

Edgar Filing: CAPITAL SOUTHWEST CORP - Form 10-Q

CAPITAL SOUTHWEST CORP  
Form 10-Q  
August 07, 2008

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

(Mark One)

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

For the quarterly period ended June 30, 2008

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  
(State or other jurisdiction of incorporation  
or organization)

75-1072796  
(I.R.S. Employer  
Identification No.)

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

75230  
(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  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  \_\_\_\_\_ 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

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

3,749,939 shares of Common Stock, \$1 Par Value as of July 31, 2008

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PART I. FINANCIAL INFORMATION

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Item 1. Consolidated Financial Statements

CAPITAL SOUTHWEST CORPORATION AND SUBSIDIARIES  
Consolidated Statements of Financial Condition

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Assets	June 30, 2008	March 31, 2008
	-----	-----
	(Unaudited)	
Investments at market or fair value		
Companies more than 25% owned		
(Cost: June 30, 2008 - \$28,758,246		
March 31, 2008 - \$28,758,246)	\$ 400,144,739	\$ 410,026,178
Companies 5% to 25% owned		
(Cost: June 30, 2008 - \$20,412,243,		
March 31, 2008 - \$20,412,243)	68,538,006	54,895,381
Companies less than 5% owned		
(Cost: June 30, 2008 - \$31,966,518,		
March 31, 2008 - \$31,856,977)	78,740,184	82,648,943
	-----	-----
Total investments		
(Cost: June 30, 2008- \$81,137,007,		
March 31, 2008 - \$81,027,466)	547,422,929	547,570,502
Cash and cash equivalents	30,031,548	31,327,758
Receivables	180,460	156,322
Other assets	7,713,448	7,630,486
	-----	-----
Totals	\$ 585,348,385	\$ 586,685,068
	=====	=====
 Liabilities and Shareholders' Equity		
Other liabilities	\$ 1,686,678	\$ 1,187,796
Deferred income taxes	1,825,558	1,797,058
	-----	-----
Total liabilities	3,512,236	2,984,854
	-----	-----
Shareholders' equity		
Common stock, \$1 par value: authorized,		
5,000,000 shares; issued, 4,326,516 shares		
at June 30, 2008 and March 31, 2008	4,326,516	4,326,516
Additional capital	115,775,142	115,687,153
Undistributed net investment income	6,066,467	7,036,929
Undistributed net realized loss on investments	(2,860,118)	(2,860,118)
Unrealized appreciation of investments	466,285,923	466,543,036
Treasury stock - at cost 443,850 shares at June		
30, 2008 and 437,365 shares at March 31, 2008	(7,757,781)	(7,033,302)
	-----	-----
Net assets at market or fair value, equivalent		
to \$149.85 per share at June 30, 2008 on the		
3,882,666 shares outstanding and \$150.09		
per share at March 31, 2008 on the 3,889,151		
shares outstanding	581,836,149	583,700,214
	-----	-----
Totals	\$ 585,348,385	\$ 586,685,068
	=====	=====

The accompanying Notes are an integral part of these  
Consolidated Financial Statements

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CAPITAL SOUTHWEST CORPORATION  
AND SUBSIDIARIES  
Consolidated Statements of Operations

-----  
(Unaudited)

	Three Months Ended June 30	
	2008	2007
	-----	-----
Investment income:		
Interest	\$ 349,852	\$ 564,687
Dividends	657,480	363,427
Management and directors' fees	231,000	225,200
	-----	-----
	1,238,332	1,153,314
	-----	-----
Operating expenses:		
Salaries	250,450	274,136
Net pension benefit	(81,837)	(36,237)
Other operating expenses	457,233	264,964
	-----	-----
	625,846	502,863
	-----	-----
Income before income taxes	612,486	650,451
Income tax expense	27,287	9,760
	-----	-----
Net investment income	\$ 585,199	\$ 640,691
	=====	=====
Proceeds from disposition of investments	\$ --	\$ 325,775
	-----	-----
Net realized gain on investments	--	325,775
	-----	-----
Net increase (decrease) in unrealized appreciation of investments	(257,114)	17,148,445
	-----	-----
Net realized and unrealized gain (loss) on investments	\$ (257,114)	\$ 17,474,220
	=====	=====
Increase in net assets from operations	\$ 328,085	\$ 18,114,911
	=====	=====

The accompanying Notes are an integral part of these  
Consolidated Financial Statements

