CAPITAL SOUTHWEST CORP
Form 10-Q
February 02, 2007

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

(Mark One)

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

For the quarterly period ended December 31, 2006

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: 814-61

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

Texas	75-1072796
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
12900 Preston Road, Suite 700, Dallas, Texas	75230
(Address of principal executive offices)	(Zip Code)

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

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

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

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

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

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

3,886,051 shares of Common Stock, $1 Par Value as of January 31, 2007

TABLE OF CONTENTS

PART I. FINANCIAL INFORMATION

Item 1. Consolidated Financial Statements

CAPITAL SOUTHWEST CORPORATION AND SUBSIDIARIES
Consolidated Statements of Financial Condition

Assets	December 31, 2006	March 31, 2006
	(Unaudited)	
Investments at market or fair value		
Companies more than 25% owned (Cost: December 31, 2006 - $32,632,356 March 31, 2006 - $23,114,866)	$521,169,985	$298,481,983
Companies 5% to 25% owned (Cost: December 31, 2006 - $18,798,896 March 31, 2006 - $18,595,746)	68,224,002	92,070,852
Companies less than 5% owned (Cost: December 31, 2006 - $23,782,504 March 31, 2006 - $46,886,344)	71,712,439	159,875,248
Total investments (Cost: December 31, 2006 - $75,213,756 March 31, 2006 - $88,596,956)	661,106,426	550,428,083
Cash and cash equivalents	56,530,336	11,503,866
Receivables	288,259	135,887
Other assets	7,466,502	7,300,297
Totals	$725,391,523	$569,368,133
Liabilities and Shareholders' Equity		
Note payable to bank	$ 8,000,000	$ 8,000,000
Other liabilities	1,598,172	1,697,086
Income taxes payable	11,080,699	982,653
Deferred income taxes	205,125,385	162,070,285
Total liabilities	225,804,256	172,750,024
Shareholders' equity		
Common stock, $1 par value: authorized, 5,000,000 shares; issued, 4,323,416 shares at December 31, 2006 and 4,297,616 shares at March 31, 2006	4,323,416	4,297,616
Additional capital	10,004,264	8,109,797
Undistributed net investment income	4,700,087	3,744,830
Undistributed net realized gain on investments	105,481,131	86,432,040
Unrealized appreciation of investments - net of deferred income taxes	382,111,671	301,067,128
Treasury stock - at cost (437,365 shares)	(7,033,302)	(7,033,302)
Net assets at market or fair value, equivalent to $128.56 per share at December 31, 2006 on the 3,886,051 shares outstanding and $102.74 per share at March 31, 2006 on the 3,860,251 shares outstanding	499,587,267	396,618,109
Totals	$725,391,523	$569,368,133

(See Notes to Consolidated Financial Statements)

CAPITAL SOUTHWEST CORPORATION
AND SUBSIDIARIES
Consolidated Statements of Operations

(Unaudited)

	Three Months Ended December 31		Nine Months En December 3	
	2006	2005	2006	
Investment income:				
Interest	$ 484,888	$ 99,140	$ 1,624,418	$
Dividends	1,626,702	1,174,743	3,167,203	
Management and directors' fees	163,750	178,950	542,150	
	2,275,340	1,452,833	5,333,771	
Operating expenses:				
Salaries	310,127	287,584	973,926	
Net pension benefit	(36,237)	(29,187)	(108,708)	
Other operating expenses	238,504	185,619	690,469	
	512,394	444,016	1,555,687	
Income before interest expense and income taxes	1,762,946	1,008,817	3,778,084	
Interest expense	133,749	105,565	458,953	
Income before income taxes	1,629,197	903,252	3,319,131	
Income tax expense	12,700	10,200	40,724	
Net investment income	$ 1,616,497	$ 893,052	$ 3,278,407	$
Proceeds from disposition of investments	$ 31,578,052	$ 7,791,129	$ 42,020,132	$2
Cost of investments sold	12,046,678	1,474,330	12,872,995	1
Realized gain on investments before income taxes	19,531,374	6,316,799	29,147,137	1
Income tax expense	6,726,027	2,185,228	10,098,046	
Net realized gain on investments	12,805,347	4,131,571	19,049,091	1
Increase in unrealized appreciation of investments before income taxes	132,210,244	15,009,434	124,061,543	4
Increase in deferred income taxes				

on appreciation of investments	46,023,000	5,254,000	43,017,000	1
Net increase in unrealized appreciation of investments	86,187,244	9,755,434	81,044,543	2
Net realized and unrealized gain on investments	$ 98,992,591	$13,887,005	$100,093,634	$4
Increase in net assets from operations	$100,609,088	$14,780,057	$103,372,041	$4

