

**UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549**

FORM 10-Q

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

FOR THE QUARTER ENDED JUNE 30, 2006

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

COMMISSION FILE NUMBER: 814-00237

GLADSTONE CAPITAL CORPORATION

(Exact name of registrant as specified in its charter)

MARYLAND

(State or other jurisdiction of incorporation or organization)

54-2040781

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

**1521 WESTBRANCH DRIVE, SUITE 200
MCLEAN, VIRGINIA 22102**

(Address of principal executive office)

(703) 287-5800

(Registrant's telephone number, including area code)

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 and (2) has been subject to such filing requirements for the past 90 days. Yes No .

Indicate by check mark whether the registrant is large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer and large accelerated filer" in Rule 12 b-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 Exchange 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. The number of shares of the issuer's Common Stock, \$0.001 par value, outstanding as of July 28, 2006 was 11,422,345.

GLADSTONE CAPITAL CORPORATION

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GLADSTONE CAPITAL CORPORATION
CONSOLIDATED STATEMENTS OF ASSETS AND LIABILITIES
(Unaudited)

	<u>June 30, 2006</u>	<u>September 30, 2005</u>
ASSETS		
Investments at fair value (Cost 6/30/2006: \$201,465,621; 9/30/2005: \$205,375,554)	\$ 202,706,650	\$ 200,846,763
Cash and cash equivalents	456,314	503,776
Interest receivable — investments in debt securities	1,132,213	1,406,212
Interest receivable — officers	24,836	27,067
Due from custodian	2,493,924	2,624,074
Due from Adviser	207,960	—
Deferred financing fees	148,762	70,000
Prepaid assets	71,946	177,848
Other assets	230,450	137,354
TOTAL ASSETS	<u>\$ 207,473,055</u>	<u>\$ 205,793,094</u>
LIABILITIES		
Accounts payable	\$ 45,342	\$ 21,893
Interest payable	188,392	183,707
Fees due to Adviser	181,398	391,322
Borrowings under lines of credit	47,846,000	53,034,064
Accrued expenses and deferred liabilities	225,367	350,665
Funds held in escrow	200,800	200,760
TOTAL LIABILITIES	<u>48,687,299</u>	<u>54,182,411</u>
NET ASSETS	<u>\$ 158,785,756</u>	<u>\$ 151,610,683</u>
ANALYSIS OF NET ASSETS		
Common stock, \$0.001 par value, 50,000,000 shares authorized and 11,384,363 and 11,303,510 shares issued and outstanding, respectively	\$ 11,385	\$ 11,304
Capital in excess of par value	166,240,635	164,610,873
Notes receivable — employees	(8,815,818)	(8,745,781)
Net unrealized appreciation (depreciation) on investments	1,241,029	(4,528,791)
Unrealized depreciation on derivative	(188,495)	(253,747)
Realized (loss) gain on sale of investments	(861,695)	42,250
Distributions less than net investment income	1,158,715	474,575
TOTAL NET ASSETS	<u>\$ 158,785,756</u>	<u>\$ 151,610,683</u>
NET ASSETS PER SHARE	<u>\$ 13.95</u>	<u>\$ 13.41</u>

THE ACCOMPANYING NOTES ARE AN INTEGRAL PART OF THESE CONSOLIDATED FINANCIAL STATEMENTS.

GLADSTONE CAPITAL CORPORATION
CONSOLIDATED SCHEDULE OF INVESTMENTS
AS OF JUNE 30, 2006
(UNAUDITED)

Advanced Homecare Management, Inc.	Home health nursing services	Senior Subordinated Term Debt (5)(6) (16.3%, Due 12/2010)	\$ 7,500,000	\$ 7,500,000
Allied Extruders, LLC	Polyethylene film manufacturer	Senior Real Estate Term Debt (9.6%, Due 3/2011)	1,000,000	1,000,000
P&O Packaging Acquisition LLC		Senior Term Debt (3) (5) (11.3%, Due 3/2011)	8,000,000	8,030,000
Badanco Acquisition Corp.	Manufacturing-luggage	Senior Term Debt (5) (10.6%, Due 2/2010)	5,512,519	5,519,409
		Senior Term Debt (3) (5) (13.6%, Due 2/2010)	8,617,563	8,649,878
Benetech, Inc.	Dust management systems for the coal and electric utility industries	Senior Term Debt (5) (10.1%, Due 5/2009)	2,275,000	2,303,438
		Senior Term Debt (3) (5) (13.1%, Due 5/2009)	3,087,500	3,141,531
Bresnan Communications, LLC	Service-telecommunications	Senior Term Debt (6) (9.6%, Due 3/2014)	1,000,000	1,000,000
Consolidated Bedding, Inc.	Manufacturing-mattresses	Senior Subordinated Term Debt (5) (13.9%, Due 3/2009)	2,466,864	2,344,186
Country Road Communications LLC	Service-telecommunications	Senior Subordinated Term Debt (5) (6) (12.6%, Due 7/2013)	5,960,181	6,060,000
Country Road Management, Inc.				
Defiance Stamping Company	Manufacturing-trucking parts	Senior Term Debt (3) (5) (13.1%, Due 4/2010)	6,325,000	6,325,000
Doe & Ingalls Management LLC	Distributor-specialty chemicals	Senior Term Debt (5) (9.6%, Due 11/2010)	4,900,000	4,918,375
Doe & Ingalls of North Carolina Operating LLC		Senior Term Debt (3) (5) (13.1%, Due 11/2010)	4,500,000	4,511,250
Doe & Ingalls of Florida Operating LLC				
Doe & Ingalls of Virginia Operating LLC				
Express Courier International, Inc.	Service-ground delivery and logistics	Line of Credit (7) (8) (9.4%, Due 6/2009)	—	—
		Senior Term Debt (7) (9.4%, Due 6/2011)	4,700,000	4,700,000
		Senior Term Debt (3) (7) (11.6%, Due 6/2011)	3,950,000	3,950,000
Finn Corporation	Manufacturing-landscape equipment	Common Stock Warrants	37,000	1,047,778

GLADSTONE CAPITAL CORPORATION
CONSOLIDATED SCHEDULE OF INVESTMENTS (Continued)
AS OF JUNE 30, 2006

<u>Company (1)</u>	<u>Industry</u>	<u>Investment (2)</u>	<u>Cost</u>	<u>Fair Value</u>
Gammill, Inc.	Designer and assembler of quilting machines and accessories	Senior Term Debt (5) (9.5%, Due 12/2008)	1,643,479	1,643,479
		Senior Term Debt (3) (5) (17) (12.0%, Due 12/2008)	4,571,875	4,807,418
Global Materials Technologies, Inc.	Manufacturing-steel wool products and metal fibers	Senior Term Debt (3) (5) (14.1%, Due 11/2009)	5,350,000	5,316,563
It's Just Lunch International, LLC	Service-dating service	Line of Credit (7) (13) (9.1%, Due 6/2009)	200,000	200,000
		Senior Term Debt (7) (14) (9.4%, Due 6/2011)	3,000,000	3,000,000
		Senior Term Debt (3) (15) (11.6%, Due 6/2011)	—	—
John Henry Holdings, Inc. Multi Packaging Solutions, Inc.	Manufacturing-packaging products	Senior Subordinated Term Debt (5) (6) (12.02%, Due 6/2011)	8,000,000	8,000,000
LocalTel, Inc.	Service-Yellow Pages publishing	Line of Credit (16) (9.6%, Due 6/2009)	—	—
		Senior Term Debt (7) (9.6%, Due 6/2011)	2,750,000	2,750,000
		Senior Term Debt (3) (7) (12.1%, Due 6/2011)	2,750,000	2,750,000

Mistras Holdings Corp.	Nondestructive testing instruments, systems and services	Senior Term Debt (3) (5) (11.1%, Due 8/2008)	9,666,666	9,461,249
		Senior Term Debt (4) (5) (12.5%, Due 8/2008)	5,333,334	5,206,667
Network Solutions LLC	Service-internet domain registry and host	Senior Term Debt (6) (10.5%, Due 1/2012)	4,475,518	4,511,081
Northern Contours Northern Contours of Kentucky, Inc. Norcon Holding LLC Norcon Lewis LLC	Manufacturing-veneer and laminate components	Senior Subordinated Term Debt (5) (12.1%, Due 5/2010)	7,000,000	7,008,750
Puerto Rico Cable Acquisition Company, Inc.	Service-telecommunications	Senior Subordinated Term Debt (5) (6) (11.8%, Due 1/2012)	7,816,958	7,833,206
QCE, LLC (d/b/a Quiznos Corp.)	Service-restaurant franchisor	Senior Term Debt (6) (7.8%, Due 5/2013)	3,018,897	2,992,580
		Senior Term Debt (3) (6) (11.2%, Due 11/2013)	3,047,171	3,037,500
RCS Management Holding Co.	Service-healthcare supplies	Senior Term Debt (3) (5) (9.6%, Due 1/2011)	3,000,000	3,003,750
		Senior Term Debt (4) (5) (12.1%, Due 1/2011)	3,000,000	3,003,750

GLADSTONE CAPITAL CORPORATION
CONSOLIDATED SCHEDULE OF INVESTMENTS (Continued)
AS OF JUNE 30, 2006

Company (1)	Industry	Investment (2)	Cost	Fair Value
SCPH Holdings, Inc. Sea Con Phoenix, Inc. Phoenix Optix, Inc.	Manufacturing-underwater and harsh environment components	Credit Facility (5) (7) (9) (9.6%, Due 2/2007)	500,000	500,000
		Senior Term Debt (5) (10.1%, Due 2/2010)	2,800,000	2,807,000
		Senior Term Debt (3) (5) (13.1%, Due 2/2010)	2,925,000	2,932,313
SCS Acquisition Corp.	Service-chemically treated equipment distribution	Senior Term Debt (3) (5) (10) (9.1%, Due 12/2011)	6,375,000	6,382,969
		Senior Term Debt (3) (5) (11) (11.1%, Due 12/2011)	6,587,500	6,595,734
Thibaut Acquisition Co.	Design and distribution-wall coverings	Credit Facility (5) (12) (9.6%, Due 1/2011)	225,000	224,719
		Senior Term Debt (5) (9.6%, Due 1/2011)	3,412,500	3,412,500
		Senior Term Debt (3) (5) (12.1%, Due 1/2011)	3,000,000	3,000,000
Visual Edge Technology, Inc. Graphic Enterprises, Inc. Copeco, Inc.	Service-office supplies distribution	Senior Subordinated Term Debt (5) (18) (13.1%, Due 8/2011)	5,000,000	5,133,000
Westlake Hardware, Inc. WHI Holding Corp.	Retail-hardware and variety	Senior Subordinated Term Debt (5) (12.4%, Due 1/2011)	15,000,000	15,000,000
Winchester Electronics	Manufacturing-high bandwidth connectors and cables	Senior Term Debt (3) (7) (12.1%, Due 6/2012)	6,000,000	6,000,000
Xspedius Communications LLC	Service-telecommunications	Senior Subordinated Term Debt (5) (15.8%, Due 3/2010)	5,185,096	5,191,577
Total:			\$ 201,465,621	\$ 202,706,650

(1) We do not "Control," and are not an "Affiliate" of, any of our portfolio companies, each as defined in the Investment Company Act of 1940, as amended (the "1940 Act"). In general, under the 1940 Act, we would "Control" a portfolio company if we owned 25% or more of its voting securities and would be an "Affiliate" of a portfolio company if we owned 5% or more of its voting securities.

(2) Percentage represents interest rates in effect at June 30, 2006 and due date represents the contractual maturity date.

(3) Last Out Tranche of senior debt, meaning if the company is liquidated then the holder of the Last Out Tranche is paid after the senior debt.

(4) Last Out Tranche of senior debt, meaning if the company is liquidated then the holder of the Last Out Tranche is paid after the senior debt, however the debt is junior to another Last Out Tranche.

(5) Fair value was based on valuation prepared and provided by Standard & Poor's Loan Evaluation Services.

(6) Marketable securities, such as syndicated loans, are valued based on the indicative bid price, as of June 30, 2006, from the respective originating syndication agent's

trading desk.

- (7) Investment valued at cost due to recent acquisition.
- (8) Availability under the credit facility totals \$1,500,000. There were no borrowings outstanding at June 30, 2006.
- (9) Availability under the credit facility totals \$500,000. The credit facility was fully drawn at June 30, 2006.
- (10) Availability under the debt facility totals \$7,500,000. The outstanding balance of the debt facility was \$6,375,000 at June 30, 2006.
- (11) Availability under the debt facility totals \$7,500,000. The outstanding balance of the debt facility was \$6,587,500 at June 30, 2006.

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- (12) Availability under the credit facility totals \$1,000,000. Borrowings of \$225,000 were outstanding at June 30, 2006.
- (13) Availability under the credit facility totals \$750,000. Borrowings of \$200,000 were outstanding at June 30, 2006.
- (14) The Company may borrow an additional \$500,000 of the Senior Term Debt facility, subject to certain conditions including Gladstone Capital's approval.
- (15) The Company may borrow an additional \$2,250,000 of the Senior Term Debt facility, subject to certain conditions including Gladstone Capital's approval.
- (16) Availability under the credit facility totals \$3,000,000. There were no borrowings outstanding at June 30, 2006.
- (17) Includes a success fee with a \$252,688 fair value and no cost basis.
- (18) Includes a success fee with a \$58,000 fair value and no cost basis.

THE ACCOMPANYING NOTES ARE AN INTEGRAL PART OF THESE CONSOLIDATED FINANCIAL STATEMENTS.

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GLADSTONE CAPITAL CORPORATION
CONSOLIDATED SCHEDULE OF INVESTMENTS
AS OF SEPTEMBER 30, 2005

<u>Company (1)</u>	<u>Industry</u>	<u>Investment (2)</u>	<u>Cost</u>	<u>Fair Value</u>
Advanced Homecare Management, Inc.	Home health nursing services	Senior Subordinated Term Debt (6) (12.6%, Due 12/2010)	\$7,500,000	\$7,500,000
Allied Extruders, Inc.	Polyethylene film manufacturer	Senior Term Debt (3) (12.3%, Due 7/2009)	3,950,000	3,964,813
ARI Holdings, Inc. (11) (12)	Manufacturing-auto parts	Senior Term Debt (12.8%, Due 2/2008)	3,933,939	2,880,000
Badanco Acquisition Corp.	Manufacturing-luggage	Senior Term Debt (6) (9.2%, Due 2/2010)	6,615,019	6,615,019
		Senior Term Debt (3) (6) (12.2%, Due 2/2010)	8,650,000	8,650,000
Benetech, Inc.	Dust management systems for the coal and electric utility industries	Senior Term Debt (6) (8.7%, Due 5/2009)	2,762,500	2,783,219
		Senior Term Debt (3) (6) (11.7%, Due 5/2009)	3,209,375	3,249,492
Consolidated Bedding, Inc.	Manufacturing-mattresses	Senior Subordinated Term Debt (6) (13.0%, Due 3/2009)	2,927,382	2,898,968
Country Road Communications LLC Country Road Management, Inc.	Service-telecommunications	Senior Subordinated Term Debt (11.6%, Due 7/2013)	5,955,942	6,060,000
Coyne International Enterprises	Industrial services	Senior Term Debt (3) (5) (6) (13.0%, PIK 2%, Due 7/2007)	6,375,052	6,367,083
Defiance Stamping Company	Manufacturing-trucking parts	Senior Term Debt (3) (11.7%, Due 4/2010)	6,325,000	6,332,906
Finn Corporation	Manufacturing-landscape equipment	Senior Subordinated Term Debt (6) (13.0%, Due 2/2006)	10,500,000	7,350,000
		Common Stock Warrants	37,000	682,114
Gammill, Inc.	Designer and assembler of quilting machines and accessories	Senior Term Debt (6) (9.5%, Due 12/2008)	3,771,427	3,771,427
		Senior Term Debt (3) (6) (12.0%, Due 12/2008)	4,690,625	4,667,172

Global Materials Technologies, Inc.	Manufacturing-steel wool products and metal fibers	Senior Term Debt (3) (6) (13.0%, Due 11/2009)	5,500,000	5,486,250
Infor Global Solutions Ltd.	Enterprise application solutions	Senior Subordinated Term Debt (7) (11.0%, Due 4/2012)	6,821,250	7,070,000
John Henry Holdings, Inc.	Manufacturing-packaging products	Senior Subordinated Term Debt(6) (11.0%, Due 6/2011)	7,067,923	7,064,500

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**GLADSTONE CAPITAL CORPORATION
CONSOLIDATED SCHEDULE OF INVESTMENTS
AS OF SEPTEMBER 30, 2005**

Company (1)	Industry	Investment (2)	Cost	Fair Value
Marcal Paper Mills, Inc. (12)	Manufacturing-paper products	Senior Subordinated Term Debt (6) (13.0%, Due 12/2006)	\$6,275,000	\$6,149,500
		First Mortgage Loan (5) (16%, PIK 1%, Due 12/2006)	9,277,877	9,277,877
Mistras Holdings Corp.	Nondestructive testing instruments, systems and services	Senior Term Debt (3) (6) (10.5%, Due 8/2008)	9,666,666	9,461,249
		Senior Term Debt (3) (6) (12.5%, Due 8/2008)	4,833,334	4,724,584
		Senior Term Debt (3) (6) (13.5%, Due 8/2008)	1,000,000	982,500
Northern Contours of Kentucky, Inc. Norcon Holding LLC Norcon Lewis LLC	Manufacturing-veneer and laminate components	Senior Subordinated Term Debt (8) (10.7%, Due 5/2010)	7,000,000	7,000,000
Penn Engineering & Manufacturing Corp. PN Merger Sub Inc. PEM Holding Co.	Manufacturing-fractional horsepower engines	Senior Subordinated Term Debt (8) (10.0%, Due 5/2012)	5,009,524	5,050,000
Polar Corporation	Manufacturing-trailer parts	Senior Subordinated Term Debt (6) (10.3%, Due 6/2010)	8,609,566	8,627,500
Puerto Rico Cable Acquisition Company, Inc.	Service-telecommunications	Senior Subordinated Term Debt (10.3%, Due 1/2012)	5,050,182	5,075,000
Regency Gas Services LLC	Midstream gas gathering and processing	Senior Subordinated Term Debt (7) (9.9%, Due 12/2010)	5,029,188	5,037,500
Santana Plastics	Manufacturing-polyethylene bathroom partitions	Senior Term Debt (3) (6) (11.7%, Due 11/2009)	6,000,000	6,007,500
		Senior Term Debt (4) (6) (13.0%, Due 11/2009)	1,950,000	1,952,438
SCPH Holdings, Inc. Sea Con Phoenix, Inc. Phoenix Optix, Inc.	Manufacturing-underwater and harsh environment components	Credit Facility (9) (8.0%, Due 3/2006) Senior Term Debt (3) (6) (8.7%, Due 2/2010) Senior Term Debt (6) (12.0%, Due 2/2010)	— 3,237,500 3,000,000	— 3,241,547 3,003,750
Survey Sampling	Service-telecommunications	Senior Subordinated Term Debt (6) (11.0%, Due 5/2012)	4,514,105	4,539,375
Tech Lighting LLC	Manufacturing-low voltage lighting systems	Senior Subordinated Term Debt (6) (10.4%, Due 10/2010)	9,012,452	9,067,500
Visual Edge Technology, Inc. Graphic Enterprises, Inc. Copeco, Inc.	Service-office supplies distribution	Senior Subordinated Term Debt (11.7%, Due 8/2011)	5,000,000	5,000,000

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GLADSTONE CAPITAL CORPORATION
CONSOLIDATED SCHEDULE OF INVESTMENTS
AS OF SEPTEMBER 30, 2005

Company (1)	Industry	Investment (2)	Cost	Fair Value
Woven Electronics Corporation	Custom electrical cable assemblies	Senior Term Debt (4) (6) (10) (11.5%, Due 3/2009)	\$8,344,999	\$8,776,435
Xspedius Communications LLC	Service-telecommunications	Senior Subordinated Term Debt (6) (14.3%, Due 3/2010)	5,972,727	4,479,545
Total:			\$205,375,554	\$200,846,763

- (1) We do not "Control," and are not an "Affiliate" of, any of our portfolio companies, each as defined in the Investment Company Act of 1940, as amended (the "1940 Act"). In general, under the 1940 Act, we would "Control" a portfolio company if we owned 25% or more of its voting securities and would be an "Affiliate" of a portfolio company if we owned 5% or more of its voting securities.
- (2) Percentage represents interest rates in effect at September 30, 2005 and due date represents the contractual maturity date.
- (3) Last Out Tranche of senior debt, meaning if the company is liquidated then the holder of the Last Out Tranche is paid after the senior debt.
- (4) Last Out Tranche of senior debt, meaning if the company is liquidated then the holder of the Last Out Tranche is paid after the senior debt, however the debt is junior to another Last Out Tranche.
- (5) Has some paid in kind (PIK) interest. Refer to Note 2 "Summary of Significant Accounting Policies" of the Company's Form 10-K for the fiscal year ended September 30, 2005.
- (6) Fair value was based on valuation prepared and provided by Standard & Poor's Loan Evaluation Services.
- (7) Marketable securities, such as syndicated loans, are valued based on the indicative bid price, as of September 30, 2005, from the respective originating syndication agent's trading desk.
- (8) Investment was valued at cost due to recent acquisition.
- (9) Availability under the credit facility totals \$500,000. There were no borrowings outstanding at September 30, 2005.
- (10) Includes a success fee with a \$347,986 fair value and no cost basis.
- (11) Non-income producing at September 30, 2005.
- (12) Subsequent to September 30, 2005, the entire investment in the portfolio company was sold at the fair value reflected herein.

THE ACCOMPANYING NOTES ARE AN INTEGRAL PART OF THESE CONSOLIDATED FINANCIAL STATEMENTS.

GLADSTONE CAPITAL CORPORATION
CONSOLIDATED STATEMENTS OF OPERATIONS
(UNAUDITED)

	Three Months Ended June 30,	
	2006	2005
INVESTMENT INCOME		
Interest income — investments	\$ 5,775,522	\$ 5,766,233
Interest income — cash and cash equivalents	8,178	7,631
Interest income — notes receivable from employees	108,877	108,065
Prepayment fees and other income	630,239	245,297
Total investment income	<u>6,522,816</u>	<u>6,127,226</u>
EXPENSES		
Loan servicing (Refer to Note 12)	693,965	687,971
Management fee (Refer to Notes 12 and 15)	331,040	358,631
Professional fees	166,405	133,505
Amortization of deferred financing fees	36,036	100,663
Interest expense	702,449	563,336
Stockholder related costs	28,371	16,475
Directors fees	27,500	26,624
Insurance expense	50,589	43,891
Stock option compensation	202,296	—
Other expenses	35,083	64,304
Expenses before credit from Gladstone Management	<u>2,273,734</u>	<u>1,995,400</u>
Credit to management fee for fees collected by Gladstone Management (Refer to Note 15)	(539,000)	(240,600)
Total expenses net of credit to management fee	<u>1,734,734</u>	<u>1,754,800</u>
NET INVESTMENT INCOME BEFORE INCOME TAXES	<u>4,788,082</u>	<u>4,372,426</u>
Income tax expense	—	—
NET INVESTMENT INCOME	<u>4,788,082</u>	<u>4,372,426</u>

REALIZED AND UNREALIZED GAIN (LOSS) ON INVESTMENTS:		
Realized loss on sale of investments	(100,850)	—
Realized gain on settlement of derivative	1,367	—
Unrealized appreciation (depreciation) on derivative	41,486	(49,044)
Net unrealized appreciation (depreciation) on investments	812,991	(389,229)
Net gain (loss) on investments	754,994	(438,273)

NET INCREASE IN NET ASSETS RESULTING FROM OPERATIONS \$ 5,543,076 \$ 3,934,153

NET INCREASE IN NET ASSETS RESULTING FROM OPERATIONS PER COMMON SHARE:

Basic	\$ 0.49	\$ 0.35
Diluted	\$ 0.48	\$ 0.34

WEIGHTED AVERAGE SHARES OF COMMON STOCK OUTSTANDING:

Basic	11,337,291	11,299,010
Diluted	11,570,425	11,578,637

THE ACCOMPANYING NOTES ARE AN INTEGRAL PART OF THESE CONSOLIDATED FINANCIAL STATEMENTS.

