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CAPITAL SOUTHWEST CORP  
Form 10-Q  
August 03, 2007

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, 2007

OR

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

For the transition period from .....to .....

Commission File Number: 814-61

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.

3,889,151 shares of Common Stock, \$1 Par Value as of July 31, 2007

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PART I. FINANCIAL INFORMATION

Item 1. Consolidated Financial Statements

CAPITAL SOUTHWEST CORPORATION AND SUBSIDIARIES  
Consolidated Statements of Financial Condition

Assets	June 30, 2007 ----- (Unaudited)	March 31, 2007 -----
Investments at market or fair value		
Companies more than 25% owned		
(Cost: June 30, 2007 - \$28,758,246		
March 31, 2007 - \$28,632,356)	\$537,279,981	\$526,993,983
Companies 5% to 25% owned		
(Cost: June 30, 2007 - \$18,948,896		
March 31, 2007 - \$18,798,896)	81,892,002	76,398,002
Companies less than 5% owned		
(Cost: June 30, 2007 - \$31,982,402		
March 31, 2007 - \$24,211,045)	87,178,742	77,763,048
	-----	-----
Total investments		
(Cost: June 30, 2007 - \$79,689,544		
March 31, 2007 - \$71,642,297)	706,350,725	681,155,033
Cash and cash equivalents	31,264,000	38,844,203
Receivables	152,972	337,892
Other assets	9,227,147	9,170,185
	-----	-----
Totals	\$746,994,844	\$729,507,313
	=====	=====
 Liabilities and Shareholders' Equity		
Other liabilities	\$ 1,320,521	\$ 1,457,847
Income taxes payable	231,274	231,274
Deferred income taxes	219,604,301	213,474,680
	-----	-----
Total liabilities	221,156,096	215,163,801
	-----	-----
 Shareholders' equity		
Common stock, \$1 par value: authorized,		
5,000,000 shares; issued, 4,326,516 shares		
at June 30, 2007 and 4,323,416 shares		
at March 31, 2007	4,326,516	4,323,416
Additional capital	11,493,477	11,221,601
Undistributed net investment income	5,518,081	5,655,020
Undistributed net realized gain on investments	102,977,794	102,766,040
Unrealized appreciation of investments -		
net of deferred income taxes	408,556,182	397,410,737
Treasury stock - at cost (437,365 shares)	(7,033,302)	(7,033,302)
	-----	-----
Net assets at market or fair value, equivalent		
to \$135.21 per share at June 30, 2007 on		
the 3,889,151 shares outstanding and \$132.36		
per share at March 31, 2007 on the 3,886,051		

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shares outstanding	525,838,748	514,343,512
	-----	-----
Totals	\$746,994,844	\$729,507,313
	=====	=====

(See Notes to Consolidated Financial Statements)

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CAPITAL SOUTHWEST CORPORATION  
AND SUBSIDIARIES  
Consolidated Statements of Operations

-----  
(Unaudited)

	Three Months Ended June 30	
	2007	2006
	-----	-----
Investment income:		
Interest	\$ 564,687	\$ 205,852
Dividends	363,427	782,566
Management and directors' fees	225,200	198,450
	-----	-----
	1,153,314	1,186,868
	-----	-----
Operating expenses:		
Salaries	274,136	343,465
Net pension benefit	(36,237)	(29,187)
Other operating expenses	264,964	221,228
	-----	-----
	502,863	535,506
	-----	-----
Income before interest expense and income taxes	650,451	651,362
Interest expense	--	146,982
	-----	-----
Income before income taxes	650,451	504,380
Income tax expense	9,760	12,824
	-----	-----
Net investment income	\$ 640,691	\$ 491,556
	=====	=====
Proceeds from disposition of investments	\$ 325,775	\$ 397,016
Cost of investments sold	--	--
	-----	-----
Realized gain on investments before income taxes	325,775	397,016
Income tax expense	114,021	138,956
	-----	-----

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Net realized gain on investments	211,754	258,060
	-----	-----
Increase (decrease) in unrealized appreciation of investments before income taxes	17,148,445	(5,217,480)
Increase (decrease) in deferred income taxes on appreciation of investments	6,003,000	(2,195,000)
	-----	-----
Net increase (decrease) in unrealized appreciation of investments	11,145,445	(3,022,480)
	-----	-----
Net realized and unrealized gain (loss) on investments	\$11,357,199	\$(2,764,420)
	=====	=====
Increase (decrease) in net assets from operations	\$11,997,890	\$(2,272,864)
	=====	=====

