review fees, by our Adviser are currently credited against the base management fee payable to our Adviser pursuant to the terms of the Amended Advisory Agreement, which has the effect of reducing our expenses to the extent of any such credits. The specific other services our Adviser provides vary by portfolio company, but generally include a broad array of services to the portfolio companies such as investment banking services, arranging bank financing, arranging equity financing, structuring financing from multiple lenders and investors, reviewing existing credit facilities, restructuring existing loans, raising equity and debt capital, turnaround management, merger and acquisition services and recruiting new management personnel. To date our Adviser has not charged for managerial assistance services, however, if our Adviser does receive fees for such managerial assistance, our Adviser will credit the managerial assistance fees to the base management fee due from us to our Adviser.

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

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

During the six months ended March 31, 2007, we extended, directly or through participations, approximately \$127.6 million of new loans to a total of 32 companies. Also, during the six months ended March 31, 2007, one borrower repaid its loans ahead of contractual maturity, one borrower refinanced its investment and we sold or were repaid in full on 11 syndicated loans of approximately \$56.9 million, and we received scheduled contractual principal repayments of approximately \$5.1 million, for total principal repayments of approximately \$62.0 million. During the fiscal year ended September 30, 2006, we extended, directly or through participations, approximately \$136 million of new loans to a total of 22 companies. Also, during the fiscal year ended September 30, 2006, 7 borrowers repaid their loans ahead of contractual

maturity and we sold or repaid in full on 9 syndicated loans, and sold 3 loan investments at a loss for an aggregate return of capital of approximately \$20 million and we received scheduled contractual principal repayments of approximately \$20 million, for total principal repayments of approximately \$124 million. Since our initial public offering in August 2001, we have made approximately 220 different loans to, or investments in approximately 120 companies for a total of approximately \$755.5 million, before giving effect to principal repayments on investments and divestitures.

We are continuously working toward the consummation of more loan originations and syndicated investments in an effort to grow our loan portfolio. These prospective loans are subject to, among other things, the satisfactory completion of our due diligence investigation of each borrower, acceptance of terms and structure and attainment of necessary consents. With respect to each prospective loan, we will only agree to provide the loan if, among other things, the results of our due diligence investigations are satisfactory, the terms and conditions of the loan are acceptable and all necessary consents are received. Our management has initiated its due diligence investigations of the potential borrowers, however we cannot assure you that we will not discover facts in the course of completing our due diligence that would render a particular investment imprudent or that any of these loans will actually be made.

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

Our Adviser is led by a management team which has extensive experience in our lines of business. Our Adviser is controlled by David Gladstone, our chairman and chief executive officer. Mr. Gladstone is also the chairman and chief executive officer of our Adviser. Terry Lee Brubaker, our vice chairman, chief operating officer, secretary and director, is a member of the board of directors of our Adviser and its vice chairman and chief operating officer. George Stelljes III, our president, chief investment officer and director, is a member of the board of directors of our Adviser and its president and chief investment officer. Harry Brill, our chief financial officer, is also the chief financial officer of our Adviser. Our Adviser's wholly-owned subsidiary, our Administrator, employs our chief financial officer, chief compliance officer, controller, treasurer and their respective staffs.

Our Adviser and Administrator also provide investment advisory and administrative services to our affiliates, Gladstone Commercial, a publicly traded real estate investment trust; Gladstone Investment, a publicly traded business development company; and Gladstone Land Corporation, an agricultural real estate company owned by Mr. Gladstone. All of our directors and executive officers serve as either directors or executive officers, or both, of Gladstone Commercial and Gladstone Investment. In the future, our Adviser may provide investment advisory and administrative services to other funds, both public and private, of which it is the sponsor.

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

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

On December 2, 2005, our stockholders approved a proposal to enter into an amended and restated investment advisory agreement, which we refer to as the Amended Advisory Agreement, with our Adviser and an administration agreement which we refer to as the Administration Agreement, with our Administrator, both of which became effective on October 1, 2006. The Amended Advisory Agreement replaced the original advisory agreement which terminated on September 30, 2006 and we refer to as the Initial Advisory Agreement. We continue to pay our direct expenses including, but not limited to, directors

fees, legal and accounting fees, and stockholder related expenses under the Amended Advisory Agreement.

Pursuant to the Initial Advisory Agreement, we paid our Adviser an annual advisory fee of 1.25% of our total assets (as reduced by cash and cash equivalents pledged to creditors), payable in quarterly computed increments of 0.3125%, and an annual administrative fee of 0.75% of our total assets (as reduced by cash and cash equivalents pledged to creditors), payable in quarterly computed increments of 0.1875%, for a total annual base management fee of 2%. This fee was then directly reduced by the amount of loan servicing fees paid to our Adviser and any other fees received by our Adviser from our borrowers and potential borrowers.

Under the Amended Advisory Agreement, we pay our Adviser an annual base management fee of 2% of our average gross assets, which is defined as total assets less cash and cash equivalents pledged to creditors calculated as of the end of the two most recently completed fiscal quarters and also consists of a two-part incentive fee.

The first part of the incentive fee is an income-based incentive fee which rewards our Adviser if our quarterly net investment income (before giving effect to any incentive fee) exceeds 1.75% of our net assets (the hurdle rate). We will pay our Adviser an income incentive fee with respect to our pre-incentive fee net investment income in each calendar quarter as follows:

- no incentive fee in any calendar quarter in which our pre-incentive fee net investment income does not exceed the hurdle rate (7% annualized);
- 100% of our pre-incentive fee net investment income with respect to that portion of such pre-incentive fee net investment income, if any, that exceeds the hurdle rate but is less than 2.1875% in any calendar quarter (8.75% annualized); and
- 20% of the amount of our pre-incentive fee net investment income, if any, that exceeds 2.1875% in any calendar quarter (8.75% annualized).

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

**Pre-incentive fee net investment income**  
(expressed as a percentage of the value of net assets)

#### **Percentage of pre-incentive fee net investment income allocated to income-related portion of incentive fee**

The second part of the incentive fee is a capital gains incentive fee that will be determined and payable in arrears as of the end of each fiscal year (or upon termination of the Amended Advisory Agreement, as of the termination date), commencing on October 1, 2006, and will equal 20% of our realized capital gains as of the end of the fiscal year. In determining the capital gains incentive fee payable to our Adviser, we will calculate the cumulative aggregate realized capital gains and cumulative aggregate realized capital losses since our inception, and the aggregate unrealized capital depreciation as of the date of the calculation, as applicable, with respect to each of the investments in our portfolio. A discussion regarding the basis for our Board of Directors' approval of the Amended Advisory Agreement is available in our Annual Report on Form 10-K for the fiscal year ended September 30, 2006.



Our Adviser's board of directors agreed to voluntarily waive 1.5% of the annual 2.0% base management fee to 0.5% for senior syndicated loans for each of the three months ended December 31, 2006 and March 31, 2007.

In addition to the base management and incentive fees under the Amended Advisory Agreement, certain fees received by our Adviser from our portfolio companies were credited against the investment advisory fee under the Initial Advisory Agreement, and will continue to be paid to our Adviser and credited under the Amended Advisory Agreement. Our Adviser services our loan portfolio pursuant to a loan servicing agreement with Gladstone Business Loan, LLC, which we refer to as Business Loan, in return for a 1.5% annual fee, based on the monthly aggregate outstanding loan balance of the loans pledged under our credit facility. Effective in April 2006, our Adviser's board of directors voted to reduce the portion of the annual fee to 0.5% for senior syndicated loans. This fee directly reduces the amount of the fees payable under both the Initial and Amended Advisory Agreements. For the three months ended March 31, 2007 and 2006, we incurred \$760,623 and \$734,644, respectively, and for the six months ended March 31, 2007 and 2006 we incurred \$1,479,775 and \$1,450,059, respectively, in loan servicing fees.

For the three months ended March 31, 2007, the gross base management fee, based on the Amended Advisory Agreement, before reductions for loan servicing and other fees was \$1,211,108, as compared to \$1,087,023 for the three months ended March 31, 2006. After being reduced by loan servicing fees of \$760,623 and other fees received by our Adviser of \$775,000, our net base management fee was a credit of \$324,516 for the three months ended March 31, 2007, as compared to reductions for loan servicing fees of \$734,644 and other fees received by our Adviser of \$673,000, our net base management fee was a credit of \$320,621 for the three months ended March 31, 2006. For the six months ended March 31, 2007, the gross base management fee, based on the Amended Advisory Agreement, before reductions for loan servicing fees and other fees was \$2,328,692. After being reduced by loan servicing fees of \$1,479,775 and other fees received by our Adviser of \$1,086,000, our net base management fee for the six months ended March 31, 2007 was a credit of \$237,084. For the six months ended March 31, 2006, the gross base management fee, before reductions for loan servicing fees and other fees was \$2,071,139. After being reduced by loan servicing fees of \$1,450,059 and other fees received by our Adviser of \$1,223,000, our net base management fee for the six months ended March 31, 2006 was a credit of \$601,920. At March 31, 2007, \$217,631 of unpaid loan servicing fees and \$324,516 of base management fee due to us was recorded net in fees due from Adviser in the accompanying consolidated statement of assets and liabilities.

For the three and six months ended March 31, 2007, we recorded a gross incentive fee of \$1,158,995 and \$2,307,478, respectively, which was offset by a waiver voluntarily issued by our Adviser's board of directors of \$1,088,378 and \$1,657,372, respectively, which resulted in a net incentive fee due to our Adviser of \$70,617 and \$650,106, respectively, of which \$70,617 is unpaid and is netted and recorded in fees due from Adviser on our consolidated statements of assets and liabilities. There was no incentive fee recorded for the three and six months ended March 31, 2006 as the Amended Advisory Agreement was not in effect.

#### **Administration Agreement**

Under the Administration Agreement, we pay separately for administrative services. The Administration Agreement provides for payments equal to our allocable portion of our Administrator's overhead expenses in performing its obligations under the Administration Agreement including, but not limited to, rent for employees of our Administrator, and our allocable portion of the salaries and benefits expenses of our chief financial officer, controller, chief compliance officer, treasurer and their respective staffs. Our allocable portion of expenses is derived by multiplying our Administrator's total allocable expenses by the percentage of our average total assets (the total assets at the beginning and end of each quarter) in comparison to the average total assets of all companies managed by our Adviser under similar agreements.

**Critical Accounting Policies**

The preparation of financial statements and related disclosures in conformity with accounting principles generally accepted in the United States, which we refer to as GAAP, requires management to make estimates and assumptions that affect the reported consolidated amounts of assets and liabilities, and 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. Our accounting policies are more fully described in the Notes to Consolidated Financial Statements contained elsewhere in the registration statement of which this prospectus is a part. 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 consolidated financial statements is the valuation of investments and the related amounts of unrealized appreciation and depreciation of investments recorded.

*General Valuation Policy:* Using procedures established by our Board of Directors, we value our investment portfolio each quarter. We carry our investments at fair value, as determined in good faith by or under the direction of our Board of Directors. Securities that are publicly traded, if any, are valued at the closing price of the exchange or securities market on which they are listed on the valuation date. Securities that are not traded on a public exchange or securities market, but for which a limited market exists and that have been rated by a nationally recognized statistical rating organizations, or NRSRO, (such as certain participations in syndicated loans) are valued at the indicative bid price offered by the syndication agent on the valuation date.

Debt and equity securities that are not publicly traded, for which a limited market does not exist, or for which a limited market exists but that have not been rated by a NRSRO (or for which we have various degrees of trading restrictions) are valued at fair value as determined in good faith by or under the direction of our Board of Directors. In making the good faith determination of the value of these securities, we start with the cost basis of the security, which includes the amortized OID and PIK interest, if any. We then apply the methods set out below in Valuation Methods. Members of our Adviser's portfolio management team prepare the valuations of our investments in portfolio companies using the most recent portfolio company financial statements and forecasts. These individuals also consult with portfolio company senior management and ownership to obtain further updates on the portfolio company's performance, including information such as industry trends, new product development, and other operational issues. 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.

At March 31, 2007, we engaged Standard & Poor's Securities Evaluations, Inc., or SPSE, to submit opinions of value for most of our loan securities. We request that SPSE also evaluate and assign values to success fees (conditional interest included in some loan securities) when we determine that the probability of receiving a success fee on a given loan is above 6-8%, a threshold of significance. Upon completing our collection of data with respect to the investments (including the information described under Credit Information, the risk ratings of the loans described under Loan Grading and Risk Rating and the factors described under Valuation Methods ), this valuation data is forwarded along 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 value 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 the Board 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 whether to accept the recommended valuation of our investment portfolio. Our Adviser and our management recommended, and the Board of Directors elected to accept, the opinions of value delivered by SPSE on the loans in our portfolio as denoted on the schedule of investments as of March 31, 2007, September 30, 2006 and September 30, 2005, included in our 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. Because SPSE does not provide values for equity securities, our Adviser determines the fair value of these investments using valuation policies approved by our Board of Directors.

*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. If we held a controlled or affiliate investment, we and our Adviser would participate in periodic board meetings of such portfolio companies and also require them to provide annual audited and monthly unaudited financial statements. Using these statements and board discussions, our Adviser would calculate and evaluate the credit statistics.

*Loan Grading and Risk Rating:* As part of our valuation procedures we risk rate all of our investments in debt securities. For syndicated loans that have been rated by a 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.