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

	Three Months Ended June 30, 2008 ----- (Unaudited)	Year Ended March 31, 2008 -----
Operations		
Net investment income	\$ 585,199	\$ 3,715,200
Net realized gain on investments	--	240,024
Net decrease in unrealized appreciation of investments	(257,114)	(142,969,698)
	-----	-----
Increase (decrease) in net assets from operations	328,085	(139,014,474)
Distributions from:		
Undistributed net investment income	(1,555,660)	(2,333,291)
Capital share transactions:		
Exercise of employee stock options	--	231,390
Change in pension plan funded status	--	(1,178,764)
Stock option expense	87,989	263,664
Treasury stock	(724,479)	--
	-----	-----
Decrease in net assets	(1,864,065)	(142,031,475)
Net assets, beginning of period	583,700,214	725,731,689
	-----	-----
Net assets, end of period	\$ 581,836,149 =====	\$ 583,700,214 =====

The accompanying Notes are an integral part of these  
Consolidated Financial Statements

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CAPITAL SOUTHWEST CORPORATION  
AND SUBSIDIARIES  
Consolidated Statements of Cash Flows

(Unaudited)

	Three Months Ended June 30	
	2008	2007
Cash flows from operating activities		
Increase in net assets from operations	\$ 328,085	\$ 18,114,911
Adjustments to reconcile increase in net assets from operations to net cash provided by (used in) operating activities:		
Proceeds from disposition of investments	--	325,775
Purchases of securities	(109,541)	(8,051,747)
Maturities of securities	--	4,500
Depreciation and amortization	9,269	4,409
Net pension benefit	(81,837)	(36,237)
Realized gain on investments before income taxes	--	(325,775)
Net (increase) decrease in unrealized appreciation of investments	257,114	(17,148,445)
Stock option expense	87,989	43,586
(Increase) decrease in receivables	(24,136)	184,920
(Increase) decrease in other assets	2,578	(6,729)
Increase (decrease) in other liabilities	520,375	(119,163)
Decrease in accrued pension liability	(34,467)	(36,568)
Increase in deferred income taxes	28,500	12,600
Net cash provided by (used in) operating activities	983,929	(7,033,963)
Cash flows from financing activities		
Distributions from undistributed net investment income	(1,555,660)	(777,630)
Proceeds from exercise of employee stock options	--	231,390
Purchase of Treasury Stock	(724,479)	--
Net cash used in financing activities	(2,280,139)	(546,240)
Net decrease in cash and cash equivalents	(1,296,210)	(7,580,203)
Cash and cash equivalents at beginning of period	31,327,758	38,844,203
Cash and cash equivalents at end of period	\$ 30,031,548	\$ 31,264,000
Supplemental disclosure of cash flow information:		
Cash paid during the period for:		
Interest	\$ --	\$ --
Income taxes	\$ --	\$ --

The accompanying Notes are an integral part of these Consolidated Financial Statements

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CAPITAL SOUTHWEST CORPORATION  
AND SUBSIDIARIES  
Consolidated Statement of Investments

-----  
June 30, 2008

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. Seguin, Texas Tractor-mounted mowing and mobile excavation equipment for governmental, industrial and agricultural markets; street- sweeping equipment for municipalities.	2,830,300 shares common stock (acquired 4-1-73 thru 5-25-07)
ALL COMPONENTS, INC. Austin, Texas Electronics contract manufacturing; distribution and production of memory and other components for computer manufacturers, retailers and value-added resellers.	8.25% subordinated note due 2012 (acquired 6-27- 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) Warrants to purchase 350,000 shares of common stock at \$11.00 per share, expiring 2017 (acquired 6-
ATLANTIC CAPITAL BANCSHARES, INC. Atlanta, Georgia Holding company of Atlantic Capital Bank a full service commercial bank.	300,000 shares common stock (acquired 4-10-07)
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 graphic imaging and design.	3,125,354 shares Series B Convertible Preferred convertible into 3,125,354 shares of common stock at \$0.50 per share (acquired 8-20-99 thru 8-8-
CMI HOLDING COMPANY, INC. Richardson, Texas Owens 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 note, due 2009, (acquired 7-2-07 thru 10-9-07) 2,327,658 shares Series A Convertible Preferred convertible into 2,327,658 shares of common stock at \$1.72 per share (acquired 8-21-02 and 6- Warrants to purchase 109,012 shares of common stock at \$1.72 per share, expiring 2012 (acquired 4- Warrant to purchase 431,982 shares of Series A-1 Convertible Preferred Stock at \$1.72 per share

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expiring 2017 (acquired 7-2-07)

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CAPITAL SOUTHWEST CORPORATION  
AND SUBSIDIARIES  
Consolidated Statement of Investments

June 30, 2008  
(continued)

