

Capital Southwest Corporation
12900 Preston Road, Suite 700
Dallas, Texas 75230

(972) 233-8242 Telephone

Fax (972) 233-7362

June 29, 1997

Securities and Exchange Commission
450 5th Street, N.W.
Judiciary Plaza
Washington, DC 20549

Gentlemen:

Pursuant to regulations of the Securities and Exchange Commission, submitted for filing on behalf of Capital Southwest Corporation is the Company's Form 10-K405 for the year ended March 31, 1997.

This filing is being effected by direct transmission to the Commission's EDGAR System.

Sincerely,

Susan Patterson
Controller

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-K 405

(Mark One)

[X] ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934

[] TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d)
OF THE SECURITIES EXCHANGE ACT OF 1934

For the Fiscal Year Ended March 31, 1997

Commission File Number: 814-61

CAPITAL SOUTHWEST CORPORATION
(Exact name of registrant as specified in its charter)

Texas
(State or other Jurisdiction of
Incorporation or Organization)

75-1072796
(I.R.S. Employer
Identification Number)

12900 Preston Road, Suite 700, Dallas, Texas 75230
(Address of principal executive offices
including zip code)

(972) 233-8242
(Registrant's telephone number including area code)

Securities registered pursuant to Section 12(b) of the Act: None

Securities registered pursuant to Section 12(g) of the Act:
Common Stock, \$1.00 par value

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes X No ___

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. [X]

The aggregate market value of the voting stock held by non-affiliates of the registrant as of May 1, 1997 was \$142,654,636, based on the last sale price of such stock as quoted by Nasdaq on such date (officers, directors and 5% shareholders are considered affiliates for purposes of this calculation).

The number of shares of common stock outstanding as of May 1, 1997 was 3,767,051:

Documents Incorporated by Reference

- (1) Annual Report to Shareholders for the Year Ended
March 31, 1997
- (2) Proxy Statement for Annual Meeting of Shareholders
to be held July 21, 1997

Part of Form 10-K

Parts I and II; and
Part IV, Item 14(a)(1) and (2)

Part III

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PART I

Item 1. Business

Capital Southwest Corporation (the "Company") was organized as a Texas corporation on April 19, 1961. Until September 1969, the Company operated as a licensee under the Small Business Investment Act of 1958. At that time, the Company transferred to its wholly-owned subsidiary, Capital Southwest Venture Corporation ("CSVC"), certain of its assets and its license as a small business investment company ("SBIC"). CSVC is a closed-end, non-diversified investment company of the management type. Prior to March 30, 1988, the Company was registered as a closed-end, non-diversified investment company under the Investment Company Act of 1940 (the "1940 Act"). On that date, the Company elected to become a business development company subject to the provisions of Sections 55 through 65 of the 1940 Act, as amended by the Small Business Incentive Act of 1980.

The Company is a venture capital investment company whose objective is to achieve capital appreciation through long-term investments in businesses believed to have favorable growth potential. The Company participates in start-up and early-stage financings, expansion financings and leveraged buyout financings in a broad range of industry segments. The Company's portfolio is a composite of investments in several companies in which the Company has major interests as well as a number of developing companies and marketable securities of established publicly-owned companies. The Company makes available significant managerial assistance to the companies in which it invests and believes that providing material assistance to such investee companies is critical to its business development activities.

The twelve largest investments of the Company had a combined cost of \$41,943,522 and a value of \$263,978,402, representing 90.0% of the value of the Company's consolidated investment portfolio at March 31, 1997. For a narrative description of the twelve largest investments, see "Twelve Largest Investments - March 31, 1997" on pages 4 through 6 of the Company's Annual Report to Shareholders for the Year Ended March 31, 1997 (the "1997 Annual Report") which is herein incorporated by reference. Certain of the information presented on the twelve largest investments has been obtained from the respective companies and, in certain cases, from public filings of such companies. The financial information presented on each of the respective companies is from such companies' financial statements, which in some instances are unaudited.

The Company competes for attractive investment opportunities with venture capital partnerships and corporations, venture capital affiliates of industrial and financial companies, other SBICs and wealthy individuals.

The number of persons employed by the Company at March 31, 1997 was eight.

Item 2. Properties

The Company maintains its offices at 12900 Preston Road, Suite 700, Dallas, Texas, 75230, where it rents approximately 3,200 square feet of office space pursuant to a lease agreement expiring in February 1998. The Company believes that its offices are adequate to meet its current and expected future needs.

Item 3. Legal Proceedings

The Company has no material pending legal proceedings to which it is a party or to which any of its property is subject.

Item 4. Submission of Matters to a Vote of Security Holders

No matters were submitted to a vote of security holders during the quarter ended March 31, 1997.

PART II

Item 5. Market for Registrant's Common Equity and Related Stockholder Matters

Information set forth under the captions "Shareholder Information - Shareholders, Market Prices and Dividends" on page 27 of the 1997 Annual Report are herein incorporated by reference.

Item 6. Selected Financial Data

"Selected Consolidated Financial Data" on page 26 of the 1997 Annual Report is herein incorporated by reference.

Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations

Pages 23 through 25 of the Company's 1997 Annual Report are herein incorporated by reference.

Item 8. Financial Statements and Supplementary Data

Pages 7 through 22 of the Company's 1997 Annual Report are herein incorporated by reference. See also Item 14 of this Form 10-K - "Exhibits, Financial Statement Schedules, and Reports on Form 8-K".

Selected Quarterly Financial Data (Unaudited)

The following presents a summary of the unaudited quarterly consolidated financial information for the years ended March 31, 1997 and 1996.

| | First Quarter ----- | Second Quarter ----- | Third Quarter ----- | Fourth Quarter ----- | Total ----- |
|--|--|----------------------------|---------------------------|----------------------------|----------------|
| | (In thousands, except per share amounts) | | | | |
| 1997 ----- | | | | | |
| Net investment income | \$ 817 | \$ 829 | \$ 442 | \$ 486 | \$ 2,574 |
| Net realized gain on investments | - | - | 892 | 5,914 | 6,806 |
| Net increase (decrease) in unrealized appreciation of investments before distributions | 8,291 | 12,505 | 11,150 | (9,141) | 22,805 |
| Net increase (decrease) in net assets from operations before distributions | 9,107 | 13,334 | 12,485 | (2,741) | 32,185 |
| Net increase (decrease) in net assets from operations before distributions per share | 2.42 | 3.54 | 3.31 | (.73) | 8.54 |
| 1996 ----- | | | | | |
| Net investment income | \$ 816 | \$ 633 | \$ 934 | \$ 472 | \$ 2,855 |
| Net realized gain (loss) on investments | - | - | 12,358 | (1,184) | 11,174 |
| Net increase (decrease) in unrealized appreciation of investments before distributions | 2,613 | 27,272 | (2,180) | 11,041 | 38,746 |
| Net increase in net assets from operations before distributions | 3,429 | 27,905 | 11,112 | 10,329 | 52,775 |
| Net increase in net assets from operations before distributions per share | .91 | 7.41 | 2.95 | 2.74 | 14.01 |

Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure

Not applicable.

PART III

Item 10. Directors and Executive Officers of the Registrant

The information set forth under the captions "Election of Directors" in the Company's definitive Proxy Statement for Annual Meeting of Shareholders to be held July 21, 1997, filed pursuant to Regulation 14A under the Securities Exchange Act of 1934, on or about June 12, 1997 (the "1997 Proxy Statement") is herein incorporated by reference.

Executive Officers of the Registrant

The officers of the Company, together with the offices in the Company presently held by them, their business experience during the last five years and their ages are as follows:

D.Scott Collier, age 34, has served as Vice President of the Company since April 1995 and was an investment associate with the Company from 1991 to 1995.

J. Bruce Duty, age 46, has served as Senior Vice President of the Company since 1993, Vice President of the Company from 1982 to 1993, Secretary of the Company from 1980 to 1993 and Treasurer of the Company from 1980 to January 1990.

Patrick F. Hamner, age 41, has served as Vice President of the Company since 1986 and was an investment associate with the Company from 1982 to 1986.

Gary L. Martin, age 50, has been a director of the Company since July 1988 and has served as Vice President of the Company since 1984. He previously served as Vice President of the Company from 1978 to 1980. Since 1980, Mr. Martin has served as President of The Whitmore Manufacturing Company, a wholly-owned subsidiary of the Company.

Tim Smith, age 36, has served as Vice President and Secretary of the Company since 1993, Treasurer of the Company since January 1990 and was an investment associate with the Company from July 1989 to January 1990.

William R. Thomas, age 68, has served as Chairman of the Board of Directors of the Company since 1982 and President of the Company since 1980. In addition, he has been a director of the Company since 1972 and was previously Senior Vice President of the Company from 1969 to 1980.

No family relationship exists between any of the above-listed officers, and there are no arrangements or understandings between any of them and any other person pursuant to which they were selected as an officer. All officers are elected to hold office for one year and until their successors are elected and qualify.

Item 11. Executive Compensation

The information set forth under the caption "Compensation of Directors and Executive Officers" in the 1997 Proxy Statement is herein incorporated by reference.

Item 12. Security Ownership of Certain Beneficial Owners and Management

The information set forth under the captions "Stock Ownership of Certain Beneficial Owners" and "Election of Directors" in the 1997 Proxy Statement is herein incorporated by reference.

Item 13. Certain Relationships and Related Transactions

There were no relationships or transactions within the meaning of this item during the fiscal year ended March 31, 1997 or proposed for the fiscal year ending March 31, 1998.