GLADSTONE CAPITAL CORPORATION
CONSOLIDATED STATEMENTS OF OPERATIONS
(UNAUDITED)

	<u>Nine Months Ended June 30,</u>	
	<u>2006</u>	<u>2005</u>
INVESTMENT INCOME		
Interest income — investments	\$ 18,497,893	\$ 16,671,756
Interest income — cash and cash equivalents	21,714	29,101
Interest income — notes receivable from employees	323,003	336,382
Prepayment fees and other income	711,225	1,054,917
Total investment income	19,553,835	18,092,156
EXPENSES		
Loan servicing (Refer to Note 12)	2,144,024	1,804,465
Management fee (Refer to Notes 12 and 15)	952,120	1,075,940
Professional fees	399,758	528,610
Amortization of deferred financing fees	94,572	284,487
Interest expense	2,302,693	1,174,587
Stockholder related costs	273,170	192,785
Directors fees	81,712	77,624
Insurance expense	151,956	134,053
Stock option compensation	279,618	—
Other expenses	151,663	176,939
Expenses before credit from Gladstone Management	6,831,286	5,449,490
Credit to management fee for fees collected by Gladstone Management (Refer to Note 15)	(1,762,000)	(977,100)
Total expenses net of credit to management fee	5,069,286	4,472,390
NET INVESTMENT INCOME BEFORE INCOME TAXES	14,484,549	13,619,766
Income tax expense	50,237	138,678
NET INVESTMENT INCOME	14,434,312	13,481,088

REALIZED AND UNREALIZED GAIN (LOSS) ON INVESTMENTS:

Net realized (loss) gain on sale of investments	(903,945)	29,750
Realized gain on settlement of derivative	1,367	—
Unrealized appreciation (depreciation) on derivative	65,252	(58,007)
Net unrealized appreciation (depreciation) on investments	5,769,820	(298,352)
Net gain (loss) on investments	4,932,494	(326,609)

NET INCREASE IN NET ASSETS RESULTING FROM OPERATIONS \$ 19,366,806 \$ 13,154,479

NET INCREASE IN NET ASSETS RESULTING FROM OPERATIONS PER COMMON SHARE:

Basic	\$ 1.71	\$ 1.17
Diluted	\$ 1.68	\$ 1.13

WEIGHTED AVERAGE SHARES OF COMMON STOCK OUTSTANDING:

Basic	11,317,437	11,288,784
Diluted	11,549,054	11,602,986

GLADSTONE CAPITAL CORPORATION
CONSOLIDATED STATEMENTS OF CHANGES IN NET ASSETS
(UNAUDITED)

	<u>Nine Months Ended June 30,</u>	
	<u>2006</u>	<u>2005</u>
Operations:		
Net investment income	\$ 14,434,312	\$ 13,481,088
Net realized (loss) gain on sale of investments	(903,945)	29,750
Realized gain on settlement of derivative	1,367	—
Unrealized appreciation (depreciation) on derivative	65,252	(58,007)
Net unrealized appreciation (depreciation) on investments	5,769,820	(298,352)
Net increase in net assets from operations	<u>19,366,806</u>	<u>13,154,479</u>
Capital transactions:		
Distributions to stockholders	(13,751,539)	(12,531,746)
Stock option compensation	279,618	—
Issuance of common stock under stock option plan	1,150,245	270,250
Repayment of principal on employee notes	129,943	797,429
Shelf offering costs	—	(111,233)
Decrease in net assets from capital share transactions	<u>(12,191,733)</u>	<u>(11,575,300)</u>
Total increase in net assets	7,175,073	1,579,179
Net assets at beginning of year	151,610,683	152,226,655
Net assets at end of period	<u>\$ 158,785,756</u>	<u>\$ 153,805,834</u>

THE ACCOMPANYING NOTES ARE AN INTEGRAL PART OF THESE CONSOLIDATED FINANCIAL STATEMENTS.

GLADSTONE CAPITAL CORPORATION
CONSOLIDATED STATEMENTS OF CASH FLOWS
(UNAUDITED)

	<u>Nine Months Ended June 30,</u>	
	<u>2006</u>	<u>2005</u>
CASH FLOWS FROM OPERATING ACTIVITIES		
Net increase in net assets resulting from operations	\$ 19,366,806	\$ 13,154,479
Adjustments to reconcile net increase in net assets resulting from operations to net cash provided by (used in) operating activities:		
Net amortization of premiums and discounts	(144,501)	(6,949)
Amortization of deferred financing fees	94,572	284,487
Stock compensation	279,618	—
Realized loss on investments	1,329,458	—
Unrealized (appreciation) depreciation on derivative	(65,252)	58,007
Change in net unrealized (appreciation) depreciation on investments	(5,769,820)	298,352
Decrease (increase) in interest receivable	276,230	(340,303)
Decrease (increase) in funds due from custodian	130,150	(11,027,346)
Decrease in prepaid assets	105,902	120,054
(Increase) decrease in due from affiliate	(207,960)	109,639
Increase in other assets	(27,845)	(11,973)
Increase in accounts payable	23,449	158
Increase in interest payable	4,685	100,320
Decrease in accrued expenses and deferred liabilities	(125,298)	(599,277)
(Decrease) increase in fees due to affiliate	(209,924)	205,900
Increase in funds held in escrow	40	200,000
Increase in investment balance due to payment in kind interest	(74,701)	(348,509)
Net cash provided by operating activities	<u>14,985,609</u>	<u>2,197,039</u>
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchase of investments	(105,076,400)	(126,195,458)
Principal repayments on investments	107,876,077	77,990,345
Repayment of repurchase agreements	—	(21,345,997)
Receipt of principal on notes receivable - employees	129,943	797,429
Net cash provided by (used in) investing activities	<u>2,929,620</u>	<u>(68,753,681)</u>
CASH FLOWS FROM FINANCING ACTIVITIES:		

Borrowings from the lines of credit	113,090,000	136,800,000
Repayments on the lines of credit	(118,278,064)	(122,953,547)
Distributions paid	(13,751,539)	(12,531,746)
Exercise of employee stock options	1,150,245	270,250
Deferred financing fees	(173,333)	(105,000)
Shelf offering costs	—	(111,233)
Net cash (used in) provided by financing activities	(17,962,691)	1,368,724
NET DECREASE IN CASH AND CASH EQUIVALENTS (1)	(47,462)	(65,187,918)
CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD	503,776	65,954,840
CASH AND CASH EQUIVALENTS, END OF PERIOD	\$ 456,314	\$ 766,922
CASH PAID DURING PERIOD FOR INTEREST	\$ 2,298,008	\$ 1,073,417
CASH PAID DURING PERIOD FOR INCOME TAXES	\$ —	\$ 138,678
NON-CASH FINANCING ACTIVITIES		
Notes receivable issued in exchange for common stock associated with the exercise of employee stock options	\$ 199,980	\$ 157,100

(1) Cash and cash equivalents consist of demand deposits and highly liquid investments with original maturities of three months or less when purchased.

THE ACCOMPANYING NOTES ARE AN INTEGRAL PART OF THESE CONSOLIDATED FINANCIAL STATEMENTS.

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GLADSTONE CAPITAL CORPORATION
FINANCIAL HIGHLIGHTS
(UNAUDITED)

	Three Months Ended June 30,	
	2006	2005
Per Share Data (1)		
Net asset value at beginning of period	\$ 13.84	\$ 13.64
<i>Income from investment operations:</i>		
Net investment income (2)	0.42	0.39
Realized (loss) gain on sale of investments (2)	(0.01)	—
Realized gain on settlement of derivative (2)	—	—
Net unrealized gain (loss) on investments (2)	0.07	(0.03)
Net unrealized gain on derivative (2)	0.01	—
Total from investment operations	0.49	0.36
Less distributions:		
Distributions from net investment income	(0.41)	(0.39)
Total distributions	(0.41)	(0.39)
Issuance of common stock under stock option plan	0.10	—
Repayment of principal on notes receivable	0.01	—
Dilutive effect of share issuance	(0.08)	—
Net asset value at end of period	\$ 13.95	\$ 13.61
Per share market value at beginning of period	\$ 21.55	\$ 21.22
Per share market value at end of period	21.39	23.40
Total return (3) (4)	1.11 %	12.19 %
Shares outstanding at end of period	11,384,363	11,303,510
Ratios/Supplemental Data		
Net assets at end of period	\$ 158,785,756	\$ 153,805,834
Average net assets (5)	\$ 156,053,816	\$ 152,484,868
Ratio of expenses to average net assets-annualized (6)	5.83 %	5.23 %
Ratio of net expenses to average net assets-annualized (7)	4.45 %	4.60 %
Ratio of net investment income to average net assets-annualized	12.27 %	11.47 %

(1) Basic per share data.

(2) Based on weighted average basic per share data.

(3) Total return equals the increase of the ending market value over the beginning market value plus monthly dividends divided by the monthly beginning market value, assuming monthly dividend reinvestment.

(4) Amounts were not annualized.

(5) Average net assets are computed by taking the average of the balance of net assets at the end of each month of the reporting period.

(6) Ratio of expenses to average net assets is computed using expenses before credit from Gladstone Management and including income tax expense.

(7) Ratio of net expenses to average net assets is computed using total expenses net of credits from Gladstone Management and including income tax expense.

THE ACCOMPANYING NOTES ARE AN INTEGRAL PART OF THESE CONSOLIDATED FINANCIAL STATEMENTS.

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**FINANCIAL HIGHLIGHTS
(UNAUDITED)**

	<u>Nine Months Ended June 30,</u>	
	<u>2006</u>	<u>2005</u>
Per Share Data (1)		
Net asset value at beginning of period	\$ 13.41	\$ 13.50
<i>Income from investment operations:</i>		
Net investment income (2)	1.28	1.19
Realized (loss) gain on sale of investments (2)	(0.08)	—
Realized gain on settlement of derivative (2)	—	—
Net unrealized gain (loss) on investments (2)	0.51	(0.03)
Net unrealized gain (loss) on derivative (2)	—	(0.01)
Total from investment operations	1.71	1.15
Less distributions:		
Distributions from net investment income	(1.22)	(1.11)
Total distributions	(1.22)	(1.11)
Issuance of common stock under stock option plan	0.10	0.02
Repayment of principal on notes receivable	0.01	0.07
Dilutive effect of share issuance	(0.06)	(0.01)
Offering costs	—	(0.01)
Net asset value at end of period	\$ 13.95	\$ 13.61
Per share market value at beginning of period	\$ 22.55	\$ 22.71
Per share market value at end of period	21.39	23.40
Total return (3)(4)	0.35 %	8.08 %
Shares outstanding at end of period	11,384,363	11,303,510
Ratios/Supplemental Data		
Net assets at end of period	\$ 158,785,756	\$ 153,805,834
Average net assets (5)	\$ 153,804,303	\$ 152,067,700
Ratio of expenses to average net assets-annualized (6)	5.97 %	4.90 %
Ratio of net expenses to average net assets-annualized (7)	4.44 %	4.04 %
Ratio of net investment income to average net assets-annualized	12.51 %	11.82 %

- (1) Basic per share data.
- (2) Based on weighted average basic per share data.
- (3) Total return equals the increase of the ending market value over the beginning market value plus monthly dividends divided by the monthly beginning market value, assuming monthly dividend reinvestment.
- (4) Amounts were not annualized.
- (5) Average net assets are computed by taking the average of the balance of net assets at the end of each month of the reporting period.
- (6) Ratio of expenses to average net assets is computed using expenses before credit from Gladstone Management and including income tax expense.
- (7) Ratio of net expenses to average net assets is computed using total expenses net of credits from Gladstone Management and including income tax expense.

THE ACCOMPANYING NOTES ARE AN INTEGRAL PART OF THESE CONSOLIDATED FINANCIAL STATEMENTS.

**GLADSTONE CAPITAL CORPORATION
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
June 30, 2006
(UNAUDITED)**

NOTE 1. ORGANIZATION

Gladstone Capital Corporation (the "Company") was incorporated under the General Corporation Laws of the State of Maryland on May 30, 2001 as a closed-end investment company. The Company has elected to be treated as a business development company, or BDC, under the Investment Company Act of 1940, as amended (the "1940 Act"). In addition, the Company has elected to be treated for tax purposes as a regulated investment company, or RIC, under the Internal Revenue Code of 1986, as amended (the "Code"). The Company's investment objectives are to achieve a high level of current income by investing in debt and equity securities of established private businesses.

Gladstone Capital Advisers, Inc. is a wholly-owned subsidiary of the Company. The financial statements of this subsidiary are consolidated with those of the Company.

Gladstone Business Loan LLC, a wholly-owned subsidiary of the Company, was established for the purpose of owning the Company's portfolio of loan investments. The financial statements of this subsidiary are consolidated with those of the Company.

The Company is externally managed by Gladstone Management Corporation ("Gladstone Management" or the "Adviser"), an unconsolidated affiliate of the Company.

NOTE 2. UNAUDITED INTERIM FINANCIAL STATEMENTS

Interim financial statements of the Company are prepared in accordance with accounting principles generally accepted in the United States of America ("GAAP") for interim financial information and pursuant to the requirements for reporting on Form 10-Q and Article 10 of Regulation S-X. Accordingly, certain disclosures accompanying annual financial statements prepared in accordance with GAAP are omitted. In the opinion of management, all adjustments, consisting solely of normal recurring accruals, necessary for the fair statement of financial statements for the interim periods have been included. The current period's results of operations are not necessarily indicative of results that ultimately may be achieved for the year. The interim financial statements and notes thereto should be read in conjunction with the financial statements and notes thereto included in the Company's Form 10-K for the fiscal year ended September 30, 2005, as filed with the Securities and Exchange Commission.

Certain amounts in the prior year's financial statements have been reclassified to conform to the current year presentation with no effect to net increase in net assets resulting from operations.

NOTE 3. RECENT ACCOUNTING PRONOUNCEMENTS

In October 2005, the Financial Accounting Standards Board (“FASB”) released FASB Staff Position No. FAS 123(R)-2 (“FSP FAS 123(R)-2”), “*Practical Accommodation to the Application of Grant Date as Defined in FASB Statement No. 123(R)*.” FSP FAS 123(R)-2 provides guidance on the application of grant date as defined in Statement of Financial Accounting Standards (“SFAS”) No. 123(R). The FASB addresses the notion of “mutual understanding,” specifically that a mutual understanding shall be presumed to exist at the date the award is approved in accordance with the relevant corporate governance requirements if, the award is a unilateral grant and therefore the recipient does not have the ability to negotiate the terms and conditions of the award with the employer and, the key terms and conditions of the award are expected to be communicated to an individual recipient within a relatively short time period for the date of approval. The Company applied FSP FAS 123(R)-2 in conjunction with the adoption of SFAS No. 123(R) on October 1, 2005.

NOTE 4. COMMON STOCK TRANSACTIONS

As of June 30, 2005 and June 30, 2006, 50,000,000 shares of \$0.001 par value common stock were authorized and 11,303,510 and 11,384,363 shares were outstanding, respectively.

Transactions in common stock were as follows:

	Common Stock	
	Shares	Amount
Balance at September 30, 2004	11,278,510	\$ 11,279
Issuance of Common Stock Under Stock Option Plan	25,000	25
Balance at June 30, 2005	<u>11,303,510</u>	<u>\$ 11,304</u>
Balance at September 30, 2005	11,303,510	\$ 11,304
Issuance of Common Stock Under Stock Option Plan	80,853	81
Balance at June 30, 2006	<u>11,384,363</u>	<u>\$ 11,385</u>

NOTE 5. STOCK OPTIONS

In December 2004, the FASB issued SFAS No. 123 (revised 2004) (“SFAS No. 123(R)”) *Share-based Payment*. SFAS No. 123(R) replaces SFAS No. 123, *Accounting for Stock-Based Compensation* and supersedes Accounting Principles Board (“APB”) Opinion No. 25, *Accounting for Stock Issued to Employees* (“APB No. 25”). SFAS No. 123(R) is effective for awards that are granted, modified, or settled in cash for annual periods beginning after June 15, 2005. The Company adopted SFAS No. 123(R) on October 1, 2005 using the modified prospective approach. Under the modified prospective approach, stock-based compensation expense will be recorded for the unvested portion of previously issued awards that remain outstanding at October 1, 2005 using the same estimate of the grant date fair value and the same attribution method used to determine the pro forma disclosure under SFAS No. 123. SFAS No. 123(R) also requires that all share-based payments to employees after October 1, 2005, including employee stock options, be recognized in the financial statements as stock-based compensation expense based on the fair value on the date of grant. Accordingly, prior period amounts have not been restated.

In connection with the externalization of the Company’s management, all of its officers and employees became direct employees of Gladstone Management Corporation, our Adviser, as of October 1, 2004, the start of fiscal year 2005. However, these individuals continue to be eligible to receive stock options under the 2001 Plan (as defined below). Effective October 1, 2004, the Company accounted for any options granted to employees of Gladstone Management Corporation, who qualify as leased employees of the Company under FIN 44, “*Accounting for Certain Transactions Involving Stock Compensation, an Interpretation of APB Opinion No. 25*”.

Prior to October 1, 2005, the Company accounted for stock-based awards in accordance with APB No. 25. For the three and nine months ended June 30, 2006, the Company recorded stock option compensation expense for the cost of stock options issued under the Amended and Restated 2001 Equity Incentive Plan (the “2001 Plan”) of \$202,296 and \$279,618, respectively. The Company’s expensing of stock options decreased both basic and diluted net increase to net assets resulting from operations per share by \$0.02 for both the three and nine months ended June 30, 2006. Additionally, SFAS No. 123(R) states that any potential tax benefits associated with incentive stock options should be recognized only at the time of settlement if those options settle through a disqualifying disposition. Thus, the related stock-based compensation expense must be treated as a permanent difference until that time which in turn, results in an increase to the Company’s effective tax rate. The Company does not record tax benefits associated with the expensing of stock options since the Company intends to qualify as a RIC under Subchapter M of the Code and as such the Company is not subject to federal income tax on the portion of its taxable income and gains distributed to stockholders, provided that at least 90% of the taxable income is distributed.

Under the provisions of APB No. 25, the Company was not required to recognize compensation expense for the cost of stock options issued under the 2001 Plan. The following table illustrates the effect on net increase to net assets resulting from operations and net increase to net assets resulting from operations per share for the three and nine months ended June 30, 2005 as if the Company had applied the fair value recognition provisions of SFAS No. 123, as amended by SFAS No. 148, *Accounting for Stock-Based Compensation-Transition and Disclosure*:

	Three Months Ended June 30, 2005	Nine Months Ended June 30, 2005
Net increase in net assets resulting from operations as reported:	\$ 3,934,153	\$ 13,154,479
Deduct: Total stock-based compensation expense determined using the fair value based method for all awards	(74,042)	(222,618)
Pro forma net increase in net assets resulting from operations per share	\$ 3,860,111	\$ 12,931,861

As reported - basic	\$ 0.35	\$ 1.17
As reported - diluted	\$ 0.34	\$ 1.13
Pro forma-basic	\$ 0.34	\$ 1.15
Pro forma-diluted	\$ 0.33	\$ 1.11

The fair value of each option grant is estimated on the date of grant using the Black-Scholes option pricing model, which incorporates a risk free interest rate, an expected life, an expected volatility factor, and an expected dividend yield.

The following is a summary of the status of the Company's 2001 Plan from September 30, 2005 through June 30, 2006:

	Shares	Weighted Average Exercise Price
Options outstanding at October 1, 2005	1,307,998	\$ 17.81
Granted	2,500	\$ 21.17
Expired	—	\$ —
Exercised	(80,853)	\$ 16.70
Forfeited	(5,000)	\$ 22.55
Options outstanding at June 30, 2006, of which 1,224,645 shares are exercisable	<u>1,224,645</u>	\$ 17.87

The following is a detailed summary of the stock options outstanding at June 30, 2006:

Range of Exercise Prices	Stock Options Outstanding	Weighted Average Remaining Contractual Life (Years)	Weighted Average Exercise Price
\$15.00 - \$21.94	895,645	0.25	\$ 16.02
\$22.21 - \$24.39	329,000	0.25	\$ 22.90
Total	<u>1,224,645</u>	0.25	\$ 17.87

On December 2, 2005, the Company held a special meeting of stockholders in which the stockholders voted to approve a proposal to enter into an amended and restated investment advisory agreement (the "Amended Advisory Agreement") with the Adviser and an administration agreement (the "Administration Agreement") between the Company and Gladstone Administration LLC, a wholly-owned subsidiary of the Adviser. (Please refer to Note 15. Advisory Agreement with Gladstone Management Corporation for further discussion.) In connection with the approval of the Amended Advisory Agreement, the Company ceased further option grants and will terminate the 2001 Plan on September 30, 2006.

On May 31, 2006, all the holders of currently outstanding stock options accepted the Company's offer to amend their stock options and accelerate the expiration date of the outstanding options to September 30, 2006. Therefore, all currently outstanding stock options must be exercised before September 30, 2006 or become forfeited on September 30, 2006. Upon termination of the 2001 Plan, the Company will implement the Amended Advisory Agreement between the Company and the Adviser effective on October 1, 2006, the first day of the Company's 2007 fiscal year.

NOTE 6. INCREASE IN NET ASSETS PER SHARE RESULTING FROM OPERATIONS

The following table sets forth the computation of basic and diluted net increase in net assets per share resulting from operations for the three and nine months ended June 30, 2006 and June 30, 2005:

	Three Months Ended June 30,		Nine Months Ended June 30,	
	2006	2005	2006	2005
Numerator for basic and diluted net increase in net assets resulting from operations per share	\$ 5,543,076	\$ 3,934,153	\$ 19,366,806	\$ 13,154,479
Denominator for basic weighted average shares	11,337,291	11,299,010	11,317,437	11,288,784
Dilutive effect of stock options	233,134	279,627	231,617	314,202
Denominator for diluted weighted average shares	<u>11,570,425</u>	<u>11,578,637</u>	<u>11,549,054</u>	<u>11,602,986</u>
Basic net increase in net assets resulting from operations per share	<u>\$ 0.49</u>	<u>\$ 0.35</u>	<u>\$ 1.71</u>	<u>\$ 1.17</u>
Diluted net increase in net assets resulting from operations per share	<u>\$ 0.48</u>	<u>\$ 0.34</u>	<u>\$ 1.68</u>	<u>\$ 1.13</u>

There were 1,224,645 options outstanding to purchase common stock at June 30, 2006. Of these, 336,000 options were not included in the computation of diluted earnings per share for the three and nine months ended June 30, 2006, because the options' exercise prices were greater than the average market price of the common shares for the period,

and therefore, were anti-dilutive.

NOTE 7. DIVIDENDS

The Company is required to pay out as a dividend 90% of its ordinary income and short-term capital gains for each taxable year in order to maintain its status as a RIC under Subtitle A, Chapter 1 of Subchapter M of the Code. It is the policy of the Company to pay out as a dividend up to 100% of those amounts. The amount to be paid out as a dividend is determined by the Board of Directors each quarter and is based on the annual earnings estimated by the management of the Company. Based on that estimate, three monthly dividends are declared each quarter. At year-end the Company may pay a bonus dividend, in addition to the monthly dividends, to ensure that it has paid out at least 90% of its ordinary income and short-term capital gains for the year. Long-term capital gains are composed of success fees, prepayment fees and gains from the sale of securities held from one year or more. The Company intends to retain long-term capital gains from the sale of securities, if any, and not pay them out as dividends, however, the Board of Directors may decide to declare and pay out capital gains during any fiscal year. If the Company decides to retain long-term capital gains, the portion of the retained capital gains will be subject to 35% tax. The Company currently pays a monthly dividend. The tax characteristics of all dividends will be reported to stockholders on Form 1099 at the end of each calendar year. The following table lists the per share dividends paid for the nine months ended June 30, 2006 and June 30, 2005:

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Fiscal Year	Record Date	Payment Date	Dividend per Share
2006	June 22, 2006	June 30, 2006	\$0.135
	May 22, 2006	May 31, 2006	\$0.135
	April 20, 2006	April 28, 2006	\$0.135
	March 23, 2006	March 31, 2006	\$0.135
	February 20, 2006	February 28, 2006	\$0.135
	January 19, 2006	January 31, 2006	\$0.135
	December 21, 2005	December 30, 2005	\$0.135
	November 21, 2005	November 30, 2005	\$0.135
	October 21, 2005	October 31, 2005	\$0.135
2005	June 16, 2005	June 30, 2005	\$0.13
	May 13, 2005	May 27, 2005	\$0.13
	April 15, 2005	April 29, 2005	\$0.13
	March 18, 2005	March 31, 2005	\$0.12
	February 11, 2005	February 28, 2005	\$0.12
	January 14, 2005	January 28, 2005	\$0.12
	December 17, 2004	December 30, 2004	\$0.12
	November 17, 2004	November 30, 2004	\$0.12
	October 18, 2004	October 29, 2004	\$0.12

NOTE 8. INVESTMENT VALUATION

The Company carries its investments at fair value, as determined by its Board of Directors. Securities that are publicly traded are valued at the closing price on the valuation date. Securities for which a limited market exists, such as participations in syndicated loans, are valued at the indicative bid price on the valuation date from the respective originating syndication agent's trading desk. Debt and equity securities that are not publicly traded are valued at fair value as determined in good faith by the Board of Directors. The Company currently engages Standard & Poor's Loan Evaluation Service ("S&P") to perform independent valuations of its investments. The Board of Directors uses the recommended valuations as prepared by S&P as a component of the foundation for the final fair value determination. In making such determination, the Board of Directors values non-convertible debt securities at cost plus amortized original issue discount plus payment in kind ("PIK") interest, if any, unless adverse factors lead to a determination of a lesser valuation. In valuing convertible debt, equity, success or exit fees or other equity like securities, the Board of Directors determines the fair value based on the collateral, the issuer's ability to make payments, the earnings of the issuer, sales to third parties of similar securities, the comparison to publicly traded securities, discounted cash flow and other pertinent factors. Due to the uncertainty inherent in the valuation process, such estimates of fair value may differ significantly from the values that would have resulted had a ready market for the securities existed, and the differences could be material. Additionally, changes in the market environment and other events that may occur over the life of the investments may cause the gains ultimately realized on these investments to be different than the valuation currently assigned. Because there is a lag between when the Company closes a loan and when the loan can be evaluated by S&P, new loans are not valued immediately by S&P; rather, the Board of Directors makes its own determination about the value of the loan in accordance with the Company's valuation policy without the input of S&P during that specific quarter in which the loan closed. Because S&P does not perform independent valuations of mortgage loans or equity securities, the Board of Directors also determines the fair value of these investments without the input of S&P. The Board of Directors considers a number of qualitative and quantitative factors in current market conditions when performing valuations. The Board of Directors is ultimately responsible for setting the fair value and disclosure of investments in the financial statements.