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 a 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 a 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 a 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 from a NRSRO, however, no assurance can be given that a 10 on our scale is equal to a BBB on a NRSRO scale.

Company s System	First NRSRO	Second NRSRO	Gladstone Capital s Description(a)
>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%

(a) The default rates set here are for a ten year term debt security. If the company s 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. Currently, none of our investments are on non-accrual. At March 31, 2007, no payments were past due on any of our debt securities. Additionally, we do not risk rate our equity securities.

The following table lists the risk ratings for all non-syndicated loans in our portfolio at March 31, 2007, September 30, 2006 and September 30, 2005, representing approximately 64%, 73% and 62%, respectively, of all loans in our portfolio:

Rating	Mar. 31, 2007	Sept. 30, 2006	Sept. 30, 2005
Average	7.1	7.2	7.6
Weighted Average	7.0	7.2	7.6
Highest	10.0	9.0	9.0
Lowest	5.0	6.0	6.0

The following table lists the risk ratings for syndicated loans in our portfolio that are not currently rated by an NRSRO at March 31, 2007, September 30, 2006 and September 30, 2005, representing approximately 14%, 17% and 32%, respectively, of all loans in our portfolio:

Rating	Mar. 31, 2007	Sept. 30, 2006	Sept. 30, 2005
Average	6.2	6.1	6.2
Weighted Average	6.1	6.3	6.3
Highest	9.0	8.0	7.0
Lowest	4.0	4.0	5.0

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 a NRSRO. The following table lists the risk ratings for all syndicated loans in our portfolio that are currently rated by an NRSRO at March 31, 2007, September 30, 2006 and September 30, 2005, representing approximately 22%, 10% and 6%, respectively, of all loans in our portfolio:

Rating	Mar. 31, 2007	Sept. 30, 2006	Sept. 30, 2005
Average	B-/B3	CCC+/Caa1	CCC+/Caa1
Weighted Average	CCC+/Caa1	CCC+/Caa1	CCC/Caa2
Highest	BB-/Ba2	B-/B3	CCC+/B3
Lowest	CCC/Caa3	CCC/Caa1	CCC+/Caa2

*Valuation Methods:* We determine the value of publicly-traded debt securities based on the closing price for the security on the exchange or securities market on which it is listed on the valuation date. We value debt securities that are not publicly traded, but for which a limited market for the security exists, such as participations in syndicated loans, at the indicative bid price offered by the syndication agent on the valuation date. At March 31, 2007, none of the debt securities in our portfolio were publicly traded and there was a limited market for 31 debt securities in our portfolio. At September 30, 2006, none of the debt securities in our portfolio were publicly traded and there was a limited market for 9 debt securities in our portfolio. At September 30, 2005, none of the debt securities in our portfolio were publicly traded and there was a limited market for 12 debt securities in our portfolio.

For debt securities that are not publicly traded, for which there is no market, or for which there is a market but have not been rated by a NRSRO, we begin with the risk rating designation of the security as described above. Using this risk rating designation, we seek to determine the value of the security as if we currently intended to sell the security and consider some or all of the following factors:

- the cost basis and the type of the security;
- the nature and realizable value of the collateral;
- the portfolio company's ability to make payments and discounted cash flow;



- reports from portfolio company senior management and board meetings;
- reported values of similar securities of the portfolio company or comparable companies; and
- changes in the economy affecting the portfolio company.

We value convertible debt, equity, success fees or other equity-like securities for which there is a market based on the market prices for such securities, even if that market is not robust. At March 31, 2007, September 30, 2006 and September 30, 2005, there was no market for any of the equity securities we owned. To value equity securities for which no market exists, we use the same information we would use for a debt security valuation described above, except risk-rating, as well as standard valuation techniques used by major valuation firms to value the equity securities of private companies. These valuation techniques consist of discounted cash flow of the expected sale price in the future, valuation of the securities based on recent sales in comparable transactions, and a review of similar companies that are publicly traded and the market multiple of their equity securities. At March 31, 2007, September 30, 2006 and September 30, 2005, we had \$146,124, \$37,000 and \$37,000, respectively, invested, at cost, in equity securities compared to our debt portfolio with a cost basis of \$281,379,326, \$216,165,986 and \$205,338,554, respectively.

At March 31, 2007, we had total unrealized depreciation of \$3,037,674, which was mainly comprised of unrealized depreciation of \$1,250,000 on our senior subordinated term debt investment in Visual Edge Technology, Inc., unrealized depreciation of \$733,000, on the aggregate of our investments in LocalTel, Inc. and unrealized depreciation of \$482,488 on our senior subordinated term debt investment in Consolidated Bedding, Inc. Unrealized appreciation of \$1,754,910 was primarily composed of unrealized appreciation of \$789,061 on our warrants in Finn Corporation, a \$180,800 success fee value on our senior term debt investment in Allied Extruders, Inc. and a \$94,219 success fee value on our senior term debt investment in SCPH Holdings, Inc. In the aggregate, we recorded net unrealized depreciation of \$1,282,764 on our total investment portfolio as of March 31, 2007.

At September 30, 2006, we had total unrealized appreciation of \$2,015,198, which was mainly comprised of unrealized appreciation of \$672,431 on our warrants of Finn Corporation, unrealized appreciation of \$607,625 on our senior term debt in Mistras Holding Corporation and unrealized appreciation of \$148,287 on our senior subordinated term debt investment in Xspedius Communications, LLC. This unrealized appreciation was offset by unrealized depreciation of \$575,434, most notably composed of unrealized depreciation of \$131,367 on our senior subordinated term debt investment in Consolidated Bedding, Inc. and unrealized depreciation of \$115,750 on our senior term debt in LocalTel Inc. In the aggregate, we recorded net unrealized appreciation of \$1,439,764 on our total investment portfolio as of September 30, 2006.

At September 30, 2005, we had total unrealized depreciation of \$6,231,296, which was mainly composed of unrealized depreciation in our senior subordinated term debt investment in Finn Corporation (excluding the warrants) of \$3,150,000, our senior subordinated term debt investment in Xspedius Communications of \$1,493,182, and our senior term debt in ARI Holdings, Inc. of \$1,053,939 (which was subsequently sold at the September 30, 2005 reflected fair value), partially offset by unrealized appreciation, most notably on, the value of our warrants of Finn Corporation, which had an unrealized appreciation of \$645,114 and our senior term debt investment in Woven Electronics Corporation, which had unrealized appreciation of \$431,436. This aforementioned unrealized appreciation plus unrealized appreciation of \$625,955 on certain other investments, primarily in our originated loan investments and certain syndicate participations, most notably Infor Global Solutions Ltd., which had unrealized appreciation of \$248,750, which resulted in overall net unrealized depreciation of \$4,528,791 as of September 30, 2005.



*Tax Status*

*Federal Income Taxes*

We currently qualify and 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 are required to distribute to stockholders at least 90% of investment company taxable income, as defined by the Code. We have a policy to pay out as a dividend up to 100% of that amount. In an effort to avoid certain excise taxes imposed on RICs, we currently intend to distribute during each calendar year, an amount at least equal 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 for preceding years that were not distributed during such years.

**Revenue Recognition**

*Interest Income Recognition*

Interest income is recorded on the accrual basis to the extent that such amounts are expected to be collected. We will stop accruing interest on investments and write off any previously accrued and uncollected interest when it is determined that interest is no longer collectible. Conditional interest or a success fee is recorded when earned upon full repayment of a loan investment.

*Paid in Kind Interest*

In the future, we may hold loans in our portfolio which contain a PIK interest 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 interest income. To maintain our status as a RIC, this non-cash source of income must be paid out to stockholders in the form of dividends, even though we have not yet collected the cash.

**RESULTS OF OPERATIONS**

*Comparison of the Six Months Ended March 31, 2007 to the Six Months Ended March 31, 2006*

**Investment Income**

Investment income for the six months ended March 31, 2007 was \$16,877,496, as compared to \$13,031,019 for the six months ended March 31, 2006. Interest income from our investment portfolio increased from March 31, 2006 due to the increase in new loans of \$127,641,175, offset by principal repayments and investment sales of approximately \$62,230,246.

Interest income from our investments in debt securities of private companies was \$16,153,059 for the six months ended March 31, 2007 as compared with \$12,722,371 for the six months ended March 31, 2006, which included approximately \$63,000 of PIK interest. This increase consisted of net new investments of approximately \$65.4 million for the six months ended March 31, 2007, as compared to net new investments of approximately \$1.6 million for the six months ended March 31, 2006. As a result of a refinancing by Badanco Acquisition Corp. and a full repayment by Mistras Holdings Corp., we recorded success fees of approximately \$1,733,000 during the six months ended March 31, 2007.

The annualized weighted average yield on our portfolio for the six months ended March 31, 2007 was 12.6%; there was no PIK interest accrued during the six months ended March 31, 2007. The annualized weighted average yield on our portfolio for the six months ended March 31, 2006 was 12.6% (with and without giving effect to PIK interest).

Interest income from invested cash and cash equivalents for the six months ended March 31, 2007 was \$68,914, as compared to \$13,536 for the six months ended March 31, 2006 due to an increase in cash held in the custodial account which is interest bearing.

For the six months ended March 31, 2007 and March 31, 2006, we recorded \$271,122 and \$214,126, respectively, in interest income from loans to our employees in connection with the exercise of employee stock options. The increase is the result of additional loans issued in connection with employee stock option exercises during the fourth quarter of the previous fiscal year.

For the six months ended March 31, 2007, we recorded \$384,401 of prepayment fees and other income, as compared to \$80,986 for the six months ended March 31, 2006. The income for both periods consisted of prepayment penalty fees received upon the full repayment of certain loan investments ahead of contractual maturity and prepayment fees received upon the early unscheduled principal repayments which, in both instances, were based on a percentage of the outstanding principal amount of the loan at the date of prepayment.

### **Operating Expenses**

Operating expenses, prior to credits from our Adviser, for the six months ended March 31, 2007 were \$8,733,585, as compared to \$4,557,552 for the six months ended March 31, 2006. Operating expenses for the six months ended March 31, 2007 reflected a significant increase in interest expense and management fees, prior to credits, as well as the addition of the incentive and administration fees, prior to credits, under the Amended Advisory and Administration Agreements.

Loan servicing fees of \$1,479,775 were incurred for the six months ended March 31, 2007, as compared to \$1,450,059 for the six months ended March 31, 2006. These fees were incurred in connection with a loan servicing agreement between Business Loan and our Adviser, which is based on the size of the portfolio. These fees were reduced against the amount of the base management fee due to our Adviser.

For the six months ended March 31, 2007, we incurred a gross base management fee of \$848,916, less credits for fees received by our Adviser of \$1,086,000, for a net base management fee credit of \$237,084, as compared to the six months ended March 31, 2006, in which we incurred a gross base management fee of \$621,080, less credits for fees received by our Adviser of \$1,223,000, for a net base management credit of \$601,920. The base management fee is computed quarterly as described under Investment Advisory and Management Agreement. The fees increased in the current period due to the growth of the investment portfolio as compared to the same period of the prior year and fewer credits for fees received by our Adviser which reduce the base management fee.

Effective October 1, 2006, the income based incentive fee became effective and as such we recorded a gross incentive fee of \$2,307,478, which was reduced by a voluntary waiver issued by our Adviser's board of directors of \$1,657,372, which resulted in a net incentive fee of \$650,106, which is recorded in fees due to Adviser on our consolidated statements of assets and liabilities. There was no incentive fee recorded for the six months ended March 31, 2006, as the Amended Advisory Agreement was not in effect.

Effective October 1, 2006, the Administration Agreement became effective in which we provide payments equal to our allocable portion of our Administrator's overhead expenses in performing its obligations under the Administration Agreement including, but not limited to, rent for employees of our Administrator, and our allocable portion of the salaries and benefits expenses of our chief financial officer, chief compliance officer and controller and their respective staffs. We incurred an administration fee of \$294,851 for the six months ended March 31, 2007. There was no administration fee recorded during the six months ended March 31, 2006, as the Administration Agreement was not in effect.

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Professional fees, consisting primarily of legal and audit fees, for the six months ended March 31, 2007 were \$220,001, as compared to \$233,353 for the six months ended March 31, 2006. The slight decrease is due to the reimbursement of certain legal fees at the time of investment funding.

Amortization of deferred financing costs, in connection with our line of credit, was \$126,500 for the six months ended March 31, 2007 and \$58,536 for the six months ended March 31, 2006. The increase is due to the amortization of additional fees incurred with our line of credit which were not in place during the prior year period.

Interest expense for the six months ended March 31, 2007 was \$2,931,276, as compared to \$1,600,244 for the six months ended March 31, 2006. This increase is primarily a result of increased borrowings under our line of credit during the six months ended March 31, 2007, which borrowings were partially used to finance our increased investments, borrowings remaining outstanding for longer periods of time and an increase in the interest rates on our borrowings.

Stockholder related costs for the six months ended March 31, 2007 were \$151,016, as compared to \$244,799 for the six months ended March 31, 2006. Stockholder related costs include such recurring items as transfer agent fees, NASDAQ listing fees, SEC filing fees and annual report printing fees. These fees decreased during the six months ended March 31, 2007 since there was no special proxy solicitation filed as there was during the six months ended March 31, 2006.

Directors' fees for the six months ended March 31, 2007 were \$111,220, as compared to \$54,212 for the six months ended March 31, 2006 due to the increase in annual stipend fees and their related monthly amortization.

