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 DECEMBER 31, 2005

☐ 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	**54-2040781**
(State or other jurisdiction of incorporation or organization)	(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 an accelerated filer (as defined in Rule 12 b-2 of the Exchange Act).
Yes ☒ No ☐.

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 February 3, 2006 was 11,308,510.

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GLADSTONE CAPITAL CORPORATION

CONSOLIDATED STATEMENTS OF ASSETS AND LIABILITIES
(Unaudited)

	December 31, 2005	September 30, 2005
ASSETS		
Investments at fair value (Cost 12/31/2005:$192,181,728; 9/30/2005: $205,375,554)	$ 192,625,362	$ 200,846,763
Cash and cash equivalents	15,393,252	503,776
Interest receivable – investments in debt securities	958,365	1,406,212
Interest receivable – officers	17,150	27,067
Due from custodian	2,413,120	2,624,074
Due from affiliate	300,638	—
Deferred financing fees	43,750	70,000
Prepaid assets	197,125	177,848
Other assets	157,381	137,354
TOTAL ASSETS	$ 212,106,143	$ 205,793,094
LIABILITIES		
Accounts payable	$ 10,784	$ 21,893
Interest payable	189,390	183,707
Fees due to affiliate	210,109	391,322
Borrowings under lines of credit	55,723,723	53,034,064
Accrued expenses and deferred liabilities	352,962	350,665
Funds held in escrow	202,164	200,760
Total Liabilities	56,689,132	54,182,411
Net Assets	$ 155,417,011	$ 151,610,683
ANALYSIS OF NET ASSETS		
Common stock, $0.001 par value, 50,000,000 shares authorized and 11,308,510 and 11,303,510 shares issued and outstanding, respectively	$ 11,309	$ 11,304
Capital in excess of par value	164,740,025	164,610,873
Notes receivable – officers	(8,722,687)	(8,745,781)
Net unrealized appreciation/(depreciation) on investments	443,631	(4,528,791)
Unrealized depreciation on derivative	(254,639)	(253,747)
Realized (loss)/gain on sale of investments	(1,138,345)	42,250
Distributions less than net investment income	337,717	474,575
Total Net Assets	$ 155,417,011	$ 151,610,683
Net Assets Per Share	$ 13.74	$ 13.41

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

GLADSTONE CAPITAL CORPORATION
CONSOLIDATED SCHEDULE OF INVESTMENTS
AS OF DECEMBER 31, 2005
(UNAUDITED)

Company (1)	Industry	Investment (2)	Cost	Fair Value
Advanced Homecare Management, Inc.	Home health nursing services	Senior Subordinated Term Debt(6)(7) (13.7%, Due 12/2010)	$ 7,500,000	$ 7,500,000
Allied Extruders, Inc.	Polyethylene film manufacturer	Senior Term Debt (3)(6) (12.3%, Due 7/2009)	3,900,000	3,909,750
Badanco Acquisition Corp.	Manufacturing-luggage	Senior Term Debt (6) (9.8%, Due 2/2010)	6,247,519	6,247,519
		Senior Term Debt (3)(6)(12) (12.8%, Due 2/2010)	8,650,000	8,879,225
Benetech, Inc.	Dust management systems for the coal and electric utility industries	Senior Term Debt (6) (9.3%, Due 5/2009)	2,600,000	2,622,750
		Senior Term Debt (3) (6) (12.3%, Due 5/2009)	3,168,750	3,212,320
Consolidated Bedding, Inc.	Manufacturing-mattresses	Senior Subordinated Term Debt (6) (13.0%, Due 3/2009)	2,890,155	2,738,895
Country Road Communications LLC Country Road Management, Inc.	Service-telecommunications	Senior Subordinated Term Debt (6)(7) (11.6%, Due 7/2013)	5,957,355	6,060,000

Coyne International Enterprises	Industrial services	Senior Term Debt (3) (5) (6) (13.0%, PIK 2%, Due 7/2007)	6,370,574	6,306,869
Defiance Stamping Company	Manufacturing-trucking parts	Senior Term Debt (3)(6)(13) (12.3%, Due 4/2010)	6,325,000	6,358,649
Doe & Ingalls Management LLC Doe & Ingalls of North Carolina Operating LLC Doe & Ingalls of Florida Operating LLC Doe & Ingalls of Virginia Operating LLC	Distributor-specialty chemicals	Senior Term Debt (6) (8.8%, Due 11/2010) Senior Term Debt (3)(6) (12.3%, Due 11/2010)	5,500,000 4,500,000	5,506,875 4,500,000
Finn Corporation	Manufacturing-landscape equipment	Common Stock Warrants	37,000	694,057
Gammill, Inc.	Designer and assembler of quilting machines and accessories	Senior Term Debt (6) (9.5%, Due 12/2008) Senior Term Debt (3) (6) (12.0%, Due 12/2008)	3,389,696 4,631,250	3,385,459 4,602,305
Global Materials Technologies, Inc.	Manufacturing-steel wool products and metal fibers	Senior Term Debt (3) (6) (13.3%, Due 11/2009)	5,450,000	5,422,750
Infor Global Solutions Ltd.	Enterprise application solutions	Senior Subordinated Term Debt (7) (11.8%, Due 5/2012)	6,828,000	6,947,500
John Henry Holdings, Inc.	Manufacturing-packaging products	Senior Subordinated Term Debt(6)(7) (11.5%, Due 6/2011)	7,069,330	6,993,500

