

GLADSTONE CAPITAL CORP
Form 10-Q
August 04, 2008
[Table of Contents](#)

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

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

FOR THE QUARTER ENDED JUNE 30, 2008

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

COMMISSION FILE NUMBER: 814-00237

GLADSTONE CAPITAL CORPORATION

(Exact name of registrant as specified in its charter)

MARYLAND

(State or other jurisdiction of incorporation or organization)

54-2040781

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

1521 WESTBRANCH DRIVE, SUITE 200

Edgar Filing: GLADSTONE CAPITAL CORP - Form 10-Q

MCLEAN, VIRGINIA 22102

(Address of principal executive office)

(703) 287-5800

(Registrant's telephone number, including area code)

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

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

Large accelerated filer Accelerated filer Non-accelerated filer Smaller reporting company .

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date. The number of shares of the issuer's Common Stock, \$0.001 par value, outstanding as of August 4, 2008 was 21,087,574.

Table of Contents

GLADSTONE CAPITAL CORPORATION

TABLE OF CONTENTS

PART I.	FINANCIAL INFORMATION
Item 1.	Financial Statements (Unaudited) <u>Condensed Consolidated Statements of Assets and Liabilities as of June 30, 2008 and September 30, 2007</u> <u>Condensed Consolidated Schedules of Investments as of June 30, 2008 and September 30, 2007</u> <u>Condensed Consolidated Statements of Operations for the three and nine months ended June 30, 2008 and 2007</u> <u>Condensed Consolidated Statements of Changes in Net Assets for the nine months ended June 30, 2008 and 2007</u> <u>Condensed Consolidated Statements of Cash Flows for the nine months ended June 30, 2008 and 2007</u> <u>Financial Highlights for the three and nine months ended June 30, 2008 and 2007</u> <u>Notes to Condensed Consolidated Financial Statements</u>
<u>Item 2.</u>	<u>Management's Discussion and Analysis of Financial Condition and Results of Operations Overview</u> <u>Results of Operations</u> <u>Liquidity and Capital Resources</u>
<u>Item 3.</u>	<u>Quantitative and Qualitative Disclosure About Market Risk</u>
<u>Item 4.</u>	<u>Controls and Procedures</u>
PART II.	<u>OTHER INFORMATION</u>
<u>Item 1.</u>	<u>Legal Proceedings</u>
<u>Item 1A.</u>	<u>Risk Factors</u>
<u>Item 2.</u>	<u>Unregistered Sales of Equity Securities and Use of Proceeds</u>
<u>Item 3.</u>	<u>Defaults Upon Senior Securities</u>
<u>Item 4.</u>	<u>Submission of Matters to a Vote of Security Holders</u>
<u>Item 5.</u>	<u>Other Information</u>
<u>Item 6.</u>	<u>Exhibits</u>
<u>SIGNATURES</u>	

Table of Contents

GLADSTONE CAPITAL CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF ASSETS AND LIABILITIES

(DOLLAR AMOUNTS IN THOUSANDS, EXCEPT PER SHARE DATA)

(UNAUDITED)

	June 30, 2008	September 30, 2007
ASSETS		
Non-Control/Non-Affiliate investments (Cost 6/30/08: \$441,319; 9/30/07: \$354,835)	\$ 411,069	\$ 348,921
Control investments (Cost 6/30/08: \$3,881; 9/30/07: \$924)	671	924
Total investments at fair value (Cost 6/30/08: \$445,200; 9/30/07 \$355,759)	411,740	349,845
Cash and cash equivalents	5,426	8,839
U.S. Treasury bill		2,484
Interest receivable investments in debt securities	3,301	2,426
Interest receivable employees (Refer to Note 4)	91	21
Due from custodian	6,637	3,230
Deferred financing fees	2,383	186
Prepaid assets	202	337
Other assets	462	361
TOTAL ASSETS	\$ 430,242	\$ 367,729
LIABILITIES		
Accounts payable	\$ 8	\$ 6
Interest payable	522	588
Fee due to Administrator (Refer to Note 4)	285	237
Fees due to Adviser (Refer to Note 4)	468	708
Borrowings under lines of credit	133,090	144,440
Accrued expenses and deferred liabilities	905	791
Funds held in escrow	290	
TOTAL LIABILITIES	135,568	146,770
NET ASSETS	\$ 294,674	\$ 220,959
ANALYSIS OF NET ASSETS		
Common stock, \$0.001 par value, 50,000,000 shares authorized and 21,087,574 and 14,762,574 shares issued and outstanding at June 30, 2008 and September 30, 2007, respectively	\$ 21	\$ 15
Capital in excess of par value	341,281	235,907
Notes receivable employees (Refer to Note 4)	(9,179)	(9,230)
Net unrealized depreciation on investments	(33,460)	(5,915)
Unrealized depreciation on derivative	(304)	(292)
(Distributions in excess of) accumulated undistributed net investment income	(3,685)	474
TOTAL NET ASSETS	\$ 294,674	\$ 220,959
NET ASSETS PER SHARE	\$ 13.97	\$ 14.97

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

Table of Contents

GLADSTONE CAPITAL CORPORATION
CONDENSED CONSOLIDATED SCHEDULE OF INVESTMENTS
AS OF JUNE 30, 2008
(DOLLAR AMOUNTS IN THOUSANDS)
(UNAUDITED)

Company	Industry	Investment (1)	Cost	Fair Value
NON-CONTROL/NON-AFFILIATE INVESTMENTS				
Access Television Network, Inc. (2)	Service-cable airtime (infomercials)	Senior Term Debt (6) (10.5% Due 3/2009)	\$ 2,078	\$ 1,960
ACE Expeditors, Inc	Service - over-the-ground logistics	Line of Credit, \$850 available (6) (6.0% Due 1/2011) Senior Term Debt (6) (9.5% Due 1/2012) Warrants (8)	200 12,544 200	197 12,356 157
ActivStyle Acquisition Co. (2)	Service-medical products distribution	Line of Credit, \$1,500 available (6) (6.7%, Due 7/2009) Senior Term Debt (6) (8.5%, Due 9/2012) Senior Term Debt (3) (6) (10.5%, Due 9/2012)	1,100 4,852 4,435	1,078 4,754 4,302
Allison Publications, LLC (2)	Service-publisher of consumer oriented magazines	Line of Credit, \$4,000 available (9.0%, Due 9/2010) Senior Term Debt (6) (9.0%, Due 9/2012)	 11,070	 10,615
Anitox Acquisition Company (2)	Manufacturing-preservatives for animal feed	Line of Credit, \$3,000 available (6) (6.7%, Due 1/2010) Senior Term Debt (6) (8.5%, Due 1/2012) Senior Term Debt (3) (6) (10.5%, Due 1/2012)	2,000 2,550 2,750	1,940 2,473 2,626
Badanco Acquisition Corp.	Service-luggage design and distribution	Senior Subordinated Term Debt (6) (11.5%, Due 7/2012)	9,506	9,150
BAS Broadcasting	Service-radio station operator	Senior Term Debt (5) (11.5%, Due 7/2013) Senior Term Debt (3) (5)	7,300 1,000	7,300 1,000

Edgar Filing: GLADSTONE CAPITAL CORP - Form 10-Q

(12.0%, Due 7/2009)

Bresnan Communications, LLC	Service-telecommunications	Senior Term Debt (7) (5.0%, Due 9/2013)	3,001	2,865
		Senior Subordinated Term Debt (7) (7.4%, Due 3/2014)	1,509	1,365
CCS, LLC	Service-cable tv franchise owner	Senior Term Debt (6) (9.0%, Due 8/2008)	3,427	3,358
CHG Companies, Inc. (2)	Service-healthcare staffing	Letter of Credit (7) (5.1%, Due 12/2012)	400	380
		Senior Term Debt (7) (4.9%, Due 12/2012)	1,580	1,501
		Senior Subordinated Term Debt (7) (8.7%, Due 12/2012)	500	445

Edgar Filing: GLADSTONE CAPITAL CORP - Form 10-Q

Table of Contents

Company	Industry	Investment (1)	Cost	Fair Value
Chinese Yellow Pages Company	Service-publisher of Chinese language directories	Line of Credit, \$950 available (6) (9.0%, Due 9/2010)	\$ 700	\$ 667
		Senior Term Debt (6) (9.0%, Due 9/2010)	748	703
Clinton Holdings, LLC (2)	Distribution-aluminum sheets and stainless steel	Senior Subordinated Term Debt (6) (12.0%, Due 1/2013)	15,500	15,422
		Common Stock Warrants (8)	109	
CMI Acquisition, LLC (2)	Service-recycling	Senior Subordinated Term Debt (6) (10.2%, Due 11/2012)	6,435	6,121
Community Media Corporation	Service-publisher of free weekly newspapers	Senior Term Debt (6) (7.0%, Due 8/2012)	2,358	2,280
Country Road Communications LLC (2)	Service-telecommunications	Senior Subordinated Term Debt (7) (10.2%, Due 7/2013)	5,971	5,820
Defiance Acquisition Corporation	Manufacturing-trucking parts	Senior Term Debt (3) (6) (11.0%, Due 4/2010)	6,245	5,496
Doe & Ingalls Management LLC (2)	Distributor-specialty chemicals	Senior Term Debt (6) (6.0%, Due 11/2010)	3,300	3,234
		Senior Term Debt (3) (6) (7.0%, Due 11/2010)	4,421	4,311
Emdeon Business Services, Inc.	Service-healthcare technology solutions	Senior Term Debt (7) (4.8%, Due 11/2013)	2,365	2,239
		Senior Subordinated Term Debt (7) (7.8%, Due 5/2014)	2,011	1,860
Express Courier International, Inc.	Service-ground delivery and logistics	Line of Credit, \$1,200 available (6) (6.7%, Due 6/2009)	900	884
		Senior Term Debt (6) (9.3%, Due 6/2011)	3,408	3,348
		Senior Term Debt (3) (6) (11.3%, Due 6/2011)	4,644	4,539
Finn Corporation	Manufacturing-landscape equipment	Common Stock Warrants (8)	37	3,197
GFRC Holdings LLC	Manufacturing-glass-fiber reinforced concrete	Line of Credit, \$3,000 available (6) (6.7%, Due 12/2010)		
		Senior Term Debt (6) (9.8%, Due 12/2012)	7,362	7,252
		Senior Subordinated Term Debt (3) (6) (12.3%, Due 12/2012)	6,716	6,565
Global Materials Technologies, Inc.	Manufacturing-steel wool products and metal fibers	Senior Term Debt (3) (6) (13.0%, Due 11/2009)	4,830	4,492
GTM Holdings, Inc.	Manufacturing-socks	Senior Term Debt (7)	493	420

Edgar Filing: GLADSTONE CAPITAL CORP - Form 10-Q

(2)	(5.4%, Due 10/2013) Senior Subordinated Term Debt (7) (8.7%, Due 4/2014)	500	400
-----	--	-----	-----

Edgar Filing: GLADSTONE CAPITAL CORP - Form 10-Q

Table of Contents

Company	Industry	Investment (1)	Cost	Fair Value
Greatwide Logistics Services, Inc.	Service - logistics and transportation	Senior Term Debt (7) (6.3%, Due 12/2013)	\$ 3,950	\$ 3,160
		Senior Subordinated Term Debt (7) (9.3%, Due 6/2014)	4,000	2,200
GS Maritime Intermediate Holdings LLC	Service-cargo transport	Senior Subordinated Term Debt (7) (10.0%, Due 12/2013)	1,000	990
Harrington Holdings, Inc. (2)	Service - healthcare products distribution	Senior Term Debt (7) (4.7%, Due 1/2014)	2,469	2,271
		Senior Subordinated Term Debt (7) (8.5%, Due 1/2014)	5,000	4,250
Heartland Communications Group, LLC (2)	Service-radio station operator	Line of Credit, \$500 available (6) (10.0%, Due 12/2008)	105	84
		Senior Term Debt (6) (10.0%, Due 5/2011)	4,606	3,651
Interfilm Holdings, Inc.	Service-slitter and distributor of plastic films	Senior Term Debt (6) (10.5%, Due 10/2012)	5,000	4,856
International Junior Golf Training Acquisition Company	Service-golf training	Line of Credit, \$1,500 available (6) (9.0%, Due 5/2010)	1,400	1,355
		Senior Term Debt (6) (6.7%, Due 5/2012)	2,650	2,564
		Senior Term Debt (3) (6) (10.5%, Due 5/2012)	2,500	2,400
It's Just Lunch International, LLC	Service-dating service	Line of Credit, \$750 available (6) (6.5%, Due 6/2009)	550	303
		Senior Term Debt (6) (6.7%, Due 6/2011)	3,300	1,815
		Senior Term Debt (3) (6) (9) (10.5%, Due 6/2011)	500	275
John Henry Holdings, Inc. (2)	Manufacturing-packaging products	Senior Subordinated Term Debt (7) (11.6%, Due 6/2011)	8,000	7,760
Kinetek Acquisition Corp.	Manufacturing-custom engineered motors & controls	Senior Term Debt (7) (5.3%, Due 11/2013)	1,482	1,359
		Senior Subordinated Term Debt (7) (8.0%, Due 5/2014)	1,508	1,275
KMBQ Corporation	Service-AM/FM radio broadcaster	Line of Credit, \$200 available (6) (10.0%, Due 3/2010)	153	143
		Senior Term Debt (6) (10.0%, Due 3/2010)	1,794	1,663

Edgar Filing: GLADSTONE CAPITAL CORP - Form 10-Q

Legend Communications of Wyoming LLC	Service-operator of radio stations	Line of Credit, \$500 available (5) (11.0%, Due 6/2011)	200	200
		Senior Term Debt (5) (11.0%, Due 6/2013)	9,250	9,250
Lindmark Outdoor Advertising LLC	Service-advertising	Senior Subordinated Term Debt (6) (11.0%, Due 10/2012)	10,000	9,350

Edgar Filing: GLADSTONE CAPITAL CORP - Form 10-Q

Table of Contents

Company	Industry	Investment (1)	Cost	Fair Value
LocalTel, Inc.	Service-yellow pages publishing	Line of Credit, \$3,000 available (6) (10) (non-accrual, Due 6/2009)	\$ 1,170	\$ 234
		Senior Term Debt (6) (10) (non-accrual, Due 6/2011)	2,688	538
		Senior Term Debt (3) (6) (10) (non-accrual, Due 6/2011)	2,750	550
Meteor Holding Corporation (2)	Manufacturing-bar code scanning and data capture	Senior Term Debt (7) (7.0%, Due 12/2013)	2,330	2,330
		Senior Subordinated Term Debt (7) (10.3%, Due 12/2013)	1,500	1,500
Multi-Ag Media LLC (2)	Service-dairy magazine publisher/ information database	Senior Term Debt (6) (9.0%, Due 12/2009)	2,203	2,121
Newhall Holdings, Inc. (2)	Service-distributor of personal care products and supplements	Line of Credit, \$4,000 available (6) (6.0%, Due 5/2010)	1,100	1,064
		Senior Term Debt (6) (8.3%, Due 5/2012)	4,320	4,190
		Senior Term Debt (3) (6) (11.3%, Due 5/2012)	4,500	4,343
Northern Contours, Inc. (2)	Manufacturing-veneer and laminate components	Senior Subordinated Term Debt (6) (10.0%, Due 5/2010)	7,000	6,440
Pinnacle Treatment Centers, Inc.	Service-Addiction treatment centers	Line of Credit, \$500 available (6) (6.7%, Due 12/2009)		
		Senior Term Debt (6) (8.5%, Due 12/2011)	3,750	3,600
		Senior Term Debt (3) (6) (10.5%, Due 12/2011)	7,500	7,163
Precision Acquisition Group Holdings, Inc. (2)	Manufacturing-consumable components for the aluminum industry	Equipment Note, \$1,500 available (6) (8.5%, Due 10/2011)	1,000	999
		Senior Term Debt (6) (8.5%, Due 10/2010)	4,875	4,869
		Senior Term Debt (3) (6) (11.5%, Due 10/2010)	4,179	4,174
PROFITSystems Acquisition Co. (2)	Service-design and develop ERP software	Line of Credit, \$1,250 available (6) (6.7%, Due 7/2009)		
		Senior Term Debt (6) (8.5%, Due 7/2011)	2,350	2,233
		Senior Term Debt (3) (6) (10.5%, Due 7/2011)	2,900	2,733
Puerto Rico Cable Acquisition Company, Inc.	Service-telecommunications	Senior Subordinated Term Debt (7) (10.3%, Due 1/2012)	7,192	5,713
RCS Management Holding Co.	Service-healthcare supplies	Senior Term Debt (3) (6) (8.5%, Due 1/2011)	2,938	2,805