PART IV

Item 14. Exhibits, Financial Statement Schedules, and Reports on Form 8-K

(a)(1) The following financial statements included in pages 7 through 22 of the Company's 1997 Annual Report are herein incorporated by reference:

(A) Portfolio of Investments - March 31, 1997

Consolidated Financial Statements of the Company and Subsidiary

Consolidated Statements of Financial Condition - March 31, 1997 and 1996

Consolidated Statements of Operations - Years Ended March 31, 1997, 1996 and 1995

Consolidated Statements of Changes in Net Assets - Years Ended March 31, 1997, 1996 and 1995

Consolidated Statements of Cash Flows - Years Ended March 31, 1997, 1996 and 1995

(B) Notes to Consolidated Financial Statements

(C) Notes to Portfolio of Investments

(D) Selected Per Share Data and Ratios

(E) Independent Auditors' Report

(a)(2) All schedules are omitted because they are not applicable or not required, or the information is otherwise supplied.

(a)(3) See the Exhibit Index on page 6.

(b) The Company filed no reports on Form 8-K during the three months ended March 31, 1997.

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

CAPITAL SOUTHWEST CORPORATION

/s/ William R. Thomas

By:-----
(William R. Thomas, President
and Chairman of the Board)

Date: June 26, 1997

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the Registrant and in the capacities and on the date indicated.

| Signature ----- | Title ----- | Date ----- |
|---|---|---------------|
| /s/ William R. Thomas ----- (William R. Thomas) | President and Chairman of the Board and Director | June 26, 1997 |
| /s/ Gary L. Martin ----- (Gary L. Martin) | Director | June 26, 1997 |
| /s/ Graeme W. Henderson ----- (Graeme W. Henderson) | Director | June 26, 1997 |
| /s/ James M. Nolan ----- (James M. Nolan) | Director | June 26, 1997 |
| /s/ John H. Wilson ----- (John H. Wilson) | Director | June 26, 1997 |
| /s/ Tim Smith ----- (Tim Smith) | Vice President and Secretary-Treasurer (Financial and Accounting Officer) | June 26, 1997 |

EXHIBIT INDEX

The following exhibits are filed with this report or are incorporated herein by reference to a prior filing, in accordance with Rule 12b-32 under the Securities Exchange Act of 1934. (Asterisk denotes exhibits filed with this report.)

| Exhibit No. ----- | Description ----- |
|----------------------|---|
| 3.1(a) | Articles of Incorporation and Articles of Amendment to Articles of Incorporation, dated June 25, 1969 (filed as Exhibit 1(a) and 1(b) to Amendment No. 3 to Form N-2 for the fiscal year ended March 31, 1979). |
| 3.1(b) | Articles of Amendment to Articles of Incorporation, dated July 20, 1987 (filed as an exhibit to Form N-SAR for the six month period ended September 30, 1987). |
| 3.2 | By-Laws of the Company, as amended (filed as Exhibit 2 to Amendment No. 11 to Form N-2 for the fiscal year ended March 31, 1987). |
| 4.1 | Specimen of Common Stock certificate (filed as Exhibit 4 to Amendment No. 3 to Form N-2 for the fiscal year ended March 31, 1979). |
| 4.2 | Subordinated debentures of CSVC guaranteed by the Small Business Administration (filed as Exhibit 5 to Amendment No. 11 to Form N-2 for the fiscal year ended March 31, 1987 and Exhibit 4.3 to Form 10-K for the fiscal year ended March 31, 1993). |
| 10.1 | The RectorSeal Corporation and Jet-Lube, Inc. Employee Stock Ownership Plan as revised and restated effective April 1, 1989. |
| 10.3 | Retirement Plan for Employees of Capital Southwest Corporation and Its Affiliates as amended and restated effective April 1, 1989 (filed as Exhibit 10.3 to Form 10-K for the fiscal year ended March 31, 1995). |
| 10.4 | Capital Southwest Corporation and Its Affiliates Restoration of Retirement Income Plan for certain highly-compensated superseded plan participants effective April 1, 1993 (filed as Exhibit 10.4 to Form 10-K for the fiscal year ended March 31, 1995). |
| 10.5 | Capital Southwest Corporation Retirement Income Restoration Plan as amended and restated effective April 1, 1989 (filed as Exhibit 10.5 to Form 10-K for the fiscal year ended March 31, 1995). |

| Exhibit No. ----- | Description ----- |
|----------------------|---|
| 10.6 | Form of Indemnification Agreement which has been established with all directors and executive officers of the Company (filed as Exhibit 10.9 to Form 8-K dated February 10, 1994). |
| 10.7 | Capital Southwest Corporation 1984 Incentive Stock Option Plan as amended and restated as of April 20, 1987 (filed as Exhibit 10.10 to Form 10-K for the fiscal year ended March 31, 1990). |
| 13. * | Annual Report to Shareholders for the fiscal year ended March 31, 1997. |
| 21. | List of subsidiaries of the Company (filed as Exhibit 22 to Form 10-K for the fiscal year ended March 31, 1992). |
| 23. * | Independent Auditors' Consent. |
| 27. * | Financial Data Schedule. |

Exhibit 13

Twelve Largest Investments-March 31, 1997

Palm Harbor Homes, Inc.

\$84,458,000

Palm Harbor Homes, Dallas, Texas, is an integrated manufactured housing company, building, retailing, financing and insuring homes produced in 15 plants in Alabama, Arizona, Florida, North Carolina, Ohio, Oregon and Texas and sold in 34 states by over 600 independent dealers and 59 company-owned or affiliated retail superstores. Palm Harbor manufactures high-quality, energy-efficient homes designed to meet the need for affordable housing, particularly among retirees and newly-formed families.

During the year ended March 28, 1997, Palm Harbor earned \$24,739,000 (\$1.68 per share on net sales of \$563,192,000, compared with earnings of \$14,978,000 (\$1.18 per share) on net sales of \$417,214,000 in the previous year. The March 31, 1997 closing Nasdaq bid price of Palm Harbor's common stock was \$21.00 per share.

At March 31, 1997, the \$10,931,955 investment in Palm Harbor by Capital Southwest and its subsidiary was valued at \$84,458,000 (\$16.80 per share) consisting of 5,027,276 restricted shares of common stock, representing a fully-diluted equity interest of 33.2%.

Skylawn Corporation

\$42,000,000

Skylawn Corporation owns and operates cemeteries, mausoleums and mortuaries. Skylawn's operations, all of which are in California, include a mausoleum and an adjacent mortuary in Oakland and cemeteries and mausoleums in San Mateo, Hayward, Sacramento and Napa, the latter three of which also have mortuaries at the cemetery sites. All of these entities are well established and have provided funeral services to their respective communities for many years.

For the fiscal year ended March 31, 1997, Skylawn Corporation earned \$3,822,000 on revenues of \$20,602,000. In the previous year, Skylawn earned \$4,462,000 on revenues of \$22,939,000.

At March 31, 1997, Capital Southwest owned 100% of Skylawn Corporation's common stock, which had a cost of \$4,510,400 and was valued at \$42,000,000.

The RectorSeal Corporation

\$35,000,000

The RectorSeal Corporation, with plants in Houston and Mount Vernon, New York, manufactures specialty chemical products including pipe thread sealants, fire-stop sealants, plastic solvent cements and other formulations for plumbing and industrial applications. RectorSeal's subsidiary, Jet-Lube, Inc., with plants in Houston, England and Canada, produces anti-seize compounds, specialty lubricants and other products used in industrial and oil field applications. RectorSeal also owns a 20% equity interest in The Whitmore Manufacturing Company (described subsequently).

During the year ended March 31, 1997, RectorSeal earned \$3,116,000 on revenues of \$37,988,000, compared with earnings of \$3,014,000 on revenues of \$29,290,000 in the previous year. RectorSeal's earnings do not reflect its 20% equity in the Whitmore Manufacturing Company.

At March 31, 1997, Capital Southwest owned 100% of RectorSeal's common Stock having a cost of \$52,600 and a value of \$35,000,000.

Alamo Group Inc.

\$31,777,000

Alamo Group Inc. is a leading designer, manufacturer and distributor of heavy-duty, tractor-mounted mowing and vegetation maintenance equipment. Founded in 1969, Alamo Group operates 12 manufacturing facilities and serves agricultural, governmental and commercial markets in the U.S. and Europe.

For the year ended December 31, 1996, Alamo reported consolidated earnings of \$8,762,000 (\$0.91 per share) on net sales of \$183,595,000, compared with earnings of \$11,615,000 (\$1.34 per share) on net sales of \$163,852,000 in the previous year. The March 31, 1997 closing NYSE market price of Alamo's common stock was \$15.875 per share.

At March 31, 1997, the \$575,000 investment in Alamo by Capital Southwest and its subsidiary was valued at \$31,777,000, consisting of 2,660,000 restricted shares of common stock valued at \$31,654,000 (\$11.90 per share) and warrants valued at \$123,000, representing a fully-diluted equity interest of 26.8% at an anticipated cost of \$1,575,000.

Encore Wire Corporation

\$16,381,000

Encore Wire Corporation, McKinney, Texas, manufactures a broad line of copper electrical wire and cable including non-metallic sheathed cable, underground feeder cable and THHN cable for residential, commercial and industrial construction. Encore's products are sold through large-volume distributors and building materials retailers.

For the year ended December 31, 1996, Encore reported net income of \$7,159,000 (\$1.00 per share) on net sales of \$179,132,000, compared with a net loss of \$545,000 (\$0.08 per share) on net sales of \$151,308,000 in the previous year. The March 31, 1997 closing Nasdaq bid price of Encore's common stock was \$18.25 per share.

