



GLADSTONE CAPITAL

2004 ANNUAL REPORT



## COMPANY PROFILE

Gladstone Capital Corporation is a specialty finance company focused on debt securities, consisting primarily of senior loans, senior subordinated loans and junior subordinated loans of established private businesses. We are dedicated to providing shareholders with consistent and stable monthly dividends. We also seek long-term capital growth through the appreciation in the value of warrants or other return enhancements that we may receive when we make loans. Our primary strategy is to benefit from our teams' years of experience lending to small and medium-sized companies.

Gladstone Capital Corporation is publicly traded on the Nasdaq® under the symbol: GLAD. Our capital resources exceed \$265 million. Visit our website for more information: [www.GladstoneCapital.com](http://www.GladstoneCapital.com). Our headquarters are in McLean, VA, a suburb of Washington, DC, and we have offices in Morristown, NJ, New York, NY, Chicago, IL and Pittsburgh, PA.





## To Our Shareholders:

(Pictured here from left to right are Terry Brubaker, David Gladstone and Chip Stelljes)

OVERALL, WE HAD A GOOD YEAR, BUT THE ECONOMY IS STILL A CONCERN. OIL PRICES ARE AT THEIR HIGHEST IN THE RECENT PAST AND THAT COST IS HURTING MANY BUSINESSES. THE TRADE DEFICIT IS AT AN ALL-TIME HIGH CAUSING A TORRENT OF U.S. DOLLARS TO BE SPENT OUTSIDE THE U.S.; THIS MUST EVENTUALLY HURT THE VALUE OF THE DOLLAR. THE WAR IN IRAQ IS DEPLETING VITAL RESOURCES AND HURTING THE ECONOMY'S CHANCES FOR GROWTH. INTEREST RATES ARE MOVING BACK TO THEIR NORM BUT THE MOVEMENT SO FAR HAS HAD LITTLE EFFECT ON ECONOMIC GROWTH. IT IS LIKELY THAT BUSINESSES WILL CONTINUE TO BORROW UNTIL SHORT-TERM BASE RATES (LIKE LIBOR) GO ABOVE 5%.

The debt segment of the capital markets on Wall Street is very strong. Big businesses are borrowing at extremely attractive rates. The lower rates and easy credit that big businesses are enjoying, have not come to the smaller businesses. We do not see a great deal of competition from Banks or Wall Street within our small business sector. The smaller businesses we market to are getting stronger and more of them should qualify for our type of financing during the next year. Many of these small and medium-sized companies are hiring again after three years of no hiring. And many of these smaller businesses have a good backlog of new orders. Overall, we continue to make investments at our own pace and seek to grow at a good speed so we can increase our distributions to shareholders.

We are pleased to report that all of our loans are paying as agreed at year end. We think the outlook for 2005 is good. The values on some of our loans were depreciated by Standard & Poor's Loan Evaluation Service (who value them for our Board) so at year end we have a portfolio of approximately \$149.2 million in cost and a fair value of approximately \$146.5 million, a difference of \$2.7 million, or about 2%. We believe these are good results since the economy is coming out of the worst recession since 1990. We believe the excesses of the late 1990s are finally over.

During the year, we made 12 investments for a total of approximately \$86.3 million. Also during 2004, 5 investments repaid for approximately \$36.5 million and in addition to the repayment, we received approximately \$2.4 million in prepayment income and conditional interest. This additional income helped increase our dividends.

We raised our dividend from \$0.33, paid for the quarter ended September 30, 2003, to \$0.36 for the quarter ended September 30, 2004. This shows a 9% increase over the prior year. Shareholders have welcomed our new monthly dividend. Currently, we are paying \$0.12 per share a month or \$0.36 per share a quarter.

Our ability to continue to build our portfolio of loans depends on our ability to raise debt and equity. In September 2004, we completed an offering of 1,150,000 shares of common stock. Net proceeds received from the offering were approximately \$24.4 million. The proceeds were used to payoff our existing debt and make new loans.

