

To Our Shareholders

Capital Southwest Corporation's net asset value at March 31, 1995 was \$147,369,904, equivalent to \$39.46 per share on 3,735,051 shares after deducting an allowance of \$14.26 per share for deferred taxes on net unrealized appreciation of investments. Assuming reinvestment of all dividends, the March 31, 1995 net asset value corresponds to a 12.0% increase over the March 31, 1994 net asset value of \$35.81 per share.

A major increase of \$14,096,600 in the value of our investment in Palm Harbor Homes (from \$19,061,400 to \$33,158,000) materially influenced the growth in net assets during the past year. *(As described later in this letter, shareholders of Capital Southwest will soon receive a dividend of Palm Harbor shares.)* Significant gains were also achieved in the values of RectorSeal and MESC Holdings, which increased by \$5,300,000 and \$3,000,000, respectively, as the earnings of both companies increased substantially. A negative factor was the \$7,000,000 decrease in the value of our investment in Skylawn (from \$47,000,000 to \$40,000,000) reflecting an 11.1% decline in earnings, which are now expected to improve as a result of recent operational changes. Another negative was the \$1,249,998 loss (partially realized) on our unsuccessful investment in CrossTies (now valued at \$1) which failed to achieve adequate market acceptance of its innovative software programs.

Measures of Performance and Value

As shown in the chart on the opposite page, Capital Southwest's net asset value per share, adjusted for stock splits, increased from \$11.05 at March 31, 1985 to \$39.46 at March 31, 1995. The growth in net asset value over this ten-year period corresponded to a compound annual rate of 18.3%, assuming shareholders reinvested all dividends and all tax credits on undistributed long-term capital gains retained by the Company. On the same basis, the market value of an investment in Capital Southwest stock grew at a compound annual rate of 21.0% over the past ten years.

Capital Southwest, unlike most other investment companies, reports its net asset value after deducting deferred taxes on unrealized appreciation of investments. If net assets as reported were increased by the amount of this deferred tax liability, the pro forma March 31, 1995 net asset value

would be \$53.72 per share. Regardless of our Company's tax circumstances or accounting presentation, it is important that our shareholders understand that the deferred tax liability will not be paid until gains are realized. Capital Southwest has a long-term investment perspective, and it is probable that a large proportion of our successful investments will be retained for many years. Meanwhile, the amount of the deferred tax liability corresponding to such investments is represented by assets which are working for the benefit of our shareholders.

The following analysis of a share of Capital Southwest Corporation common stock shows the composition of the assets and liabilities attributable to each share:

	<u>Value Per Share</u>	
Major investments:		
Skylawn Corporation	\$10.71	
Alamo Group Inc.	9.25	
Palm Harbor Homes, Inc.	8.88	
The RectorSeal Corporation	<u>6.69</u>	\$35.53
Other venture investments:		
Non-marketable securities	15.34	
Marketable securities	<u>3.41</u>	18.75
Cash and other assets		<u>2.96</u>
Total assets		57.24
Deferred taxes		(14.44)
Long-term debentures and other liabilities		<u>(3.34)</u>
Net assets at March 31, 1995		<u>\$39.46</u>

In addition to a complete list of our investments, this report includes detailed information on our twelve largest holdings. These twelve investments had a combined cost of \$29,912,422 and a value of \$177,923,515, representing 87.8% of the value of our investment portfolio at March 31, 1995.

Our four largest holdings are Skylawn Corporation, Alamo Group Inc., Palm Harbor Homes, Inc. and The RectorSeal Corporation. At March 31, 1995, investments in these four companies had an aggregate cost of

\$8,809,428 and a value (before deducting deferred taxes) of \$132,715,000 including debt securities valued at \$3,000,000 and equity securities valued at \$129,715,000 (\$34.73 per Capital Southwest share). Our Company's equity in the earnings of these companies for their most recently completed fiscal years was \$13,461,000 (\$3.60 per Capital Southwest share). At March 31, 1994, our investments in the equity securities of these companies had a value of \$31.55 per Capital Southwest share, and our equity in their earnings was \$2.84 per Capital Southwest share.

Investment Activity

A total of \$9,556,876 was invested during the year including \$6,156,876 in additions to existing investments and \$3,400,000 in the following new investments:

- \$200,000 in Amfibe, Inc. of Martinsville, Virginia, a manufacturer of nylon monofilament fibers for the textile industry; acquired from E. I. DuPont De Nemours & Company.
- \$1,200,000 in All Components, Inc. of Addison, Texas, a distributor of computer memory and other components to personal computer manufacturers, retailers and value-added resellers.
- \$2,000,000 in PTS Holdings, Inc. of Anaheim, California, a designer, developer and manufacturer of power distribution and conditioning systems for military and commercial applications; acquired from Magnetek, Inc.

Dividends and Tax Information

On June 2, 1995 our board of directors authorized the distribution of up to 755,000 common shares of Palm Harbor Homes, Inc., declaring a dividend, subject to compliance with the registration requirements of the Securities Act of 1933 and applicable securities laws, of one share of Palm Harbor common stock for each five shares of Capital Southwest common stock, payable on July 31, 1995 to shareholders of record on July 17, 1995. Shareholders of record of less than 50 shares of Capital Southwest stock on the record date will receive cash in lieu of Palm Harbor stock. It is

anticipated that this distribution will be taxed as a capital gain dividend to Capital Southwest shareholders based on the fair market value of Palm Harbor stock on the distribution date.

