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CAPITAL SOUTHWEST CORP
 Form 10-Q
 November 03, 2006

UNITED STATES
 SECURITIES AND EXCHANGE COMMISSION
 Washington, D.C. 20549
 FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2006

OR

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

For the transition period fromto

Commission File Number: 814-61

CAPITAL SOUTHWEST CORPORATION
 (Exact name of registrant as specified in its charter)

Texas 75-1072796
 (State or other jurisdiction of incorporation (I.R.S. Employer
 or organization) Identification No.)

12900 Preston Road, Suite 700, Dallas, Texas 75230
 (Address of principal executive offices) (Zip Code)

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

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

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

Large accelerated filer Accelerated filer X Non-accelerated filer
 --- --- ---

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

3,875,751 shares of Common Stock, \$1 Par Value as of October 31, 2006

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PART I. FINANCIAL INFORMATION

Item 1. Consolidated Financial Statements

CAPITAL SOUTHWEST CORPORATION AND SUBSIDIARIES

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Consolidated Statements of Financial Condition

| Assets | September 30, 2006 ----- | March 31, 2006 ----- |
|--|-----------------------------|-------------------------|
| | (Unaudited) | |
| Investments at market or fair value | | |
| Companies more than 25% owned | | |
| (Cost: September 30, 2006 - \$38,149,866 | | |
| March 31, 2006 - \$23,114,866) | \$376,922,985 | \$298,481,983 |
| Companies 5% to 25% owned | | |
| (Cost: September 30, 2006 - \$18,798,896, | | |
| March 31, 2006 - \$18,595,746) | 96,832,002 | 92,070,852 |
| Companies less than 5% owned | | |
| (Cost: September 30, 2006 - \$30,307,171, | | |
| March 31, 2006 - \$46,886,344) | 67,183,372 | 159,875,248 |
| | ----- | ----- |
| Total investments | | |
| (Cost: September 30, 2006- \$87,255,933, | | |
| March 31, 2006 - \$88,596,956) | 540,938,359 | 550,428,083 |
| Cash and cash equivalents | 24,269,495 | 11,503,866 |
| Receivables | 183,172 | 135,887 |
| Other assets | 7,419,678 | 7,300,297 |
| | ----- | ----- |
| Totals | \$572,810,704 | \$569,368,133 |
| | ===== | ===== |
| Liabilities and Shareholders' Equity | | |
| Note payable to bank | \$ 8,000,000 | \$ 8,000,000 |
| Other liabilities | 1,578,004 | 1,697,086 |
| Income taxes payable | 4,354,672 | 982,653 |
| Deferred income taxes | 159,089,685 | 162,070,285 |
| | ----- | ----- |
| Total liabilities | 173,022,361 | 172,750,024 |
| | ----- | ----- |
| Shareholders' equity | | |
| Common stock, \$1 par value: authorized, | | |
| 5,000,000 shares; issued, 4,313,116 shares | | |
| at September 30, 2006 and 4,297,616 shares | | |
| at March 31, 2006 | 4,313,116 | 4,297,616 |
| Additional capital | 9,273,628 | 8,109,797 |
| Undistributed net investment income | 4,634,690 | 3,744,830 |
| Undistributed net realized gain on investments | 92,675,784 | 86,432,040 |
| Unrealized appreciation of investments - | | |
| net of deferred income taxes | 295,924,427 | 301,067,128 |
| Treasury stock - at cost (437,365 shares) | (7,033,302) | (7,033,302) |
| | ----- | ----- |
| Net assets at market or fair value, equivalent | | |
| to \$103.15 per share at September 30, 2006 on | | |
| the 3,875,751 shares outstanding and \$102.74 | | |
| per share at March 31, 2006 on the 3,860,251 | | |
| shares outstanding | 399,788,343 | 396,618,109 |
| | ----- | ----- |
| Totals | \$572,810,704 | \$569,368,133 |
| | ===== | ===== |

(See Notes to Consolidated Financial Statements)

CAPITAL SOUTHWEST CORPORATION
AND SUBSIDIARIES
Consolidated Statements of Operations

(Unaudited)