Edgar Filing: GLADSTONE CAPITAL CORP - Form 10-Q

Senior Term Debt (4) (6) (10.5%, Due 1/2011)	3,060	2,869
---	-------	-------

Edgar Filing: GLADSTONE CAPITAL CORP - Form 10-Q

Table of Contents

Company	Industry	Investment (1)	Cost	Fair Value
RedPrairie Holding, Inc. (2)	Service-design and develop supply chain software	Senior Term Debt (7) (5.7%, Due 7/2012)	\$ 4,412	\$ 4,148
		Senior Subordinated Term Debt (7) (9.3%, Due 1/2013)	3,000	2,580
Reliable Biopharmaceutical Holdings, Inc.	Manufacturing-pharmaceutical and biochemical intermediates	Line of Credit, \$5,000 available (6) (6.0%, Due 10/2010)	1,200	1,176
		Mortgage Note (6) (9.5%, Due 10/2014)	7,422	7,311
		Senior Term Debt (6) (9.0%, Due 10/2012)	1,800	1,773
		Senior Term Debt (3) (6) (11.0%, Due 10/2012)	11,963	11,694
		Senior Subordinated Term Debt (6) (12.0%, Due 10/2013)	6,000	5,663
		Common Stock Warrants (8)	209	
RiskMetrics Group Holdings, LLC	Service - develop risk and wealth management solutions	Senior Term Debt (7) (4.8%, Due 1/2014)	1,937	1,874
Saunders & Associates	Manufacturing-equipment provider for frequency control devices	Line of Credit, \$2,500 available (5) (7.0%, Due 5/2009)		
		Senior Term Debt (5) (9.8%, Due 5/2013)	11,000	10,973
SCI Cable, Inc.	Service-cable, internet, voice provider	Senior Term Debt (6) (11.0%, Due 10/2008)	2,717	1,897
Sunburst Media - Louisiana, LLC	Service-radio station operator	Senior Term Debt (6) (9.5%, Due 6/2011)	7,862	7,020
Sunshine Media Holdings	Service-publisher regional B2B trade magazines	Line of Credit, \$3,000 available (6) (9.0%, Due 5/2010)	700	661
		Senior Term Debt (6) (9.0%, Due 5/2012)	17,000	16,108
		Senior Term Debt (3) (6) (11.5%, Due 5/2012)	10,000	9,300
Thibaut Acquisition Co.	Service-design and disribute wall covering	Line of Credit, \$2,000 available (6) (7.0%, Due 1/2011)	2,000	1,920
		Senior Term Debt (6) (7.0%, Due 1/2011)	2,188	2,100
		Senior Term Debt (3) (6) (10.5%, Due 1/2011)	3,000	2,820
Viapack, Inc. (2)	Manufacturing-polyethylene film	Senior Real Estate Term Debt (7.0%, Due 3/2011)	875	840
		Senior Term Debt (3) (6) (11.3%, Due 3/2011)	4,117	3,922
Visual Edge Technology, Inc. (2)	Service-office equipment distribution	Senior Subordinated Term Debt (6) (11.5%, Due 8/2011)	5,000	3,000

Edgar Filing: GLADSTONE CAPITAL CORP - Form 10-Q

Wesco Holdings, Inc. (2)	Service-aerospace parts and distribution	Senior Term Debt (7) (5.1%, Due 9/2013)	2,452	2,346
		Senior Subordinated Term Debt (7) (8.6%, Due 3/2014)	2,268	2,199

Edgar Filing: GLADSTONE CAPITAL CORP - Form 10-Q

Table of Contents

Company	Industry	Investment (1)	Cost	Fair Value
West Coast Yellow Pages, Inc.	Service-directory publisher	Senior Term Debt (6) (10) (non-accrual, Due 8/2010)	\$ 1,555	\$ 616
Westlake Hardware, Inc. (2)	Retail-hardware and variety	Senior Subordinated Term Debt (6) (9.0%, Due 1/2011) Senior Subordinated Term Debt (6) (10.3%, Due 1/2011)	15,000 10,000	14,325 9,400
Winchester Electronics	Manufacturing-high bandwidth connectors and cables	Senior Term Debt (6) (6.2%, Due 5/2013) Senior Subordinated Term Debt (6) (12.0%, Due 4/2013)	1,980 9,975	1,918 9,576
WP Evenflo Group Holdings Inc. (2)	Manufacturing-infant and juvenile products	Senior Term Debt (7) (5.1%, Due 2/2013) Senior Subordinated Term Debt (7) (8.6%, Due 2/2014)	1,910 2,000	1,595 1,600
Total Non-Control/Non-Affiliate Investments			\$ 441,319	\$ 411,069
CONTROL INVESTMENTS				
BERTL, Inc.	Service-web-based evaluator of digital imaging products	Line of Credit, \$700 available (11) (8.7%, Due 10/2009) Common Stock (8)	\$ 726 424	\$
U.S. HealthCare, Inc.	Service-magazine publisher/operator	Line of credit, \$200 available (10) (non-accrual, Due 3/2010) Line of credit, \$450 available (10) (non-accrual, Due 3/2010) Common Stock (8)	30 231 2,470	30 231 410
Total Control Investments			\$ 3,881	\$ 671
Total Investments			\$ 445,200	\$ 411,740

(1) Percentage represents interest rates in effect at June 30, 2008 and due date represents the contractual maturity date.

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

(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 also junior to another Last Out Tranche.

(5) Investment valued at cost due to recent acquisition.

Edgar Filing: GLADSTONE CAPITAL CORP - Form 10-Q

- (6) Fair value was based on opinions of value submitted by Standard & Poor's Securities Evaluations, Inc.
- (7) Marketable securities, such as syndicated loans, are valued based on the indicative bid price, on or near June 30, 2008, offered by the respective originating syndication agent's trading desk, or secondary desk.
- (8) Security is non-income producing.
- (9) It's Just Lunch may borrow an additional \$1,750 of the senior term debt facility, subject to certain conditions including Gladstone Capital's approval. Borrowings of \$500 were outstanding at June 30, 2008.
- (10) LocalTel, West Coast Yellow Pages and U.S. Healthcare are currently past due on interest payments and are on non-accrual.
- (11) BERTL line of credit was overdrawn by \$26 as of June 30, 2008. The Company is currently restructuring the line of credit. BERTL interest is currently being capitalized as Paid in Kind (PIK) interest. Please refer to Note 2 Summary of Significant Accounting Policies.

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

Table of Contents

GLADSTONE CAPITAL CORPORATION

CONDENSED CONSOLIDATED SCHEDULE OF INVESTMENTS

AS OF SEPTEMBER 30, 2007

(DOLLAR AMOUNTS IN THOUSANDS)

Company	Industry	Investment (1)	Cost	Fair Value
NON-CONTROL/NON-AFFILIATE INVESTMENTS				
Access Television Network, Inc. (2)	Service-cable airtime (infomercials)	Line of Credit, \$500 available (11.8% Due 3/2009) Senior Term Debt (6) (11.8% Due 3/2009)	\$ 2,616	\$ 2,558
ActivStyle Acquisition Co. (2)	Service-medical products distribution	Line of Credit, \$1,500 available (6) (10.0%, Due 7/2009) Senior Term Debt (6) (10.0%, Due 9/2012) Senior Term Debt (3) (6) (12.6%, Due 9/2012)	600 5,245 4,435	597 5,219 4,407
Allison Publications, LLC (2)	Service-publisher of consumer oriented magazines	Senior Term Debt (6) (9.8%, Due 12/2011)	7,884	7,780
Anitox Acquisition Company (2)	Manufacturing-preservatives for animal feed	Senior Real Estate Term Debt (8.8%, Due 1/2012) Line of Credit, \$3,000 available (10.0%, Due 1/2010) Senior Term Debt (6) (10.0%, Due 1/2012) Senior Term Debt (3) (6) (12.3%, Due 1/2012)	3,110 2,750 2,750	3,060 2,736 2,736
Badanco Acquisition Corp.	Service-luggage design and distribution	Senior Subordinated Term Debt (6) (12.4%, Due 7/2012)	9,653	9,628
Bresnan Communications, LLC	Service-telecommunications	Senior Term Debt (7) (7.4%, Due 9/2013) Senior Subordinated Term Debt (7) (9.9%, Due 3/2014)	3,002 1,510	2,910 1,485
CCS, LLC	Service-cable tv franchise owner	Senior Term Debt (6) (11.8%, Due 10/2007)	3,433	3,416
CHG Companies, Inc. (2)	Service-healthcare staffing	Letter of Credit (6) (7) (7.1%, Due 12/2012) Senior Term Debt (6) (7)	400 1,588	385 1,528

Edgar Filing: GLADSTONE CAPITAL CORP - Form 10-Q

		(7.9%, Due 12/2012) Senior Subordinated Term Debt (6) (7) (11.9%, Due 12/2012)	500	480
Chinese Yellow Pages Company	Service-publisher of Chinese language directories	Line of Credit, \$950 available (6) (11.8%, Due 9/2010) Senior Term Debt (6) (11.8%, Due 9/2010)	230 1,071	229 1,051
Clinton Holdings, LLC (2)	Distribution-aluminum sheets and stainless steel	Senior Subordinated Term Debt (13.0%, Due 1/2013) Common Stock Warrants (8)	15,500 109	15,500 223

Edgar Filing: GLADSTONE CAPITAL CORP - Form 10-Q

Table of Contents

Company	Industry	Investment (1)	Cost	Fair Value
CMI Acquisition, LLC (2)	Service-recycling	Senior Subordinated Term Debt (6) (12.4%, Due 11/2012)	\$ 6,500	\$ 6,451
Community Media Corporation	Service-publisher of free weekly newspapers	Senior Term Debt (6) (9.8%, Due 8/2012)	2,511	2,482
Country Road Communications LLC (2)	Service-telecommunications	Senior Subordinated Term Debt (6) (7) (13.1%, Due 7/2013)	5,967	5,880
Defiance Acquisition Corporation	Manufacturing-trucking parts	Senior Term Debt (3) (6) (13.8%, Due 4/2010)	6,325	6,246
Doe & Ingalls Management LLC (2)	Distributor-specialty chemicals	Senior Term Debt (6) (9.3%, Due 11/2010) Senior Term Debt (3) (6) (10.3%, Due 11/2010)	3,900 4,455	3,900 4,455
Emdeon Business Services, Inc.	Service-healthcare technology solutions	Senior Term Debt (7) (7.4%, Due 11/2013) Senior Subordinated Term Debt (7) (10.2%, Due 5/2014)	2,434 2,013	2,383 1,985
Express Courier International, Inc.	Service-ground delivery and logistics	Line of Credit, \$1,500 available (6) (10.0%, Due 6/2009) Senior Term Debt (6) (10.0%, Due 6/2011) Senior Term Debt (3) (6) (12.3%, Due 6/2011)	900 4,113 3,950	899 4,107 3,945
Finn Corporation	Manufacturing-landscape equipment	Common Stock Warrants (8)	37	3,005
Global Materials Technologies, Inc.	Manufacturing-steel wool products and metal fibers	Senior Term Debt (3) (6) (14.8%, Due 11/2009)	5,100	4,883
GTM Holdings, Inc. (2)	Manufacturing-socks	Senior Term Debt (7) (8.1%, Due 10/2013) Senior Subordinated Term Debt (7) (11.4%, Due 4/2014)	496 500	481 495
Greatwide Logistics Services, Inc.	Service - logistics and transportation	Senior Term Debt (7) (8.7%, Due 12/2013) Senior Subordinated Term Debt (7) (11.7%, Due 6/2014)	3,970 4,000	3,454 3,280
Harrington Holdings, Inc. (2)	Service - healthcare products distribution	Senior Term Debt (7) (7.4%, Due 1/2014) Senior Subordinated Term Debt (7) (11.2%, Due 1/2014)	2,488 5,000	2,419 4,825

Edgar Filing: GLADSTONE CAPITAL CORP - Form 10-Q

Table of Contents

Company	Industry	Investment (1)	Cost	Fair Value
Heartland Communications Group, LLC (2)	Service-radio station operator	Line of Credit, \$500 available (6) (11.3%, Due 5/2008)	\$ 10	\$ 10
		Senior Term Debt (6) (11.3%, Due 5/2011)	4,824	4,534
IJGT Acquisition Company	Service-golf training	Line of Credit, \$1,000 available (6) (10.0%, Due 5/2010)	500	498
		Senior Term Debt (6) (10.0%, Due 5/2012)	2,650	2,637
		Senior Term Debt (3) (6) (12.3%, Due 5/2012)	2,500	2,481
It's Just Lunch International, LLC	Service-dating service	Line of Credit, \$750 available (6) (9.8%, Due 6/2009)	550	492
		Senior Term Debt (6) (10.0%, Due 6/2011)	3,300	2,954
		Senior Term Debt (3) (6) (9) (12.3%, Due 6/2011)	500	448
John Henry Holdings, Inc. (2)	Manufacturing-packaging products	Senior Subordinated Term Debt (7) (12.8%, Due 6/2011)	8,000	8,000
Kinetek Acquisition Corp.	Manufacturing-custom engineered motors & controls	Senior Term Debt (7) (7.6%, Due 11/2013)	1,494	1,444
		Senior Subordinated Term Debt (7) (10.6%, Due 5/2014)	1,509	1,440
KMBQ Corporation	Service-AM/FM radio broadcaster	Line of Credit, \$200 available (12.8%, Due 3/2010)	152	151
		Senior Term Debt (6) (12.8%, Due 3/2010)	1,813	1,786
LocalTel, Inc.	Service-yellow pages publishing	Line of Credit, \$3,000 available (6) (10.3%, Due 6/2009)	1,135	948
		Senior Term Debt (6) (10.3%, Due 6/2011)	2,688	2,244
		Senior Term Debt (3) (6) (12.8%, Due 6/2011)	2,750	2,200
Macfadden Performing Arts Media, LLC	Service-magazine publisher	Line of Credit, \$1,400 available (6) (10.8%, Due 6/2009)	516	510
		Senior Term Debt (6) (10.8%, Due 6/2009)	6,705	6,558
Meteor Holding Corporation (2)	Manufacturing-bar code scanning and data capture	Senior Term Debt (7) (8.2%, Due 12/2013)	2,348	2,325
		Senior Subordinated Term Debt (7) (11.5%, Due 12/2013)	1,500	1,425

