



Gladstone Capital Corporation

2003 ANNUAL REPORT



Gladstone Capital Corporation is a lending institution traded on the Nasdaq® symbol: GLAD. Our capital resources exceed \$230 million. Our capital is invested in debt securities, consisting primarily of senior notes, senior subordinated notes, junior subordinated notes and real estate loans of established private businesses that are backed by leveraged buyout funds, venture capital funds or are family-owned businesses. We seek to provide our stockholders with consistent monthly cash dividends that we pay from the interest income we receive from our business loans. 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. See our website for more information about us: www.GladstoneCapital.com. Our headquarters are in McLean, VA, a suburb of Washington, DC and we have offices in Morristown, NJ, New York, NY and Pittsburgh, PA.



David Gladstone, *Chairman*



Terry Brubaker, *President*



Chip Stelljes, *Executive Vice President*

To Our Shareholders

There is no better description for the year that ended September 30, 2003 than that it was a trying one. Despite our forecast for an upturn beginning in October 2002, a slow pace was established for 2003 as the United States industrial base continued to fall short of the projections made by most experts. It was not until the fall of 2003 that the economy started to pull out of the recession. Despite the trying year, we managed to increase our dividend, establish a \$100 million credit line, start a new Real Estate Investment Trust (REIT), and engage Standard & Poor's Loan Evaluations Service to value our loans. These are all good achievements for the long term progress of our company.

We have gained confidence that the economic upturn that occurred in October 2003 is real because we have seen the large company debt marketplace improve dramatically. Such a change in the debt marketplace usually sparks the flame that drives the smaller businesses to grow. If this is the upturn that we have been looking for, and we believe it is, then our 2004 fiscal year will be a good one.

At this point in time, we have a good balance of portfolio loans that produce income at a good rate. We should see more positive performance from those businesses in the coming months. Our company salutes the owners and operators of our portfolio companies, who have performed well in the face of a recession that started with the excesses of the 90's, was extended by the terrorist attacks of 2001, and further complicated with the wars in Afghanistan and Iraq.

In March 2003, we changed our valuation methodology by engaging Standard & Poor's Loan Evaluations Service to value our loans at the end of each quarter. By having such an independent and prestigious firm as Standard & Poor's Loan Evaluations Service determine the

value of our investments, we believe that our shareholders will be confident that the values we publish in our financial statements are set at market values.

In August 2003, we started a sister company, Gladstone Commercial Corp., a Real Estate Investment Trust (REIT) which will buy business real estate and lease it to middle market companies. Our company cannot own real estate because lease payments are not qualifying income. We believe that Gladstone Commercial Corp. operations complement our own.

At the end of the year, we established a \$100 million line of credit with CIBC World Markets and Key Bank. We hope to use that entire line of credit during the 2004 fiscal year. We are delighted with our relationship with such a fine lending team.

Our new fiscal year began with a change in our dividend policy. We moved from paying a quarterly dividend to monthly dividends starting in October 2003. The monthly dividend has a record date near the middle of the month and a payment date at the end of the month. We believe this positive change will set us apart from our competition.

This year we updated our website to supply new information about our company and products. If you have a moment please visit our site at www.GladstoneCapital.com. Please sign up for email notices, press releases, newsletters, and feel free to send us your comments about the site.

In summary, we still have worries about the future and continue to proceed cautiously, but there are fewer storm clouds on the horizon. Today we see the sunshine and we like it.

David Gladstone, Terry Brubaker and
Chip Stelljes

Strategy

Our plan is to pay monthly dividends to our shareholders. We seek to increase our total dividend payments each year. In order to generate the income necessary to make our monthly dividend payments we make loans to small and medium-sized businesses that we believe have traditionally been underserved by conventional lenders. We expect to make loans to borrowers who need funds to finance growth, restructure their balance sheets or effect a change of control, all of which we believe are typically underserved by banks and other traditional institutional lenders.

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 derive 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 which are undergoing a change of ownership, including management-led and third party leveraged buyouts, or to those with 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 and other profit enhancements, 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 have the experience and expertise to satisfy the financing needs of such businesses.



Dedication and Experience

Dedication describes our determination to make our company the best. Our team is dedicated to paying consistent monthly dividends and seeks to raise the total amount of those dividends each year. It is a team with extensive experience in the field of lending, investing and managing small and medium-sized businesses. We all are focused on making our company a great success.



Growth and Achievement

We continue to strengthen our portfolio of loans because we are able to build partnerships with first-class buyout funds, as well as with owners and managers of small and mid-sized companies. Each investment is our opportunity to build a relationship that will benefit all parties. We seek to help all our companies become successful. Our products continue to make us competitive in our market and our goal remains to increase our portfolio with sound investments that provide us with the income to pay dividends to our shareholders.

Our portfolio companies

We make loans to small and medium-sized private businesses that meet certain criteria, including: the potential for growth, adequate assets for loan collateral, and experienced management teams with significant ownership interest, adequate capitalization, profitable operations based on cash flow and potential opportunities. 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 helping find additional financing, structuring various financings, monitoring the operations of each borrower, participating in its board and management meetings, being available for consultation with officers of the portfolio company and providing organizational and financial guidance.

We expect to invest in senior, senior subordinated, junior subordinated notes and real estate loans. 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 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. We will focus on making loans accompanied by warrants or other equity enhancements. We expect to receive warrants to

purchase stock or some form of additional income from most 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 or other yield enhancements.

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.

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 or other equity enhancements we acquire in connection with many of our loans.

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.

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, 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 or other equity enhancements by the borrower or one of its stockholders.



Ethics

The business world has been blemished by a few firms that lack the integrity and the honor we all should live by. Our team is determined to insure that shareholders, suppliers, employees and customers believe in our company. Ethics are not rules or regulations, but a conviction of the heart. We are guided by a conviction that doing the right thing is paramount.

Corporate Information

Directors, Officers and Team Members

David Gladstone

*Chief Executive Officer and
Chairman of the Board*

Terry Brubaker

*Chief Operating Officer, President
and Director*

George Stelljes, III

*Chief Investment Officer, Executive
Vice 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 President of
Discovery Consumer Products*

Anthony W. Parker

*Director and Chairman of
Medical Funding Corp.*

Joseph Bute, Principal,
Pennsylvania

Buzz Cooper, Principal, Virginia

Robert Corry, Principal,
New Jersey

John Freal, Principal, Virginia

Laura Gladstone, Principal,
New York

Virginia Rollins, Principal,
Virginia

Skye Breeden, Director of
Shareholder Relations

Pamela Keene, Director of
Corporate Records

Donya Kolcio, Controller

Brian McCahill, Associate

Andrew Ross, Associate

Stock Exchange Listing

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

Transfer Agent

The Bank of New York
Shareholder Relations

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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 Forms 10-K and 10-Q 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 and Tax Consultants

PricewaterhouseCoopers LLP

Legal Counsel

Cooley Godward, LLP
Pepper Hamilton, LLP

Company Website

www.GladstoneCapital.com



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