| | Three Months Ended September 30 | | Six Months Ended September 30 | |
|--|------------------------------------|--------------|----------------------------------|--------------|
| | 2006 | 2005 | 2006 | 2005 |
| | ----- | ----- | ----- | ----- |
| Investment income: | | | | |
| Interest | \$ 933,678 | \$ 101,763 | \$ 1,139,530 | \$ 24,471 |
| Dividends | 757,935 | 783,374 | 1,540,501 | 1,561,111 |
| Management and directors' fees | 179,950 | 308,720 | 378,400 | 47,817 |
| | ----- | ----- | ----- | ----- |
| | 1,871,563 | 1,193,857 | 3,058,431 | 2,280,209 |
| | ----- | ----- | ----- | ----- |
| Operating expenses: | | | | |
| Salaries | 320,334 | 246,500 | 663,799 | 47,817 |
| Net pension expense (benefit) | (43,284) | 5,344 | (72,471) | (5,344) |
| Other operating expenses | 230,737 | 181,534 | 451,965 | 38,817 |
| | ----- | ----- | ----- | ----- |
| | 507,787 | 433,378 | 1,043,293 | 80,978 |
| | ----- | ----- | ----- | ----- |
| Income before interest expense and income taxes | 1,363,776 | 760,479 | 2,015,138 | 1,481,411 |
| Interest expense | 178,222 | 96,323 | 325,204 | 21,817 |
| | ----- | ----- | ----- | ----- |
| Income before income taxes | 1,185,554 | 664,156 | 1,689,934 | 1,260,594 |
| Income tax expense (benefit) | 15,200 | (1,800) | 28,024 | 2,817 |
| | ----- | ----- | ----- | ----- |
| Net investment income | \$ 1,170,354 | \$ 665,956 | \$ 1,661,910 | \$ 1,240,228 |
| | ===== | ===== | ===== | ===== |
| Proceeds from disposition of investments | \$10,045,064 | \$13,001,764 | \$10,442,080 | \$19,881,111 |
| Cost of investments sold | 826,317 | 7,086,217 | 826,317 | 8,701,111 |
| | ----- | ----- | ----- | ----- |
| Realized gain on investments before income taxes | 9,218,747 | 5,915,547 | 9,615,763 | 11,179,999 |
| Income tax expense | 3,233,063 | 2,143,206 | 3,372,019 | 3,991,111 |
| | ----- | ----- | ----- | ----- |
| Net realized gain on investments | 5,985,684 | 3,772,341 | 6,243,744 | 7,188,888 |
| | ----- | ----- | ----- | ----- |
| Increase (decrease) in unrealized apprecia- tion of investments before income taxes | (2,931,221) | 26,824,183 | (8,148,701) | 30,961,111 |
| Increase (decrease) in deferred income taxes on appreciation of investments | (811,000) | 9,388,000 | (3,006,000) | 10,831,111 |
| | ----- | ----- | ----- | ----- |
| Net increase (decrease) in unrealized appreciation of investments | (2,120,221) | 17,436,183 | (5,142,701) | 20,129,999 |
| | ----- | ----- | ----- | ----- |

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| | | | | |
|---|-----------------------|-----------------------|-----------------------|-------------------|
| Net realized and unrealized gain on investments | \$ 3,865,463 ===== | \$21,208,524 ===== | \$ 1,101,043 ===== | \$27,300 ===== |
| Increase in net assets from operations | \$ 5,035,817 ===== | \$21,874,480 ===== | \$ 2,762,953 ===== | \$28,540 ===== |

(See Notes to Consolidated Financial Statements)

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CAPITAL SOUTHWEST CORPORATION
AND SUBSIDIARIES
Consolidated Statements of Changes in Net Assets

| | Six Months Ended September 30, 2006 ----- | Year Ended March 31, 2006 ----- |
|---|---|---------------------------------------|
| | (Unaudited) | |
| Operations | | |
| Net investment income | \$ 1,661,910 | \$ 2,389,256 |
| Net realized gain on investments | 6,243,744 | 13,115,874 |
| Net increase (decrease) in unrealized appreciation of investments | (5,142,701) | 80,685,303 |
| | ----- | ----- |
| Increase in net assets from operations | 2,762,953 | 96,190,433 |
| Distributions from: | | |
| Undistributed net investment income | (772,050) | (2,314,231) |
| Capital share transactions | | |
| Exercise of employee stock options | 1,097,500 | 208,000 |
| Stock option expense | 81,831 | -- |
| | ----- | ----- |
| Increase in net assets | 3,170,234 | 94,084,202 |
| Net assets, beginning of period | 396,618,109 ----- | 302,533,907 ----- |
| Net assets, end of period | \$399,788,343 ===== | \$396,618,109 ===== |

(See Notes to Consolidated Financial Statements)

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CAPITAL SOUTHWEST CORPORATION
AND SUBSIDIARIES
Consolidated Statements of Cash Flows

(Unaudited)

| | Three Months Ended September 30 | | Six M Sept |
|---|------------------------------------|---------------|---------------|
| | 2006 | 2005 | 2006 |
| | ----- | ----- | ----- |
| Cash flows from operating activities | | | |
| Increase in net assets from operations | \$ 5,035,817 | \$ 21,874,480 | \$ 2,762,953 |
| Adjustments to reconcile increase in net assets from operations to net cash provided by operating activities: | | | |
| Proceeds from disposition of investments | 10,045,064 | 13,001,764 | 10,442,080 |
| Purchases of securities | (370,230) | (10,179,665) | (370,230) |
| Maturities of securities | 482,491 | 375,000 | 884,936 |
| Depreciation and amortization | 4,022 | 3,924 | 7,887 |
| Net pension expense (benefit) | (43,284) | 5,344 | (72,471) |
| Realized gain on investments before income taxes | (9,218,747) | (5,915,547) | (9,615,763) |
| Deferred taxes on realized gain on investments | 3,233,063 | 2,143,206 | 3,372,019 |
| Net (increase) decrease in unrealized appreciation of investments | 2,120,221 | (17,436,183) | 5,142,701 |
| Stock option expense | 77,711 | -- | 81,831 |
| Increase in receivables | (31,415) | (41,569) | (47,285) |
| (Increase) decrease in other assets | 1,955 | 10,272 | (17,988) |
| Increase (decrease) in other liabilities | 21,727 | (250) | (84,856) |
| Decrease in accrued pension cost | (36,568) | (38,668) | (71,035) |
| Deferred income taxes | 15,200 | (1,800) | 25,400 |
| | ----- | ----- | ----- |
| Net cash provided by operating activities | 11,337,027 | 3,800,308 | 12,440,179 |
| | ----- | ----- | ----- |
| Cash flows from financing activities | | | |
| Decrease in notes payable to bank | (150,000,000) | -- | -- |
| Decrease in note payable to portfolio company | -- | -- | -- |
| Distributions from undistributed net | | | |

