## Our Business

Capital Southwest Corporation is one of the nation's largest publicly-owned venture capital investment companies. 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 38 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 22% of the cost and 66% of the value of our portfolio.

## Thirty-eight 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 38 years, $190.1 million was disbursed or accrued for:

| | |
|---|---|
| Cash dividends to shareholders | $ 30.3 million |
| Value of securities distributed to shareholders | 11.5 million |
| Repurchase of over two-thirds of our shares | 15.3 million |
| Federal tax payments | 36.5 million |
| Deferred taxes on unrealized appreciation | 96.5 million |

- As of March 31, 1999, after deducting all of the above items, net assets had grown to $256.2 million.
- Over the past 38 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 14.4% 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 15.4%.

## The Past Twenty Years of Investing

- As of March 31, 1979, we began with net assets of $17.8 million, after repurchasing two-thirds of our stock during 1976 and 1977.
- Over the next 20 years, $174.3 million was disbursed or accrued for:

| | |
|---|---|
| Cash dividends to shareholders | $ 28.3 million |
| Value of securities distributed to shareholders | 9.4 million |
| Repurchase of our shares | 7.0 million |
| Federal tax payments | 33.1 million |
| Deferred taxes on unrealized appreciation | 96.5 million |

- As of March 31, 1999, after deducting all of the above items, net assets had grown to $256.2 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 18.5% versus 17.6% for the S&P 500. On the same basis, the sum of net assets and deferred taxes increased at a compound annual rate of 20.0%.

## To Our Shareholders

Capital Southwest Corporation's net asset value per share at the end of the March 31, 1999 fiscal year declined for the first time in 25 years. The drop was a whopping 13.4% assuming reinvestment of dividends and tax credits on retained gains.

Net asset value at March 31, 1999 was $256,231,965, equivalent to $67.16 per share after deducting an allowance of $25.29 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, 1999 net asset value of $67.16 was 13.4% below the March 31, 1998 net asset value of $78.15 per share, which was 38.1% above the March 31, 1997 net asset value of $58.13 per share.

As revealed in our financial statements, net assets decreased by $39,790,851 during the year just ended. This decrease is net of realized gains of $994,949 after taxes and reflects other items which are minor in relation to the net decrease in unrealized appreciation of investments, which totaled $41,232,545 after accrual of taxes and $63,433,545 before taxes. On page 4, under "Analysis of Decline in Value", we will identify some of the sources of the year's disappointing performance.

### Measures of Performance and Value

As shown by the bar graph inside the cover of this report, Capital Southwest's net asset value per share increased from $4.44 at March 31, 1979 to $78.15 at March 31, 1998, then declined to $67.16 at March 31, 1999. The growth in net asset value over this 20-year period corresponded to a compound annual rate of 18.5%, 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, 1999 was equivalent to a compound annual rate of 16.2%. 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 18.8% and 16.8%, respectively.

In view of our Company's emphasis on building businesses rather than responding to stock market cycles, we do not consider the Standard & Poor's 500 Stock Index to be a suitable performance benchmark. Moreover, this capitalization-weighted index is deceptive and misleading, with only 22 large capitalization stocks having more influence on the index than the other 478 stocks. For the twelve months ended March 31, 1999, the reported capitalization-weighted return for the S&P 500 was 18.5%, although the equally rated return for all 500 stocks was only 1.3%. Despite the flawed nature of the S&P 500 Index, we have chosen to compare our 10 and 20 year results to this standard, which is surpassed by a small proportion of professional money managers, but is widely followed and generally misunderstood by investors. As shown in the following table, Capital Southwest's performance fell short of the S&P 500 over the past 10 years, but exceeded the S&P 500 over the past 20 years:

| | Investment Returns | |
|---|---|---|
| Period Ended March 31, 1999 | *Capital Southwest | **S&P 500 Stock Index |
| 10 years | 16.2% | 19.0% |
| 20 years | 18.5 | 17.6 |

* 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, 1999 net asset value would be $92.45 per share. On this basis, the return percentages shown in the above table would decrease to 16.0% for 10 years and increase to 20.0% for 20 years.