Company (1)	Industry	Investment (2)	Cost	Fair Value
Mistras Holdings Corp.	Nondestructive testing instruments, systems and services	Senior Term Debt (3) (6) (10.5%, Due 8/2008) Senior Term Debt (3) (6) (12.5%, Due 8/2008)	9,666,666 5,333,334	9,437,083 5,200,001
Northern Contours Northern Contours of Kentucky, Inc. Norcon Holding LLC Norcon Lewis LLC	Manufacturing-veneer and laminate components	Senior Subordinated Term Debt (6) (11.3%, 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 (7) (10.5%, Due 5/2012)	5,009,167	5,050,000
Polar Corporation	Manufacturing-trailer parts	Senior Subordinated Term Debt(6)(7) (10.9%, Due 6/2010)	10,012,391	10,030,346
Puerto Rico Cable Acquisition Company, Inc.	Service-telecommunications	Senior Subordinated Term Debt(6)(7) (10.8%, Due 1/2012)	7,075,780	7,105,000
Santana Plastics	Manufacturing-polyethylene bathroom partitions	Senior Term Debt (3)(6) (12.3%, Due 11/2009) Senior Term Debt (4)(6) (13.0%, Due 11/2009)	5,925,000 1,925,625	5,925,000 1,925,625
SCPH Holdings, Inc. Sea Con Phoenix, Inc. Phoenix Optix, Inc.	Manufacturing-underwater and harsh environment components	Credit Facility (9) (8.8%, Due 3/2006) Senior Term Debt (6) (9.3%, Due 2/2010) Senior Term Debt (3)(6) (12.3%, Due 2/2010)	— 3,150,000 3,000,000	— 3,150,000 3,000,000
SCS Acquisition Corp.	Service-chemically treated equipment distribution	Credit Facility (10) Senior Term Debt (8)(11) (8.4%, Due 12/2011) Senior Term Debt (3)(8)(11) (10.4%, Due 12/2011)	— 6,625,000 6,625,000	— 6,625,000 6,625,000
Survey Sampling	Service-telecommunications	Senior Subordinated Term Debt(6)(7) (11.8%, Due 5/2012)	2,263,568	2,264,063
Tech Lighting LLC	Manufacturing-low voltage lighting systems	Senior Subordinated Term Debt(6)(7) (11.5%, Due 10/2010)	9,011,837	9,045,000
Visual Edge Technology, Inc. Graphic Enterprises, Inc. Copeco, Inc.	Service-office supplies distribution	Senior Subordinated Term Debt (6) (12.3%, Due 8/2011)	5,000,000	5,000,000

Company (1)	Industry	Investment (2)	Cost	Fair Value

Woven Electronics Corporation	Custom electrical cable assemblies	Senior Term Debt (4) (6) (14) (11.5%, Due 3/2009)	8,344,999	8,675,962
Xspedius Communications LLC	Service-telecommunications	Senior Subordinated Term Debt (6) (14.8%, Due 3/2010)	5,198,732	4,678,859
Total:			**$ 192,181,728**	**$ 192,625,362**

(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 December 31, 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 9 "Payment in Kind Interest" hereto and 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 December 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 December 31, 2005.
(10) Availability under the credit facility totals $2,500,000. There were no borrowings outstanding at December 31, 2005.
(11) Availability under the debt facility totals $7,500,000. The outstanding balance of the debt facility was $6,625,000 at December 31, 2005.
(12) Includes a success fee with a $147,725 fair value and no cost basis.
(13) Includes a success fee with a $33,649 fair value and no cost basis.
(14) Includes a success fee with a $247,513 fair value and no cost basis.

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

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

Company (1)	Industry	Investment (2)	Cost	Fair Value
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

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 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)	3,237,500	3,241,547
		Senior Term Debt (6) (12.0%, Due 2/2010)	3,000,000	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

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 TO THESE CONSOLIDATED FINANCIAL STATEMENTS.

GLADSTONE CAPITAL CORPORATION
CONSOLIDATED STATEMENTS OF OPERATIONS
(UNAUDITED)

	Three Months Ended December 31, 2005	Three Months Ended December 31, 2004
INVESTMENT INCOME		
Interest income – investments	$ 5,847,107	$ 5,707,343
Interest income – cash and cash equivalents	8,912	16,340
Interest income – notes receivable from employees	107,093	114,718
Prepayment fees and other income	67,207	240,000
Total investment income	6,030,319	6,078,401
EXPENSES		
Loan servicing (Refer to Note 12)	715,415	530,952
Management fee (Refer to Notes 12 and 15)	268,701	327,302
Professional fees	122,466	238,722
Amortization of deferred financing fees	26,250	91,912
Interest expense	652,078	171,730
Stockholder related costs	128,935	71,769
Directors fees	24,000	27,000
Insurance expense	50,777	46,272
Stock option compensation	43,257	—
General and administrative exepnses	55,789	43,160
Expenses before credit from Gladstone Management	2,087,668	1,548,819
Credit to management fee for fees collected by Gladstone Management (Refer to Note 15)	(550,000)	(286,500)
Total expenses net of credit to management fee	1,537,668	1,262,319
NET INVESTMENT INCOME BEFORE INCOME TAXES	4,492,651	4,816,082
Income tax expense	50,237	138,678
NET INVESTMENT INCOME	4,442,414	4,677,404
REALIZED AND UNREALIZED GAIN/(LOSS) ON INVESTMENTS:		
Realized (loss)/gain on sale of investments	(1,180,595)	9,750
Unrealized depreciation on derivative	(892)	(24,811)
Net unrealized appreciation on investments	4,972,422	282,605
Net gain on investments	3,790,935	267,544
NET INCREASE IN NET ASSETS RESULTING FROM OPERATIONS	$ 8,233,349	$ 4,944,948
NET INCREASE IN NET ASSETS RESULTING FROM OPERATIONS PER COMMON SHARE:		
Basic	$ 0.73	$ 0.44
Diluted	$ 0.71	$ 0.43
WEIGHTED AVERAGE SHARES OF COMMON STOCK OUTSTANDING:		
Basic	11,306,510	11,278,510
Diluted	11,573,620	11,615,796