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| | | | |
|--|---------------|--------------|--------------|
| investment income | -- | -- | (772,050) |
| Proceeds from exercise of employee options | -- | -- | 1,097,500 |
| | ----- | ----- | ----- |
| Net cash provided by (used in) financing activities | (150,000,000) | -- | 325,450 |
| | ----- | ----- | ----- |
| Net increase (decrease) in cash and cash equivalents | (138,662,973) | 3,800,308 | 12,765,629 |
| Cash and cash equivalents at beginning of period | 162,932,468 | 3,678,770 | 11,503,866 |
| | ----- | ----- | ----- |
| Cash and cash equivalents at end of period | \$ 24,269,495 | \$ 7,479,078 | \$24,269,495 |
| | ===== | ===== | ===== |
| Supplemental disclosure of cash flow information: | | | |
| Cash paid during the period for: | | | |
| Interest | \$201,441 | \$96,179 | \$325,204 |
| Income taxes | \$ -- | \$ -- | \$ 20,000 |

(See Notes to Consolidated Financial Statements)

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Portfolio of Investments - September 30, 2006

| Company | Investment (a) |
|---------------------------|--|
| +AT&T INC. | ++20,770 shares common stock (acquired 3-9-99) |
| +ALAMO GROUP INC. | 2,821,300 shares common stock (acquired 4-1-73 thru 10-4-99) |
| ALL COMPONENTS, INC. | 10% subordinated note due 2008 (acquired 10-28-03 thru 10-3-05) 150,000 shares Series A convertible preferred stock, convertible 600,000 shares of common stock at \$0.25 per share (acquired 9-1 |
| +ALLTEL CORPORATION | ++8,880 shares common stock (acquired 7-1-98) |
| BALCO, INC. | 445,000 shares common stock and 60,920 shares Class B non-voting common stock (acquired 10-25-83 and 5-30-02) |
| BOXX TECHNOLOGIES, INC. | 3,125,354 shares Series B convertible preferred stock, convertible into 3,125,354 shares of common stock at \$0.50 per share (acquired 8-20-99 thru 8-8-01) |
| CMI HOLDING COMPANY, INC. | 10% convertible subordinated notes, convertible into 691,782 sha of common stock at \$1.32 per share, due 2007 (acquired 4-16-04 thru 12-17-04) 2,327,658 shares Series A convertible preferred stock, convertib into 2,327,658 shares of common stock at \$1.72 per share (acqui 8-21-02 and 6-4-03) Warrants to purchase 109,012 shares of common stock at \$1.72 per share, expiring 2012 (acquired 4-16-04) |

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| | |
|-----------------------------|---|
| +COMCAST CORPORATION | ++43,104 shares common stock (acquired 11-18-02) |
| DENNIS TOOL COMPANY | 20,725 shares 5% convertible preferred stock, convertible into 2 shares of common stock at \$48.25 per share (acquired 8-10-98) 140,137 shares common stock (acquired 3-7-94 and 8-10-98) |
| +DISCOVERY HOLDING COMPANY | ++70,501 shares Series A common stock (acquired 7-21-05) |
| +EMBARQ CORPORATION | ++4,500 shares common stock (acquired 5-17-06) |
| +ENCORE WIRE CORPORATION | 4,086,750 shares common stock (acquired 7-16-92 thru 10-7-98) |
| EXTREME INTERNATIONAL, INC. | 39,359.18 shares Series C convertible preferred stock, convertibl 157,436.72 shares of common stock at \$25.00 per share (acquired 9-30-03) 3,750 shares 8% Series A convertible preferred stock, convertibl 15,000 shares of common stock at \$25.00 per share (acquired 9 Warrants to purchase 13,035 shares of common stock at \$25.00 per expiring 2008 (acquired 8-11-98 thru 9-30-03) |

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| Company | Investment (a) |
|-----------------------------|---|
| +FMC CORPORATION | ++6,430 shares common stock (acquired 6-6-86) |
| +FMC TECHNOLOGIES, INC. | ++11,057 shares common stock (acquired 1-2-02) |
| HEELYS, INC. | 436,364 shares common stock (acquired 5-26-00) |
| HIC-STAR CORPORATION | 10% subordinated note due 2007 (acquired 10-19-04 and 1-13-05) 12% subordinated notes due 2008 (acquired 3-25-05 thru 2-27-06) 5,000 shares Series A cumulative preferred stock (acquired 2-28- 1,500 shares Series B cumulative preferred stock (acquired 3-31- 29,167 shares Series A common stock (acquired 2-28-03) Warrants to purchase 463,162 shares of Series A common stock at \$1.00 per share, expiring 2014 (acquired 3-31-04 thru 1-13-05) |
| +HOLOGIC, INC. | ++316,410 shares common stock (acquired 8-27-99) |
| +KIMBERLY-CLARK CORPORATION | ++77,180 shares common stock (acquired 12-18-97) |
| +LIBERTY GLOBAL, INC. | ++42,463 shares Series A common stock (acquired 6-15-05) ++42,463 shares Series C common stock (acquired 9-6-05) |
| +LIBERTY MEDIA CORPORATION | ++35,250 shares of Liberty Capital Series A common stock (acquir 5-9-06) ++176,252 shares of Liberty Interactive Series A common stock (acquired 5-9-06) |

