

GLADSTONE INVESTMENT CORPORATION\DE  
Form 10-K  
May 31, 2007

**UNITED STATES**  
SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, DC 20549

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**FORM 10-K**

(Mark One)

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934

for the fiscal year ended March 31, 2007

OR

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

for the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number 814-00704

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**GLADSTONE INVESTMENT CORPORATION**

(Exact name of registrant as specified in its charter)

**Delaware**

(State or other jurisdiction of  
incorporation or organization)

**1521 Westbranch Drive, Suite 200**  
**McLean, Virginia**  
(Address of principal executive offices)

**83-0423116**

(I.R.S. Employer  
Identification No.)

**22102**  
(Zip Code)

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(703) 287-5800

(Registrant's telephone number, including area code)

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

**Common Stock, \$0.001 par value per share**

(Title of each class)

**NASDAQ Global Market**

(Name of exchange on which registered)

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

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

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

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

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

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer (as defined in Rule 12b-2 of the Exchange Act).

Large Accelerated Filer

Accelerated Filer

Non-Accelerated Filer

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

The aggregate market value of the voting stock held by non-affiliates of the Registrant on September 29, 2006, based on the closing price on that date of \$14.60 on the NASDAQ Global Market, was \$239,791,663. For the purposes of calculating this amount only, all directors and executive officers of the Registrant have been treated as affiliates.

There were 16,560,100 shares of the Registrant's Common Stock, \$0.001 par value, outstanding as of May 30, 2007.

**Documents Incorporated by Reference.** Portions of the Registrant's Proxy Statement relating to the Registrant's 2007 Annual Meeting of Stockholders are incorporated by reference into Part III of this Report.

GLADSTONE INVESTMENT CORPORATION  
FORM 10-K FOR THE FISCAL YEAR ENDED  
MARCH 31, 2007

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## FORWARD-LOOKING STATEMENTS

*All statements contained herein, other than historical facts, may constitute forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. These statements may relate to, among other things, future events or our future performance or financial condition. In some cases, you can identify forward-looking statements by terminology such as may, might, believe, will, provided, anticipate, future, could, growth, plan, intend, expect, possible, potential, likely or the negative of such terms or comparable terminology. These forward-looking statements involve known and unknown risks, uncertainties and other factors that may cause our actual results, levels of activity, performance or achievements to be materially different from any future results, levels of activity, performance or achievements expressed or implied by such forward-looking statements. Such factors include, among others: (1) adverse changes in interest rates; (2) our failure or inability to establish or maintain referral arrangements with leveraged buyout funds and venture capital funds to generate loan opportunities; (3) the loss of one or more of our executive officers, in particular David Gladstone, Terry Lee Brubaker, or George Stelljes III; (4) our inability to extend, refinance, or maintain our credit facilities on terms reasonably acceptable to us, if at all, in future equity capital resources; (5) our inability to successfully securitize our loan portfolio on terms reasonably acceptable to us, if at all; (6) the decision of our competitors to aggressively seek to make senior and subordinated loans to small and medium-sized businesses on terms more favorable than we intend to provide; and (7) those factors listed under the caption Risk Factors section of this Form 10-K. We caution readers not to place undue reliance on any such forward-looking statements, which are made pursuant to the Private Securities Litigation Reform Act of 1995 and, as such, speak only as of the date made. We undertake no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events or otherwise, after the date of this Form 10-K.*

## PART I

### Item 1. Business

#### Overview

We were incorporated under the General Corporation Laws of the State of Delaware on February 18, 2005. On June 22, 2005 we completed an initial public offering and commenced operations. We were primarily established for the purpose of investing in subordinated loans, mezzanine debt, preferred stock and warrants to purchase common stock of small and medium-sized companies in connection with buyouts and other recapitalizations. We also invest in senior secured loans and common stock and, from time to time, we may also invest in senior and subordinated syndicated loans. Our investment objective is to generate both current income and capital gains through these debt and equity instruments. We operate as a closed-end, non-diversified management investment company and have elected to be treated as a business development company ( BDC ) under the Investment Company Act of 1940 as amended, which we refer to in this annual report as the 1940 Act.

#### Our Investment Strategy

We seek to achieve returns from current income from senior, subordinated and mezzanine debt, and capital gains from preferred stock and warrants to purchase common stock that we purchase in connection with buyouts and recapitalizations of small and mid-sized companies with established management teams. Our investments generally range between \$5 million and \$30 million each, although this investment size may vary proportionately as the size of our capital base changes. We invest either by ourselves or jointly with other buyout funds and/or management of the portfolio company, depending on the opportunity. If we are participating in an investment with one or more co-investors, then our investment is likely to be smaller than if we were to be investing alone.

We expect that our target portfolio over time will include mostly subordinated loans, mezzanine debt, preferred stock, and warrants to buy common stock. Structurally, subordinated loans and mezzanine loans usually rank lower in priority of payment to senior debt, such as senior bank debt, and may be unsecured. However, subordinated debt and mezzanine loans rank senior to common and preferred equity in a borrower's capital structure. Typically, subordinated debt and mezzanine loans have elements of both debt and equity instruments, offering returns in the form of interest payments associated with senior debt, while providing lenders an opportunity to participate in the capital appreciation of a borrower, if any, through an equity position. Due to its higher risk profile and often less restrictive covenants as compared to senior debt, mezzanine debt generally earns a higher return than senior secured debt. Any warrants associated with mezzanine loans are typically detachable, which allows lenders to receive repayment of their principal on an agreed amortization schedule while retaining their equity interest in the borrower. Mezzanine debt also may include a put feature, which permits the holder to sell its equity interest back to the borrower at a price determined through a pre-determined formula.



## Our Investments

### *Non-Control/Non-Affiliate Investments*

Following the completion of our initial public offering in June 2005, we began investing such proceeds in senior secured syndicated loans because these investments typically may be originated more quickly than investments in small businesses that are undergoing a buyout or recapitalization. We employed this strategy in order to more quickly invest our initial capital to generate current income. Senior secured syndicated loans typically involve a number of banks or other financial institutions and are generally more marketable than loans that are not syndicated. In order to invest in certain senior secured syndicated loans, we may purchase these investments at a premium or discount. We amortize premiums and discounts over the contractual life of the investment. In the event that an investment is sold prior to its contractual maturity date, we recognize a loss on any unamortized premium or a gain on any unamortized discount.

While we expect that, over time, our investment portfolio will consist primarily of subordinated debt, mezzanine debt and preferred and common stock that we receive when making investments in connection with buyouts and recapitalizations, our Board of Directors has recommended that we continue our current strategy of investing in senior syndicated loans, primarily in order to build a portfolio that may be securitized in the future to obtain financing to pay down borrowings and invest in additional buyout and recapitalization investments. At March 31, 2007, we had investments in 41 such syndicated loans. There can be no guarantee that we will be able to successfully securitize any loans in our portfolio.

At March 31, 2007 and 2006, we held investments in Non-Control/Non-Affiliates of approximately \$138.6 million and \$97.4 million, at cost, respectively. These investments all represent syndicated loan participations of senior notes of both public and private companies representing approximately 62% and 42% of our net assets at March 31, 2007 and 2006, respectively. We expect to continue purchasing such syndicated loans using borrowings from our credit facility.

### *Control and Affiliate Investments*

At March 31, 2007, we had investments of approximately \$107.5 million, at cost, in revolving credit facilities, senior debt and subordinated debt of six portfolio companies. In addition, at March 31, 2007, we had invested approximately \$28.6 million in preferred and common equity of those companies. These investments are the result of buyout and recapitalization transactions and represent our primary investment focus. A summary of the investments made during the year ended March 31, 2007 is as follows:

- \$22.6 million in Acme Cryogenics Inc., including senior subordinated debt of \$14.5 million, \$7.0 million in preferred equity and \$1.1 million in common equity.
- \$19.8 million in Noble Logistics, Inc., including senior debt of \$14.0 million, senior subordinated debt of \$0.5 million, a revolving credit facility of \$2.0 million, which was fully drawn at March 31, 2007, \$1.8 million in preferred equity and \$1.5 million in common equity.
- \$36.0 million in A. Stucki Holding Corp., including senior debt of \$26.0 million, senior subordinated debt of \$5.5 million, \$4.4 million in preferred equity and \$0.1 million in common equity.

Approximately 76% of the aggregate value of our investment portfolio at March 31, 2007 was comprised of senior debt, approximately 9% was senior subordinated debt, approximately 5% was subordinated debt and approximately 10% was preferred and common equity securities. At March 31, 2007, we had approximately \$275 million invested in 47 portfolio companies. The following table outlines our investments by type at March 31, 2007 and 2006:

	March 31, 2007		March 31, 2006	
	Cost	Fair Value	Cost	Fair Value
Senior Term Debt	\$ 207,367,741	\$ 206,981,112	\$ 122,323,004	\$ 122,485,972
Senior Subordinated Term Debt	24,485,760	24,467,635	4,000,000	3,950,000
Subordinated Term Debt	14,167,810	14,167,810	14,167,810	14,167,810
Preferred & Common Equity Securities	28,598,802	25,331,046	12,778,508	12,778,508
Total Investments	\$ 274,620,113	\$ 270,947,603	\$ 153,269,322	\$ 153,382,290



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Investments at fair value consisted of the following industry classifications at March 31, 2007 and 2006:

	March 31, 2007			March 31, 2006		
	Fair Value	Percentage of Total Investments	Net Assets	Fair Value	Percentage of Total Investments	Net Assets
Automobile	\$ 8,504,666	3.1 %	3.8 %	\$ 6,450,000	4.2 %	2.8 %
Beverage, Food & Tobacco	3,413,874	1.3 %	1.5 %	5,074,713	3.3 %	2.2 %
Buildings & Real Estate	3,003,750	1.1 %	1.3 %			
Cargo Transport	21,844,463	8.1 %	9.8 %	5,513,337	3.6 %	2.4 %
Chemicals, Plastics & Rubber	22,535,527	8.3 %	10.1 %			
Containers, Packaging and Glass	999,975	0.4 %	0.4 %	10,061,087	6.6 %	4.4 %
Diversified/Conglomerate Manufacturing	32,563,400	12.0 %	14.6 %	42,055,734	27.4 %	18.3 %
Diversified/Conglomerate Service	27,374,081	10.1 %	12.3 %	12,917,129	8.4 %	5.6 %
Electronics	6,758,294	2.5 %	3.0 %	10,049,063	6.6 %	4.4 %
Healthcare, Education and Childcare	31,296,111	11.6 %	14.0 %	12,417,214	8.1 %	5.4 %
Home & Office Furnishings	17,105,808	6.3 %	7.7 %	15,256,318	9.9 %	6.6 %
Machinery	41,480,716	15.3 %	18.6 %			
Oil & Gas	3,851,943	1.4 %	1.7 %	2,999,981	2.0 %	1.3 %
Personal, Non-durable Consumer Products	1,492,472	0.6 %	0.7 %			
Personal Transportation				876,560	0.6 %	0.4 %
Personal, Food, & Miscellaneous Services	16,905,483	6.2 %	7.6 %	9,984,478	6.5 %	4.3 %
Printing, Publishing, Broadcasting	18,590,084	6.9 %	8.3 %	10,774,827	7.0 %	4.7 %
Retail Stores	1,407,018	0.5 %	0.6 %			
Telecommunications	9,246,854	3.4 %	4.1 %	5,829,062	3.8 %	2.5 %
Textiles & Leather	2,573,084	0.9 %	1.2 %	3,122,787	2.0 %	1.4 %
<b>Total Investments</b>	<b>\$ 270,947,603</b>	<b>100 %</b>	<b>%</b>	<b>\$ 153,382,290</b>	<b>100 %</b>	<b>%</b>

The investments at fair value consisted of the following geographic regions of the United States at March 31, 2007 and 2006:

	March 31, 2007			March 31, 2006		
	Fair Value	Percentage of Total Investments	Net Assets	Fair Value	Percentage of Total Investments	Net Assets
Mid-Atlantic	\$ 94,257,169	34.8 %	42.3 %	\$ 55,442,199	36.1 %	24.1 %
Midwest	88,508,725	32.7 %	39.7 %	51,107,864	33.3 %	22.2 %
Northeast	14,879,654	5.5 %	6.7 %	4,359,125	2.8 %	1.9 %
Southeast	36,357,555	13.4 %	16.3 %	30,966,852	20.2 %	13.5 %
West	36,944,500	13.6 %	16.6 %	11,506,250	7.5 %	5.0 %
<b>Total Investments</b>	<b>\$ 270,947,603</b>	<b>\$ 100.0 %</b>	<b>%</b>	<b>\$ 153,382,290</b>	<b>100.0 %</b>	<b>%</b>

The geographic region depicts the location of the headquarters for the Company's portfolio companies. A portfolio company may have a number of other business locations in other geographic regions.

### Our Investment Adviser and Administrator

Gladstone Management Corporation (the "Adviser") is led by a management team which has extensive experience in our lines of business. All of our executive officers are officers or directors, or both, of our Adviser. Our Adviser also has a wholly-owned subsidiary, Gladstone Administration, LLC (the "Administrator"), which employs our chief financial officer, chief compliance officer, controller, treasurer and their respective staffs.

Our Adviser and Administrator also provide investment advisory and administrative services, respectively, to our affiliates Gladstone Commercial Corporation, a publicly traded real estate investment trust; Gladstone Capital Corporation, a publicly traded business development company; and Gladstone Land Corporation, an agricultural real estate company owned by Mr. Gladstone. All of our directors and executive officers serve as either directors or executive officers, or both, of Gladstone Commercial Corporation and Gladstone Capital Corporation. In the future, our Adviser may provide investment advisory and administrative services to other funds, both public and private, of which it is the sponsor.



