

GLADSTONE CAPITAL CORP  
Form 10-K  
November 22, 2010

**UNITED STATES SECURITIES AND EXCHANGE COMMISSION  
Washington, DC 20549**

**Form 10-K**

**(Mark One)**

- ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES  
EXCHANGE ACT OF 1934  
For the fiscal year ended September 30, 2010**
- 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  
McLean, Virginia**  
*(Address of principal executive offices)*

**22102**  
*(Zip Code)*

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

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

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

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

**Securities registered pursuant to Section 12(g) of the Act: None**

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

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

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

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

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

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

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

(Do not check if a smaller reporting company)

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

The aggregate market value of the voting stock held by non-affiliates of the Registrant on March 31, 2010, based on the closing price on that date of \$11.80 on the Nasdaq Global Select Market, was \$232,849,483. For the purposes of calculating this amount only, all directors and executive officers of the Registrant have been treated as affiliates. There were 21,039,242 shares of the Registrant's Common Stock, \$0.001 par value per share, outstanding as of November 22, 2010.

**Documents Incorporated by Reference.** Portions of the Registrant's Proxy Statement relating to the Registrant's 2011 Annual Meeting of Stockholders are incorporated by reference into Part III of this Annual Report on Form 10-K as indicated herein.

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**GLADSTONE CAPITAL CORPORATION**  
**FORM 10-K FOR THE FISCAL YEAR ENDED**  
**SEPTEMBER 30, 2010**

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## FORWARD-LOOKING STATEMENTS

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

### PART I

#### (Dollar amounts in thousands, unless otherwise indicated)

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

#### Item 1. Business

##### Overview

We were incorporated under the General Corporation Laws of the State of Maryland on May 30, 2001 and completed our initial public offering on August 24, 2001. We operate as a closed-end, non-diversified management investment company, and we have elected to be treated as a business development company ( BDC ) under the Investment Company Act of 1940, as amended ( the 1940 Act ). In addition, for tax purposes we have elected to be treated as a regulated investment company ( RIC ) under the Internal Revenue Code of 1986, as amended (the Code ).

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

We seek to invest in small and medium-sized private U.S. businesses that meet certain criteria, including some but not necessarily all of the following: the potential for growth in cash flow, adequate assets for loan collateral, experienced management teams with a significant ownership interest in the borrower, profitable operations based on the borrower's cash flow, reasonable capitalization of the borrower (usually by leveraged buyout funds or venture capital funds) and the potential to realize appreciation and gain liquidity in our equity positions, if any. We anticipate that liquidity in our equity position will be achieved through a merger or acquisition of the borrower, a public offering of the borrower's

stock or by exercising our right to require the borrower to repurchase our warrants. However, there can be no assurance that we will always have these

rights. We seek to lend to borrowers that need funds to finance growth, restructure their balance sheets or effect a change of control.

We seek to invest primarily in three categories of loans of private companies:

*Senior Loans.* We seek to invest a portion of our assets in senior notes of borrowers. Using its assets and cash flow as collateral, the borrower typically uses senior notes to cover a substantial portion of the funding needed to operate. Senior lenders are exposed to the least risk of all providers of debt because they command a senior position with respect to scheduled interest and principal payments and assets of the borrower. However, unlike senior subordinated and junior subordinated lenders, these senior lenders typically do not receive any stock, warrants to purchase stock of the borrowers or other yield enhancements. As such, they generally do not participate in the equity appreciation of the value of the business. Senior notes may include revolving lines of credit, senior term loans, senior syndicated loans and senior last-out tranche loans.

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

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

We may also receive yield enhancements in connection with many of our loans, which may include warrants to purchase stock or success fees.

#### *Investment Concentrations*

At September 30, 2010, we had aggregate investments in 39 portfolio companies, and approximately 67.1% of the aggregate fair value of such investments was senior term loans, approximately 31.9% was senior subordinated term loans, no investments were in junior subordinated loans and approximately 1.0% was in equity securities. The following table outlines our investments by type at September 30, 2010 and 2009:

	<b>September 30, 2010</b>		<b>September 30, 2009</b>	
	<b>Cost</b>	<b>Fair Value</b>	<b>Cost</b>	<b>Fair Value</b>
Senior Term Loans	\$ 200,041	\$ 172,596	\$ 240,172	\$ 212,290
Senior Subordinated Term Loans	93,987	81,899	118,743	105,794
Preferred Equity	444	387	2,028	
Common Equity/Equivalents	3,744	2,227	3,450	2,885

Total Investments	\$ 298,216	\$ 257,109	\$ 364,393	\$ 320,969
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Investments at fair value consisted of the following industry classifications as of September 30, 2010 and 2009:

Industry Classification	September 30, 2010		September 30, 2009	
	Fair Value	Percentage of Total Investments	Fair Value	Percentage of Total Investments
Broadcast (TV & Radio)	\$ 44,562	17.3%	\$ 43,403	13.5%
Healthcare, Education & Childcare	41,098	16.0%	58,054	18.1%
Printing & Publishing	37,705	14.7%	37,864	11.8%
Electronics	25,080	9.8%	27,899	8.7%
Mining, Steel, Iron & Non-Precious Metals	24,343	9.5%	21,926	6.8%
Retail Stores	19,620	7.6%	23,669	7.4%
Buildings & Real Estate	12,454	4.8%	12,882	4.0%
Home & Office Furnishings	10,666	4.1%	16,744	5.2%
Automobile	9,868	3.8%	7,999	2.5%
Personal & Non-durable Consumer Products	9,230	3.6%	8,714	2.7%
Machinery	8,719	3.4%	9,202	2.9%
Chemicals, Plastics & Rubber	7,044	2.7%	15,884	4.9%
Leisure, Amusement, Movies & Entertainment	3,994	1.6%	5,091	1.6%
Diversified/Conglomerate Manufacturing	2,042	0.8%	1,236	0.4%
Aerospace & Defense	400	0.2%	1,857	0.6%
Farming & Agriculture	284	0.1%	9,309	2.9%
Diversified Natural Resources, Precious Metals & Minerals			13,589	4.2%
Cargo Transport			5,427	1.7%
Textiles & Leather			220	0.1%
<b>Total</b>	<b>\$ 257,109</b>	<b>100.0%</b>	<b>\$ 320,969</b>	<b>100.0%</b>

The investments at fair value were included in the following geographic regions of the United States at September 30, 2010 and 2009:

Geographic Region	September 30, 2010		September 30, 2009	
	Fair Value	Percent of Total Investments	Fair Value	Percentage of Total Investments
Midwest	\$ 142,357	55.4%	\$ 172,263	53.7%
West	59,892	23.3%	65,678	20.5%
Northeast	22,913	8.9%	14,170	4.4%
Mid-Atlantic	14,482	5.6%	28,437	8.8%
Southeast	11,038	4.3%	34,708	10.8%
U.S. Territory	6,427	2.5%	5,713	1.8%
<b>Total</b>	<b>\$ 257,109</b>	<b>100.0%</b>	<b>\$ 320,969</b>	<b>100.0%</b>



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

Our loans typically range from \$5 million to \$20 million, generally mature in no more than seven years and accrue interest at a fixed or variable rate that exceeds the prime rate. Because the majority of the loans in our portfolio consist of term debt of private companies that typically cannot or will not expend the resources to have their debt securities rated by a credit rating agency, we expect that most, if not all, of the debt securities we acquire will be unrated. Accordingly, we cannot accurately predict what ratings these loans might receive if they were in fact rated, and thus cannot determine whether or not they could be considered investment grade quality.

We hold our loan investment portfolio through our wholly-owned subsidiary, Gladstone Business Loan, LLC ( Business Loan ).

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

Gladstone Management Corporation (our Adviser ) is led by a management team which has extensive experience in our lines of business. Gladstone Administration, LLC (the Administrator ), an affiliate of our Adviser, employs our chief financial officer, chief compliance officer, internal counsel, treasurer and their respective staffs. Excluding our chief financial officer, all of our executive officers are officers or directors, or both, of our Adviser and our Administrator.

Our Adviser and Administrator also provide investment advisory and administrative services, respectively, to our affiliates Gladstone Commercial Corporation ( Gladstone Commercial ), a publicly traded real estate investment trust; Gladstone Investment Corporation ( Gladstone Investment ), a publicly traded BDC and RIC; Gladstone Partners Fund, L.P., a private partnership fund formed primarily to co-invest with us and Gladstone Investment; Gladstone Land Corporation, a private agricultural real estate company owned by David Gladstone, our chairman and chief executive officer, and Gladstone Lending Corporation ( Gladstone Lending ), a private corporation that has filed a registration statement on Form N-2 with the SEC. The majority of our executive officers serve as either directors or executive officers, or both, of our Adviser, our Administrator, Gladstone Commercial, Gladstone Investment and Gladstone Lending. In the future, our Adviser and Administrator may provide investment advisory and administrative services, respectively, to other funds, both public and private.

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

### **Our Investment Strategy**

Our strategy is to make loans at favorable interest rates to small and medium-sized businesses. Our Adviser uses the loan referral networks of Mr. David Gladstone, our chairman and chief executive officer, Mr. Terry Brubaker, our vice chairman, chief operating officer and secretary, and Mr. George Stelljes III, our president and chief investment officer, and of its managing directors to identify and make senior and subordinated loans to borrowers that need funds to finance growth, restructure their balance sheets or effect a change of control. We believe that our business strategy will enable us to achieve a high level of current income by investing in debt securities, consisting primarily of senior notes, senior subordinated notes and junior subordinated notes of established private businesses that are backed by leveraged buyout funds, venture capital funds or others. In addition, from time to time we might acquire existing loans that meet this profile from leveraged buyout funds, venture capital funds and others. We also seek to provide our stockholders with long-term capital growth through the appreciation in the value of warrants or other equity instruments that we might receive when we make loans.