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| | |
|--------------------------|---|
| LIFEMARK GROUP | 1,449,026 shares common stock (acquired 7-16-69) |
| MEDIA RECOVERY, INC. | 800,000 shares Series A convertible preferred stock, convertible 800,000 shares of common stock at \$1.00 per share (acquired 11-4-97) 4,000,000 shares common stock (acquired 11-4-97) |
| PALLETONE, INC. | 12.3% senior subordinated notes due 2012 (acquired 9-25-06) 150,000 shares common stock (acquired 10-18-01) Warrant to purchase 15,294 shares of common stock at \$1.00 per share expiring 2011 (acquired 2-17-06) |
| +PALM HARBOR HOMES, INC. | 7,855,121 shares common stock (acquired 1-3-85 thru 7-31-95) |
| +PETSMART, INC. | ++300,000 shares common stock (acquired 6-1-95) |

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| Company | Investment (a) |
|---------------------------------|--|
| PHARMAFAB, INC. | 6% convertible subordinated notes, \$4,205,616 principal amount, convertible into Series A or B convertible preferred stock, convertible into 560,750 shares of common stock at \$7.50 per share, due 2013 (acquired 2-28-06) 23,000 shares Series A convertible preferred stock, convertible 306,667 shares of common stock at \$7.50 per share (acquired 8-1-06 thru 5-18-06) 32,000 shares Series B convertible preferred stock, convertible 426,667 shares of common stock at \$7.50 per share (acquired 8-1-06 thru 5-18-06) Warrants to purchase 16,668 shares of Series A or B convertible preferred stock at \$100.00 per share, convertible into 222,240 of common stock at \$7.50 per share, expiring 2012 and 2013 (acq 6-16-05 and 2-28-06) |
| THE RECTORSEAL CORPORATION | 27,907 shares common stock (acquired 1-5-73 and 3-31-73) |
| +SPRINT NEXTEL CORPORATION | ++90,000 shares common stock (acquired 6-20-84) |
| TCI HOLDINGS, INC. | 21 shares 12% Series C cumulative compounding preferred stock (acquired 1-30-90) |
| +TEXAS CAPITAL BANCSHARES, INC. | ++489,656 shares common stock (acquired 5-1-00) |
| VIA HOLDINGS, INC. | 9,118 shares Series B preferred stock (acquired 9-19-05) |
| WELLOGIX, INC. | 4,356,281 shares Series A-1 convertible participating preferred stock, convertible into 4,356,281 shares of common stock at \$1.1478 per share (acquired 8-19-05 thru 9-15-06) |

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| | |
|------------------------------------|---|
| THE WHITMORE MANUFACTURING COMPANY | 80 shares common stock (acquired 8-31-79) |
| +WINDSTREAM CORPORATION | ++9,181 shares common stock (acquired 7-17-06) |
| MISCELLANEOUS | <ul style="list-style-type: none">- BankCap Partners Fund I, L.P. - 6.2% limited partnership interest (acquired 7-14-06)- Diamond State Ventures, L.P. - 1.9% limited partnership interest (acquired 10-12-99 thru 8-26-05)- First Capital Group of Texas III, L.P. - 3.3% limited partnership interest (acquired 12-26-00 thru 8-12-05)- Humac Company - 1,041,000 shares common stock (acquired 1-31-77 and 12-31-75)- STARTech Seed Fund I - 12.1% limited partnership interest (acquired 4-17-98 thru 1-5-00)- STARTech Seed Fund II - 3.2% limited partnership interest (acquired 4-28-00 thru 2-23-05)- Sterling Group Partners I, L.P. - 1.7% limited partnership interest (acquired 4-20-01 thru 1-24-05) |
| ----- | |
| TOTAL INVESTMENTS | |
| ----- | |
| +Publicly-owned company | ++Unrestricted securities as defined in Note (a) |

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Notes to Portfolio of Investments

(a) Unrestricted securities (indicated by ++) are freely marketable securities having readily available market quotations. All other securities are restricted securities which are subject to one or more restrictions on resale and are not freely marketable. At September 30, 2006, restricted securities represented approximately 90.5% of the value of the consolidated investment portfolio.

(b) Under the valuation policy of the Company, unrestricted securities are valued at the closing sale price for listed securities and at the lower of the closing bid price or the last sale price for Nasdaq securities on the valuation date. Restricted securities, including securities of publicly-owned companies which are subject to restrictions on resale, are valued at fair value as determined by the Board of Directors. Fair value is considered to be the amount which the Company may reasonably expect to receive for portfolio securities if such securities were sold on the valuation date. Valuations as of any particular date, however, are not necessarily indicative of amounts which may ultimately be realized as a result of future sales or other dispositions of securities.

Among the factors considered by the Board of Directors in determining the fair value of restricted securities are the financial condition and operating results of the issuer, the long-term potential of the business of the issuer, the market for and recent sales prices of the issuer's securities, the values of similar securities issued by companies in similar businesses, the proportion of the issuer's securities owned by the Company, the nature and duration of resale restrictions and the nature of any rights enabling the Company to require the issuer to register restricted securities under applicable securities laws. In determining the fair value of restricted securities, the Board of Directors considers the inherent value of such securities without regard to the

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restrictive feature and adjusts for any diminution in value resulting from restrictions on resale.