At March 31, 1997, the \$4,100,000 investment in 1,122,000 shares of Encore's restricted common stock by Capital Southwest and its subsidiary was valued at \$16,381,000 (\$14.60 per share), representing a fully-diluted equity interest of 14.6%.

PETSMART, Inc.

\$13,084,400

PETSMART, Inc., Phoenix, Arizona, is the nation's leading operator of superstores specializing in pet food, pet supplies and pet services, including full scale veterinary care. PETSMART currently operates 397 superstores in North America and the United Kingdom.

For the year ended February 2, 1997, PETSMART reported net income of \$20,591,000 (\$0.17 per share) on net sales of \$1,501,017,000, compared with a net loss of \$7,018,000 (\$0.06 per share) on net sales of \$1,168,056,000 in the previous year. The March 31, 1997 closing Nasdaq bid price of PETSMART's common stock was \$20.00 per share.

At March 31, 1997, Capital Southwest and its subsidiary owned 654,220 unrestricted shares of PETSMART common stock, having a cost of \$2,878,733 and a market value of \$13,084,400 (\$20.00 per share).

Mail-Well, Inc.

\$10,966,000

Mail-Well, Inc., Englewood, Colorado, is a leading envelope manufacturer and printer in the United States and Canada, specializing in customized envelopes and high-impact color printing. Mail-Well operates over 50 plants and numerous sales offices throughout North America.

For the year ended December 31, 1996, Mail-Well reported earnings of \$16,927,000 (\$1.42 per share) on net sales of \$778,524,000, compared with earnings of \$10,373,000 (\$1.36 per share) on net sales of \$596,803,000 in the previous year. The March 31, 1997 closing Nasdaq bid price of Mail-Well's common stock was \$19.75 per share.

At March 31, 1997, the \$2,889,010 investment in Mail-Well by Capital Southwest was valued at \$10,966,000 (\$15.80 per share) consisting of 694,063 restricted shares of common stock, representing a fully-diluted equity interest of 5.3%.

American Homestar Corporation

\$8,512,002

American Homestar Corporation, League City, Texas, builds, retails and finances manufactured housing, producing homes from its eight plants and retailing its products through 52 company-owned retail sales centers and more than 300 independent dealers in 24 states.

For the year ended May 31, 1996, American Homestar reported net income of \$9,756,000 (\$0.98 per share) on net sales of \$231,232,000. Unaudited earnings for the nine months ended February 28, 1997 were \$9,713,000 (\$0.87 per share) compared with \$6,423,000 (\$0.67 per share) during the same period in the preceding year. The March 31, 1997 closing Nasdaq bid price of American Homestar's stock was \$17.00 per share.

At March 31, 1997, Capital Southwest and its subsidiary owned 500,706 unrestricted shares of American Homestar common stock, having a cost of \$3,405,824 and a market value of \$8,512,002 (\$17.00 per share), representing a fully-diluted equity interest of 4.2%.

PTS Holdings, Inc. \$6,800,000

PTS Holdings, Inc. Anaheim, California, through its subsidiary, Power Paragon, manufactures power systems which provide continuous high-quality electric power for military and commercial equipment. Operating divisions based in California, Arizona and Germany produce power conditioning systems for the U.S. Navy and navies of other countries, uninterruptible power supplies for commercial installations including computer facilities, and power conversion devices for aerospace, industrial and commercial use.

For the year ended June 30, 1996, PTS reported net income of \$6,681,000 on net sales of \$79,950,000. Earnings for the nine months ended March 31, 1997 were \$3,119,000, compared with \$4,329,000 during the same period in the preceding year.

At March 31, 1997, Capital Southwest's \$2,000,000 investment in the common stock of PTS Holdings, Inc. was valued at \$6,800,000 and represents a fully-diluted equity interest of 21.6%.

The Whitmore Manufacturing Company \$6,000,000

The Whitmore Manufacturing Company, with plants in Rockwall, Texas and Cleveland, Ohio, manufactures specialty lubricants for heavy equipment used in surface mining and other industries, and produces transit coatings for the automobile industry. Whitmore's subsidiary, Hanson-Loran Company, Inc., Buena Park, California, produces floor-finishing compounds, supplies and equipment for supermarkets.

During the year ended March 31, 1997, Whitmore reported net income of \$971,000 on net sales of \$17,431,000, compared with a net loss of \$611,000 on net sales of \$16,829,000 in the previous year. The company is owned 80% by Capital Southwest and 20% by Capital Southwest's subsidiary, The RectorSeal Corporation (described on a previous page).

At March 31, 1997, the direct investment in Whitmore by Capital Southwest was valued at \$6,000,000 and had a cost of \$1,600,000. Our Company's direct and indirect equity in Whitmore's income for the year ended March 31, 1997 was \$971,000.

SDI Holding Corp. \$6,000,000

SDI Holding Corp., Glasgow, Delaware, through its subsidiary, Sterling Diagnostic Imaging, Inc., manufactures and markets on a world-wide basis, x-ray imaging film, intensifying screens, cassettes, film development chemicals and related equipment and services. A subsidiary, Direct Radiography Corp., is developing a system, scheduled for 1998 introduction, which will capture, store and transmit conventional x-ray images in a digital format.

The net assets of the Diagnostic Imaging business were purchased from E. I. DuPont de Nemours for approximately \$315 million in March 1996. The operations acquired by SDI recorded 1995 sales of \$539 million and 1996 sales of \$500 million.

At March 31, 1997, Capital Southwest's \$6,000,000 investment in the common stock of SDI Holding Corp. was valued at cost and represents a fully-diluted equity interest of 10.6%.

Rewind Holdings, Inc. \$3,000,000

Rewind Holdings, Inc., Sugar Land, Texas, through its wholly-owned subsidiary, Bill Young Productions, Inc., is the leading producer of radio and television commercials for the touring entertainment industry and is a nationally-recognized producer of music videos, commercials and other productions.

In October 1996, Capital Southwest's subsidiary invested \$3,000,000 in a 12% subordinated note and 8% convertible preferred stock of Rewind Holdings, Inc., which acquired the outstanding common stock of Bill Young Productions, Inc. The operations acquired by Rewind reported revenues of \$6,928,000 during the twelve months ended September 30, 1996.

At March 31, 1997, the investment by Capital Southwest's subsidiary consisting of \$2,625,000 in a 12% subordinated note and \$375,000 in 8% convertible preferred stock was valued at cost and represents a fully-diluted equity interest of 40.7%.

Portfolio of Investments - March 31, 1997

| Company | Equity (a) | Investment (b) | Cost | Value (c) |
|--|------------|---|--|--|
| =ALAMO GROUP INC. San Antonio, Texas Heavy-duty, tractor-mounted mowing and vegetation maintenance equipment for agricultural and governmental markets. | 26.8% | 2,660,000 shares common stock (acquired 4-1-73 and 7-18-78) Warrant to purchase 62,500 shares of common stock at \$16.00 per share, expiring 2000 (acquired 11-25-91) | \$ 575,000 - ----- 575,000 | \$31,654,000 123,000 ----- 31,777,000 |
| ALL COMPONENTS, INC. Addison, Texas Distribution and production of memory and other components to personal computer manufacturers, retailers and value-added resellers. | 30.0% | 14% subordinated debenture, due 1999 (acquired 9-16-94) 150,000 shares Series A convertible preferred stock acquired 9-16-94) 450,000 shares Series B preferred stock (acquired 9-16-94) | 600,000 150,000 450,000 ----- 1,200,000 | 600,000 1,150,000 450,000 ----- 2,200,000 |
| =AMERICAN HOMESTAR CORPORATION League City, Texas Manufacturing, retailing and financing of manufactured housing sold in 24 states. | 4.2% | ++500,706 shares common stock (acquired 8-31-93, 7-12-94 and 3-28-96) | 3,405,824 | 8,512,002 |
| AMFIBE, INC. Martinsville, Virginia Nylon monofilament yarns for the textile industry. | 40.0% | 2,000 shares Class B non-voting stock (acquired 6-15-94) | 200,000 | 1,600,000 |
| BALCO, INC. Wichita, Kansas Specialty architectural products used the construction and remodeling of commercial and institutional buildings. | 86.0% | 14% subordinated debentures, payable 1998 to 2002 (acquired 8-13-91) 14% subordinated debenture, payable 1998 to 2002, last maturing \$250,000 convertible into 250,000 shares of common stock at \$1.00 per share (acquired 6-1-91) 110,000 shares common stock and 60,920 shares Class B non-voting stock (acquired 10-25-83) Warrants to purchase 85,000 shares of common stock a \$2.40 per share, expiring 2001 (acquired 8-13-91) | 400,000 800,000 170,920 - ----- 1,370,920 | 400,000 800,000 170,920 - ----- 1,370,920 |
| =DATA RACE, INC. San Antonio, Texas Statistical multiplexers, custom data/fax/voice modems and local and wide | 2.9% | ++176,105 shares common stock (acquired 10-7-92) 35,507 shares common stock (acquired 2-3-97) | 480,116 94,698 ----- 574,814 | 2,333,000 235,000 ----- 2,568,000 |