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

GLADSTONE CAPITAL CORPORATION
CONSOLIDATED STATEMENTS OF CHANGES IN NET ASSETS

(UNAUDITED)

	Three Months Ended December 31, 2005	Three Months Ended December 31, 2004
Operations:		
Net investment income	$ 4,442,414	$ 4,677,404
Net realized (loss)/gain on sale of investments	(1,180,595)	9,750
Unrealized depreciation on derivatives	(892)	(24,811)
Net unrealized appreciation on investments	4,972,422	282,605
Net increase in net assets from operations	8,233,349	4,944,948
Capital transactions:		
Distributions to stockholders	(4,579,272)	(4,060,263)

Stock option compensation	43,257	—
Issuance of common stock under stock option plan	85,900	—
Repayment of principal on employee notes	23,094	150,000
Shelf offering costs	—	(111,233)
Decrease in net assets from capital share transactions	(4,427,021)	(4,021,496)
Total increase in net assets	3,806,328	923,452
Net assets at beginning of year	151,610,683	152,226,655
Net assets at end of year	$ 155,417,011	$ 153,150,107

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

GLADSTONE CAPITAL CORPORATION
CONSOLIDATED STATEMENTS OF CASH FLOWS
(UNAUDITED)

	Three Months Ended December 31, 2005	2004
CASH FLOWS FROM OPERATING ACTIVITIES		
Net increase in net assets resulting from operations	$ 8,233,349	$ 4,944,948
Adjustments to reconcile net increase in net assets resulting from operations to net cash provided by operating activities:		
Net amortization of premiums and discounts	32,641	455
Amortization of deferred financing fees	26,250	91,912
Stock compensation	43,257	—
Realized loss on investments	1,180,595	—
Unrealized depreciation on derivative	892	24,811
Change in net unrealized appreciation	(4,972,422)	(282,605)
Decrease (increase) in interest receivable	457,764	(67,382)
Decrease in funds due from custodian	210,954	31,270
(Increase) decrease in prepaid assets	(19,277)	1,958
(Increase) decrease in due from affiliate	(300,638)	30,401
Increase in other assets	(20,919)	(40,097)
(Decrease) increase in accounts payable	(11,109)	137,112
Increase (decrease) in interest payable	5,683	(22,189)
Increase (decrease) in accrued expenses and deferred liabilities	2,297	(633,367)
(Decrease) increase in fees due to affiliate	(181,213)	36,400
Increase in funds held in escrow	1,404	—
Increase in investment balance due to payment in kind interest	(33,022)	(140,090)
Net cash provided by operating activities	4,656,486	4,113,537
CASH FLOWS FROM INVESTING ACTIVITIES:		
Purchase of investments	(26,688,457)	(46,949,500)
Principal repayments on investments	38,702,066	25,975,707
Repayment of repurchase agreements	—	(21,345,997)
Receipt of principal on notes receivable - employees	23,094	150,000
Net cash provided by (used in) investing activities	12,036,703	(42,169,790)
CASH FLOWS FROM FINANCING ACTIVITIES:		
Borrowings from the lines of credit	41,925,000	50,400,000
Repayments on the lines of credit	(39,235,341)	(50,743,547)
Distributions paid	(4,579,272)	(4,060,263)
Exercise of employee stock options	85,900	—
Shelf offering costs	—	(111,233)
Net cash used in financing activities	(1,803,713)	(4,515,043)
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS (1)	14,889,476	(42,571,296)
CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD	503,776	65,954,840
CASH AND CASH EQUIVALENTS, END OF PERIOD	$ 15,393,252	$ 23,383,544
CASH PAID DURING PERIOD FOR INTEREST	$ 646,934	$ 139,763
CASH PAID DURING PERIOD FOR INCOME TAXES	$ —	$ 138,678

(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 TO THESE CONSOLIDATED FINANCIAL STATEMENTS.

GLADSTONE CAPITAL CORPORATION
FINANCIAL HIGHLIGHTS
(UNAUDITED)

	Three Months Ended December 31, 2005	Three Months Ended December 31, 2004
Per Share Data (1)		
Net asset value at beginning of period	$ 13.41	$ 13.50
Income from investment operations:		
Net investment income (2)	0.39	0.41
Realized (loss)/gain on sale of investments (2)	(0.10)	—
Net unrealized gain on investments (2)	0.44	0.03
Net unrealized (loss) on derivatives (2)	—	—
Total from investment operations	0.73	0.44
Less distributions:		
Distributions from net investment income	(0.41)	(0.36)
Total distributions	(0.41)	(0.36)
Issuance of common stock under stock option plan	0.01	—
Offering costs	—	(0.01)
Repayment of principal on notes receivable	—	0.01
Net asset value at end of period	$ 13.74	$ 13.58
Per share market value at beginning of period	$ 22.55	$ 22.71
Per share market value at end of period	21.38	23.70
Total Return (3)(4)	-3.44%	5.94%
Shares outstanding at end of period	11,308,510	11,278,510
Ratios/Supplemental Data		
Net assets at end of period	$ 155,417,011	$ 153,150,107
Average net assets	$ 150,961,590	$ 151,429,917
Ratio of expenses to average net assets-annualized (5)	5.66%	4.46%
Ratio of net expenses to average net assets-annualized (6)	4.21%	3.70%
Ratio of net investment income to average net assets-annualized	11.77%	12.36%

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

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

GLADSTONE CAPITAL CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

December 31, 2005

(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 December 31, 2004 and December 31, 2005, 50,000,000 shares of $0.001 par value common stock were authorized and 11,278,510 and 11,308,510, respectively, shares were outstanding.