Insurance expense for the six months ended March 31, 2007 was \$125,092, as compared to \$101,367 for the six months ended March 31, 2006. The increase is primarily the result of an increase in the amortization of our directors and officers insurance policy premiums.

There was no stock option compensation expense recorded for the six months ended March 31, 2007 as there was no longer a stock option plan in effect. Stock option compensation expense for the six months ended March 31, 2006 was \$77,322 and was the result of the adoption of the SFAS No. 123 (revised 2004) *Share-based Payment*.

Other expenses were \$137,460 for the six months ended March 31, 2007, as compared to \$116,580 for the six months ended March 31, 2006. The expenses primarily represent direct expenses such as travel related specifically to our portfolio companies, loan evaluation services for our portfolio companies, press releases and backup servicer expenses.

### **Income Tax Expense**

During the six months ended March 31, 2006, we recorded approximately \$50,000 in connection with penalties incurred on misclassified revenue on its fiscal year 2004 corporate tax return.

### **Net Realized Gain (Loss) on Sale of Investments**

During the six months ended March 31, 2007, we sold or were repaid in full on eleven syndicate loan investments for a net gain of \$86,519, as compared to an aggregate net loss of \$803,095, which was composed of \$1,180,595 loss from the sale of two investments and a gain of \$377,500 from the sale of a syndicate investment during the six months ended March 31, 2006.

### **Realized Gain on Settlement of Derivative**

During the six months ended March 31, 2007, we received interest rate cap agreement payments of \$22,793 as a result of the one month LIBOR, the Prime Rate or the Federal Funds Rate, exceeding 5%.

There was no realization during the six months ended March 31, 2006 as the one month LIBOR was below 5%.

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

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During the six months ended March 31, 2007, we recorded net unrealized depreciation of \$25,613 due to a decrease in the fair market value of our interest rate cap agreement, as compared to unrealized appreciation of \$23,766 during the six months ended March 31, 2006.

### **Net Unrealized (Depreciation) Appreciation on Investments**

For the six months ended March 31, 2007, we recorded net unrealized depreciation on investments of \$2,722,528, as compared to net unrealized appreciation of \$4,956,829, for the six months ended March 31, 2006. The unrealized depreciation is mainly attributable to the depreciated fair value on certain investments.

### **Net Increase in Net Assets from Operations**

Overall, we realized a net increase in net assets resulting from operations of \$8,248,454 for the six months ended March 31, 2007. Based on a weighted-average of 12,272,012 basic and diluted shares outstanding, our net increase in net assets from operations per weighted-average common share for the six months ended March 31, 2007 was \$0.67, basic and diluted.

For the six months ended March 31, 2006, we realized a net increase in net assets resulting from operations of \$13,823,730. Based on a weighted-average of 11,307,510 (basic) and 11,555,479 (diluted) shares outstanding, our net increase in net assets from operations per weighted-average common share for the six months ended March 31, 2006 was \$1.22 (basic) and \$1.20 (diluted).

*Comparison of the Fiscal Years Ended September 30, 2006 and September 30, 2005*

### **Investment Income**

Investment income for the fiscal year ended September 30, 2006 was approximately \$26.9 million as compared to approximately \$23.9 million for the fiscal year ended September 30, 2005. This increase is primarily a result of a rise in interest income from an increase of approximately \$136.0 million of new investments from the prior year and the collection of approximately \$1.3 million of exit fees upon the full repayment of two portfolio company investments.

Interest income from our investments in debt securities of private companies was approximately \$25.6 million, including \$63,000 of PIK interest, for the fiscal year ended September 30, 2006 as compared to \$22.4 million for the fiscal year ended September 30, 2005, including \$394,000 of PIK interest. This increase was primarily the result of approximately \$136.0 million of new investments for the fiscal year ended September 30, 2006 and the collection of approximately \$1.3 million of exit fees upon the full repayment of two portfolio company investments. The decrease in PIK income for the fiscal year ended September 30, 2006 was the result of the early repayment in full of one loan containing a PIK provision.

The weighted average yield on our portfolio for the fiscal year ended September 30, 2006 was 12.74% (with and without giving effect to PIK interest). The weighted average yield on our portfolio for the fiscal year ended September 30, 2005 was 12.23% (without giving effect to PIK interest) and 12.36% (after giving effect to PIK interest). The yields were computed based on the cost value of the investment portfolios.

Interest income from invested cash and cash equivalents for the fiscal year ended September 30, 2006 was approximately \$38,000, as compared to approximately \$33,000 for the fiscal year ended September 30, 2005. This increase was primarily caused by an increase in cash balances during the year resulting from

sales and principal repayments of portfolio investments of approximately \$124 million for the fiscal year ended September 30, 2006.

Prepayment fees and other income was approximately \$0.8 million for the fiscal year ended September 30, 2006 and \$1.1 million for the fiscal year ended September 30, 2005. For the fiscal year ended September 30, 2006, this consisted of approximately \$0.8 million of prepayment penalty fees. For the fiscal year ended September 30, 2005, this consisted of approximately \$1.0 million of prepayment penalty fees and approximately \$24,000 of waiver fees for certain loan covenants.

### **Operating Expenses**

Operating expenses for the fiscal year ended September 30, 2006 were approximately \$9.5 million, as compared to approximately \$7.5 million for the fiscal year ended September 30, 2005. This increase was mainly a result of an increase in loan servicing fees, interest expense, stockholder related costs and other expenses, offset by reductions in professional fees and amortization of deferred financing fees.

Loan servicing fees of approximately \$2.9 million were incurred for the fiscal year ended September 30, 2006 as compared to approximately \$2.5 million for the fiscal year ended September 30, 2006. These fees were incurred in connection with a loan servicing agreement between Business Loan and our Adviser, which is based on the size of the aggregate outstanding loan portfolio. These fees were directly credited against the amount of the management fee due to our Adviser.

Effective October 1, 2004, we entered into an advisory agreement with our Adviser whereby our Adviser serves as our external adviser. As compensation for the services of our Adviser, we pay our Adviser an annual advisory fee of 1.25% of total assets (as reduced by cash and cash equivalents pledged to creditors), payable in quarterly computed increments of 0.3125%, and an annual administrative fee of 0.75% of total assets (as reduced by cash and cash equivalents pledged to creditors), payable in quarterly computed increments of 0.1875%, for a total fee of 2% of total assets (as reduced by cash and cash equivalents pledged to creditors). Effective in April 2006, our Adviser's board of directors voluntarily waived the advisory fee on a temporary basis by reducing the 1.25% annual fee to 0.5% per annum applicable only to the senior syndicated loans in which we already have a second lien position. We continue to pay direct expenses including, but not limited to, directors fees, legal and accounting fees, stockholder related expenses, and directors and officers insurance. Under the advisory agreement, our Adviser provides the managerial assistance and other services to our portfolio companies and likewise our Adviser directly receives any fees for such services. Any such fees are credited directly against the 2% management fee payable to our Adviser. The 2% management fee is also directly reduced by the amount of the monthly loan servicing fees we pay to our Adviser. Overall, the management fee due to our Adviser cannot exceed 2% of total assets (as reduced by cash and cash equivalents pledged to creditors) during any given fiscal year. On October 1, 2006, we entered into the Amended Advisory Agreement with our Adviser and the Administration Agreement with our Administrator.

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The following table sets forth the quarterly computations of the management fee for the fiscal years ended September 30, 2006 and September 30, 2005, based on the quarterly increment of 0.50% (0.3125% quarterly advisory fee plus 0.1875% quarterly administrative fee) and the reduced fee for senior syndicated loans of 0.125% per quarter:

	September 30, 2006	June 30, 2006	March 31, 2006	December 31, 2005
<b>Fee:</b>				
Total assets at	\$ 223,979,932 (a)	\$ 207,265,095	\$ 217,404,695	\$ 211,823,244
Less: Senior syndicated loans subject to reduced fee	(11,011,616)	(b) (3,018,897)	(b)	
Less: Borrowings under line of credit at				(15,000,000) (c)
Total assets subject to quarterly fee of 0.50% as of	212,968,316	204,246,198	217,404,695	196,823,244
Quarterly fee rate	0.50	% 0.50	% 0.50	% 0.50
Management fee before senior syndicated loan advisory fee	1,064,841	1,021,231	1,087,023	984,116
Total senior syndicated loan advisory fee at quarterly rate 0.125%	13,765	(d) 3,774	(d)	
Gross management fee before loan servicing fee credit	1,078,606	1,025,005	1,087,023	984,116
Less: loan servicing fee from Business Loan	763,851	693,965	734,644	715,415
Management fee before credit	314,755	331,040	352,379	268,701
<b>Direct Credit to Management Fee:</b>				
Fee revenue recorded by our Adviser	289,000	539,000	673,000	550,000
Net management fee for the three months ended(e)	\$ 25,755	\$ (207,960)	\$ (320,621)	\$ (281,299)

	September 30, 2005	June 30, 2005	March 31, 2005	December 31, 2004
<b>Fee:</b>				
Total assets	\$ 205,793,094	\$ 209,320,463	\$ 213,753,998	\$ 194,085,591
Less: Borrowings under line of credit			(18,644,179)	(f) (22,435,000)
Total assets subject to quarterly fee of 0.50% as of	205,793,094	209,320,463	195,109,819	171,650,591
Quarterly fee rate	0.50	% 0.50	% 0.50	% 0.50
Gross management fee before loan servicing fee credit	1,028,965	1,046,602	975,549	858,254
Less: loan servicing fee from Business Loan	745,263	687,971	585,542	530,952
Management fee before credit	283,702	358,631	390,007	327,302
<b>Direct Credit to Management Fee:</b>				
Fee revenue recorded by our Adviser	100,000	240,600	450,000	286,500
Net management fee for the three months ended	\$ 183,702	\$ 118,031	\$ (59,993)	\$ 40,802





- (a) Excludes amounts due from employees in connection with tax withholdings related to the exercise of non-qualified stock options during the third and fourth quarters of fiscal 2006. (Refer to Note 5 of the Notes to Consolidated Financial Statements )
- (b) In April 2006, our Adviser's board of directors waived on a temporary basis the annual advisory fee from 1.25% to 0.5% (0.125% quarterly) for those senior syndicated loans in which we also hold a syndicated second lien position.
- (c) This amount represents borrowings under one of our lines of credit that were held in cash and cash equivalents as of December 31, 2005. The \$15.0 million was to be used to fund a new loan investment, however, the investment did not fund until January 2006. Solely for the purposes of calculating the amount of the management fee due to our Adviser, we treat any such amounts as cash and cash equivalents pledged to creditors under the terms of our advisory agreement with our Adviser. As a result, such amounts are deducted from our total assets for purposes of computing the asset base upon which the management fee is determined.
- (d) This amount represents the reduced quarterly advisory fee applicable only to the senior syndicated loans.
- (e) If the amount presented is in parentheses it denotes the amount is due back to us from our Adviser; if the amount is positive, it indicates that we owe our Adviser the stated amount.
- (f) This amount represents borrowings under one of our lines of credit that were held in cash and cash equivalents as of March 31, 2005 and December 31, 2004, for the purpose of satisfying our asset diversification requirements under the Code. Solely for the purposes of calculating the amount of the management fee due to our Adviser, we treat any such amounts as cash and cash equivalents pledged to creditors under the terms of our advisory agreement with our Adviser. As a result, such amounts are deducted from our total assets for purposes of computing the asset base upon which the management fee is determined.

Professional fees, consisting primarily of legal and audit fees, for the fiscal year ended September 30, 2006 were approximately \$548,000, as compared to approximately \$725,000 for the fiscal year ended September 30, 2005. The decrease is due primarily to a decrease in non-reimbursable legal fees and extra audit fees in the prior year in connection with internal control procedures.

Amortization of deferred financing costs, in connection with our lines of credit, were approximately \$140,000 for the fiscal year ended September 30, 2006 and approximately \$386,000 for the fiscal year ended September 30, 2005. The decrease is due to the completion of the amortization cycle related to certain deferred financing costs.

Interest expense for the fiscal year ended September 30, 2006 was approximately \$3.2 million as compared to approximately \$1.8 million for the fiscal year ended September 30, 2005. This increase is primarily a result of increased borrowings under our lines of credit during the fiscal year ended September 30, 2006, which borrowings were used, in part, to finance our increased investments, borrowings remaining outstanding for longer periods of time and an increase in the interest rates on our borrowings.

Stockholder related costs for the fiscal year ended September 30, 2006 were approximately \$304,000, as compared to approximately \$220,000 for the fiscal year ended September 30, 2005. Stockholder related costs include such recurring items as transfer agent fees, securities listing fees, and electronic filing fees. The increase is due mainly to the printing and mailing of the special proxy statement in connection with the special meeting of stockholders, the printing and mailing of the annual report to stockholders and the annual proxy to stockholders, and the fees associated with the Schedule TO filed in connection with the offer to amend the terms of the options outstanding under the 2001 Plan.

Directors' fees for the fiscal year ended September 30, 2006 were approximately \$116,000, as compared to approximately \$102,000 for the fiscal year ended September 30, 2005. This is the result of the addition of a new director in December 2005.

Insurance expense for the fiscal year ended September 30, 2006 was approximately \$207,000, as compared to approximately \$178,000 for the fiscal year ended September 30, 2005. The increase is primarily the result of an increase of our directors and officers insurance premiums.

