

CAPITAL SOUTHWEST CORP
Form 10-Q
February 04, 2010

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended **December 31, 2009**

OR

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

For the transition period fromto

Commission File Number: **814-61**

CAPITAL SOUTHWEST CORPORATION

(Exact name of registrant as specified in its charter)

Texas
(State or other jurisdiction of
incorporation
or organization)

75-1072796
(I.R.S. Employer
Identification No.)

12900 Preston Road, Suite 700, Dallas, Texas
(Address of principal executive offices)

75230
(Zip Code)

Registrant's telephone number, including area code: (972) 233-8242

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

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

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Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of “accelerated filer,” “large accelerated filer” and “smaller reporting company” in Rule 12b-2 of the Exchange Act. (Check One):

Large accelerated filer	Accelerated filer	X	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	X
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Indicate the number of shares outstanding of each of the issuer’s classes of common stock, as of the latest practicable date.

3,741,638 shares of Common Stock, \$1 par value, as of January 31, 2010

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PART I. FINANCIAL INFORMATION

Item 1. Consolidated Financial Statements

CAPITAL SOUTHWEST CORPORATION AND SUBSIDIARIES

Consolidated Statements of Assets and Liabilities

Assets	December 31, 2009 (Unaudited)	March 31, 2009
Investments at market or fair value		
Companies more than 25% owned (Cost: December 31, 2009 - \$26,028,302, March 31, 2009 - \$29,208,246)	\$303,537,783	\$286,488,248
Companies 5% to 25% owned (Cost: December 31, 2009 - \$20,912,243, March 31, 2009 - \$20,412,243)	74,982,517	66,388,010
Companies less than 5% owned (Cost: December 31, 2009 - \$52,033,363, March 31, 2009 - \$39,718,702)	68,169,193	43,758,765
Total investments (Cost: December, 2009 - \$98,973,908, March 31, 2009 - \$89,339,191)	446,689,493	396,635,023
Cash and cash equivalents	4,705,829	14,721,730
Receivables		
Dividends and interest	2,613,616	498,506
Affiliates	853,456	16,706
Pension assets	5,782,124	5,468,861
Other assets	158,138	202,313
Total assets	\$460,802,656	\$417,543,139
Liabilities		
Other liabilities	\$1,701,622	\$ 253,294
Pension liability	970,859	934,427
Deferred income taxes	1,684,252	1,092,427
Total liabilities	4,356,733	2,280,148
Net Assets		
Common stock, \$1 par value: authorized, 5,000,000 shares; issued, 4,326,516 shares at December 31, 2009 and March 31, 2009	4,326,516	4,326,516
Additional capital	125,649,430	124,571,029
Undistributed net investment income	2,691,040	2,963,640
Undistributed net realized gain on investments	-	42,622
Unrealized appreciation of investments	347,715,585	307,295,832
Treasury stock - at cost 584,878 shares at December 31, 2009 and March 31, 2009	(23,936,648)	(23,936,648)
Total net assets	456,445,923	415,262,991
Total liabilities and net assets	\$460,802,656	\$417,543,139
Net asset value per share (on the 3,741,638 shares outstanding)	\$ 121.99	\$ 110.98

The accompanying Notes are an integral part of these Consolidated Financial Statements

CAPITAL SOUTHWEST CORPORATION
AND SUBSIDIARIES

Consolidated Statements of Operations

(Unaudited)

	Three Months Ended December 31		Nine Months Ended December 31	
	2009	2008	2009	2008
Investment income:				
Interest	\$ 260,822	\$ 375,602	\$ 773,076	\$ 1,052,625
Dividends	2,019,208	9,614,029	3,216,810	10,949,508
Management and directors' fees	264,389	268,680	1,014,010	810,788
	2,544,419	10,258,311	5,003,896	12,812,921
Operating expenses:				
Salaries	605,729	509,114	1,557,061	1,287,033
Net pension benefit	(92,277)	(63,306)	(276,831)	(189,923)
Other operating expenses	297,709	315,432	920,339	1,119,870
	811,161	761,240	2,200,569	2,216,980
Income before income taxes	1,733,258	9,497,071	2,803,327	10,595,941
Income tax expense	25,183	25,771	82,617	110,401
Net investment income	\$1,708,075	\$ 9,471,300	\$ 2,720,710	\$ 10,485,540
Proceeds from disposition of investments	\$ 156,926	\$ 20,655,024	\$ 5,126,865	\$ 20,655,025
Cost of investments sold	156,926	4,670,340	3,486,870	4,718,381
Realized gain on investments before income taxes	--	15,984,684	1,639,995	15,936,644
Income tax expense	814,503	5,222,964	814,503	5,222,964
Net realized gain (loss) on investments	(814,503)	10,761,720	825,492	10,713,680
Net increase (decrease) in unrealized appreciation of investments	3,157,460	(67,135,903)	40,419,753	(98,363,139)
Net realized and unrealized gain (loss) on investments	\$2,342,957	\$(56,374,183)	\$41,245,245	\$(87,649,459)
Increase (decrease) in net assets from operations	\$4,051,032	\$(46,902,883)	\$43,965,955	\$(77,163,919)

The accompanying Notes are an integral part of these Consolidated Financial Statements

CAPITAL SOUTHWEST CORPORATION

AND SUBSIDIARIES

Consolidated Statements of Changes in Net Assets

(Unaudited)