Transactions in common stock were as follows:

	Common Stock	
	Shares	Amount
Balance at September 30, 2004	11,278,510	$ 11,279
	—	—
Balance at December 31, 2004	11,278,510	$ 11,279
Balance at September 30, 2005	11,303,510	$ 11,304
Issuance of Common Stock Under Stock Option Plan	5,000	5
Balance at December 31, 2005	11,308,510	$ 11,309

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 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 months ended December 31, 2005, 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 $43,257. The Company's expensing of stock options decreased both basic and diluted net increase to net assets resulting from operations per share by $0.004 for the three months ended December 31, 2005. 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 Company's 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 months ended December 31, 2004 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 December 31, 2004
Net increase in net assets resulting from operations as reported:	$ 4,944,948
Deduct: Total stock-based compensation expense determined using the fair value based method for all awards	(72,355)
Pro forma net increase in net assets resulting from operations per share	$ 4,872,593
As reported - basic	$ 0.44
As reported - diluted	$ 0.43
Pro forma-basic	$ 0.43
Pro forma-diluted	$ 0.42

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 Company did not grant any options during the three months ended December 31, 2005.

The following is a summary of the status of the Company's 2001 Plan from September 30, 2005 through December 31, 2005:

	Shares		Weighted Average Exercise Price
Options outstanding at October 1, 2005	1,307,998	$	17.81
Granted	—	$	—
Expired	—	$	—
Exercised	(5,000)	$	17.18
Forfeited	(5,000)	$	22.55
Options outstanding at December 31, 2005, of which 1,297,998 shares are exercisable	1,297,998	$	17.80

The following is a detailed summary of the stock options outstanding at December 31, 2005:

Range of Exercise Prices	Stock Options Outstanding	Weighted Average Remaining Contractual Life (Years)		Weighted Average Exercise Price
$15.00 - $21.94	968,998	6.23	$	16.06
$22.21 - $24.39	329,000	8.39	$	22.90
Total	1,297,998	6.78	$	17.80

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 will terminate the 2001 Plan, and seek agreement from all holders of stock options to exercise or terminate their options within a limited period of time. The stockholders voted to replace the 2001 Plan with an incentive fee component of the advisory fee in place between the Company and the Adviser. The new incentive fee will take effect on the later of October 1, 2006, the first day of fiscal year 2007 or the first day of the fiscal quarter following the termination or exercise of the last outstanding stock options under the 2001 Plan. As of December 31, 2005, no formal plan has been enacted and therefore, there is no change in the remaining contractual lives of the outstanding options.

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 months ended December 31, 2005 and December 31, 2004:

		Three Months Ended December 31, 2005		Three Months Ended December 31, 2004
Numerator for basic and diluted net increase in net assets resulting from operations per share	$	8,233,349	$	4,944,948
Denominator for basic weighted average shares		11,306,510		11,278,510
Dilutive effect of stock options		267,110		337,286
Denominator for diluted weighted average shares		11,573,620		11,615,796
Basic net increase in net assets resulting from operations per share	$	0.73	$	0.44
Diluted net increase in net assets resulting from operations per share	$	0.71	$	0.43

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 fee 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. 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 three months ended December 31, 2005 and December 31, 2004:

Fiscal Year	Record Date	Payment Date		Dividend per Share
2006	Dec. 21, 2005	Dec. 30, 2005	$	0.135
	Nov. 21, 2005	Nov. 30, 2005	$	0.135
	Oct. 21, 2005	Oct. 31, 2005	$	0.135
2005			$	0.12
	Dec. 17, 2004	Dec. 30, 2004		
	Nov. 17, 2004	Nov. 30, 2004	$	0.12
	Oct. 18, 2004	Oct. 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. 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.

NOTE 9. PAYMENT IN KIND INTEREST

The Company seeks to avoid payment in kind ("PIK") interest, however the Company has one loan in its portfolio that contains 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. For the three months ended December 31, 2005, the Company recorded PIK interest income of $32,510 and for the three months ended December 31, 2004, the Company recorded PIK interest income of $140,963. At December 31, 2005 and September 30, 2005, the Company had accrued on its balance sheets, a total in PIK income of $1,027,884 and $1,273,251 respectively. The Company does not hold any investments issued at original issue discount and accordingly, has not realized any original issue discount income for the three months ended December 31, 2005 or December 31, 2004.

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 December 31, 2005 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 three months ended December 31, 2004.

NOTE 11. CONTRACTUAL OBLIGATIONS

As of December 31, 2005, the Company was a party to a signed and non-binding term sheet for one potential investment and was due to fund another investment for the Company's portfolio. The Company expects to fund these potential investments as follows:

		Payment Due by Period			
Contractual Obligations	**Total**	**Less than 1 Year**	**1-3 Years**	**3-5 Years**	**More than 5 Years**
Investments	22,500,000	22,500,000			
Total	$ 22,500,000	$ 22,500,000	$ —	$ —	$ —

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 has been extended through December 31, 2006. Interest on outstanding borrowings is based upon the one month London Interbank Offered Rate ("LIBOR") plus 2.5% per annum. The unused portion of the line of credit is subject to a fee of 0.2% per annum. The BB&T Agreement requires the Company to meet and maintain certain covenants and ratios with respect to leverage and liquidity. As of December 31, 2005, there were no borrowings outstanding under the BB&T line of credit and $15.0 million of available borrowings. At December 31, 2005 the Company was in compliance with all covenants under the BB&T Agreement.