=Publicly-owned company ++Unrestricted securities as defined in Note (b)

| Company | Equity (a) | Investment (b) | Cost | Value (c) |
|--|--------------|--|--|--|
| DENNIS TOOL COMPANY Houston, Texas Polycrystalline diamond compacts (PDCs) used in oil field drill bits and in mining and industrial applications. | 46.1% | 98,687 shares common stock (acquired 3-7-94) | \$ 330,000 | \$ 2,305,000 |
| DYMETROL COMPANY, INC. Hockessin, Delaware Nylon strapping for packaging applications and copolyester elastomeric tape used in automobiles. | 33.8% | 15% subordinated notes, payable quarterly 1998 to 1999 (acquired 5-27-93) 19,912 shares common stock, non-voting (acquired 5-27-93) | 774,379 199,115 ----- 973,494 | 774,379 199,115 ----- 973,494 |
| =ENCORE WIRE CORPORATION McKinney, Texas Electrical wire and cable for residential and commercial use. | 14.6% | 1,122,000 shares common stock (acquired 7-16-92, 3-15-94 and 4-28-94) | 4,100,000 | 16,381,000 |
| =FMC CORPORATION Chicago, Illinois Machinery and chemicals in diversified product areas. | less than 1% | ++6,430 shares common stock (acquired 6-6-86) | 123,778 | 393,838 |
| =FRONTIER CORPORATION Rochester, New York Diversified telecommunications company. | less than 1% | ++31,338 shares common stock (acquired 12-20-95) | 78,346 | 560,167 |
| LIL' THINGS, INC. Arlington, Texas Retail chain of superstores selling Products for children from birth to six years. | 7.3% | 2,250,000 shares Class A cumulative preferred stock, convertible into 2,250,000 shares of common stock at \$1.00 per share (acquired 2-12-93 and 12-1-93) 666,666 shares Class B cumulative preferred stock, convertible into 746,268 shares of common stock at \$1.34 per share (acquired 9-15-94) 617,410 shares Class C cumulative preferred stock, convertible into 617,410 shares of common stock at \$1.20 per share (acquired 12-4-95) Warrants to purchase 58,842 shares of common stock at \$.01 per share, expiring 2000 (acquired 11-6-95) | 2,250,000 1,000,000 740,894 - ----- 3,990,894 | - - 2 - ----- 2 |
| =MAIL-WELL, INC. Englewood, Colorado Customized envelopes and high-impact color printing. | 5.3% | 694,063 shares common stock (acquired 2-18-94, 12-14-94 and 7-27-95) | 2,889,010 | 10,966,000 |

=Publicly-owned company ++Unrestricted securities as defined in Note (b)

| Company | Equity (a) | Investment (b) | Cost | Value (c) |
|--|--------------|---|-----------------------------------|-----------------------------------|
| =MYLAN LABORATORIES INC. Pittsburgh, Pennsylvania Proprietary and generic pharmaceutical products. | less than 1% | ++128,286 shares common stock (acquired 11-20-91) | \$ 400,000 | \$ 1,908,254 |
| PTS HOLDINGS, INC. Anaheim, California Power systems for military and commercial applications. | 21.6% | 200,000 shares Class B non-voting common stock (acquired 11-21-94) | 2,000,000 | 6,800,000 |
| =PALM HARBOR HOMES, INC. Dallas, Texas Integrated manufacturing, retailing, financing and insuring of manufactured housing sold in 34 states. | 33.2% | 5,027,276 shares common stock (acquired 1-3-85, 3-31-88 and 7-31-95) | 10,931,955 | 84,458,000 |
| =PETSMART, INC. Phoenix, Arizona Retail chain of superstores selling pet foods, supplies and services. | less than 1% | ++654,220 shares common stock (acquired 6-1-95) | 2,878,733 | 13,084,400 |
| THE RECTORSEAL CORPORATION Houston, Texas Chemical specialty products for industrial, construction and oil field applications; owns 20% of Whitmore Manufacturing. | 100.0% | 27,907 shares common stock (acquired 1-5-73 and 3-31-73) | 52,600 | 35,000,000 |
| REWIND HOLDINGS, INC. Sugar Land, Texas Production of radio and television commercials and music videos. | 40.7% | 12% subordinated note, payable 2003 (acquired 10-21-96) 375 shares 8% Series A convertible preferred stock (acquired 10-21-96) | 2,625,000 375,000 3,000,000 | 2,625,000 375,000 3,000,000 |
| SDI HOLDING CORP. Glasgow, Delaware Owns Sterling Diagnostic Imaging, a manufacturer of x-ray imaging film and direct radiography systems. | 10.6% | 60,000 shares common stock (acquired 3-26-96) | 6,000,000 | 6,000,000 |
| SKYLAWN CORPORATION Hayward, California Cemeteries, mausoleums and mortuaries located in northern California. | 100.0% | 1,449,026 shares common stock (acquired 7-16-69) | 4,510,400 | 42,000,000 |

=Publicly-owned company ++Unrestricted securities as defined in Note (b)

| Company | Equity (a) | Investment (b) | Cost | Value (c) |
|--|--------------|---|--------------------------------|-----------------------------------|
| =SPRINT CORPORATION Westwood, Kansas Diversified telecommunications company. | less than 1% | ++36,000 shares common stock (acquired 6-20-84) | \$ 503,645 | \$ 1,633,500 |
| =TECNOL MEDICAL PRODUCTS, INC. Fort Worth, Texas Disposable medical products for health-care facilities. | less than 1% | ++183,764 shares common stock (acquired 2-7-92 and 5-11-94) | 2,396,926 | 2,894,283 |
| =TELE-COMMUNICATIONS, INC. - TCI Group Englewood, Colorado Operation of the nation's largest cable television system. | less than 1% | ++180,000 shares Series A common stock (acquired 6-3-69) | 68 | 2,137,500 |
| =TELE-COMMUNICATIONS, INC. - Liberty Media Group Englewood, Colorado Production and distribution of cable television programming services. | less than 1% | ++67,500 shares Series A common stock (acquired 8-4-95) | - | 1,341,563 |
| TEXAS PETROCHEMICAL HOLDINGS, INC. Houston, Texas Butadiene for synthetic rubber, MTBE for gasoline octane enhancement and butylenes for varied applications. | 5.4% | 30,000 shares common stock (acquired 6-27-96) | 3,000,000 | 2,400,000 |
| TEXAS SHREDDER, INC. San Antonio, Texas Design and manufacture of heavy-duty shredder systems for recycling steel and other materials from junk automobiles. | 45.7% | 14% subordinated debentures, payable 1997 to 1999 (acquired 3-6-91) 3,000 shares Series A preferred stock (acquired 3-6-91) 750 shares Series B preferred stock, convertible into 7,500 shares of common stock at \$10.00 per share (acquired 3-6-91) | 1,012,500 300,000 75,000 | 1,012,500 300,000 1,500,000 |
| =TRITON ENERGY CORPORATION Dallas, Texas Oil and gas exploration and development. | less than 1% | ++6,022 shares common stock (acquired 12-15-86) | 144,167 | 233,353 |
| VARIX CORPORATION Richardson, Texas Formerly developed software for computer-aided design of electronic circuits. | 100.0% | 12% promissory notes due 1997 (acquired 12-5-86, 3-21-88 and 1-31-90) 1,514,566 shares preferred stock, convertible into 3 shares of common stock at \$171,667 per share (acquired 6-1-84 and 3-21-88) 37 shares common stock (acquired 6-2-86, 3-21-88 and 1-31-90) | 566,486 515,000 100,000 | 325,000 - - |
| =Publicly-owned company | | ++Unrestricted securities as defined in Note (b) | | |

| Company | Equity (a) | Investment (b) | Cost | Value(c) |
|--|--------------|--|-----------------------|------------------------|
| WESTMARC COMMUNICATIONS, INC. Denver, Colorado Cable television systems and microwave relay systems. | - | 21 shares 12% Series C preferred stock (acquired 1-3-90) | \$ - | \$ 508,000 |
| THE WHITMORE MANUFACTURING COMPANY Rockwall, Texas Specialized mining and industrial lubricants; automotive transit coatings; floor-finishing compounds and equipment. | 80.0% | 80 shares common stock (acquired 8-31-79) | 1,600,000 | 6,000,000 |
| MISCELLANEOUS | - | Cherokee Communications, Inc. - Escrowed funds | - | 639,000 |
| | 98.8% | Humac Company - 1,041,000 shares common stock (acquired 1-31-75 and 12-31-75) | - | 164,000 |
| | less than 1% | =360degree Communications Company - ++12,000 shares common stock (acquired 3-7-96) | 108,355 | 207,000 |
| | less than 1% | =TCI Satellite Entertainment, Inc. - ++18,000 Series A common stock (acquired 12-4-96) | - | 137,250 |
| TOTAL INVESTMENTS | | | \$59,907,915 ===== | \$293,291,026 ===== |

=Publicly-owned company ++Unrestricted securities as defined in Note (b)

Notes to Portfolio of Investments

(a) The percentages in the "Equity" column express the potential equity interests held by Capital Southwest Corporation and Capital Southwest Venture Corporation (together, the "Company") in each issuer. Each percentage represents the amount of the issuer's common stock the Company owns or can acquire as a percentage of the issuer's total outstanding common shares, plus shares reserved for all outstanding warrants, convertible securities and employee stock options. The symbol "less than 1%" indicates that the Company holds a potential equity interest of less than one percent.

(b) Unrestricted securities (indicated by ++) are freely marketable securities having readily available market quotations. All other securities are restricted securities which are subject to one or more restrictions on resale and are not freely marketable. At March 31, 1997, restricted securities represented approximately 88% of the value of the consolidated investment portfolio.

(c) Under the valuation policy of the Company, unrestricted securities are valued at the closing sale price for listed securities and at the closing bid price for over-the-counter securities on the valuation date. Restricted securities, including securities of publicly-owned companies which are subject to restrictions on resale, are valued at fair value as determined by the Board of Directors. Fair value is considered to be the amount which the Company may reasonably expect to receive for portfolio securities if such securities were sold on the valuation date. Valuations as of any particular date, however, are not necessarily indicative of amounts which may ultimately be realized as a result of future sales or other dispositions of securities.