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

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## Investment Process

### *Overview of Investment and Approval Process*

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

### *Prospective portfolio company characteristics*

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

- *Value-and-Income Orientation and Positive Cash Flow.* Our investment philosophy places a premium on fundamental analysis from an investor's perspective and has a distinct value-and-income orientation. In seeking value, we focus on companies in which we can invest at relatively low multiples of earnings before interest, taxes, depreciation and amortization, ( EBITDA ), and that have positive operating cash flow at the time of investment. In seeking income, we seek to invest in companies that generate relatively high and stable cash flow to provide some assurance that they will be able to service their debt and pay any required dividends on preferred stock. Typically, we do not expect to invest in start-up companies or companies with speculative business plans.
- *Experienced Management.* We generally require that our portfolio companies have experienced management teams. We also require the portfolio companies to have in place proper incentives to induce management to succeed and to act in concert with our interests as investors, including having significant equity or other interests in the financial performance of their companies.
- *Strong Competitive Position in an Industry.* We seek to invest in target companies that have developed strong market positions within their respective markets and that we believe are well-positioned to capitalize on growth opportunities. We seek companies that demonstrate significant competitive advantages versus their competitors, which we believe will help to protect their market positions and profitability.
- *Exit Strategy.* We seek to invest in companies that we believe will provide a stable stream of cash flow that is sufficient to repay the loans we make to them and to reinvest in their respective businesses. We expect that such internally generated cash flow, which will allow our portfolio companies to pay interest on, and repay the principal of, our investments, will be a key means by which we exit from our investments over time. In addition, we will also seek to invest in companies whose business models and expected future cash flows offer attractive possibilities for capital appreciation on any equity interests we may obtain or retain. These capital appreciation possibilities include strategic acquisitions by other industry participants or financial buyers, initial public offerings of common stock, or other capital market transactions.
- *Liquidation Value of Assets.* The prospective liquidation value of the assets, if any, collateralizing loans in which we invest is an important factor in our investment analysis. We emphasize both tangible assets, such as accounts receivable, inventory, equipment, and real estate and intangible assets, such as intellectual property, customer lists, networks, and databases, although the relative weight we place on these asset classes will vary by

company and industry.

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### *Extensive Due Diligence*

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

- a review of the prospective portfolio company's historical and projected financial information;
- visits to the prospective portfolio company's business site(s);
- interviews with the prospective portfolio company's management, employees, customers and vendors;
- review of all loan documents;
- background checks on the prospective portfolio company's management team; and
- research on the prospective portfolio company's products, services or particular industry.

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

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

### *Investment Structure*

Once we have determined that a prospective acquisition, buyout or recapitalization meets our standards and investment criteria, we work with the management of that company and other capital providers to structure the transaction in a way that provides us the greatest opportunity to maximize our return on the investment, while providing appropriate incentives to management of the company.

*Subordinated Debt and Mezzanine Debt.* We anticipate that over time, the majority of the capital that we invest will be in the form of subordinated or mezzanine debt. Most of our mezzanine loans are unsecured loans while most of the subordinated loans are collateralized by a subordinated lien on some or all of the assets of the borrower. We structure most of our mezzanine and subordinated loans with variable interest rates; however some of such of our loans are fixed rate loans. In either event, we structure the loans at relatively high rates of interest that provide us with significant current interest income. Our subordinated and mezzanine loans typically have maturities of five to ten years and provide for interest-only payments in the early years, with amortization of principal deferred to the later years of the mezzanine loans. In some cases, we may enter into loans that, by their terms, convert into equity or additional debt securities or defer payments of interest for the first few years after our investment, however, none of our loans to date are convertible into such debt or equity securities.

We generally target a current return of 10% to 14% for our subordinated and mezzanine loan investments before giving effect to any warrants that we may receive in connection with these loans. We cannot give any assurance that our returns will approximate these estimates.

Our subordinated and mezzanine debt investments may include equity features, such as warrants or options to buy a significant common stock ownership interest in the portfolio company or success fees if the business is sold. If a portfolio company appreciates in value, we may achieve additional investment returns from any equity interests we hold. If we are a minority interest holder, we may structure the warrants to provide provisions protecting our rights as a minority-interest holder such as the right to sell the warrants back to the company upon the occurrence of specified events. In many cases, we also obtain registration rights in connection with these equity interests, which may include demand and co-

registration rights.

*Senior Secured Debt.* We also provide senior secured acquisition financing for some portfolio companies. We typically structure these senior secured loans to have terms of three to ten years, and they may provide for deferred interest payments in the first few years of the term of the loan. We generally obtain security interests in the assets of our portfolio companies that will serve as collateral in support of the repayment of these senior loans. This collateral usually takes the form of first priority liens on the assets of the portfolio company. The interest rates on our senior secured loans are generally variable rates ranging between 2% and 5% over the London Interbank Offer Rate ( LIBOR ).

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*Common and Preferred Stock.* We also acquire common or preferred stock in connection with a buyout or recapitalization. With respect to preferred or common stock investments, we target an investment return substantially higher than our investments in senior or subordinated loans. However, we can offer no assurance that we can achieve such a return with respect to any investment or our portfolio as a whole. The features of the preferred stock we receive vary by transaction, but may include priority dividend rights, superior voting rights, redemption rights, liquidation preferences and other provisions intended to protect our interests. Generally speaking, common stock does not have any current income and its value is realized, if at all, upon the sale of the business or following the company's initial public offering.

*Risk Management.* We seek to limit the downside risk of our investments by:

- making investments with an expected total return on our investments (including both interest and potential equity appreciation) that we believe compensates us for the credit risk of the investment;
- seeking collateral or superior positions in the portfolio company's capital structure where possible;
- incorporating put rights and call protection into the investment structure where possible; and
- negotiating covenants in connection with our investments that afford our portfolio companies as much flexibility as possible in managing their businesses, consistent with the preservation of our capital.

We expect to hold most of our investments in subordinated debt and mezzanine debt until maturity or repayment, but will sell our investments earlier if a liquidity event takes place, such as the sale or recapitalization of a portfolio company or, in the case of an equity investment in a company, its initial public offering. Occasionally, we may sell some or all of our subordinated debt, mezzanine debt or equity interests in a portfolio company to a third party, such as an existing investor in the portfolio company, through a privately negotiated transaction.

As described above, we may also provide senior debt in addition to subordinated debt and equity in connection with an acquisition. Finally, we may attempt to securitize some of the debt securities in our portfolio and if we do so, these loans would be transferred to a securitization vehicle and generally would be held by the securitization vehicle until maturity.

#### ***Temporary Investments***

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

#### ***Competitive Advantages***

We believe that we have the following competitive advantages over other companies that provide capital to small and mid-sized companies in connection with buyout and recapitalization transactions:

#### ***Management Expertise***

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

As a result of the extensive investment experience of our Adviser, its executive officers and other investment professionals, our Adviser and its executive officers have developed a positive reputation in the capital markets. We believe that this reputation and experience, together with the experience of the executive officers of our Adviser in investing in debt and equity securities, and managing investments in companies, affords us a competitive advantage in identifying opportunities to invest in small and mid-sized companies.

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***Increased access to investment opportunities developed through proprietary research capability and extensive network of contacts***

Our Adviser seeks to identify potential investments both through active origination and due diligence and through its dialogue with numerous management teams, members of the financial community and potential corporate partners with whom our Adviser's investment professionals have long-term relationships. We believe that our Adviser's investment professionals have developed a broad network of contacts within the investment, commercial banking, private equity and investment management communities, and that their reputation in investment management enables us to identify well-positioned prospective portfolio companies which provide attractive investment opportunities. Additionally, our Adviser expects to generate information from its professionals' network of accountants, consultants, lawyers and management teams of portfolio companies and other companies.

***Disciplined, value-and-income-oriented investment philosophy with a focus on preservation of capital***

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

- focusing on companies with good market positions, established management teams and good cash flow;
- investing in businesses with experienced management teams;
- engaging in extensive due diligence from the perspective of a long-term investor;
- investing at low price-to-cash flow multiples; or
- adopting flexible transaction structures by drawing on the experience of the investment professionals of our Adviser and its affiliates.

***Flexible transaction structuring***

We believe our management team's broad expertise and its ability to draw upon many years of combined experience enables our Adviser to identify, assess, and structure investments successfully across all levels of a company's capital structure and manage potential risk and return at all stages of the economic cycle. We are not subject to many of the regulatory limitations that govern traditional lending institutions such as banks. As a result, we are flexible in selecting and structuring investments, adjusting investment criteria and transaction structures, and, in some cases, the types of securities in which we invest. We believe that this approach enables our Adviser to identify attractive investment opportunities that will continue to generate current income and capital gain potential throughout the economic cycle, including during turbulent periods in the capital markets. One example of our flexibility is our ability to exchange our publicly-traded stock for the stock of an acquisition target in a tax-free reorganization under the Internal Revenue Code of 1986 (the Code). After completing an acquisition in such an exchange, we can restructure the capital of the small company to include senior and subordinated debt.

***Longer investment horizon with attractive publicly traded model***

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





### ***Securitization***

We have a wholly-owned subsidiary, Gladstone Business Investment, LLC ( *Business Investment* ), which acquires and holds loans that we anticipate will be securitized in the future. Through *Business Investment* we have a \$200 million credit facility which we access to make additional investments and increase the size of our investment portfolio. We currently intend to securitize all of the investments held by *Business Investment* and, if we are able to securitize these investments, we will use the proceeds from the securitization to pay down any amounts outstanding under the revolving credit facility.

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

#### ***Monitoring***

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

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

- Assessment of success in the portfolio company's overall adherence to its business plan and compliance with covenants;
- Attendance at and participation in meetings of the portfolio company's board of directors;
- Periodic contact, including formal update interviews with portfolio company management, and, if appropriate, the financial or strategic sponsor;
- Comparison with other companies in the portfolio company's industry; and
- Review of monthly and quarterly financial statements and financial projections for portfolio companies.

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

As a business development company, we make available significant managerial assistance to our portfolio companies and provide other services to such portfolio companies. Neither we nor our Adviser currently receives fees in connection with managerial assistance. Our Adviser provides other services to our portfolio companies and receives fees for these other services, certain of which are credited by 50% against the investment advisory fees that we pay our Adviser.

#### ***Valuation Process***

The following is a general description of the steps we take each quarter to determine the value of our investment portfolio. All of our portfolio investments are recorded at fair value as determined in good faith by our Adviser and our management using procedures established by, and under the direction of our Board of Directors. As a result, there is uncertainty as to the value of our portfolio investments, and our estimates of fair value may differ significantly from the values that could be obtained if a ready market for the securities existed. Investments for which market quotations are readily available are recorded in our financial statements at such market quotations. With respect to any investments for which market quotations are not readily available, we perform the following valuation process each quarter:

- Our quarterly valuation process begins with each portfolio company or investment being initially assessed by our Adviser's investment professionals responsible for the investment, using valuation policies and procedures previously established by our Board of Directors.
- For all debt securities other than those that we value using the latest bid and ask price, we will seek an independent opinion of value of such debt securities from Standard & Poor's Loan Evaluation Service, Inc. ( *SPSE* ).
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Preliminary valuation conclusions are then discussed with our management, and documented, along with any SPSE opinions of value, for review by our Board of Directors.

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

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

### Investment Advisory and Management Agreement

We have entered into an investment advisory and management agreement (the *Advisory Agreement*) with our Adviser, which is controlled by our chairman and chief executive officer. In accordance with the *Advisory Agreement*, we pay our Adviser fees, as compensation for its services, consisting of a base management fee and an incentive fee.

Prior to January 1, 2007, the base management fee was assessed at an annual rate of 2.0% computed on the basis of the average value of our gross invested assets at the end of the two most recently completed quarters, which was total assets less the cash proceeds and cash and cash equivalent investments from the proceeds of our initial public offering that were not invested in debt and equity securities of portfolio companies, and was computed and payable quarterly. Beginning in periods subsequent to December 31, 2006, the base management fee was assessed at an annual rate of 2.0% computed on the basis of the average value of our gross assets at the end of the two most recently completed quarters, which are total assets, including investments made with proceeds of borrowings, less any uninvested cash or cash equivalents resulting from borrowings. This new calculation was originally scheduled to begin in periods after March 31, 2006; however, on April 11, 2006, July 11, 2006 and October 10, 2006, our Board of Directors accepted voluntary waivers from our Adviser that allowed the former calculation of the base management fee to be effective through June 30, 2006, September 30, 2006 and December 31, 2006, respectively.

On January 9, 2007, our Board of Directors accepted a voluntary waiver from the Adviser to reduce the annual 2.0% base management fee on senior syndicated loan participations to 0.5% to the extent that proceeds resulting from borrowings under our credit facility were used to purchase such syndicated loan participations for the three months ended March 31, 2007.

When our Adviser receives fees from our portfolio companies, such as investment banking fees, structuring fees or executive recruiting services fees, 50% of certain of these fees will be credited against the base management fee that we would otherwise be required to pay to our Adviser.

In addition, our Adviser services the loans held by Business Investment, in return for which the Adviser receives a 2.0% annual fee based on the monthly aggregate balance of loans held by Business Investment. Since we own these loans, all loan servicing fees paid to our Adviser are treated as reductions against the 2.0% base management fee. Overall, the base management fee due to our Adviser cannot exceed 2.0% of total assets (as reduced by cash and cash equivalents pledged to creditors) during any given fiscal year.

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

- no incentive fee in any calendar quarter in which our pre-incentive fee net investment income does not exceed the hurdle rate (7% annualized);
- 100% of our pre-incentive fee net investment income with respect to that portion of such pre-incentive fee net investment income, if any, that exceeds the hurdle rate but is less than 2.1875% in any calendar quarter (8.75% annualized); and
- 20% of the amount of our pre-incentive fee net investment income, if any, that exceeds 2.1875% in any calendar quarter (8.75% annualized).

The second part of the incentive fee is a capital gains incentive fee that is determined and payable in arrears as of the end of each fiscal year (or upon termination of the *Advisory Agreement*, as of the termination date), and equals 20% of our realized capital gains as of the end of the fiscal year. In determining the capital gains incentive fee payable to our Adviser, we calculate the cumulative aggregate realized capital gains and cumulative aggregate realized capital losses since our inception, and the aggregate unrealized capital depreciation as of the date of the calculation, as applicable, with respect to each of the investments in our portfolio.