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CAPITAL SOUTHWEST CORPORATION
AND SUBSIDIARIES
Notes to Consolidated Financial Statements

(Unaudited)

1. Basis of Presentation

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

The financial statements included herein have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information and the instructions to Form 10-Q and Article 6 of Regulation S-X. The financial statements should be read in conjunction with the consolidated financial statements and notes thereto included in our annual report on Form 10-K for the year ended March 31, 2006. Certain information and footnotes normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States have been condensed or omitted, although we believe that the disclosures are adequate for a fair presentation. The information reflects all adjustments (consisting of normal recurring adjustments) which are, in the opinion of management, necessary for a fair presentation of the results of operations for the interim periods.

2. Stock-Based Compensation

Effective April 1, 2003, we adopted the fair value method of recording compensation expense related to all stock options granted after March 31, 2003, in accordance with Financial Accounting Standards ("FASB") Statement Nos. 123 and 148. The only options granted during this period were on July 19, 2004 to a

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new investment associate who resigned on December 31, 2004 with no options vested.

In December 2004, the FASB issued SFAS No. 123 (revised 2004), Share-Based Payment ("SFAS 123R"), which revised SFAS 123. SFAS 123R also supersedes APB 25 and amends SFAS No. 95, Statement of Cash Flows. SFAS 123R eliminates the alternative to account for employee stock options under APB 25 and requires the fair value of all share-based payments to employees, including the fair value of grants of employee stock options, be recognized in the income statement, generally over the vesting period.

In March 2005, the Securities and Exchange Commission issued Staff Accounting Bulletin ("SAB") No. 107, which provides additional implementation guidance for SFAS 123R. Among other things, SAB 107 provides guidance on share-based payment valuations, income statement classification and presentation, capitalization of costs and related income tax accounting.

Effective April 1, 2006, we adopted SFAS 123R using the modified prospective transition method. We will recognize compensation cost over the straight-line method for all share-based payments granted on or after that date and for all awards granted to employees prior to April 1, 2006 that remain unvested on that date. The fair value of stock options are determined on the date of grant using the Black-Scholes pricing model and will be expensed over the vesting period of the related stock options. Accordingly, for the quarter and six months ended September 30, 2006, we recognized compensation expense of \$77,711 and \$81,831, respectively.

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Notes to Consolidated Financial Statements (continued)

SFAS 123R also requires the benefits of tax deductions in excess of recognized compensation cost be reported as a financing cash flow. As a regulated investment company, we are subject to no tax effect as the majority of our options granted are incentive stock options and our net investment income equals the dividends that we pay out. Therefore, we do not incur any tax expense.

The following table illustrates the effect on net asset value and net asset value per share for the six months ended September 30, 2006 if we had applied the fair value recognition provisions of FASB Statement No. 123 to stock-based compensation for options granted prior to the implementation of FASB Statement No. 123.

| | September 30, 2006 ---- | September 30, 2005 ---- |
|---|-------------------------------|-------------------------------|
| Net asset value, as reported | \$399,788,343 | \$330,312,226 |
| Deduct: Total fair value computed stock-based compensation | -- | 75,468 |
| Pro forma net asset value | \$399,788,343 ===== | \$330,236,758 ===== |
| Net asset value per share: | | |
| Basic - as reported | \$103.15 ===== | \$85.64 ===== |
| Basic - pro forma | \$ -- | \$85.62 |

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| | | |
|-----------------------|----------|---------|
| | ===== | ===== |
| Diluted - as reported | \$102.98 | \$85.53 |
| | ===== | ===== |
| Diluted - pro forma | \$ -- | \$85.51 |
| | ===== | ===== |

As of September 30, 2006, the total remaining unrecognized compensation cost related to non-vested stock options was \$1,258,625, which will be amortized over the weighted-average service period of approximately 8.01 years.

3. Employee Stock Option Plan

On July 19, 1999, shareholders approved the 1999 Stock Option ("Plan"), which provides for the granting of stock options to employees and officers and authorizes the issuance of common stock upon the exercise of such options for up to 140,000 shares of common stock. All options are granted at or above market price and generally expire ten years from the date of grant and are generally exercisable on or after the first anniversary of the date of grant in five to ten annual installments.

At September 30, 2006, there were 58,500 shares available for grant under the Plan. The per share weighted-average fair value of the stock options granted on May 15, 2006 was \$31.276 per option using the Black-Scholes pricing model with the following assumptions: expected dividend yield of .64%, risk-free interest rate of 5.08%, expected volatility of 21.1%, and expected life of 7 years. The per share weighted-average fair value of the stock options granted on July 17, 2006 was \$33.045 per option using the Black-Scholes pricing model with the following assumptions: expected dividend yield of .61%, risk-free interest rate of 5.04%, expected volatility of 21.2%, and expected life of 7 years.

The following summarizes activity in the stock option plan since March 31, 2006:

| | Number of shares | Weighted-Average Exercise Price |
|-------------------------------|---------------------|------------------------------------|
| | ----- | ----- |
| Balance at March 31, 2006 | 45,300 | \$68.411 |
| Granted | 57,500 | 94.136 |
| Exercised | (15,500) | 70.806 |
| Canceled | (24,500) | 89.482 |
| | ----- | ----- |
| Balance at September 30, 2006 | 62,800 | 83.153 |
| | ===== | ===== |

Notes to Consolidated Financial Statements (continued)

At September 30, 2006, the range of exercise prices and weighted-average remaining contractual life of outstanding options was \$65.00 to \$98.44 and 7.66 years, respectively. The total intrinsic value of options exercised during the six months ended September 30, 2006 was \$349,636 with the exercise prices ranging from \$65.00 to \$77.00 per share. New shares were issued for the \$1,097,500 cash received from option exercises for the six months ended September 30, 2006.