Stock option compensation expense for the fiscal year ended September 30, 2006 was approximately \$285,000. This is the result of the adoption of SFAS No. 123(R) Share-based Payment. SFAS No. 123(R) replaces SFAS No. 123, Accounting for Stock-Based Compensation and supersedes Accounting Principles Board, or APB, Opinion No. 25, Accounting for Stock Issued to Employees, which we refer to as APB No. 25. SFAS No. 123(R) is effective for awards that are granted, modified, or settled in cash for annual periods beginning after June 15, 2005. We adopted SFAS No. 123(R) on October 1, 2005 using the modified prospective approach. Under the modified prospective approach, stock-based compensation expense will be recorded for the unvested portion of previously issued awards that remain outstanding at October 1, 2005 using the same estimate of the grant date fair value and the same attribution method used to determine the pro forma disclosure under SFAS No. 123. SFAS No. 123(R) also requires that all share-based payments to employees after October 1, 2005, including employee stock options, be recognized in the financial statements as stock-based compensation expense based on the fair value on the date of grant. There was no stock option compensation expense recorded for the fiscal year ended September 30, 2005. As a result of the amendment of the 2001 Plan, all unvested stock options became vested as of April 11, 2006 and therefore, all residual stock compensation expense related to options vesting subsequent to September 30, 2006 was recorded in the current fiscal year. As of September 30, 2006, there were no options outstanding.

Other expenses were approximately \$485,000 for the fiscal year ended September 30, 2006, as compared to approximately \$236,000 for the fiscal year ended September 30, 2005. Of this \$485,000, approximately \$300,000 relates to employer taxes, interest and penalties arising from withholding taxes on stock option exercises that were not remitted to the respective taxing authorities during the third and fourth quarters of fiscal 2006. The remaining \$185,000 of other expenses primarily represent direct expenses such as travel related specifically to our portfolio companies, loan evaluation services for our portfolio companies, press releases and backup services expenses.

#### **Income Tax Expense**

During the fiscal year ended September 30, 2006, we recorded approximately \$102,000 in tax expense in connection with interest penalties incurred on misclassified revenue on its fiscal year 2004 corporate tax return.

Gladstone Capital Advisers, Inc., our wholly-owned subsidiary, is subject to federal and state income taxation on the income it has recorded such as managerial assistance and other fees. During the fiscal year ended September 30, 2005, Gladstone Capital Advisers incurred aggregate federal and state income taxes of \$209,278 resulting from taxable income it received during the 2004 fiscal year. Following the externalization of our management effective October 1, 2004, substantially all revenues previously received by Gladstone Capital Advisers are now received by our Adviser. As a result, we do not anticipate incurring significant tax expense as a result of the activities of Gladstone Capital Advisers in the future.

#### **Realized (Loss) Gain on Sale of Investments**

During the fiscal year ended September 30, 2006, we sold our investments in ARI Holdings, Inc. and Marcal Paper Mills, Inc. for an aggregate loss of approximately \$1.18 million and were repaid on several syndicated loans which contained unamortized premiums resulting in realized gains of approximately

\$149,000 for a total net realized loss of approximately \$904,000. During the fiscal year ended September 30, 2005, we sold our \$975,000 syndicated participation in Burt's Bees, Inc. for a gain of \$9,750 and we sold our \$2.0 million syndicated participation in Marietta Corp. for a gain of \$20,000.

#### **Realized Gain on Settlement of Derivative**

During the fiscal year ended September 30, 2006, we received our first interest rate cap agreement payments totaling approximately \$15,000 as a result of the one month LIBOR exceeding 5%. There was no realization during the fiscal year ended September 30, 2005 as the one month LIBOR was below 5%.

#### **Net Unrealized Depreciation on Derivative**

As a result of the increase in fair market value of our interest rate cap agreement, we recorded a nominal net unrealized appreciation derivative for the fiscal year ended September 30, 2006, as compared to net unrealized depreciation of approximately \$39,000 for the fiscal year ended September 30, 2005.

#### **Net Unrealized Appreciation (Depreciation) on Investments**

For the fiscal year ended September 30, 2006, we recorded net unrealized appreciation on investments of approximately \$6.0 million as compared to net unrealized depreciation of approximately \$1.8 million for the fiscal year ended September 30, 2005. The unrealized appreciation is mainly attributable to the early repayment or sale of loans that were underperforming as of September 30, 2005, most notably Finn Corporation and ARI Holdings, Inc., as well as the unrealized appreciation on the Finn Corporation warrant currently still in our portfolio.

#### **Net Increase in Net Assets from Operations**

Overall, we realized a net increase in net assets resulting from operations of approximately \$24.4 million for the fiscal year ended September 30, 2006. Based on a weighted average of 11,381,378 (basic) and 11,615,922 (diluted) shares outstanding, our net increase in net assets from operations per weighted average common share for the fiscal year ended September 30, 2006 was \$2.15 (basic) and \$2.10 (diluted).

For the fiscal year ended September 30, 2005, we realized a net increase in net assets resulting from operations of approximately \$15.5 million. Based on a weighted average of 11,292,466 (basic) and 11,609,146 (diluted) shares outstanding, our net increase in net assets from operations per weighted average common share for the fiscal year ended September 30, 2005 was \$1.37 (basic) and \$1.33 (diluted).

#### *Comparison of the Fiscal Years Ended September 30, 2005 and September 30, 2004*

#### **Investment Income**

Investment income for the fiscal year ended September 30, 2005 was approximately \$23.9 million as compared to approximately \$20.4 million for the fiscal year ended September 30, 2004. This increase was primarily a result of a rise in interest income from an increase of approximately \$143.8 million of new investments from the prior year and the collection of approximately \$1.2 million of exit fees upon the full repayment of a portfolio company investment.

Interest income from our investments in debt securities of private companies was approximately \$22.4 million, including \$394,000 of PIK interest, for the fiscal year ended September 30, 2005 as compared to \$18.2 million for the fiscal year ended September 30, 2004, including \$553,000 of PIK interest. This increase was primarily the result of approximately \$143.8 million of new investments for the fiscal year ended September 30, 2005 and the collection of \$1.2 million of exit fees upon the full repayment of a portfolio company investment. The decrease in PIK income for the fiscal year ended September 30, 2005

was the result of scheduled principal repayments for one loan containing a PIK provision and an early repayment for another loan containing a PIK provision.

The weighted average yield on our portfolio for the fiscal year ended September 30, 2005 was 12.23% (without giving effect to PIK interest) and 12.36% (after giving effect to PIK interest). The weighted average yield on our portfolio for the fiscal year ended September 30, 2004 was 13.44% (without giving effect to PIK interest) and 13.78% (after giving effect to PIK interest). The yields were computed based on the cost value of the investment portfolios.

Interest income from invested cash and cash equivalents for the fiscal year ended September 30, 2005 was approximately \$33,000, as compared to approximately \$84,000 for the fiscal year ended September 30, 2004. This decrease was primarily caused by a decrease in cash balances as a result of \$143.8 million of new investments and generally maintaining less cash on hand and using borrowed funds to fund new investments.

No fee income was recorded for the fiscal year ended September 30, 2005, as compared to approximately \$1.1 million for the fiscal year ended September 30, 2004. This decrease was the result of the externalization of our management, effective October 1, 2004, through the engagement of our affiliate, our Adviser, to serve as our external adviser. Our Adviser receives all fees in connection with our investments and prospective investments, which fees are offset against the advisory fee payable to our Adviser. Fee income for the fiscal year ended September 30, 2004 consisted primarily of investment banking and annual review fees received in connection with investments we closed during the 2004 fiscal year. During the fiscal year ended September 30, 2004, the fee income was mainly attributable to the closing of the Gammill, Inc., Woven Electronics Corp., Benetech, Inc., Mistras Holdings Corp. (\$1.0 million investment), A and G, Inc. and Allied Extruders, Inc. investments, in the approximate aggregate amount of \$52.8 million.

Prepayment fees and other income was approximately \$1.1 million for the fiscal year ended September 30, 2005 and \$573,000 for the fiscal year ended September 30, 2004. For the fiscal year ended September 30, 2005, this consisted of approximately \$1.0 million of early principal payment penalty fees and approximately \$24,000 of waiver fees for certain loan covenants. For the fiscal year ended September 30, 2004, this amount was comprised of \$545,000 of early principal payment penalty fees, \$17,000 of waiver fees for certain loan covenants, and \$11,000 in up-front fees for a proposed investment.

### **Operating Expenses**

Operating expenses for the fiscal year ended September 30, 2005 were approximately \$7.5 million, as compared to approximately \$7.1 million for the fiscal year ended September 30, 2004. This increase was mainly a result of an increase in interest expense, stockholder related costs and professional fees. Additionally, operating expenses for the fiscal year ended September 30, 2005 reflected a significant reduction in direct operating expenses, as a result of the externalization of our management effective October 1, 2004, offset by an increase in loan servicing fees and management fees incurred as a result of this externalization.

Loan servicing fees of approximately \$2.5 million were incurred for the fiscal year ended September 30, 2005. These fees were incurred in connection with a loan servicing agreement between Business Loan and our Adviser, which became effective July 12, 2004. These fees were directly credited against the amount of the management fee due to our Adviser. During the fiscal year ended September 30, 2004, loan servicing fees of approximately \$502,000 were incurred from the period July 12, 2004, the date that our Adviser began to service our loan portfolio, since prior to that the loan portfolio was serviced under a similar agreement with Gladstone Capital Advisers, Inc., our wholly-owned subsidiary, and the fees Business Loan paid to Gladstone Capital Advisers, Inc. were eliminated upon consolidation of our financial results.

Effective October 1, 2004, we entered into an advisory agreement with our Adviser whereby our Adviser served as our external adviser. As compensation for the services of our Adviser, we paid our Adviser an annual advisory fee of 1.25% of total assets (as reduced by cash and cash equivalents pledged to creditors), payable in quarterly computed increments of 0.3125%, and an annual administrative fee of 0.75% of total assets (as reduced by cash and cash equivalents pledged to creditors), payable in quarterly computed increments of 0.1875%, for a total fee of 2% of total assets (as reduced by cash and cash equivalents pledged to creditors). We continued to pay direct expenses including, but not limited to, directors' fees, legal and accounting fees, stockholder related expenses, and directors and officers insurance. Under the advisory agreement, our Adviser provided the managerial assistance and other services to our portfolio companies that we previously provided through our wholly-owned subsidiary Gladstone Capital Advisers, and likewise our Adviser directly received any fees for such services. Any such fees were credited directly against the 2% management fee payable to our Adviser. The 2% management fee was also directly reduced by the amount of the monthly loan servicing fees we paid to our Adviser. Overall, the management fee due to our Adviser cannot exceed 2% of total assets (as reduced by cash and cash equivalents pledged to creditors) during any given fiscal year. Because we were internally managed at all times prior to October 1, 2004, no management fee was recorded for the three months ended September 30, 2004, June 30, 2004, March 31, 2004 or December 31, 2003.

The following table sets forth the quarterly computations of the management fee for the fiscal year ended September 30, 2005, based on the quarterly increment of 0.50% (0.3125% quarterly advisory fee plus 0.1875% quarterly administrative fee):

	September 30, 2005	June 30, 2005	March 31, 2005	December 31, 2004
<b>Fee:</b>				
Total assets	\$ 205,793,094	\$ 209,320,463	\$ 213,753,998	\$ 194,085,591
Less: Borrowings under line of credit(a)			(18,644,179)	(22,435,000)
Total assets subject to quarterly fee	205,793,094	209,320,463	195,109,819	171,650,591
Quarterly fee rate	0.50	% 0.50	% 0.50	% 0.50
Gross management fee before loan servicing fee credit	1,028,965	1,046,602	975,549	858,254
Less: loan servicing fee from Business Loan	745,263	687,971	585,542	530,952
Management fee before credit	283,702	358,631	390,007	327,302
<b>Direct Credit to Management Fee:</b>				
Fee revenue recorded by our Adviser	100,000	240,600	450,000	286,500
Net management fee for the three months ended	\$ 183,702	\$ 118,031	\$ (59,993)	\$ 40,802

(a) This amount represents borrowings under one of our lines of credit that were held in cash and cash equivalents as of March 31, 2005 and December 31, 2004, for each respective quarter, for the purpose of satisfying our asset diversification requirements under the Code. There were no borrowings outstanding for this purpose at September 30, 2005 or at June 30, 2005. Solely for the purposes of calculating the amount of the management fee due to our Adviser, we treat any such amounts as cash and cash equivalents pledged to creditors under the terms of our advisory agreement with our Adviser. As a result, such amounts are deducted from our total assets for purposes of computing the asset base upon which the management fee is determined.

Professional fees, consisting primarily of legal and audit fees, for the fiscal year ended September 30, 2005 were approximately \$725,000, as compared to approximately \$580,000 for the fiscal year ended

September 30, 2004. The increase is due primarily to an increase in non-reimbursable legal fees and audit costs incurred in connection with internal control procedures.

Amortization of deferred financing costs, in connection with our lines of credit, were approximately \$386,000 for the fiscal year ended September 30, 2005 and approximately \$1.4 million for the fiscal year ended September 30, 2004. The decrease is due to the expensing of approximately \$1.2 million of capitalized fees during the fiscal year ended September 30, 2004 which related to the assignment of the warehouse line of credit from a former lender, CIBC World Markets, Inc., to Deutsche Bank AG in September 2004.