Company	Investment (a)
+COMCAST CORPORATION Philadelphia, Pennsylvania Leading provider of cable, entertainment and communications products and services.	++64,656 shares common stock (acquired 11-18-02)
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 stock at \$48.25 per share (acquired 8-10-98) 140,137 shares common stock (acquired 3-7-94 and 8-10-98)
+DISCOVERY HOLDING COMPANY Englewood, Colorado Provider of creative content, media management and network services worldwide.	++70,501 shares Series A common stock (acquired
+EMBARQ CORPORATION Overland Park, Kansas Local exchange carrier that provides voice and data services, including high-speed Internet.	++4,500 shares common stock (acquired 5-17-06)
+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 Communi- cations, which produce radio and television commercials and corporate communica- tions videos.	39,359.18 shares Series C Convertible Preferred convertible into 157,436.72 shares of common s at \$25.00 per share (acquired 9-30-03) 3,750 shares 8% Series A Convertible Preferred S convertible into 15,000 shares of common stock \$25.00 per share (acquired 9-30-03) Warrants to purchase 13,035 shares of common sto \$25.00 per share, expiring 2008 (acquired 8-11 thru 9-30-03)



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<p>+FMC CORPORATION          Philadelphia, Pennsylvania          Chemicals for agricultural, industrial          and consumer markets.</p>	<p>++12,860 shares common stock (acquired 6-6-86          and 9-13-07)</p>
<p>+FMC TECHNOLOGIES, INC.          Houston, Texas          Equipment and systems for the energy,          food processing and air transportation          industries.</p>	<p>++22,114 shares common stock (acquired 1-2-02          and 8-31-07)</p>

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CAPITAL SOUTHWEST CORPORATION  
 AND SUBSIDIARIES  
 Consolidated Statement of Investments

-----  
 June 30, 2008  
 (continued)

Company	Investment (a)
<p>+HEELYS, INC.          Carrollton, Texas          Heelys stealth skate shoes, equipment          and apparel sold through sporting goods          chains, department stores and footwear          retailers.</p>	<p>9,317,310 shares common stock (acquired 5-26-00)</p>
<p>+HOLOGIC, INC.          Bedford, Massachusetts          Medical instruments including bone          densitometers, mammography devices          and digital radiography systems.</p>	<p>++632,820 shares common stock (acquired 8-27-99)</p>
<p>+KIMBERLY-CLARK CORPORATION          Dallas, Texas          Manufacturer of tissue, personal care          and health care products.</p>	<p>++77,180 shares common stock (acquired 12-18-97)</p>
<p>+LIBERTY GLOBAL, INC.          Englewood, Colorado          Owns interests in broadband, distribution          and content companies.</p>	<p>++42,463 shares Series A common stock (acquired          ++42,463 shares Series C common stock (acquired</p>
<p>+LIBERTY MEDIA CORPORATION          Englewood, Colorado          Holding company owning interests in          electronic retailing, media, communica-          tions and entertainment businesses.</p>	<p>++35,250 shares of Liberty Capital Series A comm          stock (acquired 5-9-06)          ++176,252 shares of Liberty Interactive Series A          common stock (acquired 5-9-06)          ++141,000 shares of Liberty Entertainment Series          common stock (acquired 3-3-08)</p>

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<p>LIFEMARK GROUP            Hayward, California            Cemeteries, mausoleums and mortuaries            located in northern California.</p>	<p>1,449,026 shares common stock (acquired 7-16-69)</p>
<p>MEDIA RECOVERY, INC.            Dallas, Texas            Computer datacenter and office automation            supplies and accessories; impact, tilt            monitoring and temperature sensing            devices to detect mishandling shipments;            dunnage for protecting shipments.</p>	<p>800,000 shares Series A Convertible Preferred Stock            convertible into 800,000 shares of common stock            \$1.00 per share (acquired 11-4-97)            4,000,002 shares common stock (acquired 11-4-97)</p>
<p>PALLETONE, INC.            Bartow, Florida            Manufacturer of wooden pallets and            pressure-treated lumber.</p>	<p>12.3% senior subordinated notes due 2012            (acquired 9-25-06)            150,000 shares common stock (acquired 10-18-01)            Warrant to purchase 15,294 shares of common stock            \$1.00 per share, expiring 2011 (acquired 2-17-01)</p>

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CAPITAL SOUTHWEST CORPORATION  
 AND SUBSIDIARIES  
 Consolidated Statement of Investments  
 -----  
 June 30, 2008  
 (continued)

Company	Investment (a)
-----	
<p>+PALM HARBOR HOMES, INC.            Dallas, Texas            Integrated manufacturing, retailing,            financing and insuring of manufactured            housing and modular homes.</p>	<p>7,855,121 shares common stock (acquired 1-3-85            thru 7-31-95)</p>
<p>+PETSMART, INC.            Phoenix, Arizona            Retail chain of more than 928 stores            selling pet foods, supplies and services.</p>	<p>++300,000 shares common stock (acquired 6-1-95)</p>
<p>THE RECTORSEAL CORPORATION            Houston, Texas            Specialty chemicals for plumbing, HVAC,            electrical, construction, industrial,            oil field and automotive applications;            smoke containment systems for building            fires; also owns 20% of The Whitmore            Manufacturing Company.</p>	<p>27,907 shares common stock (acquired 1-5-73            and 3-31-73)</p>
<p>+SPRINT NEXTEL CORPORATION            Reston, Virginia            Diversified telecommunications company.</p>	<p>++90,000 shares common stock (acquired 6-20-84)</p>