NOTE 9. PAYMENT IN KIND INTEREST

The Company seeks to avoid PIK interest, however the Company had one loan in its portfolio through March 31, 2006 that contained a PIK provision. A PIK provision requires the borrower to accrue a payment to the Company but the borrower does not have to pay that interest until the loan is paid in full. The PIK interest is added to the principal balance of the loan and recorded as income to the Company even though the cash has not been received. To maintain the Company's status as a RIC (as discussed in Note 7, above), this non-cash source of income must be paid out to stockholders in the form of cash dividends, even though the Company has not yet collected the cash. The Company recorded no PIK interest income for the three months ended June 30, 2006 and \$63,217 for the nine months ended June 30, 2006. For the three and nine months ended June 30, 2005, the Company recorded PIK interest income of \$63,597 and \$334,872, respectively. At June 30, 2006, the Company had no accrued PIK income on its statement of assets and liabilities as compared to September 30, 2005 in which the Company had accrued on its statement of assets and liabilities PIK income of \$1,273,251. On March 31, 2006, the Company's sole investment that contained a PIK provision repaid in full.

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NOTE 10. REPURCHASE AGREEMENT

A repurchase agreement involves the purchase by an investor, such as the Company, of a specified security and the simultaneous agreement by the seller to repurchase it at an agreed upon future date and at a price which is greater than the purchase price by an amount that reflects an agreed-upon interest rate. Such interest rate is effective for the period of time during which the investor's money is invested in the arrangement and is related to current market interest rates rather than the coupon rate on the purchased

security. The Company requires the continual maintenance by its custodian or the correspondent in its account with the Federal Reserve/Treasury Book Entry System of underlying securities in an amount at least equal to the repurchase price. If the seller were to default on its repurchase obligation, the Company might suffer a loss to the extent that the proceeds from the sale of the underlying securities were less than the repurchase price. A seller's bankruptcy could delay or prevent a sale of the underlying securities.

The Company had no outstanding repurchase agreement at June 30, 2006 or at September 30, 2005. On October 1, 2004, the Company repaid an outstanding repurchase obligation from September 30, 2004 and this repayment is reflected in the Consolidated Statement of Cash Flows for the nine months ended June 30, 2005.

NOTE 11. CONTRACTUAL OBLIGATIONS

As of June 30, 2006, the Company was a party to a signed and non-binding term sheet for two potential investments and was due to fund another investment for the Company's portfolio. The Company expects to fund these potential investments as follows:

Contractual Obligations	Total	Payment Due by Period			
		Less than 1 Year	1-3 Years	3-5 Years	More than 5 Years
Investments	\$ 24,900,000	24,900,000	—	—	—
Total	\$ 24,900,000	\$ 24,900,000	\$ —	\$ —	\$ —

All prospective investments are subject to, among other things, the satisfactory completion of the Company's due diligence investigation of each borrower, acceptance of terms and structure and receipt of necessary consents. With respect to each prospective loan, the Company will only agree to provide the loan if, among other things, the results of its due diligence investigations are satisfactory, the terms and conditions of the loan are acceptable and all necessary consents are received. The Company has initiated its due diligence investigations of the potential borrowers, however there can be no guarantee that facts will not be discovered in the course of completing the due diligence that would render a particular investment imprudent or that any of these investments will actually be made.

NOTE 12. LINES OF CREDIT

In June 2004, the Company entered into a \$15.0 million line of credit agreement with Branch Banking and Trust Company ("BB&T Agreement"), which originally matured in June 2005 and had been extended through December 31, 2006. On June 22, 2006, the Company terminated the BB&T Agreement due to infrequent borrowings. Interest on outstanding borrowings was based upon the one month London Interbank Offered Rate ("LIBOR") plus 2.5% per annum. The unused portion of the line of credit was subject to a fee of 0.2% per annum during the period in which the BB&T Agreement was outstanding.

Through its wholly-owned subsidiary Gladstone Business Loan LLC ("Business Loan"), the Company has a \$100 million revolving credit facility (the "DB Facility") with Deutsche Bank AG, as administrative agent, pursuant to which Business Loan has pledged the loans it holds to secure future advances by certain institutional lenders. The interest rate charged on the advances under the DB Facility is based on LIBOR, the Prime Rate or the Federal Funds Rate, depending on market conditions, and adjusts periodically. In May 2006, the Company renewed the DB Facility through May 25, 2007. In connection with the renewal, the credit facility was amended to reduce the equity contribution from \$100.0 million to \$50.0 million. As of June 30, 2006, the outstanding principal balance under the DB Facility was approximately \$47.8 million at an interest rate of 5.2%. Available borrowings are subject to various constraints imposed by Deutsche Bank AG, based on the aggregate loan balance pledged by Business Loan, which varies as loans are added and repaid, regardless of whether such repayments are early prepayment or are made as contractually required. At June 30, 2006, the remaining borrowing capacity available under the DB Facility was approximately \$52.2 million.

The DB Facility contains covenants that require Business Loan to maintain its status as a separate entity; prohibit certain significant corporate transactions (such as mergers, consolidations, liquidations or dissolutions); and restrict material changes to the Company's credit and collection policies. The DB Facility also restricts some of the terms and provisions (including interest rates, terms to

maturity and payments schedules) and limits the borrower and industry concentrations of loans that are eligible to secure advances. As of June 30, 2006, Business Loan was in compliance with all of the facility covenants.

The administrative agent also requires that any interest or principal payments on pledged loans be remitted directly by the borrower into a lockbox account with the Bank of New York as custodian. Deutsche Bank AG is also the trustee of the account and once a month remits the collected funds to the Company. At June 30, 2006, the amount due from custodian was \$2,493,924 and at September 30, 2005, the amount due from custodian was \$2,624,074.

Gladstone Management, the Company's affiliated external adviser also services the loans pledged under the DB Facility. As a condition to this servicing arrangement, the Company executed a performance guaranty pursuant to which it guaranteed that the Adviser would comply fully with all of its obligations under the DB Facility. The performance guaranty requires that the Company maintain a minimum net worth of \$100 million and to maintain "asset coverage" with respect to "senior securities representing indebtedness" of at least 200%, in accordance with Section 18 of the 1940 Act. As of June 30, 2006, the Company was in compliance with all covenants under the performance guaranty. The Adviser services these loans for an annual fee of 1.5% of the monthly aggregate outstanding loan balance of the loans pledged under the DB Facility. Effective in April 2006, the Adviser's Board of Directors voluntarily agreed to waive, on a temporary basis, the annual servicing fee rate for those senior syndicated loans in which the Company already has a second lien position to 0.5%. For the three and nine months ended June 30, 2006, the Company recorded loan servicing fees of \$693,965 and \$2,144,024, respectively, as compared to \$687,971 and \$1,804,465 for the three and nine months ended June 30, 2005, respectively. At June 30, 2006, the Company owed \$181,398 of unpaid loan servicing fees to Gladstone Management, which are recorded in fees due to Adviser. At September 30, 2005, the Company owed \$207,619 in loan servicing fees to Gladstone Management, recorded in fees due to Adviser.

Loan servicing fees received by Gladstone Management are credited to the Company's advisory fee payable to Gladstone Management under the advisory agreement between the Company and Gladstone Management. Accordingly, the advisory fee payable by the Company to Gladstone Management for the three months ended June 30, 2006 and June 30, 2005 was reduced by \$693,965 and \$687,971, respectively, for three months ended March 31, 2006 and March 31, 2005 was reduced by \$734,644 and \$585,542, respectively, and for the three months ended December 31, 2005 and December 31, 2004, was reduced by \$715,415 and \$530,952, respectively, in respect of these loan servicing fees received by Gladstone Management.

NOTE 13. INTEREST RATE CAP AGREEMENT

Pursuant to the DB Facility, the Company has an interest rate cap agreement that effectively limits the interest rate on a portion of the borrowings under the line of credit.

The use of a cap involves risks that are different from those associated with ordinary portfolio securities transactions. Cap agreements may be considered to be illiquid. Although the Company will not enter into any such agreements unless it believes that the other party to the transaction is creditworthy, the Company does bear the risk of loss of the amount expected to be received under such agreements in the event of default or bankruptcy of the agreement counterparty.

In February 2004, the Company entered into an interest rate cap agreement with a notional amount of \$35.0 million at a cost of \$304,000. The interest rate cap agreement's current notional amount is \$19.8 million and it has a current fair value of approximately \$115,505 which is recorded in other assets on the Company's consolidated balance sheet at June 30, 2006. At September 30, 2005, the interest rate cap agreement had a fair value of \$50,253. The Company records changes in the fair value of the interest rate cap agreement monthly based on the current market valuation at month end as unrealized depreciation or appreciation on derivative on the Company's consolidated statement of operations. The interest rate cap agreement expires in February 2009. The agreement provides that the Company's floating interest rate or cost of funds on a portion of the portfolio's borrowings will be capped at 5% when the LIBOR rate is in excess of 5%. During the three and nine months ended June 30, 2006, the Company recorded \$1,367 of income from the interest rate cap agreement recorded as a realized gain on the settlement of derivative on the Company's consolidated statements of operations.

NOTE 14. SERVICES TO PORTFOLIO COMPANIES

The 1940 Act requires that a business development company make available managerial assistance to its portfolio companies. The 1940 Act defines managerial assistance as the service made available to a portfolio company to provide "significant guidance and counsel concerning the management, operations, or business objectives and policies of a portfolio company." The Company offers managerial assistance and other services to its portfolio companies through its external investment adviser, Gladstone Management. Neither the Company nor its external investment adviser, Gladstone Management, charges a fee for managerial assistance. Gladstone Management also offers a wide variety of services to the portfolio companies such as investment banking services, arranging bank financing, arranging equity financing, structuring financing from multiple lenders and investors, reviewing existing credit facilities, restructuring existing loans, raising equity and debt capital, turnaround management, merger and acquisition services and recruiting

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new management personnel. Gladstone Management charges a fee for these services and credits the funds received from portfolio companies for these other services to the Company as a credit against the investment advisory fee due from the Company under the investment advisory agreement. Such fees are normally paid in part at the time of signing a non-binding letter of intent, with the remainder paid upon completion of the services, and are generally non-recurring.

While Gladstone Management receives all fees in connection with the Company's investments, such fees received by Gladstone Management are credited to the Company as a reduction of the advisory fee payable to Gladstone Management under the advisory agreement between the Company and Gladstone Management. For the three months ended June 30, 2006 and June 30, 2005, Gladstone Management received \$539,000 and \$240,600, respectively, for fees rendered to portfolio companies, for the three months ended March 31, 2006 and March 31, 2005, Gladstone Management received \$673,000 and \$450,000, respectively, of such fees and for the three months ended December 31, 2005 and December 31, 2004, Gladstone Management received \$550,000 and \$286,500, respectively, of such fees. None of these fees were for managerial assistance even though Gladstone Management provided managerial assistance to many of the Company's portfolio companies. Accordingly, the advisory fee payable by the Company to Gladstone Management for the three months ended June 30, 2006 and June 30, 2005 was reduced by \$539,000 and \$240,600, respectively, for the three months ended March 31, 2006 and March 31, 2005 was reduced by \$673,000 and \$450,000, respectively, and for the three months ended December 31, 2005 and December 31, 2004 was reduced by \$550,000 and \$286,500, respectively, in respect of these fees received by Gladstone Management.

NOTE 15. ADVISORY AGREEMENT WITH GLADSTONE MANAGEMENT CORPORATION

Effective October 1, 2004, the Company entered into an advisory agreement with Gladstone Management, an unconsolidated affiliate of the Company, whereby Gladstone Management serves as an external adviser to the Company. As compensation for the services of Gladstone Management, the Company pays Gladstone Management an annual advisory fee of 1.25% of total assets (as reduced by cash and cash equivalents pledged to creditors), payable in quarterly computed increments of 0.3125%, and an annual administrative fee of 0.75% of total assets (as reduced by cash and cash equivalents pledged to creditors), payable in quarterly computed increments of 0.1875%, for a total annual fee of 2.0% (0.50% quarterly) of total assets (as reduced by cash and cash equivalents pledged to creditors). In April 2006, the Adviser's Board of Directors voluntarily agreed to waive, on a temporary basis, the annual advisory fee from 1.25% to 0.5% (0.125% quarterly) for those senior syndicated loans in which the Company holds a second lien position as well. The Company continues to pay direct expenses including, but not limited to, directors' fees, legal and accounting fees, stockholder related expenses, and directors and officers insurance.

Gladstone Management services the loans held by Business Loan, in return for which, Gladstone Management receives a servicing fee with respect to senior syndicated loans, for which there is a second lien position in the portfolio, of 0.5% annual fee and with respect to all other loans a 1.5% annual fee based on the monthly aggregate balance of loans held by Business Loan. Since the Company owns these loans, all loan servicing fees paid to Gladstone Management are also credited directly against the 2% management fee. These credits reduce the amount of the investment advisory fee and are shown above the direct credits line item in the table below. For the three months ended June 30, 2006, March 31, 2006 and December 31, 2005, these loan servicing fees totaled \$693,965, \$734,644 and \$715,415, respectively, as compared to the loan servicing fees for the three months ended June 30, 2005, March 31, 2005 and December 31, 2004 of \$687,971, \$585,542 and \$530,952, respectively, all of which were credited against the 2% management fee in order to derive the management fee which is presented as the line item management fee in the consolidated statement of operations. Under the advisory agreement, Gladstone Management also provides the managerial assistance and other services to the Company's portfolio companies. To the extent that Gladstone Management receives any fees directly from a portfolio company for such services, Gladstone Management credits these fees directly against the 2% management fee and these amounts are shown in the table below as a credit to the management fee. For the three months ended June 30, 2006, March 31, 2006 and December 31, 2005, Gladstone Management recorded \$539,000, \$673,000 and \$550,000, respectively of such fees and credited this amount against the 2% management fee received from the Company, as compared such fees for June 30, 2005, March 31, 2005 and December 31, 2004 of \$240,600, \$450,000 and \$286,500, these credits are reflected on the consolidated statement of operations as credit to management fees for fees collected by Gladstone Management. Overall, the management fee due to Gladstone Management cannot exceed 2% of total assets (as reduced by cash and cash equivalents pledged to creditors) during any given fiscal year.

The following tables set forth the quarterly computation of the management fee for the three months ended June 30, 2006, March 31, 2006 and December 31, 2005 and for the three months ended June 30, 2005, March 31, 2005 and December 31, 2004, based on the quarterly increment of 0.50% (0.3125% quarterly advisory fee and 0.1875% quarterly administrative fee):

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Fee:	Three Months Ended		
	June 30, 2006	March 31, 2006	December 31, 2005
Total assets at	\$ 207,265,095	\$ 217,404,695	\$ 211,823,244
Less: Senior syndicated loans subject to reduced fee	(3,018,897)(a)	—	—
Less: Borrowings under line of credit at	—	—	(15,000,000)(d)
Total assets subject to quarterly fee of 0.50% as of	204,246,198	217,404,695	196,823,244
Quarterly fee rate	0.50%	0.50%	0.50%
Management fee before senior syndicated loan advisory fee	1,021,231	1,087,023	984,116

Total senior syndicated loan advisory fee at quarterly rate 0.125%	3,774	(b)	—	—
Gross management fee before loan servicing fee credit	1,025,005		1,087,023	984,116
Less: loan servicing fee from Gladstone Business Loan LLC	693,965		734,644	715,415
Management fee before credit:	331,040		352,379	268,701
Direct Credit to Management Fee:				
Fee revenue recorded by Gladstone Management:	539,000		673,000	550,000
Net management fee for the three months ended (c):	\$ (207,960)		\$ (320,621)	\$ (281,299)

Fee:	Three Months Ended		
	June 30, 2005	March 31, 2005	December 31, 2004
Total assets at	\$ 209,320,463	\$ 213,753,998	\$ 194,085,591
Less: Borrowings under line of credit at	—	(18,644,179)(e)	(22,435,000)(e)
Total assets subject to fee as of	209,320,463	195,109,819	171,650,591
Quarterly fee rate	0.50%	0.50%	0.50%
Gross management fee before loan servicing fee credit	1,046,602	975,549	858,254
Less: loan servicing fee from Gladstone Business Loan LLC	687,971	585,542	530,952
Management fee before credit:	358,631	390,007	327,302
Direct Credit to Management Fee:			
Fee revenue recorded by Gladstone Management:	240,600	450,000	286,500
Net management fee for the three months ended (c):	\$ 118,031	\$ (59,993)	\$ 40,802

- (a) In April 2006, the Adviser's Board of Directors waived on a temporary basis, the annual advisory fee from 1.25% to 0.5% (0.125% quarterly) for those senior syndicated loans in which the Company also holds a syndicated second lien position.
- (b) This amount represents the reduced quarterly advisory fee applicable only to the senior syndicated loans.
- (c) If the amount presented is in parentheses it denotes the amount is due back to the Company from the Adviser; if the amount is positive, it indicates that the Company owes the Adviser the amount.
- (d) This amount represents borrowings under one of the Company's lines of credit that were held in cash and cash equivalents as of December 31, 2005. The \$15.0 million was to be used to fund a new loan investment, however the investment did not fund until January 2006. Solely for the purposes of calculating the amount of the management fee due to Gladstone Management, the Company treats any such amounts as "cash and cash equivalents pledged to creditors" under the terms of the Company's advisory agreement with Gladstone Management. As a result, such amounts are deducted from the Company's total assets for purposes of computing the asset base upon which the management fee is determined.
- (e) This amount represents borrowings under one of the Company's lines of credit that were held in cash and cash equivalents as of March 31, 2005 and December 31, 2004, for the purpose of satisfying the Company's asset diversification requirements under the Code. Solely for the purposes of calculating the amount of the management fee due to Gladstone Management, the Company treats any such amounts as "cash and cash equivalents pledged to creditors" under the terms of the Company's advisory agreement with Gladstone Management. As a result, such amounts are deducted from the Company's total assets for purposes of computing the asset base upon which the management fee is determined.

On December 2, 2005, the Company's stockholders approved a proposal to enter into the Amended Advisory Agreement with the Adviser and the Administration Agreement between the Company and the Administrator.

The Amended Advisory Agreement provides for an annual base management fee equal to 2% of the Company's assets and an income-based incentive fee which will reward the Adviser if the Company's quarterly net investment income (before giving effect to the incentive fee) exceeds 1.75% of net assets. The agreement also provides for an annual capital gains-based incentive fee, whereby the Adviser will receive an annual fee equal to 20% of the Company's realized capital gains (net of realized capital losses and unrealized capital depreciation since inception of the Company). Under the Administration Agreement, the Company will pay separately for its allocable portion of the Administrator's overhead expenses in performing its obligations, including rent, and the Company's allocable portion of the salaries and benefits expenses of its chief financial officer, chief compliance officer and controller and their respective staffs.

In connection with the approval of the Amended Advisory Agreement, the Company will terminate the 2001 Plan. On May 31, 2006, all the holders of outstanding stock options accepted the Company's offer to amend their existing stock options and accelerate the contractual expiration date of the outstanding options to September 30, 2006. The Amended Advisory Agreement and the Administration Agreement will become effective on October 1, 2006, the first day of the 2007 fiscal year.

NOTE 16. FEDERAL AND STATE INCOME TAXES

The Company has historically operated, and intends to continue to operate, in a manner to qualify for treatment as a RIC under Subchapter M of the Code. As a RIC, the Company is not subject to federal or state income tax on the portion of its taxable income and gains distributed to stockholders. To qualify as a RIC, the Company is required to distribute to its stockholders at least 90% of investment company taxable income, as defined by the Code and, as such, no income tax provisions have been recorded for the individual companies of Gladstone Capital Corporation and Gladstone Business Loan LLC.

During the nine months ended June 30, 2006, Gladstone Capital Corporation recorded approximately \$50,000 in connection with penalties incurred on misclassified revenue on its fiscal year 2004 corporate tax return.

Gladstone Capital Advisers, Inc., a wholly-owned subsidiary of Gladstone Capital Corporation, is subject to federal and state income taxation on the income it has recorded, such as fees received from portfolio companies, resulting in aggregate federal and state income taxes of \$138,678 during the nine months ended June 30, 2005.

NOTE 17. RELATED PARTY TRANSACTIONS

The Company provides loans to employees of the Adviser for the exercise of options under the 2001 Plan. The loans require the quarterly payment of interest at the market rate in effect at the date of issue, have varying terms not exceeding nine years and have been recorded as a reduction of net assets. The loans are evidenced by full recourse notes that are due upon maturity or 60 days following termination of employment, and the shares of common stock purchased with the proceeds of the loan are posted as collateral. During the nine months ended June 30, 2006, the Company issued one loan to an employee for \$199,980 and received principal repayments of \$129,943 in

connection with the full repayment of one loan and a partial repayment on another loan. During the nine months ended June 30, 2005, the Company extended one loan for \$157,100 and received principal repayments of \$797,429. The Company recognized interest income from all employee stock option loans of \$108,877 and \$323,003 for the three and nine months ended June 30, 2006, respectively, as compared to \$108,065 and \$336,382 for the three and nine months ended June 30, 2005, respectively.

NOTE 18. SUBSEQUENT EVENTS

In July 2006, the Company funded ActivStyle, a distributor of consumable medical products, for approximately \$5.7 million and purchased an additional \$1.5 million participation in Bresnan Communications, LLC. Also, Advanced Homecare Management, Inc. repaid its entire investment of \$7.5 million and the Company reentered the investment for \$5.0 million.

In July 2006, the Company's Board of Directors declared the following monthly dividends:

Fiscal Year	Record Date	Payment Date	Dividend per Share
2006	September 21, 2006	September 29, 2006	\$0.14
	August 23, 2006	August 31, 2006	\$0.14
	July 21, 2006	July 31, 2006	\$0.14

ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS.

All statements contained herein, other than historical facts, may constitute "forward-looking statements" within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. These statements may relate to, among other things, future events or our future performance or financial condition. In some cases, you can identify forward-looking statements by terminology such as "may," "might," "believe," "will," "provided," "anticipate," "future," "could," "growth," "plan," "intend," "expect," "should," "would," "if," "seek," "possible," "potential," "likely" or the negative of such terms or comparable terminology. These forward-looking statements involve known and unknown risks, uncertainties and other factors that may cause our actual results, levels of activity, performance or achievements to be materially different from any future results, levels of activity, performance or achievements expressed or implied by such forward-looking statements. Such factors include, among others: (1) adverse changes in interest rates; (2) our failure or inability to establish or maintain referral arrangements with leveraged buyout funds and venture capital funds to generate loan opportunities; (3) the loss of one or more of our executive officers, in particular David Gladstone, Terry Lee Brubaker, or George Stelljes III; (4) our inability to extend, refinance or maintain our credit facilities on terms reasonably acceptable to us, if at all in future equity capital resources; (5) our inability to successfully securitize our loan portfolio on terms reasonably acceptable to us, if at all; (6) the decision of our competitors to aggressively seek to make senior and subordinated loans to small and medium-sized businesses on terms more favorable than we intend to provide; and (7) those factors listed under the caption "Risk Factors" of the Annual Report on Form 10-K as filed with the Securities and Exchange Commission on December 13, 2005 and under Part II, Item 1A of this Form 10-Q. We caution readers not to place undue reliance on any such forward-looking statements, which are made pursuant to the Private Securities Litigation Reform Act of 1995 and, as such, speak only as of the date made. We undertake no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events or otherwise, after the date of this Form 10-Q.

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

OVERVIEW

We were incorporated under the General Corporation Laws of the State of Maryland on May 30, 2001. Our investment objectives are to achieve a high level of current income by investing in debt securities, consisting primarily of senior notes, second lien notes, and senior subordinated notes of established private businesses that are backed by leveraged buyout funds, venture capital funds or others, with a particular emphasis on second lien and senior subordinated notes. In addition, we may acquire existing loans, which meet this profile, from leveraged buyout funds, venture capital funds and others. We also seek to provide our stockholders with long-term capital growth through the appreciation in the value of warrants, or other equity instruments that we may receive when we extend loans. We operate as a closed-end, non-diversified management investment company, and have elected to be treated as a business development company under the Investment Company Act of 1940, as amended (the "Act").