We target small and medium-sized private businesses that meet certain criteria, including some but not necessarily all of the following: the potential for growth in cash flow, adequate assets for loan collateral, experienced management teams with a significant ownership interest in the borrower, profitable operations based on the borrower's cash flow, reasonable capitalization of the borrower (usually by leveraged buyout

funds or venture capital funds) and the potential to realize appreciation and gain liquidity in our equity position, if any. We may achieve liquidity in an equity position through a merger or acquisition of the borrower, a public offering of the borrower's stock or by exercising our right to require the borrower to repurchase our warrants, although we cannot assure you that we will always have these rights. We can also achieve a similar effect by requiring the borrower to pay us conditional interest, which we refer to as a success fee, upon the occurrence of certain events. Success fees are dependent upon the success of the borrower and the occurrence of a triggering event, and are paid in lieu of warrants to purchase common stock of the borrower.

## **Investment Process**

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

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

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

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

*Value-and-Income Orientation and Positive Cash Flow.* Our investment philosophy places a premium on fundamental analysis from an investor's perspective and has a distinct value-and-income orientation. In seeking value, we focus on companies in which we can invest at relatively low multiples of earnings before interest, taxes, depreciation and amortization (EBITDA), and that have positive operating cash flow at the time of investment. In seeking income, we seek to invest in companies that generate relatively stable and high percentage of sales and cash flow to provide some assurance that they will be able to service their debt and pay any required distributions on preferred stock. Typically, we do not expect to invest in start-up companies or companies with speculative business plans.

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

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

*Exit Strategy.* We seek to invest in companies that we believe will provide a stable stream of earnings and cash flow that is sufficient to repay the loans we make to them and to reinvest in their respective businesses. We expect that such internally generated cash flow, which will allow our portfolio

companies to pay interest on, and repay the principal of, our investments, will be a key means by which we exit from our investments over time. In addition, we also seek to invest in companies whose business models and expected future cash flows offer attractive possibilities for capital appreciation on any equity interests we may obtain or retain. These capital appreciation possibilities include strategic acquisitions by other industry participants or financial buyers, initial public offerings of common stock, or other capital market transactions.

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

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

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

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

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

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

review of all loan documents;

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

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

Upon completion of a due diligence investigation and a decision to proceed with an investment, our Adviser's investment professionals who have primary responsibility for the investment present the investment opportunity to our Adviser's investment committee, which consists of Messrs. Gladstone, Brubaker and Stelljes. The investment committee determines whether to pursue the potential investment. Additional due diligence of a potential investment may be conducted on our behalf by attorneys and independent accountants, as well as other outside advisers, prior to the closing of the investment, as appropriate.

We also rely on the long-term relationships that our Adviser's investment professionals have with venture capitalists, leveraged buyout funds, investment bankers, commercial bankers and business brokers, and on the extensive direct experiences of our executive officers and managing directors in providing debt and equity capital to small and medium-sized private businesses.

### ***Investment Structure***

We typically invest in senior, senior subordinated and junior subordinated loans. Our loans typically range from \$5 million to \$20 million, although the size of our investments may vary as our capital base changes. Our loans generally mature within seven years and accrue interest at a variable rate that exceeds the London Interbank Offer Rate ( LIBOR ) and prime rates. In the past, some of our loans have had a provision that calls for some portion of the interest payments to be deferred and added to the principal balance so that the interest is paid, together with the

principal, at maturity. This form of deferred interest is often called "paid in kind" (PIK) interest. When earned, we record PIK interest as interest income and add the PIK interest to the principal balance of the loans. As of September 30, 2010, one loan in our portfolio contained a PIK provision.

To the extent possible, our loans generally are collateralized by a security interest in the borrower's assets. In senior and subordinated loans, we do not usually have the first claim on these assets. Interest payments on loans we make will generally be made monthly or quarterly (except to the extent of any PIK interest) with amortization of principal generally being deferred for several years. The principal amount of the loans and any accrued but unpaid interest will generally become due at maturity at five to seven years. We

seek to make loans that are accompanied by warrants to purchase stock in the borrowers or other yield enhancement features, such as success fees. Any warrants that we receive will typically have an exercise price equal to the fair value of the portfolio company's common stock at the time of the loan and entitle us to purchase a modest percentage of the borrower's stock. Success fees are conditional interest that is paid if the borrower is successful. The success fee is calculated as additional interest on the loan and is paid upon the occurrence of certain triggering events, such as the sale of the borrower. If the event or events do not occur, no success fee will be paid.

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

As noted above, we expect to receive yield enhancements in connection with many of our loans, which may include warrants to purchase stock or success fees. If a financing is successful, not only will our debt securities have been repaid with interest, but we will be in a position to realize a gain on the accompanying equity interests or other yield enhancements. The opportunity to realize such gain may occur if the borrower is sold to new owners or if it makes a public offering of its stock. In most cases, we will not have the right to require a borrower to undergo an initial public offering by registering securities under the Securities Act of 1933, as amended, (the Securities Act), but we generally will have the right to sell our equity interests in any subsequent public offering by the borrower. Even when we have the right to participate in a borrower's public offering, the underwriters might insist, particularly if we own a large amount of equity securities, that we retain all or a substantial portion of our shares for a specified period of time. Moreover, we may decide not to sell an equity position even when we have the right and the opportunity to do so. Thus, although we expect to dispose of an equity interest after a certain time, situations may arise in which we hold equity securities for a longer period.

### ***Risk Management***

We seek to limit the downside risk of our investments by:

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

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

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

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

### ***Temporary Investments***

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



***Hedging Strategies***

Although it has not yet happened, nor do we expect this to happen in the near future, when one of our portfolio companies goes public, we may undertake hedging strategies with regard to any equity interests that we may have in that company. We may mitigate risks associated with the volatility of publicly traded

securities by, for example, selling securities short or writing or buying call or put options. Hedging against a decline in the value of such investments in public companies would not eliminate fluctuations in the values of such investments or prevent losses if the values of such investments decline, but would establish or enhance a hedging strategy to seek to protect our investment in such securities. Therefore, by engaging in hedging transactions, we seek to moderate the decline in the value of our hedged investments in public companies. However, such hedging transactions would also limit our opportunity to gain from an increase in the value of our investment in the public company. In the future, we may enter into hedging transactions, such as interest rate cap agreements, in connection with the borrowings that we make under our line of credit. To date, we do not hold any interest rate cap agreements. Hedging strategies can pose risks to us and our stockholders, however we believe that such activities are manageable because they will be limited to only a portion of our portfolio.

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

### **Competitive Advantages**

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

### ***Management Expertise***

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

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

Our Adviser seeks to identify potential investments both through active origination and due diligence and through its dialogue with numerous management teams, members of the financial community and potential corporate partners with whom our Adviser's investment professionals have long-term relationships. We believe

that our Adviser's investment professionals have developed a broad network of contacts within the investment, commercial banking, private equity and investment management communities, and that their reputation in investment management enables us to identify well-positioned prospective portfolio companies which provide attractive investment opportunities. Additionally, our Adviser expects to generate information from its professionals' network of accountants, consultants, lawyers and management teams of portfolio companies and other companies.

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

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

focusing on companies with good market positions, established management teams and good cash flow;

investing in businesses with experienced management teams;

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

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

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

***Longer Investment Horizon with Attractive Publicly Traded Model***

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

***Flexible Transaction Structuring***

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

completing an acquisition in such an exchange, we can restructure the capital of the small company to include senior and subordinated debt.

### ***Leverage***

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

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

#### ***Monitoring***

Our Adviser's investment professionals, led by Terry Lee Brubaker, our chief operating officer, monitor the financial trends of each portfolio company on an ongoing basis to determine if each is meeting its respective business plans and to assess the appropriate course of action for each company. We monitor the status and performance of each portfolio company and use it to evaluate the overall performance of our portfolio.

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

- assessment of success in the portfolio company's overall adherence to its business plan and compliance with covenants;

- attendance at and participation in meetings of the portfolio company's board of directors;

- periodic contact, including formal update interviews with portfolio company management, and, if appropriate, the financial or strategic sponsor;

- comparison with other companies in the portfolio company's industry; and

- review of monthly and quarterly financial statements and financial projections for portfolio companies.

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

As a business development company, we make available significant managerial assistance to our portfolio companies and provide other services to such portfolio companies. Neither we nor our Adviser currently receives fees in

connection with the managerial assistance we make available. At times, our Adviser provides other services to certain of our portfolio companies and it receives fees for these other services, certain of which are credited by 50% against the investment advisory fees that we pay our Adviser.

### ***Valuation Process***

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

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

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

Our Board of Directors reviews this documentation and discusses the input of our Adviser, management, and the opinions of value of SPSE to arrive at a determination for the aggregate fair value of our portfolio of investments.

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

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

We are externally managed pursuant to contractual arrangements with our Adviser and Administrator, under which our Adviser and Administrator employ all of our personnel and pay our payroll, benefits, and general expenses directly. On October 1, 2006, we entered into an amended and restated investment advisory agreement with our Adviser (the Advisory Agreement) and an administration agreement with our Administrator (the Administration Agreement). On July 7, 2010, our Board of Directors renewed the Advisory Agreement and the Administration Agreement through August 31, 2011. The management services and fees in effect under the Advisory Agreement are described below. In addition to the fees described below, certain fees received by our Adviser from our portfolio companies were 100% credited, prior to April 1, 2007, or 50% credited effective April 1, 2007, against the investment advisory fee. In addition, we pay our direct expenses including, but not limited to, directors' fees, legal and accounting fees and stockholder related expenses under the Advisory Agreement.

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

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



*Loan Servicing Fees*

Our Adviser also services the loans held by our wholly-owned subsidiary, Gladstone Business Loan, LLC ( Business Loan ), in return for which our Advisor receives a 2.0% annual fee based on the

monthly aggregate outstanding balance of loans pledged under our line of credit. Since we own these loans, all loan servicing fees paid to our Adviser are treated as reductions directly against the 2.0% base management fee under the Advisory Agreement.

*Portfolio Company Fees*

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

*Senior Syndicated Loan Fee Waiver*

Our Board of Directors accepted an unconditional and irrevocable voluntary waiver from the Adviser to reduce the annual 2.0% base management fee on senior syndicated loan participations to 0.5%, to the extent that proceeds resulting from borrowings were used to purchase such syndicated loan participations, for the years ended September 30, 2010 and 2009.

***Incentive Fee***

The incentive fee consists of two parts: an income-based incentive fee and a capital gains-based incentive fee.