Edgar Filing: GLADSTONE CAPITAL CORP - Form 10-Q

Table of Contents

Company	Industry	Investment (1)	Cost	Fair Value
Multi-Ag Media LLC (2)	Service-dairy magazine publisher/information database	Senior Term Debt (6) (11.8%, Due 12/2009)	\$ 2,548	\$ 2,523
Newhall Holdings, Inc.(2)	Service-distributor of personal care products and supplements	Line of Credit, \$4,000 available (6) (8.8%, Due 5/2010)		
		Senior Term Debt (3) (6) (9.5%, Due 5/2012)	4,500	4,489
		Senior Term Debt (3) (6) (11.8%, Due 5/2012)	4,500	4,489
Northern Contours, Inc. (2)	Manufacturing-veneer and laminate components	Senior Subordinated Term Debt (6) (12.8%, Due 5/2010)	7,000	6,983
Pinnacle Treatment Centers, Inc.	Service-Addiction treatment centers	Line of Credit, \$500 available (10.0%, Due 12/2009)		
		Senior Term Debt (6) (10.0%, Due 12/2011)	2,500	2,488
		Senior Term Debt (3) (6) (12.8%, Due 12/2011)	4,500	4,466
Precision Acquisition Group Holdings, Inc. (2)	Manufacturing-consumable components for the aluminum industry	Equipment Note, \$1,000 available (6) (10.3%, Due 10/2011)	672	672
		Senior Term Debt (6) (10.3%, Due 10/2010)	5,000	5,006
		Senior Term Debt (3) (6) (12.3%, Due 10/2010)	4,200	4,205
PROFITSystems Acquisition Co. (2)	Service-design and develop ERP software	Line of Credit, \$1,250 available (10.0%, Due 7/2009)		
		Senior Term Debt (6) (10.0%, Due 7/2011)	2,800	2,797
		Senior Term Debt (3) (6) (12.3%, Due 7/2011)	2,900	2,896
Puerto Rico Cable Acquisition Company, Inc.	Service-telecommunications	Senior Subordinated Term Debt (6) (7) (11.5%, Due 1/2012)	7,799	7,388
RCS Management Holding Co.	Service-healthcare supplies	Senior Term Debt (3) (6) (10.3%, Due 1/2011)	3,000	2,880
		Senior Term Debt (4) (6) (12.8%, Due 1/2011)	3,000	2,865
Reading Broadcasting, Inc.	Service-television station operator	Senior Term Debt (6) (12.3%, Due 3/2008)	7,560	7,498
RedPrairie Holding, Inc. (2)	Service-design and develop supply chain software	Senior Term Debt (7) (8.5%, Due 7/2012)	4,458	4,235
		Senior Subordinated Term Debt (7) (11.9%, Due 1/2013)	3,000	2,850
RiskMetrics Group Holdings, LLC	Service - develop risk and wealth management solutions	Senior Term Debt (7) (7.4%, Due 1/2014)	1,990	1,965
		Senior Subordinated Term Debt (7)	500	495

Edgar Filing: GLADSTONE CAPITAL CORP - Form 10-Q

(10.7%, Due 7/2014)

SCI Cable, Inc.	Service-cable, internet, voice provider	Senior Term Debt (6) (13.8%, Due 10/2008)	2,482	2,398
-----------------	---	--	-------	-------

Edgar Filing: GLADSTONE CAPITAL CORP - Form 10-Q

Table of Contents

Company	Industry	Investment (1)	Cost	Fair Value
SCS Acquisition Corp. (2)	Service-chemically treated	Senior Term Debt (6)	\$ 5,117	\$ 5,111
	equipment distribution	(9.8%, Due 12/2011) Senior Term Debt (3) (6) (11.8%, Due 12/2011)	6,494	6,477
Sunburst Media - Louisiana, LLC	Service-radio station operator	Senior Term Debt (6) (11.5%, Due 6/2011)	7,878	7,800
Sunshine Media Holdings	Service-publisher regional B2B	Line of Credit, \$3,000 available (6)	700	695
	trade magazines	(9.8%, Due 5/2010) Senior Term Debt (6) (9.8%, Due 5/2012)	17,000	16,915
		Senior Term Debt (3) (6) (12.3%, Due 5/2012)	10,000	9,925
Thibaut Acquisition Co.	Service-design and disribute	Line of Credit, \$1,000 available (6)	800	798
	wall covering	(10.3%, Due 1/2011) Senior Term Debt (6) (10.3%, Due 1/2011)	2,713	2,709
		Senior Term Debt (3) (6) (12.8%, Due 1/2011)	3,000	2,992
U.S. HealthCare Communications, LLC	Service-magazine publisher/operator	Senior Term Debt (6) (10) (non-accrual, Due 4/2011)	2,244	1,809
Viapack, Inc. (2)	Manufacturing-polyethylene film	Senior Real Estate Term Debt (10.3%, Due 3/2011)	975	975
		Senior Term Debt (3) (6) (11.8%, Due 3/2011)	4,223	4,192
Visual Edge Technology, Inc. (2)	Service-office equipment distribution	Senior Subordinated Term Debt (6) (13.8%, Due 8/2011)	5,000	3,575
Wesco Holdings, Inc. (2)	Service-aerospace parts and distribution	Senior Term Debt (7) (7.5%, Due 9/2013)	2,454	2,383
		Senior Subordinated Term Debt (7) (11.0%, Due 3/2014)	2,270	2,233
West Coast Yellow Pages, Inc.	Service-directory publisher	Senior Term Debt (6) (13.3%, Due 8/2010)	1,584	1,518
Westlake Hardware, Inc. (2)	Retail-hardware and variety	Senior Subordinated Term Debt (6) (13.0%, Due 1/2011)	15,000	14,987
Winchester Electronics	Manufacturing-high bandwidth connectors and cables	Senior Term Debt (6) (9.5%, Due 5/2013)	1,995	1,990
		Senior Subordinated Term Debt (6)	10,000	9,950

Edgar Filing: GLADSTONE CAPITAL CORP - Form 10-Q

(12.8%, Due 4/2013)

WP Evenflo Group Holdings Inc. (2)	Manufacturing-infant and juvenile products	Senior Term Debt (7) (8.0%, Due 2/2013)	1,990	1,851
		Senior Subordinated Term Debt (7) (11.5%, Due 2/2014)	2,000	1,860
Total Non-Control/Non-Affiliate Investments			\$ 354,835	\$ 348,921

CONTROL INVESTMENTS

BERTL, Inc.	Service-web-based evaluator of digital imaging products	Common Stock (5) (8)	924	924
Total Investments (11)			\$ 355,759	\$ 349,845

Table of Contents

- (1) Percentage represents interest rates in effect at September 30, 2007 and due date represents the contractual maturity date.
- (2) Certain of the listed securities are issued by affiliate(s) of the indicated portfolio company.
- (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 also junior to another Last Out Tranche.
- (5) Investment valued at cost due to recent acquisition.
- (6) Fair value was based on opinions of value submitted by Standard & Poor's Securities Evaluations, Inc.
- (7) Marketable securities, such as syndicated loans, are valued based on the indicative bid price, on or near September 28, 2007, offered by the respective originating syndication agent's trading desk, or secondary desk.
- (8) Security is non-income producing.
- (9) It's Just Lunch revolving may borrow an additional \$1,750 of the senior term debt facility, subject to certain conditions including Gladstone Capital's approval. Borrowings of \$500 were outstanding at September 30, 2007.
- (10) U.S. Healthcare Communications, LLC is currently past due on interest payments and is on non-accrual.
- (11) Aggregate gross unrealized depreciation for federal income tax purposes is \$9,107; aggregate gross unrealized appreciation for federal income tax purposes is \$3,192. Net unrealized depreciation is \$5,915 based on a tax cost of \$355,759.

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

Table of Contents

GLADSTONE CAPITAL CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS

(DOLLAR AMOUNTS IN THOUSANDS, EXCEPT PER SHARE DATA)

(UNAUDITED)

	Three Months Ended June 30,		Nine Months Ended June 30,	
	2008	2007	2008	2007
INVESTMENT INCOME				
Interest income investments	\$ 11,236	\$ 8,912	\$ 33,499	\$ 25,065
Interest income cash and cash equivalents	38	109	285	178
Interest income notes receivable from employees (Refer to Note 4)	118	133	354	404
Prepayment fees and other income	28	47	34	432
Total investment income	11,420	9,201	34,172	26,079
EXPENSES				
Interest expense	1,771	1,762	5,982	4,694
Loan servicing fee (Refer to Note 4)	1,598	898	4,541	2,377
Base management fee (Refer to Note 4)	529	847	1,664	1,997
Incentive fee (Refer to Note 4)	1,340	1,167	4,089	3,474
Administration fee (Refer to Note 4)	285	187	737	482
Professional fees	167	149	706	369
Amortization of deferred financing fees	572	72	830	199
Stockholder related costs	34	39	292	190
Directors fees	52	56	163	167
Insurance expense	57	66	170	191
Other expenses	103	82	263	220
Expenses before credit from Adviser	6,508	5,325	19,437	14,360
Credit to base management and incentive fees from Adviser (Refer to Note 4)	(1,785)	(1,829)	(5,708)	(4,873)
Total expenses net of credit to base management and incentive fees	4,723	3,496	13,729	9,487
NET INVESTMENT INCOME	6,697	5,705	20,443	16,592
REALIZED AND UNREALIZED GAIN (LOSS) ON INVESTMENTS:				
Realized (loss) gain on sale of investments	(86)	(5)	(86)	82
Realized gain on settlement of derivative		8	6	31
Unrealized depreciation on derivative			(12)	(26)
Net unrealized (depreciation) appreciation on investments	(3,802)	257	(27,545)	(2,466)
Net (loss) gain on investments	(3,888)	260	(27,637)	(2,379)
NET INCREASE (DECREASE) IN NET ASSETS RESULTING FROM OPERATIONS	\$ 2,809	\$ 5,965	\$ (7,194)	\$ 14,213
NET INCREASE (DECREASE) IN NET ASSETS RESULTING FROM OPERATIONS PER COMMON SHARE:				
Basic and Diluted	\$ 0.13	\$ 0.44	\$ (0.37)	\$ 1.12

WEIGHTED AVERAGE SHARES OF COMMON STOCK

OUTSTANDING:

Basic and Diluted	21,087,574	13,561,511	19,237,203	12,701,845
-------------------	------------	------------	------------	------------

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

Table of Contents

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

	Nine Months Ended June 30,	
	2008	2007
<i>Operations:</i>		
Net investment income	\$ 20,443	\$ 16,592
Net realized (loss) gain on sale of investments	(86)	82
Realized gain on settlement of derivative	6	31
Unrealized depreciation on derivative	(12)	(26)
Net unrealized depreciation on investments	(27,545)	(2,466)
Net (decrease) increase in net assets from operations	(7,194)	14,213
<i>Capital transactions:</i>		
Issuance of common stock under shelf offering	106,226	46,075
Distributions to stockholders	(24,523)	(16,013)
Repayment of principal on employee notes	51	301
Shelf offering costs	(845)	(406)
Stock surrendered in settlement of withholding tax		(1,488)
Increase in net assets from capital transactions	80,909	28,469
Total increase in net assets	73,715	42,682
Net assets at beginning of year	220,959	172,571
Net assets at end of period	\$ 294,674	\$ 215,253

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

Table of Contents

GLADSTONE CAPITAL CORPORATION

CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS

(DOLLAR AMOUNTS IN THOUSANDS)

(UNAUDITED)

	Nine Months ended June 30,	
	2008	2007
CASH FLOWS FROM OPERATING ACTIVITIES		
Net (decrease) increase in net assets resulting from operations	\$ (7,194)	\$ 14,213
Adjustments to reconcile net (decrease) increase in net assets resulting from operations to net cash used in operating activities:		
Purchase of investments	(137,502)	(253,728)
Principal repayments on investments	47,802	99,803
Net amortization of premiums and discounts	215	30
Increase in investment balance due to payment in kind interest	(42)	
Amortization of deferred financing fees	830	199
Realized loss on investments	86	123
Unrealized depreciation on derivative	12	26
Change in net unrealized depreciation on investments	27,545	2,466
Increase in interest receivable	(945)	(822)
(Increase) decrease in funds due from custodian	(3,406)	457
Decrease in prepaid assets	135	40
Increase in other assets	(113)	(165)
Increase in accounts payable	2	1
(Decrease) increase in interest payable	(65)	269
Increase in accrued expenses and deferred liabilities	114	133
(Increase) decrease in fees due to affiliate (Refer to Note 4)	(241)	164
Increase in administration fee due to Gladstone Administration (Refer to Note 4)	47	187
Increase (decrease) in funds held in escrow	290	(1)
Net cash used in operating activities	(72,430)	(136,605)
CASH FLOW FROM INVESTING ACTIVITIES		
Redemption of U.S. Treasury Bill	2,484	
Net cash provided by investing activities	2,484	
CASH FLOWS FROM FINANCING ACTIVITIES:		
Net proceeds from the issuance of common shares	106,226	45,669
Borrowings from the line of credit	151,418	277,800
Repayments on the line of credit	(162,768)	(166,605)
Distributions paid	(24,523)	(16,013)
Receipt of principal on notes receivable employees (Refer to Note 4)	51	301
Deferred financing fees	(3,026)	(299)
Shelf offering costs	(845)	
Withholding tax obligation settlement		(1,488)
Net cash provided by financing activities	66,533	139,365
NET (DECREASE) INCREASE IN CASH AND CASH EQUIVALENTS	(3,413)	2,760
CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD	8,839	731
CASH AND CASH EQUIVALENTS, END OF PERIOD	\$ 5,426	\$ 3,491

CASH PAID DURING PERIOD FOR INTEREST	\$	6,047	\$	4,424
---	----	-------	----	-------

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

Table of Contents

GLADSTONE CAPITAL CORPORATION

FINANCIAL HIGHLIGHTS

(DOLLAR AMOUNTS IN THOUSANDS, EXCEPT PER SHARE DATA)

(UNAUDITED)

	Three Months Ended June 30,		Nine Months Ended June 30,	
	2008	2007	2008	2007
Per Share Data (1)				
Net asset value at beginning of period	\$ 14.27	\$ 13.82	\$ 14.97	\$ 14.02
Income from investment operations:				
Net investment income (2)	0.32	0.42	1.06	1.31
Net unrealized (depreciation) appreciation on investments (2)	(0.19)	0.02	(1.43)	(0.19)
Total from investment operations	0.13	0.44	(0.37)	1.12
Distributions to stockholders (3)	(0.42)	(0.42)	(1.26)	(1.26)
Issuance of common stock under shelf offering		1.50	0.68	1.50
Offering costs	(0.01)	(0.23)	(0.05)	(0.23)
Repayment of principal on notes receivable				0.02
Stock surrendered to settle withholding tax obligation				(0.06)
Net asset value at end of period	\$ 13.97	\$ 15.11	\$ 13.97	\$ 15.11
Per share market value at beginning of period	\$ 18.71	\$ 23.86	\$ 19.52	\$ 22.01
Per share market value at end of period	\$ 15.24	\$ 21.46	\$ 15.24	\$ 21.46
Total return (4)(5)	-16.53%	-7.69%	-16.15%	2.92%
Shares outstanding at end of period	21,087,574	14,249,683	21,087,574	14,249,683
Statement of Assets and Liabilities Data:				
Net assets at end of period	\$ 294,674	\$ 215,253	\$ 294,674	\$ 215,253
Average net assets (6)	\$ 295,405	\$ 197,994	\$ 284,641	\$ 179,127
Senior Securities Data:				
Borrowings under line of credit	\$ 133,090	\$ 161,188	\$ 133,090	\$ 161,188
Asset coverage ratio (7)	323%	235%	323%	235%
Asset coverage per unit (8)	\$ 4,278	\$ 3,764	\$ 4,278	\$ 3,764
Ratios/Supplemental Data:				
Ratio of expenses to average net assets-annualized (9)	8.81%	10.52%	9.10%	10.55%
Ratio of net expenses to average net assets-annualized (10)	6.40%	7.06%	6.43%	7.06%
Ratio of net investment income to average net assets-annualized	9.07%	11.53%	9.58%	12.35%

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

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

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

- (4) Total return equals the change in the ending market value of the Company's common stock from the beginning of the period taking into account dividends reinvested in accordance with the terms of our dividend reinvestment plan. Total return does not take into account dividends that may be characterized as a return of capital. For further information on estimated character of our dividends please refer to Note 9.
- (5) Amounts were not annualized.
- (6) Average net assets are computed using the average of the balance of net assets at the end of each month of the reporting period.
- (7) As a business development company, we are generally required to maintain a ratio of at least 200% of total assets to total borrowings.
- (8) Asset coverage per unit is the ratio of the carrying value of our total consolidated assets, less all liabilities and indebtedness not represented by senior securities, to the aggregate amount of senior securities representing indebtedness. Asset coverage per unit is expressed in terms of dollar amounts per \$100 of indebtedness.
- (9) Ratio of expenses to average net assets is computed using expenses before credits from Adviser to the base management and incentive fees and including income tax expense.
- (10) Ratio of net expenses to average net assets is computed using total expenses net of credits from Adviser to the base management and incentive fees and including income tax expense.