(See Notes to Consolidated Financial Statements)

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

	Nine Months Ended December 31, 2006	Year Ended March 31, 2006
	(Unaudited)	
Operations		
Net investment income	$ 3,278,407	$ 2,389,256
Net realized gain on investments	19,049,091	13,115,874
Net increase in unrealized appreciation of investments	81,044,543	80,685,303
Increase in net assets from operations	103,372,041	96,190,433
Distributions from:		
Undistributed net investment income	(2,323,150)	(2,314,231)
Capital share transactions		
Exercise of employee stock options	1,794,850	208,000
Stock option expense	125,417	--
Increase in net assets	102,969,158	94,084,202
Net assets, beginning of period	396,618,109	302,533,907
Net assets, end of period	$499,587,267	$396,618,109

(See Notes to Consolidated Financial Statements)

CAPITAL SOUTHWEST CORPORATION
AND SUBSIDIARIES
Consolidated Statements of Cash Flows

(Unaudited)

	Three Months Ended December 31		Nine M De
	2006	2005	2006
Cash flows from operating activities			
Increase in net assets from operations	$100,609,088	$14,780,057	$103,372,04
Adjustments to reconcile increase in net assets from operations to net cash provided by operating activities:			
Proceeds from disposition of investments	31,578,052	7,791,129	42,020,13
Purchases of securities	(4,500)	(1,209,231)	(374,73
Maturities of securities	--	--	884,93
Depreciation and amortization	4,426	3,968	12,31
Net pension benefit	(36,237)	(29,187)	(108,70
Realized gain on investments before income taxes	(19,531,374)	(6,316,799)	(29,147,13
Deferred taxes on realized gain on investments	6,726,027	2,185,228	10,098,04
Net increase in unrealized appreciation of investments	(86,187,244)	(9,755,434)	(81,044,54
Stock option expense	43,586	--	125,41
(Increase) decrease in receivables	(105,087)	144,240	(152,37
(Increase) decrease in other assets	3,391	5,353	(14,59
Increase (decrease) in and other liabilities	38,330	11,529	(46,52
Decrease in accrued pension cost	(36,567)	(38,669)	(107,60
Deferred income taxes	12,700	10,200	38,10
Net cash provided by operating activities	33,114,591	7,582,384	45,554,77

Cash flows from financing activities			
Decrease in note payable to portfolio company	--	--	--
Distributions from undistributed net investment income	(1,551,100)	(1,542,821)	(2,323,15
Proceeds from exercise of employee options	697,350	--	1,794,85
Net cash used in financing activities	(853,750)	(1,542,821)	(528,30
Net increase in cash and cash equivalents	32,260,841	6,039,563	45,026,47
Cash and cash equivalents at beginning of period	24,269,495	7,479,078	11,503,86
Cash and cash equivalents at end of period	$ 56,530,336	$13,518,641	$ 56,530,33
Supplemental disclosure of cash flow information:			
Cash paid during the period for:			
Interest	$ 133,749	$ 104,287	$ 458,95
Income taxes	$ --	$ --	$ 20,00

(See Notes to Consolidated Financial Statements)

6

Portfolio of Investments - December 31, 2006

Company	Investment (a)
+AT&T INC. San Antonio, Texas Global leader in local, long distance, Internet and transaction-based voice and data services.	++20,770 shares common stock (acquired 3-9-99)
+ALAMO GROUP INC. Sequin, Texas Tractor-mounted mowing and mobile excavation equipment for governmental, industrial and agricultural markets; street-sweeping equipment for municipalities.	2,821,300 shares common stock (acquired 4-1-73 thru 10-4-99)
ALL COMPONENTS, INC. Addison, Texas Electronics contract manufacturing; distribution and production of memory and other components for computer manufacturers, retailers and value-added resellers; distribution of automotive	10% subordinated note due 2008 (acquired 10-28-03 thru 10-3-05) 150,000 shares Series A convertible preferred stock, convertible into 600,000 shares of common stock at $0.25 per share (acquired 9-16-94)