### **Administration Agreement**

We have entered into an administration agreement with our Administrator (the Administration Agreement) under which the Administration Agreement, we pay our Administrator separately for administrative services. The Administration Agreement provides for payments equal to our allocable portion of our Administrator's overhead expenses in performing its obligations under the Administration Agreement including, but not limited to, rent for employees of our Administrator, and our allocable portion of the salaries and benefits expenses of our chief financial officer, controller, chief compliance officer, treasurer and their respective staffs.

### **License Agreement**

We have entered into a license agreement with our Adviser, pursuant to which our Adviser has granted us a non-exclusive license to use the name Gladstone and the Diamond G trademark. This license agreement requires us to pay the Adviser a royalty fee of \$1 per quarter. The amount of the fee is negotiable on an annual basis by our compensation committee and approved by a majority of our independent directors. The license arrangement will terminate in the event that Gladstone Management Corporation is no longer our Adviser.

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

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

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

- *Income source requirements.* At least 90% of our gross income for each taxable year must be from dividends, interest, payments with respect to securities loans, gains from sales or other dispositions of securities or other income derived with respect to our business of investing in securities, and net income derived from an interest in a qualified publicly traded partnership, and
- *Asset diversification requirements.* As of the close of each quarter of our taxable year: (1) at least 50% of the value of our assets must consist of cash, cash items, U.S. government securities, the securities of other regulated investment companies and other securities to the extent that (a) we do not hold more than 10% of the outstanding voting securities of an issuer of such other securities and (b) such other securities of any one issuer do not represent more than 5% of our total assets, and (2) no more than 25% of the value of our total assets may be invested in the securities of one issuer (other than U.S. government securities or the securities of other regulated investment companies), or of two or more issuers that are controlled by us and are engaged in the same or similar or related trades or businesses or in the securities of one or more qualified publicly traded partnerships.

*Failure to Qualify as a RIC.* If we are unable to qualify for treatment as a RIC, we will be subject to tax on all of our taxable income at regular corporate rates. We would not be able to deduct distributions to stockholders, nor would we be required to make such distributions. Distributions would be taxable to our stockholders as dividend income to the extent of our current and accumulated earnings and profits. Subject to certain limitations under the Code, corporate distributees would be eligible for the dividends received deduction. Distributions in excess of our current and accumulated earnings and profits would be treated first as a return of capital to the extent of the stockholder's tax basis, and then as a gain realized from the sale or exchange of property. If we fail to meet the RIC requirements for more than two consecutive years and then seek to requalify as a RIC, we would be required to recognize a gain to the extent of any unrealized appreciation on our assets unless we make a special election to pay corporate-level tax on any such unrealized appreciation recognized during the succeeding 10-year period. Absent such special election, any gain we recognized would be deemed distributed to our stockholders as a taxable distribution.

*Qualification as a RIC.* If we qualify as a RIC and distribute to stockholders each year in a timely manner at least 90% of our investment company taxable income, we will not be subject to federal income tax on the portion of our taxable

income and gains we distribute to stockholders. We would, however, be subject to a 4% nondeductible federal excise tax if we do not distribute, actually or on a deemed basis, 98% of our income, including both ordinary income and capital gains. The excise tax would apply only to the amount by which 98% of our income exceeds the amount of income we distribute, actually or on a deemed basis, to stockholders. We will be subject to regular corporate income tax, currently at rates up to 35%, on any undistributed income, including both ordinary income and capital gains. We intend to retain some or all of our capital gains, but to designate the retained amount as a deemed distribution. In that case, among other consequences, we will pay tax on the retained amount, each stockholder will be required to include its share of the deemed distribution in income as if it had been

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actually distributed to the stockholder and the stockholder will be entitled to claim a credit or refund equal to its allocable share of the tax we pay on the retained capital gain. The amount of the deemed distribution net of such tax will be added to the stockholder's cost basis for its common stock. Since we expect to pay tax on any retained capital gains at our regular corporate capital gain tax rate, and since that rate is in excess of the maximum rate currently payable by individuals on long-term capital gains, the amount of tax that individual stockholders will be treated as having paid will exceed the tax they owe on the capital gain dividend and such excess may be claimed as a credit or refund against the stockholder's other tax obligations. A stockholder that is not subject to U.S. federal income tax or tax on long-term capital gains would be required to file a U.S. federal income tax return on the appropriate form in order to claim a refund for the taxes we paid. In order to utilize the deemed distribution approach, we must provide written notice to the stockholders prior to the expiration of 60 days after the close of the relevant tax year. We will also be subject to alternative minimum tax, but any tax preference items would be apportioned between us and our stockholders in the same proportion that dividends, other than capital gain dividends, paid to each stockholder bear to our taxable income determined without regard to the dividends paid deduction.

If we acquire debt obligations that were originally issued at a discount, which would generally include loans we make that are accompanied by warrants, that bear interest at rates that are not either fixed rates or certain qualified variable rates or that are not unconditionally payable at least annually over the life of the obligation, we will be required to include in taxable income each year a portion of the original issue discount (OID) that accrues over the life of the obligation. Such OID will be included in our investment company taxable income even though we receive no cash corresponding to such discount amount. As a result, we may be required to make additional distributions corresponding to such OID amounts in order to satisfy the annual distribution requirement and to continue to qualify as a RIC or to avoid the 4% excise tax. In this event, we may be required to sell temporary investments or other assets to meet the RIC distribution requirements. Through March 31, 2007, we incurred no OID income.

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

*Distributions.* For any period during which we qualify for treatment as a RIC for federal income tax purposes, distributions to our stockholders attributable to our investment company taxable income generally will be taxable as ordinary income to stockholders to the extent of our current or accumulated earnings and profits. Any distributions in excess of our earnings and profits will first be treated as a return of capital to the extent of the stockholder's adjusted basis in his or her shares of common stock and thereafter as gain from the sale of shares of our common stock. Distributions of our long-term capital gains, designated by us as such, will be taxable to stockholders as long-term capital gains regardless of the stockholder's holding period for its common stock and whether the distributions are paid in cash or invested in additional common stock. Corporate stockholders are generally eligible for the 70% dividends received deduction with respect to ordinary income, but not with respect to capital gain dividends to the extent such amount designated by us does not exceed the dividends received by us from domestic corporations. Any dividend declared by us in October, November or December of any calendar year, payable to stockholders of record on a specified date in such a month and actually paid during January of the following year, will be treated as if it were paid by us and received by the stockholders on December 31 of the previous year. In addition, we may elect to relate a dividend back to the prior taxable year if we (1) declare such dividend prior to the due date for filing our return for that taxable year, (2) make the election in that return, and (3) distribute the amount in the 12-month period following the close of the taxable year but not later than the first regular dividend payment following the declaration. Any such election will not alter the general rule that a stockholder will be treated as receiving a dividend in the taxable year in which the distribution is made, subject to the October, November, December rule described above.

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

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





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

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

We intend to conduct our business so as to retain our status as a business development company. A business development company may use capital provided by public stockholders and from other sources to invest in long-term private investments in businesses. A business development company provides stockholders the ability to retain the liquidity of a publicly traded stock while sharing in the possible benefits, if any, of investing in primarily privately owned companies. In general, a business development company must have been organized and have its principal place of business in the United States and must be operated for the purpose of making investments in the types of securities described in (1) or (2) below.

### ***Qualifying Assets***

Under the 1940 Act, a business development company may not acquire any asset other than assets of the type listed in Section 55(a) of the 1940 Act, which are referred to as qualifying assets, unless, at the time the acquisition is made, qualifying assets represent at least 70% of the company's total assets. The types of qualifying assets in which we may invest under the 1940 Act include, but are not limited to the following:

- (1) Securities purchased in transactions not involving any public offering from the issuer of such securities, which issuer is an eligible portfolio company. An eligible portfolio company is generally defined in the 1940 Act as any issuer which:
  - (a) is organized under the laws of, and has its principal place of business in, any State or States in the United States;
  - (b) is not an investment company (other than a small business investment company wholly owned by the business development company); and
  - (c) satisfies one of the following:
    - (i) it does not have any class of securities with respect to which a broker or dealer may extend margin credit;
    - (ii) it is controlled by the business development company and for which an affiliate of the business development company serves as a director; or
    - (iii) it has total assets of not more than \$4 million and capital and surplus of not less than \$2 million.
- (2) Securities received in exchange for or distributed on or with respect to securities described in (1) above, or pursuant to the exercise of options, warrants or rights relating to such securities.
- (3) Cash, cash items, government securities or high quality debt securities maturing in one year or less from the time of investment.

### ***Asset Coverage***

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



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

For portfolio securities to be qualifying assets for the 70% test described above, the business development company must either exercise a controlling influence over the issuer of the securities or must make available to the issuer of the securities significant managerial assistance. However, with respect to certain, but not all such securities, where the business development company purchases such securities in conjunction with one or more other persons acting together, one of the other persons in the group may make available such managerial assistance, or the business development company may exercise such control jointly. Making available significant managerial assistance means, among other things, any arrangement whereby the business development company, through its directors, officers or employees, offers to provide, and, if accepted, does so provide, significant guidance and counsel concerning the management, operations or business objectives and policies of a portfolio company.

### ***Fundamental Investment Policies***

We seek to achieve a high level of current income and capital gains through investments in debt securities and preferred and common stock that we acquire in connection with buyout and other recapitalizations. The following restrictions, along with these investment objectives, are our only fundamental policies, which are policies that may not be changed without the approval of the holders of the majority of our outstanding voting securities, as defined in the 1940 Act. For a fuller explanation of the regulatory framework in which we operate, see Business-Regulation as a Business Development Company. The percentage restrictions set forth below, other than the restriction pertaining to the issuance of senior securities, as well as those contained elsewhere in this Form 10-K, apply at the time we effect a transaction, and a subsequent change in a percentage resulting from market fluctuations or any cause other than an action by us will not require us to dispose of portfolio securities or to take other action to satisfy the percentage restriction. We will at all times conduct our business so as to retain our status as a business development company. In order to retain that status, we may not acquire any assets (other than non-investment assets necessary and appropriate to our operations as a business development company) if, after giving effect to such acquisition, the value of our qualifying assets is less than 70% of the value of our total assets. We anticipate that the securities we seek to acquire (provided that we control or, through our officers or other participants in the financing transaction, make significant managerial assistance available to the issuers of these securities), as well as temporary investments, will generally be qualifying assets.

We may invest up to 100% of our assets in securities acquired directly from issuers in privately negotiated transactions. With respect to such securities, we may, for the purpose of public resale, be deemed an underwriter as that term is defined in the Securities Act of 1933 (the Securities Act). We may invest up to 20% of our assets in securities of a particular issuer. We may exceed this limitation in connection with bridge financings, although these bridge investments will never exceed 25% of our total assets at any time. We do not intend to concentrate our investments in any particular industry or group of industries. However, it is possible that, as the values of our portfolio companies change, one industry or a group of industries may comprise in excess of 25% of the value of our total assets.

We will at all times endeavor to conduct our business so as to retain our status as a RIC under Subchapter M of the Code. In order to do so, we must meet income source, asset diversification and annual distribution requirements. We may issue senior securities, such as debt or preferred stock, to the extent permitted by the 1940 Act for the purpose of making investments, to fund share repurchases, or for temporary emergency or other purposes. For a discussion of the risks associated with the resulting leverage, Risk Factors Our business plan is dependent upon external financing which may expose us to risks associated with leverage.

We will not (1) act as an underwriter of securities of other issuers (except to the extent that we may be deemed an underwriter of securities we purchase that must be registered under the Securities Act before they may be offered or sold to the public); (2) purchase or sell real estate or interests in real estate or real estate investment trusts (except that we may (a) purchase and sell real estate or interests in real estate in connection with the orderly liquidation of investments, (b) own the securities of companies or participate in a partnership or partnerships that are in the business of buying, selling or developing real estate, or (c) finance the purchase of real estate by our portfolio companies); (3) sell securities short (except with regard to managing the risks associated with publicly-traded securities issued by our portfolio companies); (4) purchase securities on margin (except to the extent that we may purchase securities with borrowed money); (5) write or buy put or call options (except (i) to the extent of warrants or conversion privileges in connection with our acquisition financing or other investments and rights to require the issuers of such investments or their affiliates to repurchase them under certain circumstances, (ii) with regard to managing risks associated with publicly-traded securities issued by our portfolio companies, or (iii) with regard to managing the risks associated with interest rate fluctuations); (6) engage in the purchase or sale of commodities or commodity contracts, including futures contracts (except where necessary in working out distressed loan or investment situations or in managing the risks associated with interest rate fluctuations); or (7) acquire more than 3% of the voting stock of, or invest more than 5% of our total assets in, any securities issued by any other investment company



(except as they may be acquired as part of a merger, consolidation or acquisition of assets). That portion of our investments that is in securities issued by other investment companies may subject our stockholders to additional expenses.

In April 2007, our Board of Directors approved the repeal of our fundamental investment policies in order to conform to prevailing practice among business development companies. In reaching this conclusion, our Board of Directors considered, among other things, the potential competitive disadvantage that having such policies places on us in comparison to competitors that do not have such restrictions. In accordance with the 1940 Act, we will submit this repeal of our fundamental investment policies to our stockholders for their approval at our upcoming 2007 Annual Meeting of Stockholders. The reasons for seeking to repeal our fundamental investment policies will be described in greater detail in the proxy statement to be delivered to stockholders in advance of the 2007 Annual Meeting of Stockholders.

***Code of Ethics***

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

***Compliance Policies and Procedures***

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

**Staffing**

We do not currently have any employees and do not expect to have any employees in the foreseeable future. Currently, services necessary for our business are provided by individuals who are employees of our Adviser and our Administrator pursuant to the terms of the Advisory Agreement and Administration Agreement, respectively. Each of our executive officers is an employee and executive officer of our Adviser or our Administrator. No employee of our Adviser or our Administrator will dedicate all of his or her time to us. However, we expect that 25-30 full time employees of our Adviser will spend substantial time on our matters during the remainder of calendar year 2007 and all of calendar year 2008. We anticipate that the number of employees of our Adviser and our Administrator who devote time to our matters will increase as we acquire more investments.