	Nine Months Ended December 31, 2009	Nine Months Ended December 31, 2008
Operations:		
Net investment income	\$ 2,720,710	\$ 10,485,540
Net realized gain on investments	825,492	10,713,680
Net increase (decrease) in unrealized appreciation of investments	40,419,753	(98,363,139)
Increase (decrease) in net assets from operations	43,965,955	(77,163,919)
Distributions from:		
Undistributed net investment income	(2,993,310)	(12,256,745)
Net realized gains deemed distributed to shareholders	(868,114)	(8,646,560)
Capital share transactions:		
Allocated increase in share value for deemed distribution	868,114	8,646,560
Change in pension plan funded status	(263,416)	-
Stock option expense	473,703	362,118
Treasury stock	-	(16,903,346)
Increase (decrease) in net assets	41,182,932	(105,961,892)
Net assets, beginning of period	415,262,991	583,700,214
Net assets, end of period	\$456,445,923	\$477,738,322

The accompanying Notes are an integral part of these Consolidated Financial Statements

CAPITAL SOUTHWEST CORPORATION

AND SUBSIDIARIES

Consolidated Statements of Cash Flows

(Unaudited)

	Three Months Ended December 31		Nine Months Ended December 31	
	2009	2008	2009	2008
Cash flows from operating activities				
Increase (decrease) in net assets from operations	\$4,051,032	\$(46,902,883)	\$43,965,955	\$(77,163,919)
Adjustments to reconcile increase in net assets from operations to net cash provided by operating activities:				
Proceeds from disposition of investments	156,927	20,655,024	5,126,865	20,655,025
Proceeds from repayment of debt securities	–	–	3,000,000	–
Purchases of securities	(753,000)	(7,646,287)	(16,121,588)	(11,750,107)
Depreciation and amortization	6,516	10,547	21,414	30,454
Net pension benefit	(92,277)	(63,306)	(276,831)	(189,923)
Realized (gain) loss on investments before income taxes	–	(15,984,685)	(1,639,994)	(15,936,644)
Taxes payable on behalf of shareholders on deemed distribution	814,503	5,222,964	814,503	5,222,964
Net (increase) decrease in unrealized appreciation of investments	(3,157,460)	67,135,903	(40,419,753)	98,363,139
Stock option expense	190,652	141,525	473,703	362,118
Increase in dividend and interest receivable	(1,881,293)	(73,450)	(2,115,111)	(196,083)
(Increase) decrease in receivables from affiliates	158,528	357,119	(605,539)	12,736
(Increase) decrease in other assets	(4,093)	16,374	22,760	(7,373)
Increase (decrease) in other liabilities	(64,281)	(16,216)	633,825	6,776
Decrease in accrued pension cost	–	–	–	(68,934)
Increase in deferred income taxes	32,400	22,200	97,200	66,500
Net cash used in operating activities	(541,845)	22,874,829	(7,022,591)	19,406,729
Cash flows from financing activities				
Distributions from undistributed net investment income	(1,496,655)	(10,701,085)	(2,993,310)	(12,256,745)
Purchase of treasury stock	–	–	–	(16,903,346)
Net cash used in financing activities	(1,496,655)	(10,701,085)	(2,993,310)	(29,160,091)
Net decrease in cash and cash equivalents	(2,038,500)	12,173,744	(10,015,901)	(9,753,362)
Cash and cash equivalents at beginning of period	6,744,329	9,400,652	14,721,730	31,327,758
Cash and cash equivalents at end of period	\$4,705,829	\$21,574,396	\$4,705,829	\$21,574,396
Supplemental disclosure of cash flow information:				
Cash paid during the period for:				
Interest	\$ –	\$ –	\$ –	\$ –
Income taxes	\$ –	\$ 3,571	\$ –	\$ 3,571

Noncash financing activities not included herein consist of reinvestment of dividends and distributions of \$868,114 and \$8,646,560 for the nine months ended December 31, 2009 and

2008, respectively.

The accompanying Notes are an integral part of these Consolidated Financial Statements

CAPITAL SOUTHWEST CORPORATION

AND SUBSIDIARIES

Consolidated Portfolio of Investments

December 31, 2009

(Unaudited)

Company	Investment (a)	Cost	Value (b)
†ALAMO GROUP INC. Seguin, Texas Tractor-mounted mowing and mobile excavation equipment for governmental, industrial and agricultural markets; street-sweeping equipment for municipalities.	2,830,300 shares common stock (acquired 4-1-73 thru 5-25-07)	\$ 2,190,937	\$ 36,793,900
ALL COMPONENTS, INC. Pflugerville, Texas Electronics contract manufacturing; distribution and production of memory and other components for computer manufacturers, retailers and value-added resellers.	8.25% subordinated note, \$6,000,000 principal due 2012 (acquired 6-27-07) 150,000 shares Series A Convertible Preferred Stock, convertible into 600,000 shares of common stock at \$0.25 per share (acquired 9-16-94) Warrants to purchase 350,000 shares of common stock at \$11.00 per share, expiring 2017 (acquired 6-27-07)	6,000,000 150,000 6,150,000	6,000,000 4,613,000 10,613,000
ATLANTIC CAPITAL BANCSHARES, INC. Atlanta, Georgia Holding company of Atlantic Capital Bank, a full service commercial bank.	300,000 shares common stock (acquired 4-10-07)	3,000,000	3,150,000
BALCO, INC. Wichita, Kansas Specialty architectural products used in the construction and remodeling of commercial and institutional buildings.	445,000 shares common stock and 60,920 shares Class B non-voting common stock (acquired 10-25-83 and 5-30-02)	624,920	8,000,000
BOXX TECHNOLOGIES, INC. Austin, Texas Workstations for computer graphic imaging and design.	3,125,354 shares Series B Convertible Preferred Stock, convertible into 3,125,354 shares of common stock at \$0.50 per share (acquired 8-20-99 thru 8-8-01)	1,500,000	2
CMI HOLDING COMPANY, INC. Richardson, Texas Owns Chase Medical, which develops and sells devices used in cardiac surgery	1,631,516 shares Series C-1 Convertible Preferred Stock, convertible into 1,613,516 shares of common stock at \$2.15 per share (acquired 7-10-09) 2,327,658 shares Series A Convertible Preferred Stock, convertible into 2,327,658 shares of common stock at \$1.72	2,863,347	3,507,759