Interest expense for the fiscal year ended September 30, 2005 was approximately \$1,775,000 as compared to approximately \$742,000 for the fiscal year ended September 30, 2004. This increase is a result of increased borrowings under our lines of credit during the fiscal year ended September 30, 2005, which borrowings were used, in part, to finance our increased investments, and to a lesser extent, an increase in the interest rate.

Stockholder related costs for the fiscal year ended September 30, 2005 were approximately \$220,000, as compared to approximately \$140,000 for the fiscal year ended September 30, 2004. Stockholder related costs include such recurring items as transfer agent fees, securities fees, electronic filing fees and printing and mailing of annual reports and proxy statements to stockholders.

Directors' fees for the fiscal year ended September 30, 2005 were approximately \$102,000, as compared to approximately \$112,000 for the fiscal year ended September 30, 2004. This is the result of fewer board meetings held during the fiscal year ended September 30, 2005 as compared to the fiscal year ended September 30, 2004.

Insurance expense for the fiscal year ended September 30, 2005 was approximately \$178,000, as compared to approximately \$258,000 for the fiscal year ended September 30, 2004. The decrease is primarily the result of the externalization of our management. Effective October 1, 2004, our Adviser pays general insurance expenses directly and such insurance coverage is included in the services we receive in consideration for the 2% management fee we pay to our Adviser. Insurance expense incurred during the fiscal year ended September 30, 2005 represents the amortization of our directors and officers insurance premiums, which are expenses for which we continue to be responsible following the externalization of our management.

Effective October 1, 2004, all of our employees became employees of our Adviser and therefore no salaries or benefit expenses were incurred by us for the fiscal year ended September 30, 2005, as compared to approximately \$2.6 million for the fiscal year ended September 30, 2004. We reimburse our Adviser for its employee services as part of the annual advisory and administrative fees payable under the advisory agreement.

Effective October 1, 2004, our Adviser began to pay rent directly, and therefore for the fiscal year ended September 30, 2005 no rent expense was incurred by us as compared to approximately \$139,000 of rent expense for the fiscal year ended September 30, 2004. General overhead expenses, such as rent, are also included as part of the management fee to our Adviser.

Other expenses were approximately \$236,000 for the fiscal year ended September 30, 2005, as compared to approximately \$702,000 for the fiscal year ended September 30, 2004. This decrease is primarily a result of our Adviser handling general overhead type expenses. The expenses for the fiscal year ended September 30, 2005 primarily represent direct expenses such as travel related specifically to our portfolio companies, loan evaluation services for our portfolio companies, press releases and backup services expenses.

**Income Tax Expense**



Gladstone Capital Advisers, Inc., our wholly-owned subsidiary, is subject to federal and state income taxation on the income it has recorded such as managerial assistance and other fees. During the fiscal year ended September 30, 2005, Gladstone Capital Advisers incurred aggregate federal and state income taxes of approximately \$209,000 resulting from taxable income it received during the 2004 fiscal year. Following the externalization of our management effective October 1, 2004, substantially all revenues previously received by Gladstone Capital Advisers are now received by our Adviser. As a result, we do not anticipate incurring significant tax expense as a result of the activities of Gladstone Capital Advisers in the future.

#### **Realized Gain on Sale of Investments**

During the fiscal year ended September 30, 2005, we sold our \$975,000 syndicated participation in Burt's Bees, Inc. for a gain of \$9,750 and we sold our \$2.0 million syndicated participation in Marietta Corp. for a gain of \$20,000, as compared to the fiscal year ended September 30, 2004 in which we bought and sold our \$1.0 million investment in Metokote Corporation for a gain of \$12,500.

#### **Net Unrealized Depreciation on Derivative**

As a result of the decline in fair market value of our interest rate cap agreement, we recorded net unrealized depreciation on derivative of approximately \$39,000 for the fiscal year ended September 30, 2005, as compared to net unrealized depreciation of approximately \$214,000 for the five months the investment was held during the fiscal year ended September 30, 2004.

#### **Net Unrealized Appreciation (Depreciation) on Investments**

For the fiscal year ended September 30, 2005, we recorded net unrealized depreciation on investments of approximately \$1.8 million as compared to net unrealized depreciation of approximately \$2.5 million for the fiscal year ended September 30, 2004. The increase in unrealized depreciation was mainly attributable to the decrease in the value of the Finn Corporation senior subordinated term debt of approximately \$3.2 million, a decline of approximately \$1.5 million in the fair value of Xspedius Communications, LLC and a decline in the value of ARI Holdings, Inc. of approximately \$1.1 million, partially offset by appreciation of approximately \$645,000 in the value of the Finn warrants, and the fair value of the success fee on Woven Electronics Corporation of approximately \$348,000 as well as unrealized appreciation on certain of our syndicated loan participations.

#### **Net Increase in Net Assets from Operations**

Overall, we realized a net increase in net assets resulting from operations of approximately \$15.5 million for the fiscal year ended September 30, 2005. Based on a weighted average of 11,292,466 (basic) and 11,609,146 (diluted) shares outstanding, our net increase in net assets from operations per weighted average common share for the fiscal year ended September 30, 2005 was \$1.37 (basic) and \$1.33 (diluted).

For the fiscal year ended September 30, 2004, we realized a net increase in net assets resulting from operations of approximately \$10.6 million. Based on a weighted average of 10,101,341 (basic) and 10,344,388 (diluted) shares outstanding, our net increase in net assets resulting from operations per weighted average common share for the fiscal year ended September 30, 2004 was \$1.05 (basic) and \$1.02 (diluted).

**LIQUIDITY AND CAPITAL RESOURCES**

At March 31, 2007, we had investments in debt securities of, or loans to, 51 private companies, totaling approximately \$281.5 million (cost basis) of total assets.

During the six months ended March 31, 2007 and March 31, 2006, the following investment activity occurred:

Quarter Ended	New Investments	Principal Repayments	Net Gain/(Loss) on Disposal
March 31, 2007	\$ 75,330,167	\$ 38,263,017	\$ 84,205
December 31, 2006	52,311,008	23,967,229	2,314
	\$ 127,641,175	\$ 62,230,246	\$ 86,519
March 31, 2006	\$ 38,471,109	\$ 24,815,067	\$ 377,500
December 31, 2005	26,688,457	38,702,066	(1,180,595)
	\$ 65,159,566	\$ 63,517,133	\$ (803,095)

During the years ended September 30, 2006, 2005 and 2004, the following investment activity occurred:

Year Ended	New Investments	Principal Repayments	Net Gain/(Loss) on Disposal
September 30, 2006	\$ 135,954,879	\$ 124,009,929	\$ (903,945)
September 30, 2005	\$ 143,794,006	\$ 88,019,136	\$ 29,750
September 30, 2004	\$ 86,267,500	\$ 47,158,995	\$ 12,500

The following table summarizes the contractual principal amortization and maturity of our investment portfolio by fiscal year:

Fiscal Year Ended September 30,	Amount
2007	\$ 3,467,481
2008	10,569,881
2009	18,976,253
2010	30,422,730
2011	80,548,730
Thereafter	137,540,375
	\$ 281,525,450

Net cash used in operating activities for the six months ended March 31, 2007, consisting primarily of the items described in Results of Operations and the investment activity described above, was approximately \$56.5 million as compared to net cash provided by operating activities of approximately \$1.6 million for the six months ended March 31, 2006. Net cash provided by investing activities consisted of \$300,941 and \$23,094 for the six months ended March 31, 2007 and March 31, 2006, respectively, and consisted of the principal repayment of employee loans. Net cash provided by financing activities for the six months ended March 31, 2007 was approximately \$58.5 million and mainly consisted of borrowings on our line of credit of approximately \$146.9 million, offset by repayments on line of credit borrowings of approximately \$76.6 million, and approximately \$10.3 million for the payment of dividends. Net cash used in financing activities was approximately \$1.8 million for the six months ended March 31, 2006 and consisted primarily of net cash provided from borrowings on our line of credit, net of repayments, of approximately \$7.3 million, offset by the payment of dividends of approximately \$9.2 million.

During the six months ended March 31, 2007, cash and cash equivalents increased from approximately \$732,000 to approximately \$3.0 million.

Subsequent to March 31, 2007, we sold either outright or to our affiliate Gladstone Investment approximately \$16.9 million of syndicated loan participations via an independent broker and were repaid in full on one loan origination investment of approximately \$5.6 million and received a success fee of approximately \$195,000. Sales to Gladstone Investment were made in reliance on Rule 17a-7 of the 1940 Act. The proceeds from the sales were used to reduce our borrowings on our line of credit. We also funded approximately \$39.4 million of loan originations, increased our positions in certain syndicate investments by approximately \$4.4 million and funded approximately \$1.0 million of lines of credit already held in our portfolio, for total aggregate funding of approximately \$44.8 million. As of June 15, 2007, our outstanding balance on our line of credit was approximately \$165.6 million.

Net cash provided by operating activities for the fiscal year ended September 30, 2006, consisting primarily of the items described in Results of Operations and the investment activity described above, was approximately \$7.2 million as compared to net cash used in operating activities of approximately \$61.5 million for the fiscal year ended September 30, 2005. Net cash provided by investing activities was approximately \$0.2 million for the fiscal year ended September 30, 2006 and consisted of the repayment of employee loans. Net cash used in financing activities for the fiscal year ended September 30, 2006 was approximately \$7.2 million and consisted of approximately \$149.8 million of repayments on the lines of credit, and approximately \$18.6 million for the payment of dividends. These outflows were partially offset by approximately \$146.7 million of cash received from borrowings on the lines of credit and the exercise of stock options for approximately \$14.7 million.

During the fiscal year ended September 30, 2006, cash and cash equivalents increased from approximately \$504,000 at the beginning of the year to approximately \$732,000 at the end of the year. This increase was largely the result of cash generated from operations offset by investment purchases and repayments of our revolving credit facility.

Net cash used in operating activities for the fiscal year ended September 30, 2005, consisting primarily of the items described in Results of Operations and the investment activity described above, was approximately \$61.5 million as compared to net cash used operating activities of approximately \$82.7 million for the fiscal year ended September 30, 2004. In addition, net cash used in operating activities for the year ended September 30, 2005 included the repayment of the repurchase agreement (as described below) of approximately \$21.3 million. Net cash provided by investing activities was approximately \$0.8 million for the fiscal year ended September 30, 2005 and was comprised of employee loan principal repayments. Net cash used in financing activities for the fiscal year ended September 30, 2005 was approximately \$4.8 million and consisted mainly of approximately \$142.7 million of repayments on the lines of credit, approximately \$17.1 million for the payment of dividends, \$105,000 paid to renew a line of credit and approximately \$111,000 of costs incurred subsequent to the shelf offering in September 2004. These outflows were partially offset by approximately \$155.0 million of cash received from borrowings on the lines of credit and the exercise of stock options for approximately \$270,000.

During the fiscal year ended September 30, 2005, cash and cash equivalents decreased from approximately \$66.0 million at the beginning of the year to approximately \$504,000 at the end of the year. This decrease was largely the result of the purchase of new investments, the repayment of the repurchase agreement in October 2004 (as described below) and also the payment of dividends throughout the fiscal year ended September 30, 2005.

Net cash used in operating activities for the fiscal year ended September 30, 2004, consisting primarily of the items described in Results of Operations and the investment activity described above, was approximately \$82.7 million. At September 30, 2004, the net cash used was due largely in part to \$57.1 million used in connection with the purchase of the repurchase agreement and the repayments of the repurchase agreement, and new investments of approximately \$86.3 million, partially offset by principal repayments of \$47.2 million. Net cash provided by investing activities for the fiscal year ended

September 30, 2004 was approximately \$0.2 million and consisted of principal repayments on employee loans. Net cash provided by financing activities was approximately \$47.3 million for the fiscal year ended September 30, 2004 and consisted primarily of proceeds from a public shelf offering of common stock which yielded net proceeds of approximately \$24.4 million, the borrowings, net of repayments, on the lines of credit for net proceeds of approximately \$40.7 million, partially offset by the payment of dividends of approximately \$17.1 million.

During the fiscal year ended September 30, 2004, cash and cash equivalents decreased from approximately \$101.1 million at the beginning of the year to approximately \$66.0 million at the end of the year. This decrease was largely the result of the purchase of new investments and the repurchase agreement described below.

On September 29, 2004, we entered into a repurchase agreement, which we refer to as the FBW Repurchase Agreement, with Ferris Baker Watts, Incorporated for \$44,984,950. On September 30, 2004, this amount was reduced to \$21,345,997 with the application of the net proceeds from a public offering of our common stock. This remaining balance was settled on October 1, 2004. The FBW Repurchase Agreement was recorded at cost and was fully collateralized by a United States Treasury Bill with a fair value of \$50,000,000, a carrying value of \$49,984,950 that matured on October 7, 2004 and earned interest of \$2,133. The interest rate on the FBW Repurchase Agreement was 4.25% for a cost of \$7,831. In the future, we may use a similar form of repurchase agreement as an investment option or in order to satisfy certain asset diversification requirements and maintain our status as a RIC under Subchapter M of the Code.

In order to qualify as a RIC and to 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 dividends of \$0.14 per common share for July, August, September, October, November and December 2006 and January, February and March 2007 and \$0.135 per common share for January, February, March, April, May and June 2006, and October, November and December 2005. In April 2007, our Board of Directors declared a monthly cash dividend of \$0.14 per common share for each of April, May and June 2007.

