

Our Business

Capital Southwest Corporation is the nation's largest publicly-owned venture capital investment company. Since its formation in 1961, the Company and its wholly-owned small business investment company subsidiary have provided capital to support the development and growth of small and medium-sized businesses in varied industries throughout the United States.

Investments are focused on opportunities for capital appreciation derived from early-stage financings, expansion financings, management buyouts, recapitalizations and industry consolidations. The portfolio is a composite of companies in which Capital Southwest Corporation has major interests as well as a number of developing companies and marketable securities of established publicly-owned companies.

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 37 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 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 27% of the cost and 66% of the value of our portfolio.

Thirty-seven Years of Investing

- In July 1961, we began with net assets of \$14.9 million after our initial (and only) public offering.
- Over the next 37 years, \$209.7 million was disbursed or accrued for:

Cash dividends to shareholders	\$ 28.0 million
Value of securities distributed to shareholders	11.5 million
Repurchase of over two-thirds of our shares	15.3 million
Federal tax payments	36.2 million
Deferred taxes on unrealized appreciation	118.7 million
- As of March 31, 1998, after deducting all of the above items, net assets had grown to \$296.0 million.
- Over the past 37 years, assuming reinvestment of all dividends and tax credits on retained capital gains, net asset value per share (adjusted for stock splits) increased at a compound annual rate of 15.3% versus 12.0% for the S&P 500. On the same basis, the sum of net assets and deferred taxes increased at a compound annual rate of 16.4%.

The Past Twenty Years of Investing

- As of March 31, 1978, we began with net assets of \$14.4 million, after repurchasing two-thirds of our stock during the two preceding years.
- Over the next 20 years, \$194.0 million was disbursed or accrued for:

Cash dividends to shareholders	\$ 26.0 million
Value of securities distributed to shareholders	9.4 million
Repurchase of our shares	7.0 million
Federal tax payments	32.9 million
Deferred taxes on unrealized appreciation	118.7 million
- As of March 31, 1998, after deducting all of the above items, net assets had grown to \$296.0 million.
- Over the past 20 years, assuming reinvestment of all dividends and tax credits on retained capital gains, net asset value per share (adjusted for stock splits) increased at a compound annual rate of 20.6% versus 17.7% for the S&P 500. On the same basis, the sum of net assets and deferred taxes increased at a compound annual rate of 22.5%.

To Our Shareholders

Our Company's sustained growth record is revealed in the two preceding pages, which reflect certain changes in the format of our previous reports. To be more consistent with our very long-term investment practices, the bar graph on the inside front cover page has been extended to disclose 20 years of performance and revised to better illustrate the relation between net asset value, deferred taxes and market price at the end of each year. Also, the preceding page has been added to provide abbreviated descriptions of Our Business and Our Investment Philosophy. It also includes revealing data entitled Thirty-seven Years of Investing (since Capital Southwest was formed) and The Past Twenty Years of Investing.

Capital Southwest Corporation's net asset value at March 31, 1998 was \$296,022,816, equivalent to \$78.15 per share after deducting an allowance of \$31.33 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, 1998 net asset value was 38.1% above the March 31, 1997 net asset value of \$58.13 per share.

Again, our investment in Palm Harbor Homes (Nasdaq: PHHM) was our largest growth component as its value increased by \$53,792,000 (\$34,965,000 after deferred taxes) during the year ended March 31, 1998. The next largest source of growth was our Encore Wire (Nasdaq: WIRE) holding, which increased in value by \$17,279,000 (\$11,231,000 after deferred taxes). The third significant increase during the year was provided by Mail-Well (NYSE: MWL) which rose in value by \$14,020,000 (\$9,113,000 after deferred taxes). Information on each of these companies is included in the next section of this report, which reveals the strong performance substantiating their major increases in value.

Net gains of \$9,905,069 (before taxes) were realized during the year, consisting of gains totaling \$13,895,963 and a loss of

\$3,990,894. The major gain of \$11,208,110, described in our first quarter report, resulted from the sale of our \$2,000,000 investment in PTS Holdings, Inc., the parent company of Power Paragon, a designer and manufacturer of power systems. An additional gain of \$1,619,088 was realized upon the sale of our remaining \$574,814 investment in Data Race, Inc. (Including gains realized in the previous year, our \$1,794,183 investment in Data Race yielded total gains of \$4,439,809.) Gains of \$1,068,765 on other transactions brought the total for the year to \$13,895,963. However, this was reduced by the total loss of our investment in Lil' Things, Inc., an unsuccessful retail chain which sold products for infants and young children. Our initial investment in this company in 1994 eventually increased to \$3,990,894, which was valued at \$2 at December 31, 1996 and written off at the end of 1997. In retrospect, Lil' Things was a marginal, poorly-executed retailing concept that led to major venture capital losses, including our Company's \$3,990,894. After a string of five successful retailing investments, we missed badly on Lil' Things.