Among the factors considered by the Board of Directors in determining the fair value of restricted securities are the financial condition and operating results of the issuer, the long-term potential of the business of the issuer, the market for and recent sales prices of the issuer's securities, the

Notes to Portfolio of Investments (continued)

values of similar securities issued by companies in similar businesses, the proportion of the issuer's securities owned by the Company, the nature and duration of resale restrictions and the nature of any rights enabling the Company to require the issuer to register restricted securities under applicable securities laws. In determining the fair value of restricted securities, the Board of Directors considers the inherent value of such securities without regard to the restrictive feature and adjusts for any diminution in value resulting from restrictions on resale.

(d) Agreements between certain issuers and the Company provide that the issuers will bear substantially all costs in connection with the disposition of common stocks, including those costs involved in registration under the Securities Act of 1933 but excluding underwriting discounts and commissions. These agreements, which cover common stocks owned at March 31, 1997 and common stocks which may be acquired thereafter through exercise of warrants and conversion of debentures and preferred stocks, apply to restricted securities of all issuers in the investment portfolio of the Company except securities of the following issuers, which are not obligated to bear registration costs: Humac Company, Skylawn Corporation and The Whitmore Manufacturing Company.

(e) The descriptions of the companies and ownership percentages shown in the portfolio of investments were obtained from published reports and other sources believed to be reliable, are supplemental and are not covered by the report of independent auditors. Acquisition dates indicated are the dates specific securities were acquired. Certain securities were received in exchange for or upon conversion or exercise of other securities previously acquired.

Portfolio Changes During the Year

New Investments and Additions to Previous Investments

| | Amount |
|--|--------------|
| | ----- |
| Data Race, Inc..... | \$ 23,684 |
| Rewind Holdings, Inc. | 3,000,000 |
| Texas Petrochemical Holdings, Inc..... | 3,000,000 |
| | ----- |
| | \$ 6,023,684 |
| | ===== |

Dispositions

| | Cost | Amount Received |
|--|--------------|--------------------|
| | ----- | ----- |
| Cherokee Communications, Inc..... | \$ 2,400,000 | \$ 10,113,939 |
| Columbia Scientific Industries Corporation | 0 | 23,551 |
| Data Race, Inc..... | 1,219,369 | 4,040,090 |
| | ----- | ----- |
| | \$ 3,619,369 | \$ 14,177,580 |
| | ===== | ===== |
| Repayments Received..... | | \$ 1,040,500 |
| | | ===== |

Capital Southwest Corporation and Subsidiary
Consolidated Statements of Financial Condition

| | March 31 | |
|---|---------------|---------------|
| Assets | 1997 | 1996 |
| Investments at market or fair value (Notes 1 and 2) | | |
| Companies more than 25% owned (Cost: 1997 - \$20,552,361, 1996 - \$21,480,361)..... | \$203,399,920 | \$191,043,920 |
| Companies 5% to 25% owned (Cost: 1997 - \$19,979,904, 1996 - \$18,750,404)..... | 35,747,002 | 19,633,672 |
| Companies less than 5% owned (Cost: 1997 - \$19,375,650, 1996 - \$18,313,335)..... | 54,144,104 | 46,252,869 |
| | | |
| Total investments (Cost: 1997 - \$59,907,915, 1996 - \$58,544,100)..... | 293,291,026 | 256,930,461 |
| Cash and cash equivalents..... | 14,009,481 | 67,045,185 |
| Receivables..... | 279,815 | 285,002 |
| Other assets (Note 8)..... | 3,180,171 | 2,711,802 |
| | | |
| Totals..... | \$310,760,493 | \$326,972,450 |
| | ===== | ===== |

| | March 31 | |
|--|---------------|---------------|
| Liabilities and Shareholders' Equity | 1997 | 1996 |
| Note payable to bank (Note 4) | - | \$ 50,000,000 |
| Accrued interest and other liabilities (Note 8) | 1,735,372 | 1,669,839 |
| Income taxes payable..... | 3,184,373 | 6,050,730 |
| Deferred income taxes (Note 3)..... | 81,868,628 | 69,204,128 |
| Subordinated debentures (Note 5)..... | 5,000,000 | 11,000,000 |
| | | |
| Total liabilities | 91,788,373 | 137,924,697 |
| | | |
| Shareholders' equity (Notes 3 and 6) | | |
| Common stock, \$1 par value: authorized, 5,000,000 shares; issued, 4,204,416 shares at March 31, 1997, and March 31, 1996..... | 4,204,416 | 4,204,416 |
| Additional capital..... | 4,813,121 | 4,813,121 |
| Undistributed net investment income..... | 4,804,205 | 4,490,374 |
| Undistributed net realized gain on investments..... | 60,113,568 | 53,307,782 |
| Unrealized appreciation of investments - net of deferred income taxes..... | 152,070,112 | 129,265,362 |
| Treasury stock - at cost (437,365 shares)..... | (7,033,302) | (7,033,302) |
| | | |
| Net assets at market or fair value, equivalent to \$58.13 per share at March 31, 1997, and \$50.18 per share at March 31, 1996, on the 3,767,051 shares outstanding..... | 218,972,120 | 189,047,753 |
| | | |
| Totals..... | \$310,760,493 | \$326,972,450 |
| | ===== | ===== |

See Notes to Consolidated Financial Statements

Capital Southwest Corporation and Subsidiary

Consolidated Statements of Operations

| | Years Ended March 31 | | |
|---|----------------------|--------------|--------------|
| | 1997 | 1996 | 1995 |
| Investment income (Note 9): | | | |
| Interest..... | \$ 1,371,802 | \$ 2,018,308 | \$ 1,952,557 |
| Dividends..... | 2,774,321 | 3,597,004 | 2,629,384 |
| Management and directors' fees..... | 586,900 | 561,950 | 523,750 |
| | 4,733,023 | 6,177,262 | 5,105,691 |
| Operating expenses: | | | |
| Interest..... | 634,667 | 1,700,003 | 1,394,266 |
| Salaries..... | 1,147,294 | 1,112,640 | 913,555 |
| Net pension expense (benefit) (Note 8)..... | (349,903) | (208,701) | (241,430) |
| Other operating expenses..... | 599,578 | 642,955 | 541,243 |
| | 2,031,636 | 3,246,897 | 2,607,634 |
| Income before income taxes..... | 2,701,387 | 2,930,365 | 2,498,057 |
| Income tax expense (Note 3)..... | 127,325 | 75,448 | 51,404 |
| Net investment income | \$ 2,574,062 | \$ 2,854,917 | \$ 2,446,653 |
| Proceeds from disposition of investments..... | \$14,177,580 | \$21,470,173 | \$ 1,702,276 |
| Cost of investments sold (Note 1)..... | 3,619,369 | 4,938,933 | 1,483,194 |
| Realized gain on investments before income taxes (Note 9)..... | 10,558,211 | 16,531,240 | 219,082 |
| Income tax expense | 3,752,425 | 5,357,215 | 76,679 |
| Net realized gain on investments..... | 6,805,786 | 11,174,025 | 142,403 |
| Increase in unrealized appreciation of investments before income taxes and distributions..... | 34,996,750 | 54,619,668 | 20,898,731 |
| Increase in deferred income taxes on appreciation of investments (Note 3)..... | 12,192,000 | 15,874,000 | 7,315,000 |
| Net increase in unrealized appreciation of investments before distributions..... | 22,804,750 | 38,745,668 | 13,583,731 |
| Net realized and unrealized gain on investments before distributions..... | \$29,610,536 | \$49,919,693 | \$13,726,134 |
| Increase in net assets from operations before distributions..... | \$32,184,598 | \$52,774,610 | \$16,172,787 |

See Notes to Consolidated Financial Statements

Capital Southwest Corporation and Subsidiary
Consolidated Statements of Changes in Net Assets

| | Years Ended March 31 | | |
|--|----------------------|---------------|---------------|
| | 1997 | 1996 | 1995 |
| Operations | | | |
| Net investment income..... | \$ 2,574,062 | \$ 2,854,917 | \$ 2,446,653 |
| Net realized gain on investments..... | 6,805,786 | 11,174,025 | 142,403 |
| Net increase in unrealized appreciation of investments before distributions..... | 22,804,750 | 38,745,668 | 13,583,731 |
| Increase in net assets from operations before distributions..... | 32,184,598 | 52,774,610 | 16,172,787 |
| Distributions from: | | | |
| Undistributed net investment income..... | (2,260,231) | (2,253,831) | (2,241,031) |
| Undistributed net realized gain on investments..... | - | (153,376) | - |
| Unrealized appreciation of investments..... | - | (9,264,304) | - |
| Capital share transactions | | | |
| Exercise of employee stock options..... | - | 574,750 | 384,750 |
| Increase in net assets..... | 29,924,367 | 41,677,849 | 14,316,506 |
| Net assets, beginning of year..... | 189,047,753 | 147,369,904 | 133,053,398 |
| Net assets, end of year | \$ 218,972,120 | \$189,047,753 | \$147,369,904 |

