

2002

## To Our Shareholders

Net asset value at March 31, 2002 was \$250,491,042, equivalent to \$65.42 per share after deducting an allowance of \$24.05 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, 2002 net asset value of \$65.42 was 11.2% above the March 31, 2001 net asset value of \$59.40 per share.

During the past five years, net asset value rose from \$58.13 per share at March 31, 1997 to \$65.42 at March 31, 2002 – an annual increase of only 4.1% assuming reinvestment of dividends and tax credits on retained gains. As revealed in the following table, the increase in the value of our largest holding, Palm Harbor Homes, was the major component of the increase in our Company's net asset value during the past year and the past five years:

	Year Ended <u>March 31, 2002</u>	Five Years Ended <u>March 31, 2002</u>
Increase (decrease) in unrealized gains:		
Palm Harbor Homes, Inc.....	\$ 31,420,000	\$ 25,513,000
The RectorSeal Corporation.....	2,500,000	15,000,000
Skylawn Corporation.....	-	(4,000,000)
Alamo Group Inc.....	<u>2,821,000</u>	<u>(2,233,047)</u>
	36,741,000	34,279,953
Other changes in unrealized gains.....	<u>230,348</u>	<u>(2,375,853)</u>
Net increase in unrealized gains.....	36,971,348	31,904,100
Increase in deferred taxes.....	(12,797,000)	(10,794,000)
Realized gains (losses).....	(762,114)	14,779,595
Taxes on realized gains (losses).....	224,180	(5,048,783)
Net investment income.....	2,041,896	9,915,188
Dividends.....	(2,294,631)	(11,421,555)
Other changes in net assets.....	<u>498,750</u>	<u>2,184,377</u>
Increase in net assets.....	<u>\$ 23,882,429</u>	<u>\$ 31,518,922</u>

Although not evident in the preceding table, the irrational bull market provided some excitement in this otherwise unrewarding five years as net asset value climbed to a high of \$79.09 on June 30, 1998 and

the CSWC market price reached a record \$106.00 on April 29, 1998. The ensuing decline in net asset value was not reversed until early in 2001, when wounded investors – hemorrhaging from their encounters with dot-coms and other new economy fantasies – finally rediscovered the value of real businesses with real earnings.

While the real businesses that dominate our Company's portfolio entail less risk, they are generally in mature industries and must rely on acquisitions and product innovations to achieve acceptable rates of growth. Later in this report, we will discuss our four largest holdings, which represent two-thirds of our investment portfolio, and the steps they are taking to increase sales and earnings.

## Measures of Performance and Value

As illustrated by the bar graph on the inside cover, Capital Southwest's net asset value per share increased from \$9.30 at March 31, 1982 to \$78.15 at March 31, 1998, then declined for three years, but increased to \$65.42 at March 31, 2002. The growth in net asset value over the past 20 years corresponded to a compound annual rate of 14.1%, 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, 2002 was equivalent to a compound annual rate of 11.1%. Although our long-term investment results exceeded the S&P 500 Index for many years, the following table shows the extent to which our Company's performance has fallen below the performance of this benchmark:

	<u>Investment Returns</u>	
Period Ended <u>March 31, 2002</u>	*Capital <u>Southwest</u>	**S&P 500 <u>Stock Index</u>
10 years	11.1%	13.2%
20 years	14.1	15.7

\* 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 of our 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 this deferred tax liability of \$24.05 per share, the pro forma March 31, 2002 net asset value would be \$89.47 per share. On this basis, the 20-year return percentage shown in the preceding table would increase to 14.7%.

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. ....	\$28.72	
The RectorSeal Corporation .....	13.06	
Skylawn Corporation .....	9.92	
Alamo Group Inc. ....	<u>8.11</u>	\$ 59.81
Other investments:		
Restricted securities .....	23.02	
Marketable securities .....	<u>7.92</u>	30.94
Cash, receivables and other assets .....		<u>2.53</u>
Total assets .....	93.28	
Deferred taxes .....	(23.68)	
Long-term debenture and other liabilities .....	<u>(4.18)</u>	
Net assets at March 31, 2002 .....		<u>\$ 65.42</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 \$45,316,675 and a combined value of \$309,839,711, representing 89.2% of the value of our investment portfolio at March 31, 2002.