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to relieve congestive heart failure; develops	per share (acquired 8-21-02 and 6-4-03)	4,000,000	2
and supports cardiac imaging systems.	Warrants to purchase 109,012 shares of common stock at \$1.72 per share, expiring 2012 (acquired 4-7-04)	—	—
	Warrant to purchase 575,975 shares of Series A-1 Convertible Preferred Stock at \$1.72 per share, expiring 2017 (acquired 7-2-07)	—	—
	Warrant to purchase 60,174 shares of Series A-1 Convertible Preferred Stock at \$1.72 per share, expiring 2019 (acquired 6-9-09)	—	—
		6,863,347	3,507,761

CAPITAL SOUTHWEST CORPORATION
AND SUBSIDIARIES

Consolidated Portfolio of Investments

December 31, 2009

(Unaudited)

(continued)

Company	Investment (a)	Cost	Value (b)
CINATRA CLEAN TECHNOLOGIES, INC. Houston, Texas	10% subordinated secured promissory note, \$5,687,432 principal (acquired 7-14-08 thru 12-23-09)	\$ 5,687,432	\$ 5,687,432
Cleans above ground oil storage tanks with a patented, automated system.	1,128,649 shares Series A Convertible Preferred Stock, convertible into 1,128,649 shares common stock at \$1.00 per share (acquired 7-14-08 and 11-19-08)	1,128,649	1,128,649
		6,816,081	6,816,081
†ENCORE WIRE CORPORATION McKinney, Texas	4,086,750 shares common stock (acquired 7-16-92 thru 10-7-98)	5,800,000	69,474,750
Electric wire and cable for residential, commercial and industrial construction use.			
EXTREME INTERNATIONAL, INC. Sugar Land, Texas	13,035 shares Series A common stock (acquired 9-26-08 and 12-18-08)	325,875	555,000
Owns Bill Young Productions, Texas	39,359.18 shares Series C Convertible Preferred Stock, convertible into 157,437.72 shares of common stock at \$25.00 per share (acquired 9-30-03)	2,625,000	6,715,000
Video and Post, and Extreme Communications, which produce radio and television commercials and corporate communications videos.	3,750 shares 8% Series A Convertible Preferred Stock, convertible into 15,000 shares of common stock at \$25.00 per share (acquired 9-30-03)	375,000	640,000
		3,325,875	7,910,000
†HEELYS, INC. Carrollton, Texas	9,317,310 shares common stock (acquired 5-26-00)	102,490	18,261,928
Heelys stealth skate shoes, equipment and apparel sold through sporting goods chains, department stores and footwear retailers.			
†HOLOGIC, INC. Bedford, Massachusetts	‡632,820 shares common stock (acquired 8-27-99)	220,000	9,175,890
Medical instruments including bone densitometers, mammography devices and digital radiography systems.			

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<p>iMEMORIES, INC.</p> <p>Scottsdale, AZ</p> <p>Enables online video and photo sharing and DVD creation for home movies recorded in analog and new digital format.</p>	<p>17,391,304 shares Series B Convertible Preferred Stock, convertible into 17,391,304 shares of common stock at \$0.23 per share (acquired 7-10-09)</p>	<p>4,000,000</p>	<p>4,000,000</p>
<p>KBI BIOPHARMA, INC.</p> <p>Durham, NC</p> <p>Provides fully-integrated outsourced drug development and bio-manufacturing services.</p>	<p>7,142,857 shares Series B-2 Convertible Preferred Stock, convertible into 7,142,857 shares of common stock at \$0.70 per share (acquired 9-08-09)</p>	<p>5,000,000</p>	<p>5,000,000</p>

CAPITAL SOUTHWEST CORPORATION

AND SUBSIDIARIES

Consolidated Portfolio of Investments

December 31, 2009

(Unaudited)

(continued)

Company	Investment (a)	Cost	Value (b)
LIFEMARK GROUP Hayward, California Cemeteries, mausoleums and mortuaries located in northern California.	1,449,026 shares common stock (acquired 7-16-69)	\$ 4,510,400	\$ 71,000,000
MEDIA RECOVERY, INC. Dallas, Texas Computer datacenter and office automation supplies and accessories; impact, tilt monitoring and temperature sensing devices to detect mishandling shipments; dunnage for protecting shipments.	800,000 shares Series A Convertible Preferred Stock, convertible into 800,000 shares of common stock at \$1.00 per share (acquired 11-4-97) 4,000,002 shares common stock (acquired 11-4-97)	800,000 4,615,000 5,415,000	2,300,000 11,400,000 13,700,000
PALLETONE, INC. Bartow, Florida Manufacturer of wooden pallets and pressure-treated lumber.	12.3% senior subordinated notes, \$2,000,000 principal due 2012 (acquired 9-25-06) 150,000 shares common stock (acquired 10-18-01) Warrant to purchase 15,294 shares of common stock at \$1.00 per share, expiring 2011 (acquired 2-17-06)	1,553,150 150,000 45,746 1,748,896	2,000,000 2 — 2,000,002
† PALM HARBOR HOMES, INC. Dallas, Texas Integrated manufacturing, retailing, financing and insuring of manufactured housing and modular homes.	7,855,121 shares common stock (acquired 1-3-85 thru 7-31-95) Warrant to purchase 286,625 shares of common stock at \$3.14 per share, expiring 2019 (acquired 4-24-09)	10,931,955 — 10,931,955	6,833,955 — 6,833,955
THE RECTORSEAL CORPORATION Houston, Texas Specialty chemicals for plumbing, HVAC, electrical, construction, industrial, oil field and automotive applications; smoke containment systems for building fires; also owns 20% of The Whitmore Manufacturing Company.	27,907 shares common stock (acquired 1-5-73 and 3-31-73)	52,600	109,800,000
TCI HOLDINGS, INC. Denver, Colorado Cable television systems and microwave relay systems.	21 shares 12% Series C Cumulative Compounding Preferred stock (acquired 1-30-90)	—	677,250
† TEXAS CAPITAL BANCSHARES, INC. Dallas, Texas Regional bank holding company with banking operations in six Texas cities.	489,656 shares common stock (acquired 5-1-00)	3,550,006	6,820,908