Palm Harbor has filed a registration statement with the Securities and Exchange Commission registering the 755,000 shares to be distributed by Capital Southwest along with 250,000 shares to be offered by Palm Harbor at \$12 per share to its employees, officers and directors and to its retailers, vendors and consultants. After the planned distribution and offering, and after giving effect to Capital Southwest's simultaneous purchase of 769,231 warrants from a Palm Harbor shareholder and the exercise of all warrants, Capital Southwest will own an estimated 4,018,967 Palm Harbor shares, representing a 41.0% equity interest.

To comply with provisions of the Internal Revenue Code regarding the distribution of taxable net investment income of regulated investment companies, a dividend of \$0.20 per share was paid on May 31, 1994 and a dividend of \$0.40 per share was paid on November 30, 1994. A further dividend of \$0.20 per share was paid on May 31, 1995 to shareholders of record on May 15, 1995.

Our investment activities have often resulted in net long-term capital gains which have been retained by our Company and have been reported in the tax returns of our shareholders, who have received credit for taxes paid by the Company and have increased the tax basis of their shares by the amount of the retained gains. No long-term capital gains were realized during the tax year ended December 31, 1994. Therefore, shareholders will not follow the procedure for reporting long-term capital gains (see Federal Income Tax Information, p. 32).

Letters from Shareholders

From time to time we receive letters from shareholders telling us how they feel about our Company and its management. Last year, a surprising number of shareholders wrote thoughtful, interesting letters in response to a suggestion in our July report. At the risk of being overly promotional, observations and comments extracted from a number of these letters (the favorable ones) are set forth on the following page:

Hurrah, for the President's remarks in the Annual Report when he said "we intend to make a lot of money" for our investors. It is important that business leaders speak up for Capitalism! Business profits are not synonymous with the word "greed", as the socialists would have us believe. Thank you, we will continue to place our bets on the free enterprise system. — Lido Beach, NY.

I am a small shareholder (200) in your company and I want you to know that I do read each of your shareholder reports and find them nice and short and easy to understand. Keep up the good work. I plan to buy more shares in Capital Southwest. — Scott Depot, WV.

Your reports are, of course, totally understandable. I am happy to be a shareholder of Capital Southwest directly, as well as through Third Avenue Value Fund. — Princeton, NJ.

The reason that you have not heard from us is because we have been very satisfied with Capital Southwest's performance over the years. We know that you have done an excellent job in selecting investments in a very treacherous field. — New York, NY.

I've been a happy stockholder for about 13 years — it's been a total pleasure watching your performance, your modesty, and your investment judgement. I've also been a Berkshire Hathaway shareholder for over 20 years. For my savings, you and Mr. Buffett are my two favorite custodians. — New York, NY.

... Is anybody listening? Yes, they are — myself and clients who own Capital Southwest on my recommendation. My first shares were purchased in 1980 and now I have accumulated 3,400 shares. I met with (management) in 1988. I have always appreciated the opportunity as it confirmed my reasons for owning and continuing to add to my shares. — Lodi, CA.

Actually, I am a very small shareholder, maybe even at the bottom of the list, since I only have 50 shares in my IRA account ... I'm a former schoolteacher as well as secretary ... keep up the good work at Capital. One of these days I'll have to cash in my IRA stock and pay the taxes — so, make lots of money! — Soquel, CA.

I won't tell you how old I am but will give you the year I was born ... (1910). I joined Capital Southwest in the early 60's with a purchase of only 30 shares — should have bought 1,000 shares ... Nevertheless, the 30 shares did a

great deal for me — close to \$11,000 plus I still own 240 shares. I have to thank you and your staff for the wonderful way in which you manage the Capital Southwest stock. — Berwyn, IL.

We do find your reports understandable, and appreciate being updated on the condition of your company. I enjoy following any new investments ... Capital Southwest has certainly grown and prospered since we purchased our first shares in 1962. — Abilene, TX.

I'm 30 years old and though I've had my shares for only a relatively short time, I've known about the company ever since I read about it 10 years ago in my father's copy of Forbes magazine ... I like our company a whole lot. The long-term record is outstanding with the stock returning a 20+% a year for 10-15 years. Since over the long run a stock returns only what its underlying business returns ... this implies that you and the people who work with you know — really know — what you are doing. And not only that, you channel the resulting rewards to the shareholders instead of some self-serving manner. — River Grove, IL.

Keep up the good work — you're clearly a quality outfit. Kind of rarish in today's world. — Stockton, CA.

Back in 1961 when four other investors and I formed an SBIC, I bought 10 shares of stock in 10 different new SBIC's ... I felt that most would probably fail but some would succeed. Well, out of the 10, plus our own, Capital Southwest is the only one still alive ... With three splits our 10 shares are now 80 and our \$100 investment is now over \$3,000. Thought you might like to hear from one happy stockholder who wants to say thank you. — Fresno, CA.

Our officers, directors and employees read and appreciate these and other heartwarming letters from our shareholders. We are constantly aware of the trust that you have placed in us.



June 7, 1995

President and Chairman