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<p>TCI HOLDINGS, INC.                  Denver, Colorado                  Cable television systems and microwave relay systems.</p>	<p>21 shares 12% Series C Cumulative Compounding Preferred stock (acquired 1-30-90)</p>
<p>+TEXAS CAPITAL BANCSHARES, INC.                  Dallas, Texas                  Regional bank holding company with banking operations in six Texas cities.</p>	<p>++489,656 shares common stock (acquired 5-1-00)</p>
<p>VIA HOLDINGS, INC.                  Sparks, Nevada                  Designer, manufacturer and distributor of high-quality office seating.</p>	<p>9,118 shares Series B Preferred Stock (acquired 9-19-05)                  1,118 shares Series C Preferred Stock (acquired 11-01-07)</p>
<p>WELLOGIX, INC.                  Houston, Texas                  Developer and supporter of software used by the oil and gas industry to control drilling and maintenance expenses.</p>	<p>4,788,371 shares Series A-1 Convertible Participating Preferred Stock, convertible into 4,788,371 shares of common stock at \$1.0441 per share (acquired 8-19-05 thru 6-15-08)</p>
<p>THE WHITMORE MANUFACTURING COMPANY                  Rockwall, Texas                  Specialized mining, railroad and industrial lubricants; coatings for automobiles and primary metals; fluid contamination control devices.</p>	<p>80 shares common stock (acquired 8-31-79)</p>

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CAPITAL SOUTHWEST CORPORATION  
 AND SUBSIDIARIES  
 Consolidated Statement of Investments

June 30, 2008  
 (continued)

Company	Investment (a)
<p>+WINDSTREAM CORPORATION                  Little Rock, Arkansas                  Provider of voice, broadband and entertainment services.</p>	<p>++9,181 shares common stock (acquired 7-17-06)</p>
<p>MISCELLANEOUS</p>	<ul style="list-style-type: none"> <li>- BankCap Partners Fund I, L.P. - 6.0% limited partnership interest (acquired 7-14-06 thru 6-23-08)</li> <li>- CapitalSouth Partners Fund III, L.P. - 2.8% limited partnership interest (acquired 1-22-08)</li> <li>- Diamond State Ventures, L.P. - 1.9% limited partnership interest (acquired 10-12-99 thru 8-26-05)</li> <li>- First Capital Group of Texas III, L.P. - 3.3% limited partnership interest (acquired 12-26-00 thru 8-12-05)</li> </ul>

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- Humac Company - 1,041,000 shares common stock (acquired 1- and 12-31-75)
- PharmaFab, Inc. - contingent payment agreement (acquired 2
- STARTech Seed Fund I - 12.1% limited partnership interest (acquired 4-17-98 thru 1-5-00)
- STARTech Seed Fund II - 3.2% limited partnership interest (acquired 4-28-00 thru 2-23-05)
- Sterling Group Partners I, L.P. - 1.7% limited partnership interest (acquired 4-20-01 thru 1-24-05)

-----  
TOTAL INVESTMENTS  
-----

+Publicly-owned company

++Unrestricted securities as defined in Note (a)

Notes to Portfolio of Investments  
-----

(a) Definitions

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 restriction on resale and are not freely marketable. At June 30, 2008, restricted securities represented approximately 91.1% of the value of the consolidated investment portfolio.

(b) Investment Valuation Policy

Our investments are carried at fair value in accordance with the 1940 Act and SFAS No. 157, Fair Value Measurements ("SFAS No. 157"). In accordance with the 1940 Act, unrestricted minority-owned publicly traded securities, for which the market quotations are readily available, are valued at the closing sale price for the NYSE listed securities and the lower of the closing bid price or the last sale price for NASDAQ securities on the valuation date; and restricted publicly traded securities and other privately held securities are valued as determined in good faith by our Board of Directors.

We adopted SFAS No. 157 on April 1, 2008 (see footnote 1 in "Notes to Consolidated Financial Statements," page 13). SFAS No. 157 provides a framework for measuring the fair value of assets and liabilities. SFAS No. 157 also provides guidance regarding a fair value hierarchy, which prioritizes information used to measure fair value and the effect of fair value measurements on earnings and provides for enhanced disclosures determined by the level within the hierarchy of information used for valuation. SFAS No. 157 applies whenever other standards require (or permit) assets or liabilities to be measured at fair value but does not expand the use of fair value in any new circumstances.