accessories.	
+ALLTEL CORPORATION Little Rock, Arkansas Owner and operator of the nation's largest wireless network.	++8,880 shares common stock (acquired 7-1-98)
BALCO, INC. Wichita, Kansas Specialty architectural products used in the construction and remodeling of commercial and institutional buildings.	445,000 shares common stock and 60,920 shares Class B non-voting common stock (acquired 10-25-83 and 5-30-02)
BOXX TECHNOLOGIES, INC. Austin, Texas Workstations for computer graphics imaging and design.	3,125,354 shares Series B convertible preferre stock, convertible into 3,125,354 shares of common stock at $0.50 per share (acquired 8-20-99 thru 8-8-01)
CMI HOLDING COMPANY, INC. Richardson, Texas Owns Chase Medical, which develops and sells devices used in cardiac surgery to relieve congestive heart failure; develops and supports cardiac imaging systems.	10% convertible subordinated notes, convertibl into 706,144 shares of common stock at $1.32 per share, due 2007 (acquired 4-16-04 thru 12-17-04) 2,327,658 shares Series A convertible preferre stock, convertible into 2,327,658 shares of common stock at $1.72 per share (acquired 8-21-02 and 6-4-03) Warrants to purchase 109,012 shares of common stock at $1.72 per share, expiring 2012 (acquired 4-16-04)

Company	Investment (a)
+COMCAST CORPORATION Philadelphia, Pennsylvania Leading provider of cable, entertainment and communications products and services.	++43,104 shares common stock (acquired 11-18-0
DENNIS TOOL COMPANY Houston, Texas Polycrystalline diamond compacts (PDCs) used in oil field drill bits and in mining and industrial applications.	20,725 shares 5% convertible preferred stock, convertible into 20,725 shares of common stoc at $48.25 per share (acquired 8-10-98) 140,137 shares common stock (acquired 3-7-94 and 8-10-98)
+DISCOVERY HOLDING COMPANY Englewood, Colorado Provider of creative content, media management and network services worldwide.	++70,501 shares Series A common stock (acquired 7-21-05)
+EMBARQ CORPORATION Overland Park, Kansas Local exchange carrier that provides local voice and data services, including	++4,500 shares common stock (acquired 5-17-06

high-speed Internet.	
+ENCORE WIRE CORPORATION McKinney, Texas Electric wire and cable for residential and commercial use.	4,086,750 shares common stock (acquired 7-16-92 thru 10-7-98)
EXTREME INTERNATIONAL, INC. Sugar Land, Texas Owns Bill Young Productions, Texas Video and Post, and Extreme Communications, which produce radio and television commercials and corporate communications videos.	39,359.18 shares Series C convertible preferre stock, convertible into 157,436.72 shares of common stock at $25.00 per share (acquired 9-30-03) 3,750 shares 8% Series A convertible preferred stock, convertible into 15,000 shares of common stock at $25.00 per share (acquired 9-30-03) Warrants to purchase 13,035 shares of common stock at $25.00 per share, expiring 2008 (acquired 8-11-98 thru 9-30-03)
+FMC CORPORATION Philadelphia, Pennsylvania Chemicals for agricultural, industrial and consumer markets.	++6,430 shares common stock (acquired 6-6-86)
+FMC TECHNOLOGIES, INC. Houston, Texas Equipment and systems for the energy, food processing and air transportation industries.	++11,057 shares common stock (acquired 1-2-02)
+HEELYS, INC. Carrollton, Texas Heelys stealth skate shoes sold through sporting goods chains, department stores, footwear retailers and on-line at Heelys.com.	9,317,310 shares common stock (acquired 5-26-0

8

Company	Investment (a)
HIC-STAR CORPORATION Dallas, Texas Holding company previously engaged in mortgage banking operations, which have now been sold.	10% subordinated note due 2007 (acquired 10-19-04 and 1-13-05) 12% subordinated notes due 2008 (acquired 3-25-05 thru 2-27-06) 12% demand note (acquired 12-15-06) Warrants to purchase 463,162 shares of Series common stock at $1.00 per share, expiring 201 (acquired 3-31-04 thru 1-13-05)
+HOLOGIC, INC. Bedford, Massachusetts Medical instruments including bone densitometers, mammography devices and digital radiography systems.	++316,410 shares common stock (acquired 8-27-9
+KIMBERLY-CLARK CORPORATION Dallas, Texas	++77,180 shares common stock (acquired 12-18-9