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

Table of Contents

GLADSTONE CAPITAL CORPORATION

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

JUNE 30, 2008

(DOLLAR AMOUNTS IN THOUSANDS, EXCEPT PER SHARE DATA AND AS OTHERWISE INDICATED)

(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. Currently, Gladstone SSBIC holds approximately \$2.6 million in a money market account from the proceeds from the Company's initial stock purchase in Gladstone SSBIC.

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

Edgar Filing: GLADSTONE CAPITAL CORP - Form 10-Q

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, 2007, as filed with the Securities and Exchange Commission (the SEC) on December 3, 2007.

The year-end condensed balance sheet data was derived from audited financial statements, but does not include all disclosures required by GAAP.

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

Table of Contents

The Company uses generally accepted valuation techniques to value its portfolio unless the Company has specific information about the value of an investment to determine otherwise. From time to time the Company may accept an appraisal of a business in which the Company holds securities. These appraisals are expensive and occur infrequently but provide a third-party valuation opinion that may differ in results, techniques and scopes used to value the Company's investments. When these specific third-party appraisals are engaged or accepted, the Company would use such appraisals to value the investment the Company has in that business if it was determined that the appraisals were the best estimate of fair value.

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

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

Securities for which a limited market exists: The Company values securities that are not traded on an established secondary securities market, but for which a limited market for the security exists, such as certain participations in, or assignments of, syndicated loans, at the quoted price. Firm bid prices are requested; however, if a firm bid price is unavailable, the Company bases the value of the security upon the indicative bid price offered by the respective originating syndication agent's trading desk, or secondary desk, on or near the valuation date. To the extent that the Company uses the indicative bid price as a basis for valuing the security, the Adviser may take further steps to consider additional information to validate that price in accordance with the policy.

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

(1) **Portfolio investments comprised solely of debt securities:** The fair value of the Company's debt securities that are not publicly traded, or for which a limited market does not exist (Non-Public Debt Securities), and that are issued by portfolio companies where the Company has no equity, or equity-like securities, or holds a non-control equity interest, rely on opinions of value submitted to it 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.

(2) **Portfolio investments in controlled companies comprised of a bundle of investments, which can include debt and equity securities:** The Company values Non-Public Debt Securities and equity or equity-like securities (e.g. preferred equity, equity, or other equity-like securities) that are purchased together from the same controlled portfolio company, or issuer, as part of a package based on the total enterprise value of the issuer, which is calculated using a liquidity waterfall approach. Under this approach, the Company first calculates the total enterprise value of the issuer by incorporating some or all of the following factors to determine the total 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, and 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. Once the total enterprise value of the issuer is estimated, the Company subtracts the value of all the debt securities of the issuer, which are valued at the contractual principal balance. Fair values of these debt securities are discounted for any shortfall of total enterprise value over the total debt outstanding for the issuer. Once the values for all outstanding senior securities (which include the debt securities) have been subtracted from the total enterprise value of the issuer, the remaining amount, if any, is used to determine the value of the issuer's equity or equity like securities.

(3) **Portfolio investments in non-controlled companies comprised of a bundle of investments, which can include debt and equity securities:** The Company values Non-Public Debt Securities and equity or equity-like securities that are purchased together from the same non-controlled portfolio company, or issuer, by valuing the debt portion with SPSE (as described above) and valuing the equity portion based on the total enterprise value of the issuer, which is calculated using a liquidity waterfall approach as described above.

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

Table of Contents

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. There is no single standard for determining fair value in good faith, as fair value depends upon circumstances of each individual case. In general, fair value is the amount that we might reasonably expect to receive upon the current sale of the security in an arms-length transaction in the security's principal market. 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 acquisition costs and for the 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, 2008, two Non-Control/Non-Affiliate investments were on non-accrual with an aggregate cost basis of approximately \$8.2 million or 1.8% of the cost basis of all investments in the Company's portfolio. Also at June 30, 2008, one Control investment was on non-accrual with a cost basis of approximately \$0.3 million or 0.1% of the cost basis of all investments in the Company's portfolio. At September 30, 2007, one Non-Control/Non-Affiliate investment was on non-accrual with a cost basis of approximately \$2.2 million or 0.6% of the cost basis of all investments in the Company's portfolio. Conditional interest, or a success fee, is recorded upon full repayment of a loan investment.

Paid in Kind Interest

The Company seeks to avoid PIK interest; however, the Company currently has one loan in its portfolio that contains a PIK provision. 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, 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 PIK interest income of \$16 and \$46, respectively, for the three and nine months ended June 30, 2008, from investments on the accompanying consolidated statement of operations. There were no PIK loans in the Company's portfolio during the three and nine months ended June 30, 2007.

Recent Accounting Pronouncements

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 is effective as of the beginning of an entity's first fiscal year that begins after December 15, 2006. The Company adopted this Interpretation on October 1, 2007. The adoption did not have a material impact 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. The Company will be required to adopt SFAS No. 157 on

Edgar Filing: GLADSTONE CAPITAL CORP - Form 10-Q

October 1, 2008 and is currently evaluating the impact of this pronouncement on its 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.

In November 2007, the SEC issued Staff Accounting Bulletin No. 109, *Written Loan Commitments Recorded at Fair Value Through Earnings* (SAB 109). SAB 109 provides guidance on the accounting for written loan commitments recorded at fair value under GAAP. Specifically, SAB 109 revises the Staff's views on incorporating expected net future cash flows related to loan servicing activities in the fair value measurement of a written loan commitment. SAB 109, which supersedes SAB 105, *Application of Accounting Principles to Loan Commitments*, requires the expected net future cash flows related to the associated servicing of the loan be included in the measurement of all written loan commitments that are accounted for at fair value through earnings. SAB 109 is effective in fiscal quarters beginning after December 15, 2007. The Company has evaluated the implications of SAB 109 and determined that there is no material impact on its consolidated financial statements.

Table of Contents

In December 2007, the FASB issued SFAS No. 141(R) *Business Combinations* (SFAS No. 141(R)). SFAS No. 141(R) establishes principles and requirements for how an acquirer recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, any noncontrolling interest in the acquiree and the goodwill acquired. SFAS No. 141(R) also establishes disclosure requirements to enable the evaluation of the nature and financial effects of the business combination. SFAS No. 141(R) is effective as of the beginning of an entity's fiscal year that begins after December 15, 2008. The Company is required to adopt SFAS No. 141 (R) on October 1, 2009 and is currently evaluating the impact of this pronouncement on its consolidated financial statements.

In March 2008, the FASB issued SFAS No. 161, *Disclosures about Derivative Instruments and Hedging Activities* (SFAS No. 161), which is intended to help investors better understand how derivative instruments and hedging activities affect an entity's financial position, financial performance and cash flows through enhanced disclosure requirements. The enhanced disclosures primarily surround disclosing the objectives and strategies for using derivative instruments by their underlying risk as well as a tabular format of the fair values of the derivative instruments and their gains and losses. SFAS No. 161 is effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008. The Company is evaluating the impact of this pronouncement on the reporting of its derivatives.

NOTE 3. INVESTMENTS

Non-Control/Non-Affiliate Investments

At June 30, 2008 and September 30, 2007, the Company held investments in Non-Control/Non-Affiliate of approximately \$441.3 million and \$354.8 million, at cost, respectively.

Control Investments

At June 30, 2008, the Company had two control investments: BERTL, Inc. (BERTL) and U.S. Healthcare, Inc. (U.S. Healthcare).

- *BERTL:* The Company originally purchased a past due debt instrument in MCA Communications LLC, and the Company accepted a deed in lieu of foreclosure in satisfaction of BERTL's obligations under the debt instrument on September 28, 2007. BERTL is a web-based evaluator of digital imaging products.

- *U.S. Healthcare:* The Company offered at public sale certain assets of U.S. Healthcare on January 30, 2008, consisting generally of all fixtures and all tangible and intangible personal property. The Company acquired these assets in the sale, through a newly formed subsidiary, and is continuing the business of U.S. Healthcare under its control. U.S. Healthcare is a service-magazine publisher/operator.

Edgar Filing: GLADSTONE CAPITAL CORP - Form 10-Q

The investments in BERTL and U.S. Healthcare consisted of the following as of June 30, 2008 and September 30, 2007:

Company	Investment	June 30, 2008		September 30, 2007	
		Cost	Fair Value	Cost	Fair Value
BERTL, Inc.	Line of credit	\$ 726	\$	\$	\$
	Common stock	424		924	924
U.S. Healthcare, Inc. (1)	Line of credit	30	30		
	Line of credit	231	231		
	Common stock	2,470	410		
Total control investments		\$ 3,881	\$ 671	\$ 924	\$ 924

(1) U.S. Healthcare, Inc. became a new control investment as of March 31, 2008.

Edgar Filing: GLADSTONE CAPITAL CORP - Form 10-Q

Table of Contents

Investments at fair value consisted of the following industry classifications as of June 30, 2008 and September 30, 2007:

Industry Classification	June 30, 2008			September 30, 2007		
	Fair Value	Percentage Total Investments	Net Assets	Fair Value	Percentage Total Investments	Net Assets
Aerospace & Defense	\$ 4,546	1.1%	1.5%	\$ 4,616	1.3%	2.1%
Automobile	5,496	1.3%	1.9%	6,246	1.8%	2.8%
Broadcast (TV & Radio)	56,820	13.8%	19.3%	41,934	12.0%	19.0%
Buildings and Real Estate	13,817	3.3%	4.7%			
Cargo Transport	27,831	6.8%	9.4%	15,685	4.5%	7.1%
Chemicals, Plastics & Rubber	17,163	4.2%	5.8%	25,110	7.2%	11.4%
Diversified/Conglomerate						
Manufacturing	3,195	0.8%	1.1%	3,710	1.1%	1.7%
Electronics	40,625	9.9%	13.8%	31,351	9.0%	14.2%
Farming & Agriculture	10,237	2.5%	3.5%	11,538	3.3%	5.2%
Finance	1,874	0.5%	0.6%	2,460	0.7%	1.1%
Healthcare, Education & Childcare	67,134	16.3%	22.8%	36,927	10.5%	16.7%
Home & Office Furnishings	16,280	4.0%	5.5%	17,057	4.9%	7.7%
Leisure, Amusement, Movies & Entertainment	8,711	2.1%	3.0%	9,509	2.7%	4.3%
Machinery	10,041	2.4%	3.4%	9,883	2.8%	4.5%
Mining, Steel, Iron & Non-Precious Metals	26,036	6.3%	8.8%	27,057	7.7%	12.2%
Personal and Non-durable						
Consumer Products	9,597	2.3%	3.3%	8,978	2.6%	4.1%
Printing & Publishing	58,643	14.2%	19.9%	72,191	20.6%	32.7%
Retail Stores	23,725	5.8%	8.0%	14,986	4.3%	6.8%
Textiles & Leather	9,969	2.4%	3.4%	10,605	3.0%	4.8%
Total	\$ 411,740	100.0%		\$ 349,845	100.0%	

The investments at fair value were included in the following geographic regions of the United States at June 30, 2008 and September 30, 2007:

Geographic Region	June 30, 2008			September 30, 2007		
	Fair Value	Percentage Total Investments	Net Assets	Fair Value	Percentage Total Investments	Net Assets
Midwest	\$ 204,558	49.7%	69.4%	\$ 152,928	43.7%	69.2%
West	85,444	20.7%	29.0%	70,842	20.2%	32.1%
Mid-Atlantic	43,178	10.5%	14.7%	56,866	16.3%	25.7%
Southeast	60,031	14.6%	20.4%	44,488	12.7%	20.1%
Northeast	12,816	3.1%	4.3%	17,331	5.0%	7.8%
U.S. Territory	5,713	1.4%	1.9%	7,388	2.1%	3.3%
Total	\$ 411,740	100.0%		\$ 349,845	100.0%	

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

Table of Contents*Investment Principal Repayment*

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

		Amount
For the remaining three months ending September 30:		
	2008	\$ 6,641
For the year ending September 30:	2009	25,573
	2010	48,070
	2011	109,311
	2012	91,878
	2013	111,810
	Thereafter	48,469
	Total Contractual Repayments	\$ 441,752
	Investments in Equity Securities	3,448
	Total	\$ 445,200

NOTE 4. RELATED PARTY TRANSACTIONS

Loans to Employees

The Company provided loans to employees of the Adviser, who at the time of the loans were joint employees of the Company and either the Adviser, or the Company's previous investment adviser, Gladstone Capital Advisers, Inc., 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, 2008 or June 30, 2007. The Company received \$51 and \$301 of principal repayments during the nine months ended June 30, 2008 and 2007, respectively. The Company recognized interest income from all employee stock option loans of \$118 and \$354 for the three and nine months ended June 30, 2008, respectively, as compared to \$133 and \$404 for the three and nine months ended June 30, 2007, respectively.

Investment Advisory and Management and Administration Agreements

The Company is externally managed by the Adviser, which is controlled by its chairman and chief executive officer, under a contractual investment advisory agreement. On October 1, 2006, the Company entered into the investment advisory agreement (the "Advisory Agreement").

Terms of the Advisory Agreement

Under the 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).

Table of Contents

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 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 and irrevocably waived, for the three months ended June 30, 2008 and June 30, 2007, the annual 2.0% base management fee to 0.5% for senior syndicated loan participations and also waived the entire incentive fee due for the three months ended June 30, 2008 and a portion of the incentive fee due for the three months ended June 30, 2007.

In addition to the base management and incentive fees under the Advisory Agreement, certain fees received by the Adviser from the Company's portfolio companies are credited against the investment advisory fee. Effective April 1, 2007, 50% of certain of the fees received by the Adviser have been voluntarily and irrevocably 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 Advisory Agreement.

The following tables summarize the management fees, incentive fees and associated credits reflected in the accompanying consolidated statement of operations:

	Three months ended		Nine months ended	
	June 30, 2008	June 30, 2007	June 30, 2008	June 30, 2007
Base management fee	\$ 529	\$ 847	\$ 1,664	\$ 1,997
Credit for investment advisory fees received by Adviser	(348)	(531)	(1,320)	(1,617)
Fee reduction for the voluntary, irrevocable waiver of 2% fee on senior syndicated loans to 0.5% per annum	(97)	(259)	(299)	(560)
Net base management fee	\$ 84	\$ 57	\$ 45	\$ (180)
Incentive fee	\$ 1,340	\$ 1,167	\$ 4,089	\$ 3,474
Credit from voluntary, irrevocable waiver issued by Adviser's board of directors	(1,340)	(1,039)	(4,089)	(2,696)
Net incentive fee	\$	\$ 128	\$	\$ 778
Credit for investment advisory fees received by Adviser	\$ (348)	\$ (531)	\$ (1,320)	\$ (1,617)
Fee reduction for the voluntary, irrevocable waiver of 2% fee on senior syndicated loans to 0.5% per annum	(97)	(259)	(299)	(560)
Incentive fee credit	(1,340)	(1,039)	(4,089)	(2,696)
Credit to base management and incentive fees from Adviser	\$ (1,785)	\$ (1,829)	\$ (5,708)	\$ (4,873)

As of June 30, 2008, the Company owed \$84 of base management fee to the Adviser, presented in the Fees due to Adviser in the accompanying consolidated statements of assets and liabilities. 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.