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Notes to Portfolio of Investments  
(continued)

SFAS No. 157 defines fair value in terms of the price that would be received upon the sale of an asset or paid to transfer a liability in an orderly

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transaction between market participants at the measurement date (the "exit price") and excludes transaction costs. Under SFAS No. 157, the fair value measurement also assumes that the transaction to sell an asset occurs in the principal market for the asset or, in the absence of a principal market, the most advantageous market for the asset. The principal market is the market in which the reporting entity would sell or transfer the asset with the greatest volume and level of activity for the asset. In determining the principal market for an asset or liability under SFAS No. 157, it is assumed that the reporting entity has access to the market as of the measurement date.

### (c) Valuation Methodologies

Debt Securities are generally valued on the basis of the price the security would command in order to provide a yield-to-maturity equivalent to the present yield of comparable debt instruments of similar quality.

Partnership Interests and Common Equity including unrestricted marketable securities, which are valued at the closing sale price for the NYSE listed securities and the lower of the closing bid price or the last sale price for NASDAQ securities on the valuation date; and restricted marketable securities for which there is a public market, are valued at the closing sale price for the NYSE listed securities and the lower of the closing bid price or the last sale price for NASDAQ securities on the valuation date adjusted in good faith by our Board of Directors if they deem a discount or premium would be likely or obtainable upon a sale or transfer of our interest, for those without a principal market, the Board of Directors consider 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; protective put analysis based on the Black-Scholes option pricing model, 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.

Preferred Equity are valued the basis of the price (bond value) the security would carry in the absence of the conversion feature plus the value allocable to the conversion feature (conversion value).

Equity Warrants are valued on the basis of accepted formulas derived from empirical studies which define the market value of a warrant in relation to the market price of its common stock. These formulas measure the "option value" of a warrant as well as its "exercise value" (the amount, if any, by which the value of the stock exceeds the exercise price of the warrant). In apply such formulas, the market price of the stock is usually discounted to reflect the fact that the stock is restricted and the calculated value is of the warrant itself may be discounted (if deemed appropriate) to reflect its restrictive nature. Generally, the option value is excluded if the formula indicates (i) the warrant expires within six months, (ii) the market price of the stock (discounted) is less than one-half of the exercise price of the warrant. Or (iii) the market price of the stock (discounted) is more than two times the amount of the exercise price of the warrant.

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## CAPITAL SOUTHWEST CORPORATION AND SUBSIDIARIES

### Notes to Consolidated Financial Statements

-----  
(Unaudited)

#### 1. Basis of Presentation

**Principles of Consolidation.** The consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America ("GAAP") 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 Form 10-K for the year ended March 31, 2008. 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.

**Fair Value Measurements.** The Company adopted SFAS No. 157, Fair Value Measurements ("SFAS 157"), on April 1, 2008. SFAS 157 (1) creates a single definition of fair value, (2) establishes a framework for measuring fair value, and (3) expands disclosure requirements about items measured at fair value. The Statement applies to both items recognized and reported at fair value in the financial statements and items disclosed at fair value in the notes to the financial statements. The Statement does not change existing accounting rules governing what can or what must be recognized and reported at fair value in the Company's financial statements, or disclosed at fair value in the Company's notes to the financial statements. Additionally, SFAS 157 does not eliminate practicability exceptions that exist in accounting pronouncements amended by this Statement when measuring fair value. As a result, the Company will not be required to recognize any new assets or liabilities at fair value.

Prior to SFAS 157, certain measurements of fair value were based on the price that would be paid to acquire an asset, or received to assume a liability (an entry price). SFAS 157 clarifies the definition of fair value as the price that would be received to sell an asset, or paid to transfer a liability, in an orderly transaction between market participants at the measurement date (that is, an exit price). The exit price is based on the amount that the holder of the asset or liability would receive or need to pay in an actual transaction (or in a hypothetical transaction if an actual transaction does not exist) at the measurement date. In some circumstances, the entry and exit price may be the same; however, they are conceptually different.

Fair value is generally determined based on quoted market prices in the active markets for identical assets or liabilities. If quoted market prices are not available, the Company uses valuation techniques that place greater reliance on observable inputs and less reliance on unobservable inputs. In measuring fair value, the Company may make adjustments for risks and uncertainties, if a market participant would include such an adjustment in its pricing.

Notes to Consolidated Financial Statements  
(continued)

## 2. Investments

We fair value our investments in accordance with GAAP as determined in good faith by our Board of Directors. When available we base the fair value of our investments on directly observable market prices or on market data derived for comparable assets. For all other investments, inputs used to measure fair value reflect management's best estimate of assumptions that would be used by market participants in pricing the investments in a hypothetical transaction.