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 2005, the Company renewed the DB Facility through May 26, 2006. As of December 31, 2005, the outstanding principal balance under the DB Facility was approximately $55.7 million at an interest rate of 4.3%. 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 December 31, 2005, the remaining borrowing capacity available under the DB Facility was approximately $16.8 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 December 31, 2005, 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 December 31, 2005, the amount due from custodian was $2,413,120 and at September 30, 2005, the amount due from custodian was $2,624,074.

Effective July 12, 2004, 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 Gladstone Management would comply fully with all of its obligations under the DB Facility. The performance guaranty requires the Company 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 December 31, 2005, the Company was in compliance with all covenants under the performance guaranty. Gladstone Management 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. For the three months ended December 31, 2005, the Company recorded loan servicing fees of $715,415, as compared to $530,952 for the three months ended December 31, 2004. At December 31, 2005, the Company owed $210,109 of unpaid loan servicing fees to Gladstone Management, which are recorded in fees due to affiliate. At September 30, 2005, the Company owed $207,619 in loan servicing fees to Gladstone Management, recorded in fees due to affiliate.

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 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 $25.6 million and it has a current fair value of approximately $49,361 which is recorded in other assets on the Company's consolidated balance sheet at December 31, 2005. 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%.

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 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 December 31, 2005 and December 31, 2004, Gladstone Management received $550,000 and $286,500, respectively for fees for services rendered to portfolio companies. 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 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). 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 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 December 31, 2005 and December 31, 2004, these loan servicing fees totaled $715,415 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 December 31, 2005 and December 31, 2004, Gladstone Management recorded $550,000 and $286,500, respectively, of such fees and credited this amount against the 2% management fee received from the Company and 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 table sets forth the quarterly computation of the management fee for the three months ended December 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):

	December 31, 2005	December 31, 2004
Fee:		
Total assets at	$ 211,823,244	$ 194,085,591
Less: Borrowings under line of credit at	(15,000,000)(a)	(22,435,000)(b)
Total assets subject to fee as of	196,823,244	171,650,591
Quarterly fee rate	0.50 %	0.50 %
Gross management fee before loan servicing fee credit	984,116	858,254
Less: loan servicing fee from Gladstone Business Loan LLC	715,415	530,952
Management fee before credit:	268,701	327,302
Direct Credit to Management Fee:		
Fee revenue recorded by Gladstone Management:	550,000	286,500
Net management fee for the three months ended (c):	$ (281,299)	$ 40,802

(a) 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.

(b) 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, 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.

(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.

On December 2, 2005, the Company's stockholders approved a proposal to enter into an amended and restated investment advisory agreement (the "Amended Advisory Agreement") with Gladstone Management (the "Adviser") 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 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 a capital gains-based incentive fee, whereby the Adviser will receive a fee equal to 20% of the Company's realized capital gains (net of realized capital losses and unrealized capital depreciation). 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, and seek agreement from all holders of stock options to exercise or terminate their options within a limited period of time. The Amended Advisory Agreement and the Administration Agreement will become effective upon the later of (i) October 1, 2006, or (ii) the first day of the first fiscal quarter following the date that all existing stock options are exercised. The Amended Advisory Agreement and Administration Agreement will not become effective as long as the 2001 Plan is in effect or as long as there are any outstanding stock options. The current investment advisory agreement with Gladstone Management will continue in effect until these new agreements become effective.

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 three months ended December 31, 2005, 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 three months ended December 31, 2004.

NOTE 17. SUBSEQUENT EVENTS

In January 2006, the Company extended a $15.0 million loan to Westlake Hardware, Inc., a regional hardware store chain, a $6.5 million loan to Thibaut, Inc., a designer and marketer of higher quality wallpaper, and a $6.0 million loan to RCS Management, Inc., a supplier of respiratory therapy equipment. The Company also purchased a $2.5 million syndicated loan participation in Network Solutions LLC. These investments were funded using proceeds from borrowings under the DB Facility.

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

Fiscal Year	Record Date	Payment Date	Dividend per Share
2006	March 23, 2006	March 31, 2006	$ 0.135
	Feb. 20, 2006	Feb. 28, 2006	$ 0.135
	Jan. 19, 2006	Jan. 31, 2006	$ 0.135

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. 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 1940 Act.

We seek out small and medium-sized businesses that meet certain criteria, including (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, mature in no more than seven years and accrue interest at a fixed or variable rate that exceeds the prime rate. A number of our loans have 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. The amount of cost basis PIK interest accrued on our balance sheet as of December 31, 2005 was approximately $1,028,000.

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 such fees received, with the exception of the recurring fees, by Gladstone Management are 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 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.

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 and reaching agreement on the legal documentation for the loan. 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. Prior to the externalization of our management on October 1, 2004, we recognized this as fee revenue upon execution of the non-binding term sheet. Effective October 1, 2004, 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 three months ended December 31, 2005, we extended, directly or through participations, approximately $26.7 million of new loans to a total of four companies. Also, during the three months ended December 31, 2005, one borrower repaid its loans ahead of contractual maturity at par value and we sold three loan investments at a loss of approximately $1.2 million, for an aggregate return of capital of approximately $23.3 million and we received scheduled contractual principal repayments of approximately $15.4 million, for total principal repayments of approximately $38.7 million. Since our initial public offering in August 2001, we have made 81 different loans to, or investments in, 51 companies for a total of approximately $389.6 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 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

Effective October 1, 2004, pursuant to our advisory agreement with Gladstone Management, we pay Gladstone Management 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 Gladstone Management and any other fees received by Gladstone Management from our borrowers and potential borrowers. 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. For the three months ended December 31, 2005 and December 31, 2004, we incurred approximately $715,415 and $530,952, respectively, in loan servicing fees.

