

To Our Shareholders

Capital Southwest Corporation's net asset value at March 31, 1997 was \$218,972,120, equivalent to \$58.13 per share after deducting an allowance of \$21.59 per share for deferred taxes on net unrealized appreciation of investments. Assuming reinvestment of all dividends and tax credits on retained long-term capital gains, the March 31, 1997 net asset value was 19.6% above the March 31, 1996 net asset value of \$50.18 per share.

For the third successive year, our investment in Palm Harbor Homes (Nasdaq: PHHM) was our largest growth component as its value increased by \$13,372,000 to a total of \$84,458,000. Another source of growth was our Encore Wire (Nasdaq: WIRE) holding, which increased in value by \$9,782,000 to a total of \$16,381,000 as the company achieved major gains in sales and earnings. Also contributing to our growth was our investment in RectorSeal (100% owned), which increased in value by \$7,000,000 to a total of \$35,000,000 as sales increased significantly and earnings increased slightly to \$3,116,000 - an adequate return on our \$52,600 investment and a justification of our 30-year holding period.

Gains of \$10,558,211 were realized during the year, including the \$7,713,939 gain on the sale of Cherokee Communications to Phone-Tel Technologies described in our previous report and the \$2,820,721 gain on the sale of approximately 60% of our position in Data Race.

Measures of Performance and Value

As shown on the opposite page, Capital Southwest's net asset value per share increased from \$17.58 at March 31, 1987 to \$58.13 at March 31, 1997. The growth in net asset value per share over this 10-year period corresponded to a compound annual rate of 17.7%, assuming shareholders reinvested all dividends and tax credits on long-term capital gains retained by the Company. On the same basis, the growth over the 20-year period ended March 31, 1997 was equivalent to a compound annual rate of 20.7%. These rates of return assume

that shareholders immediately sold Palm Harbor shares distributed on July 31, 1995 and reinvested the proceeds in Capital Southwest stock. Retaining the Palm Harbor stock, as most of our shareholders did, would increase the 10-year and 20-year net asset value growth rates to 18.0% and 20.8%, respectively. 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, 1997 net asset value would be \$79.72 per share. 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 underlying each share:

	<u>Value Per Share</u>
Major investments:	
Palm Harbor Homes, Inc.	\$22.42
Skylawn Corporation.....	11.15
The RectorSeal Corporation.....	9.29
Alamo Group Inc.	<u>8.44</u> \$51.30
Other venture investments:	
Non-marketable securities	17.17
Marketable securities	<u>9.39</u> 26.56
Cash and other assets.....	<u>4.63</u>
Total assets.....	82.49
Deferred taxes.....	(21.73)
Long-term debentures and other liabilities.....	<u>(2.63)</u>
Net assets at March 31, 1997	<u>\$58.13</u>

The value of investments in companies which now have publicly-owned stocks amounted to \$47.57 per share of Capital Southwest stock, including \$9.39 of marketable securities and \$38.18 of non-marketable securities which are subject to certain resale restrictions because of our ownership percentage, board representation or other factors. The reduced value of these non-marketable securities, considering relevant factors including resale restrictions, was less than the corresponding value of an identical portfolio of marketable securities by an aggregate of \$10.29 per Capital Southwest share.

Our four largest holdings are Palm Harbor Homes, Inc., Skylawn Corporation, The RectorSeal Corporation and Alamo Group Inc. At March 31, 1997, investments in these companies had an aggregate cost of \$16,069,955 and a value of \$193,235,000 (\$51.30 per Capital Southwest share); their net value after deducting an allowance for deferred taxes was \$131,536,669 (\$34.92 per Capital Southwest share). Our Company's equity in the earnings of these four companies for their most recently completed fiscal years was \$17,500,000 (\$4.65 per Capital Southwest share). The aggregate value of these companies is equivalent to a price/earnings ratio of 11.0 - substantially below the March 31, 1997 ratios of 17.9 and 19.6 for the Dow Jones Industrials and the Standard & Poor's 500.