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:

| | Value Per Share | |
|---|---|---|
| Major investments: | | |
| Palm Harbor Homes, Inc. | $32.94 | |
| The RectorSeal Corporation | 10.09 | |
| Skylawn Corporation | 9.17 | |
| Alamo Group Inc. | 4.36 | $ 56.56 |
| Other venture investments: | | |
| Restricted securities | 24.56 | |
| Marketable securities | 10.69 | 35.25 |
| Cash and other assets | | 2.76 |
| Total assets | | 94.57 |
| Deferred taxes | | (25.49) |
| Long-term debenture and other liabilities | | (1.92) |
| Net assets at March 31, 1999 | | $ 67.16 |

The value of investments in companies which now have publicly-owned stocks amounted to $57.22 per share of Capital Southwest stock. After deducting deferred taxes, the net value of such stocks was $40.00 per Capital Southwest share, including the $32.11 net value of restricted publicly-owned securities. It should be noted that the net (after-tax) value of our Palm Harbor Homes investment was $22.42 per Capital Southwest share, equivalent to 33.4% of net assets at March 31, 1999. 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, 1999 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 through unfavorable business and market cycles.

Four of our major holdings are Palm Harbor Homes, Inc., The RectorSeal Corporation, Skylawn Corporation and Alamo Group Inc. At March 31, 1999, investments in these companies had an aggregate cost of $16,069,955 and a value of $215,807,000 ($56.56 per Capital Southwest share); their net value after deducting an allowance for deferred taxes was $146,208,469 ($38.32 per Capital Southwest share). Our Company's equity in the earnings of these four companies for their most recently completed fiscal years was $20,237,000 ($5.30 per Capital Southwest share). At $56.56 per share, the aggregate value of our investments in these companies is equivalent to a price/earnings ratio of 10.7 - substantially below the March 31, 1999 ratios of 25.1 and 34.3 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 $41,277,717 and a combined value of $298,679,162, representing 85.3% of the value of our investment portfolio at March 31, 1999.

### Analysis of Decline in Value

Described below are the main sources of the $63,433,545 pre-tax net decline in the value of our investments during the year ended March 31, 1999 including a net decrease of $59,392,118 in the values of restricted securities and a net decrease of $4,041,427 in the values of unrestricted (freely marketable) securities:

| | Increase (Decrease) In Value |
|---|---|
| Restricted Securities | |
| Alamo Group reported a 70.2% decline in 1998 earnings per share as a result of a losing acquisition and the unfavorable agricultural equipment market; the planned sale of Alamo was terminated. | $(20,615,000) |
| Encore Wire's earnings per share declined by 18.3% in 1998 as competition intensified and margins declined in the wire and cable market. | (19,013,000) |
| Palm Harbor Homes increased net sales by 19.5% and earnings per share by 25.2% in the year ended March 26, 1999, but its market price dropped in concert with declines in market valuations of manufactured housing companies. | (12,568,000) |
| Skylawn's earnings declined by 48.7% in the year ended March 31, 1999 because of lower sales and unusual expenses; market valuations of death care stocks declined. | ( 7,000,000) |
| Mail-Well's 1998 earnings per share declined by 33.8% as a result of restructuring charges and other unusual items. | ( 6,214,860) |
| SDI Holding agreed to sell its x-ray film business to Agfa-Gevaert Group (*completed in May 1999*); other parts of the business will be sold separately. | 6,000,000 |
| Other changes - net | 18,742 |
| Net change in value of Restricted Securities | $(59,392,118) |
| Unrestricted Securities | |
| American Homestar's earnings per share decreased by 60.0% in the quarter ended February 28, 1999; its market price reflected the weakness of manufactured housing stocks. | $(11,547,532) |
| AT&T common stock and AT&T Liberty Media Group tracking stock were received in March 1999 as a result of AT&T's acquisition of Tele-Communications, Inc. and its Liberty Media and TCI Ventures Groups. | 6,664,564 |
| Other changes - net | 841,541 |
| Net change in value of Unrestricted Securities | $ (4,041,427) |

### Investment Activity

A total of $13,170,132 was invested during the year including $9,195,132 in additions to existing investments and $3,975,000 in the following new investments:

- A $3,750,000 new investment in Dyntec, Inc. of Louisville, Kentucky, which provides dental services through Dentistry Plus Centers in major shopping malls.
- A $225,000 investment of a $500,000 commitment to STARTech Seed Fund I of Richardson, Texas, an affiliate of the TelCor Technology Development Center, an incubator to foster the development of new enterprises.