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 are treated as reductions directly against the 2% base management fee under the Advisory Agreement. Effective in April 2006, the Adviser's board of directors voluntarily reduced the annual servicing fee rate on the senior syndicated loans to 0.5%. For the three and nine months ended June 30, 2008, these loan servicing fees totaled \$1,598 and \$4,541, respectively, as compared to loan servicing fees for the three and nine months ended June 30, 2007 of \$898 and \$2,377, 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 accompanying consolidated statements of operations. At June 30, 2008, the Company owed \$384 of unpaid loan servicing fees to the Adviser, which are netted and recorded in Fees due to Adviser. At September 30, 2007, the Company owed \$267 in loan servicing fees to the Adviser, recorded in Fees due to Adviser in the accompanying consolidated statements of assets and liabilities. Under the Advisory Agreement, the Adviser also provides managerial assistance and other services to the Company's portfolio companies and may receive fees for services other than managerial assistance services.

Table of Contents

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 \$285 and \$737, respectively, for the three and nine months ended June 30, 2008, as compared to an administration fee of \$187 and \$482, respectively, for the three and nine months ended June 30, 2007. As of June 30, 2008 and September 30, 2007, \$285 and \$237, respectively, was unpaid and included in the Fee due to Administrator in the accompanying consolidated statements of assets and liabilities.

License Agreement

The Company has entered into a license agreement with the Adviser, pursuant to which the Adviser has granted the Company a non-exclusive license to use the name Gladstone and the Diamond G trademark. This license agreement required us to pay the Adviser a royalty fee of \$1 per quarter through December 19, 2007. The amount of the fee is negotiated on an annual basis by the Company's compensation committee, and must be approved by a majority of the Company's independent directors. The fee was increased to \$10 per quarter effective at the beginning of the current contract term, which began on December 20, 2007, and as a result of the last negotiation, the fee will remain at \$10 for the next contract term, which will begin on December 20, 2008. The license arrangement will terminate in the event that Gladstone Management Corporation is no longer the Company's Adviser.

NOTE 5. LINE OF CREDIT

Through Business Loan, the Company has a \$300 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 Commercial Paper (CP) rate which is equivalent to the weighted average per annum rates paid by the DB Facility's CP lenders in respect of CP notes issued by the CP lender during such period. Business Loan also has the ability to borrow at an alternative rate from the committed lenders if CP lenders are unable to fund advances. The alternative rate is the London Interbank Offered Rate (LIBOR), or if LIBOR is unavailable, the Prime Rate or the Federal Funds Rate, plus 1.0%. In February 2008, the Company increased the DB Facility from \$220 million to \$250 million, and in April 2008, increased the DB Facility to \$300 million and added Branch Banking and Trust Company (BB&T) as a committed lender. In June 2008, the Company renewed the DB Facility, which matures on May 21, 2009. The fees incurred for the above amendments are recorded in deferred financing fees in the accompanying consolidated statements of assets and liabilities.

As of June 30, 2008, the outstanding principal balance under the DB Facility was approximately \$133.1 million at a stated interest rate of approximately 2.71%, plus a 2.50% program fee. The Company is also charged an unused commitment fee of 0.75% per annum. 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, 2008, the remaining borrowing capacity available under the DB Facility was approximately \$166.9 million. The weighted average borrowings outstanding under the DB Facility for the nine months ended June 30, 2008 and 2007 were \$138.6 million and \$96.2 million, respectively, at a weighted average annual interest cost of 6.6% and 6.8%, respectively, which was computed by using the annual stated

Edgar Filing: GLADSTONE CAPITAL CORP - Form 10-Q

interest rate plus commitment and other fees, plus the amortization of deferred financing fees divided by the weighted average debt outstanding.

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 terms to maturity and payments schedules). As of June 30, 2008, 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 Mellon 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, 2008 and September 30, 2007, the amount due from custodian was \$6,637 and \$3,230, respectively.

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 \$250 million and 75% of equity issuances after May 2008 and maintain asset coverage with respect to senior securities representing indebtedness of at least

Table of Contents

200%, in accordance with Section 18 of the 1940 Act. As of June 30, 2008, 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. The interest rate cap agreement's current notional amount is \$4.7 million and it has a nominal fair market value which is recorded in other assets on the Company's consolidated balance sheet at June 30, 2008. At September 30, 2007, the interest rate cap agreement had a nominal fair market value. 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, 2008, the Company recorded \$0 and \$6, as compared to \$8 and \$31 for the three and nine months ended June 30, 2007, 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

Transactions in common stock were as follows:

	Shares	Total value
Balance at September 30, 2007	14,762,574	\$ 235,922
Issuance of Common Stock Under Shelf Offerings	6,325,000	105,380
Balance at June 30, 2008	21,087,574	\$ 341,302

On October 19, 2007, the Company completed an offering of 2,500,000 shares of its common stock, at a price of \$18.70 per share, less an underwriter's discount of \$1.03 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 (the Registration Statement), as supplemented by a final prospectus supplement dated October 15, 2007. The underwriter exercised its over-allotment option and the Company closed on an additional 375,000 shares of common stock on November 19, 2007. Net proceeds of the offering, after deducting underwriting discounts and offering expenses borne by the Company, were approximately \$50.5 million and were used to repay a portion of outstanding borrowings under the Company's line of credit.

Edgar Filing: GLADSTONE CAPITAL CORP - Form 10-Q

On February 5, 2008, the Company completed an offering of 3,000,000 shares of common stock at a price of \$17.00 per share, less an underwriting discount of \$0.935 per share, under the Registration Statement and as supplemented by a final prospectus supplement dated January 30, 2008. On February 26, 2008, the underwriter exercised its over-allotment option and the Company closed on an additional 450,000 shares of common stock. Net proceeds of the offering, after deducting underwriting discounts and offering expenses borne by the Company, were approximately \$55.0 million and were used to repay a portion of outstanding borrowings under the Company's line of credit.

NOTE 8. NET INCREASE IN NET ASSETS RESULTING FROM OPERATIONS PER SHARE

The following table sets forth the computation of basic and diluted net increase in net assets per share resulting from operations per share for the three and nine months ended June 30, 2008 and 2007:

	Three Months Ended June 30		Nine Months Ended June 30,	
	2008	2007	2008	2007
Numerator for basic and diluted net increase (decrease) in net assets resulting from operations per share	\$ 2,809	\$ 5,965	\$ (7,194)	\$ 14,213
Denominator for basic and diluted shares	21,087,574	13,561,511	19,237,203	12,701,845
Basic and diluted net increase (decrease) in net assets resulting from operations per share	\$ 0.13	\$ 0.44	\$ (0.37)	\$ 1.12

Table of Contents

NOTE 9. DIVIDENDS

Dividends and Distributions

The following table lists the per share dividends paid for the nine months ended June 30, 2008 and 2007:

Declaration Date	Record Date	Payment Date	Dividend per Share
April 8, 2008	June 20, 2008	June 30, 2008	\$ 0.14
April 8, 2008	May 21, 2008	May 30, 2008	\$ 0.14
April 8, 2008	April 22, 2008	April 30, 2008	\$ 0.14
January 8, 2008	March 21, 2008	March 31, 2008	\$ 0.14
January 8, 2008	February 21, 2008	February 29, 2008	\$ 0.14
January 8, 2008	January 23, 2008	January 31, 2008	\$ 0.14
October 9, 2007	December 20, 2007	December 31, 2007	\$ 0.14
October 9, 2007	November 21, 2007	November 30, 2007	\$ 0.14
October 9, 2007	October 23, 2007	October 31, 2007	\$ 0.14
	Total		\$ 1.26
April 11, 2007	June 21, 2007	June 29, 2007	\$ 0.14
April 11, 2007	May 22, 2007	May 31, 2007	\$ 0.14
April 11, 2007	April 20, 2007	April 30, 2007	\$ 0.14
January 9, 2007	March 22, 2007	March 31, 2007	\$ 0.14
January 9, 2007	February 20, 2007	February 28, 2007	\$ 0.14
January 9, 2007	January 23, 2007	January 31, 2007	\$ 0.14
October 10, 2006	December 20, 2006	December 29, 2006	\$ 0.14
October 10, 2006	November 21, 2006	November 30, 2006	\$ 0.14
October 10, 2006	October 23, 2006	October 31, 2006	\$ 0.14
	Total		\$ 1.26

The timing and characterization of certain income and capital gains distributions are determined annually in accordance with federal tax regulations which may differ from GAAP. These differences primarily relate to items recognized as income for financial statement purposes and realized gains for tax purposes. As a result, net investment income and net realized gain (loss) on investment transactions for a reporting period may differ significantly from distributions during such period. Accordingly, the Company may periodically make reclassifications among certain of its capital accounts without impacting the net asset value of the Company.

Section 19(a) Disclosure

The Company's Board of Directors estimates the source of the distributions at the time of their declaration as required by Section 19(a) of the 1940 Act. On a monthly basis, if required under Section 19(a), the Company posts a Section 19(a) notice through the Depository Trust Company's Legal Notice System (LENS) and also sends to its registered stockholders a written Section 19(a) notice along with the payment of dividends for any payment which includes a dividend estimated to be paid from any other source other than net investment income. The estimates of the source of the distribution are interim estimates based on GAAP that are subject to revision, and the exact character of the

Edgar Filing: GLADSTONE CAPITAL CORP - Form 10-Q

distributions for tax purposes cannot be determined until the final books and records of the Company are finalized for the calendar year. Following the calendar year end, after definitive information has been determined by the Company, if the Company has made distributions of taxable income (or return of capital), the Company will deliver a Form 1099-DIV to its stockholders specifying such amount and the tax characterization of such amount. Therefore, these estimates are made solely in order to comply with the requirements of Section 19(a) of the 1940 Act and should not be relied upon for tax reporting or any other purposes and could differ significantly from the actual character of distributions for tax purposes.

The following GAAP estimates were made by the Board of Directors during the quarter ended June 30, 2008:

Month Ended	Ordinary Income	Return of Capital	Total Dividend
June 30, 2008	\$ 0.125	\$ 0.015	\$ 0.140
May 31, 2008	0.121	0.019	0.140
April 30, 2008	0.120	0.020	0.140

Table of Contents

Because the Board of Directors declares dividends at the beginning of a quarter, it is difficult to estimate how much of the Company's monthly dividends and distributions, based on GAAP, will come from ordinary income, capital gains, and returns of capital. Subsequent to the quarter ended June 30, 2008, the following corrections were made to the above listed estimates for that quarter:

Month Ended	Ordinary Income	Return of Capital	Total Dividend
June 30, 2008	\$ 0.086	\$ 0.054	\$ 0.140
May 31, 2008	0.105	0.035	0.140
April 30, 2008	0.127	0.013	0.140

For dividends declared subsequent to quarter end, the following estimates, based on GAAP, have been made pursuant to Section 19(a) of the 1940 Act:

Month Ended	Ordinary Income	Return of Capital	Total Dividend
September 30, 2008	\$ 0.114	\$ 0.026	\$ 0.140
August 31, 2008	0.118	0.022	0.140
July 31, 2008	0.112	0.028	0.140

NOTE 10. COMMITMENT AND CONTINGENCIES

As of June 30, 2008, the Company was a party to signed and non-binding term sheets for two loan originations for an aggregate of \$26 million and, as of August 4, 2008, funded one of those originations (see further discussion in footnote 11. Subsequent Events). The Company expects to fund the other potential investment within the next 12 months. 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.

NOTE 11. SUBSEQUENT EVENTS

Dividends

In July 2008, the Company's Board of Directors declared the following monthly cash dividends:

Declaration Date	Record Date	Payment Date	Dividend per Share
------------------	-------------	--------------	--------------------

Edgar Filing: GLADSTONE CAPITAL CORP - Form 10-Q

July 9, 2008	September 22, 2008	September 30, 2008	\$	0.14
July 9, 2008	August 21, 2008	August 29, 2008	\$	0.14
July 9, 2008	July 23, 2008	July 31, 2008	\$	0.14

Investment Activity

Subsequent to June 30, 2008, the Company funded one investment for an aggregate of \$13.1 million and also approximately \$3.0 million of revolver draws and additional investments to existing portfolio companies. The Company also received approximately \$8.7 million of scheduled and unscheduled loan repayments.

On July 2, 2008, the Company acquired certain assets of LocalTel, Inc., consisting generally of all fixtures and all tangible and intangible personal property. The Company acquired these assets from the previous owner, through a newly formed subsidiary, and intends to continue the business of LocalTel, Inc. under its control.

Employee loans

As noted in Note 4. Related Party Transactions – Loans to Employees, the Company provided loans to joint employees of the Company and either the Adviser, or the Company’s previous investment adviser, Gladstone Capital Advisers, Inc., for the exercise of options under the 2001 Plan, which plan is no longer in effect. The loans were fully collateralized at issuance by pledged shares of the Company’s common stock. Subsequent to June 30, 2008, the Company’s share price fell below the exercise price of the shares collateralizing the loans. The Company took prompt steps to increase the collateral on the loans, and obtained borrower assurances to provide additional collateral in amounts sufficient to collateralize the loans fully or to pay down the principal balance of the loans.

Renewal of Advisory Agreement

On July 9, 2008, the Company’s Board of Directors approved the renewal of the Advisory Agreement with the Adviser and its Administration Agreement with the Administrator through August 31, 2009.

Table of Contents

ITEM 2. 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. We caution readers not to place undue reliance on any such forward-looking statements. We undertake no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events or otherwise, after the date of this Form 10-Q.

The following analysis of our financial condition and results of operations should be read in conjunction with our 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, 2007.

OVERVIEW

During the nine months ended June 30, 2008, we extended, directly or through participations, \$107.4 million of new loan originations, including a common equity warrant, to 9 new portfolio companies and \$30.1 million of investments to existing portfolio companies through revolver draws or the additions of new term notes, for total new investments of \$137.5 million. During the nine months ended June 30, 2008, 3 borrowers made payments in full ahead of contractual maturity of \$25.0 million, 2 borrowers made unscheduled partial payoffs of \$3.6 million, and we experienced contractual amortization, revolver repayments and some principal payments received ahead of schedule of \$19.2 million, for total principal repayments of \$47.8 million. Since our initial public offering in August 2001, we have made 249 different loans to, or investments in, 129 companies for a total of approximately \$891.5 million, before giving effect to principal repayments on investments and divestitures.

Recent Accounting Pronouncements

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 is effective as of the beginning of an entity's first fiscal year that begins after December 15, 2006. We adopted this Interpretation on October 1, 2007. The adoption did not have a material impact 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 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 will be required to adopt SFAS No. 159 on October 1, 2008 and are currently evaluating the potential impact of this pronouncement on the consolidated financial statements.

In November 2007, the SEC issued Staff Accounting Bulletin No. 109, *Written Loan Commitments Recorded at Fair Value Through Earnings* (SAB 109). SAB 109 provides guidance on the accounting for written loan commitments recorded at fair value under GAAP. Specifically, SAB 109 revises the Staff's views on incorporating expected net future cash flows related to loan servicing activities in the fair value measurement of a written loan commitment. SAB 109, which supersedes SAB 105, *Application of Accounting Principles to Loan Commitments*, requires the expected net future cash flows related to the associated servicing of the loan be included in the measurement of all written loan commitments that are accounting for at fair value through earnings. SAB 109 is effective in fiscal quarters beginning after December 15, 2007. We have evaluated the implications of SAB 109 and determined that there is no material impact on the consolidated financial statements.

