GLADSTONE CAPITAL CORPORATION

2001 Annual Report

GLADSTONE CAPITAL CORPORATION is a specialty finance company. We invest our capital in debt securities, consisting primarily of senior notes, senior subordinated notes and junior subordinated notes, of established private businesses that are backed by leveraged buyout funds, venture capital funds or others. We 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. We seek to pay cash dividends to our shareholders every quarter. Our headquarters are in McLean, Virginia, a suburb of Washington, DC and we have offices in New York, NY and Pittsburgh, Pa.

Specialty finance

Experience

David Gladstone, *Chairman* Terry Brubaker, *President*

David Gladstone, our chairman and chief executive officer, has over 25 years experience in making loans to, and investing in, small and medium sized companies at Allied Capital Corporation and American Capital Strategies. Allied Capital Corporation is a publicly-traded subordinated-debt lender and American Capital Strategies is a publicly-traded buyout and subordinated-debt lender. While either chairman or president of Allied Capital, Mr. Gladstone oversaw, during the years 1992 through 1997, in excess of $850 million of financing for many small and medium sized businesses and raised, during the years 1985 through 1997, equity capital totaling over $430 million for seven funds. During the past four years, as either chairman or vice chairman of American Capital Strategies, Mr. Gladstone raised the company's initial $150 million in capital and assisted in the company's subsequent capital raising. During his tenure, American Capital Strategies invested in 46 businesses and had total assets of approximately $650 million.

Terry Lee Brubaker, our president and chief operating officer, has over 25 years experience in acquisitions and managing companies after their acquisition. He was a member of the management team that designed and implemented the acquisition strategy of James River Corporation that grew the company from $200 million in revenues to over $7 billion.

Our chief financial officer, **Harry Brill**, brings significant experience from his role as the chief accounting officer of Allied Capital where he was responsible for the public filings of a family of five public companies and oversaw the preparation of the operating reports and financial statements of these public companies and three private funds.

In addition to Messrs. Gladstone and Brubaker, we currently have four principals, who are involved in structuring and arranging financing for small and medium sized businesses. We believe that the expertise of our investing professionals will help us to be successful in lending to small and medium sized businesses.

Our current principals are Virginia Rollins, Joe Bute, Buzz Cooper and Laura Gladstone.

Business strategy

We intend to make loans at favorable interest rates to small and medium sized businesses that we believe have traditionally been underserved by conventional lenders. We plan to make senior and subordinated loans to selected businesses that we believe do not have sufficient access to traditional sources of lending. We expect to make loans to borrowers that need funds to finance growth, restructure their balance sheets or effect a change of control, all of which we believe are typically under-served by banks and other traditional institutional lenders.

Our business strategy contemplates that

(1) our interest income will be the primary source of our revenue

(2) 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

(3) the fee income we derive from our lending will provide us with a source of revenue in excess of our general and administrative expenses (excluding interest expense).

We believe that we are well positioned to provide financing to small and medium sized businesses that are undergoing a change of ownership, including management-led and third party leveraged buyouts, or those businesses that have good growth characteristics. We are not burdened with the regulatory requirements of the banking and savings and loan industries 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 portfolio companies, conveying our commitment to the borrowers and enhancing our attractiveness as a financing source. Perhaps most importantly, we believe that we have the experience and expertise to satisfy the financing needs of such businesses.

Freedom

On September 11, terrorists challenged our most cherished right: the right to be free. Americans have a long history of fighting all adversaries that would take away our freedom. We support those Americans who fight those who seek to destroy what America has preserved for over 200 years.

God bless America.

Our portfolio companies

We target small and medium sized private businesses that meet certain criteria, including the potential for growth, adequate assets for loan collateral, experienced management teams with significant ownership interest in the business, adequate capitalization, profitable operations based on cash flow and potential opportunities for us to realize appreciation and gain liquidity in our various equity positions.

We may achieve liquidity 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 buy back our warrants. We make available significant managerial assistance to our portfolio companies. Such assistance will typically involve closely monitoring the operations of each borrower, participating in its board and management meetings, being available for consultation with its officers and providing organizational and financial guidance.

We expect to invest in senior, senior subordinated and junior subordinated notes. We expect that our loans typically will range from $5 million to $15 million, mature in no more than seven years and accrue interest at a fixed rate or an annualized variable rate that exceeds the prime rate.

We expect that most if not all of the debt securities we acquire will be unrated by credit rating agencies. To the extent possible, our loans generally will be collateralized by a security interest in the borrower's assets though we may not have the first claim on these assets.

Interest payments will generally be made monthly or quarterly 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 will focus on making loans accompanied by warrants to purchase stock in the borrowers.

These warrants will typically 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. 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 jeopardize our investment in that borrower. We expect to receive warrants to purchase stock in many of our borrowers. If a financing is successful, not only will our debt securities have been repaid with interest, we will be in a position to realize a gain on the accompanying equity interests.

Courage

As the events of September 11 unfolded there were heroes that demonstrated great courage. Those who are fighting against terrorism are Americans most courageous. We are grateful that so many are willing to risk their lives to keep our country safe.

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 guidepost for our lending and investment decisions, although not all of these criteria may be followed in each instance.

GROWTH

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

SIGNIFICANT SPONSOR

We seek businesses in which leveraged buy-out funds or venture capital funds have invested. We believe that a business that has a substantial equity sponsor that 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 (e.g., accounts receivable, inventory, plant, property and equipment) and intangible assets (e.g., customer lists, networks, databases and recurring revenue streams).

EXPERIENCED MANAGEMENT TEAM

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

PROFITABLE OR NEAR PROFITABLE OPERATIONS

We focus on borrowers that are profitable or near profitable at the operating level. We do not intend typically to lend to or invest in startup or other early stage companies, nor do we intend typically 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.

Integrity

Americans are known for their integrity. It is a guiding light that permits a free society to function. When integrity is compromised the foundations of a free society are undermined. We believe that Integrity is the guiding light for our company as we deal with our customers, employees and shareholders.

Corporate Information

Directors and Officers

David Gladstone
Chairman of the Board

Terry Brubaker
President and Director

David A.R. Dullum
Director
Partner, New England Partners

George Stelljes, III
Director
Partner, Camden Partners

Anthony W. Parker
Director
Chairman, Medical Funding Corp.

Harry Brill
Chief Financial Officer

Virginia Rollins
Principal

Joseph Bute
Principal

Buzz Cooper
Principal

Laura Gladstone
Principal

Stock Exchange Listing

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

Transfer Agent

The Bank of New York
Shareholder Relations Department
P.O. Box 11258
Church Street Station
New York, NY 10286, USA
Email:
shareowner-svcs@bankofny.com
Website: www.stockbny.com

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 form 10K and 10Q by contacting the company or going to the SEC website at www.SEC.gov or by visiting the SEC at 450 5th Street, N.W. Washington, DC 20549

Auditors

Ernst & Young LLP

Legal Counsel

Cooley Godward, LLP

Company Website

The company has its website at www.GladstoneCapital.com

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