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At September 30, 2006, the number of options exercisable was 18,815 and the weighted-average exercise price of those options was \$68.36.

4. Summary of Per Share Information

| | Three Months Ended | | Six Months Ended | |
|---|--------------------|---------|------------------|---------|
| | September 30 | | September 30 | |
| | 2006 | 2005 | 2006 | 2005 |
| | ----- | ----- | ----- | ----- |
| Investment income | \$.48 | \$.31 | \$.79 | \$.59 |
| Operating expenses | (.13) | (.12) | (.27) | (.21) |
| Interest expense | (.04) | (.02) | (.08) | (.05) |
| Income taxes | (.01) | -- | (.01) | (.01) |
| | ----- | ----- | ----- | ----- |
| Net investment income | .30 | .17 | .43 | .32 |
| Distributions from undistributed net investment income | -- | -- | (.20) | (.20) |
| Net realized gain on investments | 1.54 | .98 | 1.61 | 1.86 |
| Net increase (decrease) in unrealized appreciation of investments after deferred taxes | (.54) | 4.52 | (1.32) | 5.22 |
| Exercise of employee stock options * | -- | -- | (.13) | -- |
| Stock option expense | .02 | -- | .02 | -- |
| | ----- | ----- | ----- | ----- |
| Increase in net asset value | 1.32 | 5.67 | .41 | 7.20 |
| Net asset value: | | | | |
| Beginning of period | 101.83 | 79.97 | 102.74 | 78.44 |
| | ----- | ----- | ----- | ----- |
| End of period | \$103.15 | \$85.64 | \$103.15 | \$85.64 |
| | ===== | ===== | ===== | ===== |
| Increase (decrease) in deferred taxes on unrealized appreciation | \$ (.21) | \$ 2.44 | \$ (.95) | \$ 2.81 |
| Deferred taxes on unrealized appreciation: | | | | |
| Beginning of period | 40.91 | 30.73 | 41.65 | 30.36 |
| | ----- | ----- | ----- | ----- |
| End of period | \$ 40.70 | \$33.17 | \$ 40.70 | \$33.17 |
| | ===== | ===== | ===== | ===== |
| Shares outstanding at end of period (000s omitted) | 3,875 | 3,857 | 3,875 | 3,857 |

* Net decrease is due to the exercise of employee stock options at prices less than beginning of period net asset value.

5. Recent Accounting Pronouncements

In June 2006, the Financial Accounting Standards Board (FASB) issued Interpretation No. 48 (FIN48), which clarifies the accounting for uncertainty in income taxes recognized in an entity's financial statements in accordance with FASB Statement 109, "Accounting for Income Taxes". FIN 48 prescribes a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. We have evaluated the positions in the tax returns we have filed and do not believe that FIN 48 will have a material impact on our financial statements.

Notes to Consolidated Financial Statements
(continued)

The state of Texas recently passed House Bill 3 (HB3), which revises the existing franchise tax system to create a new tax on virtually all Texas businesses. Starting in the fiscal year 2007, HB3 changes the franchise tax base, lowers the tax rate and extends coverage to active businesses receiving state law liability protection. We have been subject to an immaterial amount of Texas franchise taxes and expect the HB3 to have some affect, but have not determined the extent of this impact.

In September 2006, the FASB issued Statement of Financial Accounting Standard No. 157, "Fair Value Measurements" (SFAS 157). The standard defines fair value, outlines a framework for measuring fair value, and details the required disclosures about fair value measurements. The standard is effective for years beginning after November 15, 2007. We are evaluating the impact of SFAS 157.

In September 2006, the SEC issued Staff Accounting Bulletin No. 108, "Considering the Effects of Prior Year Misstatements when Quantifying Misstatements in Current Year Financial Statements" (SAB 108). SAB 108 clarifies the SEC staff's beliefs regarding the process of quantifying financial statement misstatements and is effective for fiscal years ending after November 15, 2006. We do not expect SAB 108 to have a material impact on our financial statements.

Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

Net asset value at September 30, 2006 was \$399,788,343 equivalent to \$103.15 per share after deducting an allowance of \$40.70 per share for deferred taxes on net unrealized appreciation of investments. Assuming reinvestment of all dividends and tax credits on retained long-term capital gains, the September 30, 2006 net asset value reflects an increase of 22.9% during the past twelve months.

| | September 30, 2006 ---- | September 30, 2005 ---- |
|----------------------|-------------------------------|-------------------------------|
| Net assets | \$399,788,343 | \$330,312,226 |
| Shares outstanding | 3,875,751 | 3,857,051 |
| Net assets per share | \$103.15 | \$85.64 |

Results of Operations

The composite measure of our financial performance in the Consolidated Statements of Operations is captioned "Increase in net assets from operations" and consists of three elements. The first is "Net investment income", which is the difference between our income from interest, dividends and fees and our combined operating and interest expenses, net of applicable income taxes. The second element is "Net realized gain on investments", which is the difference between the proceeds received from disposition of portfolio securities and their stated cost, net of applicable income tax expense. The third element is the "Net increase (decrease) in unrealized appreciation of investments", which is the net change in the market or fair value of our investment portfolio, compared with stated cost, net of an increase or decrease in deferred income taxes which would become payable if the unrealized appreciation were realized through the sale or other disposition of the investment portfolio. It should be noted that the "Net realized gain on investments" and "Net increase (decrease) in unrealized

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appreciation of investments" are directly related in that when an appreciated portfolio security is sold to realize a gain, a corresponding decrease in net unrealized appreciation occurs by transferring the gain associated with the transaction from being "unrealized" to being "realized". Conversely, when a loss is realized on a depreciated portfolio security, an increase in net unrealized appreciation occurs.