The levels of fair value inputs used to measure our investments are characterized in accordance with the fair value hierarchy established by SFAS No. 157, Fair Value Measurements ("SFAS 157"). Where inputs for an asset or liability fall in more than one level in the fair value hierarchy, the investment is classified in its entirety based on the lowest level input that is significant to that investment's fair value measurement. We use judgment and consider factors specific to the investment in determining the significance of an input to a fair value measurement. The three levels of the fair value hierarchy and investments that fall into each of the levels are described below:

- o Level 1: Level 1 inputs are unadjusted quoted prices in active markets that are accessible at the measurement date for identical, unrestricted assets or liabilities. We use Level 1 inputs for publicly traded unrestricted securities for which we do not have a controlling interest. Such investments are valued at the closing price for listed securities and at the lower of the closing bid price or the closing sale price for over-the-counter (NASDAQ) securities on the valuation date.
- o Level 2: Level 2 inputs are inputs other than the quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly. We did not value any of our investments using level 2 inputs as of June 30, 2008.
- o Level 3: Level 3 inputs are unobservable and cannot be corroborated by observable market data. We use Level 3 inputs for measuring the fair value of substantially all of our investments. See "Notes to Portfolio of Investments" (c) on page 12 for the investment policy used to determine the fair value of these investments.

The following fair value hierarchy table sets forth our investment portfolio by level as of June 30, 2008 (in millions):

	Level 1 -----	Level 2 -----	Level 3 -----	Total -----
Debt	\$-	\$-	\$9.0	\$9.0
Partnership Interests	-	-	9.2	9.2
Preferred Equity	-	-	21.8	21.8
Common Equity	48.7	-	458.4	507.1
Equity Warrants	-	-	.3	.3
	-----	-----	-----	-----
Total Investments	\$48.7	\$-	\$498.7	\$547.4

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The following table sets forth a summary of changes in the fair value of investment assets and liabilities measured using Level 3 inputs during the three month period ended June 30, 2008 (in millions):

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Notes to Consolidated Financial Statements  
(continued)

	Beginning Balance	Unrealized gain (loss)	Purchases, Sales, Issuance & Settlement
	-----	-----	-----
Debt	\$9.0	\$-	\$-
Partnership Interests	9.1	-	0.1
Preferred Equity	21.8	-	-
Common Equity	507.3	(0.2)	-
Equity Warrants	0.4	(0.1)	-
	-----	-----	-----
Total Investments	\$547.6	(\$0.3)	\$0.1
	=====	=====	=====

3. Stock-Based Compensation

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 ended June 30, 2008, we recognized compensation expense of \$87,989.

As of June 30, 2008, the total remaining unrecognized compensation cost related to non-vested stock options was \$1,707,846, which will be amortized over the weighted-average service period of approximately 5.7 years.

4. 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 of the Company and authorizes the issuance of common stock upon exercise of such options for up to 140,000 shares. All options are granted at or above market price, 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 June 30, 2008, there were 37,500 shares available for grant under the Plan. The per share weighted-average fair value of the stock options granted on May 15, 2006 was \$31.28 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 \$33.05 per option using the Black-Scholes pricing model with the



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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 per share weighted-average fair value of the stock options granted on July 16, 2007 was \$41.78 per option using the Black-Scholes pricing model with the following assumptions: expected dividend yield of .39%, risk-free interest rate of 4.95%, expected volatility of 19.9%, and expected life of 5 years.

The following summarizes activity in the stock option plan since June 30, 2008:

	Number of shares -----	Weighted-Average Exercise Price -----
Balance at March 31, 2008	70,400	\$109.99
Granted	-	-
Exercised	-	-
Canceled	-	-
	-----	-----
Balance at June 30, 2008	70,400 =====	\$109.99 =====

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### Notes to Consolidated Financial Statements (continued)

At June 30, 2008, the range of exercise prices and weighted-average remaining contractual life of outstanding options was \$65.00 to \$152.98 and 5.66 years, respectively. No options were exercised during the three months ended June 30, 2008.

At June 30, 2008, the number of options exercisable was 13,445 and the weighted-average exercise price of those options was \$83.17.

#### 5. Summary of Per Share Information

	Three Months Ended June 30 -----	
	2008 -----	2007 -----
Investment income	\$ .32	\$ .30
Operating expenses	(.16)	(.13)
Interest expense	--	--
Income taxes	(.01)	--
	-----	-----
Net investment income	.15	.17
Distributions from undistributed net investment income	(.40)	(.20)
Net realized gain on investments	--	.08
Net increase (decrease) in unrealized appreciation of investments	(.07)	4.41
Treasury stock repurchase *	.06	--
Exercise of employee stock options **	--	(.09)
Stock option expense	.02	.01
	-----	-----
Increase (decrease) in net asset value	(.24)	4.38

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Net asset value:

Beginning of period	150.09	186.75	
	-----	-----	
End of period	\$ 149.85	\$ 191.13	
	=====	=====	

Shares outstanding at end of period  
(000s omitted)

	3,882	3,886	
--	-------	-------	--

\* Net increase is due to purchases of Common Stock at prices less than beginning period net asset value.