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 \$41,943,522 and a combined value of \$263,978,402, representing 90.0% of the value of our investment portfolio at March 31, 1997.

To conform to certain regulatory requirements, our past reports have included the separate financial statements of Capital Southwest Venture Corporation, our wholly-owned small business investment company subsidiary. The requirement for separate statements was recently waived, therefore, this report and future reports will include only the consolidated financial statements of the Company and its subsidiary.

Investment Activity

A total of \$6,023,684 was invested during the year including \$3,000,000 in Texas Petrochemical Holdings, Inc. of Houston, Texas, a company formed to acquire Texas Olefins Company, a producer of chemical intermediates used to produce synthetic rubber, gasoline additives, plastic resins and other chemicals. A \$3,000,000 investment was also made in Rewind Holdings, Inc. of Sugar Land, Texas, to finance the acquisition of Bill Young Productions, Inc., a nationally-recognized producer of radio and television commercials for the touring entertainment industry and of music videos, commercials and other productions.

Tax Information and Dividends

For the tax year ended December 31, 1996, Capital Southwest Corporation realized and retained gains of \$4.7546 per share, paid Federal taxes thereon of \$1.6641 per share and designated such gains to shareholders of record on December 31, 1996, to be treated by them as though distributed. Shareholders are deemed to have reinvested the net after-tax amount of \$3.0905 per share retained by the Company and are entitled to increase the tax basis of their shares accordingly, thereby reducing future tax liability. Page 28 includes a historical table showing annual tax basis adjustments, which now total \$14.8834 per share for shareholders who have owned Capital Southwest stock continuously since March 31, 1968.

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, 1996 and a dividend of \$0.40 per share was paid on November 29, 1996. A further dividend of \$0.20 per share was paid on May 30, 1997 to shareholders of record on May 15, 1997.

Our Investment Philosophy

- We invest only in enterprises believed to have exceptional growth potential.
- We finance only those managers who have a proven record of achievement, exceptional ability, unyielding determination, and unquestionable integrity.
- We invest only for the long term, which to us means building companies that will lead their industries in the 21st century.
- Unlike most venture capitalists, we do not have an exit strategy that causes successful managers to sell their companies or go public.

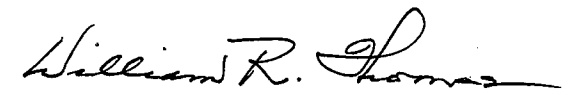
These and other investment principles have been forged by our Company's 36 years of experience in providing patient capital and management assistance to those entrepreneurs judged to be capable of building successful businesses with enduring value.

A significant cornerstone of our investment philosophy is our long-term perspective, which translates into a holding period which one of our shareholders describes as *forever* and another characterizes as *Methuselah-like*. At times this has led us to seriously overstay the market. More often, though, it has enabled us to hold positions in enterprises destined to achieve accelerating growth after 10, 20 or 30 years. It has also enabled us to defer taxes and avoid sharing gains with the tax-dependent Architects of the Welfare State. Currently, investments held over 20 years represent approximately 39% of our portfolio.

Shareholder Considerations

Capital Southwest Corporation is not a suitable holding for investors seeking short-term results and instant gratification. Our Company is engaged in developing successful businesses with fundamental value and is an appropriate investment for those investors who subscribe to our long-term philosophy of building businesses rather than irrational market valuations. In today's market the winners have been those who bet on progressively higher earnings multiples instead of fundamental valuations. If you believe this will continue and have nerves of steel, you should adjust your portfolio accordingly.

Our shareholders often comment on the unusually low trading volume of our Company's stock, which has a market capitalization of more than \$250 million and is owned by approximately 2,500 investors. In our most recent fiscal year, total volume was only 439,223 shares - less than 11.7% of the outstanding shares and even less assuming some double counting. Is this bad? Not at all. It confirms that Capital Southwest is serving long-term investors - not gamblers, market timers and other opportunists.



June 12, 1997

President and Chairman