To Our Shareholders

Capital Southwest Corporation's net asset value at March 31, 1996 was $189,047,753, equivalent to $50.18 per share after deducting an allowance of $18.35 per share for deferred taxes on net unrealized appreciation of investments. Dividends during the year totaled $3.10 per share including cash dividends of $0.60 and the distribution of Palm Harbor Homes stock having a value of $2.50 per Capital Southwest share. Assuming reinvestment of all such dividends, the March 31, 1996 net asset value was 36.5% above the March 31, 1995 net asset value of $39.46 per share.

Growth during the year reflected the strong performance of Palm Harbor Homes, Inc. (Nasdaq: PHHM), which is now our largest holding, valued at $71,086,000 at March 31, 1996. Lee Posey and his associates are achieving superior results as they develop Palm Harbor's integrated manufacturing, retailing and financing activities. Nevertheless, our valuation recognizes that the manufactured housing industry, which in 1995 built 33.7% of the nation's homes, is a cyclical business that has expanded for four consecutive years. A significant event was Capital Southwest's distribution on July 31, 1995 of 752,147 shares of Palm Harbor in conjunction with the company's sale of 300,000 shares. Simultaneously, Capital Southwest acquired 769,231 shares. Although the distribution reduced the unrealized appreciation of our Palm Harbor investment by $9,264,304, net unrealized appreciation still grew by $30,667,473 during the year to a total of $60,154,045.

Another major factor was the gain of $17,954,600 realized on our $2,500,000 investment in MESC Holdings. The value of our investment in PETsMART, Inc. (Nasdaq: PETM), which acquired Petstuff, Inc. in June 1995, increased by $7,059,004 during the year and the value of our investment in Skylawn Corporation increased by $5,000,000 as earnings improved. The value of our investment in Encore Wire Corporation (Nasdaq: WIRE) declined by $5,812,000 as an intensely competitive market climate led to a loss in 1995.

Measures of Performance and Value

As shown on the opposite page, Capital Southwest's net asset value per share increased from $12.91 at March 31, 1986 to $50.18 at March 31, 1996. The growth in net asset value per share over this 10-year period corresponded to a compound annual rate of 20.1%, assuming shareholders reinvested all dividends and all tax credits on long-term capital gains retained by the Company. On the same basis, the growth in net asset value over the 20-year period ended March 31, 1996 corresponded to a compound annual rate of 22.3%. Shareholders should be aware that past results are not indicative of future performance. Achieving sustained growth, even at a lower rate, is more difficult as our asset base grows and is more dependent on a relatively small number of key investments.

Capital Southwest, unlike most investment companies, reports its net asset value after deducting deferred taxes on unrealized appreciation of investments. If net assets were increased by the amount of this deferred tax liability, the pro forma March 31, 1996 net asset value would be $68.53 per share. Shareholders should 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 is represented by assets which are working for the benefit of our shareholders.

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

	Value Per Share	
Major investments:		
Palm Harbor Homes, Inc.	$18.87	
Skylawn Corporation	11.95	
Alamo Group Inc.	10.14	
The RectorSeal Corporation	7.43	$48.39
Other venture investments:		
Non-marketable securities	10.87	
Marketable securities	8.95	19.82
Cash and other assets		18.59
Total assets		86.80
Deferred taxes		(18.37)
Note payable		(13.27)
Long-term debentures and other liabilities		(4.98)
Net assets at March 31, 1996		$50.18

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 $40,271,590 and a combined value of $232,906,947, representing 90.6% of the value of our investment portfolio at March 31, 1996.

Our four largest holdings are Palm Harbor Homes, Inc., Skylawn Corporation, Alamo Group Inc. and The RectorSeal Corporation. At March 31, 1996, investments in these companies had an aggregate cost of $16,069,955 and a value of $182,295,000 ($48.39 per Capital Southwest share); their net value after deducting an allowance for deferred taxes was $124,425,669 ($33.03 per Capital Southwest share). Our Company's equity in the earnings of these four companies for their most recently completed fiscal years was $16,131,000 ($4.28 per Capital Southwest share). At March 31, 1995, our investments in these companies had a value of $34.73 per Capital Southwest share, and our equity in their earnings was $3.60 per Capital Southwest share.