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TRAX HOLDINGS, INC.	1,061,279 shares Series A Convertible Preferred Stock, convertible	5,000,000	5,000,000
Scottsdale, Arizona	into 1,061,279 common stock at \$4.71 per share (acquired 12-08-08 and 2-17-09)		
Provides a comprehensive set of solutions to improve the transportation validation, accounting, payment and information management process.			

CAPITAL SOUTHWEST CORPORATION

AND SUBSIDIARIES

Consolidated Portfolio of Investments

December 31, 2009

(Unaudited)

(continued)

Company	Investment (a)	Cost	Value (b)
VIA HOLDINGS, INC. Sparks, Nevada Designer, manufacturer and distributor of high-quality office seating.	9,118 shares Series B Preferred Stock (acquired 9-19-05)	\$ 4,559,000	\$ 2
	1,118 shares Series C Preferred Stock (acquired 11-01-07)	281,523	2
		4,840,523	4
WELLOGIX, INC. Houston, Texas Developer and supporter of software used by the oil and gas industry.	4,788,371 shares Series A-1 Convertible Participating Preferred Stock, convertible into 4,788,371 shares of common stock at \$1.0441 per share (acquired 8-19-05 thru 6-15-08)	5,000,000	2
THE WHITMORE MANUFACTURING COMPANY Rockwall, Texas Specialized surface mining, railroad and industrial lubricants; coatings for automobiles and primary metals; fluid contamination control devices.	80 shares common stock (acquired 8-31-79)	1,600,000	38,400,000
MISCELLANEOUS	–Ballast Point Ventures II, L.P. – 2.6% limited partnership interest (acquired 8-4-08 thru 11-3-09)	675,000	675,000
	–BankCap Partners Fund I, L.P. – 6.0% limited partnership interest (acquired 7-14-06 thru 6-18-09)	5,513,837	5,121,742
	–CapitalSouth Partners Fund III, L.P. – 2.8% limited partnership interest (acquired 1-22-08 and 2-12-09)	831,256	831,256
	–Diamond State Ventures, L.P. – 1.9% limited partnership interest (acquired 10-12-99 thru 8-26-05)	76,000	187,628
	–Discovery Alliance, LLC – 90.0% limited liability company (acquired 9-12-08 thru 6-01-09)	600,000	600,000
	–Essex Capital Corporation – 10% unsecured promissory note due 8-19-10 (acquired 8-16-09)	–	1,000,000
	–First Capital Group of Texas III, L.P. – 3.0% limited partnership interest (acquired 12-26-00 thru 8-12-05)	842,677	660,713
	–Humac Company – 1,041,000 shares common stock (acquired 1-31-75 and 12-31-75)	–	148,000
	–STARTech Seed Fund I – 12.1% limited partnership interest (acquired 4-17-98 thru 1-5-00)	178,066	1
	–STARTech Seed Fund II – 3.2% limited partnership interest (acquired		

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	4-28-00 thru 2-23-05)	950,000	1
	-Sterling Group Partners I, L.P. – 1.7% limited partnership interest (acquired 4-20-01 thru 1-24-05)	1,064,042	529,719
TOTAL INVESTMENTS		\$98,973,908	\$446,689,493
†Publicly-owned company	‡Unrestricted securities as defined in Note (a)		

Notes to Consolidated Portfolio of Investments

(Unaudited)

(a) Definitions

Unrestricted securities (indicated by ±) are freely marketable securities having readily available market quotations. All other securities are **restricted securities**, which are subject to one or more restriction on resale and are not freely marketable. At December 31, 2009, restricted securities represented approximately **96.4%** of the value of the consolidated investment portfolio.

Notes to Consolidated Portfolio of Investments
(continued)

(b) Investment Valuation Policy

Our investments are carried at fair value in accordance with the Investment Company Act of 1940 (the “1940 Act”) and FASB Accounting Standards Codification™ (ASC) Topic 820, *Fair Value Measurements and Disclosures*. In accordance with the 1940 Act, unrestricted minority-owned publicly traded securities, for which the market quotations are readily available, are valued at the closing sale price for the NYSE listed securities and the lower of the closing bid price or the last sale price for NASDAQ securities on the valuation date; and restricted publicly traded securities and other privately held securities are valued as determined in good faith by our Board of Directors.

We adopted FASB ASC Topic 820 on April 1, 2008 (see footnote 3 in “Notes to Consolidated Financial Statements,” page 13). ASC Topic 820 provides a framework for measuring the fair value of assets and liabilities along with guidance regarding a fair value hierarchy, which prioritizes information used to measure fair value and the effect of fair value measurements on earnings and provides for enhanced disclosures determined by the level within the hierarchy of information used for valuation. ASC Topic 820 applies whenever other standards require (or permit) assets or liabilities to be measured at fair value but does not expand the use of fair value in any new circumstances.