### Building Blocks

As our Company evolves and we retain many of our successful ventures, our investments fall into one of three categories: 1) holding company type assets including the four major investments discussed on the next page and other 25% to 100% owned long-term investments, 2) venture capital assets and 3) marketable (unrestricted) securities. As of March 31, 2002, we classify our portfolio as follows:

	<u>Cost</u>	<u>Value</u>	<u>%</u>
Holding company assets (mainly Palm Harbor, RectorSeal, Skylawn, Alamo and Whitmore)	\$19,864,922	\$241,025,000	69.4
Venture capital assets	56,156,344	76,112,082	21.9
Marketable securities	<u>6,172,589</u>	<u>30,343,984</u>	<u>8.7</u>
Total investments	<u>\$82,193,855</u>	<u>\$347,481,066</u>	<u>100.0</u>

### Investment Activity

An aggregate of \$3,545,458 was invested during the year, including \$1,276,358 in additions to existing investments and \$2,269,100 in the following new investments:

- \$319,100 of a \$2,000,000 commitment to Sterling Group Partners I, L.P., a Houston-based leveraged buyout firm capitalized at \$120,000,000. For many years, our Company has co-invested with the Sterling Group and this investment maintains our longstanding relationship.
- \$450,000 in the common stock of Exopack Holding Corp. of Spartanburg, South Carolina, in the first transaction originated by the Sterling Group limited partnership described above. Exopack, with annual sales of over \$400 million, produces paper and plastic bags for pet food, building materials, fertilizer and other commodities.
- \$1,500,000 in the preferred and common stock of PalletOne, Inc. of Bartow, Florida, a manufacturer of wood pallets produced in 12 plants in the eastern half of the United States.

## Four Major Investments

Four of our major holdings - Palm Harbor Homes, Inc., The RectorSeal Corporation, Skylawn Corporation and Alamo Group Inc. - represent 65.9% of the value of our investment portfolio. At March 31, 2002, investments in these companies had an aggregate cost of \$17,560,002 and a value of \$229,005,000 (\$59.81 per Capital Southwest share). Our Company's equity in their earnings for the most recently completed fiscal years was \$18,661,000 (\$4.87 per Capital Southwest share). At \$59.81 per share, the aggregate value of our investments in these companies is equivalent to a price/earnings ratio of 12.3 - far below the March 31, 2002 ratios of 28.2 for the Dow Jones Industrials and 29.6 for the Standard & Poor's 500.

Because of the importance of these four companies and their influence on Capital Southwest's net asset value, we are giving a brief status report on each of them, including a description of some of the steps which have been taken to increase sales and earnings:

**Palm Harbor Homes, Inc.** (Nasdaq: PHHM) is 34.3% owned by Capital Southwest. Looking at Palm Harbor's results over the past five years, initially net sales grew by 38.0% through the third year to a record \$777.5 million, then declined by 19.3% to \$627.4 million in the year ended March 29, 2002. Through the third year in the five year period, Palm Harbor's earnings grew by 56.0% to \$38.6 million, then declined by 49.6% to \$19.5 million in the last year. This extreme cycle paralleled the rise and fall of the manufactured housing industry, which shipped a record 373,000 homes in 1998 and only 193,000 homes in 2001. The market collapse was the result of lax credit standards by the providers of consumer financing, which led to soaring defaults and foreclosures and the eventual exit of most of the finance companies that served the manufactured housing industry. With 15 plants and 151 company-owned retail outlets, Palm Harbor's challenge is to make adequate financing available to its credit-worthy customers. As a first step in this direction, it recently became a 50% limited partner (with an option to acquire 100%) of Bank Source Mortgage, a Dallas-based mortgage banking firm that provides conventional land-home loans to Palm Harbor's retail customers. In the near future, Palm Harbor expects to expand the scope of its captive finance company to provide a vehicle for securitizing and servicing chattel mortgage loans. Recently, Palm Harbor entered into a tentative agreement to acquire a well established manufacturer of modular housing. If completed, this acquisition will open a significant avenue for expansion. Modular homes conform to building codes in most communities and appeal to a broader customer base.

**The RectorSeal Corporation**, 100% owned by Capital Southwest, achieved a 50.9% expansion of its net sales over the past five years to a total of \$57.3 million in the year ended March 31, 2002. During this five year period, net income increased by 69.3% to \$5.3 million in the most recent year. RectorSeal's sales and earnings growth has been fueled by a combination of internal product development and acquisitions to broaden its lines of branded specialty chemicals, specialty lubricants and other varied products for the plumbing, construction, oil field, industrial and automotive markets. A total of \$16.6 million has been invested to acquire seven companies during the past five years. The largest of these were two companies that positioned RectorSeal in the automotive chemicals market: Cargo Chemical Corporation, a producer of epoxy putty, radiator sealants and other maintenance products acquired in January 1999 and Blue Magic, Inc., a producer of cleaners, waxes, polishes and other automotive appearance chemicals acquired in April 2002. Products developed internally or acquired by RectorSeal and its autonomous subsidiary, Jet-Lube, Inc., are produced in one of their six plants and distributed through their marketing organizations, which serve over 12,000 accounts.