We seek out small and medium-sized businesses that meet certain criteria, including some or all of the following: (1) the potential for growth in cash flow, (2) adequate assets for loan collateral, (3) experienced management teams with a significant ownership interest in the borrower, (4) profitable operations based on the borrower's cash flow, (5) reasonable capitalization of the borrower (usually by buyout funds or venture capital funds) and (6) the potential to realize appreciation and gain liquidity in our equity position, if any. We anticipate that liquidity in our equity position will be achieved through a merger or acquisition of the borrower, a public offering by the borrower or by exercise of our right to require the borrower to buy back its warrants. We lend to borrowers that need funds to finance growth, restructure their balance sheets or effect a change of control.

Our loans typically range from \$5 million to \$15 million, generally mature in no more than seven years and accrue interest at a fixed or variable rate that exceeds the prime rate. Some of our loans may contain a provision that calls for some portion of the interest payments to be deferred and added to the principal balance so that the interest is paid, together with the principal, at maturity. This form of deferred interest is often called "payment in kind" or "PIK" interest, and, when earned, we record PIK interest as interest income and add the PIK interest to the principal balance of the loans. We seek to avoid PIK interest with all potential investments under review. We currently do not hold any investments with PIK and therefore, there was no PIK accrued on our balance sheet as of June 30, 2006.

Because our loans will generally be subordinated debt of private companies who typically cannot or will not expend the resources to have their debt securities rated by a credit rating agency, we expect that most, if not all, of the debt securities we acquire will be unrated. We cannot accurately predict what ratings these loans might receive if they were in fact rated, and therefore we cannot determine whether or not they could be considered to be "investment grade" quality.

To the extent possible, our loans generally are collateralized by a security interest in the borrower's assets. Interest payments are generally made monthly or quarterly (except to the extent of any PIK interest) with amortization of principal generally being deferred for several years. The principal amount of the loans and any accrued but unpaid interest generally become due at maturity at five to seven years. When we receive a warrant to purchase stock in a borrower in connection with a loan, the warrant will typically have an exercise price equal to the fair value of the portfolio company's common stock at the time of the loan and entitle us to purchase a modest percentage of the

borrower's stock.

Original issue discounts ("OID") arise when we extend a loan and receive an equity interest in the borrower at the same time. To the extent that the price paid for the equity is not at market value, the Company must allocate part of the price paid for the loan, to the value of the equity. Then the amount allocated to the equity, the OID, must be amortized over the life of the loan. As with PIK interest, the amortization of OID also produces income that must be recognized for purposes of satisfying the regulated investment company ("RIC") distribution requirements, whereas the cash is received, if at all, when the equity instrument is sold.

In addition, as a business development company under the 1940 Act, we are required to make available significant managerial assistance to our portfolio companies. Effective October 1, 2004, our investment adviser, Gladstone Management Corporation ("Gladstone Management" or the "Adviser") began to provide these services on our behalf through its officers who are also our officers. In addition, Gladstone Management provides other services to our portfolio companies, for which it receives fees, in connection with our investments. The fees for these services are generally paid to Gladstone Management in part at the time a prospective portfolio company signs a non-binding term sheet with us (as further described in the following paragraph), with the remainder paid at the closing of the investment. These fees are generally non-recurring, however in some instances they may have a recurring component which is also paid to Gladstone Management. Any fees received for other services, with the exception of the recurring fees, by Gladstone Management are currently credited against the management advisory fee payable to Gladstone Management pursuant to the terms of our advisory agreement, which has the effect of reducing our expenses to the extent of any such fees received by Gladstone Management. The specific other services Gladstone Management provides vary by portfolio company, but generally include a wide variety of services to the portfolio companies such as investment banking services, arranging bank financing, arranging equity financing structuring financing from multiple lenders and investors, reviewing existing credit facilities, restructuring existing loans, raising equity and debt capital, turnaround management, merger and acquisition services and recruiting new management personnel. In addition, the Adviser provides managerial assistance to portfolio companies. To date the Adviser has not charged for these managerial assistance services, however if the Adviser does provide such managerial assistance the Adviser will credit the managerial assistance fees to the management advisory fee due from us to the Adviser.

Prior to making an investment, we ordinarily enter into a non-binding term sheet with the potential borrower. These non-binding term sheets are generally subject to a number of conditions, including, but not limited to, the satisfactory completion of our due diligence investigations of the potential borrower's business, reaching agreement on the legal documentation for the loan, and the receipt of all necessary consents. Upon execution of the non-binding term sheet, the potential borrower generally pays Gladstone Management a non-refundable fee for its services rendered through the date of the non-binding term sheet. These fees are received by Gladstone Management and are offset against amounts due to Gladstone Management, which has the effect of reducing our expenses to the extent of any such fees received by Gladstone Management.

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

The only significant continuing revenue associated with the investments we have already closed is interest income and, potentially, capital gains realized in connection with the liquidation of any associated equity interest (e.g., warrants).

During the nine months ended June 30, 2006, we extended, directly or through participations, approximately \$105.1 million of new loans to a total of 17 companies. Also, during the nine months ended June 30, 2006, six borrowers repaid loans ahead of contractual maturity at par value, we sold or were repaid in full on eight syndicated loans, and sold three loan investments at a loss for an aggregate return of capital of approximately \$96.5 million and we received scheduled contractual principal repayments of approximately \$11.3 million, for total principal repayments of approximately \$107.9 million. Since our initial public offering in August 2001, we have made 110 different loans to, or investments in, 62 companies for a total of approximately \$471.3 million, before giving effect to principal repayments on investments and divestitures.

We are continuously working toward the consummation of more investments. These prospective loans are subject to, among other things, the satisfactory completion of our due diligence investigation of each borrower, acceptance of terms and structure and obtaining necessary consents. With respect to each prospective loan, we will only agree to provide the loan if, among other things, the results of our due diligence investigations are satisfactory, the terms and conditions of the loan are acceptable and all necessary consents are received. Our management has initiated its due diligence investigations of the potential borrowers, however we cannot assure you that we will not discover facts in the course of completing our due diligence that would render a particular investment imprudent or that any of these loans will actually be made.

External Adviser

Pursuant to our advisory agreement with Gladstone Management, we pay the Adviser an annual advisory fee of 1.25% of our total assets (as reduced by cash and cash equivalents pledged to creditors), payable in quarterly computed increments of 0.3125%, and an annual administrative fee of 0.75% of our total assets (as reduced by cash and cash equivalents pledged to creditors), payable in quarterly computed increments of 0.1875%. This fee is then directly reduced by the amount of loan servicing fees paid to the Adviser and any other fees received by the Adviser from our borrowers and potential borrowers. In April 2006, the Adviser's Board of Directors reduced the annual advisory fee of 1.25% to 0.5% for those senior syndicated loans in which we already have a syndicated second lien position. We continue to pay direct expenses including, but not limited to, directors' fees, legal and accounting fees, stockholder related expenses, and directors and officers insurance.

Gladstone Management services our loan portfolio pursuant to a loan servicing agreement with Gladstone Business Loan LLC ("Business Loan") in return for a 1.5% annual fee, based on the monthly aggregate outstanding loan balance of the loans pledged under the facility. Effective in April 2006, the Adviser's Board of Directors voted to reduce the portion of the annual fee to 0.5% for those senior syndicated loans in which we already have a syndicated second lien position. For the three months ended June 30, 2006 and June 30, 2005 we incurred \$693,965 and \$687,971, respectively and for the nine months ended June 30, 2006 and June 30, 2005, we incurred \$2,144,024 and \$1,804,465, respectively, in loan servicing fees.

For the three months ended June 30, 2006, the gross management fee, before reductions for loan servicing fees and other fees was approximately \$1.0 million. After being reduced by loan servicing fees of approximately \$694,000 and other fees received by Gladstone Management of \$539,000, our net management fee for the three months ended June 30, 2006 was a credit of approximately \$208,000. For the three months ended June 30, 2005, the gross management fee, before reductions for loan servicing fees and other fees was approximately \$1.0 million. After being reduced by loan servicing fees of approximately \$688,000 and other fees received by Gladstone Management of \$241,000, our net management fee for the three months ended June 30, 2005 was approximately \$118,000. For the three months ended March 31, 2006, the gross management fee, before reductions for loan servicing fees and other fees was approximately \$1.1 million. After being reduced by loan servicing fees of approximately \$735,000 and other fees received by Gladstone Management of \$673,000, our net management fee for the three months ended March 31, 2006 was a credit of approximately \$321,000. For the three months ended March 31, 2005, the gross management fee, before reductions for loan servicing fees and other fees was approximately \$976,000. After being reduced by loan servicing fees of approximately \$586,000 and other fees received by Gladstone Management of \$450,000, our net management fee for the three months ended March 31, 2005 was a credit of approximately \$60,000. For the three months ended December 31, 2005 and December 31, 2004, the gross management fee, before reductions for loan servicing fees and other fees was approximately \$984,000 and \$858,000, respectively. After being reduced by loan servicing fees of approximately \$715,000 and \$531,000, respectively, and other fees received by Gladstone Management of approximately \$550,000 and \$286,500, respectively, our net management fees for the three months ended December 31, 2005 and December 31, 2004 was a credit of \$281,299 and \$40,802, respectively. Since the fees are computed quarterly it is necessary to sum the three quarters in order to derive the year to date management fee, therefore for the nine months ended June 30, 2006 and June 30, 2005 gross management fees

before reductions were approximately \$3.1 million and \$2.9 million, respectively, and the aggregate net management fees after reductions were a credit of approximately \$810,000 and an expense of approximately \$99,000, respectively, for the nine months ended June 30, 2006 and June 30, 2005.

On December 2, 2005, our stockholders approved a proposal to enter into an amended and restated investment advisory agreement (the “Amended Advisory Agreement”) with Gladstone Management and an administration agreement (the “Administration Agreement”) between the Company and Gladstone Administration, LLC (the “Administrator”), a wholly-owned subsidiary of the Adviser.

The Amended Advisory Agreement provides for an annual base management fee equal to 2% of our assets and an income-based incentive fee which will reward the Adviser if our quarterly net investment income (before giving effect to the incentive fee) exceeds 1.75% of our net assets. The agreement also provides for an annual capital gains-based incentive fee, whereby the Adviser will receive an annual fee equal to 20% of our realized capital gains (net of realized capital losses and unrealized capital depreciation since inception of the Company). Under the Administration Agreement, we will pay separately for our allocable portion of the Administrator’s overhead expenses in performing our obligations, including rent, and our allocable portion of the salaries and benefits expenses of our chief financial officer, chief compliance officer and controller and their respective staffs.

The Amended Advisory Agreement and Administration Agreement will not become effective as long as the Amended and Restated 2001 Equity Incentive Plan (the “2001 Plan”) is in effect or as long as there are any outstanding stock options. In connection with the approval of the Amended Advisory Agreement, and pursuant to an offer approved by our Board of Directors on April 11, 2006, we extended an offer to the then current stock option holders to amend the terms of all outstanding stock options under the Plan to accelerate the contractual expiration date of these options to September 30, 2006. The offer was filed with the U.S. Securities and Exchange Commission (the “SEC”) on April 12, 2006, was conducted in accordance with the federal tender offer rules and regulations, and was conditioned upon the acceptance by 100% of the current stock option holders. On May 31, 2006, 100% of the current stock option holders accepted the offer. The acceptance of this offer enables the implementation of the Amended Advisory Agreement and Administration Agreement on October 1, 2006, the first day of the first fiscal quarter following the September 30, 2006 amended contractual expiration date of the stock options. The current investment advisory agreement with Gladstone Management will continue in effect until these new agreements become effective at the start of fiscal year 2007.

Our Board of Directors also accelerated in full the vesting of all outstanding options other than options held by the non-employee Directors effective April 11, 2006. This action resulted in accelerated vesting of 34,500 outstanding options.

As of July 18, 2006 there are 1,186,663 outstanding options under the 2001 Plan, and no further options will be granted. The shares underlying these stock options have been registered under the Securities Act of 1933 (as amended). 1,156,663 of these options are now vested with the remaining 30,000, which are held by our non-employee directors, scheduled to terminate on September 30, 2006 prior to their vesting. Upon exercise, the holders of these options will be able to publicly resell their shares without restriction. Sales of substantial amounts of our common stock in the public market, pursuant to the registration statement, such option exercises, under Rule 144 or otherwise, or the availability of such shares for sale, including as a result of the recent actions taken by our Board of Directors to facilitate the implementation of the Amended Advisory Agreement and Administration Agreement, could adversely affect the prevailing market prices for our common stock, and could dilute the interests of existing stockholders. This would be particularly the case if a significant number of option holders elect not to “exercise and hold” their options, but rather seek to monetize their option holdings through broker-assisted cashless exercises. If this occurs, it could impair our ability to raise additional capital through the sale of equity securities should we desire to do so.

In addition, the Board of Directors of the Adviser has voluntarily agreed to waive, on a temporary basis, certain fees paid by us to the Adviser under the advisory agreement. We currently pay 1.25% of our total assets (as reduced by cash and cash equivalents pledged to creditors) and the waiver provides that the 1.25% will be reduced to 0.5% for the portion of total assets that consists of investments in senior syndicated loans for which we also have a second lien position.

Off-Balance Sheet Arrangements

We do not have any significant off-balance sheet arrangements as defined in Item 303(a)(4)(ii) of SEC Regulation S-K as of June 30, 2006.

Recent Accounting Pronouncements

FSP FAS 123(R)-2

In October 2005, the Financial Accounting Standards Board (“FASB”) released FASB Staff Position No. FAS 123(R)-2 (“FSP FAS 123(R)-2”), *“Practical Accommodation to the Application of Grant Date as Defined in FASB Statement No. 123(R).”* FSP FAS 123(R)-2 provides guidance on the application of grant date as defined in SFAS No. 123(R). The FASB addresses the notion of “mutual understanding,” specifically that a mutual understanding shall be presumed to exist at the date the award is approved in accordance with the relevant corporate governance requirements if, the award is a unilateral grant and therefore the recipient does not have the ability to negotiate the terms and conditions of the award with the employer and, the key terms and conditions of the award

are expected to be communicated to an individual recipient within a relatively short time period for the date of approval. We applied FSP FAS 123(R)-2 in conjunction with our adoption of SFAS No. 123(R) on October 1, 2005.

Critical Accounting Policies

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

Investment Valuation

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

General Valuation Policy: We value our investment portfolio each quarter. We carry our investments at fair value, as determined in good faith by our Board of Directors. Securities that are publicly traded, if any, are valued at the closing price of the exchange or securities market on which they are listed on the valuation date. Securities which

are not traded on a public exchange or securities market, but for which a limited market exists and that have been rated by a nationally recognized statistical rating organizations ("NRSRO"), such as certain participations in syndicated loans, are valued at the indicative bid price offered by the syndication agent on the valuation date.

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

We currently engage Standard & Poor's Loan Evaluation Service ("S&P") to help evaluate the value of the majority of our loan securities (other than those which are publicly traded or for which a limited market exists, as described above), as well as for evaluations on success fees (conditional interest included in some loan securities). We and S&P only evaluate the value of a success fee if the probability of receiving the success fee on a given loan is above 6-8%, a threshold of significance, in which case a value is assigned. Upon completing our collection of data with respect to the investments (including the information described under "Credit Information," the risk ratings of the loans described under "Loan Grading and Risk Rating" and the factors described under "Valuation Methods"), this valuation data is presented to S&P. S&P makes its independent assessment of the data that we have assembled and assesses its own data to determine market values for the securities. With regard to its work, S&P has issued the following paragraph:

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

With our assessment and S&P value estimates as a backdrop, our Board of Directors votes to accept or not accept the analyses and values recommended by management and S&P. At June 30, 2006 and September 30, 2005, the Board of Directors elected to accept the valuations recommended by S&P on the loans in our portfolio as denoted on the Schedule of Investments as of June 30, 2006 and September 30, 2005 in our consolidated financial statements. Subsequent to September 30, 2005, the fair value of our investment in

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ARI Holdings, Inc. was reduced from the value proposed by S&P because the investment was sold in November 2005 at a value less than that indicated by S&P on September 30, 2005. Our Board of Directors determined to reduce the value proposed by S&P to the value of the sale price and as such the sale price of the investment is reflected in the fair value on our Schedule of Investments as of September 30, 2005 in our consolidated financial statements.

Because there is a delay between when we close a loan and when the loan can be evaluated by S&P, new loans are not valued immediately by S&P; rather, the Board of Directors makes its own determination about the value of these loans in accordance with our valuation policy. These new loans are usually valued at par. Because S&P does not provide values for mortgage loans or equity securities, our Board of Directors also determines the fair value of these investments using our valuation policy without the input of S&P. At June 30, 2006, we had one mortgage loan in our portfolio at a cost basis of \$1.0 million and warrants with a cost basis of \$37,000.

Credit Information: We monitor a wide variety of key credit statistics that provide information regarding our portfolio companies to help us assess credit quality and portfolio performance. We require our portfolio companies to provide annual audited and either monthly or quarterly unaudited financial statements. Using these statements, we calculate and evaluate the credit statistics. For purposes of analyzing the financial performance of our portfolio companies, we may make certain adjustments to their cash flow statements to reflect the pro forma results of a company consistent with a change of control transaction, to reflect anticipated cost savings resulting from a merger or restructuring, costs related to new product development, compensation to previous owners, and other acquisition or restructuring related items. For those investments for which S&P prepares valuation recommendations, we provide this credit information to S&P for its use in preparing its recommendations. For those investments for which S&P does not prepare valuation recommendations, management uses this credit information in connection with its preparation of valuation recommendations.

Loan Grading and Risk Rating: As part of our valuation procedures we risk rate all of our loans. Our risk rating system uses a scale of 0 to 10. This system is used to estimate the probability of default on our debt securities and the probability of loss if there is a default. These types of systems are referred to as risk rating systems and are used by banks and rating agencies. The risk rating system covers both qualitative and quantitative aspects of the business and the securities we hold. For those investments for which S&P prepares valuation recommendations, we compile this information and provide it to S&P for its consideration in determining its valuation recommendations. For those investments for which S&P does not prepare valuation recommendations, management uses this information to develop its own valuation recommendations.

We seek to have our risk rating system mirror the risk rating systems of major risk rating organizations such as those provided by NRSRO as defined in Rule 2a-7 under the 1940 Act. While we seek to mirror the NRSRO systems, we cannot provide any assurance that our risk rating system provides the same risk rating as a NRSRO. The following chart is an estimate of the relationship of our risk rating system to the designations used by two NRSROs as they risk rate debt securities of major companies. Because we have established our system to rate debt securities of companies that are unrated by any NRSRO, there can be no assurance that the correlation to the NRSRO set out below is accurate. We believe our risk rating would be significantly higher than a typical NRSRO risk rating because the risk rating of the typical NRSRO is designed for larger businesses that can afford to pay an NRSRO to rate their securities. However, our risk rating has been designed to risk rate the securities of smaller businesses that are not rated by a typical NRSRO. Therefore, when we use our risk rating on larger business securities, the risk rating is higher than a typical NRSRO rating. The primary difference between our risk rating and the rating of a typical NRSRO is that our risk rating uses more quantitative determinants and includes qualitative determinants that are not used in the NRSRO rating. It is our understanding that most debt securities of middle market companies do not exceed the grade of BBB on a NRSRO scale, so there would be no debt securities in the middle market that would meet the definition of AAA, AA or A. Therefore, our scale begins with the designation BBB as the best risk rating.

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

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

The above scale gives an indication of the probability of default and the magnitude of the loss if there is a default. The following table lists the risk ratings for all of the debt securities outstanding at June 30, 2006, March 31, 2006, December 31, 2005 and September 30, 2005:

Rating	June 30, 2006	March 31, 2006	Dec. 31, 2005	Sept. 30, 2005
Average	6.9	7.1	7.1	7.0
Weighted Average	6.8	7.1	7.2	7.1
Highest	9.0	9.0	9.0	9.0
Lowest	4.0	4.0	5.0	5.0

Our policy is to stop accruing interest on an investment if we determine that interest is no longer collectible. Currently, none of our investments are on non-accrual. At June 30, 2006, no payments were past due on any of our debt securities. At September 30, 2005, ARI Holdings, Inc. was past due on its payments and was placed on non-accrual. This investment was sold in November 2005 at an approximate loss of \$1.1 million. We do not risk rate our equity securities.

Valuation Methods: For debt securities, we first determine if the debt security is publicly traded (i.e., if it is listed on an exchange or securities market). If it is publicly traded, then we determine the value based on the closing price for the security on the exchange or securities market on which it is listed on the valuation date. If the security is not publicly traded, but a limited market for the security exists, such as for syndicated loans, and if the security has been rated by a NRSRO, then we value the loan at the indicative bid price offered by the syndication agent on the valuation date. At June 30, 2006, none of the debt securities in our portfolio were publicly traded and there was a limited market for eight debt securities in our portfolio. At September 30, 2005, none of the debt securities in our portfolio were publicly traded and there was a limited market for 12 debt securities in our portfolio.

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

- financial standing of the issuer of the security;
- comparison of the business and financial plan of the issuer with actual results;
- the cost of the security;
- the size of the security held as it relates to the liquidity of the market for such securities;
- contractual restrictions on the disposition of the security;
- pending public offering of the issuer of the security;
- pending reorganization activity affecting the issuer, such as mergers or debt restructuring;
- reported prices of similar securities of the issuer or comparable issuers;
- ability of the issuer to obtain needed financing;
- changes in the economy affecting the issuer;

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- recent purchases or sale of a security of the issuer;
- pricing by other buyers or sellers of similar securities;
- financial statements of the borrower;
- reports from portfolio company senior management and ownership;
- the type of security;
- cost at date of purchase;
- size of holding;
- discount from market value of unrestricted securities of the same class at the time of purchase;
- special reports prepared by analysts;
- information as to any transactions or offers with respect to the security;
- existence of merger proposals or tender offers affecting the securities;
- the collateral;
- the issuer's ability to make payments;
- the current and forecasted earnings of the issuer;
- sales to third parties of similar securities;
- statistical ratios compared to lending standards;
- statistical ratios compared to other similar securities; and
- other pertinent factors.

For those debt securities for which S&P prepares valuation recommendations, we provide the foregoing information to S&P for its use in preparing its recommendations.

For convertible debt, equity, success fees or other equity-like securities, we first determine if there is any market for the security. If there is a market, then we determine the value based on the market prices for the security, even if that market is not robust. At June 30, 2006 and September 30, 2005 there was no market for any of the equity securities we owned. If there is no market for the equity securities, then we use the same information we would use for a debt security valuation described above, except risk-rating, as well as standard valuation techniques used by major valuation firms to value the equity securities of private companies. These valuation techniques consist of:

discounted cash flow of the expected sale price in the future, valuation of the securities based on recent sales in comparable transactions, and a review of similar companies that are publicly traded and the market multiple of their equity securities. At June 30, 2006 and September 30, 2005 we had \$37,000 invested, at cost, in equity securities compared to our debt portfolio with a cost basis of \$201,428,621 and \$205,338,554, respectively.

At June 30, 2006, we had total unrealized appreciation of \$1,782,643, which was mainly composed of unrealized appreciation of \$1,010,778 on our warrants of Finn Corporation, \$235,543 of unrealized appreciation on our senior term debt in GQM Acquisition Corporation, \$133,000 of unrealized appreciation on our senior subordinated term debt investment in Visual Edge Technology, Inc. This unrealized appreciation was offset by unrealized depreciation of \$541,614, most notably composed of unrealized depreciation of \$332,084 on our senior term debt investments in Mistras Holdings Corporation and unrealized depreciation of \$122,678 on our senior subordinated term debt investment in Consolidated Bedding, Inc. In the aggregate, we recorded net unrealized appreciation of \$1,241,029 on our total investment portfolio.

At September 30, 2005, we had total unrealized depreciation of \$6,231,296, which was mainly composed of unrealized depreciation in our senior subordinated term debt investment in Finn Corporation (excluding the warrants) of \$3,150,000 (which was repaid in full in December 2005), our senior subordinated term debt investment in Xspedius Communications of \$1,493,182, and our senior term debt in ARI Holdings, Inc. of \$1,053,939 (which was subsequently sold at the September 30, 2005 reflected fair value), partially offset by unrealized appreciation, most notably on the value of our warrants of Finn Corporation, which had an unrealized appreciation of \$645,114 and our senior term debt investment in Woven Electronics Corporation, which had unrealized appreciation of \$431,436. This aforementioned unrealized appreciation plus unrealized appreciation of \$625,955 on certain other investments, primarily in our originated loan investments and certain syndicate participations, most notably Infor Global Solutions, which had unrealized appreciation of \$248,750, resulted in overall net unrealized depreciation of \$4,528,791.