As of April 30, 2007, our Adviser and our Administrator collectively had 52 full-time employees. A break-down of these employees by functional area is summarized in the table below:

<b>Number of Individuals</b>	<b>Functional Area</b>
6	Executive Management
37	Investment Management, Portfolio Management, and Due Diligence
9	Administration, Accounting, Compliance and Human Resources

**Available Information:**

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



## Item 1A. Risk Factors

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

### **We are a relatively new company with limited operating history.**

We were incorporated in Delaware on February 18, 2005. We are subject to all of the business risks and uncertainties associated with any new business, including the risk that we will not achieve our investment objectives and that the value of your investment could decline substantially.

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

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

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

The Advisory Agreement entitles our Adviser to incentive compensation for each fiscal quarter in an amount equal to a percentage of the excess of our investment income for that quarter (before deducting incentive compensation, net operating losses and certain other items) above a threshold return for that quarter. Our pre-incentive fee net investment income for incentive compensation purposes excludes realized and unrealized capital losses that we may incur in the fiscal quarter, even if such capital losses result in a net loss on our statement of operations for that quarter. Thus, we may be required to pay our Adviser incentive compensation for a fiscal quarter even if there is a decline in the value of our portfolio or we incur a net loss for that quarter. For additional information on incentive compensation under the Advisory Agreement with our Adviser, see Business Investment Advisory and Management Agreement.

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

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

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

A number of entities compete with us for investments in small and mid-sized companies. We will compete with public and private buyout funds, commercial and investment banks, commercial financing companies, and, to the extent they provide an alternative form of financing, hedge funds. Many of our competitors are substantially larger and have considerably greater financial, technical, and marketing resources than we do. For example, some competitors may have a lower cost of funds and access to funding sources that are not available to us. In addition, some of our competitors may have higher risk tolerances or different risk assessments, which would allow them to consider a wider variety of investments and establish more relationships than us. Furthermore, many of our competitors are not subject to the regulatory restrictions that the 1940 Act





imposes on us as a business development company. The competitive pressures we face could have a material adverse effect on our business, financial condition, and results of operations. Also, as a result of this competition, we may not be able to take advantage of attractive investment opportunities from time to time, and we can offer no assurance that we will be able to identify and make investments that are consistent with our investment objective. We do not seek to compete primarily based on the interest rates we offer, and we believe that some of our competitors may make loans with interest rates that will be comparable to or lower than the rates we offer. We may lose investment opportunities if we do not match our competitors' pricing, terms, and structure. However, if we match our competitors' pricing, terms, and structure, we may experience decreased net interest income and increased risk of credit loss.

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

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

- **Small and medium-sized businesses may have limited financial resources and may not be able to repay the loans we make to them.** Our strategy includes providing financing to portfolio companies that typically is not readily available to them. While we believe that this provides an attractive opportunity for us to generate profits, this may make it difficult for the portfolio companies to repay their loans to us upon maturity. A borrower's ability to repay its loan may be adversely affected by numerous factors, including the failure to meet its business plan, a downturn in its industry or negative economic conditions. A deterioration in a borrower's financial condition and prospects usually will be accompanied by deterioration in the value of any collateral and a reduction in the likelihood of us realizing on any guarantees we may have obtained from the borrower's management. Although we will sometimes seek to be the senior, secured lender to a borrower, in most of our loans we expect to be subordinated to a senior lender, and our interest in any collateral would, accordingly, likely be subordinate to another lender's security interest.
- **Small and medium-sized businesses typically have narrower product lines and smaller market shares than large businesses.** Because our target portfolio companies are smaller businesses, they will tend to be more vulnerable to competitors' actions and market conditions, as well as general economic downturns. In addition, our portfolio companies may face intense competition, including competition from companies with greater financial resources, more extensive development, manufacturing, marketing and other capabilities and a larger number of qualified managerial and technical personnel.
- **There is generally little or no publicly available information about these businesses.** Because we seek to invest in privately owned businesses, there is generally little or no publicly available operating and financial information about our potential portfolio companies. As a result, we rely on our officers, our Adviser and its employees and consultants to perform due diligence investigations of these portfolio companies, their operations and their prospects. We may not learn all of the material information we need to know regarding these businesses through our investigations.
- **Small and medium-sized businesses generally have less predictable operating results.** We expect that our portfolio companies may have significant variations in their operating results, may from time to time be parties to litigation, may be engaged in rapidly changing businesses with products subject to a substantial risk of obsolescence, may require substantial additional capital to support their operations, to finance expansion or to maintain their competitive position, may otherwise have a weak financial position or may be adversely affected by changes in the business cycle. Our portfolio companies may not meet net income, cash flow and other coverage tests typically imposed by their senior lenders. A borrower's failure to satisfy financial or operating covenants imposed by senior lenders could lead to defaults and, potentially, foreclosure on its senior credit facility, which could additionally trigger cross-defaults in other agreements. If this were to occur, it is possible that the borrower's ability to repay our loan would be jeopardized.
- **Small and medium-sized businesses are more likely to be dependent on one or two persons.**

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

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- **Small and medium-sized businesses are likely to have greater exposure to economic downturns than larger businesses.** We expect that our portfolio companies will have fewer resources than larger businesses and an economic downturn is more likely to have a material adverse effect on them. If one of our portfolio companies is adversely impacted by an economic downturn, its ability to repay our loan would be diminished.
- **Small and medium-sized businesses may have limited operating histories.** While we intend to target stable companies with proven track records, we may make loans to new companies that meet our other investment criteria. Portfolio companies with limited operating histories will be exposed to all of the operating risks that new businesses face and may be particularly susceptible to, among other risks, market downturns, competitive pressures and the departure of key executive officers.

**We may not realize gains from our equity investments.**

When we invest in mezzanine or senior secured loans, we may acquire warrants or other equity securities as well. In addition we may invest in preferred and common stock. Our goal is ultimately to dispose of such equity interests and realize gains upon our disposition of such interests. However, the equity interests we receive may not appreciate in value and, in fact, may decline in value. Accordingly, we may not be able to realize gains from our equity interests, and any gains that we do realize on the disposition of any equity interests may not be sufficient to offset any other losses we experience.

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

A large percentage of our portfolio investments are, and will continue to be, in the form of securities that are not publicly traded. The fair value of securities and other investments that are not publicly traded may not be readily determinable. Our Board of Directors has established a valuation policy and consistently applied valuation procedures used to determine the fair value of these securities quarterly. These procedures for the determination of value of many of our debt securities rely on the opinions of value submitted to us by SPSE. SPSE will only evaluate the debt portion of our investments for which we specifically request evaluation, and SPSE may decline to make requested evaluations for any reason in its sole discretion. However, to date, SPSE has accepted each of our requests for evaluation.

Our procedures also include provisions whereby our Adviser will establish the fair value of any equity securities we may hold where SPSE is unable to provide evaluations. The types of factors that may be considered in determining the fair value of our debt and equity investments include some or all of the following: the nature and realizable value of any collateral, the portfolio company's earnings and cash flows and its ability to make payments on its obligations, the markets in which the portfolio company does business, comparison to publicly traded companies, discounted cash flow, and other relevant factors. Because such valuations, particularly valuations of private securities and private companies, are inherently uncertain, may fluctuate over short periods of time, and may be based on estimates, our determinations of fair value may differ materially from the values that might have resulted from a readily available market for these securities.

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

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

We will generally make investments in private companies whose securities are not traded in any public market. Substantially all of these securities will be subject to legal and other restrictions on resale and will otherwise be less liquid than publicly traded securities. The illiquidity of our investments may make it difficult for us to sell such investments if the need arises. In addition, if we are required to liquidate all or a portion of our portfolio quickly, we may realize substantial book losses upon liquidation. In addition, we may face other restrictions on our ability to liquidate an investment in a portfolio company to the extent that we, our Adviser, or our respective officers, employees or affiliates have material non-public information regarding such portfolio company.



**Our business plan is dependent upon external financing, which may expose us to risks associated with leverage.**

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

- **Senior Securities.** We intend to issue debt securities, other evidences of indebtedness (including borrowings under our line of credit) and possibly preferred stock, up to the maximum amount permitted by the 1940 Act. The 1940 Act currently permits us, as a business development company, to issue debt securities and preferred stock, to which we refer collectively as senior securities, in amounts such that our asset coverage, as defined in the 1940 Act, is at least 200% after each issuance of senior securities. As a result of issuing senior securities, we will be exposed to the risks associated with leverage. Although borrowing money for investments increases the potential for gain, it also increases the risk of a loss. A decrease in the value of our investments will have a greater impact on the value of our common stock to the extent that we have borrowed money to make investments. There is a possibility that the costs of borrowing could exceed the income we receive on the investments we make with such borrowed funds. In addition, our ability to pay dividends or incur additional indebtedness would be restricted if asset coverage is not at least twice our indebtedness. If the value of our assets declines, we might be unable to satisfy that test. If this happens, we may be required to liquidate a portion of our loan portfolio and repay a portion of our indebtedness at a time when a sale may be disadvantageous. Furthermore, any amounts that we use to service our indebtedness will not be available for distributions to our stockholders.
- **Common Stock.** Because we are constrained in our ability to issue debt for the reasons given above, we are dependent on the issuance of equity as a financing source. If we raise additional funds by issuing more common stock or debt securities convertible into or exchangeable for our common stock, the percentage ownership of our stockholders at the time of the issuance would decrease and they may experience dilution. In addition, any convertible or exchangeable securities that we issue in the future may have rights, preferences and privileges more favorable than those of our common stock.
- **Securitization.** In addition to issuing securities to raise capital as described above, we anticipate that in the future we will securitize our loans to generate cash for funding new investments. An inability to successfully securitize our loan portfolio could limit our ability to grow our business, fully execute our business strategy and impact our profitability. Moreover, successful securitization of our loan portfolio might expose us to losses as the loans in which we do not plan to sell interests will be those that are riskier and more apt to generate losses.

**Regulations governing our operation as a business development company will affect our ability to and the way in which we raise additional capital.**

We may issue debt securities or preferred stock and/or borrow money from banks or other financial institutions, which we refer to collectively as senior securities, up to the maximum amount permitted by the 1940 Act. Senior securities are defined by the 1940 Act to include bonds, debentures, notes or similar obligations or instruments that are securities and evidence indebtedness and stock of a class having priority over any other class as to distribution of assets or payment of dividends. Under the provisions of the 1940 Act, we will be permitted, as a business development company, to issue senior securities only in amounts such that our asset coverage, as defined in the 1940 Act, equals at least 200% after each issuance of senior securities. If the value of our assets declines, we may be unable to satisfy this test. If that happens, we may be required to sell a portion of our investments and, depending on the nature of our leverage, repay a portion of our indebtedness at a time when such sales may be disadvantageous.

We are not generally able to issue and sell our common stock at a price below net asset value per share. We may, however, sell our common stock or warrants, options, or rights to acquire our common stock at a price below the current net asset value of the common stock if our Board of Directors determines that such sale is in our best interests and the best interests of our stockholders, and our stockholders approve such sale. In any such case, the price at which our securities are to be issued and sold may not be less than a price which, in the determination of our Board of Directors, closely approximates the market value of such securities (less any distributing commission or discount).

In addition to issuing securities to raise capital as described above, we may in the future seek to securitize certain of our assets to generate cash for funding new investments. Securitization involves our creating a wholly-owned subsidiary and contributing a pool of loans to the subsidiary,

which then would deposit the loans to a single purpose trust. The trust would then typically sell a class of investment grade interests to the public, and we would retain a residual portion of the equity in the securitized pool of loans. The declaration of trust for the securitization entity would typically provide for preferential distributions of interest, principal and liquidation proceeds to the holders other than the holder of the residual equity. Accordingly, in a securitization transaction, the residual equity that we would retain would typically bear greater risk than if we held all the loans comprising the securitized pool in their entirety. An inability to successfully securitize our loan portfolio could limit our ability to grow our business, fully execute our business strategy, and decrease our earnings, if any. Moreover, the successful securitization of our loan portfolio might expose us to losses as the residual loans in which we do not sell interests will tend to be those that are riskier and more apt to generate losses.

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**If we issue senior securities, including debt, we will be exposed to additional risks, including the typical risks associated with leverage.**

We will be exposed to increased risk of loss if we incur debt to make investments. If we do incur debt, a decrease in the value of our investments would have a greater negative impact on the value of our common stock than if we did not use debt. Our ability to pay dividends would be restricted if our asset coverage ratio was not at least 200%, and any amounts that we would use to service our indebtedness would not be available for dividends to our common stockholders. It is likely that any senior debt securities we issue will be governed by an indenture or other instrument containing covenants restricting our operating flexibility. We, and indirectly our stockholders, will bear the cost of issuing and servicing such securities. Any convertible or exchangeable securities that we issue in the future may have rights, preferences and privileges more favorable than those of our common stock.

**We are exposed to risks associated with changes in interest rates.**

General interest rate fluctuations may have a substantial negative impact on our investments and investment opportunities and, accordingly, may have a material adverse effect on investment objectives and our rate of return on invested capital. In addition, an increase in interest rates would make it more expensive to use debt to finance our investments.

**Our credit facility imposes certain limitations on us.**

The administrative agent and lenders under our credit facility have fixed dollar claims on our assets that are senior to the claims of our stockholders and, thus, have a preference over our stockholders with respect to our assets. Our credit facility also contains customary default provisions and financial covenants for loans of this nature, such as a minimum portfolio yield, maximum charge-off ratios and default ratios with respect to the loans purchased from us, a restriction on changing our business and loan quality standards. An event of default under our credit facility would likely result, among other things, in termination of further funds available under that facility and an accelerated maturity date for all amounts outstanding under the facility. This would likely disrupt the portfolio companies whose loans we financed through the facility, could reduce our revenues and, by delaying any cash payment allowed to us under our facility until the lenders have been paid in full, could reduce our liquidity and cash flow.