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Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations (continued)

Net Investment Income

Interest income of \$1,139,530 in the six months ended September 30, 2006 increased from \$243,666 in the year-ago period due to an increase in excess cash and interest rates and a \$631,000 interest payment from a portfolio company for prior interest that had been on a non-accrual basis. During the six months ended September 30, 2006 and 2005, we recorded dividend income from the following sources:

| | Six Months Ended September 30 | |
|------------------------------------|----------------------------------|-------------|
| | 2006 | 2005 |
| Alamo Group Inc. | \$ 338,556 | \$ 338,556 |
| Dennis Tool Company | 49,999 | 49,999 |
| Kimberly-Clark Corporation | 75,636 | 69,462 |
| Lifemark Group | 300,000 | 300,000 |
| PalletOne, Inc. | 89,842 | 89,842 |
| The RectorSeal Corporation | 480,000 | 480,000 |
| Sprint Nextel Corporation | 4,500 | 13,500 |
| TCI Holdings, Inc. | 40,635 | 40,635 |
| The Whitmore Manufacturing Company | 120,000 | 120,000 |
| Other | 41,333 | 63,626 |
| | \$1,540,501 | \$1,565,620 |
| | ===== | ===== |

Net Realized Gain on Investments

During the six months ended September 30, 2006, we reported a realized gain before income taxes of \$9,615,763 which included a gain of \$8,884,936, on our sale of 500,000 shares of Cenveo, Inc.

Net Increase (Decrease) in Unrealized Appreciation of Investments

Set forth in the following table are the significant increases and decreases in unrealized appreciation (before the related change in deferred income taxes and excluding the effect of gains or losses realized during the periods) by portfolio company:

| | Three Months Ended September 30 | | Six Months Ended September 30 | |
|-------------------------|------------------------------------|-------------|----------------------------------|--------------|
| | 2006 | 2005 | 2006 | 2005 |
| Encore Wire Corporation | -- | \$8,174,000 | \$ 8,174,000 | \$ 8,174,000 |

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| | | | | |
|-------------------------|---------------|-----------|--------------|------------|
| Heelys, Inc. | \$ 30,000,000 | 6,600,000 | 30,000,000 | 7,750,000 |
| Media Recovery, Inc. | -- | 7,744,000 | -- | 7,744,000 |
| Palm Harbor Homes, Inc. | (15,710,000) | 3,927,000 | (23,565,000) | 15,710,000 |

During the six months ended September 30, 2006, the value of our investment in Palm Harbor Homes, Inc. was decreased from the March 31, 2006 value by \$23,565,000 due to the continued deterioration of the manufactured housing market, the losses attributable to the closing of a manufacturing plant and eight retail centers, and the write-off of Palm Harbor's entire 50% limited partnership interest in its BankSource Mortgage business. The value of our investment in Heelys, Inc. was increased due to the major increases in the company's sales and earnings and its order backlog. This producer of specialty footwear with a removable wheel housed in the heel of the shoe has filed an S-1 registration statement with the SEC in anticipation of an initial public offering of its stock.

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Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations (continued)

Portfolio Investments

During the quarter ended September 30, 2006, we invested \$167,080 in a new portfolio company and made additional investments of \$203,150 in an existing portfolio company.

We have agreed, subject to certain conditions, to invest up to \$6,819,820 in three portfolio companies.

Financial Liquidity and Capital Resources

At September 30, 2006, we had cash and cash equivalents of approximately \$24.3 million. Pursuant to Small Business Administration (SBA) regulations, cash and cash equivalents of \$0.9 million held by Capital Southwest Venture Corporation (CSVC) may not be transferred or advanced to us without the consent of the SBA. Under current SBA regulations and subject to SBA's approval of its credit application, CSVC would be entitled to borrow up to \$69.7 million. We also have an unsecured \$25.0 million revolving line of credit from a commercial bank, of which \$17.0 million was available at September 30, 2006. With the exception of a capital gain distribution made in the form of a distribution of the stock of a portfolio company in the fiscal year ended March 31, 1996, we have elected to retain all gains realized during the past 38 years. Retention of future gains is viewed as an important source of funds to sustain our investment activity. Approximately \$51.6 million of our investment portfolio is represented by unrestricted publicly-traded securities, and represent a source of liquidity.

On June 30, 2006, we borrowed \$150 million from JPMorgan Chase in order to maintain our tax status as a regulated investment company. On July 3, 2006, we repaid the \$150 million note payable to bank from our cash and cash equivalents.

Funds to be used by us for operating or investment purposes may be transferred in the form of dividends, management fees or loans from Lifemark Group, The RectorSeal Corporation and The Whitmore Manufacturing Company, wholly-owned portfolio companies, to the extent of their available cash reserves and borrowing capacities.

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Management believes that our cash and cash equivalents and cash available from other sources described above are adequate to meet our expected requirements. Consistent with our long-term strategy, the disposition of investments from time to time may also be an important source of funds for future investment activities.