See Notes to Consolidated Financial Statements

Capital Southwest Corporation and Subsidiary
Consolidated Statements of Cash Flows

| | Years Ended March 31 | | |
|--|----------------------|---------------|---------------|
| | 1997 | 1996 | 1995 |
| Cash flows from operating activities | | | |
| Increase in net assets from operations before distributions..... | \$ 32,184,598 | \$ 52,774,610 | \$ 16,172,787 |
| Adjustments to reconcile increase in net assets from operations before distributions to net cash provided by operating activities: | | | |
| Depreciation and amortization..... | 31,240 | 33,439 | 42,623 |
| Net pension benefit..... | (349,903) | (208,701) | (241,430) |
| Net realized and unrealized gain on investments..... | (29,610,536) | (49,919,693) | (13,793,624) |
| (Increase) decrease in receivables..... | 5,187 | (41,369) | 63,301 |
| (Increase) decrease in other assets..... | (17,812) | 28,950 | (18,354) |
| Increase (decrease) in accrued interest and other liabilities..... | (66,361) | 48,075 | 7,092 |
| Deferred income taxes..... | 122,500 | 72,640 | 84,500 |
| Net cash provided by operating activities..... | 2,298,913 | 2,787,951 | 2,316,895 |
| Cash flows from investing activities | | | |
| Proceeds from disposition of investments..... | 14,177,580 | 21,470,173 | 1,611,976 |
| Purchases of securities..... | (6,023,684) | (19,406,816) | (9,556,876) |
| Maturities of securities..... | 1,040,500 | 5,515,824 | 574,625 |
| Income taxes paid on realized gain on investments..... | (6,268,782) | - | - |
| Net cash provided (used) by investing activities..... | 2,925,614 | 7,579,181 | (7,370,275) |
| Cash flows from financing activities | | | |
| Increase (decrease) in note payable to bank..... | (50,000,000) | 50,000,000 | (75,000,000) |
| Repayment of subordinated debentures..... | (6,000,000) | - | (4,000,000) |
| Distributions from undistributed net investment income..... | (2,260,231) | (2,253,831) | (2,241,031) |
| Distributions from undistributed net realized gain on investments..... | - | (15,842) | - |
| Proceeds from exercise of employee stock options..... | - | 574,750 | 384,750 |
| Net cash provided (used) by financing activities..... | (58,260,231) | 48,305,077 | (80,856,281) |
| Net increase (decrease) in cash and cash equivalents..... | (53,035,704) | 58,672,209 | (85,909,661) |
| Cash and cash equivalents at beginning of year..... | 67,045,185 | 8,372,976 | 94,282,637 |
| Cash and cash equivalents at end of year..... | \$ 14,009,481 | \$ 67,045,185 | \$ 8,372,976 |
| Supplemental disclosure of cash flow information: | | | |
| Cash paid during the year for: Interest..... | \$ 691,397 | \$ 1,653,277 | \$ 1,419,883 |
| Income taxes..... | \$ 6,270,291 | \$ 483 | \$ 15,049 |

Supplemental disclosure of financing activities:

On July 31, 1995, Capital Southwest Corporation distributed to its shareholders 940,184 shares of common stock of Palm Harbor Homes, Inc., which had a cost of \$137,534 and a fair market value of \$10.00 per share, or \$9,401,838, as adjusted for a 5-for-4 stock split on August 2, 1996.

See Notes to Consolidated Financial Statements

1. Summary of Significant Accounting Policies

Capital Southwest Corporation ("CSC") is a business development company subject to regulation under the Investment Company Act of 1940. Capital Southwest Venture Corporation ("CSVC"), a wholly-owned subsidiary of CSC, is a Federal licensee under the Small Business Investment Act of 1958. The following is a summary of significant accounting policies followed in the preparation of the consolidated financial statements of CSC and CSVC (together, the "Company"):

Principles of Consolidation. The consolidated financial statements have been prepared on the value method of accounting in accordance with generally accepted accounting principles for investment companies. All significant intercompany accounts and transactions have been eliminated in consolidation.

Cash and Cash Equivalents. All temporary cash investments having a maturity of three months or less when purchased are considered to be cash equivalents.

Portfolio Security Valuations. Investments are stated at market or fair value determined by the Board of Directors as described in the Notes to Portfolio of Investments and Note 2 below. The average cost method is used in determining cost of investments sold.

2. Valuation of Investments

The consolidated financial statements as of March 31, 1997 and 1996 include securities valued at \$257,914,916 (88% of the value of the consolidated investment portfolio) and \$223,234,086 (87% of the value of the consolidated investment portfolio), respectively, whose values have been determined by the Board of Directors in the absence of readily ascertainable market values. Because of the inherent uncertainty of valuation, these values may differ significantly from the values that would have been used had a ready market for the securities existed, and the differences could be material.

3. Income taxes

For the tax years ended December 31, 1996, 1995 and 1994, CSC and CSVC qualified to be taxed as regulated investment companies ("RICs") under applicable provisions of the Internal Revenue Code. As RICs, CSC and CSVC must distribute at least 90% of their taxable net investment income (investment company taxable income) and may either distribute or retain their taxable net realized gain on investments (capital gains). Both CSC and CSVC intend to meet the applicable qualifications to be taxed as RICs in future years; however, either company's ability to meet certain portfolio diversification requirements of RICs in future years may not be controllable by such company.

No provision was made for Federal income taxes on the investment company taxable income of CSC and CSVC for the 1997, 1996 and 1995 fiscal years. Such income was distributed to shareholders in the form of cash dividends for which CSC and CSVC receive a tax deduction. With respect to net investment income, the income tax expense for each of the three years ended March 31, 1997 includes a deferred tax provision related to the net pension benefit.

With respect to the net increase in unrealized appreciation of investments before distributions during fiscal 1996, the increase in deferred income taxes on appreciation of investments at the Federal statutory rate of 35% differs from the amounts reported in the financial statements due to the distribution of appreciated securities with no associated tax liability.

CSC and CSVC may not qualify or elect to be taxed as RICs in future years. Therefore, consolidated deferred Federal income taxes of \$81,313,000 and \$69,121,000 have been provided on net unrealized appreciation of investments of \$233,383,111 and \$198,386,361 at March 31, 1997 and 1996, respectively. Such appreciation is not included in taxable income until realized. Deferred income taxes on net unrealized appreciation of investments have been provided at the then currently effective maximum Federal corporate tax rate on capital gains of 35% at March 31, 1997 and 1996.

4. Notes Payable to Bank

The Company has an unsecured \$15,000,000 revolving line of credit, all of which was available at March 31, 1997. The revolving line of credit bears interest at the bank's base rate less .50%, and matures on July 31, 1997. The note payable to bank at March 31, 1996 was an unsecured note with interest payable at 6.24%. The note was paid in full on April 1, 1996.

5. Subordinated Debentures

The subordinated debentures, payable to others and guaranteed by the Small Business Administration ("SBA"), are as follows:

| | March 31 | |
|-------------------------|--------------|---------------|
| | ----- | ----- |
| | 1997 | 1996 |
| | ---- | ---- |
| 8.75%, due in 1996..... | \$ - | \$ 6,000,000 |
| 8.00%, due in 2002..... | 5,000,000 | 5,000,000 |
| | ----- | ----- |
| Total | \$ 5,000,000 | \$ 11,000,000 |
| | ===== | ===== |

6. Employee Stock Option Plan

Under the 1984 Incentive Stock Option Plan, options to purchase 90,000 shares at prices ranging from \$23.25 to \$39.1875 per share (the adjusted market prices at the time of grant) were outstanding at March 31, 1997. Options on 53,825 shares were exercisable at March 31, 1997. During the year ended March 31, 1997, no options were exercised. Outstanding options expire 2000 through 2003. The 1984 Incentive Stock Option Plan expired in 1994 and no options have been authorized or granted since that date. At March 31, 1997 and 1996, the dilution of net assets per share arising from options outstanding was not material.

7. Employee Stock Ownership Plan

The Company and one of its wholly-owned subsidiaries sponsor a qualified employee stock ownership plan ("ESOP") in which certain employees participate. Contributions to the plan, which are invested in Company stock, are made at the discretion of the Company's Board of Directors. A participant's interest in contributions to the ESOP fully vests after five years of active service. During the three years ended March 31, the Company made contributions to the ESOP, which were charged against net investment income, of \$54,104 in 1997, \$76,341 in 1996 and \$19,338 in 1995.

8. Retirement Plan

The Company sponsors a defined benefit pension plan which covers its employees and employees of certain of its wholly-owned subsidiaries. The following information about the plan represents amounts and information related to the Company's participation in the plan and is presented as though the Company sponsored a single-employer plan. Benefits are based on years of service and an average of the highest five consecutive years of compensation during the last ten years of employment. The funding policy of the plan is to contribute annual amounts that are currently deductible for tax reporting purposes. No contribution was made to the plan during the three years ended March 31, 1997.

Components of net pension benefit related to the qualified plan include the following:

| | Years Ended March 31 | | |
|--|----------------------|--------------|--------------|
| | ----- | ----- | ----- |
| | 1997 | 1996 | 1995 |
| | ---- | ---- | ---- |
| Service cost - benefits earned during the year..... | \$ 47,662 | \$ 42,184 | \$ 36,661 |
| Interest cost on projected benefit obligation..... | 174,792 | 165,906 | 148,318 |
| Actual return on assets..... | (961,831) | (1,421,745) | (94,881) |
| Net amortization and deferral.... | 257,580 | 873,696 | (469,483) |
| | ----- | ----- | ----- |
| Net pension expense (benefit) from qualified plan..... | \$(481,797) | \$ (339,959) | \$ (379,385) |
| | ===== | ===== | ===== |

The following table sets forth the plan's funded status and amounts recognized in the Company's consolidated statements of financial condition:

| | March 31 | |
|---|---------------|----------------|
| | ----- | ----- |
| | 1997 | 1996 |
| | ---- | ---- |
| Actuarial present value of benefit obligations: Accumulated benefit obligation, including vested benefits of \$2,017,257 in 1997 and \$2,002,992 in 1996..... | \$(2,082,399) | \$ (2,056,275) |
| | ===== | ===== |
| Projected benefit obligation for service rendered to date..... | \$(2,376,257) | \$ (2,289,114) |
| Plan assets at fair value*..... | 7,820,401 | 6,927,656 |
| | ----- | ----- |
| Excess of plan assets over the projected benefit obligation..... | 5,444,144 | 4,638,542 |
| Unrecognized net gain from past experience different from that assumed and effects of changes in assumptions..... | (1,819,422) | (1,418,507) |
| Prior service costs not yet recognized..... | (39,719) | (42,998) |
| Unrecognized net assets being amortized over 19 years..... | (590,632) | (664,463) |
| | ----- | ----- |
| Prepaid pension cost included in other asset | \$ 2,994,371 | \$ (2,512,574) |
| | ===== | ===== |

*Primarily equities and bonds including approximately 29,200 shares of common stock of the Company.