**We may experience fluctuations in our quarterly results.**

We could experience fluctuations in our quarterly operating results due to a number of factors, including the interest rates payable on the debt securities we acquire, the default rates on such securities, the level of our expenses, variations in and the timing of the recognition of realized and unrealized gains or losses, the degree to which we encounter competition in our markets, and general economic conditions. As a result of these factors, results for any period should not be relied upon as being indicative of performance in future periods. For additional information concerning the fluctuations in our operating results, see Management's Discussion and Analysis of Financial Condition and Results of Operations.

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

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

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

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





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

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

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

Our executive officers and directors, and the officers and directors of our Adviser and our Administrator serve or may serve as officers, directors or principals of entities that operate in the same or a related line of business as we do or of investment funds managed by our affiliates. Accordingly, they may have obligations to investors in those entities, the fulfillment of which might not be in the best interests of us or our stockholders. In addition, all of our directors and executive officers serve as either directors or executive officers, or both, of Gladstone Commercial and Gladstone Capital and our Adviser and Administrator also provide investment advisory and administrative services to these affiliates as well as Gladstone Land. In the future, the Adviser and the Administrator may provide investment advisory and administrative services, as applicable, to other funds, both public and private, of which it is the sponsor. Moreover, the Adviser may establish or sponsor other investment vehicles which from time to time may have potentially overlapping investment objectives with those of ours and accordingly may invest in, whether principally or secondarily, asset classes similar to those we targeted. While the Adviser generally has broad authority to make investments on behalf of the investment vehicles that it advises, the Adviser has adopted investment allocation procedures to address these potential conflicts and intends to direct investment opportunities to the Gladstone affiliate with the investment strategy that most closely fits the investment opportunity to ensure the fair and equitable treatment of all the funds it manages. Nevertheless, the management of the Adviser may face conflicts in the allocation of investment opportunities to other entities managed by the Adviser. As a result, it is possible that we may not be given the opportunity to participate in certain investments made by other members of the Gladstone Companies or investment funds managed by investment managers affiliated with the Adviser.

In certain circumstances, we may make investments in a portfolio company in which one of our affiliates has or will have an investment, subject to satisfaction of any regulatory restrictions and, where required, to the prior approval of our board of directors. As of March 31, 2007, our Board of Directors has approved the following types of co-investment transactions:

- Our affiliate, Gladstone Commercial, may lease property to portfolio companies that we do not control under certain circumstances. We may pursue such transactions only if (i) the portfolio company is not controlled by us or any of our affiliates, (ii) the portfolio company satisfies the tenant underwriting criteria of Gladstone Commercial, and (iii) the transaction is approved by a majority of our independent directors and a majority of the independent directors of Gladstone Commercial. We expect that any such negotiations between Gladstone Commercial and our portfolio companies would result in lease terms consistent with the terms that the portfolio companies would be likely to receive were they not portfolio companies of ours.
- We may invest simultaneously with our affiliate Gladstone Capital in senior syndicated loans whereby neither we nor any affiliate has the ability to dictate the terms of the loans.

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

In the course of our investing activities, we will pay management and incentive fees to the Adviser and will reimburse the Administrator for certain expenses it incurs. As a result, investors in our common stock will invest on a gross basis and receive distributions on a net basis after expenses, resulting in, among other things, a lower rate of return than one might achieve through our investors themselves making direct investments. As a result of this arrangement, there may be times when the management team of the Adviser or the Administrator has interests that differ from those of our stockholders, giving rise to a conflict.

**We typically invest in transactions involving acquisitions, buyouts and recapitalizations of companies, which will subject us to the risks associated with change in control transactions.**

Our strategy includes making debt and equity investments in companies in connection with acquisitions, buyouts and recapitalizations, which subjects us to the risks associated with change in control transactions. Change in control transactions often present a number of uncertainties. Companies undergoing change in control transactions often face challenges retaining key employees, maintaining relationships with customers and suppliers. While we hope to avoid many of these difficulties by participating in transactions where the management team is retained and by conducting thorough due diligence in advance of our decision to invest, if our portfolio companies experience one or more of these problems, we may not realize the value that we expect in connection with our investments which would likely harm our operating results and financial condition

**Our portfolio companies are likely to have debt that ranks equally with, or senior to, our investments in such companies.**

We invest primarily in subordinated debt, mezzanine debt and preferred and common equity securities issued by our portfolio companies in connection with buyouts or recapitalizations of these companies. Portfolio companies undergoing these types of transactions usually will have other debt that ranks equally with, or senior to, the debt securities in which we invest. By their terms, such debt instruments may provide that the holders are entitled to receive payment of interest or principal on or before the dates on which we are entitled to receive payments in respect of the debt securities in which we invest. Also, in the event of insolvency, liquidation, dissolution, reorganization, or bankruptcy of a portfolio company, holders of debt instruments ranking senior to our investment in that portfolio company would typically be entitled to receive payment in full before we receive any distribution with respect to our investment. After repaying its senior creditors, our portfolio company may not have any remaining assets to use for repaying its obligation to us. In the case of debt ranking equally with debt securities in which we invest, we would have to share on an equal basis any distributions with other creditors holding such debt in the event of an insolvency, liquidation, dissolution, reorganization, or bankruptcy of the relevant portfolio company. In addition, we may not be in a position to control any portfolio company by investing in its debt securities. Therefore, we are subject to the risk that a portfolio company in which we invest may make business decisions with which we disagree, and the management of such company, as representatives of the holders of their equity securities, may take risks or otherwise act in ways that do not serve our interests as debt investors.

**Hedging activities may not fully protect us from adverse changes in exchange rates or interest rates.**

While we are not currently engaged in any hedging transactions, if we were to engage in hedging transactions in the future, we may expose ourselves to risks associated with such transactions. We may utilize instruments such as forward contracts, currency options and interest rate swaps, caps, collars and floors to seek to hedge against fluctuations in the relative values of our portfolio positions from changes in currency exchange rates and market interest rates. Hedging against a decline in the values of our portfolio positions does not eliminate the possibility of fluctuations in the values of such positions or prevent losses if the values of such positions decline. However, such hedging can establish other positions designed to gain from those same developments, thereby offsetting the decline in the value of such portfolio positions. Such hedging transactions may also limit the opportunity for gain if the values of the portfolio positions should increase. Moreover, it may not be possible to hedge against a situation of an exchange rate or interest rate fluctuation that is so generally anticipated that we are not able to enter into a hedging transaction at an acceptable price.

The success of our hedging transactions will depend on our ability to correctly predict movements in currency exchange and interest rates. Therefore, while we may enter into such transactions to seek to reduce currency exchange rate and interest rate risks, unanticipated changes in currency exchange rates or interest rates may result in poorer overall investment performance than if we had not engaged in any such hedging transactions. In addition, the degree of correlation between price movements of the instruments used in a hedging strategy and price movements in the portfolio positions being hedged may vary. Moreover, for a variety of reasons, we may not seek to establish a perfect correlation between such hedging instruments and



the portfolio holdings being hedged. Any such imperfect correlation may prevent us from achieving the intended hedge and expose us to risk of loss. In addition, it may not be possible to hedge fully or perfectly against currency fluctuations affecting the value of securities denominated in non-U.S. currencies because the value of those securities is likely to fluctuate as a result of factors not related to currency fluctuations.

**There is a risk that you may not receive dividends or that our dividends may not grow over time.**

Our current intention is to distribute at least 90% of our ordinary income and short-term capital gains to our stockholders on a quarterly basis. We expect to retain net realized long-term capital gains to supplement our equity capital and support the growth of our portfolio, although our Board of Directors may determine in certain cases to distribute these gains. We cannot assure you that we will achieve investment results or maintain a tax status that will allow or require any specified level of cash distributions or year-to-year increases in cash distributions.

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

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

- price and volume fluctuations in the stock market from time to time, which are often unrelated to the operating performance of particular companies;
- significant volatility in the market price and trading volume of shares of RICs, business development companies or other companies in our sector, which is not necessarily related to the operating performance of these companies;
- changes in regulatory policies or tax guidelines, particularly with respect to RICs or business development companies;
- loss of BDC status;
- loss of RIC status;
- changes in our earnings or variations in our operating results;
- changes in the value of our portfolio of investments;
- any shortfall in our revenue or net income or any increase in losses from levels expected by securities analysts;
- departure of key personnel;
- operating performance of companies comparable to us;
- short-selling pressure with respect to our shares or business development companies generally;
- general economic trends and other external factors; and
- loss of a major funding source.

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

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

Shares of closed-end investment companies frequently trade at a discount from net asset value. This characteristic of shares of closed-end investment companies is separate and distinct from the risk that our net asset value per share will decline. Although shares of our common stock have historically traded at a premium to net asset value, there can be no guarantee that they will continue to do so.

**Provisions of the Delaware General Corporation Law and of our certificate of incorporation and bylaws could restrict a change in control and have an adverse impact on the price of our common stock.**

We are subject to provisions of the Delaware corporation law that, in general, prohibit any business combination with a beneficial owner of 15% or more of our common stock for three years unless the holder's acquisition of our stock was either approved in advance by our board of directors or ratified by the board of directors and stockholders owning two-thirds of our outstanding stock not owned by the acquiring holder. Although we believe these provisions collectively provide for an opportunity to receive higher bids by requiring potential acquirers to negotiate with our board of directors, they would apply even if the offer may be considered beneficial by some stockholders.

We have also adopted other measures that may make it difficult for a third party to obtain control of us, including provisions of our certificate of incorporation classifying our board of directors in three classes serving staggered three-year terms, and provisions of our certificate of incorporation authorizing our board of directors to induce the issuance of additional shares of our stock. These provisions, as well as other provisions of our certificate of incorporation and bylaws, may delay, defer, or prevent a transaction or a change in control that might otherwise be in the best interests of our stockholders.

**We could face losses and potential liability if intrusion, viruses or similar disruptions to our technology jeopardize our confidential information or that of users of our technology.**

Although we have implemented, and will continue to implement, security measures, our technology platform is and will continue to be vulnerable to intrusion, computer viruses or similar disruptive problems caused by transmission from unauthorized users. The misappropriation of proprietary information could expose us to a risk of loss or litigation.

**Item 1B. Unresolved Staff Comments**

None.

**Item 2. Properties**

We do not own any real estate or other physical properties materially important to our operation. Our Adviser is the current leaseholder of all properties in which we operate. We occupy these premises pursuant to the Advisory and Administrative Agreements with our Adviser and Administrator, respectively. Our headquarters are located in McLean, Virginia and we also have operations in the states of New York, New Jersey, Illinois, Pennsylvania, Kentucky, Texas and Washington.

**Item 3. Legal Proceedings**

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

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

No matters were submitted to a vote of security holders during the fourth quarter of the fiscal year ended March 31, 2007.

**PART II**

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

Our common stock is traded on the NASDAQ Global Market under the symbol GAIN. The following table reflects, by quarter, the high and low closing prices per share of our common stock on the NASDAQ Global Market (The Nasdaq National Market for periods prior to July 1, 2006) for each fiscal quarter during the current and prior fiscal years.

	Quarter Ended	High	Low
FY 2007	3/31/07	\$ 16.00	\$ 14.41
	12/31/06	15.31	14.17
	9/30/06	14.82	13.50
	6/30/06	15.01	13.56
FY 2006	3/31/06	\$ 15.25	\$ 13.84
	12/31/05	14.96	13.43
	9/30/05	16.10	14.68
	6/30/05	15.09	15.00

As of May 18, 2007 there were approximately 35 stockholders of record of our Common Stock.



**Dividends**

We currently intend to distribute in the form of cash dividends a minimum of 90% of our ordinary income and short-term capital gains, if any, on a quarterly basis to our stockholders in the form of monthly dividends. Amounts presented for each fiscal quarter of 2007 and 2006 represent the cumulative amount of the dividends declared for the months composing such quarter. The following table reflects, by quarter, the dividends per share that we have declared on our common stock during fiscal years 2007 and 2006:

	<b>Quarter Ended</b>	<b>Cash Dividend Per Share</b>
FY 2007	3/31/07	\$ 0.225
	12/31/06	0.21
	9/30/06	0.21
	6/30/06	0.21
FY 2006	3/31/06	\$ 0.21
	12/31/05	0.12
	9/30/05	0.06
	6/30/05	0.00

**Recent Sales of Unregistered Securities**

There were no unregistered sales of our securities during the fiscal year ended March 31, 2007.



**Item 6. Selected Financial Data**

The following selected financial data for the fiscal year ended March 31, 2007 and the period June 22, 2005 (commencement of operations) through March 31, 2006 are derived from our audited consolidated financial statements. The data should be read in conjunction with our consolidated financial statements and notes thereto and Management's Discussion and Analysis of Financial Condition and Results of Operations included elsewhere in this report.

**GLADSTONE INVESTMENT CORPORATION  
SELECTED FINANCIAL DATA**

	<b>Year Ended March 31, 2007</b>	<b>Period June 22, 2005 (commencement of operations) Through March 31, 2006</b>
Total Investment Income	\$ 17,261,636	\$ 7,370,856
Total Expenses	6,113,904	1,486,958
Net Investment Income	11,147,732	5,883,898
Net (Loss) Gain on Investments	(3,879,328	) 170,399
Net Increase in Net Assets Resulting from Operations	\$ 7,268,404	\$ 6,054,297
<b>Per Share Data:</b>		
Net Increase in Net Assets Resulting from Operations:		
Basic & Diluted	\$ 0.44	\$ 0.37
Cash Distributions Declared per Share	0.855	0.39
<b>Statement of Assets and Liabilities Data:</b>		
Total Assets	\$ 323,590,215	\$ 230,323,807
Net Assets	222,818,509	229,841,697
<b>Other Data:</b>		
Number of Portfolio Companies at Period End	47	22
New Investments	\$ 182,953,071	\$ 160,646,470
Proceeds from Loan Repayments and Investments Sold	61,166,782	7,381,468
Total Return (1)	4.36	% 3.39
Weighted Average Yield on Investments (2)	8.72	% 7.02

(1) 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.