ASC Topic 820 defines fair value in terms of the price that would be received upon the sale of an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date (the “exit price”) and excludes transaction costs. Under ASC Topic 820, the fair value measurement also assumes that the transaction to sell an asset occurs in the principal market for the asset or, in the absence of a principal market, the most advantageous market for the asset. The principal market is the market in which the reporting entity would sell or transfer the asset with the greatest volume and level of activity for the asset. In determining the principal market for an asset or liability under ASC, it is assumed that the reporting entity has access to the market as of the measurement date.

(c) Valuation Methodologies

Debt Securities are generally valued on the basis of the price the security would command in order to provide a yield-to-maturity equivalent to the present yield of comparable debt instruments of similar quality. Issuers whose debt securities are judged to be of poor quality and doubtful collectability may instead be valued by assigning major percentage discounts commensurate with the quality of such debt securities. Debt securities may also be valued based on the resulting value from the sale of the business at the estimated fair market value.

Partnership Interests, Preferred Equity and Common Equity including unrestricted marketable securities, which are valued at the closing sale price for the NYSE listed securities and the lower of the closing bid price or the last sale price for NASDAQ securities on the valuation date, and restricted marketable securities for which there is a public market, are valued at the closing sale price for the NYSE listed securities and the lower of the closing bid price or the last sale price for NASDAQ securities on the valuation date adjusted in good faith by our Board of Directors if they deem a discount or premium would be likely or obtainable upon a sale or transfer of our interest. For those without a principal market, the Board of Directors considers the financial condition and operating results of the issuer; the long-term potential of the business of the issuer; the market for and recent sales prices of the issuer’s securities; the values of similar securities issued by companies in similar businesses; the proportion of the issuer’s securities owned by the Company; protective put analysis based on the Black-Scholes option pricing model; the nature and duration of resale restrictions; and the nature of any rights enabling the Company to require the issuer to register restricted securities under applicable securities laws. In determining the fair value of restricted securities, the Board of Directors considers the inherent value of such securities without regard to the restrictive feature and adjusts for any diminution in value resulting from restrictions on resale. Investments, in certain entities that calculate net asset value per share (or its equivalent) and for which fair market value is not readily determinable, are valued using the net asset value per share (or its equivalent, such as member units or ownership interest in partners’ capital to which a proportionate share

of net assets is attributed) of the investment.

(continued)

Equity Warrants are valued on the basis of accepted formulas derived from empirical studies which define the market value of a warrant in relation to the market price of its common stock. These formulas measure the “option value” of a warrant as well as its “exercise value” (the amount, if any, by which the value of the stock exceeds the exercise price of the warrant). In applying such formulas, the market price of the stock is usually discounted to reflect the fact that the stock is restricted and the calculated value of the warrant itself may be discounted (if deemed appropriate) to reflect its restrictive nature. Generally, the option value is excluded if the formula indicates (i) the warrant expires within six months, (ii) the market price of the stock (discounted) is less than one-half of the exercise price of the warrant, or (iii) the market price of the stock (discounted) is more than two times the amount of the exercise price of the warrant.

Notes to Consolidated Financial Statements

(Unaudited)

1. The Company

Capital Southwest Corporation (“CSC” or the “Company”) was organized as a Texas corporation on April 19, 1961. Until September 1969, we operated as a licensee under the Small Business Investment Act of 1958. At that time, we transferred to our wholly-owned subsidiary, Capital Southwest Venture Corporation (“CSVC”) certain assets and our license as a small business investment company (“SBIC”). CSVC is a closed-end, non-diversified investment company of the management type registered under the Investment Company Act of 1940 (the “1940 Act”). Prior to March 30, 1988, we were registered as a closed-end, non-diversified investment company under the 1940 Act. On that date, we elected to become a business development company subject to the provisions of the 1940 Act, as amended by the Small Business Incentive Act of 1980. Because we wholly own CSVC, the portfolios of both entities are referred to collectively as “our,” “we” and “us.” Capital Southwest Management Company (“CSMC”), a wholly-owned subsidiary of CSC, is the management company for CSC and CSVC. CSMC generally incurs all normal operating and administrative expenses, including but not limited to salaries and related benefits, rent, equipment and other administrative costs required for its day-to-day operations.

Our portfolio is a composite of companies in which we have major interests as well as a number of developing companies and marketable securities of established publicly-owned companies. We make available significant managerial assistance to the companies in which we invest and believe that providing material assistance to such investee companies is critical to their business development activities. When appropriate CSMC receives a monthly fixed fee for their management services provided to the portfolio companies.

2. Unaudited Interim Consolidated Financial Statements

The consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America (GAAP) for investment companies. Under rules and regulations applicable to investment companies, we are precluded from consolidating any entity other than another investment company. An exception to this general principle occurs if the investment company has an investment in an operating company that provides services to the investment company. Our consolidated financial statements include our management company.

The financial statements included herein have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information and the instructions to Form 10-Q and Article 6 of Regulation S-X. The financial statements should be read in conjunction with the consolidated financial statements and notes thereto included in our Form 10-K for the year ended March 31, 2009, as filed with the Securities and Exchange Commission (SEC). Certain information and footnotes normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States have been condensed or omitted, although we believe that the disclosures are adequate for a fair presentation. The information reflects all adjustments (consisting of normal recurring adjustments) which are, in the opinion of management, necessary for a fair presentation of the results of operations for the interim periods.