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

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

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

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

*Quarterly Incentive Fee Based on Net Investment Income*

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

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

The second part of the incentive fee is a capital gains-based incentive fee that is determined and payable in arrears as of the end of each fiscal year (or upon termination of the Advisory Agreement, as of the termination date), and equals 20% of our realized capital gains as of the end of the fiscal year. In determining the capital gains-based incentive fee payable to our Adviser, we calculate the cumulative aggregate realized capital gains and cumulative aggregate realized

capital losses since our inception, and the aggregate unrealized capital depreciation as of the date of the calculation, as applicable, with respect to each of the investments in

our portfolio. For this purpose, cumulative aggregate realized capital gains, if any, equals the sum of the differences between the net sales price of each investment, when sold, and the original cost of such investment since our inception. Cumulative aggregate realized capital losses equals the sum of the amounts by which the net sales price of each investment, when sold, is less than the original cost of such investment since our inception. Aggregate unrealized capital depreciation equals the sum of the difference, if negative, between the valuation of each investment as of the applicable calculation date and the original cost of such investment. At the end of the applicable year, the amount of capital gains that serves as the basis for our calculation of the capital gains-based incentive fee equals the cumulative aggregate realized capital gains less cumulative aggregate realized capital losses, less aggregate unrealized capital depreciation, with respect to our portfolio of investments. If this number is positive at the end of such year, then the capital gains-based incentive fee for such year equals 20% of such amount, less the aggregate amount of any capital gains-based incentive fees paid in respect of our portfolio in all prior years.

### ***Administration Agreement***

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

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

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

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

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

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

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

*Failure to Qualify as a RIC.* If we are unable to qualify for treatment as a RIC, we will be subject to tax on all of our taxable income at regular corporate rates. We would not be able to deduct distributions to stockholders, nor would we be required to make such distributions. Distributions would be taxable to our stockholders as dividend income to the extent of our current and accumulated earnings and profits. Subject to certain limitations under the Code, corporate distributees would be eligible for the dividends received

deduction. Distributions in excess of our current and accumulated earnings and profits would be treated first as a return of capital to the extent of the stockholder's tax basis, and then as a gain realized from the sale or exchange of property. If we fail to meet the RIC requirements for more than two consecutive years and then seek to requalify as a RIC, we would be required to recognize a gain to the extent of any unrealized appreciation on our assets unless we make a special election to pay corporate-level tax on any such unrealized appreciation recognized during the succeeding 10-year period. Absent such special election, any gain we recognized would be deemed distributed to our stockholders as a taxable distribution.

*Qualification as a RIC.* If we qualify as a RIC and distribute to stockholders each year in a timely manner at least 90% of our investment company taxable income, we will not be subject to federal income tax on the portion of our taxable income and gains we distribute to stockholders. We would, however, be subject to a 4% nondeductible federal excise tax if we do not distribute, actually or on a deemed basis, 98% of our income, including both ordinary income and capital gains. The excise tax would apply only to the amount by which 98% of our income exceeds the amount of income we distribute, actually or on a deemed basis, to stockholders. We will be subject to regular corporate income tax, currently at rates up to 35%, on any undistributed income, including both ordinary income and capital gains. We intend to retain some or all of our capital gains, but to designate the retained amount as a deemed distribution. In that case, among other consequences, we will pay tax on the retained amount, each stockholder will be required to include its share of the deemed distribution in income as if it had been actually distributed to the stockholder and the stockholder will be entitled to claim a credit or refund equal to its allocable share of the tax we pay on the retained capital gain. The amount of the deemed distribution net of such tax will be added to the stockholder's cost basis for its common stock. Since we expect to pay tax on any retained capital gains at our regular corporate capital gain tax rate, and since that rate is in excess of the maximum rate currently payable by individuals on long-term capital gains, the amount of tax that individual stockholders will be treated as having paid will exceed the tax they owe on the capital gain dividend and such excess may be claimed as a credit or refund against the stockholder's other tax obligations. A stockholder that is not subject to U.S. federal income tax or tax on long-term capital gains would be required to file a U.S. federal income tax return on the appropriate form in order to claim a refund for the taxes we paid. In order to utilize the deemed distribution approach, we must provide written notice to the stockholders prior to the expiration of 60 days after the close of the relevant tax year. We will also be subject to alternative minimum tax, but any tax preference items would be apportioned between us and our stockholders in the same proportion that distributions, other than capital gain dividends, paid to each stockholder bear to our taxable income determined without regard to the dividends paid deduction.

If we acquire debt obligations that were originally issued at a discount, which would generally include loans we make that are accompanied by warrants, that bear interest at rates that are not either fixed rates or certain qualified variable rates or that are not unconditionally payable at least annually over the life of the obligation, we will be required to include in taxable income each year a portion of the original issue discount (OID) that accrues over the life of the obligation. Such OID will be included in our investment company taxable income even though we receive no cash corresponding to such discount amount. As a result, we may be required to make additional distributions corresponding to such OID amounts in order to satisfy the annual distribution requirement and to continue to qualify as a RIC or to avoid the 4% excise tax. In this event, we may be required to sell temporary investments or other assets to meet the RIC distribution requirements. For the year ended September 30, 2010, we incurred \$21 of OID income.

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

*Distributions.* For any period during which we qualify for treatment as a RIC for federal income tax purposes, distributions to our stockholders attributable to our investment company taxable income generally will be taxable as ordinary income to stockholders to the extent of our current or accumulated earnings and profits. Any distributions in excess of our earnings and profits will first be treated as a return of capital to the extent of the stockholder's adjusted basis in his or her shares of common stock and thereafter as gain from the sale of shares of our common stock.

Distributions of our long-term capital gains, designated by us as such, will be taxable to stockholders as long-term capital gains regardless of the stockholder's holding period for its

common stock and whether the distributions are paid in cash or invested in additional common stock. Corporate stockholders are generally eligible for the 70% dividends received deduction with respect to ordinary income, but not to capital gains dividends to the extent such amount designated by us does not exceed the dividends received by us from domestic corporations. Any dividend declared by us in October, November or December of any calendar year, payable to stockholders of record on a specified date in such a month and actually paid during January of the following year, will be treated as if it were paid by us and received by the stockholders on December 31 of the previous year. In addition, we may elect to relate a dividend back to the prior taxable year if we (1) declare such dividend prior to the due date for filing our return for that taxable year, (2) make the election in that return, and (3) distribute the amount in the 12-month period following the close of the taxable year but not later than the first regular dividend payment following the declaration. Any such election will not alter the general rule that a stockholder will be treated as receiving a dividend in the taxable year in which the distribution is made, subject to the October, November, December rule described above.

In general, the tax rates applicable to our distributions other than distributions designated as capital gain distributions will be the standard ordinary income tax rates, and not the lower federal income tax rate applicable to qualified dividend income. If we distribute dividends that are attributable to actual dividend income received by us that is eligible to be, and is, designated by us as qualified dividend income, such dividends would be eligible for such lower federal income tax rate. For this purpose, qualified dividend income means dividends received by us from United States corporations and qualifying foreign corporations, provided that both we and the stockholder recipient of our dividend satisfy certain holding period and other requirements in respect of our shares (in the case of our stockholder) and the stock of such corporations (in our case). However, we do not anticipate receiving or distributing a significant amount of qualified dividend income. Unless further legislative action is taken, the preferential treatment for qualified dividend income will expire for taxable years beginning after December 31, 2010.

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

*Sale of Our Shares.* A U.S. stockholder generally will recognize taxable gain or loss if the U.S. stockholder sells or otherwise disposes of his, her or its shares of our common stock. Any gain arising from such sale or disposition generally will be treated as long-term capital gain or loss if the U.S. stockholder has held his, her or its shares for more than one year. Otherwise, it will be classified as short-term capital gain or loss. However, any capital loss arising from the sale or disposition of shares of our common stock held for six months or less will be treated as long-term capital loss to the extent of the amount of capital gain dividends received, or undistributed capital gain deemed received, with respect to such shares. Under the tax laws in effect as of the date of this filing, individual U.S. stockholders are subject to a maximum federal income tax rate of 15% on their net capital gain (i.e. the excess of realized net long-term capital gain over realized net short-term capital loss for a taxable year) including any long-term capital gain derived from an investment in our shares. Such rate is lower than the maximum rate on ordinary income currently payable by individuals. Corporate U.S. stockholders currently are subject to federal income tax on net capital gain at the same rates applied to their ordinary income (currently up to a maximum of 35%). Capital losses are subject to limitations on use for both corporate and non-corporate stockholders.

*Backup Withholding.* We may be required to withhold federal income tax, or backup withholding, currently at a rate of 28%, from all taxable distributions to any non-corporate U.S. stockholder (1) who fails to furnish us with a correct taxpayer identification number or a certificate that such stockholder is exempt from backup withholding, or (2) with respect to whom the Internal Revenue Service (IRS) notifies us that such stockholder has failed to properly report certain interest and dividend income to the IRS and to respond to notices to that effect. An individual's taxpayer



identification number is generally his or her social security

number. Any amount withheld under backup withholding is allowed as a credit against the U.S. stockholder's federal income tax liability, provided that proper information is provided to the IRS.

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

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

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

### ***Qualifying Assets***

Under the 1940 Act, a business development company may not acquire any asset other than assets of the type listed in Section 55(a) of the 1940 Act, which are referred to as qualifying assets, unless, at the time the acquisition is made, qualifying assets, other than certain interests in furniture, equipment, real estate, or leasehold improvements (operating assets) represent at least 70% of the company's total assets, exclusive of operating assets.

### ***Asset Coverage***

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

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

A business development company generally must make available significant managerial assistance to issuers of certain of its portfolio securities that the business development company counts as a qualifying asset for the 70% test described above. Making available significant managerial assistance means, among other things, any arrangement whereby the business development company, through its directors, officers or employees, offers to provide, and, if accepted, does so provide, significant guidance and counsel concerning the management, operations or business

objectives and policies of a portfolio company. Significant managerial assistance also includes the exercise of a controlling influence over the management and policies of the portfolio company. However, with respect to certain, but not all such securities, where the business

development company purchases such securities in conjunction with one or more other persons acting together, one of the other persons in the group may make available such managerial assistance, or the business development company may exercise such control jointly.