Investment Activity

A total of $19,406,816 was invested during the year including $13,406,816 in additions to existing investments and $6,000,000 in new investments. The primary addition was $9,230,772 invested in July 1995 to acquire 769,231 Palm Harbor shares at $12.00 per share, and $1,167,288 to exercise warrants, making our total position 4,021,820 shares — a 37.0% equity interest. Our investment in another manufactured housing company, American Homestar Corporation (formerly Oak Creek Homes), was increased by $1,428,000 through the purchase of 84,000 shares at $17.00 per share in the company's March 1996 offering, increasing our holding to 400,564 shares — a 4.3% equity interest.

A major new investment of $6,000,000 was made in March 1996 to acquire a 12% fully-diluted equity interest in SDI Holding Corp., a company formed to acquire the assets of the medical imaging business of E.I. DuPont de Nemours. This company, which had 1995 sales of $539 million and will operate as Sterling Diagnostic Imaging, Inc., manufactures and markets on a worldwide basis x-ray medical imaging film, intensifying screens, cassettes, film development chemicals and related products and services. A subsidiary is developing a direct radiography equipment system, scheduled for introduction in 1998, which will capture, store and transmit conventional x-ray images in a digital format. The aggregate cost of this leveraged acquisition, adjusted for certain post-closing transactions, was approximately $396 million.

Dividends and Tax Information

A dividend of one share of Palm Harbor common stock for each five shares of Capital Southwest common stock was paid on July 31, 1995. Subsequently, the market value of Palm Harbor stock increased from $12.50 on the distribution date to $25.25 at the end of our fiscal year. Cash payments were made in lieu of Palm Harbor stock to record holders of fewer than 50 shares of Capital Southwest and in lieu of fractional shares. *This distribution was taxable in 1995 in its entirety as a long-term capital gain dividend of $2.50 per Capital Southwest share.*

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, 1995 and a dividend of $0.40 per share was paid on November 30, 1995. A further dividend of $0.20 per share was paid on May 31, 1996 to shareholders of record on May 16, 1996.

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. Tax basis adjustments since 1968 have totaled $11.7929 per Capital Southwest share as explained in the Federal Income Tax Information on page 32, which includes a schedule of each such adjustment. No taxable long-term capital gains were retained during the tax year ended December 31, 1995, but based on taxable long-term capital gains realized early in the 1996 tax year, it is anticipated that gains will be realized and retained for the tax year ending December 31, 1996. Shareholders will then be advised of the procedure to follow in reporting retained gains and related tax credits.

The Power of Compounding and Tax Avoidance

Patient long-term investors are often rewarded in two ways:

- By selecting and holding good investments for many years, they achieve better results than most traders and market timers. The tortoise with a sound portfolio will generally outperform the hare with an ever-changing list of hot stocks.
- By electing not to sell their successful holdings, they compound the value of their investments without constantly sharing their gains with the architects of our welfare state, who are delighted for investors to sell and send money to Washington.

Most of our shareholders know that the above ideas are ingrained in our Company's investment philosophy as evidenced by our Methuselah-like holding periods, which now exceed 20 years for companies having an aggregate value of $115 million and representing 45% of our portfolio, and by our deferral of potential taxes of $69 million, which equate to 27% of the value of our portfolio and remain invested for the benefit of our shareholders.

Obviously, the deferral of taxes enhances our Company's investment results. However, to measure the dramatic effect of tax deferral, we have prepared two models, both based on the investment of $1,000,000 over a 20-year period at an increase in value of 15% compounded annually. Model H assumes sales of investments and immediate reinvestment of after-tax proceeds at the end of each 3-year period, sale at the end of 20 years, and all tax payments at the 35% corporate rate. Model T assumes an investment sale only at the end of 20 years and a tax payment at the same 35% rate:

	Model H	Model T
	Sales Every 3 Years	Sale at End of 20 Years
Investment	$1,000,000	$ 1,000,000
Taxes at 35%	3,208,000	5,378,000
Value (after taxes) at end of 20 years	6,958,000	10,989,000

This example confirms that patience is indeed a virtue and that deferring tax payments for 20 years will generate an added reward which is over $4,000,000 or 58% greater than that received by the corporate investor who sells and pays taxes at 35% every 3 years. Viewed another way, the hare who sells every 3 years must earn 18.6% each year to stay even with the tortoise who earns 15%. The even more patient (Model T) investor who does not choose to sell and pay taxes at the end of 20 years is holding an investment with a value of $16,367,000 (before deferred taxes); the effect of continued compounding is too dramatic to contemplate.