3. Summary of Significant Accounting Policies

Accounting Standards Codification The Financial Accounting Standards Board's (FASB) Accounting Standards Codification™ (ASC) became effective on July 1, 2009. At that date, the ASC became FASB's officially recognized source of authoritative U.S. generally accepted accounting principles (GAAP) applicable to all public and non-public non-governmental entities, superseding existing FASB, American Institute of Certified Public Accountants (AICPA), Emerging Issues Task Forces (EITF) and related literature. Rules and interpretive releases of the SEC under the authority of federal securities laws are also sources of authoritative GAAP for SEC registrants. All other accounting literature is considered non-authoritative. The switch to ASC affects the way companies refer to U.S. GAAP in financial statements and accounting policies. Citing particular content in the ASC involves specifying the unique numeric path to the content through the Topic, Subtopic, Section and Paragraph structure.

Fair Value Measurements The Company adopted FASB ASC Topic 820 on April 1, 2008. ASC Topic 820 (1) creates a single definition of fair value, (2) establishes a framework for measuring fair value, and (3) expands disclosure requirements about items measured at fair value.

The Statement applies to both items recognized and reported at fair value in the financial statements and items disclosed at fair value in the notes to the financial statements. The Statement does not change existing accounting rules governing what can or what must be recognized and reported at fair value in the Company's financial statements, or disclosed at fair value in the Company's notes to the financial statements. Additionally, ASC Topic 820 does not eliminate practicability exceptions that exist in accounting pronouncements amended by this Statement when measuring fair value.

Prior to ASC Topic 820, certain measurements of fair value were based on the price that would be paid to acquire an asset, or received to assume a liability (an entry price). FASB ASC Topic 820 clarifies the definition of fair value as the price that would be received from the sale of an asset, or paid to transfer a liability, in an orderly transaction between market participants at the measurement date (that is, an exit price). The exit price is based on the amount that the holder of the asset or liability would receive or need to pay in an actual transaction (or in a hypothetical transaction if an actual transaction does not exist) at the measurement date. In some circumstances, the entry and exit price may be the same; however, they are conceptually different.

Fair value is generally determined based on quoted market prices in the active markets for identical assets or liabilities. If quoted market prices are not available, the Company uses valuation techniques that place greater reliance on observable inputs and less reliance on unobservable inputs. In measuring fair value, the Company may make adjustments for risks and uncertainties, if a market participant would include such an adjustment in its pricing.

(continued)

Cash and Cash Equivalents Cash equivalents include all highly liquid investments with an original maturity of three months or less. We maintain cash and cash equivalents at several financial institutions, which at times may not be federally insured or may exceed federally insured limits. We have not experienced any losses in such accounts and believe we are not exposed to any significant credit risks on such accounts.

Segment Information The Company operates and manages its business in a singular segment. As an investment company, the Company invests in portfolio companies in various industries and geographic areas as presented in the portfolio of investments.

Use of Estimates The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of increases and decreases in net assets from operations during the reporting period. Actual results could differ from those estimates.

Federal Income Taxes CSC and CSVC intend to comply with the requirements of the Internal Revenue Code (IRC) necessary to qualify as regulated investment companies (RICs). By meeting these requirements, they will not be subject to corporate federal income taxes on ordinary income distributed to shareholders. The Company's policy is to retain and pay the 35% corporate tax on realized long-term capital gains. For investment companies that qualify as RICs under the IRC, federal income taxes payable on security gains that the company elects to retain are accrued only on the last day of the tax year, December 31. As discussed in detail in *Note 5 – Income Taxes*, a provision for taxes on long-term capital gains deemed distributed to shareholders in the amount of \$814,503 was recorded for our tax year ended December 31, 2009.

CSMC, a wholly owned subsidiary of CSC, is not a RIC and is required to pay taxes at the current corporate rate.

Deferred Taxes The Company sponsors a qualified defined benefit pension plan which covers its employees and employees of certain of its controlled affiliates. Deferred taxes related to the qualified defined benefit pension plan are recorded as incurred.

Stock-Based Compensation The Company recognizes compensation cost over the straight-line method for all share-based payments granted on or after that date and for all awards granted to employees prior to April 1, 2006 that remain unvested on that date. The fair value of stock options are determined on the date of grant using the Black-Scholes pricing model and are expensed over the vesting period of the related stock options.

Defined Pension Benefits and Other Postretirement Plans The Company is required to, as an employer that sponsors one or more postretirement defined benefit plan(s), (i) recognize the funded status of postretirement defined benefit plans – measured as the difference between the fair value of plan assets and the benefit obligations – in its balance sheet; (ii) recognize changes in the funded status of postretirement defined benefit plans in shareholder's equity in the year in which the changes occur; and (iii) measure postretirement defined benefit plan assets and obligations as of the date of the employer's fiscal year-end. The Company presently uses March 31 as the measurement date for all of its postretirement defined benefit plans.

(continued)

4. Investments

The Company fair values its investments in accordance with GAAP as determined in good faith by our Board of Directors. When available, we base the fair value of our investments on directly observable market prices or on market data derived for comparable assets. For all other investments, inputs used to measure fair value reflect management's best estimate of assumptions that would be used by market participants in pricing the investments in a hypothetical transaction.