### ***Investment Policies***

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

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

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

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

### **Code of Ethics**

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

### **Compliance Policies and Procedures**

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

### **Staffing**

We do not currently have any employees and do not expect to have any employees in the foreseeable future. Currently, services necessary for our business are provided by individuals who are employees of our Adviser and our Administrator pursuant to the terms of the Advisory Agreement and the Administration Agreement, respectively.

Excluding our chief financial officer, each of our executive officers is an employee or officer, or both, of our Adviser and our Administrator. No employee of our Adviser or our Administrator will dedicate all of his or her time to us. However, we expect that 25-30 full time employees of our Adviser and our Administrator will spend substantial time on our matters during the remainder of calendar year 2010 and

all of calendar year 2011. To the extent we acquire more investments, we anticipate that the number of employees of our Adviser and our Administrator who devote time to our matters will increase.

As of November 19, 2010, our Adviser and our Administrator collectively had 52 full-time employees. A breakdown of these employees is summarized by functional area in the table below:

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

### **Available Information**

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

### **Item 1A. Risk Factors**

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

#### ***Risks Related to the Economy***

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

The United States is beginning to recover from the recession that largely began in late 2007. Despite signs of economic improvement and stabilization in both the equity and debt markets, however, conditions within the global credit markets generally continue to experience dislocation and stress. As a result, we do not know if adverse conditions will again intensify, and we are unable to gauge the full extent to which the disruptions will affect us. The longer these uncertain conditions persist, the greater the probability that these factors could continue to increase our costs of, and significantly limit our access to, debt and equity capital and, thus, have an adverse effect on our operations and financial results. Many of our portfolio companies, as well as those companies that we evaluate for investment, are impacted by these economic conditions, and if these conditions persist, it may affect their ability to

repay our loans or engage in a liquidity event, such as a sale, recapitalization or initial public offering.

The uncertain economic conditions have affected the availability of credit generally. Our current credit facility limits our distributions to stockholders and as a result we decreased our monthly cash distribution rate by 50% starting with the April 2009 distributions in an effort to more closely align our distributions to our net investment income. We do not know when market conditions will stabilize, if adverse conditions will intensify

or the full extent to which the disruptions will continue to affect us. Also, it is possible that persistent instability of the financial markets could have other unforeseen material effects on our business.

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

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

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

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

We have no employees. Our chief executive officer, president and chief investment officer, chief operating officer and chief financial officer, and the employees of our Adviser, do not spend all of their time managing our activities and our investment portfolio. We are particularly dependent upon David Gladstone, George Stelljes III and Terry Lee Brubaker in this regard. Our executive officers and the employees of our Adviser allocate some, and in some cases a material portion, of their time to businesses and activities that are not related to our business. We have no separate facilities and are completely reliant on our Adviser, which has significant discretion as to the implementation and execution of our business strategies and risk management practices. We are subject to the risk of discontinuation of our Adviser's operations or termination of the Advisory Agreement and the risk that, upon such event, no suitable replacement will be found. We believe that our success depends to a significant extent upon our Adviser and that discontinuation of its operations could have a material adverse effect on our ability to achieve our investment objectives.

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

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

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

The Advisory Agreement entitles our Adviser to incentive compensation for each fiscal quarter in an amount equal to a percentage of the excess of our investment income for that quarter (before deducting incentive compensation, net operating losses and certain other items) above a threshold return for that quarter. When calculating our incentive compensation, our pre-incentive fee net investment income excludes realized and unrealized capital losses that we may incur in the fiscal quarter, even if such capital losses result in a net loss on our statement of operations for that



quarter. Thus, we may be required to pay our Adviser incentive compensation for a fiscal quarter even if there is a decline in the value of our portfolio or we incur a net loss for that quarter. For additional information on incentive compensation under the Advisory Agreement with our

Adviser, see Business Investment Advisory and Management Agreements Management services and fees under the Advisory Agreement.

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

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

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

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

In certain circumstances, we may make investments in a portfolio company in which one of our affiliates has or will have an investment, subject to satisfaction of any regulatory restrictions and, where required, to the prior approval of our Board of Directors. As of September 30, 2010, our Board of Directors has approved the following types of co-investment transactions:

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

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

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

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

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

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

The Advisory Agreement provides for a base management fee based on our gross assets. Since our 2008 fiscal year, our Board of Directors has accepted on a quarterly basis voluntary, unconditional and irrevocable waivers to reduce the annual 2.0% base management fee on senior syndicated loan participations to 0.5% to the extent that proceeds resulting from borrowings were used to purchase such syndicated loan participations, and any waived fees may not be recouped by our Adviser in the future. However, our Adviser is not required to issue these or other waivers of fees under the Advisory Agreement, and to the extent our investment portfolio grows in the future, we expect these fees will increase. If our Adviser does not issue these waivers in future quarters, it could negatively impact our earnings and may compromise our ability to maintain our current level of distributions to our stockholders, which could have a material adverse impact on our stock price.

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

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

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

*Because of the limited amount of committed funding under our credit facility, we will have limited ability to fund new investments if we are unable to expand the facility.*

In recent years, creditors have significantly curtailed their lending to business development companies, including us. In March 2010, we entered into a fourth amended and restated credit agreement providing for a revolving line of credit

(the Credit Facility ). Committed funding under the Credit Facility is \$127.0 million. The Credit Facility may be expanded up to \$202.0 million through the addition of other committed lenders to the facility. However, if additional lenders are unwilling to join the facility on its terms, we will be unable to expand the facility and thus will continue to have limited availability to finance new investments under our line of credit. The Credit Facility matures on March 15, 2012, and, if the facility is not renewed or extended

by this date, all principal and interest will be due and payable on March 15, 2013. As of September 30, 2010, we had \$16.8 million drawn and outstanding under the Credit Facility.

There can be no guarantee that we will be able to renew, extend or replace the Credit Facility upon its maturity on terms that are favorable to us, if at all. Our ability to expand the Credit Facility, and to obtain replacement financing at the time of maturity, will be constrained by then-current economic conditions affecting the credit markets. In the event that we are not able to expand the Credit Facility, or to renew, extend or refinance the Credit Facility at the time of its maturity, this could have a material adverse effect on our liquidity and ability to fund new investments, our ability to make distributions to our stockholders and our ability to qualify as a RIC under the Code.

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

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

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

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

for the last year.

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

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

Ultimately, we expect approximately 80% of the loans in our portfolio to be at variable rates determined on the basis of the LIBOR, and approximately 20% to be at fixed rates. As of September 30, 2010, our portfolio had approximately 82% of the total loan cost value at variable rates with floors, approximately 8% of the total of the loan cost value at variable rates without a floor or ceiling and approximately 10% of the total loan portfolio cost basis at fixed rates.

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

We will have a continuing need for capital to finance our loans. In order to maintain RIC status, we are required to distribute to our stockholders at least 90% of our ordinary income and short-term capital gains on an annual basis. Accordingly, such earnings will not be available to fund additional loans. Therefore, we are party to the Credit Facility, which provides us with a revolving credit line facility of \$127.0 million, of which \$110.2 million was available for borrowings as of September 30, 2010. The Credit Facility permits us to fund additional loans and investments as long as we are within the conditions set out in the credit agreement. Current market conditions have forced us to write down the value of a portion of our assets as required by the 1940 Act and fair value accounting rules. These are not realized losses, but constitute adjustment in asset values for purposes of financial reporting and for collateral value for the Credit Facility. As assets are marked down in value, the amount we can borrow on the Credit Facility decreases.

As a result of the Credit Facility, we are subject to certain limitations on the type of loan investments we make, including restrictions on geographic concentrations, sector concentrations, loan size, dividend payout, payment frequency and status, and average life. The credit agreement also requires us to comply with other financial and operational covenants, which require us to, among other things, maintain certain financial ratios, including asset and interest coverage and a minimum net worth. As of September 30, 2010, we were in compliance with these covenants, however, our continued compliance with these covenants depends on many factors, some of which are beyond our control. In particular, depreciation in the valuation of our assets, which valuation is subject to changing market conditions that remain very volatile, affects our ability to comply with these covenants. During the year ended September 30, 2010, net unrealized appreciation on our investments was approximately \$2.3 million, compared to \$9.5 million unrealized appreciation during the prior fiscal year. Given the continued deterioration in the capital markets, the cumulative unrealized depreciation in our portfolio may increase in future periods and threaten our ability to comply with the covenants under the Credit Facility. Accordingly, there are no assurances that we will continue to comply with these covenants. Under the Credit Facility, we are also required to maintain our status as a BDC under the 1940 Act and as a RIC under the Code. Our failure to satisfy these covenants could result in foreclosure by our lenders, which would accelerate our repayment obligations under the facility and thereby have a material adverse effect on our business, liquidity, financial condition, results of operations and ability to pay distributions to our stockholders.

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

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



A large number of entities compete with us and make the types of investments that we seek to make in small and mid-sized companies. We compete with public and private buyout funds, commercial and investment banks, commercial financing companies, and, to the extent they provide an alternative form of financing, hedge funds. Many of our competitors are substantially larger and have considerably greater financial, technical and marketing resources than we do. For example, some competitors may have a lower cost of funds and access to funding

sources that are not available to us. In addition, some of our competitors may have higher risk tolerances or different risk assessments, which would allow them to consider a wider variety of investments and establish more relationships than us. Furthermore, many of our competitors are not subject to the regulatory restrictions that the 1940 Act imposes on us as a business development company. The competitive pressures we face could have a material adverse effect on our business, financial condition and results of operations. Also, as a result of this competition, we may not be able to take advantage of attractive investment opportunities from time to time and we can offer no assurance that we will be able to identify and make investments that are consistent with our investment objective. We do not seek to compete based on the interest rates we offer, and we believe that some of our competitors may make loans with interest rates that will be comparable to or lower than the rates we offer. We may lose investment opportunities if we do not match our competitors' pricing, terms, and structure. However, if we match our competitors' pricing, terms, and structure, we may experience decreased net interest income and increased risk of credit loss.