**Skylawn Corporation**, 100% owned by Capital Southwest, increased its net sales of cemetery property, funeral services and insurance by 30.7% over the past five years to \$26.9 million in the year ended March 31, 2002. However, Skylawn's earnings declined by 1.3% during this five year period to \$3.8 million in the year just ended. The company's inability to achieve earnings growth which matches revenue growth has been the result of persistent problems in building an effective organization for pre-need sales of cemetery property, continuing losses from its funeral insurance company formed in 1997 and large expenses incurred in applying for County approval of the design and location of a proposed funeral home at Skylawn's major cemetery in San Mateo, California. While these items penalize current earnings, they provide an essential foundation for Skylawn's future earnings growth. Of particular importance is the Skylawn Funeral Home, which will be opened in 2004 if approved in the near future. Because of the diminished acquisition activity of the publicly-owned death care companies, there may be opportunities for Skylawn to acquire funeral homes and cemeteries at acceptable prices for the first time in over ten years.

**Alamo Group Inc.** (NYSE: ALG), 27.2% owned by Capital Southwest on a fully-diluted basis, experienced a 34.0% growth in net sales over the past five years to a total of \$246.0 million in the year ended December 31, 2001. During the same five years, earnings increased by only 23.4% to \$10.8 million in 2001 as Alamo coped with the adverse effects of the cyclical softness of the agricultural equipment market, the budget cutbacks by governmental purchasers of mowers and the European farmers' responses to the foot and mouth epidemic. To strengthen its future earnings potential, Alamo has invested \$41 million to acquire five companies during the past two years. These acquisitions extended the product lines and market penetration of the company's mowing equipment and parts businesses in both agricultural and governmental markets. The largest acquisition, Schwarze Industries Inc. of Huntsville, Alabama, acquired in February 2000, enabled Alamo to expand into the street-sweeping business with an established product line sold by many Alamo dealers to governmental agencies and contractors who buy Alamo's mowers.

### **Rating the Capital Southwest Management**

In an objective rating system, the Capital Southwest management would probably receive a *D* for its investment performance during the past five years – a marked decline from the *A* which would be appropriate for the preceding 20 years. On the other hand, I believe we deserve an *A* for our fiduciary relationship to shareholders.

While I am not proud of the *D*, and we are working to improve it, at least it is an honest *D* based on a very conservative valuation of our portfolio and on the fairest possible accounting, including the accrual of deferred taxes on the substantial gains in the values of our investments.

Although the *A* for our role as a fiduciary is nothing shareholders can take to the bank, you may be able to sleep well, knowing that we are not hatching up new ways to feather our nests at your expense. Perhaps you get what you pay for, but our company is a cheap operation. As shown on page 26 of this report, operating expenses during the last fiscal year were only 0.42% of average net assets (0.63% if we ignore the required expense reduction caused by our overfunded pension trust). This is far below most venture partnerships' expenses of over 2.5% and typical mutual funds' expenses of over 1.0%. Also, the stock options now outstanding plus those available for future grant are only 4.2% of the Company's total shares if all options were granted and exercised. This compares with the carried interest of 20% typically allocated to the managers of venture partnerships.

Our conviction that the interests of shareholders come first extends to our portfolio companies, where we strive to establish reasonable management compensation which is commensurate with the rewards delivered to shareholders.

### **Rating Big Corporations' Managements**

If called on to rate the managements of America's big corporations (and some that are not so big), I would give them collectively a *C+* for

their performance over the past five years, although individually there would be a lot of *A*'s and many, many *F*'s. Collectively, their roles as fiduciaries obligated to serve the interests of their shareholders would at best deserve a *D-*, with a few individual *A*'s and many, many *F*'s.

Capitalism works because of the rewards it bestows on those who create, manage and own profitable enterprises. At its best, capitalism provides fair and reasonable rewards to managers and workers who deliver rewards to shareholders. At its worst, capitalism provides inordinate, undeserved rewards to elite managers without regard for the rewards they deliver to shareholders.

During the past 25 years – especially since 1990 – there has been an accelerating trend toward capitalism at its worst. Corporate governance, especially in big corporations, has usually been inadequate. Now, it is largely ineffective as boards of directors and compensation committees ignore their obligations to shareholders, yielding to the insatiable demands and unbridled greed of arrogant (but replaceable) managers. There are occasional shareholder protests, but most investors, both institutional and individual, have passively accepted this failure of corporate democracy. The impending takeover of Corporate America by self-serving elitist managers may prove to be far more damaging to capitalism than anything Karl Marx could have conceived.