The weighted-average discount rate and rate of increase in future compensation levels used in determining the actuarial present value of the projected benefit obligation were 8.0% and 5.0%, respectively, at March 31, 1997, 7.75% and 5.25%, respectively, at March 31, 1996 and 8.0% and 5.5%, respectively, at March 31, 1995. The expected long-term rate of return used to project estimated earnings on plan assets was 8.5% for the years ended March 31, 1997, 1996 and 1995. The calculations also assume retirement at age 65, the normal retirement age.

The Company also sponsors an unfunded Retirement Restoration Plan, which is a nonqualified plan that provides for the payment, upon retirement, of the difference between the maximum annual payment permissible under the qualified retirement plan pursuant to Federal limitations and the amount which would otherwise have been payable under the qualified plan.

The following table sets forth the status of the Retirement Restoration Plan and the amounts recognized in the consolidated statements of financial condition:

| | March 31 | |
|--|---------------|---------------|
| | ----- | ----- |
| | 1997 | 1996 |
| | ---- | ---- |
| Projected benefit obligation..... | \$(1,474,701) | \$(1,465,570) |
| Unrecognized net (gain) loss from past experience different from that assumed and effects of changes in assumptions..... | (11,453) | 91,477 |
| Unrecognized net obligation..... | 79,322 | 99,155 |
| | ----- | ----- |
| Accrued pension cost included in other liabilities | \$(1,406,832) | \$(1,274,938) |
| | ===== | ===== |

The expenses recognized during the years ended March 31, 1997, 1996 and 1995 of \$131,894, \$131,258 and \$137,955, respectively, are offset against the net pension benefit from the qualified plan.

9. Sources of Income

Income was derived from the following sources:

| Years Ended March 31 1997 | Investment Income | | Other Income | Realized Gain (Loss) on Investments Before Income Taxes |
|---|--------------------|--------------------|------------------|---|
| | Interest | Dividends | | |
| ----- | | | | |
| Companies more than 25% owned..... | \$ 237,600 | \$2,454,895 | \$531,400 | \$ - |
| Companies 5% to 25% owned..... | - | - | 55,500 | 2,844,272 |
| Companies less than 5% owned..... | 496,847 | 319,426 | - | 7,713,939 |
| Other sources, including temporary investments..... | 637,355 | - | - | - |
| | ----- | ----- | ----- | ----- |
| | <u>\$1,371,802</u> | <u>\$2,774,321</u> | <u>\$586,900</u> | <u>\$10,558,211</u> |
| | ===== | ===== | ===== | ===== |
| 1996 | | | | |
| ----- | | | | |
| Companies more than 25% owned..... | \$ 755,146 | \$3,101,219 | \$545,200 | \$ - |
| Companies 5% to 25% owned..... | 2,730 | - | 16,750 | 17,954,600 |
| Companies less than 5% owned..... | 568,915 | 495,785 | - | (1,423,360) |
| Other sources, including temporary investments..... | 691,517 | - | - | - |
| | ----- | ----- | ----- | ----- |
| | <u>\$2,018,308</u> | <u>\$3,597,004</u> | <u>\$561,950</u> | <u>\$16,531,240</u> |
| | ===== | ===== | ===== | ===== |
| 1995 | | | | |
| ----- | | | | |
| Companies more than 25% owned..... | \$ 661,252 | \$2,269,312 | \$501,500 | \$ - |
| Companies 5% to 25% owned..... | 2,083 | - | 22,250 | 774,943 |
| Companies less than 5% owned..... | 618,073 | 360,072 | - | (408,506) |
| Other sources, including temporary investments..... | 671,149 | - | - | (147,355) |
| | ----- | ----- | ----- | ----- |
| | <u>\$1,952,557</u> | <u>\$2,629,384</u> | <u>\$523,750</u> | <u>\$ 219,082</u> |
| | ===== | ===== | ===== | ===== |

10. Summarized Financial Information of Unconsolidated Subsidiaries

The Company has three significant wholly-owned subsidiaries - The RectorSeal Corporation, The Whitmore Manufacturing Company and Skylawn Corporation which are neither investment companies nor business development companies. Accordingly, the accounts of such subsidiaries are not included with those of the Company. Summarized combined financial information of the three subsidiaries is as follows:

(all figures in thousands)

| | March 31 | | | |
|---|----------|----------|----------|----------|
| | 1997 | | | 1996 |
| | ----- | | | ----- |
| Condensed Balance Sheet Data | | | | |
| Assets | | | | |
| Cash and temporary investments..... | \$11,240 | | | \$11,444 |
| Receivables..... | 22,762 | | | 20,517 |
| Inventories..... | 32,825 | | | 31,209 |
| Property, plant and equipment..... | 19,252 | | | 15,910 |
| Other assets..... | 11,553 | | | 12,238 |
| | ----- | | | ----- |
| Totals..... | \$97,632 | | | \$91,318 |
| | ===== | | | ===== |
| Liabilities and Shareholder's Equity | | | | |
| Long-term debt..... | \$ 681 | | | \$ 2,092 |
| Other liabilities..... | 11,486 | | | 10,533 |
| Shareholder's equity..... | 85,465 | | | 78,693 |
| | ----- | | | ----- |
| Totals..... | \$97,632 | | | \$91,318 |
| | ===== | | | ===== |
| Condensed Statements of Income | | | | |
| | 1997 | 1996 | 1995 | |
| | ----- | ----- | ----- | |
| Revenues..... | \$76,021 | \$69,058 | \$63,987 | |
| Costs and operating expenses..... | \$67,088 | \$60,050 | \$56,373 | |
| Net income..... | \$ 7,909 | \$ 6,865 | \$ 6,186 | |

11. Commitments and Contingencies

The Company leases office space under an operating lease which requires base annual rentals of \$44,285 through February 1998 and provides one five-year renewal option subject to certain rental escalations. For the three years ended March 31, total rental expense charged to investment income was \$43,844 in 1997, \$43,449 in 1996 and \$42,754 in 1995.

Selected Per Share Data and Ratios

| | Years Ended March | | | | |
|--|-------------------|---------|---------|---------|---------|
| | 1997 | 1996 | 1995 | 1994 | 1993 |
| Investment income..... | \$ 1.26 | \$ 1.64 | \$ 1.37 | \$ 1.48 | \$ 1.34 |
| Operating expenses..... | (.37) | (.41) | (.32) | (.30) | (.37) |
| Interest expense..... | (.17) | (.45) | (.37) | (.39) | (.37) |
| Income taxes..... | (.03) | (.02) | (.01) | (.02) | (.01) |
| Net investment income..... | .69 | .76 | .67 | .77 | .59 |
| Distributions from undistributed net investment income..... | (.60) | (.60) | (.60) | (.60) | (.60) |
| Net realized gain (loss) on investments..... | 1.81 | 2.97 | .04 | (.13) | 1.39 |
| Distributions from undistributed net realized gain on investments..... | - | (.04) | - | - | - |
| Net increase in unrealized appreciation of investments before distributions... | 6.05 | 10.28 | 3.64 | 3.00 | 2.32 |
| Distributions from unrealized appreciation of investments..... | - | (2.46) | - | - | - |
| Exercise of employee stock options*..... | - | (.19) | (.10) | (.22) | (.22) |
| Increase in net asset value..... | 7.95 | 10.72 | 3.65 | 2.82 | 3.48 |
| Net asset value: | | | | | |
| Beginning of year..... | 50.18 | 39.46 | 35.81 | 32.99 | 29.51 |
| End of year..... | \$58.13 | \$50.18 | \$39.46 | \$35.81 | \$32.99 |
| Ratio of operating expenses to average net assets..... | .7% | .9% | .9% | .9% | 1.2% |
| Ratio of net investment income to average net assets..... | 1.2% | 1.7% | 1.8% | 2.3% | 1.9% |
| Portfolio turnover rate..... | 1.6% | 4.5% | 1.3% | 1.3% | 5.2% |
| Shares outstanding at end of period (000s omitted)..... | 3,767 | 3,767 | 3,735 | 3,715 | 3,681 |

*Net decrease is due to exercise of employee stock options at less than beginning of period net asset value.

Independent Auditors' Report

The Board of Directors and Shareholders of
Capital Southwest Corporation:

We have audited the accompanying consolidated statements of financial condition of Capital Southwest Corporation and subsidiary as of March 31, 1997 and 1996, the portfolio of investments as of March 31, 1997, the related consolidated statements of operations, changes in net assets and cash flows for each of the years in the three-year period ended March 31, 1997 and the selected per share data and ratios for each of the years in the five-year period ended March 31, 1997. These financial statements and per share data and ratios are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements and per share data and ratios based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements and per share data and ratios are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. Our procedures included verification of securities owned as of March 31, 1997 and 1996, by examination of such securities held by the custodian. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion the consolidated financial statements and selected per share data and ratios referred to above present fairly, in all material respects, the financial position of Capital Southwest Corporation and subsidiary as of March 31, 1997 and 1996, and the results of their operations, the changes in their net assets and their cash flows for each of the years in the three-year period ended March 31, 1997 and the selected per share data and ratios for each of the years in the five-year period ended March 31, 1997, in conformity with generally accepted accounting principles.