Table of Contents

In December 2007, the FASB issued SFAS No. 141(R) *Business Combinations* (SFAS No. 141(R)). SFAS No. 141(R) establishes principles and requirements for how an acquirer recognizes and measures in its financial statements the identifiable assets acquired, the liabilities assumed, any noncontrolling interest in the acquiree and the goodwill acquired. SFAS No. 141(R) also establishes disclosure requirements to enable the evaluation of the nature and financial effects of the business combination. SFAS No. 141(R) is effective as of the beginning of an entity's fiscal year that begins after December 15, 2008. We will be required to adopt SFAS No. 141(R) on October 1, 2009 and are currently evaluating the impact of this pronouncement on the consolidated financial statements.

In March 2008, the FASB issued SFAS No. 161, *Disclosures about Derivative Instruments and Hedging Activities* (SFAS No. 161), which is intended to help investors better understand how derivative instruments and hedging activities affect an entity's financial position, financial performance and cash flows through enhanced disclosure requirements. The enhanced disclosures primarily surround disclosing the objectives and strategies for using derivative instruments by their underlying risk as well as a tabular format of the fair values of the derivative instruments and their gains and losses. SFAS No. 161 is effective for financial statements issued for fiscal years and interim periods beginning after November 15, 2008. We are evaluating the impact of this pronouncement on the reporting of our derivatives.

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

We use generally accepted valuation techniques to value our portfolio unless we have specific information about the value of an investment to determine otherwise. From time to time we may accept an appraisal of a business in which we hold securities. These appraisals are expensive and occur infrequently but provide a third-party valuation opinion that may differ in results, techniques and scopes used to value our investments. When these specific third-party appraisals are engaged or accepted, we would use such appraisals to value the investment we have in that business if we determined that the appraisals were the best estimate of fair value.

Edgar Filing: GLADSTONE CAPITAL CORP - Form 10-Q

In determining the value of our investments, our Adviser has established an investment valuation policy (the "policy"). The policy has been approved by our Board of Directors and each quarter the Board of Directors reviews whether our Adviser has applied the policy consistently, and votes whether or not to accept the recommended valuation of our investment portfolio.

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

- Publicly-traded securities;
- Securities for which a limited market exists; and
- Securities for which no market exists.

Valuation Methods:

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

Securities for which a limited market exists: We value securities that are not traded on an established secondary securities market, but for which a limited market for the security exists, such as certain participations in, or assignments of, syndicated loans, at the quoted bid price. Firm bid prices are requested; however, if a firm bid price is unavailable, we base the value of the security upon the indicative bid price offered by the respective originating syndication agent's trading desk, or secondary desk, on or near the valuation

Table of Contents

date. To the extent that we use the indicative bid price as a basis for valuing the security, our Adviser may take further steps to consider additional information to validate that price in accordance with the policy.

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

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

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

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

SPSE opinions of value of our debt securities that are issued by portfolio companies where we have no equity, or equity-like securities are submitted to our Board of Directors along with our Adviser's supplemental assessment and recommendation regarding valuation of each of these investments. Our Adviser generally accepts the opinion of value given by SPSE, however, in certain limited circumstances, such as when our Adviser may learn new information regarding an investment between the time of submission to SPSE and the date of 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 to accept or reject 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, 2008 included in our accompanying

consolidated financial statements.

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

(2) **Portfolio investments in controlled companies comprised of a bundle of investments, which can include debt and equity securities:** We value Non-Public Debt Securities and equity or equity-like securities (e.g. preferred equity, equity, or other equity-like securities) that are purchased together from the same controlled portfolio company, or issuer, as part of a package based on the total enterprise value of the issuer, which is calculated using a liquidity waterfall approach. Under this approach, we first calculate the total enterprise value of the issuer by incorporating some or all of the following factors:

- the issuer's ability to make payments;
- the earnings of the issuer;
- recent sales to third parties of similar securities;
- the comparison to publicly traded securities; and
- discounted cash flow or other pertinent factors.

Table of Contents

In gathering the sales to third parties of similar securities, we may reference industry statistics and use outside experts. Once we have estimated the total enterprise value of the issuer, we subtract the value of all the debt securities of the issuer; which are valued at the contractual principal balance. Fair values of these debt securities are discounted for any shortfall of total enterprise value over the total debt outstanding for the issuer. Once the values for all outstanding senior securities (which include the debt securities) have been subtracted from the total enterprise value of the issuer, the remaining amount, if any, is used to determine the value of the issuer's equity or equity like securities.

(3) **Portfolio investments in non-controlled companies comprised of a bundle of investments, which can include debt and equity securities:** We value Non-Public Debt Securities and equity or equity-like securities that are purchased together from the same non-controlled portfolio company, or issuer, by valuing the debt portion with SPSE (as described above) and valuing the equity portion based on the total enterprise value of the issuer, which is calculated using a liquidity waterfall approach as described above.

Due to the uncertainty inherent in the valuation process, such estimates of fair value may differ significantly from the values that would have been obtained had a ready market for the securities existed, and the differences could be material. Additionally, changes in the market environment and other events that may occur over the life of the investments may cause the gains or losses ultimately realized on these investments to be different than the valuations currently assigned. There is no single standard for determining fair value in good faith, as fair value depends upon circumstances of each individual case. In general, fair value is the amount that we might reasonably expect to receive upon the current sale of the security in an arms-length transaction in the security's principal market.

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

- the risk rating of the security (see Loan Grading and Risk Rating);
- the principal balance or 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;
- changes in the economy affecting the portfolio company; and
- other third-party appraisals of the portfolio companies.

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

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

Table of Contents

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

The above scale gives an indication of the probability of default and the magnitude of the loss if there is a default. Our policy is to stop accruing interest on an investment if we determine that interest is no longer collectible. At June 30, 2008 three investments were on non-accrual and at September 30, 2007, one investment was on non-accrual. 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, 2008 and September 30, 2007, representing approximately 82% and 79%, respectively, of all loans in our portfolio at the end of each period:

Rating	June 30, 2008	Sept. 30, 2007
Average	7.3	7.3
Weighted Average	7.1	7.1
Highest	10.0	9.0
Lowest	5.0	4.0

The following table lists the risk ratings for syndicated loans in our portfolio that were not rated by an NRSRO at June 30, 2008 and September 30, 2007, representing approximately 4% of all loans in our portfolio at the end of each period:

Rating	June 30, 2008	Sept. 30, 2007
Average	6.5	6.0

Edgar Filing: GLADSTONE CAPITAL CORP - Form 10-Q

Weighted Average	6.4	6.0
Highest	7.0	6.0
Lowest	6.0	6.0

For syndicated loans that are currently rated by a 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 were rated by an NRSRO at June 30, 2008 and September 30, 2007, representing approximately 13% and 17%, respectively, of all loans in our portfolio at the end of each period:

Rating	June 30, 2008	Sept.30, 2007
Average	CCC+/Caa1	CCC+/Caa1
Weighted Average	CCC+/Caa1	CCC+/Caa1
Highest	BB/Ba3	B/B3
Lowest	CCC/Caa2	CCC/Caa2

Table of Contents

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

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.

Services Provided to Portfolio Companies

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

Edgar Filing: GLADSTONE CAPITAL CORP - Form 10-Q

officers. Currently, neither we nor our Adviser charges a fee for managerial assistance, 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.

Our Adviser receives fees for the other services it provides to our 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 the closing of the investment. The services our Adviser provides to our 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. Effective April 1, 2007, when our Adviser receives fees for these services, 50% of certain of those fees are voluntarily and irrevocably credited against the base management fee that we pay to our Adviser, whereas prior to such date fees were 100% credited. 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 fee.

We may receive fees for the origination and closing services we provide to portfolio companies through our Adviser. These fees are paid directly to us and are recognized as revenue upon closing of the originated investment and are reported as fee income in the accompanying consolidated statements of operations.

Table of Contents**RESULTS OF OPERATIONS (dollar amounts in thousands, unless otherwise indicated)***Comparison of the Three Months Ended June 30, 2008 to the Three Months Ended June 30, 2007***Investment Income**

Investment income for the three months ended June 30, 2008 was \$11,420, as compared to \$9,201 for the three months ended June 30, 2007.

Interest income from our investments in debt securities of private companies was \$11,236 for the three months ended June 30, 2008, as compared to \$8,912 for the three months ended June 30, 2007. The level of interest income from investments is directly related to the balance, at cost, of the interest-bearing investment portfolio outstanding during the period multiplied by the weighted average yield. The weighted average yield varies from period to period based on the current stated interest rate on interest-bearing investments and the amounts of loans for which interest is not accruing. Interest income from our investments increased \$2.3 million, or 26%, during the three months ended June 30, 2008 compared to the prior year period based on the overall growth in the cost basis of our investments. The success fees during the three months ended June 30, 2008 and 2007 were \$500 and \$515, respectively. The success fee for the three months ended June 30, 2008 resulted from a refinancing by Defiance Acquisition Corp, while the success fee for the three months ended June 30, 2007 resulted from a full repayment by Allied Extruders LLC and SCPH Holdings.

- The interest-bearing investment portfolio had an average cost basis of approximately \$440.2 million for the three months ended June 30, 2008, as compared to an average cost basis of \$325.7 million for the three months ended June 30, 2007. The following table lists the interest income from investments for the five largest portfolio companies during the respective periods:

Company	Three months ended June 30, 2008		Three months ended June 30, 2007		
	Interest Income	% of Total	Company	Interest Income	% of Total
Reliable Biopharma	\$ 758	6.7%	Allied Extruders	\$ 566	6.4%
Sunshine Media	693	6.2%	Clinton Aluminum	493	5.5%
Defiance Acquisition	674	6.0%	Westlake Hardware	477	5.4%
Westlake Hardware	521	4.6%	Sunshine Media	377	4.2%
Clinton Aluminum	470	4.2%	Specialty Coatings	315	3.5%
Subtotal	\$ 3,116	27.7%	Subtotal	\$ 2,228	25.0%
Other companies	8,120	72.3%	Other companies	6,684	75.0%
Total interest income	\$ 11,236	100.0%	Total interest income	\$ 8,912	100.0%

- The annualized weighted average yield on our portfolio, excluding cash and cash equivalents, for the three months ended June 30, 2008 was 10.1%, compared to 11.8% for the three months ended June 30, 2007. The weighted average yields were not materially impacted by the PIK interest, which were \$16 and \$0 for the three months ended June 30, 2008 and 2007, respectively. The decrease in the annualized weighted average yield primarily resulted from

a reduction in the average LIBOR, which was 2.7% for the three months ended June 30, 2008, compared to 5.3% in the prior year period, as well as three investments being on non-accrual during the three months ended June 30, 2008 (LocalTel, West Cost Yellow Pages, and U.S. Healthcare) and none in the prior year period.

Interest income from invested cash and cash equivalents for the three months ended June 30, 2008 was \$38, as compared to \$109 for the three months ended June 30, 2007. Interest income decreased 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.

Interest income from loans to our employees, in connection with the exercise of employee stock options, for the three months ended June 30, 2008 and June 30, 2007, was \$118 and \$133, respectively. The decrease is due to the cancellation of one employee loan during the fourth quarter of the prior fiscal year, and repayment of another employee loan in the second quarter of this fiscal year.

Prepayment fees and other income for the three months ended June 30, 2008 was \$28, as compared to \$47 for the three months ended June 30, 2007. 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 was based on a percentage of the outstanding principal amount of the loan at the date of prepayment.

Operating Expenses

Operating expenses, net of credits from the Adviser for fees earned and voluntary and irrevocable waivers to the base management and incentive fees, were \$4,723 for the three months ended June 30, 2008, as compared to \$3,496 for the three months ended June 30,

Table of Contents

2007. Operating expenses for the three months ended June 30, 2008 reflected a significant increase in loan servicing fees and amortization of deferred financing fees incurred in connection with certain amendments to our credit facility with Deutsche Bank AG.

Interest expense for the three months ended June 30, 2008 was \$1,771, as compared to \$1,762 for the three months ended June 30, 2007. This increase is primarily a result of increased borrowings under our line of credit during the three months ended June 30, 2008, which borrowings were partially used to finance our increased investments.

Loan servicing fees for the three months ended June 30, 2008 were \$1,598, as compared to \$898 for the three months ended June 30, 2007. These fees were incurred in connection with a loan servicing agreement between Business Loan and our Adviser, which is based on the size and mix of the portfolio. The average size of our investment portfolio, excluding equity investments and control investments, was approximately \$408.1 million for the three months ended June 30, 2008 as compared to approximately \$322.6 million for the three months ended June 30, 2007. In terms of portfolio mix, senior syndicated loans comprised 6.4% and 11.1% of the portfolio during the three months ended June 30, 2008 and 2007, respectively. Due to voluntary, irrevocable waivers in place during these periods, senior syndicated loans incurred a 0.5% annual fee whereas proprietary loans incurred a 1.5% annual fee. These fees were reduced against the amount of the base management fee due to our Adviser.

Base management fee for the three months ended June 30, 2008 was \$529, as compared to \$847 for the three months ended June 30, 2007. The base management fee is computed quarterly as described under *Investment Advisory and Management Agreement* in footnote 4, and is summarized in the table below:

	Three months ended	
	June 30, 2008	June 30, 2007
Base management fee	\$ 529	\$ 847
Credit for investment advisory fees received by Adviser (1)	(348)	(531)
Fee reduction for the voluntary, irrevocable waiver of 2% fee on senior syndicated loans to 0.5% (2)	(97)	(259)
Net base management fee	\$ 84	\$ 57

(1) Effective April 1, 2007, the board of our Adviser reduced the amount of voluntary irrevocable credit for investment advisory fees received by our Adviser from 100% of the fees received to 50% of the fees received. Therefore, the three months ended June 30, 2008 and 2007 reflect the reduced credit for fees received by our Adviser.

(2) The board of our Adviser voluntarily and irrevocably waived, for the three months ended June 30, 2008 and 2007, the annual 2.0% base management fee to 0.5% for senior syndicated loan participations.

Incentive fee for the three months ended June 30, 2008 was \$1,340, as compared to \$1,167 for the three months ended June 30, 2007. The board of our Adviser waived the entire incentive fee for the three months ended June 30, 2008 and a portion of the incentive fee due for the three months ended June 30, 2007. The incentive fees and associated credits are summarized in the table below:

Edgar Filing: GLADSTONE CAPITAL CORP - Form 10-Q

	Three months ended	
	June 30, 2008	June 30, 2007
Incentive fee	\$ 1,340	\$ 1,167
Credit from voluntary, irrevocable waiver issued by Adviser's board of directors	(1,340)	(1,039)
Net incentive fee	\$	\$ 128

Administration fee for the three months ended June 30, 2008 was \$285 as compared to \$187 for the three months ended June 30, 2007. The increase is due to the addition of administration staff and related expenses.

Professional fees, consisting primarily of legal and audit fees, for the three months ended June 30, 2008 were \$167, as compared to \$149 for the three months ended June 30, 2007. The increase is due to the recording of audit accruals and non reimbursable legal fees.

Amortization of deferred financing fees, in connection with our line of credit, was \$572 for the three months ended June 30, 2008, as compared to \$72 for the three months ended June 30, 2007. The increase is due to the amortization of additional fees incurred with our line of credit. In February 2008, we increased the DB Facility from \$220 million to \$250 million, and in April 2008, increased the DB Facility to \$300 million and added Branch Banking and Trust Company (BB&T) as a committed lender. In June 2008, we renewed the DB Facility. The fees incurred for the above amendments are recorded in deferred financing fees on our consolidated statement of assets and liabilities, and amortized over the life of the DB Facility.

Table of Contents

Stockholder related costs for the three months ended June 30, 2008 were \$34, as compared to \$39 for the three months ended June 30, 2007. Stockholder related costs include such recurring items as transfer agent fees, NASDAQ listing fees, costs associated with SEC filings, and the annual report printing and distribution costs.