Also in September, Deutsche Bank AG and Key Bank were brought in to refinance our \$100 million warehouse line of credit. Our past supplier of credit, CIBC, decided to get out of the business. The line of credit will be used to build the portfolio of loans and later, we will seek to securitize loans for long-term funding. One negative of the change to Deutsche Bank AG and Key Bank is that we wrote off the fees charged by CIBC when the line was set up. We had planned to amortize approximately \$1.0 million in fees but had to write them off now that CIBC was not going to be the lender and that lowered our earnings for the year.

At year end, we changed to being externally managed. This transformation will mean that all salaries and bonuses will be paid by the management company. For example, this past year the compensation committee granted employee bonuses totaling about \$800,000 in the last two quarters of the year. With the change to an external management company, the management company will pay the employees in the future and therefore there will not be an end of the year adjustment for a bonus as there was in 2004.

We rely heavily on the experience of our employees. In the last three years, we have become an active lender and have established a name for ourselves with our customers. We believe in bringing an ethical approach to every business transaction. We are dedicated to our shareholders, customers and employees and appreciate their loyalty during these first 3 years since our initial stock offering.

Thank you for support.

**David Gladstone**, CHAIRMAN OF THE BOARD OF DIRECTORS AND CEO

**Terry Brubaker**, VICE CHAIRMAN AND CHIEF OPERATING OFFICER

**Chip Stelljes**, PRESIDENT AND CHIEF INVESTMENT OFFICER

# Strategy

WE ARE A SPECIALTY FINANCE COMPANY THAT MAKES LOANS TO SMALL AND MEDIUM-SIZED PRIVATE BUSINESSES. WE PROVIDE THREE TYPES OF FINANCING OPTIONS TO THESE PRIVATE COMPANIES:

- SENIOR LOANS
- SENIOR SUBORDINATED LOANS
- JUNIOR SUBORDINATED LOANS

Senior loans are exposed to the least risk of debt because they command a senior position with respect to scheduled interest, principal payments and collateral. However, unlike senior subordinated and junior subordinated loans, these senior loans typically do not entitle the lender to obtain any stock or warrants to purchase stock of the borrowers.

Senior subordinated loans or last-out-tranche loans are typically subordinated in their rights to receive principal and interest payments from the borrower to the rights of the holders of senior debt. As a result, senior subordinated debt is riskier than senior debt.

Junior subordinated loans are subordinated in their rights to receive principal and interest payments from the borrower to the rights of the holders of senior debt and senior subordinated debt. The risk profile of junior subordinated debt is high, which permits the junior subordinated lender to obtain higher interest rates and warrants to purchase a greater portion of the borrower's stock.

Businesses come to us because they do not have sufficient access to traditional lending sources. Borrowers need funds to finance growth, restructure their balance sheets or effect a change of control.

# \$1.365

CASH DISTRIBUTIONS PER SHARE FOR 2004



**DISTRIBUTIONS PER  
SHARE INCREASED 24%  
OVER LAST YEAR.**

Our business strategy contemplates that:

- interest income will be the primary source of our revenue and will be used to pay our monthly dividends and distributions,
- the net capital gains from the sale of the warrants or stock (as well as other profit enhancements) we receive in connection with our lending activities will exceed any losses we may experience from loans that are not repaid, and
- the fee income we receive from our lending will provide us with a source of revenue that will cover our general and administrative expenses (excluding interest expense from the line of credit to our company).

We believe we are well positioned to provide financing to small and medium-sized businesses undergoing a change of ownership, including management-led and third-party leveraged buyouts as well as those businesses that need to borrow money for growth. We are not burdened with the regulatory requirements of the banking industry and we have relatively low overhead and administrative expenses. Moreover, our strategy of accepting warrants to purchase stock of our borrowers is intended to closely align our interests with those of our borrowers, conveying our commitment to the borrowers and enhancing our attractiveness as a financing source. Perhaps most importantly, we have the experience and expertise to understand the financing needs of such businesses.