(See Notes to Consolidated Financial Statements)

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

	Three Months Ended June 30, 2007	Year Ended March 31, 2007
	----- (Unaudited)	-----
Operations:		
Net investment income	\$ 640,691	\$ 4,233,340
Net realized gain on investments	211,754	16,334,000
Net increase in unrealized appreciation of investments	11,145,445	96,343,609
	-----	-----
Increase in net assets from operations	11,997,890	116,910,949
Distributions from:		
Undistributed net investment income	(777,630)	(2,323,150)
Capital share transactions:		
Exercise of employee stock options	231,390	1,794,850
Adjustment to initially apply FASB No. 158, net of tax	--	1,173,751

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Stock option expense	43,586	169,003
	-----	-----
Increase in net assets	11,495,236	117,725,403
Net assets, beginning of period	514,343,512	396,618,109
	-----	-----
Net assets, end of period	\$525,838,748	\$514,343,512
	=====	=====

(See Notes to Consolidated Financial Statements)

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CAPITAL SOUTHWEST CORPORATION  
AND SUBSIDIARIES  
Consolidated Statements of Cash Flows

-----  
(Unaudited)

	Three Months Ended June 30	
	2007	2006
	-----	-----
Cash flows from operating activities		
Increase (decrease) in net assets from operations	\$ 11,997,890	\$ (2,272,864)
Adjustments to reconcile increase in net assets from operations to net cash provided by operating activities:		
Proceeds from disposition of investments	325,775	397,016
Purchases of securities	(8,051,747)	--
Maturities of securities	4,500	402,445
Depreciation and amortization	4,409	3,865
Net pension benefit	(36,237)	(29,187)
Realized gain on investments before income taxes	(325,775)	(397,016)
Deferred taxes on realized gain on investments	114,021	138,956
Net (increase) decrease in unrealized appreciation		

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of investments	(11,145,445)	3,022,480
Stock option expense	43,586	4,120
(Increase) decrease in receivables	184,920	(15,871)
Increase in other assets	(6,729)	(19,943)
Decrease in other liabilities	(119,163)	(106,582)
Decrease in accrued pension cost	(36,568)	(34,467)
Deferred income taxes	12,600	10,200
	-----	-----
Net cash provided by (used in) operating activities	(7,033,963)	1,103,152
	-----	-----
Cash flows from financing activities		
Increase in notes payable to bank	--	150,000,000
Distributions from undistributed net investment income	(777,630)	(772,050)
Proceeds from exercise of employee stock options	231,390	1,097,500
	-----	-----
Net cash provided by (used in) financing activities	(546,240)	150,325,450
	-----	-----
Net increase (decrease) in cash and cash equivalents	(7,580,203)	151,428,602
Cash and cash equivalents at beginning of period	38,844,203	11,503,866
	-----	-----
Cash and cash equivalents at end of period	\$ 31,264,000	\$162,932,468
	=====	=====
Supplemental disclosure of cash flow information:		
Cash paid during the period for:		
Interest	\$ --	\$ 123,763
Income taxes	\$ --	\$ 20,000

(See Notes to Consolidated Financial Statements)

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Portfolio of Investments - June 30, 2007

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	2,830,300 shares common stock (acquired 4-1-73 thru 5-25-07)