Manufacturer of tissue, personal care and health care products.	
+LIBERTY GLOBAL, INC. Englewood, Colorado Owns interests in broadband, distribution and content companies.	++42,463 shares Series A common stock (acquired 6-15-05) ++42,463 shares Series C common stock (acquired 9-6-05)
+LIBERTY MEDIA CORPORATION Englewood, Colorado Holding company owning interests in electronic retailing, media, communications and entertainment businesses.	++35,250 shares of Liberty Capital Series A common stock (acquired 5-9-06) ++176,252 shares of Liberty Interactive Series common stock (acquired 5-9-06)
LIFEMARK GROUP Hayward, California Cemeteries, mausoleums and mortuaries located in northern California.	1,449,026 shares common stock (acquired 7-16-6
MEDIA RECOVERY, INC. Graham, Texas Computer and office automation supplies and accessories; impact and tilt monitoring devices to detect mishandled shipments; dunnage for protecting shipments.	800,000 shares Series A convertible preferred stock, convertible into 800,000 shares of com stock at $1.00 per share (acquired 11-4-97) 4,000,000 shares common stock (acquired 11-4-9
PALLETONE, INC. Bartow, Florida Wood pallet manufacturer with 17 pallet manufacturing facilities.	12.3% senior subordinated notes due 2012 (acquired 9-25-06) 150,000 shares common stock (acquired 10-18-01 Warrant to purchase 15,294 shares of common st at $1.00 per share, expiring 2011 (acquired 2-17-06)
+PALM HARBOR HOMES, INC. Dallas, Texas Integrated manufacturing, retailing, financing and insuring of manufactured housing and modular homes.	7,855,121 shares common stock (acquired 1-3-85 thru 7-31-95)

Company	Investment (a)
+PETSMART, INC. Phoenix, Arizona Retail chain of more than 885 stores selling pet foods, supplies and services.	++300,000 shares common stock (acquired 6-1-95
PHARMAFAB, INC. Grand Prairie, Texas Contract manufacturer of branded and generic pharmaceutical drugs; developer of drug delivery technology.	6% convertible subordinated notes, $4,205,616 principal amount, convertible into Series A o B convertible preferred stock, convertible in 560,750 shares of common stock at $7.50 per share, due 2013 (acquired 2-28-06) Warrants to purchase 16,668 shares of Series A or B convertible preferred stock at $100.00

	per share, convertible into 222,240 shares of common stock at $7.50 per share, expiring 2012 and 2013 (acquired 6-16-05 and 2-28-06)
THE RECTORSEAL CORPORATION Houston, Texas Specialty chemicals for plumbing, HVAC, electrical, construction, industrial, oil field and automotive applications; smoke containment systems for building fires; owns 20% of Whitmore Manufacturing Company.	27,907 shares common stock (acquired 1-5-73 and 3-31-73)
+SPRINT NEXTEL CORPORATION Reston, Virginia Diversified telecommunications company.	++90,000 shares common stock (acquired 6-20-8
TCI HOLDINGS, INC. Denver, Colorado Cable television systems and microwave relay systems.	21 shares 12% Series C cumulative compounding preferred stock (acquired 1-30-90)
+TEXAS CAPITAL BANCSHARES, INC. Dallas, Texas Regional bank holding company with banking operations in six Texas cities.	++489,656 shares common stock (acquired 5-1-00
VIA HOLDINGS, INC. Sparks, Nevada Designer, manufacturer and distributor of high-quality office seating.	9,118 shares Series B preferred stock (acquired 9-19-05)
WELLOGIX, INC. Houston, Texas Developer and supporter of software used by the oil and gas industry to control drilling and maintenance expenses.	4,417,815 shares Series A-1 convertible participating preferred stock, convertible in 4,417,815 shares of common stock at $1.1318 p share (acquired 8-19-05 thru 9-15-06)
THE WHITMORE MANUFACTURING COMPANY Rockwall, Texas Specialized mining, industrial and railroad lubricants; coatings for automobiles and primary metals; fluid contamination control devices.	80 shares common stock (acquired 8-31-79)