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

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

*Small and medium-sized businesses are likely to have greater exposure to economic downturns than larger businesses.* Our portfolio companies may have fewer resources than larger businesses. Therefore, current uncertain economic conditions and any future economic downturns or recessions are more likely to have a material adverse effect on them. If one of our portfolio companies is adversely impacted by a recession, its ability to repay our loan or engage in a liquidity event, such as a sale, recapitalization or initial public offering, would be diminished. Moreover, in light of our current near-term strategy of preserving capital, our inability to make additional investments in our portfolio companies at a time when they need capital may increase their exposure to the risks of current uncertain economic conditions and future economic downturns.

*Small and medium-sized businesses may have limited financial resources and may not be able to repay the loans we make to them. Our strategy includes providing financing to portfolio companies that typically is not readily available to them.* While we believe that this provides an attractive opportunity for us to generate profits, this may make it difficult for the portfolio companies to repay their loans to us upon maturity. A borrower's ability to repay its loan may be adversely affected by numerous factors, including the failure to meet its business plan, a downturn in its industry, or negative economic conditions. A deterioration in a borrower's financial condition and prospects usually will be accompanied by a deterioration in the value of any collateral and a reduction in the likelihood of us realizing on any guarantees we may have obtained from the borrower's management. As of September 30, 2010, six investments were on non-accrual. While we are working with the portfolio companies to improve their profitability and cash flows, there can be no assurance that our efforts will prove successful. Although we will sometimes seek to be the senior, secured lender to a borrower, in most of our loans we expect to be subordinated to a senior lender, and our interest in any collateral would, accordingly, likely be subordinate to another lender's security interest.

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

*There is generally little or no publicly available information about these businesses.* Because we seek to invest in privately owned businesses, there is generally little or no publicly available operating and financial information about our potential portfolio companies. As a result, we rely on our officers, our Adviser, and its employees and consultants to perform due diligence investigations of these portfolio

companies, their operations, and their prospects. We may not learn all of the material information we need to know regarding these businesses through our investigations.

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

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

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

*We may not be able to replace lost income due to the reduction in the size of our portfolio and as a result, we may have to reduce our distributions to stockholders.*

Since September 30, 2009, the cost basis of our portfolio has experienced a net decrease of 18%. The decrease in the size of our portfolio was driven predominantly by repayments and sales during the year ended September 30, 2010 totaling approximately \$85.6 million. The decrease in our portfolio has resulted in a reduction of income-producing assets which has reduced our income and may result in reduced income in future periods if we are unable to reinvest our cash in comparable income producing assets. Even though this lost income is partially offset by a reduction in interest expense due to reduced borrowings outstanding under our Credit Facility and, to a lesser extent, reduced operating expenses, we still have experienced a net decrease in our net investment income as a result of these sales. While we intend to reinvest our cash as quickly as possible into income and capital gain-generating assets, there is no guarantee that that we will be able to do so or that we will be able to do so at yields comparable to the assets that we have recently sold. If we are unable to reinvest our cash and replace our lost income, we may need to reduce our distributions to stockholders.

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

A large percentage of our portfolio investments are, and we expect will continue to be, in the form of securities that are not publicly traded. The fair value of securities and other investments that are not publicly traded may not be readily determinable. Our Board of Directors has established an investment valuation policy and consistently applied valuation procedures used to determine the fair value of these securities quarterly. These procedures for the determination of value of many of our debt securities rely on the opinions of value submitted to us by SPSE, the use of

internally developed discounted cash flow, or DCF, methodologies, or internal methodologies based on the total enterprise value, or TEV, of the issuer used for certain of our equity investments. SPSE will only evaluate the debt portion of our investments for which we specifically request evaluation, and SPSE may decline to make requested evaluations for any reason in its sole discretion. However, to date, SPSE has accepted each of our requests for evaluation.

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

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

the nature and realizable value of any collateral;

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

the markets in which the portfolio company does business;

the comparison to publicly traded companies; and

discounted cash flow and other relevant factors.

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

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

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

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

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

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

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

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

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

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

We invest primarily in debt securities issued by our portfolio companies. In some cases portfolio companies will be permitted to have other debt that ranks equally with, or senior to, the debt securities in which we invest. By their terms, such debt instruments may provide that the holders thereof are entitled to receive payment of interest and principal on or before the dates on which we are entitled to receive payments in respect of the debt securities in which we invest. Also, in the event of insolvency, liquidation, dissolution, reorganization, or bankruptcy of a portfolio company, holders of debt instruments ranking senior to our investment in that portfolio company would typically be entitled to receive payment in full before we receive any distribution in respect of our investment. After repaying such senior creditors, such portfolio company may not have any remaining assets to use for repaying its obligation to us. In the case of debt ranking equally with debt securities in which we invest, we would have to share on an equal basis any distributions with other creditors holding such debt in the event of an insolvency, liquidation, dissolution, reorganization, or bankruptcy of a portfolio company.

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

In addition to risks associated with delays in investing our capital, we are also subject to the risk that investments that we make in our portfolio companies may be repaid prior to maturity. For the year ended September 30, 2010, we received principal payments prior to maturity of \$59.7 million. We will first use any proceeds from prepayments to repay any borrowings outstanding on our credit facility. In the event that funds remain after repayment of our outstanding borrowings, then we will generally reinvest these proceeds in government securities, pending their future investment in new debt and/or equity securities. These government securities will typically have substantially lower yields than the debt securities being prepaid and we could experience significant delays in reinvesting these amounts. As a result, our results of operations could be materially adversely affected if one or more of our portfolio companies elects to prepay amounts owed to us. Additionally, prepayments could negatively impact our return on equity, which could result in a decline in the market price of our common stock.

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

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

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



As of September 30, 2010 we had loans outstanding to 39 portfolio companies. A consequence of a limited number of investments is that the aggregate returns we realize may be substantially adversely affected

by the unfavorable performance of a small number of such loans or a substantial write-down of any one investment. Beyond our regulatory and income tax diversification requirements, we do not have fixed guidelines for industry concentration and our investments could potentially be concentrated in relatively few industries. In addition, while we do not intend to invest 25.0% or more of our total assets in a particular industry or group of industries at the time of investment, it is possible that as the values of our portfolio companies change, one industry or a group of industries may comprise in excess of 25.0% of the value of our total assets. As of September 30, 2010, 17.3% of our total assets were invested in broadcast companies, 16.0% were invested in healthcare, education and childcare companies, and 14.7% were invested in printing and publishing companies. As a result, a downturn in an industry in which we have invested a significant portion of our total assets could have a materially adverse effect on us.

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

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

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

Currently, all of our investments involve private securities. In connection with the disposition of an investment in private securities, we may be required to make representations about the business and financial affairs of the underlying portfolio company typical of those made in connection with the sale of a business. We may also be required to indemnify the purchasers of such investment to the extent that any such representations turn out to be inaccurate or with respect to certain potential liabilities. These arrangements may result in contingent liabilities that ultimately yield funding obligations that must be satisfied through our return of certain distributions previously made to us.

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

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

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

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

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

When we make a subordinated loan, we may receive warrants to purchase stock issued by the borrower or other yield enhancements, such as success fees. Our goal is to ultimately dispose of these equity interests

and realize gains upon our disposition of such interests. We expect that, over time, the gains we realize on these warrants and other yield enhancements will offset any losses we experience on loan defaults. However, any warrants we receive may not appreciate in value and, in fact, may decline in value and any other yield enhancements, such as success fees, may not be realized. Accordingly, we may not be able to realize gains from our equity interests or other yield enhancements and any gains we do recognize may not be sufficient to offset losses we experience on our loan portfolio.

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

As a 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.

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

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

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

From time to time, some of our debt investments may include success fees that would generate payments to us if the business underlying such a debt investment is ultimately sold. Because the satisfaction of these success fees, and the ultimate payment of these fees, is uncertain, to date we have not recognized any of these success fees as income, either for financial accounting or tax purposes, until the time that the success fees have actually been paid. We have recently sought a determination from the IRS that it agrees with our tax treatment. If the IRS were to disagree with this approach, we would be required to accrue these amounts as investment company taxable income, including an immediate accrual of amounts related to success fees that were not accrued in prior periods. As a result, we would be required to distribute such amounts to our stockholders in order to maintain RIC status.



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

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

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

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

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

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

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

an affiliate of an interested stockholder.

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

Our articles of incorporation permit our Board of Directors to issue up to 50,000,000 shares of capital stock. In addition, our Board of Directors, without any action by our stockholders, may amend our articles of incorporation from time to time to increase or decrease the aggregate number of shares or the number of shares of any class or series of stock that we have authority to issue. Our Board of Directors may classify or reclassify any unissued common stock or preferred stock and establish the preferences, conversion or other rights, voting powers, restrictions, limitations as to distributions, qualifications and terms or conditions of redemption of any such stock. Thus, our Board of Directors could authorize the issuance of senior common stock or preferred stock with terms and conditions that could have a

priority as to distributions and amounts payable upon liquidation over the rights of the holders of our common stock. Senior Common Stock or Preferred stock could also have the effect of delaying, deferring or preventing a change in control of us, including an extraordinary transaction (such as a merger, tender offer or sale of all or substantially all of our assets) that might provide a premium price for holders of our common stock.

***Risks Related to an Investment in Our Common Stock***

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

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

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

Our current intention is to distribute at least 90% of our ordinary income and short-term capital gains to our stockholders on a quarterly basis by paying monthly distributions. On an annual basis, we intend to distribute net long-term capital gains, after giving effect to any prior year realized losses that are carried forward, by paying a one-time distribution. However, our Board of Directors may determine in certain cases to retain net realized long-term capital gains through a deemed distribution to supplement our equity capital and support the growth of our portfolio.

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

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

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

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

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



general economic trends and other external factors;

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

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

changes in regulatory policies or tax guidelines, particularly with respect to RICs or business development companies;

loss of business development company status;

loss of RIC status;

changes in our earnings or variations in our operating results;

changes in the value of our portfolio of investments;

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

departure of key personnel;

operating performance of companies comparable to us;

short-selling pressure with respect to our shares or business development companies generally;

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

loss of a major funding source.