Tax Status

Federal Income Taxes

We intend to continue to qualify for treatment as a RIC under Subtitle A, Chapter 1 of Subchapter M of the Code. As a RIC, we are not subject to federal income tax on the portion of our taxable income and gains distributed to stockholders. To qualify as a RIC, we are required to distribute to stockholders at least 90% of investment company taxable income, as defined by the Code. We have a policy to pay out as a dividend up to 100% of that amount.

Revenue Recognition

Interest Income Recognition

Interest income is recorded on the accrual basis to the extent that such amounts are expected to be collected. We will stop accruing interest on investments and write off any previously accrued and uncollected interest when it is determined that interest is no longer collectible. Conditional interest or a success fee is recorded when earned upon full repayment of a loan investment.

Payment in Kind Interest

In the future, we may once again hold some loans in our portfolio which contain a PIK interest provision. The PIK interest, computed at the contractual rate specified in each loan agreement, is added to the principal balance of the loan and recorded as interest income. To maintain our status as a RIC, this non-cash source of income must be paid out to stockholders in the form of dividends, even though we have not yet collected the cash.

RESULTS OF OPERATIONS

Comparison of the three months ended June 30, 2006 to the three months ended June 30, 2005

Investment Income

Investment income for the three months ended June 30, 2006 was approximately \$6.5 million as compared to approximately \$6.1 million for the three months ended June 30, 2005. Interest income from our investment portfolio increased from June 30, 2005 due to the increase in new loans of \$122.7 million, offset by principal repayments and investment sales of approximately \$117.9 million.

Interest income from our investments in debt securities of private companies was approximately \$5.8 million for the three months ended June 30, 2006 which is consistent with approximately \$5.8 million for the three months ended June 30, 2005, which included approximately \$64,000 of PIK interest. This was primarily a result of a modest net increase in investments of approximately \$4.8 million over June 30, 2005. This increase consisted of \$122.7 million of new investments, offset by principal repayments and investment sales of approximately \$117.9 million.

The annualized weighted average yield on our portfolio for the three months ended June 30, 2006 was 11.7%, there was no PIK interest accrued during the three months ended June 30, 2006. The annualized weighted average yield on our portfolio for the three months ended June 30, 2005 was 11.4% (without giving effect to PIK interest) and 11.8% (after giving effect to PIK interest).

Interest income from invested cash and cash equivalents for the three months ended June 30, 2006 was approximately \$8,000, as compared to approximately \$8,000 for the three months ended June 30, 2005.

For the three months ended June 30, 2006 and June 30, 2005, we recorded approximately \$109,000 and \$108,000, respectively, in interest income from loans to our employees in connection with the exercise of employee stock options.

For the three months ended June 30, 2006, we recorded approximately \$630,000 of prepayment fees and other income as compared to \$245,000 for the three months ended June 30, 2005. The income for both periods consisted of prepayment penalty fees received upon the full repayment of certain loan investments ahead of contractual maturity and prepayment fees received upon the early unscheduled principal repayments ahead of scheduled payment dates which, in both instances, were based on a percentage of the outstanding principal amount of the loan at the date of prepayment.

Operating Expenses

Operating expenses for the three months ended June 30, 2006 were approximately \$1.7 million, as compared to approximately \$1.8 million for the three months ended June 30, 2005. Operating expenses for the three months ended June 30, 2006 reflected a significant increase in interest expense, professional fees, and stockholder related costs.

Loan servicing fees of approximately \$694,000 were incurred for the three months ended June 30, 2006 as compared to approximately \$688,000 for the three months ended June 30, 2005. These fees were incurred in connection with a loan servicing agreement between Gladstone Business Loan LLC ("Business Loan") and Gladstone Management, which is based on the size of the portfolio. These fees were directly credited against the amount of the management fee due to Gladstone Management.

Effective October 1, 2004, we entered into an advisory agreement with Gladstone Management whereby Gladstone Management serves as our external adviser. As compensation for the services of Gladstone Management, we pay Gladstone Management an annual advisory fee of 1.25% of total assets (as reduced by cash and cash equivalents pledged to creditors), payable in quarterly computed increments of 0.3125%, and an annual administrative fee of 0.75% of total assets (as reduced by cash and cash equivalents pledged to creditors), payable in quarterly computed increments of 0.1875%, for a total fee of 2% of total assets (as reduced by cash and cash equivalents pledged to creditors). Effective in April 2006, Gladstone Management's Board of Directors agreed to voluntarily waive the advisory fee on a temporary basis by reducing the 1.25% annual fee to 0.5% per annum applicable only to the senior syndicated loans in which we already have a second lien position. We continue to pay direct expenses including, but not limited to, directors' fees, legal and accounting fees, stockholder related expenses, and directors and officers insurance. Under the advisory agreement, Gladstone Management provides managerial assistance and other services to our portfolio companies and likewise Gladstone Management directly receives any fees for such services. Any such fees are credited directly against the 2% management fee payable to Gladstone Management. The 2% management fee is also directly reduced by the amount of the monthly loan servicing fees we pay to Gladstone Management.

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Overall, the management fee due to Gladstone Management cannot exceed 2% of total assets (as reduced by cash and cash equivalents pledged to creditors) during any given fiscal year.

The following table sets forth the computation of the management fee for the three months ended June 30, 2006 and June 30, 2005, based on the quarterly increment of 0.50% (0.3125% quarterly advisory fee plus 0.1875% quarterly administrative fee):

	Three Months Ended	
	June 30, 2006	June 30, 2005
Fee:		
Total assets at	\$ 207,265,095	\$ 209,320,463
Less: Senior syndicated loans subject to reduced fee	(3,018,897) (a)	—
Less: Borrowings under line of credit at	—	—
Total assets subject to quarterly fee of 0.50% as of	204,246,198	209,320,463
Quarterly fee rate	0.50 %	0.50 %
Management fee before senior syndicated loan advisory fee	1,021,231	1,046,602
Total senior syndicated loan advisory fee at quarterly rate 0.125%	3,774 (b)	—
Gross management fee before loan servicing fee credit	1,025,005	1,046,602
Less: loan servicing fee from Gladstone Business Loan LLC	693,965	687,971
Management fee before credit:	<u>331,040</u>	<u>358,631</u>
Direct Credit to Management Fee:		
Fee revenue recorded by Gladstone Management:	539,000	240,600
Net management fee for the three months ended (c):	<u>\$ (207,960)</u>	<u>\$ 118,031</u>

(a) In April 2006, the Adviser's Board of Directors waived on a temporary basis the annual advisory fee from 1.25% to 0.5% (0.125% quarterly) for those senior syndicated loans in which the Company also holds a syndicated second lien position.

(b) This amount represents the reduced quarterly advisory fee applicable only to the senior syndicated loans.

(c) If the amount presented is in parentheses it denotes the amount is due back to us from the Adviser; if the amount is positive, it indicates that we owe the Adviser the stated amount.

Professional fees, consisting primarily of legal and audit fees, for the three months ended June 30, 2006 were approximately \$166,000 as compared to approximately \$134,000 for the three months ended June 30, 2005. The increase is due primarily to an increase in non-reimbursable legal fees associated with the stock option tender offer.

Amortization of deferred financing costs, in connection with our lines of credit, was approximately \$36,000 for the three months ended June 30, 2006 and approximately \$101,000 for the three months ended June 30, 2005. The decrease is due to the completion of the amortization cycle related to certain deferred financing costs.

Interest expense for the three months ended June 30, 2006 was approximately \$702,000 as compared to approximately \$563,000 for the three months ended June 30, 2005. This increase is primarily a result of increased borrowings under our line of credit during the three months ended June 30, 2006, which borrowings were used, in part, to finance our increased investments, of which these borrowings remained outstanding for longer periods of time and an increase in the interest rates on our borrowings.

Stockholder related costs for the three months ended June 30, 2006 were approximately \$28,000, as compared to approximately \$16,000 for the three months ended June 30, 2005. Stockholder related costs include such recurring items as transfer agent fees, securities fees, and electronic filing fees and increased during the three months ended June 30, 2006 mainly in association with the stock option tender offer.

Directors' fees for the three months ended June 30, 2006 were approximately \$28,000, as compared to approximately \$27,000 for the three months ended June 30, 2005 due to the addition of a new director in December 2005.

Insurance expense for the three months ended June 30, 2006 was approximately \$51,000, as compared to approximately \$44,000 for the three months ended June 30, 2005. The increase is primarily the result of an increase in the amortization of our directors and officers insurance premiums.

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Stock option compensation expense for the three months ended June 30, 2006 was approximately \$202,000. This is the result of the adoption of the Statement of Financial Accounting Standards No. 123 (revised 2004) ("SFAS No. 123(R)") *Share-based Payment*. SFAS No. 123(R) replaces SFAS No. 123, *Accounting for Stock-Based Compensation* and supersedes Accounting Principles Board ("APB") Opinion No. 25, *Accounting for Stock Issued to Employees* ("APB No. 25"). SFAS No. 123(R) is effective for awards that are granted, modified, or settled in cash for annual periods beginning after June 15, 2005. The Company adopted SFAS No. 123(R) on October 1, 2005 using the modified prospective approach. Under the modified prospective approach, stock-based compensation expense will be recorded for the unvested portion of previously issued awards that remain outstanding at October 1, 2005 using the same estimate of the grant date fair value and the same attribution method used to determine the pro forma disclosure under SFAS No. 123. SFAS No. 123(R) also requires that all share-based payments to employees after October 1, 2005, including employee stock options, be recognized in the financial statements as stock-based compensation expense based on the fair value on the date of grant. There was no stock option compensation expense recorded for the three months ended June 30, 2005.

Other expenses were approximately \$35,000 for the three months ended June 30, 2006, as compared to approximately \$64,000 for the three months ended June 30, 2005. The expenses primarily represent direct expenses such as travel related specifically to our portfolio companies, loan evaluation services for our portfolio companies, press releases and backup servicer expenses.

Realized Gain (Loss) on Sale of Investments

During the three months ended June 30, 2006, we realized a net loss of approximately \$101,000 as a result of the repayment in full of some syndicated loans that contained unamortized premiums. There were no realized gains or losses on sale of investments during the three months ended June 30, 2005.

Realized Gain on Settlement of Derivative

During the three months ended June 30, 2006, we received our first interest rate cap agreement payment as a result of the one month LIBOR exceeding 5%. There was no realization during the three months ended June 30, 2005 as the one month LIBOR was below 5%.

Net Unrealized Appreciation (Depreciation) on Derivative

During the three months ended June 30, 2006, we recorded net unrealized appreciation of approximately \$41,000 due to an increase in the fair market value of our interest rate cap agreement, as compared to unrealized depreciation of approximately \$49,000 during the three months ended June 30, 2005. The increase in the fair market value is attributable to the one month LIBOR exceeding 5% which is when we would start to receive payments.

Net Unrealized Appreciation (Depreciation) on Investments

For the three months ended June 30, 2006, we recorded net unrealized appreciation on investments of approximately \$813,000 as compared to net unrealized depreciation of approximately \$389,000, for the three months ended June 30, 2005. The unrealized appreciation increased during the three months ended June 30, 2006 mainly in part to the increase in the value of the Finn Corporation warrant.

Net Increase in Net Assets from Operations

Overall, we realized a net increase in net assets resulting from operations of approximately \$5.5 million for the three months ended June 30, 2006. Based on a weighted-average of 11,337,291 (basic) and 11,570,425 (diluted) shares outstanding, our net increase in net assets from operations per weighted-average common share for the three months ended June 30, 2006 was \$0.49 (basic) and \$0.48 (diluted).

For the three months ended June 30, 2005, we realized a net increase in net assets resulting from operations of approximately \$3.9 million. Based on a weighted-average of 11,299,010 (basic) and 11,578,637 (diluted) shares outstanding, our net increase in net assets resulting from operations per weighted-average common share for the three months ended June 30, 2005 was \$0.35 (basic) and \$0.34 (diluted).

Comparison of the nine months ended June 30, 2006 to the nine months ended June 30, 2005

Investment Income

Investment income for the nine months ended June 30, 2006 was approximately \$19.6 million as compared to approximately \$18.1 million for the nine months ended June 30, 2005. The increase is mainly attributable to an increase in interest income from our investment portfolio which had new investments of \$122.7 million, offset by principal repayments and investment sales of approximately \$117.9 million, for net new investments of \$4.8 million from June 30, 2005 through June 30, 2006.

Interest income from our investments in debt securities of private companies was approximately \$18.5 million, including approximately \$556,000 of success fees from the full repayment of Woven Electronics Corporation and \$63,000 of PIK interest, for the nine months ended June 30, 2006 as compared to approximately \$16.7 million for the nine months ended June 30, 2005, which included approximately \$335,000 of PIK interest. This increase was primarily a result of a net increase in investments of approximately \$4.8 million over June 30, 2005. There was also an increase in investments that are variable rate or that the variable rate has exceeded the floor which contributed to the growth in interest income.

The annualized weighted average yield on our portfolio for the nine months ended June 30, 2006 was 12.3% (without giving effect to PIK interest) and 12.3% (after giving effect to PIK interest). The annualized weighted average yield on our portfolio for the nine months ended June 30, 2005 was 12.5% (without giving effect to PIK interest) and 12.6% (after giving effect to PIK interest). The decline is due to the early repayments of principal balances on certain loans, which had higher interest rates.

Interest income from invested cash and cash equivalents for the nine months ended June 30, 2006 was approximately \$22,000, as compared to approximately \$29,000 for the nine months ended June 30, 2005. This decrease was primarily a result of a decrease in invested cash and cash equivalents.

For the nine months ended June 30, 2006 and June 30, 2005, we recorded approximately \$323,000 and \$336,000, respectively, in interest income from loans to our employees in connection with the exercise of employee stock options.

For the nine months ended June 30, 2006, we recorded approximately \$711,000 of prepayment fees and other income as compared to \$1.1 million for the nine months ended June 30, 2005. The income for both periods consisted of prepayment penalty fees received upon the full repayment of certain loan investments ahead of contractual maturity and prepayment fees received upon the early unscheduled principal repayments ahead of scheduled payment dates which, in both instances, were based on a percentage of the outstanding principal amount of the loan at the date of prepayment.

Operating Expenses

Operating expenses for the nine months ended June 30, 2006 were approximately \$5.1 million, as compared to approximately \$4.5 million for the nine months ended June 30, 2005. Operating expenses for the nine months ended June 30, 2006 reflected a significant increase in interest expense, loan servicing fees, stockholder related costs and stock option compensation expense.

Loan servicing fees of approximately \$2.1 million were incurred for the nine months ended June 30, 2006 as compared to approximately \$1.8 million for the nine months ended June 30, 2005. These fees were incurred in connection with a loan servicing agreement between Gladstone Business Loan LLC ("Business Loan") and Gladstone Management, which is based on the size of the portfolio. These fees were directly credited against the amount of the management fee due to Gladstone Management.

Effective October 1, 2004, we entered into an advisory agreement with Gladstone Management whereby Gladstone Management serves as our external adviser. As compensation for the services of Gladstone Management, we pay Gladstone Management an annual advisory fee of 1.25% of total assets (as reduced by cash and cash equivalents pledged to creditors), payable in quarterly computed increments of 0.3125%, and an annual administrative fee of 0.75% of total assets (as reduced by cash and cash equivalents pledged to creditors), payable in quarterly computed increments of 0.1875%, for a total fee of 2% of total assets (as reduced by cash and cash equivalents pledged to creditors). Effective in April 2006, Gladstone Management's Board of Directors voluntarily waived the advisory fee on a temporary basis by reducing the 1.25% annual fee to 0.5% per annum applicable only to the senior syndicated loans in which we already have a second lien position. We continue to pay direct expenses including, but not limited to, directors' fees, legal and accounting fees, stockholder related expenses, and directors and officers insurance. Under the advisory agreement, Gladstone Management provides managerial assistance and other services to our portfolio companies and likewise Gladstone Management directly receives any fees for such services. Any such fees are credited directly against the 2% management fee payable to Gladstone Management. The 2% management fee is also directly reduced by the amount of the monthly loan servicing fees we pay to Gladstone Management.

Overall, the management fee due to Gladstone Management cannot exceed 2% of total assets (as reduced by cash and cash equivalents pledged to creditors) during any given fiscal year.

The following table sets forth the computation of the management fee for the nine months ended June 30, 2006 and June 30, 2005, based on the quarterly increment of 0.50% (0.3125% quarterly advisory fee plus 0.1875% quarterly administrative fee) and the reduced fee for senior syndicated loans of 0.125% per quarter:

	Three Months Ended		
	June 30, 2006	March 31, 2006	December 31, 2005
Fee:			
Total assets at	\$ 207,265,095	\$ 217,404,695	\$ 211,823,244
Less: Senior syndicated loans subject to reduced fee	(3,018,897)(a)	—	
Less: Borrowings under line of credit at	—	—	(15,000,000)(d)
Total assets subject to quarterly fee of 0.50% as of	204,246,198	217,404,695	196,823,244
Quarterly fee rate	0.50%	0.50%	0.50%
Management fee before senior syndicated loan advisory fee	1,021,231	1,087,023	984,116
Total senior syndicated loan advisory fee at quarterly rate 0.125%	3,774 (b)	—	—
Gross management fee before loan servicing fee credit	1,025,005	1,087,023	984,116
Less: loan servicing fee from Gladstone Business Loan LLC	693,965	734,644	715,415
Management fee before credit:	331,040	352,379	268,701

Direct Credit to Management Fee:

Fee revenue recorded by Gladstone Management:	539,000	673,000	550,000
Net management fee for the three months ended (c):	\$ (207,960)	\$ (320,621)	\$ (281,299)

	Three Months Ended		
	June 30, 2005	March 31, 2005	December 31, 2004
Fee:			
Total assets at	\$ 209,320,463	\$ 213,753,998	\$ 194,085,591
Less: Borrowings under line of credit at	—	(18,644,179)(e)	(22,435,000)(e)
Total assets subject to fee as of	209,320,463	195,109,819	171,650,591
Quarterly fee rate	0.50%	0.50%	0.50%
Gross management fee before loan servicing fee credit	1,046,602	975,549	858,254
Less: loan servicing fee from Gladstone Business Loan LLC	687,971	585,542	530,952
Management fee before credit:	358,631	390,007	327,302
Direct Credit to Management Fee:			
Fee revenue recorded by Gladstone Management:	240,600	450,000	286,500
Net management fee for the three months ended (c):	\$ 118,031	\$ (59,993)	\$ 40,802

- (a) In April 2006, the Adviser's Board of Directors waived on a temporary basis the annual advisory fee from 1.25% to 0.5% (0.125% quarterly) for those senior syndicated loans in which the Company also holds a syndicated second lien position.
- (b) This amount represents the reduced quarterly advisory fee applicable only to the senior syndicated loans.
- (c) If the amount presented is in parentheses it denotes the amount is due back to us from the Adviser; if the amount is positive, it indicates that we owe the Adviser the stated amount.
- (d) This amount represents borrowings under one of our lines of credit that were held in cash and cash equivalents as of December 31, 2005. The \$15.0 million was to be used to fund a new loan investment, however the investment did not fund until January 2006. Solely for the purposes of calculating the amount of the management fee due to Gladstone Management, we treat any such amounts as "cash and cash equivalents pledged to creditors" under the terms of our advisory agreement with Gladstone Management. As a result, such amounts are deducted from our total assets for purposes of computing the asset base upon which the management fee is determined.
- (e) This amount represents borrowings under one of our lines of credit that were held in cash and cash equivalents as of March 31, 2005 and December 31, 2004, for the purpose of satisfying our asset diversification requirements under the Code. Solely for the purposes of calculating the amount of the management fee due to Gladstone Management, we treat any such amounts as "cash and cash equivalents pledged to creditors" under the terms of our advisory agreement with Gladstone Management. As a result, such amounts are deducted from our total assets for purposes of computing the asset base upon which the management fee is determined.

Professional fees, consisting primarily of legal and audit fees, for the nine months ended June 30, 2006 were approximately \$400,000 as compared to approximately \$529,000 for the nine months ended June 30, 2005. The decrease is due primarily to a decrease in non-reimbursable legal fees.

Amortization of deferred financing costs, in connection with our lines of credit, was approximately \$95,000 for the nine months ended June 30, 2006 and approximately \$284,000 for the nine months ended June 30, 2005. The decrease is due to the completion of the amortization cycle related to certain deferred financing costs.

Interest expense for the nine months ended June 30, 2006 was approximately \$2.3 million as compared to approximately \$1.2 million for the nine months ended June 30, 2005. This increase is primarily a result of increased borrowings under our lines of credit during the nine months ended June 30, 2006, which borrowings were used, in part, to finance our increased investments, borrowings remaining outstanding for longer periods of time and an increase in the interest rates on our borrowings.

Stockholder related costs for the nine months ended June 30, 2006 were approximately \$273,000, as compared to approximately \$193,000 for the nine months ended June 30, 2005. Stockholder related costs include such recurring items as transfer agent fees, securities fees, and electronic filing fees. The increase is due mainly to the printing and mailing of the special proxy statement in connection with the special meeting of stockholders, the printing and mailing of the annual report to stockholders and the annual proxy to stockholders, and the filing fees associated with the stock option tender offer.

Directors' fees for the nine months ended June 30, 2006 were \$82,000, as compared to approximately \$78,000 for the nine months ended June 30, 2005 due to the addition of a new director in December 2005.

Insurance expense for the nine months ended June 30, 2006 was approximately \$152,000, as compared to approximately \$134,000 for the nine months ended June 30, 2005. The increase is primarily the result of an increase in the amortization of our directors and officers insurance premiums.

Stock option compensation expense for the nine months ended June 30, 2006 was approximately \$280,000. This is the result of the adoption of SFAS No. 123(R) *Share-based Payment*. SFAS No. 123(R) replaces SFAS No. 123, *Accounting for Stock-Based Compensation* and supersedes Accounting Principles Board ("APB") Opinion No. 25, *Accounting for Stock Issued to Employees* ("APB No. 25"). SFAS No. 123(R) is effective for awards that are granted, modified, or settled in cash for annual periods beginning after June 15, 2005. The Company adopted SFAS No. 123(R) on October 1, 2005 using the modified prospective approach. Under the modified prospective approach, stock-based compensation expense will be recorded for the unvested portion of previously issued awards that remain outstanding at October 1, 2005 using the same estimate of the grant date fair value and the same attribution method used to determine the pro forma disclosure under SFAS No. 123. SFAS No. 123(R) also requires that all share-based payments to employees after October 1, 2005, including employee stock options, be recognized in the financial statements as stock-based compensation expense based on the fair value on the date of grant. There was no stock option compensation expense recorded for the nine months ended June 30, 2005.

Other expenses were approximately \$152,000 for the nine months ended June 30, 2006, as compared to approximately \$177,000 for the nine months ended June 30, 2005. The expenses primarily represent direct expenses such as travel related specifically to our portfolio companies, loan evaluation services for our portfolio companies, press releases and backup servicer expenses.

Income Tax Expense

During the nine months ended June 30, 2006, Gladstone Capital Corporation recorded approximately \$50,000 in connection with penalties incurred on misclassified revenue on its fiscal year 2004 corporate tax return.

Gladstone Capital Advisers, Inc., a wholly-owned subsidiary of Gladstone Capital Corporation, is subject to federal and state income taxation on the income it has recorded such as managerial assistance and other fees. During the nine months ended June 30, 2005, Gladstone Capital Advisers incurred aggregate federal and state income taxes of \$138,678 resulting from taxable income it received during the 2004 fiscal year. Following the externalization of our management effective October 1, 2004 substantially all revenues previously received by Gladstone Capital Advisers are now received by Gladstone Management. As a result, we do not anticipate incurring significant tax expense as a result of the activities of Gladstone Capital Advisers in the future.

Realized (Loss) Gain on Sale of Investments

During the nine months ended June 30, 2006, we sold our investments in ARI Holdings, Inc. and Marcal Paper Mills, Inc. for an aggregate loss of approximately \$1.18 million and were repaid on several syndicated loans which contained unamortized premiums of approximately \$149,000, partially offset by gains of approximately \$426,000 on the sale of some syndicated loans and the repayment in full of some syndicated loans which contained unamortized discounts, for a total net realized loss of approximately \$904,000. During the nine months ended June 30, 2005, we sold our \$975,000 syndicated participation in Burt's Bees, Inc. for a gain of \$9,750 and we sold our \$2.0 million syndicated participation in Marietta Corp. for a gain of \$20,000, for a total net realized gain of approximately \$30,000.

Realized Gain on Settlement of Derivative

During the nine months ended June 30, 2006, we received our first interest rate cap agreement payment as a result of the one month LIBOR exceeding 5%. There was no realization during the nine months ended June 30, 2005 as the one month LIBOR was below 5%.