For the three months ended December 31, 2005, the gross management fee, before reductions for loan servicing fees and other fees was approximately $984,000. After being reduced by loan servicing fees of approximately $715,000 and other fees received by Gladstone Management of $550,000, our net management fee for the three months ended December 31, 2005 was a credit of approximately $281,000. For the three months ended December 31, 2004, the gross management fee, before reductions for loan servicing fees and other fees was approximately $858,000. After being reduced by loan servicing fees of approximately $531,000 and other fees received by Gladstone Management of $286,500, our net management fee for the three months ended December 31, 2004 was $40,802.

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 a capital gains-based incentive fee, whereby the Adviser will receive a fee equal to 20% of our realized capital gains (net of realized capital losses and unrealized capital depreciation). 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.

In connection with the approval of the Amended Advisory Agreement, we will terminate our Amended and Restated 2001 Equity Incentive Plan (the "Plan"), and seek agreement from all holders of stock options to exercise or terminate their options within a limited period of time. The Amended Advisory Agreement and the Administration Agreement will become effective upon the later of (i) October 1, 2006, or (ii) the first day of the first fiscal quarter following the date that all existing stock options are exercised or terminated. The Amended Advisory Agreement and Administration Agreement will not become effective as long as the Plan is in effect or as long as there are any outstanding stock options. The current investment advisory agreement with Gladstone Management will continue in effect until these new agreements become effective.

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 December 31, 2005.

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 NRSRO (as defined below), 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 December 31, 2005 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 December 31, 2005 and September 30, 2005 in our consolidated financial statements. Subsequent to September 30, 2005, the fair value of our investment in 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 December 31, 2005, there were no mortgage loans in our portfolio.

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 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 nationally recognized statistical rating organizations ("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. 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.

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 22.0% and the EL is 5% to 6.5%
5	B2	B	PD is 25% and the EL is 6.5% to 8%
4	B3	B-	PD is 27% and the EL is 8% to 10%
3	Caa1	CCC+	PD is 30% and the EL is 10.0% to 13.3%
2	Caa2	CCC	PD is 35% and the EL is 13.3% to 16.7%
1	Caa3	CC	PD is 65% and the EL is 16.7% to 20%
0	N/a	D	PD is 85% or there is a Payment Default: and the EL is greater than 20%

(a) the default rates set 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 December 31, 2005 and September 30, 2005:

Rating	**Dec. 31, 2005**	**Sept. 30, 2005**
Average	**7.1**	**7.0**
Weighted Average	**7.2**	**7.1**
Highest	**9.0**	**9.0**
Lowest	**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 December 31, 2005, 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 December 31, 2005, none of the debt securities in our portfolio were publicly traded and there was a limited market for 11 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 sell the security in a current sale. 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;
- 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 December 31, 2005 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 December 31, 2005 and September 30, 2005 we had $37,000 invested, at cost, in equity securities compared to our debt portfolio with a cost basis of $192,144,728 and $205,338,554, respectively.

At December 31, 2005, we had total unrealized appreciation of $1,677,649, which was mainly composed of unrealized appreciation of $657,057 on our warrants of Finn Corporation, $330,963 of unrealized appreciation on our senior term debt investment in Woven Electronics Corporation, and $229,225 of unrealized appreciation on our senior term debt investment in Badanco Acquisition Corporation. This unrealized appreciation was offset by unrealized depreciation of $1,234,018, most notably composed of unrealized depreciation of $519,873 on our senior subordinated term debt investment in Xspedius Communications, unrealized depreciation of $362,916 on our senior term debt investments in Mistras Holdings Corporation, and unrealized depreciation of $151,260 on our senior subordinated term debt investment in Consolidated Bedding, Inc. In the aggregate, we recorded net unrealized appreciation of $443,631 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 investment 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

We also have 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 December 31, 2005 to the three months ended December 31, 2004

Investment Income

Investment income for the three months ended December 31, 2005 was approximately $6.0 million as compared to approximately $6.1 million for the three months ended December 31, 2004. Although, overall interest income from our investment portfolio increased, the decrease in total investment income was due primarily to a decline in prepayment fees as compared to the three months ended December 31, 2004.

Interest income from our investments in debt securities of private companies was approximately $5.8 million, including approximately $33,000 of PIK interest, for the three months ended December 31, 2005 as compared to approximately $5.7 million for the three months ended December 31, 2004, which included approximately $141,000 of PIK interest. This increase was primarily a result of a net increase in investments of approximately $22.8 million over December 31, 2004. This increase consisted of $123.5 million of new investments, offset by principal repayments and investment sales of approximately $100.7 million.

The annualized weighted average yield on our portfolio for the three months ended December 31, 2005 was 12.6% (without giving effect to PIK interest) and 12.6% (after giving effect to PIK interest). The annualized weighted average yield on our portfolio for the three months ended December 31, 2004 was 14.7% (without giving effect to PIK interest) and 15.0% (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 three months ended December 31, 2005 was approximately $9,000, as compared to approximately $16,000 for the three months ended December 31, 2004. This decrease was primarily a result of a decrease in invested cash and cash equivalents.

For the three months ended December 31, 2005 and December 31, 2004, we recorded approximately $107,000 and $115,000, respectively, in interest income from loans to our employees in connection with the exercise of employee stock options.

For the three months ended December 31, 2005, we recorded approximately $67,000 of prepayment fees and other income as compared to $240,000 of other income for the three months ended December 31, 2004. 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 December 31, 2005 were approximately $1.5 million, as compared to approximately $1.3 million for the three months ended

December 31, 2004. Operating expenses for the three months ended December 31, 2005 reflected a significant increase in interest expense, loan servicing fees, stockholder related costs and stock option compensation expense.