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

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

There are significant capital raising constraints applicable to us under the 1940 Act when our stock is trading below its net asset value per share. In the event that we issue subscription rights to our existing stockholders, there is a significant possibility that the rights offering will dilute the ownership interest and voting power of stockholders who do not fully exercise their subscription rights. Stockholders who do not fully exercise their subscription rights should expect that they will, upon completion of the rights offering, own a smaller proportional interest in the Company than would otherwise be the case if they fully exercised their subscription rights. In addition, because the subscription price of the rights offering is likely to be less than the Company's most recently determined net asset value per share, our stockholders are likely to experience an immediate dilution of the per share net asset value of their shares as a result of the offer. As a result of these factors, any future rights offerings of our common stock, or our announcement of our intention to conduct a rights offering, could have a material adverse impact on the trading price of our common stock.

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

Shares of closed-end investment companies frequently trade at a discount from net asset value. Since our inception, our common stock has at times traded above net asset value, and at times traded below net asset value. During the past year, our common stock has traded consistently, and at times significantly, below net asset value. Subsequent to September 30, 2010, our stock has traded at discounts of up to 7% of our net asset value as of September 30, 2010. This characteristic of shares of closed-end investment companies is separate and distinct from the risk that our net asset value per share will decline. As with any stock, the price of our shares will fluctuate with market conditions and other factors. If shares are sold, the price received may be more or less than the original investment. Whether investors will realize gains or losses upon the sale of our shares will not depend directly upon our net asset value, but will depend upon the market price of the shares

at the time of sale. Since the market price of our shares will be affected by such factors as the relative demand for and supply of the shares in the market, general market and economic conditions and other factors beyond our control, we cannot predict whether the shares will trade at, below or above our net asset value. Under the 1940 Act, we are generally not able to issue additional shares of our common stock at a price below net asset value per share to purchasers other than our existing stockholders through a rights offering without first obtaining the approval of our stockholders and our independent directors. Additionally, at times when our stock is trading below its net asset value per share, our dividend yield may exceed the weighted average returns that we would expect to realize on new investments that would be made with the proceeds from the sale of such stock, making it unlikely that we would determine to issue additional shares in such circumstances. Thus, for as long as our common stock trades below net asset value we will be subject to significant constraints on our ability to raise capital through the issuance of common stock. Additionally, an extended period of time in which we are unable to raise capital may restrict our ability to grow and adversely impact our ability to increase or maintain our distributions.

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

At our most recent annual meeting, our stockholders approved a proposal designed to allow us to access the capital markets in a way that we were previously unable to as a result of restrictions that, absent stockholder approval, apply to business development companies under the 1940 Act. Specifically, our stockholders approved a proposal that authorizes us to sell shares of our common stock below the then current net asset value per share of our common stock in one or more offerings for a period of one year. At the upcoming annual stockholders meeting scheduled for February 17, 2011, our stockholders will again be asked to vote in favor of renewing this proposal for another year. During the past year, our common stock has traded consistently, and at times significantly, below net asset value. Any decision to sell shares of our common stock below the then current net asset value per share of our common stock would be subject to the determination by our Board of Directors that such issuance is in our and our stockholders' best interests.

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

### ***Other Risks***

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

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



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

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

**Item 1B. *Unresolved Staff Comments***

None.

**Item 2. *Properties***

We do not own any real estate or other physical properties materially important to our operations. Gladstone Management Corporation is the current leaseholder of all properties in which we operate. We occupy these premises pursuant to our Advisory and Administration Agreements with our Adviser and Administrator, respectively. Our Adviser and Administrator are headquartered in McLean, Virginia and our Adviser also has operations in New York, New Jersey, Illinois, Connecticut, Texas and Georgia.

**Item 3. *Legal Proceedings***

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

**Item 4. *Removed and Reserved***

**PART II**

**Item 5. *Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities***

Our common stock is traded on the Nasdaq Global Select Market under the symbol GLAD. The following table reflects, by quarter, the high and low closing prices per share of our common stock on the Nasdaq Global Select Market, the closing sale price as a percentage of net asset value ( NAV ) and quarterly dividends declared per share for each fiscal quarter during the last two fiscal years. Amounts presented for each fiscal quarter of 2010 and 2009 represent the cumulative amount of the dividends declared for the months composing such quarter.

	Quarter		Closing Sales Price		Premium (Discount) of High to NAV(2)	Premium (Discount) of Low to NAV(2)	Declared
	Ended	NAV(1)	High	Low			Dividends
FY 2010	09/30/10	\$ 11.85	\$ 12.34	\$ 10.30	4%	(13)%	\$ 0.210
	06/30/10	11.81	13.94	10.09	18%	(15)%	0.210
	03/31/10	12.10	12.19	7.19	1%	(41)%	0.210

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FY 2009	12/31/09	11.92	9.49	7.50	(20)%	(37)%	0.210
	09/30/09	11.81	10.40	7.17	(12)%	(39)%	0.210
	06/30/09	11.86	7.80	5.49	(34)%	(54)%	0.210
	03/31/09	12.10	10.28	5.01	(15)%	(59)%	0.420
	12/31/08	12.04	15.38	5.50	28%	(54)%	0.420

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

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

As of November 18, 2010, there were approximately 70 stockholders of record of our common stock.

### Distributions

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

### Recent Sales of Unregistered Securities

There were no unregistered sales of securities during the fiscal year ended September 30, 2010.

### Item 6. Selected Financial Data

The following tables summarize our consolidated selected financial data and other data. The consolidated selected financial data for the fiscal years ended September 30, 2010, 2009, 2008, 2007 and 2006 are derived from our audited consolidated financial statements. The other data included in the second table below is unaudited. The data should be read in conjunction with our consolidated financial statements and notes thereto and Management's Discussion and Analysis of Financial Condition and Results of Operations included elsewhere in this report.

#### CONSOLIDATED SELECTED FINANCIAL AND OTHER DATA

	Year Ended September 30,				
	2010	2009	2008	2007	2006
	(Dollar amounts in thousands, except per share and per unit data)				
Statement of Operations Data:					
Total Investment Income	\$ 35,539	\$ 42,618	\$ 45,725	\$ 36,687	\$ 26,900
Total Expenses	\$ 17,780	\$ 21,587	\$ 19,172	\$ 14,426	\$ 7,447
Net Investment Income	\$ 17,759	\$ 21,031	\$ 26,553	\$ 22,261	\$ 19,351
Net Gain (Loss) on Investments, Derivative and Borrowings	\$ (1,365)	\$ (17,248)	\$ (47,815)	\$ (7,309)	\$ 5,079
Net Increase (Decrease) in Net Assets Resulting from Operations	\$ 16,394	\$ 3,783	\$ (21,262)	\$ 14,952	\$ 24,430



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Per Share Data(1):

Basic:	\$	0.78	\$	0.18	\$	(1.08)	\$	1.13	\$	2.15
Diluted:	\$	0.78	\$	0.18	\$	(1.08)	\$	1.13	\$	2.10

Cash Distributions Declared

Per Share	\$	0.840	\$	1.260	\$	1.680	\$	1.680	\$	1.635
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Statement of Assets and

Liabilities Data:

Total Assets	\$	270,518	\$	335,910	\$	425,698	\$	367,729	\$	225,783
Net Assets	\$	249,246	\$	249,076	\$	271,748	\$	220,959	\$	172,570
Net Asset Value Per Share	\$	11.85	\$	11.81	\$	12.89	\$	14.97	\$	14.02
Common Shares Outstanding		21,039,242		21,087,574		21,087,574		14,762,574		12,305,008

**Year Ended September 30,**  
**2010                      2009                      2008                      2007                      2006**  
**(Dollar amounts in thousands, except per share and per unit data)**

## Senior Securities Data:

Borrowings under line of credit(2)	\$ 17,940	\$ 83,350	\$ 151,030	\$ 144,440	\$ 49,993
Asset coverage ratio(3)(4)	1,419%	396%	279%	252%	443%
Asset coverage per unit(4)	\$ 14,187	\$ 3,963	\$ 2,792	\$ 2,524	\$ 4,435

- (1) Per share data for net increase (decrease) in net assets resulting from operations is based on the weighted average common stock outstanding for both basic and diluted.
- (2) See Management's Discussion and Analysis of Financial Condition and Results of Operations for more information regarding our level of indebtedness.
- (3) As a business development company, we are generally required to maintain a ratio of 200% of total consolidated assets, less all liabilities and indebtedness not represented by senior securities, to total borrowings and guaranty commitments.
- (4) Asset coverage ratio 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 the asset coverage ratio expressed in terms of dollar amounts per one thousand dollars of indebtedness.

**Year Ended September 30,**  
**2010                      2009                      2008                      2007                      2006**

## Other Unaudited Data:

Number of Portfolio Companies at Year End	39	48	63	56	32
Principal Amount of Loan Originations	\$ 23,245	\$ 24,911	\$ 176,550	\$ 261,700	\$ 135,955
Principal Amount of Loan Repayments and Investments Sold	\$ 85,634	\$ 96,693	\$ 70,482	\$ 121,818	\$ 124,010
Weighted Average Yield on Investments(1):	9.88%	9.82%	10.00%	11.22%	12.08%
Total Return(2)	37.46%	(30.94)%	(13.90)%	(4.40)%	5.21%

- (1) Weighted average yield on investments equals interest income on investments divided by the annualized weighted average investment balance throughout the year.
- (2) Total return equals the increase (decrease) of the ending market value over the beginning market value plus monthly distributions divided by the monthly beginning market value.

**Item 7.**

***Management's Discussion and Analysis of Financial Condition and Results of Operations***  
***(dollar amounts in thousands, unless otherwise indicated)***

*The following analysis of our financial condition and results of operations should be read in conjunction with our financial statements and the notes thereto contained elsewhere in this Form 10-K.*

**OVERVIEW**

**General**

We were incorporated under the General Corporation Laws of the State of Maryland on May 30, 2001. Our investment objective is to achieve a high level of current income by investing in debt securities, consisting primarily of senior notes, senior subordinated notes and junior subordinated notes, of established private businesses that are substantially owned by leveraged buyout funds, individual investors or are family-owned businesses, with a particular focus on senior notes. In addition, we may acquire from other funds existing loans that meet this profile. We also seek to provide our stockholders with long-term capital growth through the appreciation in the value of warrants or other equity instruments that we may receive when we make loans.