Net Unrealized Appreciation (Depreciation) on Derivative

During the nine months ended June 30, 2006, we recorded net unrealized appreciation of approximately \$65,000 due to an increase in the fair market value of our interest rate cap agreement, as compared to unrealized depreciation of approximately \$58,000 during the nine months ended June 30, 2005.

Net Unrealized Appreciation (Depreciation) on Investments

For the nine months ended June 30, 2006, we recorded net unrealized appreciation on investments of approximately \$5.8 million as compared to net unrealized depreciation of approximately \$298,000, for the nine months ended June 30, 2005. The unrealized appreciation is mainly attributable to the early repayment or sale of loans that were underperforming as of September 30, 2005, most notably Finn Corporation and ARI Holdings, Inc., as well as the unrealized appreciation on the Finn Corporation warrant currently still in our portfolio.

Net Increase in Net Assets from Operations

Overall, we realized a net increase in net assets resulting from operations of approximately \$19.3 million for the nine months ended June 30, 2006. Based on a weighted-

average of 11,317,437 (basic) and 11,549,054 (diluted) shares outstanding, our net increase in net assets from operations per weighted-average common share for the nine months ended June 30, 2006 was \$1.71 (basic) and \$1.68 (diluted).

For the nine months ended June 30, 2005, we realized a net increase in net assets resulting from operations of approximately \$13.2 million for the nine months ended June 30, 2005. Based on a weighted-average of 11,288,784 (basic) and 11,602,986 (diluted) shares outstanding, our net increase in net assets from operations per weighted-average common share for the nine months ended June 30, 2005 was \$1.17 (basic) and \$1.13 (diluted).

LIQUIDITY AND CAPITAL RESOURCES

At June 30, 2006, we had investments in debt securities of, or loans to, 29 private companies, totaling approximately \$201.5 million (cost basis) of total assets.

During the nine months ended June 30, 2006 and June 30, 2005, the following investment activity occurred:

<u>Quarter Ended</u>	<u>New Investments</u>	<u>Principal Repayments</u>	<u>Net Gain/(Loss) on Disposal</u>
June 30, 2006	\$ 39,916,834	\$ 44,358,944	\$ (100,850)
March 31, 2006	38,471,109	24,815,067	377,500
December 31, 2005	26,688,457	38,702,066	(1,180,595)
	<u>\$ 105,076,400</u>	<u>\$ 107,876,077</u>	<u>\$ (903,945)</u>
June 30, 2005	\$ 34,732,083	\$ 18,154,720	\$ —
March 31, 2005	44,513,875	33,859,918	20,000
December 31, 2004	46,949,500	25,975,707	9,750
	<u>\$ 126,195,458</u>	<u>\$ 77,990,345</u>	<u>\$ 29,750</u>

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

<u>Fiscal Year Ended September 30,</u>	<u>Amount</u>
2006	\$ 2,532,673
2007	10,216,270
2008	23,415,615
2009	24,354,132
2010	36,118,831
Thereafter	104,828,100
	<u>\$ 201,465,621</u>

Net cash provided by operating activities for the nine months ended June 30, 2006, consisting primarily of the items described in “Results of Operations”, was approximately \$15.0 million as compared to net cash provided by operating activities of approximately \$2.2 million for the nine months ended June 30, 2005. Net cash provided by investing activities was approximately \$2.9 million for the nine months ended June 30, 2006 and mainly consisted of the net repayment of investments of approximately \$2.8 million, as compared to net cash used in investing activities of approximately \$68.8 million for the nine months ended June 30, 2005, which consisted mainly of new investments of \$126.2 million and the repayment of a repurchase agreement of approximately \$21.3 million, partially offset by principal repayments of approximately \$78.0 million. Net cash used in financing activities for the nine months ended June 30, 2006 was approximately \$18.0 million and mainly consisted of repayments of borrowings on the line of credit of approximately \$118.3 million and approximately \$13.8 million for the payment of dividends. These outflows were partially offset by approximately \$113.1 million of cash received from borrowings on the line of credit and the exercise of stock options for approximately \$1.2 million. Net cash provided by financing activities was approximately \$1.4 million for the nine months ended June 30, 2005 and consisted primarily of cash provided from borrowings on our lines of credit, net of repayments, of approximately \$13.8 million and the exercise of stock options which provided approximately \$270,000, offset by the payment of dividends of approximately \$12.5 million.

During the nine months ended June 30, 2006, cash and cash equivalents decreased from approximately \$504,000 to approximately \$456,000.

Subsequent to June 30, 2006, we funded a loan investment in the aggregate amount of \$5.7 million and purchased an additional \$6.5 million syndicate participation using borrowings from our line of credit and received an early repayment of approximately \$7.5 million, of which the net proceeds were used to pay down the line of credit.

In order to qualify as a regulated investment company and to avoid corporate level tax on the income we distribute to our stockholders, we are required, under Subchapter M of the Internal Revenue Code, to distribute at least 90% of our ordinary income and short-term capital gains to our stockholders on an annual basis. In accordance with these requirements, we declared and paid monthly cash dividends of \$0.135 per common share for January, February, March, April, May, and June 2006, October, November, and December 2005 and \$0.12 per common share for October, November and December 2004 and January, February, and March 2005, \$0.13 for April, May, and June 2005, and \$0.135 for July, August and September 2005. In July 2006, our Board of Directors declared a monthly dividend of \$0.14 per common share for each July, August, and September 2006.

We anticipate continuing to borrow funds and, from time to time issuing additional equity securities to obtain additional capital to make further investments. To this end, we have an effective registration statement on file with the SEC that would permit us to issue, through one or more transactions, up to an aggregate of \$48.8 million in securities, which may consist of shares of our common stock, preferred stock, and/or debt securities.

Revolving Credit Facilities

Through our wholly-owned subsidiary, Business Loan, we have a \$100 million revolving credit facility (the “DB Facility”) with Deutsche Bank AG, as administrative agent,

which currently matured on May 26, 2006 and was renewed and extended through May 27, 2007. In connection with the renewal, the credit facility was amended to reduce the equity contribution from \$100.0 million to \$50.0 million. Pursuant to the DB Facility, Business Loan has pledged the loans it holds to secure future advances by certain institutional lenders. Interest rates charged on the advances under the DB Facility will be based on LIBOR, the Prime Rate or the Federal Funds Rate, depending on market conditions, and will adjust periodically. As of June 30, 2006, our outstanding principal balance under the DB Facility was approximately \$47.8 million at an interest rate of 5.2%. Available borrowings are subject to various constraints imposed by Deutsche Bank AG, based on the aggregate loan balance pledged by Business Loan, which varies as loans are added and repaid, regardless of whether such repayments are early prepayment or are made as contractually required. At June 30, 2006, the remaining borrowing capacity available under the DB Facility was approximately \$52.2 million. In October 2005, our Board of Directors approved a resolution to seek to increase this credit facility to \$150 million if the need should arise in the future.

The DB Facility contains covenants that, among other things, require Business Loan to maintain its status as a separate entity; prohibit certain significant corporate transactions (such as mergers, consolidations, liquidations or dissolutions); and restrict material changes to our credit and collection policies. The DB Facility also restricts some of the terms and provisions (including interest rates, terms to maturity and payments schedules) and limits the borrower and industry concentrations of loans that are eligible to secure advances. As of June 30, 2006, Business Loan was in compliance with all of the DB Facility covenants. We currently intend to securitize all of the loans held by Business Loan and to use the proceeds from the securitization to pay down any amounts then outstanding under the revolving credit facility. However, there can be no assurance that we will be able to successfully securitize any of these loans on terms acceptable to us, if at all.

The administrative agent also requires that any interest or principal payments on pledged loans be remitted directly by the borrower into a lockbox account with the Bank of New York as custodian. Deutsche Bank AG is also the trustee of the account and once a month remits the collected funds to the Company. For the nine months ended June 30, 2006, the amount due from custodian decreased by approximately \$130,000.

Gladstone Management, our affiliated external adviser, services the loans pledged under the DB Facility. As a condition to this servicing arrangement, we executed a performance guaranty pursuant to which we guaranteed that Gladstone Management would comply fully with all of its obligations under the facility. The performance guaranty requires us to maintain a minimum net worth of \$100 million and to maintain "asset coverage" with respect to "senior securities representing indebtedness" of at least 200%, in accordance with Section 18 of the 1940 Act. As of June 30, 2006, we were in compliance with our covenants under the performance guaranty.

The DB facility is available for general corporate purposes.

We also had a \$15.0 million line of credit agreement with Branch Banking and Trust Company ("BB&T Agreement") which originally matured on June 1, 2005. The line of credit was subsequently modified for quarterly extensions and in December 2005, it was modified to extend the maturity date through December 31, 2006. On June 22, 2006, we terminated the BB&T Agreement due to infrequent borrowings. Interest on outstanding borrowings was based upon the one month LIBOR plus 2.5% per annum. The unused portion of the line of credit was subject to a fee of 0.2% per annum during the period in which the BB&T Agreement was outstanding.

ITEM 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK.

We are subject to financial market risks, including changes in interest rates. We expect that ultimately approximately 20% of the loans in our portfolio will be made at fixed rates and approximately 80% will be made at variable rates. Currently our portfolio has approximately 69% of the total loan portfolio cost basis at variable rates with a floor, approximately 3% of the total loan portfolio cost basis at a variable rate with a floor and ceiling, and the remaining 28% of the total loan portfolio cost basis at variable rates without a floor or ceiling.

We have a \$100 million revolving credit facility, based on variable rates, with Deutsche Bank AG which matured in May 2006 and was extended and amended through May 2007.

In February 2004, we entered into an interest rate cap agreement in order to fulfill an obligation under our line of credit to enter into certain hedging transactions in connection with our borrowings under the line of credit. We purchased this interest rate cap agreement with a notional amount of \$35 million (which is amortized quarterly) for a one-time, up-front payment of \$304,000. The interest rate cap agreement entitles us to receive payments, if any, equal to the amount by which interest payments on the current notional amount at one month LIBOR exceed the payments on the current notional amount at 5%. The cap expires in February 2009. This interest rate cap agreement effectively caps our interest payments on our line of credit borrowing, up to the notional amount of the interest rate cap, at five percent. This mitigates our exposure to increases in interest rates on our borrowings on our lines of credit, which are at variable rates. At June 30, 2006, the cap agreement had a fair market value of \$115,505 and a current notional amount of \$19.8 million. At June 30, 2006, the one month LIBOR rate was approximately 5.33%.

To illustrate the potential impact of changes in interest rates on our net increase in net assets resulting from operations, we have performed the following analysis, which assumes that our balance sheet remains constant and no further actions beyond the interest rate cap agreement are taken to alter our existing interest rate sensitivity. Under this analysis, a hypothetical increase in the one month LIBOR by 1% would increase our net increase in net assets resulting from operations by approximately \$1.7 million or 8.0%, over the next twelve months, compared to the net increase in net assets resulting from operations for the twelve months ended June 30, 2006. A hypothetical decrease in the one month LIBOR by 1% would decrease net increase in net assets resulting from operations by approximately \$1.7 million, or 8.0%, over the next twelve months, compared to the net increase in net assets resulting from operations for the twelve months ended June 30, 2006. Although management believes that this analysis is indicative of our existing interest rate sensitivity, it does not adjust for potential changes in credit quality, size and composition of our loan portfolio on the balance sheet and other business developments that could affect net increase in net assets resulting from operations. Accordingly, no assurances can be given that actual results would not differ materially from the results under this hypothetical analysis.

In the event that we securitize a portion of our loan portfolio, we believe that we will likely be required to enter into further hedging arrangements in the future with respect to securitized loans. While hedging activities may mitigate our exposure to adverse fluctuations in interest rates, certain hedging transactions that we may enter into in the future, such as interest rate swap agreements, may also limit our ability to participate in the benefits of lower interest rates with respect to our portfolio of investments.

We may also experience risk associated with investing in securities of companies with foreign operations. We currently do not anticipate investing in debt or equity of foreign companies, however, some potential portfolio companies may have operations located outside the United States. These risks include, but are not limited to, fluctuations in foreign currency exchange rates, imposition of foreign taxes, changes in exportation regulations and political and social instability.

ITEM 4. CONTROLS AND PROCEDURES.

As of June 30, 2006, we, including our Chief Executive Officer and Chief Financial Officer, evaluated the effectiveness of the design and operation of our disclosure controls and procedures. Based on that evaluation, our management, including the Chief Executive Officer and Chief Financial Officer, concluded that our disclosure controls and procedures were effective in timely alerting management, including the Chief Executive Officer and Chief Financial Officer, of material information about us required to be included in periodic Securities and Exchange Commission filings. However, in evaluating the disclosure controls and procedures, management recognized that any controls and procedures, no matter how well designed and operated can provide only reasonable assurance of achieving the desired control objectives, and management necessarily was required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures.

There have been no changes in our internal control over financial reporting that occurred during the quarter ended June 30, 2006, that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

PART II—OTHER INFORMATION

ITEM 1. LEGAL PROCEEDINGS.

Neither we, nor any of our subsidiaries, are currently subject to any material legal proceeding, nor, to our knowledge, is any material legal proceeding threatened against us or any of our subsidiaries.

ITEM 1A. RISK FACTORS.

Our business is subject to certain risks and events that, if they occur, could adversely affect our financial condition and results of operations and the trading price of our common stock. For a discussion of these risks, please refer to the “Risk Factors” section of our Annual Report on Form 10-K for the fiscal year ended September 30, 2005, filed by us with the Securities and Exchange Commission on December 13, 2005. In connection with our preparation of this quarterly report, management has reviewed and considered these risk factors and has determined that the following risk factors should be read in connection with the existing risk factors disclosed in our Annual Report on Form 10-K for the fiscal year ended September 30, 2005.

The recent acceleration of vesting of all outstanding options except those of our non-employee directors, coupled with the new expiration dates of our outstanding options, could result in significant selling pressure from option holders, which could reduce our stock price.

As a result of the recent vesting acceleration of the majority of our outstanding options and the recent amendment of all of our outstanding options to shorten the remaining exercise period of these options to September 30, 2006, there could be significant downward pressure on our common stock price. This would be particularly the case if a significant number of option holders elect not to “buy and hold,” but rather seek to monetize their option holdings (e.g., through a broker-assisted cashless exercise). This downward pressure could reduce the current market price of our common stock and dilute the interests of existing stockholders.

Additional risks and uncertainties not presently known to us or that we currently deem immaterial also may impair our business operations. If any of the risks actually occur, our business could be harmed. In that event, the trading price of our common stock could decline.

At the start of the 2007 fiscal year, the Amended Advisory Agreement with Gladstone Management Corporation and the Administration Agreement with Gladstone Administration LLC will become effective and could potentially reduce our net investment income.

The Amended Advisory Agreement provides for an annual base management fee equal to 2% of our assets and an income-based incentive fee which will reward our Adviser, Gladstone Management Corporation, if our quarterly net investment income (before giving effect to the incentive fee) exceeds 1.75% of our net assets. The agreement also provides for an annual capital gains-based incentive fee, whereby the Adviser will receive an annual fee equal to 20% of our realized capital gains (net of realized capital losses and unrealized capital depreciation since inception of the Company). Under the Administration Agreement, we will pay separately for our allocable portion of the Administrator’s overhead expenses in performing our obligations, including rent, and our allocable portion of the salaries and benefits expenses of our chief financial officer, chief compliance officer and controller and their respective staffs.

These additional fees could potentially reduce our net investment income which is the basis for our dividend declaration.

ITEM 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS.

Not applicable.

ITEM 3. DEFAULTS UPON SENIOR SECURITIES.

Not applicable.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS.

No matters were submitted to a vote of security holders during the three months ended June 30, 2006.

ITEM 5. OTHER INFORMATION.

Not applicable

ITEM 6. EXHIBITS

See the exhibit index.

SIGNATURE

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.

GLADSTONE CAPITAL CORPORATION

By: /s/ HARRY BRILL
Harry Brill
Chief Financial Officer

Date: August 1, 2006

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EXHIBIT INDEX

Exhibit	Description
3.1	Articles of Amendment and Restatement of the Articles of Incorporation, incorporated by reference to Exhibit a.2 to Pre-Effective Amendment No. 1 to the Registration Statement on Form N-2 (File No. 333-63700), filed July 27, 2001.
3.2	By-laws, incorporated by reference to Exhibit b to Pre-Effective Amendment No. 1 to the Registration Statement on Form N-2 (File No. 333-63700), filed July 27, 2001.
3.3	Amendment to by-laws, incorporated by reference to Exhibit 3.3 to the Company's Quarterly Report on Form 10-Q for the quarter ended December 31, 2003 (File No. 814-00237), filed February 17, 2004.
10.1	Amended and Restated Credit Agreement by and among Gladstone Business Loan LLC, Deutsche Bank AG, and certain other parties, dated as of May 26, 2006, incorporated by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K (File No. 814-00237), filed on May 30, 2006.
10.2	Joint Directors Nonqualified Excess Plan of Gladstone Commercial Corporation, Gladstone Capital Corporation and Gladstone Investment Corporations, dated as of July 11, 2006, incorporated by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K (File No. 814-00237), filed on July 12, 2006.
10.3	Custodian Agreement between Gladstone Capital Corporation and The Bank of New York, dated as of May 5, 2006.
11	Computation of Per Share Earnings (included in the notes to the unaudited financial statements contained in this report).
31.1	Certification of Chief Executive Officer pursuant to section 302 of The Sarbanes-Oxley Act of 2002.
31.2	Certification of Chief Financial Officer pursuant to section 302 of The Sarbanes-Oxley Act of 2002.
32.1	Certification of Chief Executive Officer pursuant to section 906 of The Sarbanes-Oxley Act of 2002.
32.2	Certification of Chief Financial Officer pursuant to section 906 of The Sarbanes-Oxley Act of 2002.

All other exhibits for which provision is made in the applicable regulations of the Securities and Exchange Commission are not required under the related instruction or are inapplicable and therefore have been omitted.

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CUSTODY AGREEMENT

AGREEMENT, dated as of May 5, 2006 between Gladstone Capital Corporation, a corporation existing under the laws of the State of Maryland having its principal office and place of business at 1521 Westbranch Drive, Suite 200, McLean, Virginia 22102 (the "Corporation") and The Bank of New York, a New York corporation authorized to do a banking business having its principal office and place of business at One Wall Street, New York, New York 10286 ("Custodian").

WITNESSETH:

that for and in consideration of the mutual promises hereinafter set forth the Corporation and Custodian agree as follows:

**ARTICLE I
DEFINITIONS**

Whenever used in this Agreement, the following words shall have the meanings set forth below:

1. **"Authorized Person"** shall be any person, whether or not an officer or employee of the Corporation, duly authorized by the Corporation's board to execute any Certificate or to give any Oral Instruction with respect to one or more Accounts, such persons to be designated in a Certificate annexed hereto as Schedule I hereto or such other Certificate as may be received by Custodian from time to time.
2. **"Custodian Affiliate"** shall mean any office, branch or subsidiary of The Bank of New York Company, Inc.
3. **"Book-Entry System"** shall mean the Federal Reserve/Treasury book-entry system for receiving and delivering securities, its successors and nominees.
4. **"Business Day"** shall mean any day on which Custodian and relevant Depositories are open for business.
5. **"Certificate"** shall mean any notice, instruction, or other instrument in writing, authorized or required by this Agreement to be given to Custodian, which is actually received by Custodian by letter or facsimile transmission and signed on behalf of the Corporation by an Authorized Person or a person reasonably believed by Custodian to be an Authorized Person.
6. **"Composite Currency Unit"** shall mean the Euro or any other composite currency unit consisting of the aggregate of specified amounts of specified currencies, as such unit may be constituted from time to time.
7. **"Depository"** shall include (a) the Book-Entry System, (b) the Depository Trust Company, (c) any other clearing agency or securities depository registered with the Securities and

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Exchange Commission identified to the Corporation from time to time, and (d) the respective successors and nominees of the foregoing.

8. **"Foreign Depository"** shall mean (a) Euroclear, (b) Clearstream Banking, societe anonyme, (c) each Eligible Securities Depository as defined in Rule 17f-7 under the Investment Company Act of 1940, as amended, identified to the Corporation from time to time, and (d) the respective successors and nominees of the foregoing.
9. **"Instructions"** shall mean communications actually received by Custodian by S.W.I.F.T., tested telex, letter, facsimile transmission, or other method or system specified by Custodian as available for use in connection with the services hereunder.
10. **"Oral Instructions"** shall mean verbal instructions received by Custodian from an Authorized Person or from a person reasonably believed by Custodian to be an Authorized Person.
11. **"Series"** shall mean the various portfolios, if any, of the Corporation listed on Schedule II hereto, and if none are listed references to Series shall be references to the Corporation.
12. **"Securities"** shall include, without limitation, any common stock and other equity securities, bonds, debentures and other debt securities, notes, mortgages or other obligations, and any instruments representing rights to receive, purchase, or subscribe for the same, or representing any other rights or interests therein (whether represented by a certificate or held in a Depository or by a Subcustodian).
13. **"Subcustodian"** shall mean a bank (including any branch thereof) or other financial institution (other than a Foreign Depository) located outside the U.S. which is utilized by Custodian in connection with the purchase, sale or custody of Securities hereunder and identified to the Corporation from time to time, and their respective successors and nominees.

**ARTICLE II
APPOINTMENT OF CUSTODIAN; ACCOUNTS;
REPRESENTATIONS, WARRANTIES, AND COVENANTS**

1. (a) The Corporation hereby appoints Custodian as custodian of all Securities and cash at any time delivered to Custodian during the term of this Agreement, and authorizes Custodian to hold Securities in registered form in its name or the name of its nominees. Custodian hereby accepts such appointment and agrees to establish and maintain one or more securities accounts and cash accounts for each Series in which Custodian will hold Securities and cash as provided herein. Custodian shall maintain books and records segregating the assets of each Series from the assets of any other Series. Such accounts (each, an "Account"; collectively, the "Accounts") shall be in the name of the Corporation.

(b) Custodian may from time to time establish on its books and records such sub-accounts within each Account as the Corporation and Custodian may agree upon (each a "Special

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Account”), and Custodian shall reflect therein such assets as the Corporation may specify in a Certificate or Instructions.

(c) Custodian may from time to time establish pursuant to a written agreement with and for the benefit of a broker, dealer, future commission merchant or other third party identified in a Certificate or Instructions such accounts on such terms and conditions as the Corporation and Custodian shall agree, and Custodian shall transfer to such account such Securities and money as the Corporation may specify in a Certificate or Instructions.

2. The Corporation hereby represents and warrants, which representations and warranties shall be continuing and shall be deemed to be reaffirmed upon each delivery of a Certificate or each giving of Oral Instructions or Instructions by the Corporation, that:

(a) It is duly organized and existing under the laws of the jurisdiction of its organization, with full power to carry on its business as now conducted, to enter into this Agreement, and to perform its obligations hereunder;

(b) This Agreement has been duly authorized, executed and delivered by the Corporation, approved by a resolution of its board, constitutes a valid and legally binding obligation of the Corporation, enforceable in accordance with its terms, and there is no statute, regulation, rule, order or judgment binding on it, and no provision of its charter or by-laws, nor of any mortgage, indenture, credit agreement or other contract binding on it or affecting its property, which would prohibit its execution or performance of this Agreement;

(c) It is conducting its business in substantial compliance with all applicable laws and requirements, both state and federal, and has obtained all regulatory licenses, approvals and consents necessary to carry on its business as now conducted;

(d) It will not use the services provided by Custodian hereunder in any manner that is, or will result in, a violation of any law, rule or regulation applicable to the Corporation;

(e) Its board or its foreign custody manager, as defined in Rule 17f-5 under the Investment Company Act of 1940, as amended (the “‘40 Act”), has determined that use of each Subcustodian (including any Replacement Custodian) which Custodian is authorized to utilize in accordance with Section 1(a) of Article III hereof satisfies the applicable requirements of the ‘40 Act and Rule 17f-5 thereunder;

(f) The Corporation or its investment adviser has determined that the custody arrangements of each Foreign Depository provide reasonable safeguards against the custody risks associated with maintaining assets with such Foreign Depository within the meaning of Rule 17f-7 under the ‘40 Act;

(g) It is fully informed of the protections and risks associated with various methods of transmitting Instructions and Oral Instructions and delivering Certificates to Custodian, shall, and shall cause each Authorized Person, to safeguard and treat with extreme care any user and authorization codes, passwords and/or authentication keys, understands that there may be more secure methods of transmitting or delivering the same than the methods

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selected by it, agrees that the security procedures (if any) to be followed in connection therewith provide a commercially reasonable degree of protection in light of its particular needs and circumstances, and acknowledges and agrees that Instructions need not be reviewed by Custodian, may conclusively be presumed by Custodian to have been given by person(s) duly authorized, and may be acted upon as given;

(h) It shall manage its borrowings, including, without limitation, any advance or overdraft (including any day-light overdraft) in the Accounts, so that the aggregate of its total borrowings for each Series does not exceed the amount such Series is permitted to borrow under the ‘40 Act;

(i) Its transmission or giving of, and Custodian acting upon and in reliance on, Certificates, Instructions, or Oral Instructions pursuant to this Agreement shall at all times comply with the ‘40 Act;

(j) It shall impose and maintain restrictions on the destinations to which cash may be disbursed by Instructions to ensure that each disbursement is for a proper purpose; and

(k) It has the right to make the pledge and grant the security interest and security entitlement to Custodian contained in Section 1 of Article V hereof, free of any right of redemption or prior claim of any other person or entity, such pledge and such grants shall have a first priority subject to no setoffs, counterclaims, or other liens or grants prior to or on a parity therewith, and it shall take such additional steps as Custodian may require to assure such priority.