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

### 6. Share Repurchase Plan

On June 12, 2008, the Company announced that its Board of Directors authorized a share repurchase plan, which allows for the repurchase of up to 10 percent (or 388,915 shares) of its Common Stock at prices not above the lower of the net asset value per share of its Common Stock, or prices prevailing in the over-the-counter market at the time of such purchases. The Company anticipates that share purchases will be made from time to time, depending upon market conditions. Shares may be purchased on the open market, including block repurchases, or through privately negotiated transactions. The Company does not intend to purchase any shares from its directors, officers or other affiliates. The repurchase program does not obligate the Company to acquire any specific number of shares and may be discontinued at any time. The Company intends to fund the purchases with available cash and or the sale of marketable securities readily available for sale. The repurchase program is expected to be in effect through December 10, 2008, or until the approved number of shares has been repurchased. During the quarter ended June 30, 2008, the Company purchased a total of 6,485 shares of its Common Stock on the open market for \$724,479 at an average price of \$111.72 per share.

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Notes to Consolidated Financial Statements  
(continued)

### 7. Subsequent Events

In July 2008, Gary L. Martin was named Chairman of the Board, Tracy L. Morris was named Treasurer and Chief Financial Officer, and William R. Thomas III was named Assistant Vice President.

In July 2008, the Company purchased 132,727 shares of its Common Stock on the open market for \$15,141,572 at an average price of \$114.08, which resulted in cumulative year-to-date purchases of 139,212 shares or 35.8% of the 388,915 shares approved by its Board of Directors on June 12, 2008.

### 8. Recent Accounting Pronouncements

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 financial statements issued for fiscal years beginning after November 15,

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2007, and interim periods within those fiscal years. The Company has adopted this statement on a prospective basis beginning in the quarter ended June 30, 2008. Adoption of this statement did not have a material effect on the Company's consolidated financial statements for the period ended June 30, 2008. However the impact on its consolidated financial statements for the periods subsequent to the period of adoption cannot be determined at this time as it will be influenced by the estimates of fair value for those periods, the number and amount of investments the Company originates, acquires or exits, and the effect of any additional guidance or any changes in the interpretation of this statement.

In February 2007, the FASB issued SFAS No. 159, "The Fair Value Option for Financial Assets and Financial Liabilities" (SFAS 159). SFAS 159 permits entities to choose to measure many financial instruments and certain other items at fair value and establishes presentation and disclosure requirements designed to facilitate comparisons between entities that choose different measurement attributes for similar types of assets and liabilities. SFAS 159 is effective for us beginning April 1, 2008. We did not elect the fair value option provisions upon adoption of SFAS 159 on April 1, 2008.

In February 2008, the FASB issued FASB Staff Position ("FSP") SFAS 157-2, "Effective Date of FASB Statement No. 157" (FSP 157-2), which defers the effective date of SFAS 157 to fiscal years beginning after November 15, 2008, and interim periods within those fiscal years, for all nonfinancial assets and nonfinancial liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). We are currently evaluating the impact of our adoption of FSP 157-2 effective April 1, 2009 on our consolidated financial statements.

### Item 2. Managements Discussion and Analysis of Financial Condition and Results of Operations

Net asset value at June 30, 2008 was \$581,836,149, equivalent to \$149.85 per share. Assuming reinvestment of all dividends and tax credits on retained long-term capital gains, the June 30, 2008 net asset value reflects a decrease of 21.2% during the past twelve months.

	June 30, 2008 ----	June 30, 2007 ----
Net assets	\$581,836,149	\$743,343,946
Shares outstanding	3,882,666	3,889,151
Net assets per share	\$149.85	\$191.13

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### Item 2. Managements Discussion and Analysis of Financial Condition and Results of Operations (continued)

#### Results of Operations

The composite measure of our financial performance in the Consolidated Statements of Operations is captioned "Increase (decrease) 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

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fees and our combined operating and interest expenses, net of applicable income taxes. The second element is "Net realized gain (loss) on investments", which is the difference between the proceeds received from disposition of portfolio securities and their stated cost. The third element is the "Net increase (decrease) in unrealized appreciation of investments", which is the net change in the market or fair value of our investment portfolio, compared with stated cost. It should be noted that the "Net realized gain (loss) on investments" and "Net increase (decrease) 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 "unrealized" to "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 \$349,852 for the three months ended June 30, 2008 decreased from \$564,687 in the year-ago period due to an decrease in interest rates. During the three months ended June 30, 2008 and 2007, we recorded dividend income from the following sources:

	Three Months Ended June ----	
	2008 ----	2007 ----
Alamo Group Inc.	\$169,818	\$169,278
Dennis Tool Company	12,500	25,000
Encore Wire Corporation	81,735	81,735
Kimberly-Clark Corporation	44,764	40,905
The RectorSeal Corporation	240,000	--
TCI Holdings, Inc.	20,318	20,318
The Whitmore Manufacturing Company	60,000	--
Other	28,345	26,191
	-----	-----
	\$657,480	\$363,427
	=====	=====