10

Company	Investment (a)
+WINDSTREAM CORPORATION Little Rock, Arkansas Provider of voice, broadband and entertain-ment services.	++9,181 shares common stock (acquired 7-17-06)
MISCELLANEOUS	- BankCap Partners Fund I, L.P. - 6.2% limited partnership interest (acquired 7-14-06) - Diamond State Ventures, L.P. - 1.9% limited partnership interest (acquired 10-12-99 thru 8-26-05)

- First Capital Group of Texas III, L.P. - 3.3
  limited partnership interest (acquired
  12-26-00 thru 8-12-05)
- Humac Company - 1,041,000 shares common stoc
  (acquired 1-31-75 and 12-31-75)
- STARTech Seed Fund I - 12.1% limited
  partnership interest (acquired 4-17-98 thru
  1-5-00)
- STARTech Seed Fund II - 3.2% limited
  partnership interest (acquired 4-28-00 thru
  2-23-05)
- Sterling Group Partners I, L.P. - 1.7% limit
  partnership interest (acquired 4-20-01 thru
  1-24-05)

TOTAL INVESTMENTS

+Publicly-owned company ++Unrestricted securities as defined in Note (

Notes to Portfolio of Investments

(a) Unrestricted securities (indicated by ++) are freely marketable securities having readily available market quotations. All other securities are restricted securities which are subject to one or more restrictions on resale and are not freely marketable. At December 31, 2006, restricted securities represented approximately 91.6% of the value of the consolidated investment portfolio.

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

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

CAPITAL SOUTHWEST CORPORATION
AND SUBSIDIARIES
Notes to Consolidated Financial Statements

(Unaudited)

1. Basis of Presentation

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

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

2. Stock-Based Compensation

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

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

Effective April 1, 2006, we adopted SFAS 123R using the modified prospective transition method. We recognize compensation cost over the straight-line method for all share-based payments granted on or after that date and for all awards granted to employees prior to April 1, 2006 that remain unvested on that date. The fair value of stock options are determined on the date of grant using the Black-Scholes pricing model and are expensed over the vesting period of the related stock options. Accordingly, for the quarter and nine months ended December 31, 2006, we recognized compensation expense of $43,586 and $125,417, respectively.

The following table illustrates the effect on net asset value and net asset value per share for the nine months ended December 31, 2006 if we had applied the fair value recognition provisions of FASB Statement No. 123 to stock-based compensation for options granted prior to the implementation of FASB Statement No. 123.

Notes to Consolidated Financial Statements
(continued)

	December 31, 2006	December 31, 2005
Net asset value, as reported	$499,587,267	$343,549,462
Deduct: Total fair value computed stock-based compensation	-	113,202
Pro forma net asset value	$499,587,267	$343,436,260
Net asset value per share:		
Basic - as reported	$128.56	$89.07
Basic - pro forma	$ -	$89.04
Diluted - as reported	$128.43	$88.90
Diluted - pro forma	$ -	$88.87

As of December 31, 2006, the total remaining unrecognized compensation cost related to non-vested stock options was $1,215,039, which will be amortized over the weighted-average service period of approximately 7.78 years.

3. Employee Stock Option Plan

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

At December 31, 2006, there were 58,500 shares available for grant under the Plan. The per share weighted-average fair value of the stock options granted on May 15, 2006 was $31.276 per option using the Black-Scholes pricing model with the following assumptions: expected dividend yield of .64%, risk-free interest rate of 5.08%, expected volatility of 21.1%, and expected life of 7 years. The per share weighted-average fair value of the stock options granted on July 17, 2006 was $33.045 per option using the Black-Scholes pricing model with the following assumptions: expected dividend yield of .61%, risk-free interest rate of 5.04%, expected volatility of 21.2%, and expected life of 7 years.

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

	Number of shares	Weighted-Average Exercise Price
Balance at March 31, 2006	45,300	$68.411
Granted	57,500	94.136
Exercised	(25,800)	69.568
Canceled	(24,500)	89.482
Balance at December 31, 2006	52,500	86.184

At December 31, 2006, the range of exercise prices and weighted-average remaining contractual life of outstanding options was $65.00 to $98.44 and 8.03 years, respectively. The total intrinsic value of options exercised during the nine months ended December 31, 2006 was $571,565 with the exercise prices ranging from $65.00 to $77.00 per share. New shares were issued for the $1,794,850 cash received from option exercises for the nine months ended December 31, 2006.