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<p>mobile excavation equipment for governmental, industrial and agricultural markets; street-sweeping equipment for municipalities.</p>	
<p>ALL COMPONENTS, INC. Addison, Texas Electronics contract manu- facturing; distribution and production of memory and other components for computer manufacturers, retailers and value-added resellers.</p>	<p>8.25% subordinated note due 2012 (acquired 6-27-07) 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) Warrant to purchase 350,000 shares of common stock at \$11.00 per share, expiring 2017 (acquired 6-27-07)</p>
<p>+ALLTEL CORPORATION Little Rock, Arkansas Owner and operator of the nation's largest wireless network.</p>	<p>++8,880 shares common stock (acquired 7-1-98)</p>
<p>+ATLANTIC CAPITAL BANCSHARES, INC. Atlanta, Georgia Holding company of Atlantic Capital Bank a full service commercial bank.</p>	<p>300,000 shares common stock (acquired 4-10-07)</p>
<p>BALCO, INC. Wichita, Kansas Specialty architectural products used in the construction and remodeling of commercial and insti- tutional buildings.</p>	<p>445,000 shares common stock and 60,920 shares Class B non-voting common stock (acquired 10-25-83 and 5-30-02)</p>
<p>BOXX TECHNOLOGIES, INC. Austin, Texas Workstations for computer graphics imaging and design.</p>	<p>3,125,354 shares Series B convertible preferred stock, convertible into 3,125,354 shares of common stock at \$0.50 per share (acquired 8-20-99 thru 8-8-01)</p>
<p>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.</p>	<p>10% demand note (acquired 6-7-07) 10% convertible subordinated notes, convertible into 720,350 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 preferred 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)</p>



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<p>+COMCAST CORPORATION  Philadelphia, Pennsylvania  Leading provider of cable,  entertainment and communi-  cations products and  services.</p>	<p>++64,656 shares common stock (acquired 11-18-02)</p>
<p>DENNIS TOOL COMPANY  Houston, Texas  Polycrystalline diamond  compacts (PDCs) used in oil  field drill bits and in  mining and industrial  applications.</p>	<p>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 8-10-9</p>
<p>+DISCOVERY HOLDING COMPANY  Englewood, Colorado  Provider of creative  content, media management  and network services  worldwide.</p>	<p>++70,501 shares Series A common stock (acquired 7-21-05)</p>
<p>+EMBARQ CORPORATION  Overland Park, Kansas  Local exchange carrier that  provides voice and data  services, including  high-speed Internet.</p>	<p>++4,500 shares common stock (acquired 5-17-06)</p>
<p>+ENCORE WIRE CORPORATION  McKinney, Texas  Electric wire and cable for  residential and commercial  use.</p>	<p>4,086,750 shares common stock (acquired 7-16-92 thru 10</p>
<p>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.</p>	<p>39,359.18 shares Series C convertible preferred  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)</p>
<p>+FMC CORPORATION  Philadelphia, Pennsylvania  Chemicals for agricultural,  industrial and consumer  markets.</p>	<p>++6,430 shares common stock (acquired 6-6-86)</p>
<p>+FMC TECHNOLOGIES, INC.  Houston, Texas  Equipment and systems for  the energy, food processing  and air transportation  industries.</p>	<p>++11,057 shares common stock (acquired 1-2-02)</p>

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+HEELYS, INC. Carrollton, Texas Heelys stealth skate shoes, equipment and apparel sold through sporting goods chains, department stores and footwear retailers.	9,317,310 shares common stock (acquired 5-26-00)
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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) Warrants to purchase 463,162 shares of Series A common stock at \$1.00 per share, expiring 2014 (acquired 3-31-04 thru 1-13-05)
+HOLOGIC, INC. Bedford, Massachusetts Medical instruments including bone densi- tometers, mammography devices and digital radiography systems.	++316,410 shares common stock (acquired 8-27-99)
+KIMBERLY-CLARK CORPORATION Dallas, Texas Manufacturer of tissue, personal care and health care products.	++77,180 shares common stock (acquired 12-18-97)
+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, communi- cations and entertainment businesses.	++35,250 shares of Liberty Capital Series A common stock (acquired 5-9-06) ++176,252 shares of Liberty Interactive Series A common stock (acquired 5-9-06)
LIFEMARK GROUP Hayward, California Cemeteries, mausoleums and mortuaries located in	1,449,026 shares common stock (acquired 7-16-69)

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northern California.