Loan servicing fees of approximately $715,000 were incurred for the three months ended December 31, 2005 as compared to approximately $531,000 for the three months ended December 31, 2004. 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). 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 three months ended December 31, 2005 and December 31, 2004, based on the quarterly increment of 0.50% (0.3125% quarterly advisory fee plus 0.1875% quarterly administrative fee):

	December 31, 2005	December 31, 2004
Fee:		
Total assets at	$ 211,823,244	$ 194,085,591
Less: Borrowings under line of credit at	(15,000,000)(a)	(22,435,000)(b)
Total assets subject to fee as of	196,823,244	171,650,591
Quarterly fee rate	0.50 %	0.50 %
Gross management fee before loan servicing fee credit	984,116	858,254
Less: loan servicing fee from Gladstone Business Loan LLC	715,415	530,952
Management fee before credit:	268,701	327,302
Direct Credit to Management Fee:		
Fee revenue recorded by Gladstone Management:	550,000	286,500
Net management fee for the three months ended (c):	$ (281,299)	$ 40,802

(a) 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.

(b) This amount represents borrowings under one of our lines of credit that were held in cash and cash equivalents as of 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.

(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 December 31, 2005 were approximately $122,000 as compared to approximately $239,000 for the three months ended December 31, 2004. 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, were approximately $26,000 for the three months ended December 31, 2005 and approximately $92,000 for the three months ended December 31, 2004. The decrease is due to the completion of the amortization cycle related to certain deferred financing costs.

Interest expense for the three months ended December 31, 2005 was approximately $652,000 as compared to approximately $172,000 for the three months ended December 31, 2004. This increase is primarily a result of increased borrowings under our lines of credit during the three months ended December 31, 2005, which borrowings were used, in part, to finance our increased investments, borrowings remaining outstanding for longer periods of time and, to a lesser extent, an increase in the interest rates on our borrowings.

Stockholder related costs for the three months ended December 31, 2005 were approximately $129,000, as compared to approximately $72,000 for the three months ended December 31, 2004. 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 report to stockholders and the printing of the annual report to stockholders.

Directors' fees for the three months ended December 31, 2005 were $24,000, as compared to approximately $27,000 for the three months ended December 31, 2004.

Insurance expense for the three months ended December 31, 2005 was approximately $51,000, as compared to approximately $46,000 for the three months ended December 31, 2004. 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 three months ended December 31, 2005 was approximately $43,000. 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 December 31, 2004.

General and administrative expenses were approximately $56,000 for the three months ended December 31, 2005, as compared to approximately $43,000 for the three months ended December 31, 2004. 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 three months ended December 31, 2005, 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 three months ended December 31, 2004, 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. No income tax expense was recorded for the three months ended December 31, 2005.

Realized Gain/(Loss) on Sale of Investments

During the three months ended December 31, 2005, we sold our investments in ARI Holdings, Inc. and Marcal Paper Mills, Inc. for an aggregate loss of approximately $1.2 million. During the three months ended December 31, 2004, we sold our $975,000 syndicated loan participation in Burt's Bees, Inc. for a gain of $9,750.

Net Unrealized Depreciation on Derivative

During the three months ended December 31, 2005, we recorded net unrealized depreciation of approximately $900 due to a decrease in the fair market value of our interest rate cap agreement, as compared to unrealized depreciation of approximately $25,000 during the three months ended December 31, 2004.

Net Unrealized Appreciation on Investments

For the three months ended December 31, 2005, we recorded net unrealized appreciation on investments of approximately $5.0 million as compared to net unrealized appreciation of approximately $283,000, for the three months ended December 31, 2004. 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.

Net Increase in Net Assets from Operations

Overall, we realized a net increase in net assets resulting from operations of approximately $8.2 million for the three months ended December 31, 2005. Based on a weighted-average of 11,306,510 (basic) and 11,573,620 (diluted) shares outstanding, our net increase in net assets from operations per weighted average common share for the three months ended December 31, 2005 was $0.73 (basic) and $0.71 (diluted).

For the three months ended December 31, 2004, werealized a net increase in net assets resulting from operations of approximately $5.0 million. Based on a weighted-average of 11,278,510 (basic) and 11,615,796 (diluted) shares outstanding, our net increase in net assets resulting from operations per weighted average common share for the three months ended December 31, 2004 was $0.44 (basic) and $0.43 (diluted).

LIQUIDITY AND CAPITAL RESOURCES

At December 31, 2005, we had investments in debt securities of, or loans to 27 private companies, totaling approximately $192.2 million (cost basis) of total assets. This number includes approximately $33,000 in accrued PIK interest income for the three months ended December 31, 2005, which as described in "Overview," is added to the carrying value of our investments.