Additional amounts invested in existing portfolio companies included $1,249,579 in CDC Technologies, Inc., $2,999,944 in Dennis Tool Company, $1,343,000 in Airformed Composites, Inc. and $1,119,679 in Intelligent Reasoning Systems, Inc. Also, $1,700,000 was invested in open market purchases of the stock of Encore Wire Corporation.

### Our Building Blocks

As our company evolves and we continue to hold many of our successful investments, our investments usually fall into one of three categories: 1) holding company type assets including certain 25% to 100% owned long-term investments, 2) venture capital assets and 3) marketable (unrestricted) securities. As of March 31, 1999, we classify our portfolio as follows:

| | Cost | Value | % |
|---|---|---|---|
| Holding company assets (mainly RectorSeal, Whitmore, Skylawn, Palm Harbor and Alamo) | $18,800,875 | $229,319,360 | 65.5 |
| Venture capital assets | 44,739,298 | 80,178,730 | 22.9 |
| Marketable securities | 10,039,841 | 40,780,412 | 11.6 |
| Total investments | $73,580,014 | $350,278,502 | 100.0 |

The building blocks in our portfolio change gradually as investments are added and subtracted, as they grow or fail to grow and as they are influenced by economic and cyclical conditions. However, the size of the holding company category has grown dramatically during the past decade as successful venture investments have prospered and entered this category. The Capital Southwest staff continues to increase its efforts to develop acquisitions to complement these key holdings. During the past five years, for example, our staff has been instrumental in adding five acquisitions to expand the scope of RectorSeal's business.

Our staff is also continually engaged in the search for attractive, fairly-priced venture capital opportunities which will serve as primary building blocks for the sustained growth of our Company. However, in a market that is now characterized by too much money chasing too few good deals, we will not compromise our quality standards or price discipline.

**More Clouds on the Horizon**

In a section of last year's report entitled "Clouds on the Horizon", we pointed to the excess supply of venture capital. Nevertheless, capital commitments to U. S. venture funds increased by 66.4% to $25.3 billion in 1998 versus $15.2 billion in 1997 and $3.5 billion in 1988. We also opined that the stock market was at an unsustainable level that grossly overvalued many equity securities. Despite this apparently premature warning, the Dow Jones Industrial Average soared by over 24% within the next year to a new record level of 11,107, while a growing herd of greater fools continued to buy tulip bulbs (and internet stocks) with ever wilder abandon.

There will be a day of reckoning and an eventual collapse of the irrational market prices that have little or no fundamental support. This collapse will inevitably curtail the supply of venture capital which is being invested in anticipation of a continuing new issue market which places outrageous values on questionable concepts rather than realizable earnings.

**Delayed Gratification**

When it comes, the long overdue bear market will certainly affect the value of our Company's holdings, but to a limited extent because of the fundamental, earnings-based standard of most of our valuations and because of the market's already low valuation of most small capitalization stocks.

Meanwhile, we are undeterred by the inflated stock market and the inordinate over-supply of venture capital. Despite these negative factors, we will stay the course that has served us well for most of the past 38 years and will continue our pedestrian approach to building the values of the businesses we own and developing new investment opportunities in enterprises ranging from prosaic businesses to technology companies.

In the fiscal year ended March 31, 1999, we experienced a 13.4% decline in our net asset value per share and a 21.8% decline in our stock's market value, assuming reinvestment of dividends and tax credits. During the same twelve months, the Standard and Poor's 500 Stock Index grew by 18.5%. If you are disappointed by Capital Southwest's losing performance, as I am, you have several options: (a) replace the management (not a bad idea), (b) sell your stock and enjoy the free lunch offered by today's market, or (c) resign yourself and your money to our boring effort to develop value by developing businesses.

Our investment strategy is, if anything, very long term. If you have the patience of Job, we will do our best to ultimately reward that patience. If not, we wish you the best of luck in index funds and internet stocks.

William R. Thomas

June 1, 1999

President and Chairman