The levels of fair value inputs used to measure our investments are characterized in accordance with the fair value hierarchy established by ASC Topic 820, "*Fair Value Measurements and Disclosures*". Where inputs for an asset or liability fall in more than one level in the fair value hierarchy, the investment is classified in its entirety based on the lowest level input that is significant to that investment's fair value measurement. We use judgment and consider factors specific to the investment in determining the significance of an input to a fair value measurement. While management believes our valuation methodologies are appropriate and consistent with market participants, the use of different methodologies or assumptions to determine the fair value of certain financial instruments could result in a different estimate of fair value at the reporting date. The three levels of the fair value hierarchy and investments that fall into each of the levels are described below:

- *Level 1:* Unadjusted quoted prices in active markets for identical assets or liabilities that the Company has the ability to access. We use Level 1 inputs for publicly traded unrestricted securities. Such investments are valued at the closing price for listed securities and at the lower of the closing bid price or the closing sale price for over-the-counter (NASDAQ) securities on the valuation date.
- *Level 2:* Observable inputs other than quoted prices included in level 1 that are observable for the asset or liability, either directly or indirectly. These inputs may include quoted prices for the identical instrument in non-active markets, quoted prices for similar instruments in active markets and similar data. We did not value any of our investments using level 2 inputs as of December 31, 2009.
- *Level 3:* Unobservable inputs for the asset or liability, to the extent relevant observable inputs are not available, representing the company's own assumptions about the assumptions a market participant would use in valuing the asset or liability, and would be based on the best information available. We use Level 3 inputs for measuring the fair value of substantially all of our investments. See "Notes to Portfolio of Investments" (c) on page 11 for the investment policy used to determine the fair value of these investments.

The following fair value hierarchy table sets forth our investment portfolio by level as of December 31, 2009 (in millions):

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	Fair Value Measurements at Reporting Date Using			
	Quoted Prices in Active Markets for Identical Assets	Significant Other Observable Inputs	Significant Unobservable Inputs	
	Total	(Level 1)	(Level 2)	(Level 3)
Debt	\$ 14.7	\$ -	\$ -	\$ 14.7
Partnership Interests	8.5	-	-	8.5
Preferred Equity	33.6	-	-	33.6
Common Equity	389.9	16.0	-	373.9
Total Investments	\$446.7	\$16.0	\$ -	\$430.7

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Notes to Consolidated Financial Statements

(continued)

The following table provides a summary of changes in the fair value of investment assets and liabilities measured using Level 3 inputs during the three months ended December 31, 2009 (in millions):

	Fair Value 9/30/2009	Net Unrealized Appreciation (Depreciation)	Net New Investments (Divestitures)	Fair Value 12/31/2009
Debt	\$13.2	\$1.0	\$0.6	\$14.7
Partnership Interest	8.6	(0.1)	-	8.5
Preferred Equity	31.9	1.7	-	33.6
Common Equity	370.7	3.2	-	373.9
Total Investments	\$424.4	\$5.7	\$0.6	\$430.7

The following table provides a summary of changes in the fair value of investment assets and liabilities measured using Level 3 inputs during the nine months ended December 31, 2009 (in millions):

	Fair Value 3/31/2009	Net Unrealized Appreciation (Depreciation)	Net New Investments (Divestitures)	Conversion of Security from Debt to Equity	Fair Value 12/31/2009
Debt	\$8.3	\$6.0	\$1.8	\$(1.3)	\$14.7
Partnership Interest	6.7	(0.2)	2.0	-	8.5
Preferred Equity	16.4	7.7	8.2	1.3	33.6
Common Equity	351.4	24.7	(2.3)	-	373.9
Total Investments	\$382.8	\$38.2	\$9.7	\$-	\$430.7

The total unrealized gains (losses) for the three and nine month periods ended December 31, 2009 included in earnings that related to assets still held at December 31, 2009 were \$5,714,505 and \$38,208,870, respectively

5. Income Taxes

We operate to qualify as a RIC under Subchapter M of the IRC. In order to qualify as a RIC, we must annually distribute at least 90% of our taxable ordinary income, based on our tax year, to our shareholders in a timely manner. Ordinary income includes net short-term capital gains but excludes net long-term capital gains. A RIC is not subject to federal income tax on the portion of its ordinary income and long-term capital gains that are distributed to its shareholders, including “deemed distributions” discussed below. As permitted by the Code, a RIC can designate dividends paid in the subsequent tax year as dividends of current year ordinary income and net long-term gains if those dividends are both declared by the extended due date of the RIC’s federal income tax return and paid to shareholders by the last day of the subsequent tax year. We have distributed or intend to distribute sufficient dividends to eliminate taxable income for our completed tax years. If we fail to satisfy the 90% distribution requirement or otherwise fail to qualify as a RIC in any tax year, we would be subject to tax in such year on all of our taxable income, regardless of whether we made any distributions to our shareholders. Additionally, we are also subject to a nondeductible federal excise tax of 4% if we do not distribute at least 98% of our investment company ordinary

taxable income before the end of our tax year. We have a calendar tax year end of December 31. For the tax years ended December 31, 2009 and 2008, CSC and CSVC qualified to be taxed as RICs. We intend to meet the applicable qualifications to be taxed as a RIC in future years. Management feels it is probable that we will maintain our RIC status for a period longer than one year. However, either company's ability to meet certain portfolio diversification requirements of RICs in future years may not be controllable by such company.

(continued)

A RIC may elect to retain its long-term capital gains by designating them as a “deemed distribution” to its shareholders and paying a federal tax of 35% on the long-term capital gains for the benefit of its shareholders. Shareholders would then report their share of the retained capital gains on their income tax returns as if it had been received and report a tax credit for the tax paid on their behalf by the RIC. Shareholders then add the amount of the “deemed distribution,” net of such tax, to the basis of their shares.

As permitted by the Internal Revenue Code, a RIC can designate dividends paid in the subsequent tax year as dividends of the current year ordinary taxable income and long-term capital gains if those dividends are both declared by extended due date of the RIC’s federal income tax return and paid to shareholders by the last day of the subsequent tax year. For tax years ended December 31, 2009 and 2008, we declared and paid ordinary dividends in the amount of \$2,993,310 and \$12,256,745, respectively.