Notes to Consolidated Financial Statements
(continued)

At December 31, 2006, the number of options exercisable was 8,515 and the weighted-average exercise price of those options was $69.15.

4. Summary of Per Share Information

	Three Months Ended December 31		Nine Months Ended December 31	
	2006	2005	2006	200
Investment income	$ .58	$ .38	$ 1.37	$ .9
Operating expenses	(.13)	(.12)	(.40)	(.3
Interest expense	(.04)	(.03)	(.12)	(.0
Income taxes	-	-	(.01)	(.0
Net investment income	.41	.23	.84	.5
Distributions from undistributed net investment income	(.40)	(.40)	(.60)	(.6
Net realized gain on investments	3.29	1.07	4.90	2.9
Net increase in unrealized appreciation of investments after deferred taxes	22.18	2.53	20.86	7.7
Exercise of employee stock options*	(.08)	-	(.21)	
Stock option expense	.01	-	.03	
Increase in net asset value	25.41	3.43	25.82	10.6
Net asset value:				
Beginning of period	103.15	85.64	102.74	78.4
End of period	$128.56	$ 89.07	$128.56	$ 89.0

Increase in deferred taxes on

unrealized appreciation	$ 11.74	$ 1.36	$ 10.79	$ 4.1
Deferred taxes on unrealized appreciation:				
Beginning of period	40.70	33.17	41.65	30.3
End of period	$ 52.44	$ 34.53	$ 52.44	$ 34.5
Shares outstanding at end of period (000s omitted)	3,886	3,857	3,886	3,85

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

5. Recent Accounting Pronouncements

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

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

14

Notes to Consolidated Financial Statements
(continued)

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

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

In September 2006, the FASB issued SFAS No. 158, "Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans." SFAS No. 158 requires employers to fully recognize the obligations associated with single-employer defined benefit pension, retiree healthcare and other post-retirement plans in their financial statements. The provisions of SFAS No.

158 are effective for us as of the end of our fiscal year ending March 31, 2007. We are evaluating the impact of the provisions of this statement on our consolidated financial position, results of operations and cash flows.

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

Net asset value at December 31, 2006 was $499,587,267 equivalent to $128.56 per share after deducting an allowance of $52.44 per share for deferred taxes on net unrealized appreciation of investments. Assuming reinvestment of all dividends and tax credits on retained long-term capital gains, the December 31, 2006 net asset value reflects increases of 27.8% during the preceding three months and 48.4% during the past twelve months.

	December 31, 2006	December 31, 2005
Net assets	$499,587,267	$343,549,462
Shares outstanding	3,886,051	3,857,051
Net assets per share	$128.56	$89.07

Results of Operations

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

by transferring the gain associated with the transaction from being "unrealized" to being "realized". Conversely, when a loss is realized on a depreciated portfolio security, an increase in net unrealized appreciation occurs.

Net Investment Income

Interest income of $1,624,418 in the nine months ended December 31, 2006 increased from $342,806 in the year-ago period due to an increase in excess cash and interest rates and a $631,000 interest payment from a portfolio company for prior interest that had been on a non-accrual basis. During the nine months ended December 31, 2006 and 2005, we recorded dividend income from the following sources:

	Nine Months Ended December 31	
	2006	2005
Alamo Group Inc.	$ 507,834	$ 507,834
Balco, Inc.	-	252,960
Dennis Tool Company	62,499	49,999
Kimberly-Clark Corporation	113,455	104,193
Lifemark Group	450,000	450,000
PalletOne, Inc.	89,842	134,764
The RectorSeal Corporation	1,629,947	866,893
TCI Holdings, Inc	60,953	60,953
The Whitmore Manufacturing Company	180,000	180,000
Other	72,673	132,767
	$3,167,203	$2,740,363

Net Realized Gain on Investments

During the nine months ended December 31, 2006, we reported a realized gain before income taxes of $29,147,137 which included a gain of $31,070,149 on our sale of 1,591,790 shares of Heelys, Inc. and a gain of $8,884,936 on our sale of 500,000 shares of Cenveo, Inc. which were offset by losses of $6,529,167 on Hic-Star Corporation and $5,500,000 on PharmaFab, Inc.