CURRENT MONTHLY CASH DISTRIBUTION **12¢** PER SHARE

# Selection of Opportunities

WE HAVE IDENTIFIED CERTAIN CHARACTERISTICS THAT WE BELIEVE ARE IMPORTANT TO PROFITABLY LEND TO SMALL AND MEDIUM-SIZED BUSINESSES. THE CRITERIA LISTED BELOW PROVIDE A GENERAL GUIDELINE FOR OUR LENDING AND INVESTMENT DECISIONS.

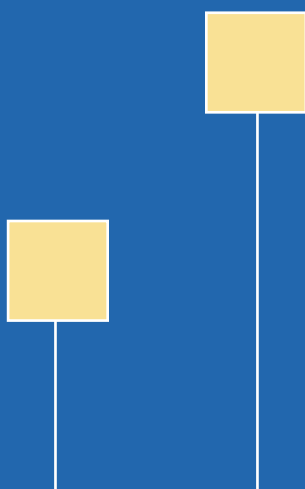
- GROWTH
- EXPERIENCED MANAGEMENT TEAM
- SIGNIFICANT SPONSOR
- LIQUIDATION VALUE OF ASSETS
- PROFITABLE OR NEAR-PROFITABLE OPERATIONS
- EXIT STRATEGY

NET INVESTMENT INCOME

FOR 2004

**\$13.3**

MILLION



#### **GROWTH**

In addition to generating sufficient cash flow to service its debt, a potential borrower generally will be required to establish its ability to grow its cash flow. Anticipated growth will be a key factor in determining the value ascribed to the warrants we acquire in connection with many of our loans.

#### **EXPERIENCED MANAGEMENT TEAM**

We will usually require that each borrower have a management team that is experienced and properly incentivized through a significant ownership interest in the borrower. We require that a borrower have, at a minimum, a strong chief executive officer and chief financial officer who have demonstrated the ability to accomplish the borrower's objectives and implement its business plan.

#### **SIGNIFICANT SPONSOR**

We seek businesses in which buy-out funds or venture capital funds have invested. We believe a business that has a substantial equity sponsor and has made a meaningful investment is a good borrowing candidate.

#### **LIQUIDATION VALUE OF ASSETS**

Although we do not intend to operate as an asset-based lender, liquidation value of the assets collateralizing our loans is an important factor in each credit decision. Emphasis is placed both on tangible assets and intangible assets.

#### **PROFITABLE OR NEAR-PROFITABLE OPERATIONS**

We focus on borrowers that have positive cash flow at the operating level. We do not typically lend to or invest in startup or other early-stage companies, nor do we intend to lend to or invest in businesses that are experiencing operating problems.

#### **EXIT STRATEGY**

Prior to making a loan for which we receive a warrant to purchase stock of the borrower, we will analyze the potential for the borrower to experience a liquidity event that will allow us to realize value for our equity position. Liquidity events include, among other things, an initial public offering, a private sale of our financial interest, a merger or acquisition of the borrower or a purchase of our equity position by the borrower or one of its stockholders.

# Portfolio Companies

THE LOANS WE MAKE TO SMALL AND MEDIUM-SIZED PRIVATE BUSINESSES MEET A CERTAIN CRITERIA, INCLUDING: THE POTENTIAL FOR GROWTH, ADEQUATE COLLATERAL AND EXPERIENCED MANAGEMENT TEAMS.