As a RIC, we are also subject to a nondeductible federal excise tax of 4% if we do not distribute at least 98% of our investment company ordinary taxable income before the end of our tax year. For the tax years ended December 31, 2009 and 2008, we distributed 100% of our investment company ordinary taxable income. Therefore, we have made no tax provisions for income taxes on ordinary taxable income for the tax years ended December 31, 2009 and 2008.

For the tax year ended December 31, 2009, we have estimated net long-term capital gains of \$2,327,150 for tax purposes and \$1,682,616 for book purposes, which we elected to retain and treat as deemed distributions to our shareholders. Likewise, for the tax year ended December 31, 2008, we had net long-term capital gains of \$14,922,751 for tax purposes and \$15,936,644 for book purposes; which we also elected to retain and treat as deemed distributions to our shareholders. In order to make the election to retain capital gains, we incurred federal taxes on behalf of our shareholders in the amount of \$814,502 and \$5,222,964 for the tax years ended December 31, 2009 and 2008, respectively. As of December 31, 2009, we did not have any undistributed long-term capital gains since they are being treated as distributed through the “deemed distribution.”

CSMC, a wholly owned subsidiary of CSC, is not a RIC and is required to pay taxes at the current corporate rate. CSC sponsors a qualified defined benefit pension plan which covers its employees and employees of certain of its wholly owned portfolio companies. Deferred taxes related to the qualified defined pension plan are recorded as incurred.

6. Employee Stock Option Plans

On July 20, 2009, shareholders approved the Company’s 2009 Stock Incentive Plan (the “2009 Plan”), which provides for the granting of stock options to employees and officers of the Company and authorizes the issuance of common stock upon exercise of such options for up to 140,000 shares. All options are granted at or above market price, generally expire up to ten years from the date of grant and are generally exercisable on or after the first anniversary of the date of grant in five annual installments. Options to purchase 38,750 shares at a price of \$76.74 (market price at the time of the grant) were granted on October 19, 2009 and remain outstanding, thus leaving a total of 101,250 options available for future grant.

The Company previously granted stock options under its 1999 Stock Option Plan (the “1999 Plan”), as approved by shareholders on July 19, 1999. The 1999 Plan expired on April 19, 2009. Options previously made under the Company’s 1999 Stock Option Plan and outstanding on July 20, 2009 continue in effect governed by provisions of the 1999 plan. All options granted under the 1999 Plan were granted at or above market price, generally expire up to ten years from the date of grant and are generally exercisable on or after the first anniversary of the date of grant in five to ten annual installments.

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Notes to Consolidated Financial Statements

(continued)

We recognize compensation cost over the straight-line method for all share-based payments granted on or after that date and for all awards granted to employees prior to April 1, 2006 that remain unvested on that date. The fair value of stock options are determined on the date of grant using the Black-Scholes pricing model and are expensed over the vesting period of the related stock options. Accordingly, for the quarter and nine months ended December 31, 2009, we recognized compensation expense of \$190,652 and \$473,703, respectively.

As of December 31, 2009, the total remaining unrecognized compensation cost related the 2009 Plan and 1999 Plan non-vested stock options was \$2,871,764, which will be amortized over the weighted-average service period of approximately 4.2 years. The following table summarizes the 2009 Plan and the 1999 Plan price per option at grant date using the Black-Scholes pricing model:

Date of Issuance	Black-Scholes Pricing Model Assumptions				
	Weighted Average Fair Value	Expected Dividend Yield	Risk-Free Interest Rate	Expected Volatility	Expected Life (in years)
<u>2009 Plan</u>					
October 19, 2009	\$ 25.36	1.04%	2.36%	37.6%	5
<u>1999 Plan</u>					
July 30, 2008	\$ 29.93	0.62%	3.36%	20.2%	5
July 21, 2008	\$ 27.35	0.67%	3.41%	20.2%	5
July 16, 2007	\$ 41.78	0.39%	4.95%	19.9%	5
July 17, 2006	\$ 33.05	0.61%	5.04%	21.2%	7
May 15, 2006	\$ 31.28	0.64%	5.08%	21.1%	7

The following table summarizes activity in the 2009 Plan and the 1999 Plan as of December 31, 2009:

	Number of shares	Weighted-Average Exercise Price
<u>2009 Plan</u>		
Balance at March 31, 2009	–	\$ –
Granted	38,750	76.74
Exercised	–	–
Canceled	–	–
Balance at December 31, 2009	38,750	\$76.74
<u>1999 Plan</u>		
Balance at March 31, 2009	107,900	\$114.78
Granted	–	–
Exercised	–	–
Canceled	–	–
Balance at December 31, 2009	107,900	\$114.78
Combined Balance at December 31, 2009	146,650	\$104.72

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Notes to Consolidated Financial Statements

(continued)

At December 31, 2009, the range of exercise prices and weighted-average remaining contractual life of outstanding options was \$65.00 to \$152.98 and 4.2 years, respectively. The number of options exercisable under the 2009 Plan and the 1999 Plan, at December 31, 2009, was 35,960 with a weighted-average exercise price of \$110.30. No options were exercised during the nine months ended December 31, 2009.

7. Summary of Per Share Information

	Three Months Ended		Nine Months Ended	
	December 31		December 31	
	2009	2008	2009	2008
Investment income	\$.68	\$ 2.74	\$ 1.34	\$ 3.42
Operating expenses	(.21)	(.20)	(.59)	(.59)
Interest expense	—	—	—	—
Income taxes	(.01)	(.01)	(.02)	(.03)
Net investment income	.46	2.53	.73	2.80
Distributions from undistributed net investment income				