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We operate as a closed-end, non-diversified management investment company, and have elected to be treated as a business development company ( BDC ) under the Investment Company Act of 1940, as amended (the 1940 Act ). In addition, for tax purposes we have elected to be treated as a regulated investment company ( RIC ) under the Internal Revenue Code of 1986, as amended (the Code ).

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

### **Business Environment**

While economic conditions generally appear to be improving somewhat, we remain cautious about a long-term economic recovery. The recent recession generally, and the disruptions in the capital markets in particular, have decreased liquidity and increased our cost of debt and equity capital, where available. The longer these uncertain conditions persist, the greater the probability that these factors could continue to increase our costs of, and significantly limit our access to, debt and equity capital and, thus, have an adverse effect on our operations and financial results. Many of our portfolio companies, as well as those that we evaluate for investment, are impacted by these economic conditions, and if these conditions persist, it may affect their ability to repay our loans or engage in a liquidity event, such as a sale, recapitalization or initial public offering. While these conditions are challenging, we have observed an increase in the number of opportunities for new investments consistent with our investing strategy of providing senior term loans to small and medium-sized companies.

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

Market conditions have affected the trading price of our common stock and our ability to finance new investments through the issuance of equity. When our stock is trading below net asset value ( NAV ) per share, as it has consistently traded for more than a year, our ability to issue equity is constrained by provisions of the 1940 Act which generally prohibit the issuance and sale of our common stock below NAV per share without stockholder approval other than through sales to our then-existing stockholders pursuant to a rights offering. At our annual meeting of stockholders held on February 18, 2010, stockholders approved a proposal which authorizes us to sell shares of our common stock at a price below our then current NAV per share for a period of one year from the date of approval, provided that our Board of Directors makes certain determinations prior to any such sale. On November 19, 2010, the closing market price of our common stock was \$11.50, a 3% discount to our September 30, 2010 NAV per share. At the upcoming

annual stockholders meeting scheduled for February 17, 2011, our stockholders will again be asked to vote in favor of renewing this proposal for another year.

The unstable economic conditions may also continue to decrease the value of collateral securing some of our loans, as well as the value of our equity investments, which has impacted and may continue to impact our ability to borrow under our credit facility. Additionally, our credit facility contains covenants regarding the maintenance of certain minimum net worth requirements which are affected by the decrease in value of our portfolio. Failure to meet these requirements would result in a default which, if we are unable to obtain a waiver from our lenders, would result in the acceleration of our repayment obligations under our credit facility. As of September 30, 2010, we were in compliance with all of the facility covenants.

We expect that, given these regulatory and contractual constraints in combination with current market conditions, debt and equity capital may be costly or difficult for us to access. However, we believe that our entry into a new \$127,000 credit facility with a two-year term (discussed in detail further below in Financing Highlights) increases our ability to make new investments consistent with our strategy of making conservative investments in businesses that we believe will weather the current economic conditions and will be likely to produce attractive long-term returns for our stockholders.

### **Syndicated Loan Valuations**

In monitoring the market activity during the year ended September 30, 2010, we noted market conditions indicating continued liquidity and a better functioning secondary market for syndicated loans. Therefore, in accordance with Financial Accounting Standards Board ( FASB ) Accounting Standards Codification ( ASC ) 820, and following our valuation procedures which specify the use of third-party indicative bid quotes for valuing syndicated loans where there is a liquid public market for those loans and market pricing quotes are readily available, third-party bid quotes were used to value the syndicated loans as of September 30, 2010. While there is some liquidity in the public market, other factors exist that cause us to believe that the third-party indicative bid quotes are not representative of Level 2 inputs.

### **Investment Highlights**

*Purchases:* During the year ended September 30, 2010, we extended \$10,580 of investments to three new portfolio companies and \$12,665 of investments to existing portfolio companies through revolver draws or the additions of new term notes, for total investments of \$23,245.

*Repayments:* During the year ended September 30, 2010, eight borrowers made unscheduled full payoffs of \$58,731, one borrower made an unscheduled partial payoff of \$950 and we experienced contractual amortization, revolver repayments and some principal payments received ahead of schedule for an aggregate of \$22,885, for total principal repayments of \$82,566.

*Sales:* During the year ended September 30, 2010, we sold three syndicated loans (which resulted in our exit from three portfolio companies) for an aggregate of \$3,119 in net proceeds. In addition, we wrote off our investment in Western Directories, which had a cost basis of \$2,865.

Since our initial public offering in August 2001, we have made 268 different loans to, or investments in, 129 companies for a total of approximately \$972,350, before giving effect to principal repayments on investments and divestitures.

### **Financing Highlights**

On March 15, 2010, through our wholly-owned subsidiary, Gladstone Business Loan, LLC ( Business Loan ), we entered into a fourth amended and restated credit agreement, which provides for a \$127,000 revolving line of credit

arranged by Key Equipment Finance Inc. as administrative agent (the Credit Facility ). Branch Banking and Trust Company and ING Capital LLC also joined the Credit Facility as committed lenders. Subject to certain terms and conditions, the Credit Facility may be expanded up to \$202 million through the addition of other committed lenders to the facility. The Credit Facility matures on March 15, 2012, and, if the facility is not renewed or extended by this date, all unpaid principal and interest will be due and payable one year thereafter on March 15, 2013. Advances under the Credit Facility initially bore interest at the 30-day LIBOR (subject to a minimum rate of 2%), plus 4.5% per annum, with a

commitment fee of 0.5% per annum on undrawn amounts. However, on November 22, 2010 (the Amendment Date), we amended our Credit Facility such that advances bear interest at the 30-day LIBOR (subject to a minimum rate of 1.5%), plus 3.75% per annum, with a commitment fee of 0.5% per annum on undrawn amounts when the facility is drawn more than 50% and 1.0% per annum on undrawn amounts when the facility is drawn less than 50%.

In addition to the annual interest rate on borrowings outstanding, under the terms of the Credit Facility prior to the Amendment Date, we were obligated to pay an annual minimum earnings shortfall fee to the committed lenders on March 15, 2011, which was calculated as the difference between the weighted average of borrowings outstanding under the Credit Facility and 50% of the commitment amount of the Credit Facility, multiplied by 4.5% per annum, less commitment fees paid during the year. However, as a result of the amendment to the Credit Facility, we are no longer obligated to pay an annual minimum earnings shortfall fee. As of September 30, 2010, we had accrued approximately \$590 in minimum earnings shortfall fees. On the Amendment Date, we paid a \$665 fee.

During the year ended September 30, 2010, we elected to apply ASC 825, Financial Instruments, specifically to our Credit Facility, which requires us to apply a fair value methodology to the Credit Facility as of September 30, 2010. The Credit Facility was fair valued at \$17,940 as of September 30, 2010.

### **Investment Strategy**

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

Some of our loans may contain a provision that calls for some portion of the interest payments to be deferred and added to the principal balance so that the interest is paid, together with the principal, at maturity. This form of deferred interest is often called paid in kind (PIK) interest and, when earned, we record PIK interest as interest income and add the PIK interest to the principal balance of the loans. We seek to avoid PIK interest with all potential investments under review. As of September 30, 2010, one investment bore PIK interest.

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

Original issue discount (OID) arises when we extend a loan and receive an equity interest in the borrower at the same time. To the extent that the price paid for the equity is not at market value, we must allocate part of the price paid for the loan, to the value of the equity. Then the amount allocated to the equity, the OID, must be amortized over the life of the loan. As with PIK interest, the amortization of OID also produces income that must be recognized for purposes of satisfying the distribution requirements for a RIC under Subchapter M of the Code, whereas the cash is received, if at all, when the equity instrument is sold. We seek to avoid OID with all potential investments under review. As of September 30, 2010, we had four loans with OID income.





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

Our Adviser 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 from other investors, turnaround management, merger and acquisition services and recruiting new management personnel. When our Adviser receives fees for these services, 50% of certain of those fees are credited against the base management fee that we pay to our Adviser. Any services of this nature subsequent to 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 consolidated statements of operations.

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

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

### **Our Adviser and Administrator**

Our Adviser is led by a management team which has extensive experience in our lines of business. Our Adviser is controlled by David Gladstone, our chairman and chief executive officer. Mr. Gladstone is also the chairman and chief executive officer of our Adviser. Terry Lee Brubaker, our vice chairman, chief operating officer, secretary and director, is a member of the board of directors of our Adviser and its vice chairman and chief operating officer, George Stelljes III, our president, chief investment officer and director, is a member of the board of directors of our

Adviser and its president and chief investment officer. Gladstone Administration, LLC (the Administrator ), an affiliate of our Adviser, employs our chief financial officer, chief compliance officer, internal counsel, treasurer and their respective staffs.

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

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

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

We also pay our Adviser a two-part incentive fee under the *Advisory Agreement*. The first part of the incentive fee is an income-based incentive fee which rewards our Adviser if our quarterly net investment income (before giving effect to any incentive fee) exceeds 1.75% of our net assets (the *hurdle rate* ). The second part of the incentive fee is a capital gains-based incentive fee that is determined and payable in arrears as of the end of each fiscal year (or upon termination of the *Advisory Agreement*, as of the termination date), and equals 20% of our realized capital gains as of the end of the fiscal year. In determining the capital gains-based incentive fee payable to our Adviser, we will calculate the cumulative aggregate realized capital gains and cumulative aggregate realized capital losses since our inception, and the aggregate unrealized capital depreciation as of the date of the calculation, as applicable, with respect to each of the investments in our portfolio. The Adviser did not earn the capital gains-based portion of the incentive fee for the fiscal year ended September 30, 2010.

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

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

The Adviser services our loan portfolio pursuant to a loan servicing agreement with Business in return for a 1.5% annual fee, based on the monthly aggregate outstanding loan balance of the loans pledged under our credit facility. All fees received by the Adviser from Business Loan are credited toward the 2% base management fee.