Information on our typical loans is listed below:

- the amount ranges from \$5 million to \$15 million
- the loan matures in no more than seven years
- loans accrue interest at a fixed rate or a variable rate that exceeds the prime rate
- interest payments will generally be made monthly 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 in five to seven years
- most of the loans are unrated by credit rating agencies—we use our own risk rating system
- some loans are accompanied by warrants that entitle us to purchase a modest percentage of the borrower’s stock
- from time to time, a portfolio company may request additional financing, providing us with additional lending opportunities

PORTFOLIO INDUSTRY SECTOR

**MANUFACTURING**  
Industrial and Commercial Machinery  
Sanitary Paper Products  
Apparel and Accessories  
Measuring and Controlling Devices  
Motor Vehicle Parts and Accessories  
Perfumes, Cosmetics and Other Toiletry Preparations  
Household Appliances  
Knit Outwear Mills

**SERVICES**  
Industrial Launderers  
Equipment Rental and Leasing

**WHOLE SALE TRADE**  
Medical, Dental and Hospital Equipment and Supplies  
Chemicals and Allied Products  
Stationery and Office Supplies

**RETAIL TRADE**  
Miscellaneous Retail Stores

**AGRICULTURE**  
Deciduous Tree Fruits



NET INVESTMENT INCOME  
INCREASED 18% OVER  
LAST YEAR.



# Financial Highlights

	Year Ended September 30, 2004	Year Ended September 30, 2003	Year Ended September 30, 2002	Period May 30, 2001 (Inception) Through September 30, 2001
Total Investment Income	\$ 20,395,968	\$ 15,154,874	\$ 10,455,703	\$ 394,855
Total Expenses	\$ 7,103,193	\$ 3,858,953	\$ 2,839,102	\$ 487,499
Net Investment Income (Loss)	\$ 13,292,775	\$ 11,295,921	\$ 7,616,601	\$ (92,644)
Net Increase (Decrease) in Stockholders' Equity Resulting from Operations	\$ 10,570,290	\$ 11,073,581	\$ 7,616,601	\$ (92,644)
<b>Per Share Data:</b>				
Net Increase (Decrease) in Stockholders' Equity Resulting from Operations:				
Basic	\$ 1.05	\$ 1.10	\$ 0.76	\$ (0.03)
Diluted	\$ 1.02	\$ 1.09	\$ 0.75	\$ (0.03)
Cash Distributions Declared per Share	\$ 1.365	\$ 1.10	\$ 0.81	\$ 0.00
<b>Balance Sheet Data:</b>				
Total Assets	\$215,333,727	\$214,566,663	\$172,922,039	\$ 132,205,486
Total Shareholders' Equity	\$152,226,655	\$130,802,382	\$130,663,273	\$ 131,249,144
<b>Other Data:</b>				
Number of Portfolio Companies at Period End	16	11	7	NONE
Principal Amount of Loan Originations <sup>(1)</sup>	\$ 86,267,500	\$ 47,011,278	\$ 97,705,054	NONE
Principal Amount of Loan Repayments <sup>(1)</sup>	\$ 47,158,995	\$ 18,005,827	\$ 18,387,191	NONE
Total Return <sup>(2)</sup>	24.40%	21.74%	9.60%	7.60%
<b>Weighted Average Yield on Investments<sup>(3)</sup>:</b>				
With PIK Interest <sup>(4)</sup>	13.78%	13.86%	14.79%	N/A
Without PIK Interest <sup>(4)</sup>	13.44%	13.14%	13.82%	N/A

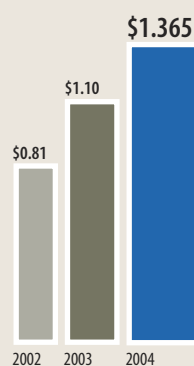
<sup>(1)</sup> Includes all originations/prepayments related to a line of credit to one of our portfolio companies during the fiscal year ended September 30, 2002.

<sup>(2)</sup> For the fiscal year ended September 30, 2004, the total return equals the increase of the ending market value over the beginning market value plus monthly dividends divided by the monthly beginning market value. For the fiscal year ended September 30, 2003 and prior periods, total return equals the increase of the ending market value over the beginning market value, plus distributions, divided by the beginning market value. The return for 2001 has not been annualized.