Measures of Performance and Value

As shown by the preceding bar graph, Capital Southwest's net asset value per share increased from \$3.59 at March 31, 1978 to \$78.15 at March 31, 1998. The growth in net asset value over this 20-year period corresponded to a compound annual rate of 20.6%, 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 10-year period ended March 31, 1998 was equivalent to a compound annual rate of 18.7%. These rates of return assume that shareholders immediately sold the Palm Harbor shares distributed on July 31, 1995 and reinvested the proceeds in Capital Southwest Corporation stock. Retaining the Palm Harbor stock, as most of our shareholders did, would increase the 20-year and 10-year net asset value growth rates to 21.0% and 19.6%, respectively.

In view of our Company's emphasis on building businesses rather than responding to stock market cycles, we do not consider the widely-followed Standard & Poor's 500 Stock Index to be a suitable performance benchmark. Nevertheless, Capital Southwest approximately matched the S&P 500 over the past 10 years and substantially outperformed the S&P 500 over the past 20 years:

Period Ended	Total Investment Returns	
	*Capital Southwest	**S&P 500 Stock Index
March 31, 1998		
10 years	18.7%	18.9%
20 years	20.6	17.7

* Compound annual return for Capital Southwest based on net asset value per share assuming reinvestment of dividends and tax credits.

** Compound annual return for the S&P 500 Stock Index assuming reinvestment of dividends.

Capital Southwest, unlike most investment companies, reports its net asset value after deducting deferred taxes on unrealized appreciation of investments. Because Capital Southwest has a long-term investment perspective, 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. If net assets were increased by the amount of this deferred tax liability, the pro forma March 31, 1998 net asset value would be \$109.48 per share and the return percentages shown in the above table would be higher (18.9% for 10 years and 22.5% for 20 years). The return percentages for the past 10 and 20 years would be even higher if total investment returns were based on the market price of Capital Southwest stock instead of net asset value.

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.

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.	\$36.50
Skylawn Corporation	11.09
The RectorSeal Corporation	10.16
Alamo Group Inc.	<u>9.83</u> \$ 67.58
Other venture investments:	
Non-marketable securities	26.53
Marketable securities	<u>11.83</u> 38.36
Cash and other assets	<u>31.95</u>
Total assets	137.89
Deferred taxes	(31.50)
Note payable to bank	(26.40)
Long-term debenture and other liabilities	<u>(1.84)</u>
Net assets at March 31, 1998	<u>\$ 78.15</u>

The value of investments in companies which now have publicly-owned stocks amounted to \$73.64 per share of Capital Southwest stock. After deducting deferred taxes, the net value of such stocks was \$50.48 per Capital Southwest share, including the \$41.89 net value of non-marketable (restricted) publicly-owned securities. It should be noted that the net (after-tax) value of our Palm Harbor Homes investment was \$24.73 per Capital Southwest share, equivalent to 31.6% of net assets at March 31, 1998. In addition to Palm Harbor, the stocks of Alamo Group, Encore Wire and Mail-Well are subject to resale restrictions because of our ownership percentage, board representation or other factors. Therefore, the restricted securities of these four companies were valued substantially below their March 31, 1998 market prices cited in the discussion of each company on pages 6 and 7. The extent to which such valuations discount the market prices of these companies' freely-tradable stocks is judged to be an appropriate reflection of Capital Southwest's long-term investment philosophy and our tendency to hold investments despite unfavorable business and market cycles.

Our four largest holdings are Palm Harbor Homes, Inc., Skylawn Corporation, The RectorSeal Corporation and Alamo Group Inc. At March 31, 1998, investments in these companies had an aggregate cost of \$16,069,955 and a value of \$255,990,000 (\$67.58 per Capital Southwest share); their net value after deducting an allowance for deferred taxes was \$172,327,419 (\$45.49 per Capital Southwest share). Our Company's equity in the earnings of these four companies for their most recently completed fiscal years was \$22,196,000 (\$5.86 per Capital Southwest share). The aggregate value of our investments in these companies is equivalent to a price/earnings ratio of 11.5 - substantially below the March 31, 1998 ratios of 22.7 and 27.7 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 \$42,851,522 and a combined value of \$359,713,686, representing 89.6% of the value of our investment portfolio at March 31, 1998.

Investment Activity

A total of \$9,709,195 was invested during the year including \$600,000 in additions to existing investments and \$9,109,195 in the following new investments:

- A \$634,616 investment in Intelligent Reasoning Systems, Inc. of Austin, Texas, a company which has introduced a machine vision system to automatically inspect electronic circuit boards.
- A \$1,449,579 investment of a total commitment of \$2,500,000 to CDC Technologies, Inc. of Oxford, Connecticut, which manufactures and sells hematology and blood chemistry analyzers for use by veterinarians and has developed and applied for FDA approval of a hematology unit for human blood analysis.