Net Increase in Unrealized Appreciation of Investments

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

	Three Months Ended December 31		Nine Months Ended December 31	
	2006	2005	2006	2005
Encore Wire Corporation	$ (28,608,000)	$20,433,000	$ (20,434,000)	$28,607,000
Heelys, Inc.	140,040,908	4,250,000	170,040,908	12,000,000
Palm Harbor Homes, Inc.	(3,928,000)	-	(27,493,000)	15,710,000
The RectorSeal Corporation	10,500,000	-	10,500,000	2,100,000

On December 8, 2006, we realized a significant gain on the sale of a small fraction of our Heelys investment, and during the nine months ended December 31, 2006, the value of our remaining Heelys stock increased from the March 31, 2006 value by $170,040,908. This was attributable to the dramatic increases in the company's sales and earnings during 2006 and the very strong market interest in the initial public offering of Heelys common stock, which attracted a severalfold over-subscription. This producer of specialty footwear with a removable wheel housed in the heel of the shoe completed the initial public offering of its stock on December 8, 2006, selling a total of 7,393,750 shares at $21.00 per share. A total of 4,268,750 shares were sold by selling stockholders including 1,591,790 shares sold by our Company.

Offsetting part of the major increase in Heelys' value during the nine months ended December 31, 2006 were significant decreases in the values of the restricted stocks of two of our major holdings, which experienced earnings declines in the face of unfavorable industry conditions. These included Palm Harbor Homes and Encore Wire, which decreased in value by $27,493,000 and $20,434,000 respectively.

Portfolio Investments

During the quarter ended December 31, 2006, we made an additional investment of $4,500 in an existing portfolio company.

We have agreed, subject to certain conditions, to invest up to $10,319,820 in three portfolio companies.

Financial Liquidity and Capital Resources

At December 31, 2006, we had cash and cash equivalents of approximately $56.5 million. Pursuant to Small Business Administration ("SBA") regulations, cash and cash equivalents of $2.2 million held by Capital Southwest Venture Corporation ("CSVC") may not be transferred or advanced to us without the consent of the SBA. Under current SBA regulations and subject to SBA's approval of its credit application, CSVC would be entitled to borrow up to $16.4 million. We also have an unsecured $25.0 million revolving line of credit from a commercial bank, of which $17.0 million was available at December 31, 2006. With the exception of a capital gain distribution made in the form of a distribution of the stock of a portfolio company in the fiscal year ended March 31, 1996, we have elected to retain all gains realized during the past 38 years. Retention of future gains is viewed as an important source of funds to sustain our investment activity. Approximately $55.7 million of our investment portfolio is represented by unrestricted publicly-traded securities which represent a source of liquidity.

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

On January 2, 2007, we repaid the $8 million note payable to bank from our cash and cash equivalents.

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

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

Item 3. Quantitative and Qualitative Disclosures About Market Risk

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

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

Our investment in portfolio securities includes fixed rate debt securities which totaled $6,461,886 at December 31, 2006, equivalent to 1.0% of the value of our total investments. Generally these debt securities are below investment grade and have relatively high fixed rates of interest; therefore, minor changes in market yields of publicly-traded debt securities have little or no effect on the values of debt securities in our portfolio and no effect on interest income. Our investments in debt securities are generally held to maturity and their fair values are determined on the basis of the terms of the debt security and the financial condition of the issuer.

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

Item 4. Controls and Procedures

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

During the fiscal quarter ended December 31, 2006, there were no changes to the internal controls over financial reporting that have materially affected, or are reasonably likely to materially affect our internal controls over financial reporting.

PART II. OTHER INFORMATION

Item 1A. Risk Factors

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

Item 6. Exhibits and Reports on Form 8-K

(a) Exhibits

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

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

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

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

(b) Reports on Form 8-K

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

SIGNATURES

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

CAPITAL SOUTHWEST CORPORATION

Date: February 2, 2007	By: /s/ William R. Thomas William R. Thomas, President and Chairman of the Board (chief executive officer)
Date: February 2, 2007	By: /s/ Susan K. Hodgson Susan K. Hodgson, Secretary-Treasurer (chief financial/accounting officer)