(2) Weighted average yield on investments equals interest income on investments divided by the annualized weighted average investment balance throughout the year.

## Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

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

### OVERVIEW

We were incorporated under the General Corporation Laws of the State of Delaware on February 18, 2005. We were primarily established for the purpose of investing in subordinated loans, mezzanine debt, preferred stock and warrants to purchase common stock of small and medium-sized companies in connection with buyouts and other recapitalizations. We also invest in common stock and in senior and subordinated syndicated loans. Our investment objective is to generate both current income and capital gains through these debt and equity instruments. We operate as a closed-end, non-diversified management investment company, and have elected to be treated as a business development company under the Investment Company Act of 1940 (the "1940 Act").

Our primary investment focuses are situations involving buyouts and recapitalizations of small and mid-sized companies with established management teams. We expect that our investments will generally range between \$10 million and \$30 million each, although this investment size may vary proportionately as the size of our capital base changes. We intend to invest either by ourselves or jointly with other buyout funds and/or management of the portfolio company, depending on the opportunity. If we are participating in an investment with one or more co-investors, then our investment is likely to be smaller than if we were to be investing alone.

We have invested some of the proceeds of our initial public offering in senior secured syndicated loans, since these investments typically may be made more quickly than investments in companies undergoing a buyout or recapitalization. We employed this strategy in order to more quickly invest our initial capital to generate current income, and have continued this strategy in order to build a portfolio of investments that may be securitized. Senior secured syndicated loans typically involve a number of banks or other financial institutions and are generally more marketable than loans that are not syndicated.

Certain loan investments may have a form of interest that is not paid currently but is accrued and added to the loan balance and paid at the end of the term. This interest is called "paid in kind" interest or "PIK." We generally seek investments that do not generate PIK interest as we have to pay out this accrued interest as dividends to our stockholders and we may have to borrow money or raise additional capital in order to meet the tax test for regulated investment companies ("RICs") by having to pay out at least 90% of our income. As of March 31, 2007, none of our investments bore PIK interest.

Original issue discounts ("OID") arise when we extend a loan and receive an equity interest in the borrower at the same time. To the extent that the price paid for the equity is not at market value, we must allocate part of the price paid for the loan to the value of the equity. Then the amount allocated to the equity, the OID, must be amortized over the life of the loan. As with PIK interest, the amortization of OID also produces income that must be recognized for purposes of satisfying the distribution requirements for a RIC under Subchapter M of the Internal Revenue Code of 1986 (the "Code"), whereas the cash is received, if at all, when the equity instrument is sold. We seek to avoid OID with all potential investments under review and to date do not hold any investments with OID.

In addition, as a business development company under the 1940 Act, we are required to make available significant managerial assistance to our portfolio companies. We provide these services through Gladstone Management Corporation (our "Adviser"), who provides these services on our behalf through its officers who are also our officers. Currently, neither we nor our Adviser charges a fee for managerial assistance.

Our Adviser receives fees for other services it provides to portfolio companies. These other fees are typically non-recurring, are recognized as revenue when earned and are generally paid directly to our Adviser by the borrower or potential borrower upon closing of the investment. The services our Adviser provides to portfolio companies vary by investment, but generally include a broad array of services, such as investment banking services, arranging bank and equity financing, structuring financing from multiple lenders and investors, reviewing existing credit facilities, restructuring existing loans, raising equity and debt capital, turnaround management, merger and acquisition services and recruiting new management personnel. When our Adviser receives fees for these services, 50% of those fees are credited to the base management fees we pay to the Adviser. Any services of this nature subsequent to the closing would typically generate a separate fee at the time of completion.

Our Adviser also receives fees for monitoring and reviewing portfolio company investments. These fees are recurring and are generally paid annually or quarterly in advance to our Adviser throughout the life of the investment. Fees of this nature are recorded as revenue by our Adviser when earned and are not credited against the base management fees. While our Adviser receives all fees in connection with our investments, such fees received by our Adviser, with the exception of monitoring and review fees, are partially credited to us as a reduction of the advisory fee payable under the advisory agreement between us.

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

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

Our Adviser is led by a management team which has extensive experience in our lines of business. Our Adviser also has a wholly-owned subsidiary, Gladstone Administration, LLC (the Administrator), which employs our chief financial officer, chief compliance officer, controller, treasurer and their respective staffs. All of our executive officers are officers or directors, or both, of our Adviser.

Our Adviser also provides investment advisory and administrative services to our affiliates Gladstone Commercial Corporation, a publicly traded real estate investment trust; Gladstone Capital Corporation, a publicly traded registered investment company; and Gladstone Land Corporation, an agricultural real estate company owned by Mr. Gladstone. All of our directors and executive officers serve as either directors or executive officers, or both, of Gladstone Commercial Corporation and Gladstone Capital Corporation. In the future, our Adviser may provide investment advisory and administrative services to other funds, both public and private, of which it is the sponsor.

We have been externally managed by our Adviser pursuant to an investment advisory and administrative agreement since our inception. Our Adviser was organized as a corporation under the laws of the State of Delaware on July 2, 2002, and is a registered investment adviser under the 1940 Act. Our Adviser is headquartered in McLean, Virginia, a suburb of Washington, D.C., and has offices in the states of New York, Illinois, Pennsylvania, New Jersey, Kentucky, Texas and Washington.

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

Pursuant to the investment advisory and management agreement (the Advisory Agreement) with our Adviser we pay our Adviser fees, as compensation for its services, consisting of a base management fee and an incentive fee.

The base management fee is assessed at an annual rate of 2.0% computed on the basis of the average value of our gross invested assets at the end of the two most recently completed quarters, which are total assets less the cash proceeds and cash and cash equivalent investments from the proceeds of our initial public offering that are not invested in debt and equity securities of portfolio companies. Through December 31, 2006, the base management fee was computed and payable quarterly. Beginning in periods subsequent to December 31, 2006, the base management fee is computed and payable quarterly and is assessed at an annual rate of 2.0% computed on the basis of the average value of our gross assets at the end of the two most recently completed quarters, which are total assets, including investments made with proceeds of borrowings, less any uninvested cash or cash equivalents resulting from borrowings. This new calculation was originally scheduled to begin in periods after March 31, 2006; however, on April 11, 2006, July 11, 2006 and October 10, 2006, our Board of Directors accepted voluntary waivers from our Adviser that allowed the current calculation of the base management fee to be effective through June 30, 2006, September 30, 2006 and December 31, 2006, respectively.

On January 9, 2007, our Board of Directors accepted a voluntary waiver from the Adviser to reduce the annual 2.0% base management fee on senior syndicated loan participations to 0.5% to the extent that proceeds resulting from borrowings were used to purchase such syndicated loan participations for the three months ended March 31, 2007

When our Adviser receives fees from our portfolio companies, such as investment banking fees, structuring fees or executive recruiting services fees, 50% of certain of these fees will be credited against the base management fee that we would otherwise be required to pay to our Adviser.

In addition, our Adviser services the loans held by Gladstone Business Investment, LLC ( *Business Investment* ), in return for which the Adviser receives a 2.0% annual fee based on the monthly aggregate balance of loans held by Business Investment. Since we own these loans, all loan servicing fees paid to our Adviser are treated as reductions against the 2.0% base management fee. Overall, the base management fee due to our Adviser cannot exceed 2.0% of total assets (as reduced by cash and cash equivalents pledged to creditors) during any given fiscal year.

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

- no incentive fee in any calendar quarter in which our pre-incentive fee net investment income does not exceed the hurdle rate (7% annualized);
- 100% of our pre-incentive fee net investment income with respect to that portion of such pre-incentive fee net investment income, if any, that exceeds the hurdle rate but is less than 2.1875% in any calendar quarter (8.75% annualized); and
- 20% of the amount of our pre-incentive fee net investment income, if any, that exceeds 2.1875% in any calendar quarter (8.75% annualized).

The second part of the incentive fee is a capital gains incentive fee that is determined and payable in arrears as of the end of each fiscal year (or upon termination of the Advisory Agreement, as of the termination date), and equals 20% of our realized capital gains as of the end of the fiscal year. In determining the capital gains incentive fee payable to our Adviser, we calculate the cumulative aggregate realized capital gains and cumulative aggregate realized capital losses since our inception, and the aggregate unrealized capital depreciation as of the date of the calculation, as applicable, with respect to each of the investments in our portfolio.

#### **Administration Agreement**

We have entered into an administration agreement with our Administrator (the *Administration Agreement* ) whereby under the Administration Agreement, we pay separately for administrative services. The Administration Agreement provides for payments equal to our allocable portion of our Administrator's overhead expenses in performing its obligations under the Administration Agreement including, but not limited to, rent for employees of our Administrator, and our allocable portion of the salaries and benefits expenses of our chief financial officer, controller, chief compliance officer, treasurer and their respective staffs.

#### **Critical Accounting Policies**

The preparation of financial statements and related disclosures in conformity with accounting principles generally accepted in the United States ( *GAAP* ) requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, and disclosure of contingent assets and liabilities at the date of the financial statements, and revenues and expenses during the period reported. Actual results could differ materially from those estimates. Our accounting policies are more fully described in the *Notes to Consolidated Financial Statements* contained elsewhere in this report. We have identified our investment valuation process as our most critical accounting policy.

#### **Investment Valuation**

The most significant estimate inherent in the preparation of our consolidated financial statements is the valuation of investments and the related amounts of unrealized appreciation and depreciation of investments recorded.

*General Valuation Policy:* Using procedures established by our Board of Directors, we value our investment portfolio each quarter. We carry our investments at fair value, as determined in good faith by or under the direction of our Board of Directors. Securities that are publicly traded, if any, are valued at the closing price of the exchange or securities market on which they are listed on the valuation date. Securities that are not traded on a public exchange or securities market, but for which a limited market exists and that have been rated by a nationally recognized statistical rating organizations ( *NRSRO* ), (such as certain participations in syndicated loans) are valued at the indicative bid price offered by the syndication agent on the valuation date.



Debt and equity securities that are not publicly traded, for which a limited market does not exist, or for which a limited market exists but that have not been rated by a NRSRO (or for which we have various degrees of trading restrictions) are valued at fair value as determined in good faith by or under the direction of our Board of Directors. In making the good faith determination of the value of these securities, we start with the cost basis of the security, which includes the amortized OID and PIK interest, if any. We then apply the methods set out below in Valuation Methods. Members of our Adviser's portfolio management team prepare the valuations of our investments in portfolio companies using the most recent portfolio company financial statements and forecasts. These individuals also consult with portfolio company senior management and ownership to obtain further updates on the portfolio company's performance, including information such as industry trends, new product development, and other operational issues. Due to the uncertainty inherent in the valuation process, such estimates of fair value may differ significantly from the values that would have been obtained had a ready market for the securities existed, and the differences could be material. Additionally, changes in the market environment and other events that may occur over the life of the investments may cause the gains or losses ultimately realized on these investments to be different than the valuations currently assigned. There is no single standard for determining fair value in good faith, as fair value depends upon circumstances of each individual case. In general, fair value is the amount that we might reasonably expect to receive upon the current sale of the security.

At March 31, 2007, we engaged Standard and Poor's Securities Evaluations, Inc. ( SPSE ) to submit opinions of value for 13 of our loan securities. We request that SPSE also evaluate and assign values to success fees (conditional interest included in some loan securities) when we determine that the probability of receiving a success fee on a given loan is above 6-8%, a threshold of significance. Upon completing our collection of data with respect to the investments (including the information described under Credit Information, the risk ratings of the loans described under Loan Grading and Risk Rating and the factors described under Valuation Methods ), this valuation data is forwarded to SPSE for review and analysis. SPSE makes its independent assessment of the data that we have assembled and assesses its independent data to form an opinion as to what they consider to be the market values for the securities. With regard to its work, SPSE has issued the following paragraph:

SPSE provides evaluated price opinions which are reflective of what SPSE believes the bid side of the market would be for each loan after careful review and analysis of descriptive, market and credit information. Each price reflects SPSE's best judgment based upon careful examination of a variety of market factors. Because of fluctuation in the market and in other factors beyond its control, SPSE cannot guarantee these evaluations. The evaluations reflect the market prices, or estimates thereof, on the date specified. The prices are based on comparable market prices for similar securities. Market information has been obtained from reputable secondary market sources. Although these sources are considered reliable, SPSE cannot guarantee their accuracy.

SPSE opinions of value are submitted to our Board of Directors along with our Adviser's supplemental assessment and recommendation regarding valuation of each of these investments. Our Adviser generally accepts the opinion of value given by SPSE, however in certain limited circumstances, such as when our Adviser may learn new information regarding an investment between the time of submission to SPSE and the date of the board assessment, our Adviser's conclusions as to value may differ from the opinion of value delivered by SPSE. Our Board of Directors then reviews whether our Adviser has followed its established procedures for determinations of fair value, and votes to accept or not accept the recommended valuation of our investment portfolio. Our Adviser and our management recommended, and the Board of Directors elected to accept, the opinions of value delivered by SPSE on the 13 loans in our portfolio as denoted on the Schedule of Investments as of March 31, 2007 included in our consolidated financial statements.

Because there is a delay between when we close an investment and when the investment can be evaluated by SPSE, new loans are not valued immediately by SPSE; rather, management makes its own determination about the value of these investments in accordance with our valuation policy. Because SPSE does not provide values for equity securities, our Adviser determines the fair value of these investments using valuation policies approved by our Board of Directors.

*Credit Information:* Our Adviser monitors a wide variety of key credit statistics that provide information regarding our portfolio companies to help us assess credit quality and portfolio performance. We and our Adviser participate in the

periodic board meetings of our portfolio companies in which we hold control and affiliate investments and also require them to provide annual audited and monthly unaudited financial statements. Using these statements and board discussions, our Adviser calculates and evaluates the credit statistics.