3. The Corporation hereby covenants that it shall from time to time complete and execute and deliver to Custodian upon Custodian’s request a Form FR U-1 (or successor form) whenever the Corporation borrows from Custodian any money to be used for the purchase or carrying of margin stock as defined in Federal Reserve Regulation U.

ARTICLE III CUSTODY AND RELATED SERVICES

1. (a) Subject to the terms hereof, the Corporation hereby authorizes Custodian to hold any Securities received by it from time to time for the Corporation’s account. Custodian shall be entitled to utilize, subject to subsection (c) of this Section 1, Depositories, Subcustodians, and, subject to subsection (d) of this Section 1, Foreign Depositories, to the extent possible in connection with its performance hereunder. Securities and cash held in a Depository or Foreign Depository will be held subject to the rules, terms and conditions of such entity. Securities and cash held through Subcustodians shall be held subject to the terms and conditions of Custodian’s agreements with such Subcustodians. Subcustodians may be authorized to hold Securities in Foreign Depositories in which such Subcustodians participate. Unless otherwise required by local law or practice or a particular subcustodian agreement, Securities deposited with a Subcustodian, a Depository or a Foreign Depository will be held in a commingled account, in the name of Custodian, holding only Securities held by Custodian as custodian for its customers. Custodian shall identify on its books and records the Securities and cash belonging to the Corporation, whether held directly or indirectly through Depositories, Foreign Depositories, or

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Subcustodians. Custodian shall, directly or indirectly through Subcustodians, Depositories, or Foreign Depositories, endeavor, to the extent feasible, to hold Securities in the country or other jurisdiction in which the principal trading market for such Securities is located, where such Securities are to be presented for cancellation and/or payment and/or registration, or where such Securities are acquired. Custodian at any time may cease utilizing any Subcustodian and/or may replace a Subcustodian with a different

Subcustodian (the "Replacement Subcustodian"). In the event Custodian selects a Replacement Subcustodian, Custodian shall not utilize such Replacement Subcustodian until after the Corporation's board or foreign custody manager has determined that utilization of such Replacement Subcustodian satisfies the requirements of the '40 Act and Rule 17f-5 thereunder.

(b) Unless Custodian has received a Certificate or Instructions to the contrary, Custodian shall hold Securities indirectly through a Subcustodian only if (i) the Securities are not subject to any right, charge, security interest, lien or claim of any kind in favor of such Subcustodian or its creditors or operators, including a receiver or trustee in bankruptcy or similar authority, except for a claim of payment for the safe custody or administration of Securities on behalf of the Corporation by such Subcustodian, and (ii) beneficial ownership of the Securities is freely transferable without the payment of money or value other than for safe custody or administration.

(c) With respect to each Depository, Custodian (i) shall exercise due care in accordance with reasonable commercial standards in discharging its duties as a securities intermediary to obtain and thereafter maintain Securities or financial assets deposited or held in such Depository, and (ii) will provide, promptly upon request by the Corporation, such reports as are available concerning the internal accounting controls and financial strength of Custodian.

(d) With respect to each Foreign Depository, Custodian shall exercise reasonable care, prudence, and diligence (i) to provide the Corporation with an analysis of the custody risks associated with maintaining assets with the Foreign Depository, and (ii) to monitor such custody risks on a continuing basis and promptly notify the Corporation of any material change in such risks. The Corporation acknowledges and agrees that such analysis and monitoring shall be made on the basis of, and limited by, information gathered from Subcustodians or through publicly available information otherwise obtained by Custodian, and shall not include any evaluation of Country Risks. As used herein the term "Country Risks" shall mean with respect to any Foreign Depository: (a) the financial infrastructure of the country in which it is organized, (b) such country's prevailing custody and settlement practices, (c) nationalization, expropriation or other governmental actions, (d) such country's regulation of the banking or securities industry, (e) currency controls, restrictions, devaluations or fluctuations, and (f) market conditions which affect the order execution of securities transactions or affect the value of securities.

2. Custodian shall furnish the Corporation with an advice of daily transactions (including a confirmation of each transfer of Securities) and a monthly summary of all transfers to or from the Accounts.

3. With respect to all Securities held hereunder, Custodian shall, unless otherwise instructed to the contrary:

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(a) Receive all income and other payments and advise the Corporation as promptly as practicable of any such amounts due but not paid;

(b) Present for payment and receive the amount paid upon all Securities which may mature and advise the Corporation as promptly as practicable of any such amounts due but not paid;

(c) Forward to the Corporation copies of all information or documents that it may actually receive from an issuer of Securities which, in the opinion of Custodian, are intended for the beneficial owner of Securities;

(d) Execute, as custodian, any certificates of ownership, affidavits, declarations or other certificates under any tax laws now or hereafter in effect in connection with the collection of bond and note coupons;

(e) Hold directly or through a Depository, a Foreign Depository, or a Subcustodian all rights and similar Securities issued with respect to any Securities credited to an Account hereunder; and

(f) Endorse for collection checks, drafts or other negotiable instruments.

4. (a) Custodian shall notify the Corporation of rights or discretionary actions with respect to Securities held hereunder, and of the date or dates by when such rights must be exercised or such action must be taken, provided that Custodian has actually received, from the issuer or the relevant Depository (with respect to Securities issued in the United States) or from the relevant Subcustodian, Foreign Depository, or a nationally or internationally recognized bond or corporate action service to which Custodian subscribes, timely notice of such rights or discretionary corporate action or of the date or dates such rights must be exercised or such action must be taken. Absent actual receipt of such notice, Custodian shall have no liability for failing to so notify the Corporation.

(b) Whenever Securities (including, but not limited to, warrants, options, tenders, options to tender or non-mandatory puts or calls) confer discretionary rights on the Corporation or provide for discretionary action or alternative courses of action by the Corporation, the Corporation shall be responsible for making any decisions relating thereto and for directing Custodian to act. In order for Custodian to act, it must receive the Corporation's Certificate or Instructions at Custodian's offices, addressed as Custodian may from time to time request, not later than noon (New York time) at least two (2) Business Days prior to the last scheduled date to act with respect to such Securities (or such earlier date or time as Custodian may specify to the Corporation). Absent Custodian's timely receipt of such Certificate or Instructions, Custodian shall not be liable for failure to take any action relating to or to exercise any rights conferred by such Securities.

5. All voting rights with respect to Securities, however registered, shall be exercised by the Corporation or its designee. Custodian will make available to the Corporation proxy voting

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services upon the request of, and for the jurisdictions selected by, the Corporation in accordance with terms and conditions to be mutually agreed upon by Custodian and the Corporation.

6. Custodian shall promptly advise the Corporation upon Custodian's actual receipt of notification of the partial redemption, partial payment or other action affecting less than all Securities of the relevant class. If Custodian, any Subcustodian, any Depository, or any Foreign Depository holds any Securities in which the Corporation has an interest as part of a fungible mass, Custodian, such Subcustodian, Depository, or Foreign Depository may select the Securities to participate in such partial redemption, partial payment or other action in any non-discriminatory manner that it customarily uses to make such selection.

7. Custodian shall not under any circumstances accept bearer interest coupons which have been stripped from United States federal, state or local government or agency securities unless explicitly agreed to by Custodian in writing.

8. The Corporation shall be liable for all taxes, assessments, duties and other governmental charges, including any interest or penalty with respect thereto ("Taxes"), with respect to any cash or Securities held on behalf of the Corporation or any transaction related thereto. The Corporation shall indemnify Custodian and each

Subcustodian for the amount of any Tax that Custodian, any such Subcustodian or any other withholding agent is required under applicable laws (whether by assessment or otherwise) to pay on behalf of, or in respect of income earned by or payments or distributions made to or for the account of the Corporation (including any payment of Tax required by reason of an earlier failure to withhold). Custodian shall, or shall instruct the applicable Subcustodian or other withholding agent to, withhold the amount of any Tax which is required to be withheld under applicable law upon collection of any dividend, interest or other distribution made with respect to any Security and any proceeds or income from the sale, loan or other transfer of any Security. In the event that Custodian or any Subcustodian is required under applicable law to pay any Tax on behalf of the Corporation, Custodian is hereby authorized to withdraw cash from any cash account in the amount required to pay such Tax and to use such cash, or to remit such cash to the appropriate Subcustodian or other withholding agent, for the timely payment of such Tax in the manner required by applicable law. If the aggregate amount of cash in all cash accounts is not sufficient to pay such Tax, Custodian shall promptly notify the Corporation of the additional amount of cash (in the appropriate currency) required, and the Corporation shall directly deposit such additional amount in the appropriate cash account promptly after receipt of such notice, for use by Custodian as specified herein. In the event that Custodian reasonably believes that Corporation is eligible, pursuant to applicable law or to the provisions of any tax treaty, for a reduced rate of, or exemption from, any Tax which is otherwise required to be withheld or paid on behalf of the Corporation under any applicable law, Custodian shall, or shall instruct the applicable Subcustodian or withholding agent to, either withhold or pay such Tax at such reduced rate or refrain from withholding or paying such Tax, as appropriate; provided that Custodian shall have received from the Corporation all documentary evidence of residence or other qualification for such reduced rate or exemption required to be received under such applicable law or treaty. In the event that Custodian reasonably believes that a reduced rate of, or exemption from, any Tax is obtainable only by means of an application for reCorporation, Custodian and the applicable Subcustodian shall have no responsibility for the accuracy or validity of any forms or documentation provided

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by the Corporation to Custodian hereunder. The Corporation hereby agrees to indemnify and hold harmless Custodian and each Subcustodian in respect of any liability arising from any underwithholding or underpayment of any Tax which results from the inaccuracy or invalidity of any such forms or other documentation, and such obligation to indemnify shall be a continuing obligation of the Corporation, its successors and assigns notwithstanding the termination of this Agreement.

9. (a) For the purpose of settling Securities and foreign exchange transactions, the Corporation shall provide Custodian with sufficient immediately available Corporations for all transactions by such time and date as conditions in the relevant market dictate. As used herein, "sufficient immediately available Corporations" shall mean either (i) sufficient cash denominated in U.S. dollars to purchase the necessary foreign currency, or (ii) sufficient applicable foreign currency, to settle the transaction. Custodian shall provide the Corporation with immediately available Corporations each day which result from the actual settlement of all sale transactions, based upon advices received by Custodian from Subcustodians, Depositories, and Foreign Depositories. Such Corporations shall be in U.S. dollars or such other currency as the Corporation may specify to Custodian.

(b) Any foreign exchange transaction effected by Custodian in connection with this Agreement may be entered with Custodian or a Custodian Affiliate acting as principal or otherwise through customary banking channels. The Corporation may issue a standing Certificate or Instructions with respect to foreign exchange transactions, but Custodian may establish rules or limitations concerning any foreign exchange facility made available to the Corporation. The Corporation shall bear all risks of investing in Securities or holding cash denominated in a foreign currency.

(c) To the extent that Custodian has agreed to provide pricing or other information services in connection with this Agreement, Custodian is authorized to utilize any vendor (including brokers and dealers of Securities) reasonably believed by Custodian to be reliable to provide such information. The Corporation understands that certain pricing information with respect to complex financial instruments (e.g., derivatives) may be based on calculated amounts rather than actual market transactions and may not reflect actual market values, and that the variance between such calculated amounts and actual market values may or may not be material. Where vendors do not provide information for particular Securities or other property, an Authorized Person may advise Custodian in a Certificate regarding the fair market value of, or provide other information with respect to, such Securities or property as determined by it in good faith. Custodian shall not be liable for any loss, damage or expense incurred as a result of errors or omissions with respect to any pricing or other information utilized by Custodian hereunder.

10. Until such time as Custodian receives a certificate to the contrary with respect to a particular Security, Custodian may release the identity of the Corporation to an issuer which requests such information pursuant to the Shareholder Communications Act of 1985 for the specific purpose of direct communications between such issuer and shareholder.

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ARTICLE IV PURCHASE AND SALE OF SECURITIES; CREDITS TO ACCOUNT

1. Promptly after each purchase or sale of Securities by the Corporation, the Corporation shall deliver to Custodian a Certificate or Instructions, or with respect to a purchase or sale of a Security generally required to be settled on the same day the purchase or sale is made, Oral Instructions specifying all information Custodian may reasonably request to settle such purchase or sale. Custodian shall account for all purchases and sales of Securities on the actual settlement date unless otherwise agreed by Custodian.

2. The Corporation understands that when Custodian is instructed to deliver Securities against payment, delivery of such Securities and receipt of payment therefor may not be completed simultaneously. Notwithstanding any provision in this Agreement to the contrary, settlements, payments and deliveries of Securities may be effected by Custodian or any Subcustodian in accordance with the customary or established securities trading or securities processing practices and procedures in the jurisdiction in which the transaction occurs, including, without limitation, delivery to a purchaser or dealer therefor (or agent) against receipt with the expectation of receiving later payment for such Securities. The Corporation assumes full responsibility for all risks, including, without limitation, credit risks, involved in connection with such deliveries of Securities.

3. Custodian may, as a matter of bookkeeping convenience or by separate agreement with the Corporation, credit the Account with the proceeds from the sale, redemption or other disposition of Securities or interest, dividends or other distributions payable on Securities prior to its actual receipt of final payment therefor. All such credits shall be conditional until Custodian's actual receipt of final payment and may be reversed by Custodian to the extent that final payment is not received. Payment with respect to a transaction will not be "final" until Custodian shall have received immediately available Corporations which under applicable local law, rule and/or practice are irreversible and not subject to any security interest, levy or other encumbrance, and which are specifically applicable to such transaction.

ARTICLE V OVERDRAFTS OR INDEBTEDNESS

1. If Custodian should in its sole discretion advance Corporations on behalf of any Series which results in an overdraft (including, without limitation, any day-light overdraft) because the money held by Custodian in an Account for such Series shall be insufficient to pay the total amount payable upon a purchase of Securities specifically allocated to such Series, as set forth in a Certificate, Instructions or Oral Instructions, or if an overdraft arises in the separate account of a Series for some other reason,

including, without limitation, because of a reversal of a conditional credit or the purchase of any currency, or if the Corporation is for any other reason indebted to Custodian with respect to a Series, including any indebtedness to The Bank of New York under the Corporation's Cash Management and Related Services Agreement (except a borrowing for investment or for temporary or emergency purposes using Securities as collateral pursuant to a separate agreement and subject to the provisions of Section 2 of this Article), such

overdraft or indebtedness shall be deemed to be a loan made by Custodian to the Corporation for such Series payable on demand and shall bear interest from the date incurred at a rate per annum ordinarily charged by Custodian to its institutional customers, as such rate may be adjusted from time to time. In addition, the Corporation hereby agrees that Custodian shall to the maximum extent permitted by law have a continuing lien, security interest, and security entitlement in and to any property, including, without limitation, any investment property or any financial asset, of such Series at any time held by Custodian for the benefit of such Series or in which such Series may have an interest which is then in Custodian's possession or control or in possession or control of any third party acting in Custodian's behalf. The Corporation authorizes Custodian, in its sole discretion, at any time to charge any such overdraft or indebtedness together with interest due thereon against any balance of account standing to such Series' credit on Custodian's books.

2. If the Corporation borrows money from any bank (including Custodian if the borrowing is pursuant to a separate agreement) for investment or for temporary or emergency purposes using Securities held by Custodian hereunder as collateral for such borrowings, the Corporation shall deliver to Custodian a Certificate specifying with respect to each such borrowing: (a) the Series to which such borrowing relates; (b) the name of the bank, (c) the amount of the borrowing, (d) the time and date, if known, on which the loan is to be entered into, (e) the total amount payable to the Corporation on the borrowing date, (f) the Securities to be delivered as collateral for such loan, including the name of the issuer, the title and the number of shares or the principal amount of any particular Securities, and (g) a statement specifying whether such loan is for investment purposes or for temporary or emergency purposes and that such loan is in conformance with the '40 Act and the Corporation's prospectus. Custodian shall deliver on the borrowing date specified in a Certificate the specified collateral against payment by the lending bank of the total amount of the loan payable, provided that the same conforms to the total amount payable as set forth in the Certificate. Custodian may, at the option of the lending bank, keep such collateral in its possession, but such collateral shall be subject to all rights therein given the lending bank by virtue of any promissory note or loan agreement. Custodian shall deliver such Securities as additional collateral as may be specified in a Certificate to collateralize further any transaction described in this Section. The Corporation shall cause all Securities released from collateral status to be returned directly to Custodian, and Custodian shall receive from time to time such return of collateral as may be tendered to it. In the event that the Corporation fails to specify in a Certificate the Series, the name of the issuer, the title and number of shares or the principal amount of any particular Securities to be delivered as collateral by Custodian, Custodian shall not be under any obligation to deliver any Securities.

ARTICLE VI SALE AND REDEMPTION OF SHARES

1. Whenever the Corporation shall sell any shares issued by the Corporation ("Shares") it shall deliver to Custodian a Certificate or Instructions specifying the amount of money and/or Securities to be received by Custodian for the sale of such Shares and specifically allocated to an Account for such Series.

2. Upon receipt of such money, Custodian shall credit such money to an Account in the name of the Series for which such money was received.

3. Except as provided hereinafter, whenever the Corporation desires Custodian to make payment out of the money held by Custodian hereunder in connection with a redemption of any Shares, it shall furnish to Custodian a Certificate or Instructions specifying the total amount to be paid for such Shares. Custodian shall make payment of such total amount to the transfer agent specified in such Certificate or Instructions out of the money held in an Account of the appropriate Series.

4. Notwithstanding the above provisions regarding the redemption of any Shares, whenever any Shares are redeemed pursuant to any check redemption privilege which may from time to time be offered by the Corporation, Custodian, unless otherwise instructed by a Certificate or Instructions, shall, upon presentment of such check, charge the amount thereof against the money held in the Account of the Series of the Shares being redeemed, provided, that if the Corporation or its agent timely advises Custodian that such check is not to be honored, Custodian shall return such check unpaid.

ARTICLE VII PAYMENT OF DIVIDENDS OR DISTRIBUTIONS

1. Whenever the Corporation shall determine to pay a dividend or distribution on Shares it shall furnish to Custodian Instructions or a Certificate setting forth with respect to the Series specified therein the date of the declaration of such dividend or distribution, the total amount payable, and the payment date.

2. Upon the payment date specified in such Instructions or Certificate, Custodian shall pay out of the money held for the account of such Series the total amount payable to the dividend agent of the Corporation specified therein.

ARTICLE VIII CONCERNING CUSTODIAN

1. (a) Except as otherwise expressly provided herein, Custodian shall not be liable for any costs, expenses, damages, liabilities or claims, including attorneys' and accountants' fees (collectively, "Losses"), incurred by or asserted against the Corporation, except those Losses arising out of Custodian's own negligence or willful misconduct. Custodian shall have no liability whatsoever for the action or inaction of any Depositories or of any Foreign Depositories, except in each case to the extent such action or inaction is a direct result of the Custodian's failure to fulfill its duties hereunder. With respect to any Losses incurred by the Corporation as a result of the acts or any failures to act by any Subcustodian (other than a Custodian Affiliate), Custodian shall take appropriate action to recover such Losses from such Subcustodian; and Custodian's sole responsibility and liability to the Corporation shall be limited to amounts so received from such Subcustodian (exclusive of costs and expenses incurred by Custodian). In no event shall Custodian be liable to the Corporation or any third party for special, indirect or consequential damages, or lost profits or loss of business, arising in connection with this Agreement, nor shall Custodian or any Subcustodian be liable: (i) for acting in accordance with any Certificate or Oral Instructions actually received by Custodian and reasonably believed by Custodian to be given by an Authorized Person; (ii) for acting in accordance with Instructions

without reviewing the same; (iii) for conclusively presuming that all Instructions are given only by person(s) duly authorized; (iv) for conclusively presuming that all disbursements of cash directed by the Corporation, whether by a Certificate, an Oral Instruction, or an Instruction, are in accordance with Section 2(i) of Article II hereof; (v) for holding property in any particular country, including, but not limited to, Losses resulting from nationalization, expropriation or other governmental actions; regulation of the banking or securities industry; exchange or currency controls or restrictions, devaluations or fluctuations; availability of cash or Securities or market conditions which prevent the transfer of property or execution of Securities transactions or affect the value of property; (vi) for any Losses due to forces beyond the control of Custodian, including without limitation strikes, work stoppages, acts of war or terrorism, insurrection, revolution, nuclear or natural catastrophes or acts of God, or interruptions, loss or malfunctions of utilities, communications or computer (software and hardware) services; (vii) for the insolvency of any Subcustodian (other than a Custodian Affiliate), any Depository, or, except to the extent such action or inaction is a direct result of the Custodian's failure to fulfill its duties hereunder, any Foreign Depository; or (viii) for any Losses arising from the applicability of any law or regulation now or hereafter in effect, or from the occurrence of any event, including, without limitation, implementation or adoption of any rules or procedures of a Foreign Depository, which may affect, limit, prevent or impose costs or burdens on, the transferability, convertibility, or availability of any currency or Composite Currency Unit in any country or on the transfer of any Securities, and in no event shall Custodian be obligated to substitute another currency for a currency (including a currency that is a component of a Composite Currency Unit) whose transferability, convertibility or availability has been affected, limited, or prevented by such law, regulation or event, and to the extent that any such law, regulation or event imposes a cost or charge upon Custodian in relation to the transferability, convertibility, or availability of any cash currency or Composite Currency Unit, such cost or charge shall be for the account of the Corporation, and Custodian may treat any account denominated in an affected currency as a group of separate accounts denominated in the relevant component currencies.

(b) Custodian may enter into subcontracts, agreements and understandings with any Custodian Affiliate, whenever and on such terms and conditions as it deems necessary or appropriate to perform its services hereunder. No such subcontract, agreement or understanding shall discharge Custodian from its obligations hereunder.

(c) The Corporation agrees to indemnify Custodian and hold Custodian harmless from and against any and all Losses sustained or incurred by or asserted against Custodian by reason of or as a result of any action or inaction, or arising out of Custodian's performance hereunder, including reasonable fees and expenses of counsel incurred by Custodian in a successful defense of claims by the Corporation; provided however, that the Corporation shall not indemnify Custodian for those Losses arising out of Custodian's own negligence or willful misconduct. This indemnity shall be a continuing obligation of the Corporation, its successors and assigns, notwithstanding the termination of this Agreement.

2. Without limiting the generality of the foregoing, Custodian shall be under no obligation to inquire into, and shall not be liable for:

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(a) Any Losses incurred by the Corporation or any other person as a result of the receipt or acceptance of fraudulent, forged or invalid Securities, or Securities which are otherwise not freely transferable or deliverable without encumbrance in any relevant market;

(b) The validity of the issue of any Securities purchased, sold, or written by or for the Corporation, the legality of the purchase, sale or writing thereof, or the propriety of the amount paid or received therefor;

(c) The legality of the sale or redemption of any Shares, or the propriety of the amount to be received or paid therefor;

(d) The legality of the declaration or payment of any dividend or distribution by the Corporation;

(e) The legality of any borrowing by the Corporation;

(f) The legality of any loan of portfolio Securities, nor shall Custodian be under any duty or obligation to see to it that any cash or collateral delivered to it by a broker, dealer or financial institution or held by it at any time as a result of such loan of portfolio Securities is adequate security for the Corporation against any loss it might sustain as a result of such loan, which duty or obligation shall be the sole responsibility of the Corporation. In addition, Custodian shall be under no duty or obligation to see that any broker, dealer or financial institution to which portfolio Securities of the Corporation are lent makes payment to it of any dividends or interest which are payable to or for the account of the Corporation during the period of such loan or at the termination of such loan, provided, however that Custodian shall promptly notify the Corporation in the event that such dividends or interest are not paid and received when due;

(g) The sufficiency or value of any amounts of money and/or Securities held in any Special Account in connection with transactions by the Corporation; whether any broker, dealer, futures commission merchant or clearing member makes payment to the Corporation of any variation margin payment or similar payment which the Corporation may be entitled to receive from such broker, dealer, futures commission merchant or clearing member, or whether any payment received by Custodian from any broker, dealer, futures commission merchant or clearing member is the amount the Corporation is entitled to receive, or to notify the Corporation of Custodian's receipt or non-receipt of any such payment; or

(h) Whether any Securities at any time delivered to, or held by it or by any Subcustodian, for the account of the Corporation and specifically allocated to a Series are such as properly may be held by the Corporation or such Series under the provisions of its then current prospectus and statement of additional information, or to ascertain whether any transactions by the Corporation, whether or not involving Custodian, are such transactions as may properly be engaged in by the Corporation.