### **Administration Agreement**

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

managed by our Adviser under similar agreements. On July 7, 2010, our Board of Directors approved the renewal of this Administration Agreement through August 31, 2011. We expect that the Board of Directors will consider a further one year renewal in July 2011.

**RESULTS OF OPERATIONS****COMPARISON OF THE FISCAL YEARS ENDED SEPTEMBER 30, 2010 AND 2009**

A comparison of our operating results for the fiscal years ended September 30, 2010 and 2009 is below:

	<b>For the Year Ended September 30,</b>			
	<b>2010</b>	<b>2009</b>	<b>\$ Change</b>	<b>% Change</b>
<b>INVESTMENT INCOME</b>				
Interest income				
Non-Control/Non-Affiliate investments	\$ 29,938	\$ 40,747	\$ (10,809)	(26.5)%
Control investments	2,645	933	1,712	183.5%
Cash	1	11	(10)	(90.9)%
Notes receivable from employees	437	468	(31)	(6.6)%
<b>Total interest income</b>	<b>33,021</b>	<b>42,159</b>	<b>(9,138)</b>	<b>(21.7)%</b>
Other income	2,518	459	2,059	448.6%
<b>Total investment income</b>	<b>35,539</b>	<b>42,618</b>	<b>(7,079)</b>	<b>(16.6)%</b>
<b>EXPENSES</b>				
Loan servicing fee (Refer to Note 4)	3,412	5,620	(2,208)	(39.3)%
Base management fee (Refer to Note 4)	2,673	2,005	668	33.3%
Incentive fee (Refer to Note 4)	1,823	3,326	(1,503)	(45.2)%
Administration fee (Refer to Note 4)	807	872	(65)	(7.5)%
Interest expense	4,390	7,949	(3,559)	(44.8)%
Amortization of deferred financing fees	1,490	2,778	(1,288)	(46.4)%
Professional fees	2,101	1,586	515	32.5%
Compensation expense (Refer to Note 4)	245		245	NM
Other expenses	1,259	1,131	128	11.3%
<b>Expenses before credit from Adviser</b>	<b>18,200</b>	<b>25,267</b>	<b>(7,067)</b>	<b>(28.0)%</b>
Credit to fees from Adviser (Refer to Note 4)	(420)	(3,680)	3,260	(88.6)%
<b>Total expenses net of credit to credits to fees</b>	<b>17,780</b>	<b>21,587</b>	<b>(3,807)</b>	<b>(17.6)%</b>
<b>NET INVESTMENT INCOME</b>	<b>17,759</b>	<b>21,031</b>	<b>(3,272)</b>	<b>(15.6)%</b>
<b>REALIZED AND UNREALIZED LOSS ON:</b>				
Net realized loss on investments	(2,893)	(26,411)	23,518	(89.0)%
Net unrealized appreciation on investments	2,317	9,513	(7,196)	(75.6)%
Realized loss on settlement of derivative		(304)	304	(100.0)%
Net unrealized appreciation on derivative		304	(304)	(100.0)%
Net unrealized appreciation on borrowings under line of credit	(789)	(350)	(439)	NM

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Net loss on investments, derivative and borrowings under line of credit	(1,365)	(17,248)	15,883	(92.1)%
NET INCREASE IN NET ASSETS RESULTING FROM OPERATIONS	\$ 16,394	\$ 3,783	\$ 12,611	333.4%

*NM = Not Meaningful*

## Investment Income

Investment income for the year ended September 30, 2010 was \$35,539 as compared to \$42,618 for the year ended September 30, 2009. Interest income from our aggregate investment portfolio decreased for the year ended September 30, 2010 as compared to the prior year. The level of interest income from investments is directly related to the balance, at cost, of the interest-bearing investment portfolio outstanding during the year multiplied by the weighted average yield. The weighted average yield varies from year to year based on the current stated interest rate on interest-bearing investments and the amounts of loans for which interest is not accruing. Interest income from our investments decreased primarily due to the overall reduction in the cost basis of our investments, resulting primarily from the exit of 12 investments during the year ended September 30, 2010. The annualized weighted average yield on our portfolio was 9.9% for the year ended September 30, 2010 as compared to 9.8% for the prior year. As of September 30, 2010, six investments were on non-accrual, for an aggregate of approximately \$29,926 at cost, or 10.0% of the aggregate cost of our investment portfolio and as of September 30, 2009, five investments were on non-accrual, for an aggregate of approximately \$10,022 at cost, or 2.8% of the aggregate cost of our investment portfolio.

Interest income from Non-Control/Non-Affiliate investments decreased for the year ended September 30, 2010 as compared to the prior year, primarily from an overall decrease in the aggregate cost basis of our Non-Control/Non-Affiliate investments during the year.

Interest income from Control investments increased for the year ended September 30, 2010 as compared to the prior year. The increase was attributable to the Control investments (mainly Defiance and Midwest Metal) held for the entire year ended September 30, 2010, where those same investments were held for only a portion of the year ended September 30, 2009.

Interest income from invested cash was nominal for the years ended September 30, 2010 and 2009.

Interest income from loans to employees, in connection with the exercise of employee stock options, decreased slightly for the year ended September 30, 2010 as compared to the prior year due to principal payments on the employee loans during the year ended September 30, 2010. In addition, during the year ended September 30, 2010, \$515 of an employee stock option loan to a former employee of the Adviser was transferred from notes receivable employees to other assets in connection with the termination of her employment with the Adviser and the later amendment of the loan. The interest on the loan from the time the employee stopped working for the Adviser is included in other income on the accompanying consolidated statement of operations.

Other income increased for the year ended September 30, 2010 as compared to the prior year. Other income includes success fees as well as prepayment fees received upon the full repayment of certain loan investments ahead of contractual maturity and prepayment fees received upon the early unscheduled principal repayments, which was based on a percentage of the outstanding principal amount of the loan at the date of prepayment. Success fees earned during the year ended September 30, 2010 totaled \$1,866, which we received from ActivStyle, Anitox, Doe & Ingalls, Saunders, Northern Contours, Tulsa Welding and Visual Edge. Success fees earned during the year ended September 30, 2009 totaled \$387, which we received from ActivStyle, Interfilm and It's Just Lunch.

The following table lists the investment income for the five largest portfolio companies during the respective years:

### Year Ended September 30, 2010

Investment	% of
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<b>Company</b>	<b>Income</b>	<b>Total</b>
Sunshine Media	\$ 3,254	9.3%
Reliable Biopharma	3,003	8.6%
Westlake Hardware	2,940	8.4%
Midwest Metal (Clinton)#	2,127	6.1%
Winchester	1,589	4.5%
<b>Subtotal</b>	<b>\$ 12,913</b>	<b>36.9%</b>
Other companies	22,036	63.1%
<b>Total income from investments*</b>	<b>\$ 34,949</b>	<b>100.0%</b>

## Year Ended September 30, 2009

Company	Investment Income	% of Total
Sunshine Media	\$ 3,352	8.0%
Reliable Biopharma	3,073	7.3%
Westlake Hardware	2,417	5.7%
Clinton Holdings	1,888	4.5%
VantaCore	1,696	4.0%
<b>Subtotal</b>	<b>\$ 12,426</b>	<b>29.5%</b>
Other companies	29,711	70.5%
<b>Total income from investments*</b>	<b>\$ 42,137</b>	<b>100.0%</b>

# During the year ended September 30, 2010 Clinton Holdings was restructured as Midwest Metal.

\* Includes interest and other income from Non-Control and Control investments.

### Operating Expenses

Operating expenses, net of credits from the Adviser for fees earned and voluntary irrevocable and unconditional waivers to the base management and incentive fees, decreased for the year ended September 30, 2010 as compared to the prior year. This reduction was primarily due to a decrease in interest expense and amortization of deferred financing fees incurred in connection with the Credit Facility, which were partially offset by an increase in professional fees.

Loan servicing fees decreased for the year ended September 30, 2010 as compared to the prior year. 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 decrease was primarily due to the reduction in the size of our investment portfolio. Due to voluntary, irrevocable and unconditional waivers in place during these years, senior syndicated loans incurred a 0.5% annual fee, whereas proprietary loans incurred a 1.5% annual fee. All of these fees were reduced against the amount of the base management fee due to our Adviser.

Base management fee (which is net of loan servicing fees) increased for the year ended September 30, 2010 as compared to the prior year. However, the gross management fee (consisting of the loan servicing fees plus the base management fee) decreased from the prior year as shown below:

	Year Ended	
	September 30, 2010	September 30, 2009
Loan servicing fee	\$ 3,412	\$ 5,620
Base management fee	2,673	2,005

Gross management fee	\$	6,085	\$	7,625
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Gross management fee decreased due to fewer total assets held during the year ended September 30, 2010. The base management fee is computed quarterly as described under Investment Advisory and Management Agreement in Note 4 of the notes to the accompanying consolidated financial statements, and is summarized in the table below:

	<b>Year Ended</b>	
	<b>September 30, 2010</b>	<b>September 30, 2009</b>
Base management fee(1)	\$ 2,673	\$ 2,005
Credit for fees received by Adviser from the portfolio companies	(213)	(89)
Fee reduction for the voluntary, irrevocable and unconditional waiver of 2% fee on senior syndicated loans to 0.5%(2)	(42)	(265)
Net base management fee	\$ 2,418	\$ 1,651

(1) Base management fee is net of loan servicing fees per the terms of the Advisory Agreement.

- (2) The board of our Adviser voluntarily, irrevocably and unconditionally waived on a quarterly basis the annual 2% base management fee to 0.5% for senior syndicated loan participations for the years ended September 30, 2010 and 2009. Fees waived cannot be recouped by the Adviser in the future.

Incentive fee decreased for the year ended September 30, 2010 as compared to the prior year. The board of our Adviser voluntarily, irrevocably and unconditionally waived a portion of the incentive fee for the year ended September 30, 2010 and the entire incentive fee for the year ended September 30, 2009. The incentive fee and associated credits are summarized in the table below:

	<b>Year Ended</b>	
	<b>September 30, 2010</b>	<b>September 30, 2009</b>
Incentive fee	\$ 1,823	\$ 3,326
Credit from voluntary, irrevocable and uncondi		