<p>MEDIA RECOVERY, INC.                  Graham, Texas                  Computer datacenter and office automation supplies and accessories; impact, tilt monitoring and temperature sensing devices to detect mishandled shipments; dunnage for protecting shipments.</p>	<p>800,000 shares Series A convertible preferred stock, convertible into 800,000 shares of common stock at \$1.00 per share (acquired 11-4-97)                  4,000,000 shares common stock (acquired 11-4-97)</p>
<p>PALLETONE, INC.                  Bartow, Florida                  Manufacturer of wooden pallets and pressure-treated lumber.</p>	<p>12.3% senior subordinated notes due 2012 (acquired 9-2-01)                  150,000 shares common stock (acquired 10-18-01)                  Warrant to purchase 15,294 shares of common stock at \$1.00 per share, expiring 2011 (acquired 2-17-06)</p>
<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 7-3-01)</p>

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Company	Investment (a)
<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>
<p>TCI HOLDINGS, INC.                  Denver, Colorado</p>	<p>21 shares 12% Series C cumulative compounding preferred stock (acquired 1-30-90)</p>

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Cable television systems and  
microwave relay systems.

+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.	4,540,883 shares Series A-1 convertible participating preferred stock, convertible into 4,540,883 shares of common stock at \$1.1011 per share (acquired 8-19-05 thru 6-15-07)
THE WHITMORE MANUFACTURING COMPANY Rockwall, Texas Specialized mining, railroad and industrial lubricants; coatings for automobiles and primary metals; fluid contamination control devices.	80 shares common stock (acquired 8-31-79)
+WINDSTREAM CORPORATION Little Rock, Arkansas Provider of voice, broadband and entertainment services.	++9,181 shares common stock (acquired 7-17-06)

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Company	Investment (a)
MISCELLANEOUS	- BankCap Partners Fund I, L.P. - 6.0% limited partnership interest (acquired 7-14-06 thru 4-3-07) - 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)

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- Humac Company - 1,041,000 shares common stock (acquired 1-31-75 and 12-31-75)
- PharmaFab, Inc. - contingent payment agreement (acquired 2-15-07)
- 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) 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 June 30, 2007, restricted securities represented approximately 91.0% 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, 2007. 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 ended June 30, 2007, we recognized compensation expense of \$43,586.

As of June 30, 2007, the total remaining unrecognized compensation cost related to non-vested stock options was \$1,127,866, which will be amortized over the weighted-average service period of approximately 7.34 years.

Notes to Consolidated Financial Statements  
(continued)

## 3. Employee Stock Option Plan

On July 19, 1999, shareholders approved the 1999 Stock Option ("Plan"), which provided for the granting of stock options to employees and officers and authorized 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, 2007, 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, 2007:

	Number of shares	Weighted-Average Exercise Price
	-----	-----
Balance at March 31, 2007	52,500	\$86.184
Granted	-	-
Exercised	(3,100)	74.642
Canceled	-	-
	-----	-----
Balance at June 30, 2007	49,400	86.908
	=====	=====

At June 30, 2007, the range of exercise prices and weighted-average remaining contractual life of outstanding options was \$65.00 to \$98.44 and 7.66 years, respectively. The total intrinsic value of options exercised during the three months ended June 30, 2007 was \$37,529 with the exercise prices ranging from \$65.00 to \$93.49 per share. New shares were issued for the \$231,390 cash received from option exercises for the three months ended June 30, 2007.

At June 30, 2007, the number of options exercisable was 8,915 and the weighted-average exercise price of those options was \$76.80.

On July 16, 2007, a stock option to purchase 25,000 shares of common stock was issued to the new president, Gary L. Martin.

Notes to Consolidated Financial Statements  
(continued)

## 4. Summary of Per Share Information

	Three Months Ended June 30	
	2007	2006
	-----	-----
Investment income	\$ .30	\$ .31
Operating expenses	(.13)	(.14)
Interest expense	--	(.04)
Income taxes	--	--
	-----	-----
Net investment income	.17	.13
Distributions from undistributed net investment income	(.20)	(.20)
Net realized gain on investments	.05	.07
Net increase (decrease) in unrealized appreciation of investments after deferred taxes	2.87	(.78)
Exercise of employee stock options*	(.05)	(.13)
Stock option expense	.01	--
	-----	-----
Increase (decrease) in net asset value	2.85	(.91)
Net asset value:		
Beginning of period	132.36	102.74
	-----	-----
End of period	\$135.21	\$101.83
	=====	=====
Increase (decrease) in deferred taxes on unrealized appreciation	\$ 1.50	\$ (.74)
Deferred taxes on unrealized appreciation:		
Beginning of period	54.58	41.65
	-----	-----
End of period	\$ 56.08	\$ 40.91
	=====	=====
Shares outstanding at end of period (000s omitted)	3,889	3,875

\* 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

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 future effect of HB3 to also be immaterial.