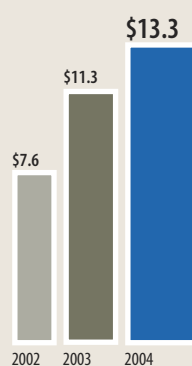
<sup>(3)</sup> Weighted average yield on investments equals interest income on investments divided by the average investment balance throughout the year.

<sup>(4)</sup> Refer to Note 2 of the "Notes to Financial Statements" for an explanation of PIK, or "Paid-in-Kind," interest.

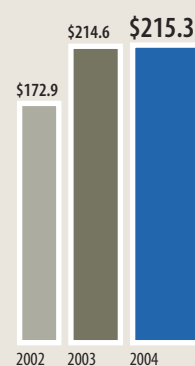
## Cash Distributions Declared per Share



## Net Investment Income (dollars in millions)



## Total Assets (dollars in millions)



## 2004 CORPORATE INFORMATION

### Directors, Officers and Team Members

**David Gladstone**  
Chief Executive Officer and  
Chairman of the Board

**Terry Brubaker**  
Chief Operating Officer,  
Vice Chairman and Director

**Chip Stelljes, III**  
Chief Investment Officer,  
President and Director

**Harry Brill**  
Chief Financial Officer

**Paul Adelgren**  
Director and Pastor of  
Missionary Church

**Maurice Coulon**  
Director and Private  
Real Estate Investor

**David A.R. Dullum**  
Director and Partner of  
New England Partners

**Michela English**  
Director and Private Investor

**Anthony W. Parker**  
Director and Chairman of  
Medical Funding Corp.

**John Outland**  
Director and Vice President  
of Genworth Financial

**Joseph Bute**, *Managing Director*,  
PENNSYLVANIA

**Buzz Cooper**, *Managing Director*,  
VIRGINIA

**Robert Corry**, *Managing Director*,  
NEW JERSEY

**John Freal**, *Managing Director*,  
VIRGINIA

**Laura Gladstone**, *Managing  
Director*, NEW YORK

**Chris Massey**, *Managing Director*,  
VIRGINIA

**Bob Pierce**, *Managing Director*,  
CHICAGO

**Virginia Rollins**, *Principal*,  
VIRGINIA

**Greg Bowie**, *Associate*

**Jonathan Chou**, *Associate*

**Pamela Keene**, *Director of  
Portfolio Records*

**Donya Kolcio**, *Controller*

**Brian McCahill**, *Portfolio  
Manager*

**Paula Novara**, *Head of  
Resources Management and  
Chief Compliance Officer*

**Danielle Siedman**, *Senior  
Accountant*

### Stock Exchange Listing

The common stock of the company trades on The Nasdaq National Stock Market under the symbol GLAD.

### Auditors and Tax Consultants

PricewaterhouseCoopers LLP

### Legal Counsel

Cooley Godward, LLP  
Pepper Hamilton, LLP

### Transfer Agent

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Shareholder Relations  
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Church Street Station  
New York, NY 10286, USA  
Email:

shareowners@bankofny.com  
Website: www.stockbny.com  
Shareholder Inquiries:  
Inside the US:  
1 800 524 4458 (toll-free)  
Outside the US:  
1 610 382 7833  
(collect calls accepted)

### Dividend Reinvestment Plan

The company offers a dividend reinvestment plan to its shareholders. Shareholders whose shares are held in their names should contact the transfer agent to enroll. Shareholders whose shares are held by a brokerage firm should contact their broker to enroll.

### Financial Information

Shareholders may receive a copy of SEC Forms 10-K and 10-Q by visiting the company website at [www.GladstoneCapital.com](http://www.GladstoneCapital.com) or going to the SEC website at [www.SEC.gov](http://www.SEC.gov) or by visiting the SEC at 450 5th Street, N.W., Washington, DC 20549.

### Company Website

[www.GladstoneCapital.com](http://www.GladstoneCapital.com)



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