We anticipate continuing to borrow funds and, from time to time issuing additional equity securities, to obtain additional capital to make further investments. On May 2, 2007, we completed a public offering of 2,000,000 shares of our common stock, at a price of \$24.25 per share, under a shelf registration statement and pursuant to the terms set forth in a prospectus dated April 16, 2007, as supplemented by a final prospectus dated April 27, 2007. Net proceeds of the offering, after underwriting discounts and offering expenses were approximately \$45,625,000 and were used to repay outstanding borrowings under our line of credit.

We have filed a registration statement with the SEC, of which this prospectus is a part, that once declared effective by the SEC, would permit us to issue, through one or more transactions, up to an aggregate of \$300 million in securities, consisting of common stock and/or debt securities. We may not issue any securities under this registration statement until the SEC has declared the registration statement effective, and we currently have no immediate plans to issue any securities under the registration statement.

#### **Revolving Credit Facility**

Through our wholly-owned subsidiary, Business Loan, we have a \$220 million revolving credit facility, which we refer to as the DB Facility, with Deutsche Bank AG, as administrative agent, which is scheduled to mature on May 23, 2008. Pursuant to the DB Facility, Business Loan has pledged the loans it holds to secure future advances by certain institutional lenders. Interest rates charged on the advances under the

DB Facility will be based on LIBOR, depending on market conditions, and will adjust periodically. As of June 15, 2007, our outstanding principal balance under the DB Facility was approximately \$165.6 million at an interest rate of approximately 6.07%. Available borrowings are subject to various constraints imposed by Deutsche Bank AG, based on the aggregate loan balance pledged by Business Loan, which varies as loans are added and repaid, regardless of whether such repayments are early prepayment or are made as contractually required. At June 15, 2007, the remaining borrowing capacity available under the DB Facility was approximately \$54.4 million.

The DB Facility, which is available for general corporate purposes, contains covenants that, among other things, 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 DB Facility also restricts some of the terms and provisions (including interest rates, terms to maturity and payments schedules) and limits the borrower and industry concentrations of loans that are eligible to secure advances. As of March 31, 2007, Business Loan was in compliance with all of the DB Facility covenants. We currently intend to securitize all of the loans held by Business Loan and to use the proceeds from the securitization to pay down any amounts then outstanding under the revolving credit facility. However, there can be no assurance that we will be able to successfully securitize any of these loans on terms acceptable to us, if at all.

The administrative agent also requires that any interest or principal payments on pledged loans be remitted directly by the borrower into a lockbox account with the Bank of New York as custodian. Deutsche Bank AG is also the trustee of the account and once a month remits the collected funds to us. For the six months ended March 31, 2007, the amount due from custodian increased by approximately \$1.2 million.

Our Adviser services the loans pledged under the DB Facility. As a condition to this servicing arrangement, we executed a performance guaranty pursuant to which we guaranteed that our Adviser would comply fully with all of its obligations under the facility. The performance guaranty requires us to maintain a minimum net worth of \$100 million plus 75% of any new equity or subordinated debt issued. The performance guaranty also requires us to maintain asset coverage with respect to senior securities representing indebtedness of at least 200%, in accordance with Section 18 of the 1940 Act. As of March 31, 2007, we were in compliance with our covenants under the performance guaranty.

***Contractual Obligations and Off-Balance Sheet Arrangements***

As of March 31, 2007, we were party to signed and non-binding term sheets for two loan originations for \$14.0 million. We expect to fund these potential investments as follows:

Contractual Obligations	Total	Payment Due by Period			
		Less than 1 Year	1-3 Years	3-5 Years	More than 5 Years
Investments	\$ 14,000,000	\$ 14,000,000			
Total	\$ 14,000,000	\$ 14,000,000	\$	\$	\$

As of the date of this prospectus, one of the investment purchase obligations summarized above in an aggregate amount of \$7.0 million has been funded. See Note 11 Contractual Obligations in our unaudited Consolidated Financial Statements for further information.

All prospective investments are subject to, among other things, the satisfactory completion of our due diligence investigation of each borrower, acceptance of terms and structure and receipt of necessary consents. With respect to each prospective loan, we will only agree to provide the loan if, among other things, the results of our due diligence investigations are satisfactory, the terms and conditions of the loan are acceptable and all necessary consents are received. We have initiated our due diligence investigations

of the potential borrowers, however, there can be no guarantee that facts will not be discovered in the course of completing the due diligence that would render a particular investment imprudent or that any of these investments will actually be made.

We did not have any significant off-balance sheet arrangements, as defined in Item 303(a)(4)(ii) of SEC Regulation S-K, as of March 31, 2007.

***Quantitative and Qualitative Disclosures about Market Risk.***

We are subject to financial market risks, including changes in interest rates. We estimate that ultimately approximately 20% of the loans in our portfolio will be made at fixed rates and approximately 80% will be made at variable rates. As of March 31, 2007, our portfolio had approximately 56% of the total loan portfolio cost basis at variable rates with a floor, approximately 2% of the total loan portfolio cost basis at a variable rate with a floor and ceiling, 40% of the total loan portfolio cost basis at variable rates without a floor or ceiling and approximately 1% of the total loan portfolio cost basis at a fixed rate.

We have a \$220 million revolving credit facility, based on variable rates, with Deutsche Bank AG, which matures May 23, 2008.

In February 2004, we entered into an interest rate cap agreement in order to fulfill an obligation under our line of credit to enter into certain hedging transactions in connection with our borrowings under the line of credit. We purchased this interest rate cap agreement with a notional amount of \$35 million (which is amortized quarterly) for a one-time, up-front payment of \$304,000. The interest rate cap agreement entitles us to receive payments, if any, equal to the amount by which interest payments on the current notional amount at one month LIBOR exceed the payments on the current notional amount at 5%. The cap expires in February 2009. This interest rate cap agreement effectively caps our interest payments on our line of credit borrowing, up to the notional amount of the interest rate cap, at five percent. This mitigates our exposure to increases in interest rates on our borrowings on our lines of credit, which are at variable rates. At March 31, 2007, the cap agreement had a fair market value of \$24,671 and a current notional amount of \$10.9 million. At March 31, 2007, the one month LIBOR rate was approximately 5.32%.

To illustrate the potential impact of changes in interest rates on our net increase in net assets resulting from operations, we have performed the following analysis, which assumes that our balance sheet remains constant and no further actions beyond the interest rate cap agreement are taken to alter our existing interest rate sensitivity. Under this analysis, a hypothetical increase in the one month LIBOR by 1% would increase our net increase in net assets resulting from operations by approximately \$1.5 million or 8.2%, over the next twelve months, compared to the net increase in net assets resulting from operations for the twelve months ended March 31, 2007. A hypothetical decrease in the one month LIBOR by 1% would decrease net increase in net assets resulting from operations by approximately \$1.5 million, or 8.2%, over the next twelve months, compared to the net increase in net assets resulting from operations for the twelve months ended March 31, 2007. Although management believes that this analysis is indicative of our existing interest rate sensitivity, it does not adjust for potential changes in credit quality, size and composition of our loan portfolio on the balance sheet and other business developments that could affect net increase in net assets resulting from operations. Accordingly, no assurances can be given that actual results would not differ materially from the results under this hypothetical analysis.

In the event that we securitize a portion of our loan portfolio, we believe that we will likely be required to enter into further hedging arrangements in the future with respect to securitized loans. While hedging activities may mitigate our exposure to adverse fluctuations in interest rates, certain hedging transactions that we may enter into in the future, such as interest rate swap agreements, may also limit our ability to participate in the benefits of lower interest rates with respect to our portfolio of investments.

We may also experience risk associated with investing in securities of companies with foreign operations. We currently do not anticipate investing in debt or equity of foreign companies, however, some potential portfolio companies may have operations located outside the United States. These risks include, but are not limited to, fluctuations in foreign currency exchange rates, imposition of foreign taxes, changes in exportation regulations and political and social instability.

On October 1, 2006, we implemented an amended and restated investment advisory and management agreement with our Adviser. In addition to providing for a base management fee based on our total assets, this agreement contemplates a quarterly incentive fee based on our pre-incentive fee net investment income and an annual incentive fee based on our capital gains, if any. Our Adviser has the ability to issue a full or partial waiver of the incentive fee for current and future periods, however our Adviser is not required to issue this waiver. If our Adviser does not issue this waiver in future quarters, it could negatively impact our earnings and may compromise our ability to maintain our current level of, or increase, distributions to our stockholders, which could have a material adverse impact on our stock price.

## **BUSINESS**

### **Overview**

We were incorporated under the General Corporation Laws of the State of Maryland on May 30, 2001. Our investment objectives are to achieve a high level of current income by investing in debt securities, consisting primarily of senior notes, second lien notes, and senior subordinated notes of established private businesses that are backed by leveraged buyout funds, venture capital funds or others, with a particular emphasis on second lien and senior subordinated notes. In addition, we may acquire existing loans, which meet this profile, from leveraged buyout funds, venture capital funds and others. 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 extend 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 1940 Act.

### *Our Investment Strategy*

We seek to invest in small and medium-sized businesses that meet certain criteria, including some or all of the following: (1) the potential for growth in cash flow, (2) adequate assets for loan collateral, (3) experienced management teams with a significant ownership interest in the borrower, (4) profitable operations based on the borrower's cash flow, (5) reasonable capitalization of the borrower (usually by buyout funds or venture capital funds) and (6) 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 by the borrower or by exercise of our right to require the borrower to buy back its warrants. We lend to borrowers that need funds to, among other things, effect a change of control, restructure their balance sheets, or finance growth, including acquisitions.

We believe that our business strategy will enable us 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 backed by leveraged buyout funds, venture capital funds or others. In addition, from time to time we might acquire existing loans that meet this profile from leveraged buyout funds, venture capital funds and others. 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 might receive when we make loans. Our loans typically range from \$5 million to \$15 million, although this investment size may vary proportionately as the size of our capital base changes. Our loans generally mature in no more than seven years and accrue interest at fixed or variable rates.

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

Our Adviser is our investment adviser and is led by a management team which has extensive experience in our lines of business. All of our directors and executive officers serve as either directors or executive officers, or both, of Gladstone Commercial, a publicly traded real estate investment trust; Gladstone Investment, a publicly traded business development company; our Adviser; and our Administrator. Our Adviser also has a wholly-owned subsidiary, our Administrator, which employs our chief financial officer, chief compliance officer, controller, treasurer and their respective staffs.

Our Adviser and our Administrator also provide investment advisory and administrative services to our affiliates Gladstone Commercial, Gladstone Investment and Gladstone Land Corporation, an agricultural real estate company owned by Mr. Gladstone. In the future, our Adviser may provide investment advisory and administrative services to other funds, both public and private, of which it is the sponsor.



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

### **Corporate Information**

Our executive offices are located at 1521 Westbranch Drive, Suite 200, McLean, Virginia 22102 and our telephone number is (703) 287-5800. Our corporate website is located at [www.gladstonecapital.com](http://www.gladstonecapital.com). Our website and the information contained therein or connected thereto shall not be deemed to be incorporated into this prospectus or the registration statement of which it forms a part.

### **Investment Process**

#### ***Overview of Loan Origination and Approval Process***

To originate loans, our Adviser's lending professionals use an extensive referral network comprised of venture capitalists, leveraged buyout funds, investment bankers, attorneys, accountants, commercial bankers and business brokers. Our Adviser's lending professionals review informational packages from these and other sources in search of potential financing opportunities. If a potential opportunity matches our investment objectives, the lending professionals will seek an initial screening of the opportunity from our Adviser's investment committee, which is composed of Messrs. Gladstone, Brubaker and Stelljes. If the applicant passes this initial screening, the lending professionals will conduct a due diligence investigation of the applicant. Upon completion of the due diligence investigation, the lending professionals create a detailed borrower profile summarizing the prospective borrower's historical financial statements, industry and management team and analyzing its conformity to our general investment criteria. The lending professionals then present this profile to the investment committee, which must unanimously approve each loan.

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

We have identified certain characteristics that we believe are important to profitably lend to small and medium-sized businesses. The criteria listed below provide general guideposts for our lending and investment decisions, although not all of these criteria may be followed in each instance.

- *Growth.* In addition to generating sufficient cash flow to service its debt, a potential borrower generally will be required to establish its ability to grow its cash flow. Anticipated growth will be a key factor in determining the value ascribed to any equity position we acquire in connection with our loans.
- *Significant sponsor.* We seek businesses in which leveraged buyout funds or venture capital funds have invested. We believe that a business in which a substantial equity sponsor has made a meaningful investment is more likely to be a good borrowing candidate.
- *Liquidation value of assets.* Although we do not generally intend to operate as an asset-based lender, liquidation value of the assets collateralizing our loans is an important factor in each credit decision. Emphasis is placed both on tangible assets (e.g., inventory, plant, property and equipment) and intangible assets (e.g., accounts receivable, customer lists, networks, databases and recurring revenue streams).
- *Experienced management team.* We generally require that each borrower have a management team that is experienced and properly incentivized through a significant ownership interest in the borrower. We generally will require that a borrower have, at a minimum, a strong chief executive



officer and chief financial officer who have demonstrated the ability to accomplish the borrower's objectives and implement its business plan.