*Loan Grading and Risk Rating:* As part of our valuation procedures we risk rate all of our investments in debt securities. For syndicated loans that have been rated by a NRSRO (as defined in Rule 2a-7 under the 1940 Act), we use the NRSRO's risk rating for such security. For all other debt securities, we use a proprietary risk rating system. Our risk rating system uses a scale of 0 to 10, with 10 being the lowest probability of default. This system is used to estimate the probability of default on debt securities and the probability of loss if there is a default. These types of systems are referred to as risk rating systems and are used by banks and rating agencies. The risk rating system covers both

qualitative and quantitative aspects of the business and the securities we hold.

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For the debt securities for which we do not use a third-party NRSRO risk rating, we seek to have our risk rating system mirror the risk rating systems of major risk rating organizations, such as those provided by a NRSRO. While we seek to mirror the NRSRO systems, we cannot provide any assurance that our risk rating system will provide the same risk rating as a NRSRO for these securities. The following chart is an estimate of the relationship of our risk rating system to the designations used by two NRSROs as they risk rate debt securities of major companies. Because our system rates debt securities of companies that are unrated by any NRSRO, there can be no assurance that the correlation to the NRSRO set out below is accurate. We believe our risk rating would be significantly higher than a typical NRSRO risk rating because the risk rating of the typical NRSRO is designed for larger businesses. However, our risk rating has been designed to risk rate the securities of smaller businesses that are not rated by a typical NRSRO. Therefore, when we use our risk rating on larger business securities, the risk rating is higher than a typical NRSRO rating. The primary difference between our risk rating and the rating of a typical NRSRO is that our risk rating uses more quantitative determinants and includes qualitative determinants that we believe are not used in the NRSRO rating. It is our understanding that most debt securities of medium-sized companies do not exceed the grade of BBB on a NRSRO scale, so there would be no debt securities in the middle market that would meet the definition of AAA, AA or A. Therefore, our scale begins with the designation 10 as the best risk rating which may be equivalent to a BBB from a NRSRO, however, no assurance can be given that a 10 on our scale is equal to a BBB on a NRSRO scale.

Company s System	First NRSRO	Second NRSRO	Gladstone Investment s Description(a)
>10	Baa2	BBB	Probability of Default (PD) during the next ten years is 4% and the Expected Loss (EL) is 1% or less
10	Baa3	BBB-	PD is 5 and the EL is 1 to 2%
9	Ba1	BB+	PD is 10 and the EL is 2 to 3%
8	Ba2	BB	PD is 16 and the EL is 3 to 4%
7	Ba3	BB-	PD is 17.8 and the EL is 4 to 5%
6	B1	B+	PD is 22 and the EL is 5 to 6.5%
5	B2	B	PD is 25 and the EL is 6.5 to 8%
4	B3	B-	PD is 27 and the EL is 8 to 10%
3	Caa1	CCC+	PD is 30 and the EL is 10.0 to 13.3%
2	Caa2	CCC	PD is 35 and the EL is 13.3 to 16.7%
1	Caa3	CC	PD is 65 and the EL is 16.7 to 20%
0	N/a	D	PD is 85 or there is a Payment Default and the EL is greater than 20%

(a) *the default rates set forth are for a ten year term debt security. If a debt security is less than ten years, then the probability of default is adjusted to a lower percentage for the shorter period, which may move the security higher on our risk rating scale.*

The above scale gives an indication of the probability of default and the magnitude of the loss if there is a default. Our policy is to stop accruing interest on an investment if we determine that interest is no longer collectible. At March 31, 2007 and 2006, no payments were past due on any of our debt securities. Additionally, we do not risk rate our equity securities.

The following table lists the risk ratings for all non-syndicated loans in our portfolio at March 31, 2007 and March 31, 2006, representing approximately 44% and 31%, respectively, of all loans in our portfolio:

Rating	March 31, 2007	March 31, 2006
Highest	8.0	6.0
Average	5.7	5.3
Weighted Average	5.0	5.3
Lowest	2.0	5.0

The following table lists the risk ratings for syndicated loans in our portfolio that are not currently rated by an NRSRO at March 31, 2007 and March 31, 2006, representing approximately 14% and 12%, respectively, of all loans in our portfolio:

Rating	March 31, 2007	March 31, 2006
Highest	8.0	9.0
Average	7.2	7.8
Weighted Average	7.3	7.7
Lowest	6.0	7.0





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For syndicated loans that are currently rated by an NRSRO, we risk rate such loans in accordance with the risk rating systems of major risk rating organizations such as those provided by a NRSRO. The following table lists the risk ratings for all syndicated loans in our portfolio that are currently rated by an NRSRO at March 31, 2007 and March 31, 2006, representing approximately 42% and 57%, respectively, of all loans in our portfolio:

Rating	March 31, 2007	March 31, 2006
Highest	BB-/Ba2	BB/Ba2
Average	B+/B1	B+/B1
Weighted Average	B+/B1	B/B2
Lowest	B/B2	B/B2

*Valuation Methods:* We determine the value of publicly-traded debt securities based on the closing price for the security on the exchange or securities market on which it is listed on the valuation date. We value debt securities that are not publicly traded, but for which a limited market for the security exists, such as participations in syndicated loans, at the indicative bid price offered by the syndication agent on the valuation date. At March 31, 2007, none of the debt securities in our portfolio were publicly traded and there was a limited market for 42 debt securities in our portfolio. At March 31, 2006, none of the debt securities in our portfolio were publicly traded and there was a limited market for 19 debt securities in our portfolio.

For debt securities that are not publicly traded, for which there is no market, or for which there is a market but the securities have not been rated by a NRSRO, we begin with the risk rating designation of the security as described above. Using this risk rating designation, we seek to determine the value of the security as if we intended currently to sell the security and consider some or all of the following factors:

- the cost basis and the type of the security;
- the nature and realizable value of the collateral;
- the portfolio company's ability to make payments and discounted cash flow;
- reports from portfolio company senior management and board meetings;
- reported values of similar securities of the portfolio company or comparable companies; and
- changes in the economy affecting the portfolio company.

We value convertible debt, equity, success fees or other equity-like securities for which there is a market based on the market prices for such securities, even if that market is not robust. At March 31, 2007 and March 31, 2006 there was no market for any of the equity securities we owned. To value convertible debt, equity, success fees or other equity-like securities for which no market exists, we use the same information we would use for a debt security valuation described above, except risk-rating, as well as standard valuation techniques used by major valuation firms to value the equity securities of private companies. These valuation techniques consist of discounted cash flow of the expected sale price in the future, valuation of the securities based on recent sales in comparable transactions, and a review of similar companies that are publicly traded and the market multiple of their equity securities. At March 31, 2007 we had \$28.6 million invested, at cost, in equity securities compared to our debt portfolio with a cost basis of \$246.0 million. At March 31, 2006 we had \$12.8 million invested, at cost, in equity securities compared to our debt portfolio with a cost basis of \$140.5 million.

At March 31, 2007, we had total unrealized depreciation of approximately \$3.7 million, which was primarily comprised of net unrealized depreciation of our preferred and common stock in Chase II Acquisition Corp. At March 31, 2006 we had total unrealized appreciation of approximately \$113,000, which was mainly composed of net unrealized appreciation of our syndicated loan investments.

### Tax Status

#### *Federal Income Taxes*

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We currently qualify and intend to continue to qualify for treatment as a RIC under Subtitle A, Chapter 1 of Subchapter M of the Internal Revenue Code of 1986, as amended (the Code ). As a RIC, we are not subject to federal income tax on the portion of our taxable income and gains distributed to stockholders. To qualify as a RIC, we are required to distribute to stockholders at least 90% of investment company taxable income, as defined by the Code. It is our policy to pay out as a dividend up to 100% of those amounts.

In an effort to avoid certain excise taxes imposed on RICs, we currently intend to distribute during each calendar year, an amount at least equal the sum of (1) 98% of our ordinary income for the calendar year, (2) 98% of our capital gains in excess of capital losses for the one-year period ending on October 31 of the calendar year, and (3) any ordinary income and net capital gains for preceding years that were not distributed during such years.

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## Revenue Recognition

### *Interest and Dividend Income Recognition*

Interest income is recorded on the accrual basis to the extent that such amounts are expected to be collected. We will stop accruing interest on investments when it is determined that interest is no longer collectible. There were no uncollectible accounts at March 31, 2007 or March 31, 2006. Conditional interest, or a success fee, is recorded when earned upon full repayment of a loan investment. To date we have not recorded any conditional interest. Dividend income on preferred equity securities is accrued to the extent that such amounts are expected to be collected and that we have the option to collect such amounts in cash. To date, we have not accrued any dividend income.

### *Services Provided to Portfolio Companies*

The 1940 Act requires that a business development company make available managerial assistance to its portfolio companies by providing significant guidance and counsel concerning the management, operations, or business objectives and policies of the respective portfolio company. We provide these and other services to portfolio companies through our Adviser. Currently, neither we nor our Adviser receive fees in connection with managerial assistance.

Our Adviser receives fees for the other services it provides to portfolio companies. These other fees are typically non-recurring, are recognized as revenue when earned and are generally paid directly to our Adviser by the borrower or potential borrower upon the closing of the investment. The services our Adviser provides vary by investment, but generally include a broad array of services such as investment banking services, arranging bank and equity financing, structuring financing from multiple lenders and investors, reviewing existing credit facilities, restructuring existing investments, raising equity and debt capital, turnaround management, merger and acquisition services and recruiting new management personnel. When our Adviser receives fees for these services, 50% of certain of those fees are credited against the base management fee due to the Adviser from us. Any services of this nature subsequent to the closing would typically generate a separate fee at the time of completion.

Our Adviser also receives fees for monitoring and reviewing portfolio company investments. These fees are recurring and are generally paid annually or quarterly in advance to our Adviser throughout the life of the investment. Fees of this nature are recorded as revenue when earned by our Adviser which are not credited against the base management fee.

We may receive fees for the origination and closing services we provide to portfolio companies through our Adviser. These fees are paid directly to us and are recognized as revenue upon closing of the originated investment.

## RESULTS OF OPERATIONS

*For the fiscal year ended March 31, 2007 compared to the period June 22, 2005 (commencement of operations) to March 31, 2006.*

### **Investment Income**

Investment income for the year ended March 31, 2007 was \$17,261,636, compared to investment income for the period June 22, 2005 (commencement of operations) to March 31, 2006 of \$7,370,856.

Interest income from Non-Control/Non-Affiliate investments increased \$7,121,687 to \$9,572,593 for the year ended March 31, 2007, compared to \$2,450,906 for the period June 22, 2005 (commencement of operations) to March 31, 2006. This increase was mainly the result of additional Non-Control/Non-Affiliate investments made during the year ended March 31, 2007 compared to the prior year period, coupled with the incremental investment activity over the shortened prior year period.

Interest income from Control investments was \$5,486,060 for the year ended March 31, 2007, compared to \$255,059 for the period June 22, 2005 (commencement of operations) to March 31, 2006. This increase is mainly attributable to the purchase of two additional Control investments, as well as holding the three Control investments purchased in the prior year for a full fiscal year.

Interest income from Affiliate investments was \$535,629 for year ended March 31, 2007 representing interest on our loan investments to our Non-Control affiliates. At March 31, 2006, we had not yet invested in any Affiliate investments.

Interest income from cash and equivalents decreased \$2,773,059 to \$1,661,647 for year ended March 31, 2007 from \$4,434,706 for the period June 22, 2005 (commencement of operations) to March 31, 2006. This decrease is the result of the complete investment of the proceeds of our initial public offering in Control, Affiliate and Non-Control/Non-Affiliate investments.

The annualized weighted average yield on our portfolio of investments, excluding cash and cash equivalents, was 8.72% for the year ended March 31, 2007, compared to 7.02% for the period June 22, 2005 (commencement of operations) to March 31, 2006.

For the period June 22, 2005 (commencement of operations) to March 31, 2006 we recognized fee income of \$230,000 representing financing fees from the acquisition of one Control Investment. No fee income was recorded during fiscal 2007.

Other income increased \$5,522 to \$5,707 for the year ended March 31, 2007 from \$185 in the prior year period. Other income is comprised of loan amendment fees that are amortized over the remaining lives of the respective loans.

### **Operating Expenses**

Operating expenses for year ended March 31, 2007 were \$6,991,487 compared to \$2,041,547 for the period June 22, 2005 (commencement of operations) March 31, 2006, representing an overall increase of \$4,949,940.

For the year ended March 31, 2007, we incurred gross base management fees of \$3,981,970, less credits for fees received by our Adviser of \$1,568,854, for a net management fee of \$2,413,116 as compared to the period June 22, 2005 (commencement of operations) to March 31, 2006, in which we incurred gross base management fees of \$915,360. The base management fee is currently computed quarterly as described under Investment Advisory and Management Agreement. The fees increased in the current period due to the growth of the investment portfolio as compared to the same period of the prior year, however, the increase was partially offset by increased credits against the management fee in the current fiscal year of \$877,583 compared to \$554,589 in the prior fiscal year.

Loan servicing fees of \$1,568,854 were incurred for the year ended March 31, 2007. These fees were incurred in connection with a loan servicing agreement between Business Investment and our Adviser, which is based on the size of the aggregate outstanding loan portfolio. These fees reduced the amount of the base management fee due to our Adviser. There were no loan servicing fees in the prior period as we did not enter into our credit facility until October 2006.

The administration fee incurred to our Administrator was \$526,595 for the year ended March 31, 2007 compared to \$288,471 for the period June 22, 2005 (commencement of operations) to March 31, 2006. This fee consists of our allocable portion of our Administrator's rent and other overhead expenses, and our allocable portion of the salaries and benefits of our chief financial officer, chief compliance officer, treasurer, controller and their respective staffs. The increase was mainly attributable to the personnel growth of our Administrator and fewer periods included in the prior year period.