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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, therefore we will adopt SFAS 157 effective April 1, 2008. We are evaluating the impact of SFAS 157.

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### Notes to Consolidated Financial Statements (continued)

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. The impact, if any, from the adoption of SFAS 159 has not been determined.

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

Net asset value at June 30, 2007 was \$525,838,748 equivalent to \$135.21 per share after deducting an allowance of \$56.08 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 June 30, 2007 net asset value reflects an increase of 36.4% during the past twelve months.

	June 30, 2007 ----	June 30, 2006 ----
Net assets	\$525,838,748	\$394,674,815
Shares outstanding	3,889,151	3,875,751
Net assets per share	\$135.21	\$101.83

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

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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 \$564,687 in the three months ended June 30, 2007 increased from \$205,852 in the year-ago period due to an increase in excess cash and interest rates. During the three months ended June 30, 2007 and 2006, we recorded dividend income from the following sources:

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

	Three Months Ended June 30 -----	
	2007	2006
Alamo Group Inc.	\$169,278	\$169,278
Dennis Tool Company	25,000	37,499
Encore Wire Corporation	81,735	-
Kimberly-Clark Corporation	40,905	37,818
Lifemark Group	-	150,000
PalletOne, Inc.	-	44,921
The RectorSeal Corporation	-	240,000
TCI Holdings, Inc	20,318	20,318
The Whitmore Manufacturing Company	-	60,000
Other	26,191	22,732
	\$363,427	\$782,566

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

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

	Three Months Ended June 30 -----	
	2007	2006
Encore Wire Corporation	\$ 6,130,000	\$ 8,174,000
Heelys, Inc.	(9,318,000)	-
Palm Harbor Homes, Inc.	-	(7,855,000)
The RectorSeal Corporation	10,850,000	-

During the three months ended June 30, 2007, the value of our investment in Encore Wire Corporation was increased \$6,130,000 due to an increase in the company's stock price. The value of our investment in The RectorSeal Corporation was increased \$10,850,000 due to increased sales and earnings at the company.

Offsetting the gains at RectorSeal and Encore Wire during the three months ended June 30, 2007, was a \$9,318,000 decline in the value of Heelys, which has

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experienced a market price decline in each of the past two quarters.

### Portfolio Investments

During the quarter ended June 30, 2007, we made an investment of \$3,000,000 in a new portfolio company and additional investments of \$5,051,747 in existing portfolio companies.

We have agreed, subject to certain conditions, to invest up to \$4,115,423 in two portfolio companies.

### Financial Liquidity and Capital Resources

At June 30, 2007, we had cash and cash equivalents of approximately \$31.3 million. Pursuant to Small Business Administration (SBA) regulations, cash and cash equivalents of \$3.2 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

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

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 \$25.0 million was available at June 30, 2007. 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 \$63.4 million of our investment portfolio is represented by unrestricted publicly-traded securities which 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 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

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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 \$9,000,000 at June 30, 2007, equivalent to 1.3% of the value of our total investments. Generally these debt securities are below investment grade and have relatively high fixed rates of interest; therefore, minor changes in market yields of publicly-traded debt securities have little or no effect on the values of debt securities in our portfolio and no effect on interest income. Our investments in debt securities are generally held to maturity and their fair values are determined on the basis of the terms of the debt security and the financial condition of the issuer.

A portion of our investment portfolio consists of debt and equity securities of private companies. We anticipate little or no effect on the values of these investments from modest changes in public market equity valuations. Should significant changes in market valuations of comparable publicly-owned companies occur, there may be a corresponding effect on valuations of private

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

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 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 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 Secretary-Treasurer, as appropriate, to allow timely decisions regarding such required disclosure.

During the fiscal quarter ended June 30, 2007, 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 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, 2007.

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

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

(b) Reports on Form 8-K

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

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SIGNATURES

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

CAPITAL SOUTHWEST CORPORATION

Date: August 3, 2007  
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By: /s/ Gary L. Martin  
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Gary L. Martin, President  
(chief executive officer)

Date: August 3, 2007  
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By: /s/ Susan K. Hodgson  
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Susan K. Hodgson, Secretary-Treasurer  
(chief financial/accounting officer)