Directors' fees for the three months ended June 30, 2008 and 2007 were \$52 and \$56 respectively, and consisted of amortization of their annual stipend and meeting stipends.

Insurance expense for the three months ended June 30, 2008 was \$57, as compared to \$66 for the three months ended June 30, 2007. The decrease was primarily the result of a decrease of our directors and officers insurance policy premiums.

Other expenses for the three months ended June 30, 2008 were \$103, as compared to \$82 for the three months ended June 30, 2007. 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. The increase is primarily due to the increase in direct expenses as the overall size of our investment portfolio continued to grow from the prior year period.

Net Realized Loss on Sale of Investments

During the three months ended June 30, 2008, we realized a net loss of \$86 from the payoff of two loans (in particular the unamortized investment acquisition costs related to the Anitox and Macfadden loans), as compared to a realized net loss of \$5 from the sale or repayment of eleven syndicated loan investments in the three months ended June 30, 2007.

Realized Gain on Settlement of Derivative

During the three months ended June 30, 2008, we did not receive any interest rate cap agreement payments. During the three months ended June 30, 2007, we received interest rate cap agreement payments of \$8 as a result of the one month LIBOR having an increasing trend. We receive payments when the one month LIBOR is over 5%.

Net Unrealized Depreciation on Derivative

During the three month periods ended June 30, 2008 and June 30, 2007, we recorded nominal amounts of net unrealized depreciation due to a decrease in the fair market value of our interest rate cap agreement.

Net Unrealized (Depreciation) Appreciation on Investments

For the three months ended June 30, 2008, we recorded net unrealized depreciation on investments of \$3,802, as compared to net unrealized appreciation of \$257, for the three months ended June 30, 2007. The unrealized depreciation is mainly attributable to the decrease in fair value on our portfolio, most notably in the following investments: Reliable Biopharmaceutical, Westlake Hardware, SCI Cable, Sunshine Media, and Greatwide Logistics Services. We believe that our investment portfolio was valued at a depreciated value due primarily to the general instability of the loan markets and, to a lesser extent, the use of a modified valuation procedure for our non-control/non-affiliate investments, which was implemented during the quarter ended June 30, 2008. Previously, we valued the debt portion of bundled debt and equity investments in non-controlled companies in accordance with board approved valuation procedures, which valued the debt securities at the contractual principal balance. Consistent with the Board's ongoing review and analysis of appropriate valuation procedures, and in consideration of the fair value measurements of SFAS No. 157 (which we will be required to adopt on October 1, 2008), the Board of Directors modified our valuation procedure so that the debt portion of bundled investments in non-controlled companies is based on opinions of value provided by SPSE. This change in valuation procedure accounted for \$1,037, or 27%, of the net unrealized depreciation for the quarter. Although our investment portfolio has depreciated, our entire portfolio was fair valued at 92% of cost as of June 30, 2008. The unrealized depreciation of our investments does not have an impact on our current ability to pay distributions to stockholders.

Net Increase in Net Assets from Operations

Overall, we realized a net increase in net assets resulting from operations of \$2,809 for the three months ended June 30, 2008. Based on a weighted-average of 21,087,574 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, 2008 was \$0.13, basic and diluted.

For the three months ended June 30, 2007, we realized a net increase in net assets resulting from operations of \$5,965. 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.

Table of Contents*Comparison of the Nine Months Ended June 30, 2008 to the Nine Months Ended June 30, 2007***Investment Income**

Investment income for the nine months ended June 30, 2008 was \$34,172, as compared to \$26,079 for the nine months ended June 30, 2007.

Interest income from our investments in debt securities of private companies was \$33,499 for the nine months ended June 30, 2008, as compared to \$25,065 for the nine months ended June 30, 2007. The level of interest income from investments is directly related to the balance, at cost, of the interest-bearing investment portfolio outstanding during the period multiplied by the weighted average yield. The weighted average yield varies from period to period based on the current stated interest rate on interest-bearing investments and the amounts of loans for which interest is not accruing. Interest income from our investments increased \$8.4 million, or 33.6%, during the nine months ended June 30, 2008 compared to the prior year period based on the overall growth in the cost basis of our investments, offset by the decrease in the weighted average yield. The success fees during the nine months ended June 30, 2008 and 2007 were \$846 and \$2,249, respectively. The success fee for the nine months ending June 30, 2008 resulted from a refinancing by Westlake Hardware, Inc. and Defiance Acquisition Corp., while the success fee for the nine months ended June 30, 2007 resulted from a refinancing by Badanco Acquisition Corp. and a full repayment by Mistras Holdings Corp., SCPH Holdings and Allied Extruders LLC.

- The interest-bearing investment portfolio had an average cost basis of approximately \$398.1 million for the nine months ended June 30, 2008, as compared to an average cost basis of \$293.0 million for the nine months ended June 30, 2007. The following table lists the interest income from investments for the five largest portfolio companies during the respective periods:

Company	Nine months ended June 30, 2008		Company	Nine months ended June 30, 2007	
	Interest Income	% of Total		Interest Income	% of Total
Westlake Hardware	\$ 2,245	6.7%	Badanco	\$ 1,604	6.4%
Sunshine Media	2,096	6.3%	Westlake Hardware	1,430	5.7%
Reliable Biopharma	2,090	6.2%	Mistras Holdings	1,356	5.4%
Clinton Aluminum	1,427	4.3%	Allied Extruders	1,074	4.3%
Defiance Acquisition	1,071	3.2%	Specialty Coatings	967	3.9%
Subtotal	\$ 8,929	26.7%	Subtotal	\$ 6,431	25.7%
Other companies	24,570	73.3%	Other companies	18,634	74.3%
Total interest income	\$ 33,499	100.0%	Total interest income	\$ 25,065	100.0%

- The annualized weighted average yield on our portfolio, excluding cash and cash equivalents, for the nine months ended June 30, 2008 was 10.5% compared to 12.3% for the nine months ended June 30, 2007. The weighted average yields were not materially impacted by the PIK interest, which were \$46 and \$0 for the nine months ended June 30, 2008 and 2007, respectively. The decrease in the annualized weighted average yield primarily resulted from a reduction in the average LIBOR, which was 3.8% for the nine months ended June 30, 2008, compared to 5.3% in the prior year period, as well as three investments being on non-accrual during the nine months ended June 30, 2008 (LocalTel, West Cost Yellow Pages, and U.S. Healthcare) and none in the prior year period.

Edgar Filing: GLADSTONE CAPITAL CORP - Form 10-Q

Interest income from invested cash and cash equivalents for the nine months ended June 30, 2008 was \$285, as compared to \$178 for the nine months ended June 30, 2007 due to the amount of cash that was held in interest bearing accounts and the interest earned on our custodial account prior to disbursement.

Interest income from loans to our employees, in connection with the exercise of employee stock options, for the nine months ended June 30, 2008 and June 30, 2007, was \$354 and \$404 respectively. The decrease is due to the cancellation in full of one employee loan during the fourth quarter of the prior fiscal year, and repayment of another employee loan in the second quarter of this fiscal year.

Prepayment fees and other income for the nine months ended June 30, 2008 was \$34, as compared to \$432 for the nine months ended June 30, 2007. The income for the prior period 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 was based on a percentage of the outstanding principal amount of the loan at the date of prepayment.

Table of Contents**Operating Expenses**

Operating expenses, net of credits from the Adviser for fees earned and voluntary waivers to the base management and incentive fees, were \$13,729 for the nine months ended June 30, 2008, as compared to \$9,487 for the nine months ended June 30, 2007. Operating expenses for the nine months ended June 30, 2007 reflected a significant increase in interest expense, loan servicing fees and amortization of deferred financing fees incurred in connection with certain amendments to our credit facility.

Interest expense for the nine months ended June 30, 2008 was \$5,982, as compared to \$4,694 for the nine months ended June 30, 2007. This increase is primarily a result of increased borrowings under our line of credit during the nine months ended June 30, 2008, 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.

Loan servicing fees for the nine months ended June 30, 2008 were \$4,541, as compared to \$2,377 for the nine months ended June 30, 2007. These fees were incurred in connection with a loan servicing agreement between Business Loan and our Adviser, which is based on the size and mix of the portfolio. The average size of our investment portfolio, excluding equity investments and control investments, was approximately \$376.7 million for the nine months ended June 30, 2008 as compared to approximately \$291.4 million for the nine months ended June 30, 2007. In terms of portfolio mix, senior syndicated loans comprised 6.9% and 12.3% of the portfolio during the three months ended June 30, 2008 and 2007, respectively. Due to voluntary, irrevocable waivers in place during these periods, senior syndicated loans incurred a 0.5% annual fee whereas proprietary loans incurred a 1.5% annual fee. These fees were reduced against the amount of the base management fee due to our Adviser.

Base management fee for the nine months ended June 30, 2008 was \$1,664, as compared to \$1,997 for the nine months ended June 30, 2007. The base management fee is computed quarterly as described under *Investment Advisory and Management Agreement* in footnote 4, and is summarized in the table below:

	Nine months ended	
	June 30, 2008	June 30, 2007
Base management fee	\$ 1,664	\$ 1,997
Credit for investment advisory fees received by Adviser (1)	(1,320)	(1,617)
Fee reduction for the voluntary, irrevocable waiver of 2% fee on senior syndicated loans to 0.5% (2)	(299)	(560)
Net base management fee	\$ 45	\$ (180)

(1) Effective April 1, 2007, the board of our Adviser reduced the amount of voluntary irrevocable credit for investment advisory fees received by our Adviser from 100% of the fees received to 50% of the fees received. Therefore, the nine months ended June 30, 2008 and third quarter ended June 30, 2007 reflect the reduced credit for fees received by our Adviser.

(2) The board of our Adviser voluntarily and irrevocably waived, for the nine months ended June 30, 2008 and 2007,

Edgar Filing: GLADSTONE CAPITAL CORP - Form 10-Q

the annual 2.0% base management fee to 0.5% for senior syndicated loan participations.

Incentive fee for the nine months ended June 30, 2008 was \$4,089, as compared to \$3,474 for the nine months ended June 30, 2007. The board of our Adviser waived the entire incentive fee for the nine months ended June 30, 2008 and a portion of the incentive fee due for the nine months ended June 30, 2007. The incentive fees and associated credits are summarized in the table below:

	Nine months ended	
	June 30, 2008	June 30, 2007
Incentive fee	\$ 4,089	\$ 3,474
Credit from voluntary, irrevocable waiver issued by Adviser's board of directors	(4,089)	(2,696)
Net incentive fee	\$	\$ 778

Administration fee for the nine months ended June 30, 2008 was \$737, compared to \$482 for the nine months ended June 30, 2007. The increase is due to the addition of administration staff and related expenses.

Professional fees, consisting primarily of legal and audit fees, for the nine months ended June 30, 2008 were \$706, as compared to \$369 for the nine months ended June 30, 2007. The increase is due to legal fees incurred for converting troubled loans to control investments.

Amortization of deferred financing costs, in connection with our line of credit, was \$830 for the nine months ended June 30, 2008, as compared to \$199 for the nine months ended June 30, 2007. The increase is due to the amortization of additional fees incurred with

Table of Contents

our line of credit. In February 2008, we increased the DB Facility from \$220 million to \$250 million, and in April 2008, increased the DB Facility to \$300 million and added BB&T as a committed lender. In June 2008, the Company renewed the DB Facility. The fees incurred for the above amendments are recorded in deferred financing fees on our consolidated statement of assets and liabilities, and amortized over the life of the DB Facility.

Stockholder related costs for the nine months ended June 30, 2008 were \$292, as compared to \$190 for the nine months ended June 30, 2007. Stockholder related costs include such recurring items as transfer agent fees, NASDAQ listing fees, costs associated with SEC filings, and annual report printing and distribution costs. These fees increased during the nine months ended June 30, 2008 due to the size and quantity of our annual report and additional filing fees as compared to the prior year.

Directors' fees for the nine months ended June 30, 2008 and 2007 were \$163 and \$167 respectively, and consisted of amortization of their annual stipend and meeting stipends.

Insurance expense for the nine months ended June 30, 2008 was \$170, as compared to \$191 for the nine months June 30, 2007. The increase is primarily the result of a decrease in the amortization of our directors and officers insurance policy premiums.

Other expenses for the nine months ended June 30, 2008 was \$263, as compared to \$220 for the nine months ended June 30, 2007. 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 services expenses. The increase is primarily due to the increase in direct expenses as the overall size of our investment portfolio continued to grow from the prior year period.

Net Realized Gain (Loss) on Sale of Investments

During the nine months ended June 30, 2008, we realized a net loss of \$86 from the payoff of two loans (in particular the unamortized investment acquisition costs related to the Anitox and Macfadden loans), as compared to a realized net gain of \$82 from the sale or repayment of 21 syndicated loan investments in the nine months ended June 30, 2007.

Realized Gain on Settlement of Derivative

During the nine months ended June 30, 2008 and June 30, 2007, we received interest rate cap agreement payments of \$6 and \$31, respectively, as a result of the one month LIBOR exceeding 5%.

Net Unrealized Depreciation on Derivative

During the nine months ended June 30, 2008, we recorded net unrealized depreciation of \$12 due to a decrease in the fair market value of our interest rate cap agreement, as compared to unrealized depreciation of \$26 during the nine months ended June 30, 2007.

Net Unrealized Depreciation on Investments

For the nine months ended June 30, 2008, we recorded net unrealized depreciation on investments of \$27,545, as compared to net unrealized depreciation of \$2,466, for the nine months ended June 30, 2007. The unrealized depreciation is mainly attributable to the decrease in fair value on our portfolio, most notably in the following investments: LocalTel, Greatwide Logistics Services, U.S. Healthcare, and Visual Edge Technology. We believe that our investment portfolio was valued at a depreciated value due primarily to the general instability of the loan markets and, to a lesser extent, the use of a modified valuation procedure for our non-control/non-affiliate investments. Previously, we valued the debt portion of bundled debt and equity investments in non-controlled companies in accordance with board approved valuation procedures, which valued the debt securities at the contractual principal balance. Consistent with the Board's ongoing review and analysis of appropriate valuation procedures, and in consideration of the fair value measurements of SFAS No. 157 (which we will be required to adopt on October 1, 2008), the Board of Directors modified our valuation procedure so that the debt portion of bundled investments in non-controlled companies is based on opinions of value provided by SPSE. This change in valuation estimate accounted for \$1,037, or 4%, of the net unrealized depreciation for the nine month period. Although our investment portfolio has depreciated, our entire portfolio was fair valued at 92% of cost as of June 30, 2008. The unrealized depreciation of our investments does not have an impact on our current ability to pay distributions to stockholders.

Net (Decrease) Increase in Net Assets from Operations

Overall, we realized a net decrease in net assets resulting from operations of \$7,194 for the nine months ended June 30, 2008. Based on a weighted-average of 19,237,203 basic and diluted shares outstanding, our net decrease in net assets from operations per weighted-average common share for the nine months ended June 30, 2007 was \$0.37, basic and diluted.

Table of Contents

For the nine months ended June 30, 2007, we realized a net increase in net assets resulting from operations of \$14,213. 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, 2007 was \$1.12, basic and diluted.