- *Profitable or near-profitable operations.* We focus on borrowers that are profitable or near-profitable at the operating level. We do not typically lend to, or invest in, start-up or other early stage companies, nor do we typically lend to, or invest in, businesses that are experiencing significant operating problems.
- *Exit strategy.* Prior to making a loan for which we receive a warrant to purchase stock of the borrower or other yield enhancement, we analyze the potential for the borrower to experience a liquidity event that will allow us to realize value for our equity position. Liquidity events include, among other things, an initial public offering, a private sale of our financial interest, a merger or acquisition of the borrower or a purchase of our equity position by the borrower or one of its stockholders.

#### *Extensive Due Diligence*

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

- a review of the potential borrower's historical and projected financial information;
- interviews with management, employees, customers and vendors of the applicant;
- background checks; and
- research on the applicant's products, services or particular industry.

We also rely on the long-term relationships that our Adviser's professionals have with venture capitalists, leveraged buyout funds, investment bankers, commercial bankers and business brokers, and on the extensive direct experiences of our executive officers and managing directors in providing debt and equity capital to small and medium-sized private businesses. Prior to closing on our investments, additional due diligence may be conducted on our behalf by attorneys, accountants or other outside advisers as appropriate.

#### *Investment Structure*

We typically invest in senior, senior subordinated and junior subordinated loans. Our loans typically range from \$5 million to \$15 million, although the size of our investments may vary as our capital base changes. Our loans generally mature within seven years and accrue interest at a fixed or variable rate that exceeds the prime rate. In the past, some of our loans have had a provision that calls for some portion of the interest payments to be deferred and added to the principal balance so that the interest is paid, together with the principal, at maturity. This form of deferred interest is often called "paid in kind," or PIK, interest, and, when earned, we record PIK income as interest income and add the PIK interest to the principal balance of the loans. At present, none of our loans contain a PIK provision.

To the extent possible, our loans generally are collateralized by a security interest in the borrower's assets. In senior and subordinated loans, we do not usually have the first claim on these assets. Interest payments on loans we make will generally be made monthly or quarterly (except to the extent of any PIK interest) with amortization of principal generally being deferred for several years. The principal amount of the loans and any accrued but unpaid interest will generally become due at maturity at five to seven years. We seek to make loans that are accompanied by warrants to purchase stock in the borrowers or other yield enhancement features, such as success fees. Any warrants that we receive will typically have an exercise price equal to the fair value of the portfolio company's common stock at the time of the loan and entitle us

to purchase a modest percentage of the borrower's stock. Success fees are conditional interest that is paid if the borrower is successful. The success fee is calculated as additional interest on the loan and is paid upon the occurrence of certain triggering events, such as the sale of the borrower. If the event or events do not occur, no success fee will be paid.

From time to time, a portfolio company may request additional financing, providing us with additional lending opportunities. We will consider such requests for additional financing under the criteria we have established for initial investments and we anticipate that any debt securities we acquire in a follow-on financing will have characteristics comparable to those issued in the original financing. In some situations, our failure, inability or decision not to make a follow-on investment may be detrimental to the operations or survival of a portfolio company, and thus may jeopardize our investment in that borrower.

As noted above, we expect to receive yield enhancements in connection with many of our loans, which may include warrants to purchase stock. If a financing is successful, not only will our debt securities have been repaid with interest, but we will be in a position to realize a gain on the accompanying equity interests or other yield enhancements. The opportunity to realize such gain may occur if the borrower is sold to new owners or if it makes a public offering of its stock. In most cases, we will not have the right to require that a borrower undergo an initial public offering by registering securities under the Securities Act, but we generally will have the right to sell our equity interests in any subsequent public offering by the borrower. Even when we have the right to participate in a borrower's public offering, the underwriters might insist, particularly if we own a large amount of equity securities, that we retain all or a substantial portion of our shares for a specified period of time. Moreover, we may decide not to sell an equity position even when we have the right and the opportunity to do so. Thus, although we expect to dispose of an equity interest after a certain time, situations may arise in which we hold equity securities for a longer period.

#### ***Temporary Investments***

Pending investment in the debt of private companies, we invest our otherwise uninvested cash primarily in cash, cash items, government securities or high-quality debt securities maturing in one year or less from the time of investment, to which we refer collectively as temporary investments, so that 70% of our assets are qualifying assets for purposes of the business development company provisions of the 1940 Act. For information regarding regulations to which we are subject and the definition of qualifying assets, see Regulation as a Business Development Company.

#### ***Hedging Strategies***

Although it has not yet happened, nor do we expect this to happen in the near future, when one of our portfolio companies goes public, we may undertake hedging strategies with regard to any equity interests that we may have in that company. We may mitigate risks associated with the volatility of publicly traded securities by, for instance, selling securities short or writing or buying call or put options. Hedging against a decline in the value of such investments in public companies would not eliminate fluctuations in the values of such investments or prevent losses if the values of such investments decline, but would establish other investments designed to gain from those same developments. Therefore, by engaging in hedging transactions, we can moderate the decline in the value of our hedged investments in public companies. However, such hedging transactions would also limit our opportunity to gain from an increase in the value of our investment in the public company. Pursuant to our initial line of credit, we agreed to enter into hedging transactions, such as interest rate cap agreements. To date, we hold only one interest rate cap agreement. In the event that we securitize a portion of our loan portfolio in the future, we believe that we will likely be required to enter into similar arrangements with respect to the securitized loans. Hedging strategies do pose risks to us and our stockholders, however we believe that such activities, because they will be limited to only a portion of our portfolio, are manageable.

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

#### ***Extensive Loan Referral Network***

Our executive officers and our Adviser's managing directors have an extensive referral network of venture capitalists, leveraged buyout funds, investment bankers, attorneys, commercial bankers and business and financial brokers. We believe that this established network, consisting of relationships established over many years by Messrs. Gladstone, Stelljes, and Brubaker and our Adviser's managing directors will generate opportunities to identify and make senior and subordinated loans to selected businesses that satisfy our investment criteria. We intend to continue to pursue additional informal relationships with other leveraged buyout funds and venture capital funds that we believe may lead to the origination of loans.

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

We believe our management team's broad expertise and its ability to draw upon many years of combined experience enables our Adviser to identify, assess, and structure investments successfully across all levels of a company's capital structure and manage potential risk and return at all stages of the economic cycle. We are not subject to many of the regulatory limitations that govern traditional lending institutions such as banks. As a result, we expect to be flexible in selecting and structuring investments, adjusting investment criteria and transaction structures, and, in some cases, the types of securities in which we invest. We believe that this approach should enable our Adviser to identify attractive investment opportunities that will continue to generate current income and capital gain potential throughout the economic cycle, including during turbulent periods in the capital markets. One example of our flexibility is our ability to exchange our publicly-traded stock for the stock of an acquisition target in a tax-free reorganization under the Code. After completing an acquisition in such an exchange, we can restructure the capital of the small company to include senior and subordinated debt.

#### ***Leverage***

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

privileges as it deems appropriate, provided that such an issuance adheres to the requirements of the 1940 Act. See Regulation as a Business Development Company Asset Coverage for a discussion of our leveraging constraints.

### ***Securitization***

We have a wholly-owned subsidiary, Business Loan, which acquires and holds loans that we anticipate will be securitized in the future. Business Loan entered into a credit agreement with a group of institutional lenders that provides for a \$170 million revolving credit facility. We use these proceeds to make additional loans and increase the size of our loan portfolio. We currently intend to securitize all or a portion of the loans held by Business Loan and, if we are able to securitize these loans, we will use the proceeds from the securitization to pay down any amounts outstanding under the revolving credit facility. On February 9, 2007, we increased our revolving credit facility by \$20 million to \$170 million and on May 25, 2007 we further increased the facility by \$50 million to \$220 million.

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

#### ***Monitoring***

Our Adviser's investment professionals monitor the financial trends of each portfolio company on an ongoing basis to determine if each is meeting its respective business plans and to assess the appropriate course of action for each company. We monitor this information regarding the status and performance of each portfolio company, and use it to evaluate the overall performance of our portfolio.

Our Adviser employs various methods of evaluating and monitoring the performance of our investments, which include some or all of the following:

- Assessment of success in the portfolio company's overall adherence to its business plan and compliance with covenants;
- Attendance at and participation in meetings of the portfolio company's board of directors;
- Periodic contact, including formal update interviews with portfolio company management, and, if appropriate, the financial or strategic sponsor;
- Comparison with other companies in the portfolio company's industry; and
- Review of monthly and quarterly financial statements and financial projections for portfolio companies.

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

The 1940 Act requires that a business development company make available managerial assistance to its portfolio companies by providing significant guidance and counsel concerning the management, operations, or business objectives and policies of the respective portfolio company. We provide these and other services to our portfolio companies through our Adviser. Currently, neither we nor our Adviser charges a fee for managerial assistance. Our Adviser receives fees for other services it provides to portfolio companies. These other fees are typically non-recurring, are recognized as revenue when earned and are generally paid directly to our Adviser by the borrower or potential borrower upon closing of the investment. The services our Adviser provides to portfolio companies vary by investment, but generally include a broad array of services, such as investment banking services, arranging bank and equity financing, structuring financing from multiple lenders and investors, reviewing existing credit facilities, restructuring existing loans, raising equity and debt capital, turnaround management, merger and acquisition services and recruiting new management personnel. When our Adviser receives fees for these services, all of those fees are credited to the base management fees we pay to our Adviser. Any services of this nature subsequent to the closing would typically generate a separate fee at the time of completion.



Our Adviser also receives fees for monitoring and reviewing portfolio company investments. These fees are recurring and are generally paid annually or quarterly in advance to our Adviser throughout the life of the investment. Fees of this nature are recorded as revenue by our Adviser when earned and are not credited against the base management fees. While our Adviser receives all fees in connection with our investments, such fees received by our Adviser, with the exception of monitoring and review fees, are entirely credited to us as a reduction of the advisory fee payable under the advisory agreement between us.

Prior to making an investment, we ordinarily enter into a non-binding term sheet with the potential borrower. Upon execution of the non-binding term sheet, the potential borrower generally pays our Adviser a non-refundable fee for its services rendered through the date of the non-binding term sheet. These fees are received by our Adviser and are offset against the base management fee payable to our Adviser, which has the effect of reducing our expenses to the extent of any such fees received by our Adviser.

#### ***Valuation Process***

The following is a general description of the steps we take each quarter to determine the value of our investment portfolio. All of our portfolio investments are recorded at fair value as determined in good faith by our Adviser and our management using procedures established by, and under the direction of our Board of Directors. As a result, there is uncertainty as to the value of our portfolio investments, and our estimates of fair value may differ significantly from the values that could be obtained if a ready market for the securities existed. Investments for which market quotations are readily available are recorded in our financial statements at such market quotations. With respect to any investments for which market quotations are not readily available, we follow the following valuation process each quarter:

- Our quarterly valuation process begins with each portfolio company or investment being initially assessed by our Adviser's investment professionals responsible for the investment, using valuation policies and procedures previously established by our Board of Directors.
- For all debt securities other than those that we value using the latest bid and ask price, we will seek an independent opinion of value of such debt securities from SPSE.
- Preliminary valuation conclusions are then discussed with our management, and documented, along with any SPSE opinions of value, for review by our Board of Directors.
- Our Board of Directors reviews this documentation and discusses the input of our Adviser, management, and the opinions of value of SPSE to arrive at a determination for the aggregate fair value of our portfolio of investments.

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

#### **Investment Advisory and Administration Agreements**

Since October 1, 2004, we have been externally managed pursuant to a contractual investment advisory arrangement with our Adviser, under which our Adviser has directly employed all of our personnel and paid its payroll, benefits, and general expenses directly. Our initial investment advisory agreement with our Adviser, which we refer to as the Initial Advisory Agreement, was in place from October 1, 2004 through September 30, 2006. On October 1, 2006, we entered into an amended and restated investment advisory agreement with our Adviser, which we refer to as the Amended Advisory Agreement, and an administration agreement with our Administrator, which we refer to as the Administration Agreement. Our Board of Directors proposed the Amended Advisory Agreement to stockholders in order to provide what it considers to be more appropriate incentives to reward fund



management, and our stockholders approved each of these agreements on December 2, 2005. The management services and fees in effect under the Initial and Amended Advisory Agreements are described below. In addition to the fees described below, certain fees received by our Adviser from our portfolio companies were credited against the investment advisory fee under the Initial Advisory Agreement, and will continue to be paid to our Adviser and credited under the Amended Advisory Agreement. In addition, we continue to pay our direct expenses including, but not limited to, directors fees, legal and accounting fees, and stockholder related expenses under the Amended Advisory Agreement.

***Management services and fees in effect through September 30, 2006***

Pursuant to the Initial Advisory Agreement, we paid our Adviser an annual advisory fee of 1.25% of our total assets (as reduced by cash and cash equivalents pledged to creditors), payable in quarterly increments of 0.3125%, and an annual administrative fee of 0.75% of our total assets (as reduced by cash and cash equivalents pledged to creditors), payable in quarterly increments of 0.1875%. Our Adviser's board of directors agreed to waive, for the quarters ending June 30, 2006 and September 30, 2006, the annual advisory fee of 1.25% to 0.5% for those senior syndicated loans in which we had existing syndicated second lien participations.