During the three months ended December 31, 2005 and December 31, 2004, the following investment activity occurred:

Quarter Ended	New Investments	Principal Repayments	Net Gain/(Loss) on Disposal
December 31, 2005	$ 26,688,457	$ 38,702,066	$ (1,180,595)
December 31, 2004	46,949,500	25,975,707	9,750

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

Fiscal Year Ended September 30,	Amount
2006	$ 6,444,737
2007	14,675,393
2008	21,109,819
2009	31,843,965
2010	47,710,382
Thereafter	70,397,432
	$ 192,181,728

Net cash provided by operating activities for the three months ended December 31, 2005, consisting primarily of the items described in "Results of Operations", was approximately $4.7 million as compared to net cash provided by operating activities of approximately $4.1 million for the three months ended December 31, 2004. Net cash provided by investing activities was approximately $12.0 million for the three months ended December 31, 2005 and mainly consisted of $38.7 million of principal repayments partially offset by new investments of $26.7 million, as compared to net cash used in investing activities of approximately $42.2 million for the three months ended December 31, 2004, which consisted mainly of new investments of $46.9 million and the repayment of a repurchase agreement of approximately $21.3 million, partially offset by principal repayments of approximately $26.0 million. Net cash used in financing activities for the three months ended December 31, 2005 was approximately $1.8 million and mainly consisted of repayments of borrowings on the line of credit of approximately $39.2 million and approximately $4.6 million for the payment of dividends. These outflows were partially offset by approximately $41.9 million of cash received from borrowings on the line of credit and the exercise of stock options for approximately $86,000. Net cash used in financing activities was approximately $4.5 million for the three months ended December 31, 2004 and consisted primarily of the payment of dividends of approximately $4.1 million, repayments, net of borrowings, of our line of credit of approximately $0.3 million, and some costs incurred in connection with the shelf offering of common stock completed in September 2004.

During the three months ended December 31, 2005, cash and cash equivalents increased from approximately $504,000 to approximately $15.4 million. This increase was largely the result of $15.0 million of borrowings which were used to fund a new loan investment subsequent to December 31, 2005.

Subsequent to December 31, 2005, we funded four new additional loan investments in the aggregate amount of $30.0 million using borrowings from our 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 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 January 2006, our Board of Directors declared a monthly dividend of $0.135 per common share for each January, February, and March 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 Securities and Exchange Commission ("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 matures on May 26, 2006. 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 the London Interbank Offered Rate ("LIBOR"), the Prime Rate or the Federal Funds Rate, depending on market conditions, and will adjust periodically. As of December 31, 2005, our outstanding principal balance under this DB Facility was approximately $55.7 million at an interest rate of 4.3%. 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 or added and repaid, regardless of whether such repayments are early prepayment or are made as contractually required. At December 31, 2005, the remaining borrowing capacity available under the DB Facility was approximately $16.8 million. We are in the process of negotiating a renewal of this DB Facility, however there can be no guarantee that we will be able to renew the DB Facility on terms that are favorable to us, if at all. In the event that we are not able to renew the DB Facility this could have a material adverse impact on our liquidity and ability to fund new investments. In October 2005, our Board of Directors approved a resolution to seek to increase this credit facility to $150 million.

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 December 31, 2005, 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 three months ended December 31, 2005, the amount due from custodian decreased by approximately $211,000.

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 December 31, 2005, we were in compliance with our covenants under the performance guaranty.

We also have 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. Interest on outstanding borrowings is based on the one month LIBOR plus 2.5% per annum. The unused portion of the line of credit is subject to a fee of 0.2% per annum. The BB&T Agreement requires us to meet and maintain certain covenants and ratios with respect to leverage and liquidity. As of December 31, 2005, there were no borrowings outstanding under the BB&T line of credit with a remaining borrowing capacity available under the BB&T Agreement of $15.0 million. As of December 31, 2005, we were in compliance with all covenants under the BB&T Agreement.

Both lines of credit are available for general corporate purposes.

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, with approximately 80% made at variable rates. Currently our portfolio has approximately 3% of the total of the loan portfolio cost basis at fixed rates, approximately 50% of the total loan portfolio cost basis at variable rates with a floor. Approximately 4% of the total loan portfolio cost basis is at a variable rate with a floor and ceiling, and the remaining 43% of the total loan portfolio cost basis is at variable rates without a floor or ceiling.

In addition, we have two variable rate borrowing facilities. We have a $100 million revolving credit facility with Deutsche Bank AG which matures in May 2006. We also have a $15 million line of credit agreement with Branch Banking and Trust Company which matured in December 2005 and was modified to extend the maturity through December 2006.

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 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 $35 million at one month LIBOR exceed the payments on $35 million 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 December 31, 2005, the cap agreement had a fair market value of $49,361 and a current notional amount of $25.6 million. At December 31, 2005, the one month LIBOR rate was approximately 4.39%.

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 $1.6 million or 8.4%, over the next twelve months, compared to the net increase in net assets resulting from operations for the twelve months ended December 31, 2005. A hypothetical decrease in the one month LIBOR by 1% would decrease net increase in net assets resulting from operations by approximately $1.6 million, or 8.4%, over the next twelve months, compared to the net increase in net assets resulting from operations for the twelve months ended December 31, 2005. 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.

ITEM 4. CONTROLS AND PROCEDURES.

As of December 31, 2005, 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 December 31, 2005, 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 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.

A special meeting of stockholders was held on December 2, 2005. The stockholders voted to approve an amended Investment Advisory Agreement between Gladstone Capital Corporation and Gladstone Management Corporation and an Administration Agreement between Gladstone Capital Corporation and Gladstone Administration LLC, a wholly owned subsidiary of Gladstone Management Corporation. The voting results are set forth below:

Shares Voted For	Shares Voted Against	Shares Abstained
5,250,866	801,946	158,756

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 and Treasurer

Date: February 7, 2006

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.
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.

Exhibit 31.1

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: February 7, 2006

/s/ DAVID GLADSTONE

David Gladstone
Chief Executive Officer

Exhibit 31.2

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: February 7, 2006

/s/ HARRY BRILL

Harry Brill
Chief Financial Officer and Treasurer

Exhibit 32.1

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 December 31, 2005 ("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: February 7, 2006

/s/ David Gladstone

David Gladstone
Chief Executive Officer

Exhibit 32.2

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 December 31, 2005 (“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: February 7, 2006

/s/ Harry Brill

Harry Brill
Chief Financial Officer