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

At June 30, 2008, we had investments in debt securities of, or loans to, 62 private companies, totaling approximately \$441.8 million (cost basis) of total assets. During the nine months ended June 30, 2008 and June 30, 2007, the following investment activity occurred:

Quarter Ended	New Investments (1)	Principal Repayments (2)	Net Gain (Loss) on Disposal
June 30, 2008	\$ 43,678	\$ 40,755	\$ (86)
March 31, 2008	20,483	3,000	
December 31, 2007	73,341	4,047	
	\$ 137,502	\$ 47,802	\$ (86)
June 30, 2007	\$ 126,087	\$ 37,573	\$ (5)
March 31, 2007	75,330	38,263	85
December 31, 2006	52,311	23,967	2
	\$ 253,728	\$ 99,803	\$ 82

(1) New Investments

During the nine months ended June 30, 2008, we extended, directly or through participations, \$107.4 million of loan originations to 9 new portfolio companies, in one instance receiving a common equity warrant, and \$30.1 million of investments to existing portfolio companies through revolver draws or additions of new notes, for total new investments of \$137.5 million. The originations of loans to new portfolio companies by quarter were as follows:

Quarter ended	Originations	Companies	Description
June 30, 2008	\$ 35.7 million	3	Saunders, Legend and BAS Broadcasting
March 31, 2008	13.7 million	1	ACE Expeditors
December 31, 2007	58.0 million	5	Interfilm, Reliable, Lindmark, GS Maritime and GFRC
Total	\$ 107.4 million	9	

During the nine months ended June 30, 2007, we extended, directly or through participations, \$214.6 million of loan originations to 52 new portfolio companies, in one instance receiving a common equity warrant, and \$39.1 million of investments to existing portfolio companies

Edgar Filing: GLADSTONE CAPITAL CORP - Form 10-Q

through revolver draws or additions of new notes, for total new investments of \$253.7 million. The new loan originations by quarter were as follows:

Quarter ended	Originations	Companies	Description
June 30, 2007	\$ 112.7 million	20	Includes acquisition of \$63.3 million in senior debt with 16 different borrowers in June 2007
March 31, 2007	53.1 million	12	Most notably Clinton Holdings and Greatwide Logistics
December 31, 2006	48.8 million	20	Most notably Precision and Pinnacle Treatment Centers
Total	\$ 214.6 million	52	

(2) Principal Repayments

During the nine months ended June 30, 2008, 3 borrowers made payments in full ahead of contractual maturity of \$25.0 million, 2 borrowers made unscheduled partial payoffs of \$3.6 million, and we experienced contractual amortization, revolver repayments and some principal payments received ahead of schedule of \$19.2 million, for total principal repayments of \$47.8 million. The total and partial payoffs by quarter were as follows:

Quarter ended	Repayments	Companies	Description
June 30, 2008	Repaid in full ahead of maturity	3	Reading Broadcasting, Macfadden Performing Arts and SCS Acquisition Corp.
	Partial payoff	1	Anitox Senior Real Estate Term Debt
March 31, 2008	Partial payoff	1	Risk Metrics Senior Subordinated Term Debt
December 31, 2007	None		

Edgar Filing: GLADSTONE CAPITAL CORP - Form 10-Q

Table of Contents

During the nine months ended June 30, 2007, 4 borrowers made payments in full ahead of contractual maturity, 1 borrower refinanced its investment and we sold or were repaid in full on 21 syndicated loans of \$87.6 million, and we experienced contractual amortization, revolver repayments and some principal payments received ahead of schedule of \$12.2 million, for total principal repayments of \$99.8 million. The total payoffs and refinancing by quarter were as follows:

Quarter ended	Repayments	Companies	Description
June 30, 2007	Repaid in full ahead of maturity	3	SCPH Holdings, Benetech and Allied Extruders
	Syndicated loans	11	
March 31, 2007	Refinanced	1	Badanco Acquisition Corp.
	Syndicated loans	8	
December 31, 2006	Repaid in full ahead of maturity	1	Mistras Holdings
	Syndicated loans	2	

The following table summarizes the contractual principal repayments and maturity of our investment portfolio by fiscal year, assuming no voluntary prepayments:

		Amount
For the remaining three months ending September 30:	2008	\$ 6,641
For the year ending September 30:	2009	25,573
	2010	48,070
	2011	109,311
	2012	91,878
	2013	111,810
	Thereafter	48,469
	Total Contractual Repayments	\$ 441,752
	Investments in Equity Securities	3,448
	Total	\$ 445,200

Net cash used in operating activities for the nine months ended June 30, 2008, consisting primarily of the items described in *Results of Operations* and the investment activity described above, was \$72,430 as compared to net cash used in operating activities of \$136,605 for the nine months ended June 30, 2007.

Investing Activities

Net cash provided by investing activities for the nine months ended June 30, 2008 was \$2,484, which resulted from the redemption of the U.S. Treasury bill held by Gladstone Financial.

Financing Activities

Net cash provided by financing activities for the nine months ended June 30, 2008 was \$66,533 and mainly consisted of two offerings of common stock for aggregate net proceeds of \$106,226, offset by net repayments on our line of credit of \$11,350, dividend payments of \$24,523, and payments to amend our DB Facility totaling \$3,026. Net cash provided by financing activities was \$139,365 for the nine months ended June 30, 2007 and consisted primarily of one offering of common stock for net proceeds of \$45,669, net borrowings on our line of credit of approximately \$111,195, offset by dividend payments of \$16,013.

Dividends

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 April, May and June 2008 and also January, February and March 2007. In July 2008, our Board of Directors declared a monthly dividend of \$0.14 per common share for each of July, August, and September 2008.

Table of Contents

Issuance of Equity

We anticipate borrowing funds and issuing additional equity securities to obtain additional capital in the future. However, we cannot determine the terms of any future equity issuances or whether we will be able to issue equity on terms favorable to us, or if at all. During fiscal year 2007, we filed a registration statement on Form N-2 (File No. 333-143027) (the Registration Statement) with the SEC that permits us to issue, through one or more transactions, up to an aggregate of \$300 million in securities, consisting of common stock, or debt securities, of which to date we have issued \$123.8 million in common stock, which leaves a remaining capacity of \$176.2 million.

On October 19, 2007, we completed an offering of 2,500,000 shares of our common stock at a price of \$18.70 per share, less an underwriting discount of \$1.03 per share, under the Registration Statement and as supplemented by a final prospectus supplement dated October 15, 2007. On November 19, 2007, the underwriter exercised its over-allotment option and we closed on an additional 375,000 shares of common stock, at the same price. Net proceeds of the offering, after deducting underwriting discounts and offering expenses borne by us, were approximately \$50.5 million and were used to repay a portion of outstanding borrowings under our line of credit.

On February 5, 2008, we completed an offering of 3,000,000 shares of our common stock at a price of \$17.00 per share, less an underwriting discount of \$0.935 per share, under the Registration Statement and as supplemented by a final prospectus supplement dated January 30, 2008. On February 26, 2008, the underwriter exercised its over-allotment option and we closed on an additional 450,000 shares of common stock, at the same price. Net proceeds of the offering, after deducting underwriting discounts and offering expenses borne by us, were approximately \$55.0 million and were used to repay a portion of outstanding borrowings under our line of credit.

On February 21, 2008, our stockholders approved a proposal to authorize us to offer and issue long-term rights, including warrants, to purchase shares of our common stock at an exercise price that, at the time such rights are issued, will not be less than the greater of the market value of our common stock or the net asset value (NAV) of our common stock. Such rights may be part of or accompanied by other securities of ours such as convertible debt. We have determined that it would be advantageous to have the ability to sell, either alone or as part of another security, warrants, options or rights to purchase common stock in connection with our financing and capital raising activities. This ability may give us a cost-effective way to raise capital. We believe that the rights to purchase shares of our common stock give us additional flexibility over and above the limited amount that can be raised without stockholder approval through short-term transferable rights offering to take advantage of investment opportunities that may arise in the future.

Generally, the 1940 Act provides that we may not issue and sell our common stock at a price below our NAV per share, other than to our then existing stockholders pursuant to a rights offering, without first obtaining approval from our stockholders and our independent directors. As of June 30, 2008, our NAV per share was \$13.97 per share on that date and our closing market price was \$15.24 per share. To the extent that our common stock trades at a market price below our NAV per share, we will generally be precluded from raising equity capital through public offerings of our common stock, other than pursuant to a rights offering. The asset coverage requirement of a BDC under the 1940 Act effectively limits our ratio of debt to equity to 1:1. To the extent that we are unable to raise capital through the issuance of equity, our ability to raise capital through the issuance of debt may also be inhibited to the extent of our regulatory debt to equity ratio limits.

Revolving Credit Facility

Edgar Filing: GLADSTONE CAPITAL CORP - Form 10-Q

Through our wholly-owned subsidiary, Business Loan, we have a \$300 million revolving credit facility (the DB Facility) with Deutsche Bank AG, as administrative agent, which is scheduled to mature on May 21, 2009. Pursuant to the DB Facility, Business Loan has pledged 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 Commercial Paper (CP) rate, which is equivalent to the weighted average per annum rates paid by the DB Facility's CP lenders in respect of CP notes issued by the CP lender during such period. Business Loan also has the ability to borrow at an alternative rate from the committed lenders if CP lenders are unable to fund advances. The alternative rate is the London Interbank Offered Rate (LIBOR), or if LIBOR is unavailable, the Prime Rate or the Federal Funds Rate plus 1.0%. In February 2008, we increased the DB Facility from \$220 million to \$250 million, and in April 2008, increased the DB Facility to \$300 million and added Branch Banking and Trust Company (BB&T) as a committed lender. In June 2008, we renewed the DB Facility, which matures on May 21, 2009.

As of June 30, 2008, the outstanding principal balance under this credit facility was approximately \$133.1 million at an interest rate of approximately 2.71% plus a 2.50% program fee. We are also charged an unused commitment fee of 0.75% per annum. 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, 2008, the remaining borrowing capacity available under the DB Facility was approximately \$166.9 million.

Table of Contents

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 our credit and collection policies. The 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, 2008, Business Loan was in compliance with all of the facility covenants. We currently intend to securitize the loans held by Business Loan and if we are able to do so, we will use the proceeds from the securitization to pay down any amounts then outstanding under the revolving credit facility.

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 Mellon as custodian. Deutsche Bank AG is also the trustee of the account and once a month remits the collected funds to us. At June 30, 2008 and September 30, 2007, the amount due from custodian was \$6,637 and \$3,230, respectively.

Our Adviser also 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 equity issued after May 2003 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, 2008, we were in compliance with our covenants under the performance guaranty.

Contractual Obligations and Off-Balance Sheet Arrangements

As of June 30, 2008, we were a party to signed and non-binding term sheets for two loan originations for an aggregate of \$26 million and, as of August 4, 2008, funded one of those originations (see further discussion in footnote 11. Subsequent Events). We expect to fund the other potential investment within the next 12 months.

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 investment, the Company will only agree to provide the investment if, among other things, the results of its due diligence investigations are satisfactory, the terms and conditions of the investment 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.

We do not have any off-balance sheet arrangements as defined in Item 303(a)(4)(ii) of Regulation S-K as of June 30, 2008.

ITEM 3. 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. Currently, our portfolio consists of the following:

63% variable rates with a floor
2% variable rates with a floor and ceiling
32% variable rates without a floor or ceiling
3% fixed rate
100% total

There have been no material changes in the quantitative and qualitative market risk disclosures for the nine months ended June 30, 2008 from that disclosed in our Annual Report on Form 10-K for the fiscal year ended September 30, 2007, as filed with the Securities and Exchange Commission on December 3, 2007.

ITEM 4. CONTROLS AND PROCEDURES.

As of June 30, 2008, we, including our Chief Executive Officer and Chief Financial Officer, evaluated the effectiveness of the design and operation of our disclosure controls and procedures. Based on that evaluation, our management, including the Chief Executive Officer and Chief Financial Officer, concluded that our disclosure controls and procedures were effective in timely alerting management, including the Chief Executive Officer and Chief Financial Officer, of material information about us required to be included in periodic Securities and Exchange Commission filings. However, in evaluating the disclosure controls and procedures, management recognized that any controls and procedures, no matter how well designed and operated can provide only reasonable

Table of Contents

assurance of achieving the desired control objectives, and management necessarily was required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures.

There have been no changes in our internal control over financial reporting that occurred during the quarter ended June 30, 2008, that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Table of Contents

PART II OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS.

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

ITEM 1A. RISK FACTORS.

Our business is subject to certain risks and events that, if they occur, could adversely affect our financial condition and results of operations and the trading price of our common stock. For a discussion of these risks, please refer to the Risk Factors section of our Annual Report on Form 10-K for the fiscal year ended September 30, 2007, filed by us with the Securities and Exchange Commission on December 3, 2007. In connection with our preparation of this quarterly report, management has reviewed and considered these risk factors and has determined that the following risk factors should be read in connection with the existing risk factors disclosed in the Form 10-K.

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

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

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

Shares of closed-end investment companies frequently trade at a discount from net asset value. Since our inception, our common stock has traded above net asset value. However, subsequent to June 30, 2008, our common stock at times traded below the June 30, 2008 net asset value of \$13.97 per share. This characteristic of shares of closed-end investment companies is separate and distinct from the risk that our net asset value per share will decline. As with any stock, the price of our shares will fluctuate with market conditions and other factors. If shares are sold, the price received may be more or less than the original investment. Whether investors will realize gains or losses upon the sale of our shares will not depend directly upon our net asset value, but will depend upon the market price of the shares at the time of sale. Since the market price of our shares will be affected by such factors as the relative demand for and supply of the shares in the market, general market and economic conditions and other factors beyond our control, we cannot predict whether the shares will trade at, below or above our net asset value.

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

Not applicable.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES.

Not applicable.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS.

Not applicable.

ITEM 5. OTHER INFORMATION.

Not applicable

ITEM 6. EXHIBITS

See the exhibit index.

Table of Contents

SIGNATURE

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

GLADSTONE CAPITAL CORPORATION

By: */s/ GRESFORD GRAY*
Gresford Gray
Chief Financial Officer

Date: August 4, 2008

Table of Contents

EXHIBIT INDEX

Exhibit	Description
3.1	Articles of Amendment and Restatement of the Articles of Incorporation, incorporated by reference to Exhibit a.2 to Pre-Effective Amendment No. 1 to the Registration Statement on Form N-2 (File No. 333-63700), filed July 27, 2001.
3.2	By-laws, incorporated by reference to Exhibit b to Pre-Effective Amendment No. 1 to the Registration Statement on Form N-2 (File No. 333-63700), filed July 27, 2001.
3.3	Amendment to by-laws, incorporated by reference to Exhibit 3.3 to the Company's Quarterly Report on Form 10-Q for the quarter ended December 31, 2003 (File No. 814-00237), filed February 17, 2004.
3.4	Second amendment to by-laws, incorporated by reference to Exhibit 99.1 to the Company's Current Report on Form 8-K (File No. 814-00237), filed July 10, 2007.
10.1	Amendment No. 6 to the Amended and Restated Credit Agreement by and among Gladstone Business Loan LLC, Deutsche Bank AG, and certain other parties, dated as of April 24, 2008, incorporated by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K (File No. 814-00237), filed April 25, 2008.
10.2	Amendment No. 7 to the Amended and Restated Credit Agreement by and among Gladstone Business Loan LLC, Deutsche Bank AG, and certain other parties, dated as of May 23, 2008, incorporated by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K (File No. 814-00237), filed May 23, 2008.
10.3	Second Amended and Restated Credit Agreement by and among Gladstone Business Loan LLC, Deutsche Bank AG, and certain other parties, dated as of June 6, 2008, incorporated by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K (File No. 814-00237), filed June 9, 2008.
11	Computation of Per Share Earnings (included in the notes to the unaudited consolidated financial statements contained in this report).
31.1	Certification of Chief Executive Officer pursuant to section 302 of The Sarbanes-Oxley Act of 2002.
31.2	Certification of Chief Financial Officer pursuant to section 302 of The Sarbanes-Oxley Act of 2002.
32.1	Certification of Chief Executive Officer pursuant to section 906 of The Sarbanes-Oxley Act of 2002.
32.2	Certification of Chief Financial Officer pursuant to section 906 of The Sarbanes-Oxley Act of 2002.

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