***Management services and fees under the amended and restated investment advisory agreement and administrative fees under the administrative agreement***

Effective October 1, 2006, we now pay our Adviser an annual base management fee of 2% of our average gross assets, which is defined as total assets less cash and cash equivalents pledged to creditors calculated as of the end of the two most recently completed fiscal quarters, in addition to a two-part incentive fee. The first part of the incentive fee is an income-based incentive fee which rewards our Adviser if our quarterly net investment income (before giving effect to any incentive fee) exceeds 1.75% of our net assets (the hurdle rate). We will pay our Adviser an income incentive fee with respect to our pre-incentive fee net investment income in each calendar quarter as follows:

- no incentive fee in any calendar quarter in which our pre-incentive fee net investment income does not exceed the hurdle rate (7% annualized);
- 100% of our pre-incentive fee net investment income with respect to that portion of such pre-incentive fee net investment income, if any, that exceeds the hurdle rate but is less than 2.1875% in any calendar quarter (8.75% annualized); and
- 20% of the amount of our pre-incentive fee net investment income, if any, that exceeds 2.1875% in any calendar quarter (8.75% annualized).

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

**Pre-incentive fee net investment income**  
(expressed as a percentage of the value of net assets)

**Percentage of pre-incentive fee net investment income**  
**allocated to income-related portion of incentive fee**





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The second part of the incentive fee is a capital gains incentive fee that will be determined and payable in arrears as of the end of each fiscal year (or upon termination of the Amended Advisory Agreement, as of the termination date), commencing on October 1, 2006, and will equal 20% of our realized capital gains as of the end of the fiscal year. In determining the capital gains incentive fee payable to our Adviser, we will calculate the cumulative aggregate realized capital gains and cumulative aggregate realized capital losses since our inception, and the aggregate unrealized capital depreciation as of the date of the calculation, as applicable, with respect to each of the investments in our portfolio.

Our Adviser's board of directors agreed to waive, for the fiscal quarters ending December 31, 2006 and March 31, 2007, the annual 2.0% base management fee to 0.5% for senior syndicated loan participations.

Under the Amended Advisory Agreement, we will pay separately for administrative services under the Administration Agreement. The Administration Agreement provides for payments equal to our allocable portion of our Administrator's overhead expenses in performing its obligations under the Administration Agreement, including but not limited to rent, and our allocable portion of the salaries and benefits expenses of our chief financial officer, chief compliance officer and controller and their respective staffs.

The same individuals who managed our portfolio continue to manage our portfolio under the Amended Advisory Agreement and, although the administrative services are now provided separately pursuant to the Administration Agreement, we do not expect that our stockholders will notice any change or diminution in services because of this organizational separation.

Regulations promulgated by the SEC prohibit business development companies from implementing an incentive advisory fee while having in place a stock option plan or any outstanding stock options. In connection with the approval of the Amended Advisory Agreement, and pursuant to an offer approved by our Board of Directors on April 11, 2006, we extended an offer to the then-current stock option holders to amend the terms of all outstanding stock options under our Amended and Restated 2001 Equity Incentive Plan, which we refer to as the 2001 Plan, to accelerate the contractual expiration date of these options to September 30, 2006. The offer was filed with the SEC on April 12, 2006, was conducted in accordance with the federal tender offer rules and regulations, and was conditioned upon the acceptance by 100% of the current stock option holders. Our Board of Directors also accelerated in full the vesting of all outstanding options other than options held by the non-employee directors effective April 11, 2006, resulting in accelerated vesting of 34,500 outstanding options. On May 31, 2006, 100% of the current stock option holders accepted the tender offer, and on September 30, 2006, all outstanding stock options and the 2001 Plan were terminated. Upon the effectiveness of the Amended Advisory Agreement and Administration Agreement on October 1, 2006, the Initial Advisory Agreement terminated.

### **License Agreement**

We have entered into a license agreement with our Adviser, pursuant to which our Adviser has granted us a non-exclusive license to use the name Gladstone and the Diamond G trademark. This license agreement requires us to pay our Adviser a royalty fee of \$1 per quarter. The amount of the fee is negotiable on an annual basis by our compensation committee and approved by a majority of our independent directors. The license arrangement will terminate in the event that our Adviser is no longer our adviser.

### **Code of Ethics**

We and our Adviser have each adopted a Code of Ethics and Business Conduct applicable to our officers, directors and all employees of our Adviser and our Administrator that comply with the guidelines set forth in Item 406 of Regulation S-K of the Securities Act. As required by the 1940 Act, this code establishes procedures for personal investments, restricts certain transactions by our personnel and

requires the reporting of certain transactions and holdings by our personnel. A copy of this code is available for review, free of charge, at our website at [www.gladstonecapital.com](http://www.gladstonecapital.com). We intend to provide disclosure of any amendments to or waivers of the provisions of this code by posting information regarding any such amendment or waiver to our website within four days of its effectiveness.

### **Compliance Policies and Procedures**

We and our Adviser have adopted and implemented written policies and procedures reasonably designed to prevent violation of the federal securities laws, and our Board of Directors is required to review these compliance policies and procedures annually to assess their adequacy and the effectiveness of their implementation.

### **Competition**

A large number of entities compete with us and make the types of investments that we seek to make in small and medium-sized privately-owned businesses. Such competitors include private equity funds, leveraged buyout funds, venture capital funds, investment banks and other equity and non-equity based investment funds, and other financing sources, including traditional financial services companies such as commercial banks. Many of our competitors are substantially larger than we are and have considerably greater funding sources that are not available to us. In addition, certain of our competitors may have higher risk tolerances or different risk assessments, which could allow them to consider a wider variety of investments, establish more relationships and build their market shares. Furthermore, many of these competitors are not subject to the regulatory restrictions that the 1940 Act imposes on us as a business development company. There is no assurance that the competitive pressures we face will not have a material adverse effect on our business, financial condition and results of operations. In addition, because of this competition, we may not be able to take advantage of attractive investment opportunities from time to time and there can be no assurance that we will be able to identify and make investments that satisfy our investment objectives or that we will be able to meet our investment goals. Recently we have seen an increase in our competition such that terms and rates for proposed loans have been reduced. However, we believe that our extensive loan referral network and flexible transaction structuring enable us to compete effectively for opportunities in the current market environment.

### **Staffing**

We do not currently have any employees and do not expect to have any employees in the foreseeable future. Currently, services necessary for our business are provided by individuals who are employees of our Adviser and our Administrator pursuant to the terms of the Amended Advisory Agreement and the Administration Agreement, respectively. Each of our executive officers is an employee or officer, or both, of our Adviser and our Administrator. No employee of our Adviser or our Administrator will dedicate all of his or her time to us. However, we expect that 20-25 full time employees of our Adviser or our Administrator will spend substantial time on our matters during the remainder of calendar year 2007. We anticipate that the number of employees of our Adviser who devote time to our matters will increase as we acquire more investments. Effective October 1, 2006, with our entrance into the Amended Advisory and Administration Agreements, as approved by our stockholders on December 2, 2005, accounting and compliance services are provided by the same individuals who currently provide these services to us, however these individuals now provide these services to us through our Administrator pursuant to the Administration Agreement. All other services will continue to be performed by the same individuals under the Amended Advisory Agreement.

As of May 31, 2007, our Adviser and our Administrator had 53 full-time employees. A breakdown of these full-time employees is summarized by functional area in the table below:

Number of Individuals	Functional Area
6	Executive Management
36	Investment Management, Portfolio Management, and Due Diligence
11	Administration, Accounting, Compliance and Human Resources

**Properties**

We do not own any real estate or other physical properties materially important to our operation. Our Adviser is the current leaseholder of all properties in which we operate. We occupy these premises pursuant to our investment advisory and management agreement with our Adviser. Our headquarters are located at our Adviser’s headquarters in McLean, Virginia, a suburb of Washington D.C., and we also have operations at our Adviser’s seven other offices in New York, New Jersey, Pennsylvania, Illinois, Texas, Kentucky and Washington.

**Legal Proceedings**

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

## PORTFOLIO COMPANIES

The following table sets forth certain information as of March 31, 2007, regarding each portfolio company in which we had a debt or equity security as of such date. All such investments have been made in accordance with our investment policies and procedures described in this prospectus.

Company (1)	Industry	Investment(2)	Cost	Fair Value
ActivStyle Acquisition Co. ActivStyle, Inc. 3100 Pacific Street North Minneapolis, MN 55411	Service-medical products distribution	Line of Credit(5)(9) (9.6%, Due 7/2009) Senior Term Debt(5)  (9.6%, Due 7/2011) Senior Term Debt(3)(5) (11.9%, Due 7/2011)	\$ 450,000  3,040,000  2,500,000	\$ 448,875  3,040,000  2,500,000
Advanced Homecare Management, Inc. 7502 Greenville Ave., Suite 100 Dallas, TX 75231	Service-home health nursing services	Senior Subordinated Term Debt(5)(6) (11.8%, Due 12/2013)	6,300,000	6,300,000
Allied Extruders, LLC P&O Packaging Acquisition LLC 36-08 Review Avenue Long Island City, NY 11101	Manufacturing-polyethylene film	Senior Real Estate Term Debt (9.8%, Due 3/2011) Senior Term Debt (3)(5)(19) (11.3%, Due 3/2011)	1,000,000  8,000,000	1,000,000  8,170,800
Anitox Acquisition Company Anitox Holding, Inc. Anitox Corporation 1055 Progress Circle Lawrenceville, GA 30043	Manufacturing-preservatives for animal feed	Senior Real Estate Term Debt (8.8%, Due 1/2012) Senior Term Debt(5) (9.6%, Due 1/2012) Senior Term Debt(3)(5) (11.8%, Due 1/2012)	3,415,828  2,750,000  2,750,000	3,360,000  2,750,000  2,750,000
Badanco Acquisition Corp.  994 Riverview Drive Totowa, NJ 07512	Service-luggage design and distribution	Senior Subordinated Term Debt(5) (12.1%, Due 7/2012)	9,750,000	9,762,188
Benetech, Inc. 1851 Albright Rd. Montgomery, IL 60538	Service & Manufacuring-dust management systems for the coal and electric utility industries	Senior Term Debt(5) (10.3%, Due 5/2009) Senior Term Debt(3)(5) (13.3%, Due 5/2009)	1,787,500  2,965,625	1,816,547  3,028,645
Bresnan Communications, LLC One Manhattanville Rd. Purchase, NY 10577-2596	Service-telecommunications	Senior Term Debt(6) (7.1%, Due 9/2013) Senior Subordinated Term Debt(6) (9.9%, Due 3/2014)	1,001,958  1,510,780	1,000,000  1,530,000
CHG Companies, Inc. CHG Medical Staffing, Inc. CHG Healthcare East, Services, Inc. 4021 South 700 Suite 300 Salt Lake City, UT 84107	Service-healthcare staffing	Letter of Credit(5)(6) (7.9%, Due 12/2012) Senior Term Debt(5)(6) (7.9%, Due 12/2012) Senior Subordinated Term Debt(5)(6)  (11.3%, Due 12/2012)	400,000  1,596,000  500,000	404,500  1,613,955  507,500
Clinton Holdings, LLC  Clinton Aluminum Acquisition, LLC Metal Transportation, LLC Clinton Distribution Center, LLC Clinton Aluminum 6270 Van Buren Road Clinton, OH 44216	Distribution-aluminum sheets and stainless steel	Senior Subordinated Term Debt(5) (12.6%, Due 1/2013) Common Stock Warrants(7)	15,500,000  109,124	15,538,750  109,124
Consolidated Bedding, Inc.	Manufacturing-mattresses	Senior Subordinated Term Debt(5)	2,340,538	1,858,050

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(14.4%, Due 3/2009)

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Country Road Communications LLC Country Road Management, Inc. 1500 Mt. Kemble Avenue, Suite 203 Morristown, NJ 07960	Service-telecommunications	Senior Subordinated Term Debt (5)(6) (13.2%, Due 7/2013)	5,964,420	6,030,000
Critical Healthcare Solutions, Inc. Two Tower Building One Fayette Street Suite 150 Conshohocken, PA 19428	Service-home therapy and respiratory therapy	Senior Term Debt(8) (8.6%, Due 1/2012)	1,987,500	1,986,258
Dealer Computer Services, Inc. (d/b/a Reynolds & Reynolds) The Reynolds and Reynolds Company One Reynolds Way Dayton, OH 45430	Manufacturing & Service Systems for automotive retailers	Senior Term Debt(8) (7.4%, Due 10/2012)	947,240	954,936
Defiance Acquisition Corporation 1090 Perry Street Defiance, OH 43512	Manufacturing-trucking parts	Senior Term Debt(3)(5) (13.3%, Due 4/2010)	6,325,000	6,317,094
Doe & Ingalls Management LLC Doe & Ingalls of North Carolina Operating LLC Doe & Ingalls of Florida Operating LLC Doe & Ingalls of Virginia Operating LLC Doe & Ingalls of Maryland Operating LLC 1301 Person Street Durham, NC 27703	Distributor-specialty chemicals	Senior Term Debt(5) (9.8%, Due 11/2010) Senior Term Debt(3)(5) (13.3%, Due 11/2010)	4,300,000 4,477,500	4,310,750 4,483,097
Emdeon Business Services, Inc. 26 Century Blvd. Nashville, TN 37214	Service-healthcare technology solutions	Senior Term Debt(6) (7.6%, Due 11/2013)  Senior Subordinated Term Debt(6) (10.4%, Due 5/2014)	2,479,803  2,013,952	2,486,483  2,030,000