For a better understanding of what is happening to Corporate America, read the cover story in the May 6, 2002 BusinessWeek entitled The Crisis in Corporate Governance. Before continuing with my letter, please read the extract from this article entitled Executive Pay in the side bar on the next page and your blood may also boil.

The highway robbery of America's 500 largest corporations by their executives is detailed in the May 13, 2002 issue of Forbes, which tabulates the compensation (including gains on exercised stock options) of their CEOs in 2001. The median compensation of the highest paid 100 was \$15,601,000. The median compensation of all 500 was a paltry \$3,050,000. You do not want to know the compensation of the top 10. According to BusinessWeek, the nation's highest paid corpo-

rate executive back in 1950 was General Motors' Charles E. Wilson, who was paid a total of \$652,156 (\$4.4 million in inflation-adjusted dollars). Are today's managers that much better? Or outrageously overpaid?

The corruption of capitalism by officers and directors of big corporations (and many that are not so big) really troubles me. I am reminded of Eddie Chiles, the legendary Texan who built a major oil service company and ran conservative radio commercials 20 years ago with a trademark sign-on "I'm Eddie Chiles, and I'm mad". To borrow Eddie's phrase, I'm also mad. In fact, I'm madder than Hell when I see our capitalist system misused by grossly overpaid, egocentric executives and their accommodating boards of directors.

- I'm mad because they are ripping off their shareholders with their exorbitant salaries, bonuses and stock options.
- I'm mad because their unbridled greed is poisoning the system that has been the source of our nation's wealth.
- I'm mad because many of them have embraced misleading accounting practices which overstate earnings.
- I'm mad because self-serving managers of corporations – big and small – are again trying to avoid accounting reforms which would require expensing the value of stock options.

If you are also mad, I urge you to act as an owner of the businesses in which you have invested. Call or write the directors to register your complaints. Vote your shares as you feel, regardless of management's recommendations. If you have questions or thoughts about Capital Southwest, call or write me directly. I work for you.

June 4, 2002

President and Chairman

Extract from May 6, 2002 BusinessWeek

Special Report – The Crisis in Corporate Governance

#### Executive Pay

As a matter of basic fairness, Plato posited that no one in a community should earn more than five times the wages of the ordinary worker. Management guru Peter F. Drucker has long warned that the growing pay gap between CEOs and workers could threaten the very credibility of leadership. He argued in the mid-1980s that no leader should earn more than 20 times the company's lowest-paid employee. His reasoning: If the CEO took too large a share of the rewards, it would make a mockery of the contributions of all the other employees in a successful organization.

After massive increases in compensation, Drucker's suggested standard looks quaint. CEOs of large corporations last year made 411 times as much as the average factory worker. In the past decade, as rank-and-file wages increased 36%, CEO pay climbed 340%, to \$11 million. "It's just way off the charts," says Jennifer Ladd, a shareholder who is fighting for lower executive pay at companies in her portfolio. "A certain amount of wealth is ridiculous after a while."

Oddly enough, CEOs came to command such vast wealth through the abuse of a financial instrument once viewed as a symbol of enlightened governance: the humble stock option. Throughout the 1990s, governance experts applauded the use of options, maintaining that they would give executives a big payday only when shareholders profited. And for a while, as the bull market ran its course, that's the way it worked. But as the market cratered during the past two years, a funny thing happened: Shareholders lost their shirts, but executives went right on raking in the dough.

In recent months, especially, shareholder anger has boiled over, as company proxies disclosed the many ways compensation committees subverted pay for performance. There is, of course, a fundamental difference between investors who have their own money at risk in the market and option holders, who do not. But companies have gone even further to shield top executives from losses in a falling market. Some awarded huge option grants despite poor performance, while others made performance goals easier to reach. Nearly 200 companies swapped or repriced options—all to enrich members of a corporate elite who already were among the world's wealthiest people.

When CEOs can clear \$1 billion during their tenures, executive pay is clearly too high. Worse still, the system is not providing an incentive for outstanding performance. It should be a basic tenet of corporate governance never to reprice or swap a stock option that is under water. After all, no company would hand out free shares to stockholders to make them whole in a falling market.

To really fix the problem, Congress needs to require companies to expense options. If every option represented a direct hit to the bottom line, boards would be less inclined to dole them out by the millions.