- A \$4,800,000 investment in Media Recovery, Inc. of Graham, Texas, to finance the acquisition of a predecessor company with annual sales of \$57 million derived from two businesses: (i) distribution of computer supplies and (ii) manufacture and sale of impact and tilt monitoring devices.

- A \$2,225,000 investment of a total commitment of \$3,568,000 to Airformed Composites, Incorporated of Charleston, South Carolina, which is building a state-of-the-art facility to manufacture high absorbency materials for use in products such as diapers, feminine hygiene products and disposable medical products.

The Portfolio of Investments on pages 9-13 shows the form of our investment and our equity interest in each of the above companies.

Tax Information and Dividends

For the tax year ended December 31, 1997, Capital Southwest Corporation realized and retained gains of \$4.9821 per share, paid Federal taxes thereon of \$1.7437 per share and designated such gains to shareholders of record on December 31, 1997, to be treated by them as though distributed. Shareholders are deemed to have reinvested the net after-tax amount of \$3.2384 per share retained by the Company and are entitled to increase the tax basis of their shares accordingly, thereby reducing future tax liability. Page 31 includes a historical table showing annual tax basis adjustments, which now total \$18.1218 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 30, 1997 and a dividend of \$0.40 per share was paid on November 28, 1997. A further dividend of \$0.20 per share was paid on May 29, 1998 to shareholders of record on May 15, 1998.

A Shareholder's Observations

Recently, I received a letter from a California shareholder telling me that the combined value of his Capital Southwest stock and his Palm Harbor distribution was over \$10,000. His letter then said:

"I have a vague recollection of having bought 10 shares of Capital Southwest at \$10 per share, I think on your initial offering, many years ago when I was a young man. I may be wrong about the offering price, but in any case, you have made me a lot of money.

"Someone once said that the way to prosper in the stock market was to buy a good stock and live a long time. Owning Capital Southwest for all these years has shown me the truth of this old adage. Thank you for your continuing fine management."

My response to your thoughtful letter is to thank you and our many other long-term shareholders for entrusting us to manage your Company and enabling me and my associates to work in this exciting business.

Clouds on the Horizon

Like all shareholders, my associates and I want to see sustained growth. However, this will be more difficult in the future because:

- There is now an excess supply of venture capital, leveraged buyout capital and other forms of private equity, i.e. too much money is chasing too few good deals.
- The stock market is at an unsustainable level that grossly overvalues many equity securities, i.e. we will soon run out of greater fools or they will cease buying tulip bulbs.

During other periods when there has been too much venture capital, we have maintained our selectivity and price discipline. At times, this has caused us to marshal our cash until the supply of urgent, reckless money has been dissipated. We may have to do this again.

During other periods when runaway stock markets have collapsed, we have felt the pain, but have experienced a smaller decline in value

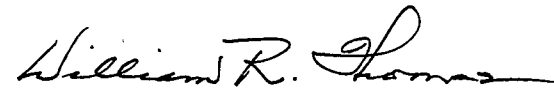
than the major market indexes because of the lower valuations placed on our investments – particularly non-public companies and restricted stocks of public companies.

Despite these unfavorable influences, we expect to exploit growth opportunities in both our present investments, which may be enhanced by internal growth and acquisitions, and in carefully selected new investments in businesses in varied industries and in varied stages ranging from start-ups to management buyouts. All we need is an occasional Palm Harbor.

The Palm Harbor Bonanza

Approximately 20 years ago – on December 31, 1977 – we made our initial \$500,000 investment in Palm Harbor Homes. As that company grew, and at times encountered problems, our investment grew to \$7,121,428 in 1990. In July 1995, Palm Harbor became a public company as a result of its offering of stock to employees and our distribution to Capital Southwest shareholders of 1,175,230 shares at a value of \$8.00 per share (adjusted). In conjunction with this distribution, we invested \$9,230,772 to acquire additional stock at the offering price. As of March 31, 1998, our \$10,931,955 investment in Palm Harbor was valued at \$138,250,000 and consisted of 6,284,096 shares valued at \$22.00 per share, including 5,082,172 shares at an average cost of \$0.335 per share and 1,201,924 shares at a cost of \$7.68 per share.

On behalf of the 2,600 shareholders of Capital Southwest, I salute Palm Harbor's founder, Lee Posey, and his dedicated associates for building a company that began with one man and a vision and grew to a national company with 4,800 employees, annual sales of \$637,268,000 and earnings of \$31,854,000. This is capitalism at its best!



June 1, 1998

President and Chairman