Interest expense for the year ended March 31, 2007 was \$607,661 and resulted from borrowings on our credit facility in the third and fourth quarters of fiscal 2007, which were used to finance our investment purchases during those quarters. Interest expense for the period June 22, 2005 (commencement of operations) to March 31, 2006 was \$378 and consisted of interest due on a loan payable to an affiliate, which was repaid in June 2005.

Deferred finance cost amortization for the year ended March 31, 2007 was \$233,779 and is directly attributable to the amortization of the capitalized finance costs associated with our credit facility.

Professional fees for the year ended March 31, 2007 were \$586,028, an increase of \$422,659 over the professional fees for the period June 22, 2005 (commencement of operations) to March 31, 2006 of \$163,369. Professional fees primarily consist of legal fees and audit and accounting fees. The increase is mainly due to the shortened prior year period, an increase in audit fees related to our compliance with Sarbanes-Oxley regulations and direct consulting and legal fees incurred on potential investments that were not executed.

Stockholder related costs increased \$183,920 for the year ended March 31, 2007 to \$273,483 from \$89,563 in the period June 22, 2005 (commencement of operations) to March 31, 2006. Stockholder related costs consist of the amortization of annual Nasdaq listing fees, transfer agent fees, annual report printing fees, Securities and Exchange Commission (SEC) filing fees and press release costs. The increase in stockholder related costs is mainly due to the shortened prior year period and fees incurred in connection with our inaugural annual meeting of stockholders on August 10, 2006.



Insurance expense for the year ended March 31, 2007 was \$262,339, compared to \$184,642 for the period June 22, 2005 (commencement of operations) to March 31, 2006. Insurance expense consists of the amortization of the directors and officers insurance policy and professional liability policy. The increase of \$77,697 is mainly due to our policies not beginning until August 2005, thereby resulting in the amortization of only eight months of insurance premiums in the prior year period.

Directors' fees for the year ended March 31, 2007 and the period June 22, 2005 (commencement of operations) to March 31, 2006 were \$208,100 and \$160,000, respectively. Directors' fees consist of the amortization of the directors' annual stipend and individual meeting fees. The directors' fees for the prior year period were not declared until July 2005 and, therefore, only nine months of expense was recognized in the prior year.

Taxes and licenses expense for the year ended March 31, 2007 was \$168,873 and was primarily comprised of franchise taxes due to the state of Delaware and other fees surrounding state and regulatory licensing, registration and other corporate filing fees. For the period June 22, 2005 (commencement of operations) to March 31, 2006, taxes and licenses expense was \$195,270 and consisted of approximately \$185,000 related to franchise taxes to the state of Delaware for calendar year 2005 and the first quarter of calendar year 2006. The maximum franchise tax to be paid to the state of Delaware for a calendar year is \$165,000; however the prior fiscal year expense includes franchise tax from our date of incorporation in February 2005 through December 31, 2005, in addition to an accrual of \$41,250 for January through March of the 2006 calendar year.

Other expenses for the year ended March 31, 2007 were \$142,659, compared to \$37,492 for the period June 22, 2005 (commencement of operations) to March 31, 2006. Other expenses consist primarily of direct expenses such as travel related specifically to our portfolio companies, loan evaluation services for our portfolio companies and backup servicer expenses. The overall increase of \$105,167 is mainly due to the increase in direct expenses as the overall size of our investment portfolio grew from the prior year period and fewer direct expenses from the shorter prior year period.

#### **Realized and Unrealized Loss on Investments**

For the year ended March 31, 2007, we recognized a net loss on the sale of nine loan participations in the aggregate amount of \$93,850 and we recorded net unrealized depreciation of investments in the aggregate amount of \$3,785,478.

At March 31, 2006, the fair value of our investment portfolio exceeded the cost basis of our portfolio by approximately \$113,000. At March 31, 2007, the fair value of our investment portfolio was less than the cost basis of our portfolio by approximately \$3.7 million, representing an unrealized loss of approximately \$3.8 million for the fiscal year. This decrease is primarily the result of the decline in market value of the equity securities from one of our Control investments.

#### **Net Increase in Net Assets from Operations**

Overall, we realized a net increase in net assets resulting from operations of \$7,268,404 for the year ended March 31, 2007 as a result of the factors discussed above. Our net increase in net assets from operations per basic and diluted weighted average common share for the year ended March 31, 2007 was \$0.44 and our net increase in net assets from operations per basic and diluted weighted average common share for the period June 22, 2005 (commencement of operations) to March 31, 2006 was \$0.37.

We will continue to incur base management fees which are likely to increase as our investment portfolio grows, and we may begin to incur incentive fees. Our administrative expenses payable to our Administrator are also likely to grow during future periods as our average assets increase in comparison to our average assets at March 31, 2007 and as the expenses incurred by our Administrator to support our operations increase.

### **LIQUIDITY AND CAPITAL RESOURCES**

#### **Operating Activities**

At March 31, 2007, we held investments in Non-Control/Non-Affiliates of approximately \$138.6 million and we held investments in Control and Affiliate investments of approximately \$136.1 million at cost. At March 31, 2006, we held investments in Non-Control/Non-Affiliates of approximately \$97.4 million and we held investments in Control investments of approximately \$55.8 million at cost.





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During the year ended March 31, 2007 and the period from June 22, 2005 (commencement of operations) to March 31, 2006, the following investment activity occurred during each quarter of the respective fiscal year:

Quarter Ended	New Investments	Principal Repayments	Investments Sold	Net Gain/(Loss) on Disposal
June 30, 2006	\$ 33,665,549	\$ 874,222	\$ 15,548,453	\$ 3,273
September 30, 2006	15,812,230	5,964,245	999,436	(1,934 )
December 31, 2006	69,372,847	3,610,221	3,043,000	(2,283 )
March 31, 2007	64,102,446	19,973,880	11,247,175	(92,906 )
Total fiscal year 2007	\$ 182,953,072	\$ 30,422,568	\$ 30,838,064	\$ (93,850 )
June 30, 2005	\$	\$	\$	\$
September 30, 2005	40,844,381	333,363		
December 31, 2005	23,376,958	1,043,120	2,000,000	38,056
March 31, 2006	96,425,131	425,054	3,522,500	19,375
Total fiscal year 2006	\$ 160,646,470	\$ 1,801,537	\$ 5,522,500	\$ 57,431

The following table summarizes the contractual principal amortization and maturity of our investment portfolio by fiscal year:

Fiscal Year Ended March 31,	Amount
2008	\$ 8,311,428
2009	10,047,620
2010	11,698,781
2011	52,080,567
2012	34,029,743
Thereafter	129,212,533
<b>Total contractual repayments</b>	<b>\$ 245,380,672</b>
Investments in equity securities	\$ 28,598,801
Unamortized premiums on debt securities	640,639
<b>Total</b>	<b>\$ 274,620,112</b>

Net cash used in operating activities for the year ended March 31, 2007 was approximately \$122.7 million and consisted primarily of the purchase of investments, an increase in our investment interest receivable and amounts due from custodian and a decrease in our base management fee payable to our Adviser, offset by sales and repayments of existing portfolio investments, increases in loan servicing and administration fees payable, net amortization of loan premiums and unrealized depreciation of our portfolio investments.

Net cash used in operating activities for the period June 22, 2005 (commencement of operations) to March 31, 2006 was approximately \$148.1 million and consisted of the funding of our portfolio investments and their respective principal repayments, net investment income generated from our portfolio and short-term investments, an increase in accounts payable, base management fee and administrative fees payable and accrued expenses offset by an increase in interest receivable and prepaid assets.

### Financing Activities

During the year ended March 31, 2007, we recorded net borrowings under our credit facility of \$100.0 million, which were used to purchase new investments. As a result of our credit facility, we incurred approximately \$862,000 of legal, accounting and other associated expenses that will be amortized over the remaining life of the facility.

We anticipate issuing equity securities to obtain additional capital in the future. The terms of the future equity issuances cannot be determined and there can be no assurances that the equity markets will be available to us on terms we deem favorable, if at all. On October 13, 2006 we filed a registration statement with the SEC (as amended on December 22, 2006) that, if and when declared effective, would permit us to issue, through one or more transactions, up to an aggregate of \$100 million in securities, consisting of common stock, preferred stock and/or debt securities. To date we have incurred approximately \$133,000 of costs in connection with this registration statement.

For the year ended March 31, 2007, our dividends paid of \$14,158,885 exceeded our net investment income (including realized losses) by \$3,105,003. We declared these dividends based on our estimates of net investment income for the fiscal year. Our investment pace continues to be slower than expected in our second year of operations and, consequently, our net investment income was lower than our original estimates. A portion of the dividends declared during fiscal 2007 were treated as a return of capital to our stockholders.

For the period June 22, 2005 (commencement of operations) to March 31, 2006 cash provided by financing activities consisted of the net proceeds from the initial public offering of \$230,292,203 (which includes \$30.1 million of proceeds received in July 2005 in connection with the closing of the underwriters over-allotment option and other related offering costs and does not include approximately \$48,000 of offering costs incurred prior to fiscal 2006), partially offset by the payment of dividends of \$6,458,439 and the repayment of the loan payable to affiliate of \$50,000. Our dividends paid of \$6,458,439 for the 2006 fiscal year exceeded net investment income (including realized gains) by \$517,110. We declared these dividends based on estimates of net investment income for the 2006 fiscal year. Our investment pace was slower than expected in our first year of operations and consequently, net investment income was lower than originally anticipated. A portion of the dividends declared during fiscal 2006 were treated as a return of capital to our stockholders.

### **Revolving Credit Facility**

On October 19, 2006, through our wholly-owned subsidiary, Business Investment, we initially obtained a \$100 million revolving credit facility (the Credit Facility). On October 19, 2006, we executed a purchase and sale agreement pursuant to which we agreed to sell certain loans to Business Investment in consideration for a membership interest therein. Simultaneously, Business Investment executed a credit agreement (the Credit Agreement) with Deutsche Bank AG, New York Branch (Deutsche Bank), as administrative agent, and others, pursuant to which Business Investment pledged the loans purchased from us to secure future advances by certain institutional lenders. Availability under the Credit Facility will terminate on October 18, 2007, unless extended in the discretion of the lenders, at the request of Business Investment. Interest is payable monthly during the term of the Credit Facility and principal is payable out of collections on loans purchased from us during the period following the date of which availability for advances has terminated through maturity. The Credit Facility will mature two years following the date on which availability for advances has terminated and on such date, all principal, interest and other amounts owing under the Credit Facility will be due and payable. Interest rates charged on the advances under the facility are based on the rate paid by the lenders on commercial paper notes issued by such lenders to fund some or all of the advances, the London Interbank Offered Rate (LIBOR), the Prime Rate or the Federal Funds Rate, depending on market conditions, and adjusts periodically. On March 29, 2007, we increased our borrowing capacity under the Credit Facility from \$100 million to \$150 million through June 27, 2007 and to \$200 million thereafter. As of March 31, 2007, there was an outstanding principal balance of \$100.0 million under the Credit Facility at an interest rate of approximately 5.3%. Available borrowings are subject to various constraints imposed under the Credit Agreement, based on the aggregate loan balance pledged by Business Investment, which varies as loans are added and repaid, regardless of whether such repayments are early prepayment or are made as contractually required. At March 31, 2007, the remaining borrowing capacity available under the Credit Facility was approximately \$50.0 million. If we request a renewal of the Credit Facility, any such renewal will be granted in the discretion of the lenders and there can be no guarantee that we will be able to renew the Credit Facility on terms that are favorable to us, if at all. In the event that we are not able to renew or refinance the Credit Facility this could have a material adverse impact on our liquidity and ability to fund new investments.

The Credit Facility contains covenants that require Business Investment to maintain its status as a separate entity; prohibit certain significant corporate transactions (such as mergers, consolidations, liquidations or dissolutions); and restrict material changes to our credit and collection policies. The facility also restricts some of the terms and provisions (including interest rates, terms to maturity and payments schedules) and limits the borrower and industry concentrations of loans that are eligible to secure advances. As of March 31, 2007, Business Investment was in compliance with all of the facility covenants. We currently intend to securitize some or all of the loans held by Business Investment and if we are able to do so, we will use the proceeds from the securitization to pay down any amounts then outstanding under the revolving credit facility.

The administrative agent also requires that any interest or principal payments on pledged loans be remitted directly by the borrower into lockbox accounts controlled by Deutsche Bank. Once a month, Deutsche Bank remits the collected funds to the Company after payment of any interest and expenses provided for under the Credit Agreement.



Our Adviser services the loans pledged under the Credit Facility. As a condition to this servicing arrangement, we executed a performance guaranty pursuant to which we guaranteed that our Adviser would comply fully with all of its obligations under the Credit Facility. The performance guaranty requires us to maintain a minimum net worth of \$100 million and to maintain asset coverage with respect to senior securities representing indebtedness of at least 200%, in accordance with Section 18 of the 1940 Act. As of March 31, 2007, we were in compliance with our covenants under the performance guaranty.

### Dividends

In order to qualify as a RIC and to avoid corporate level tax on the income we distribute to our stockholders, we are required, under Subchapter M of the Code, to distribute at least 90% of our ordinary income and realized net short-term capital gains to our stockholders on an annual basis. In accordance with these requirements, we declared the following dividends:

Declaration Date	Record Date	Payment Date	Dividend per Share
April 11, 2007	June 21, 2007	June 29, 2007	\$ 0.075
April 11, 2007	May 22, 2007	May 31, 2007	\$ 0.075
April 11, 2007	April 20, 2007	April 30, 2007	\$ 0.075
January 10, 2007	March 22, 2007	March 30, 2007	\$ 0.075
January 10, 2007	February 20, 2007	February 28, 2007	\$ 0.075
January 10, 2007	January 23, 2007	January 31, 2007	\$ 0.075
October 10, 2006	December 20, 2006	December 29, 2006	\$ 0.07
October 10, 2006	November 21, 2006	November 30, 2006	\$ 0.07
October 10, 2006	October 23, 2006	October 31, 2006	\$ 0.07
July 11, 2006	September 21, 2006	September 29, 2006	\$ 0.07