Item 3. Quantitative and Qualitative Disclosure About Market Risk

We are subject to financial market risks, including changes in marketable equity security prices. We do not use derivative financial instruments to mitigate any of these risks.

Our investment performance is a function of our portfolio companies' profitability, which may be affected by economic cycles, competitive forces, foreign currency fluctuations and production costs including labor rates, raw material prices and certain commodity prices. Most of the companies in our investment portfolio do not hedge their exposure to raw material and commodity price fluctuations. However, the portfolio company with the greatest exposure to foreign currency fluctuations generally hedges its exposure. All of these factors may have an adverse effect on the value of our investments on our net asset value.

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Item 3. Quantitative and Qualitative Disclosure About Market Risk (continued)

Our investment in portfolio securities includes fixed-rate debt securities which totaled \$6,820,171 at September 30, 2006, equivalent to 1.3% of the value of our total investments. Generally these debt securities are below investment grade and have relatively high fixed rates of interest; therefore, minor changes in market yields of publicly-traded debt securities have little or no effect on the values of debt securities in our portfolio and no effect on interest income. Our investments in debt securities are generally held to maturity and their fair values are determined on the basis of the terms of the debt security and the financial condition of the issuer.

A portion of our investment portfolio consists of debt and equity securities of private companies. We anticipate little or no effect on the values of these investments from modest changes in public market equity valuations. Should significant changes in market valuations of comparable publicly-owned companies occur, there may be a corresponding effect on valuations of private companies, which would affect the value and the amount and timing of proceeds eventually realized from these investments. A portion of our investment portfolio also consists of restricted common stocks of publicly-owned companies. The fair values of these restricted securities are influenced by the nature of applicable resale restrictions, the underlying earnings and financial condition of the issuers of such restricted securities and the market valuations of comparable publicly-owned companies. A portion of our investment portfolio also consists of unrestricted, freely marketable common stocks of publicly-owned companies. These freely marketable investments, which are valued at the public market price, are directly exposed to equity price risks, in that a change in an issuer's public market equity price would result in an identical change in the fair value of our investment in such security.

Item 4. Controls and Procedures

As of the end of the period covered by this report, an evaluation was performed under the supervision and with the participation of our management, including the President and Chairman of the Board and Secretary-Treasurer, of

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the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rules 13a-15 and 15d-15 of the Securities Exchange Act of 1934). Based on that evaluation, the President and Chairman of the Board and Secretary-Treasurer concluded that our disclosure controls and procedures are effective to ensure that the information required to be disclosed is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms, and is accumulated and communicated to management, including the President and Chairman of the Board and Secretary-Treasurer, as appropriate, to allow timely decisions regarding such required disclosure.

During the fiscal quarter ended September 30, 2006, there were no changes to the internal controls over financial reporting that have materially affected, or are reasonably likely to materially affect, our internal controls over financial reporting.

PART II. OTHER INFORMATION

Item 1A. Risk Factors

There have been no material changes to our risk factors as disclosed in Item 1A, "Risk Factors", in our Annual Report on Form 10-K for the fiscal year ended March 31, 2006.

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Item 4. Submission of Matters to a Vote of Security Holders

Our Annual Meeting of Stockholders was held on July 17, 2006, with the following results of elections and approval:

| | Votes Cast | | |
|---|------------|----------------------|--------------------------|
| | For | Against/ Withheld | Abstentions Non-Votes |
| a. The following Directors were elected to serve until the next Annual Meeting of Stockholders: | | | |
| Donald W. Burton | 3,405,450 | 4,173 | 450,628 |
| Graeme W. Henderson | 3,382,490 | 27,133 | 450,628 |
| Samuel B. Ligon | 3,406,000 | 3,623 | 450,628 |
| Gary L. Martin | 3,382,346 | 27,277 | 450,628 |
| William R. Thomas | 3,175,855 | 233,768 | 450,628 |
| John H. Wilson | 3,375,719 | 33,904 | 450,628 |
| Votes Cast | | | |
| | For | Against/ Withheld | Abstentions Non-Votes |
| b. Grant Thornton LLP was approved as our auditors for the 2007 fiscal year. | 3,406,316 | 413 | 453,522 |

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Item 6. Exhibits and Reports on Form 8-K

(a) Exhibits

Exhibit 31.1- Certification of President and Chairman of the Board required by Rule 13a-14(a) or Rule 15d-14(a) of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), filed herewith.

Exhibit 31.2- Certification of Secretary-Treasurer required by Rule 13a-14(a) or Rule 15d-14(a) of the Exchange Act, filed herewith.

Exhibit 32.1- Certification of President and Chairman of the Board required by Rule 13a-14(b) or Rule 15d-14(b) of the Exchange Act and Section 1350 of Chapter 63 of Title 18 of the United States Code, furnished herewith.

Exhibit 32.2- Certification of Secretary-Treasurer required by Rule 13a-14(b) or Rule 15d-14(b) of the Exchange Act and Section 1350 of Chapter 63 of Title 18 of the United States Code, furnished herewith.

(b) Reports on Form 8-K

No reports on Form 8-K have been filed during the quarter for which this report is filed.

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

CAPITAL SOUTHWEST CORPORATION

Date: November 3, 2006

By: /s/ William R. Thomas

William R. Thomas, President and Chairman
of the Board (chief executive officer)

Date: November 3, 2006

By: /s/ Susan K. Hodgson

Susan K. Hodgson, Secretary-Treasurer
(chief financial/accounting officer)