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3. Custodian may, with respect to questions of law specifically regarding an Account, obtain the advice of counsel and shall be fully protected with respect to anything done or omitted by it in good faith in conformity with such advice.

4. Custodian shall be under no obligation to take action to collect any amount payable on Securities in default, or if payment is refused after due demand and presentment.

5. Custodian shall have no duty or responsibility to inquire into, make recommendations, supervise, or determine the suitability of any transactions affecting any Account.

6. The Corporation shall pay to Custodian the fees and charges as may be specifically agreed upon from time to time and such other fees and charges at Custodian's standard rates for such services as may be applicable. The Corporation shall reimburse Custodian for all costs associated with the conversion of the Corporation's Securities hereunder and the transfer of Securities and records kept in connection with this Agreement. The Corporation shall also reimburse Custodian for out-of-pocket expenses which are a normal incident of the services provided hereunder.

7. Custodian has the right to debit any cash account for any amount payable by the Corporation in connection with any and all obligations of the Corporation to Custodian. In addition to the rights of Custodian under applicable law and other agreements, at any time when the Corporation shall not have honored any of its obligations to

Custodian, Custodian shall have the right without notice to the Corporation to retain or set-off, against such obligations of the Corporation, any Securities or cash Custodian or a Custodian Affiliate may directly or indirectly hold for the account of the Corporation, and any obligations (whether matured or unmatured) that Custodian or a Custodian Affiliate may have to the Corporation in any currency or Composite Currency Unit. Any such asset of, or obligation to, the Corporation may be transferred to Custodian and any Custodian Affiliate in order to effect the above rights.

8. The Corporation agrees to forward to Custodian a Certificate or Instructions confirming Oral Instructions by the close of business of the same day that such Oral Instructions are given to Custodian. The Corporation agrees that the fact that such confirming Certificate or Instructions are not received or that a contrary Certificate or contrary Instructions are received by Custodian shall in no way affect the validity or enforceability of transactions authorized by such Oral Instructions and effected by Custodian. If the Corporation elects to transmit Instructions through an on-line communications system offered by Custodian, the Corporation's use thereof shall be subject to the Terms and Conditions attached as Appendix I hereto. If Custodian receives Instructions which appear on their face to have been transmitted by an Authorized Person via (i) computer facsimile, email, the Internet or other insecure electronic method, or (ii) secure electronic transmission containing applicable authorization codes, passwords and/or authentication keys, the Corporation understands and agrees that Custodian cannot determine the identity of the actual sender of such Instructions and that Custodian shall conclusively presume that such Written Instructions have been sent by an Authorized Person, and the Corporation shall be responsible for ensuring that only Authorized Persons transmit such Instructions to Custodian. If the Corporation elects (with Custodian's prior consent) to transmit Instructions through an on-

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line communications service owned or operated by a third party, the Corporation agrees that Custodian shall not be responsible or liable for the reliability or availability of any such service.

9. The books and records pertaining to the Corporation which are in possession of Custodian shall be the property of the Corporation. Such books and records shall be prepared and maintained as required by the '40 Act and the rules thereunder. The Corporation, or its authorized representatives, shall have access to such books and records during Custodian's normal business hours. Upon the reasonable request of the Corporation, copies of any such books and records shall be provided by Custodian to the Corporation or its authorized representative. Upon the reasonable request of the Corporation, Custodian shall provide in hard copy or on computer disc any records included in any such delivery which are maintained by Custodian on a computer disc, or are similarly maintained.

10. It is understood that Custodian is authorized to supply any information regarding the Accounts which is required by any law, regulation or rule now or hereafter in effect. The Custodian shall provide the Corporation with any report obtained by the Custodian on the system of internal accounting control of a Depository, and with such reports on its own system of internal accounting control as the Corporation may reasonably request from time to time.

11. Custodian shall have no duties or responsibilities whatsoever except such duties and responsibilities as are specifically set forth in this Agreement, and no covenant or obligation shall be implied against Custodian in connection with this Agreement.

ARTICLE IX TERMINATION

1. Either of the parties hereto may terminate this Agreement by giving to the other party a notice in writing specifying the date of such termination, which shall be not less than ninety (90) days after the date of giving of such notice. In the event such notice is given by the Corporation, it shall be accompanied by a copy of a resolution of the board of the Corporation, certified by the Secretary or any Assistant Secretary, electing to terminate this Agreement and designating a successor custodian or custodians, each of which shall be a bank or trust company having not less than \$2,000,000 aggregate capital, surplus and undivided profits. In the event such notice is given by Custodian, the Corporation shall, on or before the termination date, deliver to Custodian a copy of a resolution of the board of the Corporation, certified by the Secretary or any Assistant Secretary, designating a successor custodian or custodians. In the absence of such designation by the Corporation, Custodian may designate a successor custodian which shall be a bank or trust company having not less than \$2,000,000 aggregate capital, surplus and undivided profits. Upon the date set forth in such notice this Agreement shall terminate, and Custodian shall upon receipt of a notice of acceptance by the successor custodian on that date deliver directly to the successor custodian all Securities and money then owned by the Corporation and held by it as Custodian, after deducting all fees, expenses and other amounts for the payment or reimbursement of which it shall then be entitled.

2. If a successor custodian is not designated by the Corporation or Custodian in accordance with the preceding Section, the Corporation shall upon the date specified in the notice

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of termination of this Agreement and upon the delivery by Custodian of all Securities (other than Securities which cannot be delivered to the Corporation) and money then owned by the Corporation be deemed to be its own custodian and Custodian shall thereby be relieved of all duties and responsibilities pursuant to this Agreement, other than the duty with respect to Securities which cannot be delivered to the Corporation to hold such Securities hereunder in accordance with this Agreement.

ARTICLE X MISCELLANEOUS

1. The Corporation agrees to furnish to Custodian a new Certificate of Authorized Persons in the event of any change in the then present Authorized Persons. Until such new Certificate is received, Custodian shall be fully protected in acting upon Certificates or Oral Instructions of such present Authorized Persons.

2. Any notice or other instrument in writing, authorized or required by this Agreement to be given to Custodian, shall be sufficiently given if addressed to Custodian and received by it at its offices at One Wall Street, New York, New York 10286, or at such other place as Custodian may from time to time designate in writing.

Any notice or other instrument in writing, authorized or required by this Agreement to be given to the Corporation shall be sufficiently given if addressed to the Corporation and received by it at its offices at 1521 Westbranch Drive, Suite 200, McLean, Virginia 22102, or at such other place as the Corporation may from time to time designate in writing.

3. Each and every right granted to either party hereunder or under any other document delivered hereunder or in connection herewith, or allowed it by law or equity, shall be cumulative and may be exercised from time to time. No failure on the part of either party to exercise, and no delay in exercising, any right will operate as a waiver thereof, nor will any single or partial exercise by either party of any right preclude any other or future exercise thereof or the exercise of any other right.

4. In case any provision in or obligation under this Agreement shall be invalid, illegal or unenforceable in any exclusive jurisdiction, the validity, legality and enforceability of the remaining provisions shall not in any way be affected thereby. This Agreement may not be amended or modified in any manner except by a written agreement executed by both parties, except that any amendment to the Schedule I hereto need be signed only by the Corporation and any amendment to Appendix I hereto

need be signed only by Custodian. This Agreement shall extend to and shall be binding upon the parties hereto, and their respective successors and assigns; provided, however, that this Agreement shall not be assignable by either party without the written consent of the other.

5. This Agreement shall be construed in accordance with the substantive laws of the State of New York, without regard to conflicts of laws principles thereof. The Corporation and Custodian hereby consent to the jurisdiction of a state or federal court situated in New York City,

New York in connection with any dispute arising hereunder. The Corporation hereby irrevocably waives, to the fullest extent permitted by applicable law, any objection which it may now or hereafter have to the laying of venue of any such proceeding brought in such a court and any claim that such proceeding brought in such a court has been brought in an inconvenient forum. The Corporation and Custodian each hereby irrevocably waives any and all rights to trial by jury in any legal proceeding arising out of or relating to this Agreement.

6. The Corporation hereby acknowledges that Custodian is subject to federal laws, including the Customer Identification Program (CIP) requirements under the USA PATRIOT Act and its implementing regulations, pursuant to which Custodian must obtain, verify and record information that allows Custodian to identify the Corporation. Accordingly, prior to opening an Account hereunder Custodian will ask the Corporation to provide certain information including, but not limited to, the Corporation's name, physical address, tax identification number and other information that will help Custodian to identify and verify the Corporation's identity such as organizational documents, certificate of good standing, license to do business, or other pertinent identifying information. The Corporation agrees that Custodian cannot open an Account hereunder unless and until Custodian verifies the Corporation's identity in accordance with its CIP.

7. This Agreement may be executed in any number of counterparts, each of which shall be deemed to be an original, but such counterparts shall, together, constitute only one instrument.

IN WITNESS WHEREOF, the Corporation and Custodian have caused this Agreement to be executed by their respective officers, thereunto duly authorized, as of the day and year first above written.

GLADSTONE CAPITAL CORPORATION

By: /s/ Harry Brill
Name: Harry Brill
Title: Chief Financial Officer
Tax Identification No: 54-2040781

THE BANK OF NEW YORK

By: _____
Name: Edward G. McGann
Title: Managing Director

**SCHEDULE I
CERTIFICATE OF AUTHORIZED PERSONS
(The Corporation - Oral and Written Instructions)**

The undersigned hereby certifies that he/she is the duly elected and acting _____ of Gladstone Capital Corporation (the "Corporation"), and further certifies that the following officers or employees of the Corporation have been duly authorized in conformity with the Corporation's Declaration of Trust and By-Laws to deliver Certificates and Oral Instructions to The Bank of New York ("Custodian") pursuant to the Custody Agreement between the Corporation and Custodian dated May 5, 2006 and that the signatures appearing opposite their names are true and correct:

<u>David Gladstone</u> Name	<u>Chief Executive Officer</u> Title	<u>/s/ David Gladstone</u> Signature
<u>George Stelljes III</u> Name	<u>Chief Investment Officer</u> Title	<u>/s/ George Stelljes III</u> Signature
<u>Harry Brill</u> Name	<u>Chief Financial Officer</u> Title	<u>/s/ Harry Brill</u> Signature
<u>_____</u> Name	<u>_____</u> Title	<u>_____</u> Signature
<u>_____</u> Name	<u>_____</u> Title	<u>_____</u> Signature

Name	Title	Signature
Name	Title	Signature

This certificate supersedes any certificate of Authorized Persons you may currently have on file.

[seal] By: _____
 Date: Title: _____

SCHEDULE II

Gladstone Capital Corporation

APPENDIX I

ELECTRONIC SERVICES TERMS AND CONDITIONS

1. License: Use. (a) This Appendix I shall govern the Corporation's use of electronic communications, information delivery, portfolio management and banking services, that The Bank of New York and its affiliates ("Custodian") may provide to the Corporation, such as The Bank of New York Inform™ and The Bank of New York CASH-Register Plus®, and any computer software, proprietary data and documentation provided by Custodian to the Corporation in connection therewith (collectively, the "Electronic Services"). In the event of any conflict between the terms of this Appendix I and the main body of this Agreement with respect to the Corporation's use of the Electronic Services, the terms of this Appendix I shall control.

(b) Custodian grants to the Corporation a personal, nontransferable and nonexclusive license to use the Electronic Services to which the Corporation subscribes solely for the purpose of transmitting instructions and information ("Written Instructions"), obtaining reports, analyses and statements and other information and data, making inquiries and otherwise communicating with Custodian in connection with the Corporation's relationship with Custodian. The Corporation shall use the Electronic Services solely for its own internal and proper business purposes and not in the operation of a service bureau. Except as set forth herein, no license or right of any kind is granted to with respect to the Electronic Services. The Corporation acknowledges that Custodian and its suppliers retain and have title and exclusive proprietary rights to the Electronic Services, including any trade secrets or other ideas, concepts, know-how, methodologies, and information incorporated therein and the exclusive rights to any copyrights, trade dress, look and feel, trademarks and patents (including registrations and applications for registration of either), and other legal protections available in respect thereof. The Corporation further acknowledges that all or a part of the Electronic Services may be copyrighted or trademarked (or a registration or claim made therefor) by Custodian or its suppliers. The Corporation shall not take any action with respect to the Electronic Services inconsistent with the foregoing acknowledgments, nor shall the Corporation attempt to decompile, reverse engineer or modify the Electronic Services. The Corporation may not copy, distribute, sell, lease or provide, directly or indirectly, the Electronic Services or any portion thereof to any other person or entity without Custodian's prior written consent. The Corporation may not remove any statutory copyright notice or other notice included in the Electronic Services. The Corporation shall reproduce any such notice on any reproduction of any portion of the Electronic Services and shall add any statutory copyright notice or other notice upon Custodian's request.

(c) Portions of the Electronic Services may contain, deliver or rely on data supplied by third parties ("Third Party Data"), such as pricing data and indicative data,

and services supplied by third parties ("Third Party Services") such as analytic and accounting services. Third Party Data and Third Party Services supplied hereunder are obtained from sources that Custodian believes to be reliable but are provided without any independent investigation by Custodian. Custodian and its suppliers do not represent or warrant that the Third Party Data or Third Party Services are correct, complete or current. Third Party Data and Third Party Services are proprietary to their suppliers, are provided solely for the Corporation's internal use, and may not be reused, disseminated or redistributed in any form. The Corporation shall not use any Third Party Data in any manner that would act as a substitute for obtaining a license for the data directly from the supplier. Third Party Data and Third Party Services should not be used in making any investment decision. **CUSTODIAN AND ITS SUPPLIERS ARE NOT RESPONSIBLE FOR ANY RESULTS OBTAINED FROM THE USE OF OR RELIANCE UPON THIRD PARTY DATA OR THIRD PARTY SERVICES.** Custodian's suppliers of Third Party Data and Services are intended third party beneficiaries of this Section 1(c) and Section 5 below.

(d) The Corporation understands and agrees that any links in the Electronic Services to Internet sites may be to sites sponsored and maintained by third parties. Custodian make no guarantees, representations or warranties concerning the information contained in any third party site (including without limitation that such information is correct, current, complete or free of viruses or other contamination), or any products or services sold through third party sites. All such links to third party Internet sites are provided solely as a convenience to the Corporation and the Corporation accesses and uses such sites at its own risk. A link in the Electronic Services to a third party site does not constitute Custodian's endorsement, authorization or sponsorship of such site or any products and services available from such site.

2. Equipment. The Corporation shall obtain and maintain at its own cost and expense all equipment and services, including but not limited to communications services, necessary for it to utilize and obtain access to the Electronic Services, and Custodian shall not be responsible for the reliability or availability of any such equipment or services.

3. Proprietary Information. The Electronic Services, and any proprietary data (including Third Party Data), processes, software, information and documentation made available to the Corporation (other than which are or become part of the public domain or are legally required to be made available to the public) (collectively, the "Information"), are the exclusive and confidential property of Custodian or its suppliers. However, for the avoidance of doubt, reports generated by the Corporation containing information relating to its account(s) (except for Third Party Data contained therein) are not deemed to be within the meaning of the term "Information." the

Corporation shall keep the Information confidential by using the same care and discretion that the Corporation uses with respect to its own confidential property and trade secrets, but not less than

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reasonable care. Upon termination of the Agreement or the licenses granted herein for any reason, the Corporation shall return to Custodian any and all copies of the Information which are in its possession or under its control (except that the Corporation may retain reports containing Third Party Data, provided that such Third Party Data remains subject to the provisions of this Appendix). The provisions of this Section 3 shall not affect the copyright status of any of the Information which may be copyrighted and shall apply to all information whether or not copyrighted.

4. Modifications. Custodian reserves the right to modify the Electronic Services from time to time. The Corporation agrees not to modify or attempt to modify the Electronic Services without Custodian's prior written consent. The Corporation acknowledges that any modifications to the Electronic Services, whether by the Corporation or Custodian and whether with or without Custodian's consent, shall become the property of Custodian.

5. NO REPRESENTATIONS OR WARRANTIES; LIMITATION OF LIABILITY. CUSTODIAN AND ITS MANUFACTURERS AND SUPPLIERS MAKE NO WARRANTIES OR REPRESENTATIONS WITH RESPECT TO THE ELECTRONIC SERVICES OR ANY THIRD PARTY DATA OR THIRD PARTY SERVICES, EXPRESS OR IMPLIED, IN FACT OR IN LAW, INCLUDING BUT NOT LIMITED TO WARRANTIES OF MERCHANTABILITY, NON-INFRINGEMENT AND FITNESS FOR A PARTICULAR PURPOSE. THE CORPORATION ACKNOWLEDGES THAT THE ELECTRONIC SERVICES, THIRD PARTY DATA AND THIRD PARTY SERVICES ARE PROVIDED "AS IS." TO THE FULLEST EXTENT PERMITTED BY APPLICABLE LAW, IN NO EVENT SHALL CUSTODIAN OR ANY SUPPLIER BE LIABLE FOR ANY DAMAGES, WHETHER DIRECT, INDIRECT SPECIAL, OR CONSEQUENTIAL, WHICH CUSTOMER MAY INCUR IN CONNECTION WITH THE ELECTRONIC SERVICES, THIRD PARTY DATA OR THIRD PARTY SERVICES, EVEN IF CUSTODIAN OR SUCH SUPPLIER KNEW OF THE POSSIBILITY OF SUCH DAMAGES. IN NO EVENT SHALL CUSTODIAN OR ANY SUPPLIER BE LIABLE FOR ACTS OF GOD, MACHINE OR COMPUTER BREAKDOWN OR MALFUNCTION, INTERRUPTION OR MALFUNCTION OF COMMUNICATION FACILITIES, LABOR DIFFICULTIES OR ANY OTHER SIMILAR OR DISSIMILAR CAUSE BEYOND THEIR REASONABLE CONTROL.

6. Security; Reliance; Unauthorized Use; Corporations Transfers. Custodian will establish security procedures to be followed in connection with the use of the Electronic Services, and the Corporation agrees to comply with the security procedures. The Corporation understands and agrees that the security procedures are intended to determine whether instructions received by Custodian through the Electronic Services are authorized but are not (unless otherwise specified in writing) intended to detect any errors contained in such instructions. The Corporation will cause all persons utilizing the

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Electronic Services to treat any user and authorization codes, passwords, authentication keys and other security devices with the highest degree of care and confidentiality. Upon termination of the Corporation's use of the Electronic Services, the Corporation shall return to Custodian any security devices (e.g., token cards) provided by Custodian. Custodian is hereby irrevocably authorized to comply with and rely upon on Written Instructions and other communications, whether or not authorized, received by it through the Electronic Services. The Corporation acknowledges that it has sole responsibility for ensuring that only Authorized Persons use the Electronic Services and that to the fullest extent permitted by applicable law Custodian shall not be responsible nor liable for any unauthorized use thereof or for any losses sustained by the Corporation arising from or in connection with the use of the Electronic Services or Custodian's reliance upon and compliance with Written Instructions and other communications received through the Electronic Services. With respect to instructions for a transfer of Corporations issued through the Electronic Services, when instructed to credit or pay a party by both name and a unique numeric or alpha-numeric identifier (e.g. ABA number or account number), the Custodian, its affiliates, and any other bank participating in the Corporations transfer, may rely solely on the unique identifier, even if it identifies a party different than the party named. Such reliance on a unique identifier shall apply to beneficiaries named in such instructions as well as any financial institution which is designated in such instructions to act as an intermediary in a Corporations transfer. It is understood and agreed that unless otherwise specifically provided herein, and to the extent permitted by applicable law, the parties hereto shall be bound by the rules of any Corporations transfer system utilized to effect a Corporations transfer hereunder.

7. Acknowledgments. Custodian shall acknowledge through the Electronic Services its receipt of each Written Instruction communicated through the Electronic Services, and in the absence of such acknowledgment Custodian shall not be liable for any failure to act in accordance with such Written Instruction and the Corporation may not claim that such Written Instruction was received by Custodian. Custodian may in its discretion decline to act upon any instructions or communications that are insufficient or incomplete or are not received by Custodian in sufficient time for Custodian to act upon, or in accordance with such instructions or communications.

8. Viruses. The Corporation agrees to use reasonable efforts to prevent the transmission through the Electronic Services of any software or file which contains any viruses, worms, harmful component or corrupted data and agrees not to use any device, software, or routine to interfere or attempt to interfere with the proper working of the Electronic Services.

9. Encryption. The Corporation acknowledges and agrees that encryption may not be available for every communication through the Electronic Services, or for all data. The Corporation agrees that Custodian may deactivate any encryption features at

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any time, without notice or liability to the Corporation, for the purpose of maintaining, repairing or troubleshooting its systems.

10. On-Line Inquiry and Modification of Records. In connection with the Corporation's use of the Electronic Services, Custodian may, at the Corporation's request, permit the Corporation to enter data directly into a Custodian database for the purpose of modifying certain information maintained by Custodian's systems, including, but not limited to, change of address information. To the extent that the Corporation is granted such access, the Corporation agrees to indemnify and hold Custodian harmless from all loss, liability, cost, damage and expense (including attorney's fees and expenses) to which Custodian may be subjected or which may be incurred in connection with any claim which may arise out of or as a result of changes to Custodian database records initiated by the Corporation.

11. Agents. the Corporation may, on advance written notice to the Custodian, permit its agents and contractors ("Agents") to access and use the Electronic Services on the Corporation's behalf, except that the Custodian reserves the right to prohibit the Corporation's use of any particular Agent for any reason. The Corporation shall require its Agent(s) to agree in writing to be bound by the terms of the Agreement, and the Corporation shall be liable and responsible for any act or omission of such Agent in the same manner, and to the same extent, as though such act or omission were that of the Corporation. Each submission of a Written Instruction or other communication by the Agent through the Electronic Services shall constitute a representation and warranty by the Corporation that the Agent continues to be duly authorized

by the Corporation to so act on its behalf and the Custodian may rely on the representations and warranties made herein in complying with such Written Instruction or communication. Any Written Instruction or other communication through the Electronic Services by an Agent shall be deemed that of the Corporation, and the Corporation shall be bound thereby whether or not authorized. The Corporation may, subject to the terms of this Agreement and upon advance written notice to the Bank, provide a copy of the Electronic Service user manuals to its Agent if the Agent requires such copies to use the Electronic Services on the Corporation's behalf. Upon cessation of any such Agent's services, the Corporation shall promptly terminate such Agent's access to the Electronic Services, retrieve from the Agent any copies of the manuals and destroy them, and retrieve from the Agent any token cards or other security devices provided by Custodian and return them to Custodian.

CERTIFICATION
Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

I, David Gladstone, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Gladstone Capital Corporation;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - d) Disclosed in this report any changes in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent functions):
 - a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: August 1, 2006

/s/ DAVID GLADSTONE

David Gladstone
Chief Executive Officer

CERTIFICATION
Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002

I, Harry Brill, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Gladstone Capital Corporation;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer(s) and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - d) Disclosed in this report any changes in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter (the registrant's fourth fiscal quarter in the case of an annual report) that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer(s) and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent functions):
 - a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
 - b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal control over financial reporting.

Date: August 1, 2006

/s/ HARRY BRILL

Harry Brill
Chief Financial Officer

**CERTIFICATION PURSUANT TO 18 U.S.C. SECTION 1350,
AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

The undersigned, the Chief Executive Officer and Chairman of the Board of Gladstone Capital Corporation (the "Company"), hereby certifies on the date hereof, pursuant to 18 U.S.C. §1350(a), as adopted pursuant to Section 906 of The Sarbanes-Oxley Act of 2002, that the Quarterly Report on Form 10-Q for the quarter ended June 30, 2006 ("Form 10-Q"), filed concurrently herewith by the Company, fully complies with the requirements of Section 13(a) or Section 15(d) of the Securities Exchange Act of 1934, as amended, and that the information contained in the Form 10-Q fairly presents, in all material respects, the financial condition and results of operations of the Company.

Dated: August 1, 2006

/s/ David Gladstone

David Gladstone
Chief Executive Officer

**CERTIFICATION PURSUANT TO 18 U.S.C. SECTION 1350,
AS ADOPTED PURSUANT TO
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002**

The undersigned, the Chief Financial Officer of Gladstone Capital Corporation (the "Company"), hereby certifies on the date hereof, pursuant to 18 U.S.C. §1350(a), as adopted pursuant to Section 906 of The Sarbanes-Oxley Act of 2002, that the Quarterly Report on Form 10-Q for the quarter ended June 30, 2006 ("Form 10-Q"), filed concurrently herewith by the Company, fully complies with the requirements of Section 13(a) or Section 15(d) of the Securities Exchange Act of 1934, as amended, and that the information contained in the Form 10-Q fairly presents, in all material respects, the financial condition and results of operations of the Company.

Dated: August 1, 2006

/s/ Harry Brill

Harry Brill
Chief Financial Officer