The preceding illustration is based on the 35% corporate capital gains tax rate, which exceeds the composite state and Federal rate for most individual investors. The following is based on a 28% individual capital gains tax rate and the same assumptions for Model H and Model T investors:

	Model H	Model T
	Sales Every 3 Years	Sale at End of 20 Years
Investment	$1,000,000	$ 1,000,000
Taxes at 28%	2,850,000	4,303,000
Value (after taxes) at end of 20 years	8,328,000	12,064,000

These examples, which clearly reveal the superiority of the tortoise over the hare, should not be interpreted as a prediction that Capital Southwest's present or future investments will achieve a 15% annual increase in value or that it will be prudent to hold investments and defer taxes for as long as 20 years. Achieving such results on a sustained basis is improbable. Also, tax deferrals will be less beneficial if capital gains tax rates are reduced in future years. Nevertheless, we believe patient long-term investors who defer taxes will be rewarded.

The Power of Leverage and More Tax Avoidance

Many conservative investors have an understandable aversion to employing borrowed funds and therefore fail to take advantage of the deductibility of investment interest. Consequently, they pay taxes year after year on dividend and interest income (investment income) that could otherwise be used to service interest on funds from margin accounts or other lenders. To illustrate the significant advantage of acquiring stock with borrowed funds and deductible investment interest, consider the contrast between the 10 year investment plans of Investor U (unleveraged) and Investor L (leveraged), both of whom plan to acquire Capital Southwest stock by using their currently available cash of $1,000 and their continuing yearly investment income of $1,000 and both of whom currently own marginable securities having a value of $15,000.

Investor U, who remembers October 1987, decides to acquire $1,000 worth of stock initially and to purchase $690 worth of stock at the end of each of the next 10 years after paying taxes of $310 per year on investment income at the applicable 31% rate.

Investor L, who has a higher tolerance for risk, immediately borrows $12,121, the amount which will require annual interest of $1,000 at 8.25%, and invests $13,121 including available cash of $1,000. Investor L, whose investment income is offset by investment interest, will pay no tax on $1,000 of yearly investment income.

Assuming Capital Southwest stock grows at a compound rate of 15% annually and continues to pay annual dividends of $0.60, which (after tax) are reinvested, Investor U (unleveraged) and Investor L (leveraged) will fare as follows:

	Investor U (unleveraged)	Investor L (leveraged)
Initial investment	$ 1,000	$13,121
Annual investment for 10 years	690	—
Annual interest	—	1,000
Value (net of loan) at end of 10 years	18,414	42,827
Capital gains tax at 28%	2,886	11,453
Value (net of loan and after taxes) at end of 10 years	15,528	31,374

The preceding table assumes investment income is taxed at a rate of 31%. The maximum Federal rate of 39.6% would result in a value (after taxes) at the end of 10 years equivalent to $13,969 for Investor U and $31,171 (net of loan) for Investor L.

These examples illustrate the advantage of using leverage and making tax-deductible interest payments on funds borrowed to acquire a security which grows at an annual rate of 15%. As stated before, achieving such results on a sustained basis is improbable. It should be noted that a leveraged investment entails a significant risk, which may lead to a substantial loss if the value of the investment grows at a low rate or declines. On the other hand, the gain on a leveraged investment is magnified as its growth in value exceeds the cost of borrowing.

Investing borrowed funds to leverage investment opportunities has been instrumental in creating great fortunes and colossal disasters. My father, who was a prudent risk taker, introduced me to the potential and pitfalls of leverage and to the difficulty of borrowing. He first sent me at the age of 16 to borrow $1,000 from the First National Bank of Bryan, Texas, where Travis B. Bryan summarily declined my request. Many years later, other bankers who believed in me and in our Company were there when we needed their support to leverage our investments and magnify our returns.

William R. Thomas
President and Chairman

June 3, 1996