### Net Increase (Decrease) in Unrealized Appreciation of Investments

Set forth in the following table are the significant increases and decreases in unrealized appreciation by portfolio company:

	Three Months Ended June ----	
	2008 ----	2007 ----
Encore Wire Corporation	\$14,303,625	\$ 6,130,000
Heelys, Inc.	--	(9,318,000)
Palm Harbor Homes, Inc.	3,927,561	--
The RectorSeal Corporation	(15,000,000)	10,850,000

During the three months ended June 30, 2008, the value of our investment in The RectorSeal Corporation was decreased by \$15,000,000 due to decreased sales resulting from slow downs in the residential and commercial construction segments of its business.

Offsetting the loss at RectorSeal during the three months ended June 30, 2008, was a \$14,303,625 increase in the value of Encore Wire Corporation and a \$3,927,561 increase in the value of Palm Harbor Homes, Inc. due to increases in their respective stock prices.

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

Portfolio Investments

During the quarter ended June 30, 2008, we made additional investments of \$109,541 in an existing portfolio company.

We have agreed, subject to certain conditions, to invest up to \$19,318,963 in five portfolio companies.

Financial Liquidity and Capital Resources

At June 30, 2008, we had cash and cash equivalents of approximately \$30.0 million. Pursuant to Small Business Administration (SBA) regulations, cash and cash equivalents of \$4.6 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 \$17.0 million. 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 39 years. Retention of future gains is viewed as an important source of funds to sustain our investment activity. Approximately \$48.7 million of our investment portfolio is represented by unrestricted publicly-traded securities, and represent a source of liquidity.

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 Disclosure About Market Risk

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

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

Our investment in portfolio securities includes fixed-rate debt

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securities which totaled \$9,000,000 at June 30, 2008, equivalent to 1.6% 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.

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

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

### Item 4. Controls and Procedures

As of the end of the period covered by this report, an evaluation was performed under the supervision and with the participation of our management, including the President and Chairman of the Board and Chief Financial Officer, 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 Chief Financial Officer 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 Chief Financial Officer, as appropriate, to allow timely decisions regarding such required disclosure.

During the fiscal quarter ended June 30, 2008, 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

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### Item 1. Legal Proceedings

We are currently the subject of certain legal actions. In our judgment,

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none of the lawsuits currently pending against us, either individually or in the aggregate, is likely to have a material adverse effect on our business, results of operations, or financial position.

We, Capital Southwest Corporation and Capital Southwest Venture Corporation, have been named in a lawsuit filed on August 27, 2007 in the United States District Court of the Northern District of Texas, Dallas Division, against Heelys, Inc and its Chief Executive Officer, Chief Financial Officer and the directors who signed its registration statement with the Securities and Exchange Commission in connection with its December 7, 2006 initial public offering ("IPO"), and its underwriters for the IPO. The complaint alleges violations of Sections 11 and 15 of the Securities Act of 1933 and the plaintiffs are seeking compensatory damages in an unspecified amount, as well as reasonable costs and expenses incurred in the action, including counsel fees and expert fees.

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### Item 1. Legal Proceedings (continued)

Similar suits were also filed in 2007 and 2008 in the United States District Court of the Northern District of Texas making substantially similar allegations under Sections 11, 12 and 15 of the Securities Act of 1933, and seeking substantially similar damages. These lawsuits have been transferred to a single judge, and we expect that all the cases will be consolidated into a single action, with a consolidated complaint filed shortly thereafter.

We believe that the plaintiffs' claims are without merit, we deny the allegations in the complaints, and we intend to vigorously defend the lawsuits.

### 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, 2008.

### Item 6. Exhibits and Reports on Form 8-K

- (a) Exhibits
  - Exhibit 31.1- Certification of President 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 Chief Financial Officer required by Rule 13a-14(a) or Rule 15d-14(a) of the Exchange Act, filed herewith.
  - Exhibit 32.1- Certification of President 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 Chief Financial Officer 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

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Current report on Form 8-K filed with the SEC on June 12, 2008 relating to the share repurchase plan that was recently approved by the Company's Board of Directors. Under this Plan, the Company may repurchase up to 10 percent (or 388,915 shares) of its Common Stock at prices not above the lower of the net asset value per share of its Common Stock, or prices prevailing in the over-the-counter market at the time of such purchases.

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SIGNATURES

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

CAPITAL SOUTHWEST CORPORATION

Date: August 7, 2008  
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By: /s/ Gary L. Martin  
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Gary L. Martin, President and  
Chairman of the Board

Date: August 7, 2008  
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By: /s/ Tracy L. Morris  
-----  
Tracy L. Morris, Chief Financial Officer