KPMG PEAT MARWICK LLP

Dallas, Texas
April 25, 1997

Management's Discussion and Analysis
Financial Condition and Results of Operations

Results of Operations

The composite measure of the Company's financial performance in the Consolidated Statements of Operations is captioned "Increase in net assets from operations before distributions" and consists of three elements. The first is "Net investment income", which is the difference between the Company's income from interest, dividends and fees and its combined operating and interest expenses, net of applicable income taxes. The second element is "Net realized gain on investments", which is the difference between the proceeds received from disposition of portfolio securities and their stated cost, net of applicable income tax expense. The third element is the "Net increase in unrealized appreciation of investments before distributions", which is the net change in the market or fair value of the Company's investment portfolio, compared with stated cost, net of an increase or decrease in deferred income taxes which would become payable if the unrealized appreciation was realized through the sale or other disposition of the investment portfolio. It should be noted that the "Net realized gain on investments" and "Net increase in unrealized appreciation of investments before distributions" are directly related in that when an appreciated portfolio security is sold to realize a gain, a corresponding decrease in net unrealized appreciation occurs by transferring the gain associated with the transaction from being "unrealized" to being "realized." Conversely, when a loss is realized on a depreciated portfolio security, an increase in net unrealized appreciation occurs.

Net Investment Income

The Company's principal objective is to achieve capital appreciation. Therefore, a significant portion of the investment portfolio is structured to maximize the potential return from equity participation and provides minimal current yield in the form of interest or dividends. The Company also earns interest income from the short-term investment of cash funds, and the annual amount of such income varies based upon the average level of funds invested during the year and fluctuations in short-term interest rates. During the three years ended March 31, the Company had interest income from temporary cash investments of \$637,000 in 1997, \$687,000 in 1996 and \$667,000 in 1995. The Company also receives management fees from its wholly-owned subsidiaries which aggregated \$506,400 in the year ended March 31, 1997, \$523,200 in the year ended March 31, 1996 and \$480,000 in the year ended March 31, 1995. During the three years ended March 31, 1997, the Company recorded dividend income from the following sources:

| | Years Ended March 31 | | |
|-----------------------------------|----------------------|-------------|-------------|
| | 1997 | 1996 | 1995 |
| | ----- | ----- | ----- |
| Alamo Group Inc. | \$1,064,000 | \$1,064,000 | \$ 984,200 |
| Cherokee Communications, Inc. ... | 108,789 | 144,000 | 180,000 |
| Humac Company..... | - | 208,200 | - |
| The RectorSeal Corporation..... | 940,895 | 1,529,019 | 1,285,112 |
| Skylawn Corporation..... | 450,000 | 300,000 | - |
| Texas Shredder, Inc. | 37,500 | 178,125 | - |
| Other..... | 173,137 | 173,660 | 180,072 |
| | ----- | ----- | ----- |
| | \$2,774,321 | \$3,597,004 | \$2,629,384 |
| | ===== | ===== | ===== |

Total operating expenses, excluding interest expense, decreased by \$149,925 or 9.7% and increased by \$333,526 or 27.5% during the years ended March 31, 1997 and 1996, respectively. Due to the nature of its business, the majority of the Company's operating expenses are related to employee and director compensation, office expenses, legal and accounting fees and the net pension benefit. Interest expense, the majority of which is related to the SBA-guaranteed subordinated debentures, decreased by \$1,065,336 and increased by \$305,737 during the years ended March 31, 1997 and 1996, respectively.

Net Realized Gain on Investments

Net realized gain on investments was \$6,805,786 (after income tax expense of \$3,752,425) during the year ended March 31, 1997, compared with a gain of \$11,174,025 (after income tax expense of \$5,357,215) during 1996 and a gain of \$142,403 (after income tax expense of \$76,679) during 1995. Management does not attempt to maintain a comparable level of realized gains from year to year, but instead attempts to maximize total investment portfolio appreciation. This strategy often dictates the long-term holding of portfolio securities in pursuit of increased values and increased unrealized appreciation, but may at opportune times dictate realizing gains through the disposition of certain portfolio investments.

Net Increase in Unrealized Appreciation of Investments

For the three years ended March 31, the Company recorded an increase in unrealized appreciation of investments before income taxes and distributions of \$34,996,750, \$54,619,668 and \$20,898,731 in 1997, 1996 and 1995, respectively. As explained in the first paragraph of this discussion and analysis, the realization of gains or losses results in a corresponding decrease or increase in unrealized appreciation of investments. Set forth in the following table are the significant increases and decreases in unrealized appreciation (before the related change in deferred income taxes and distributions and excluding the effect of gains or losses realized during the year) by portfolio company for securities held at the end of each year.

| | Years Ended March 31 | | |
|--|----------------------|--------------|-------------|
| | 1997 | 1996 | 1995 |
| Alamo Group Inc..... | \$(6,432,000) | \$ 3,652,000 | \$ 103,000 |
| All Components, Inc..... | 1,000,000 | - | - |
| American Homestar Corporation.. | 550,792 | 3,834,276 | 921,434 |
| Amfibe, Inc..... | 1,400,000 | - | - |
| Data Race, Inc..... | 2,118,317 | (1,905,300) | 920,600 |
| Dennis Tool Company..... | 1,105,000 | (500,000) | - |
| Encore Wire Corporation..... | 9,782,000 | (5,812,000) | 358,250 |
| Lil' Things, Inc..... | (1,835,670) | (2,155,222) | - |
| Mail-Well, Inc. | 6,830,000 | 1,246,990 | - |
| Mylan Laboratories, Inc..... | (785,752) | (21,381) | 1,218,717 |
| PTS Holdings, Inc..... | 4,800,000 | - | - |
| Palm Harbor Homes, Inc..... | 13,372,000 | 39,931,777 | 14,096,600 |
| PETsMART, Inc. | 1,226,663 | 7,059,004 | 1,639,320 |
| The RectorSeal Corporation.... | 7,000,000 | 3,000,000 | 5,300,000 |
| Skylawn Corporation..... | (3,000,000) | 5,000,000 | (7,000,000) |
| Tecnol Medical Products, Inc. . | (321,587) | (275,646) | 1,017,758 |
| Tele-Communications, Inc..... | (1,192,500) | (450,000) | 45,000 |
| Texas Shredder, Inc..... | 250,000 | 1,175,000 | 749,998 |
| The Whitmore Manufacturing Company..... | 1,200,000 | (1,200,000) | (400,000) |

A description of the investments listed above and other material components of the investment portfolio is included elsewhere in this report under the caption "Portfolio of Investments - March 31, 1997."

Deferred Taxes on Unrealized Appreciation of Investments

The Company provides for deferred Federal income taxes on net unrealized appreciation of investments. Such taxes would become payable at such time as unrealized appreciation is realized through the sale or other disposition of those components of the investment portfolio which would result in taxable transactions. At March 31, 1997, consolidated deferred Federal income taxes of \$81,313,000 were provided on net unrealized appreciation of investments of \$233,383,111 compared with deferred taxes of \$69,121,000 on net unrealized appreciation of \$198,386,361 at March 31, 1996. Deferred income taxes at March 31, 1997 and 1996 were provided at the then currently effective maximum Federal corporate tax rate on capital gains of 35%.

Portfolio Investments

During the year ended March 31, 1997, the Company invested \$6,023,684 in various portfolio securities listed elsewhere in this report under the caption "Portfolio Changes During the Year," which also lists dispositions of portfolio securities. During the 1996 and 1995 fiscal years, the Company invested a total of \$19,406,816 and \$9,556,876, respectively.

Financial Liquidity and Capital Resources

At March 31, 1997, the Company had cash and cash equivalents of \$14.0 million. Pursuant to Small Business Administration ("SBA") regulations, cash and cash equivalents of \$11.5 million held by CSVC may not be transferred or advanced to CSC without the consent of the SBA. The Company also has an unsecured \$15,000,000 revolving line of credit, all of which was available at March 31, 1997. Under current SBA regulations and subject to SBA's approval of its credit application, CSVC would be entitled to borrow up to \$43.2 million in addition to the \$5 million presently outstanding. Approximately \$35.4 million of the Company's investment portfolio is represented by unrestricted publicly-traded securities, which have an ascertainable market value and represent a primary source of liquidity.

Funds to be used by the Company for operating or investment purposes may be transferred in the form of dividends, management fees or loans from Skylawn Corporation, The RectorSeal Corporation and The Whitmore Manufacturing Company, wholly-owned subsidiaries of the Company, to the extent of their available cash reserves and borrowing capacities.

Management believes that the Company's cash and cash equivalents are adequate to meet its expected requirements. Consistent with the long-term strategy of the Company, the disposition of investments from time to time may also be an important source of funds for future investment activities.

Impact of Inflation

The Company does not believe that its business is materially affected by inflation, other than the impact which inflation may have on the securities markets, the valuations of business enterprises and the relationship of such valuations to underlying earnings, all of which will influence the value of the Company's investments.

Risks

Pursuant to Section 64(b)(1) of the Investment Company Act of 1940, a business development company is required to describe the risk factors involved in an investment in the securities of such company due to the nature of the company's investment portfolio. Accordingly the Company states that:

The Company's objective is to achieve capital appreciation through investments in businesses believed to have favorable growth potential. Such businesses are often undercapitalized small companies which lack management depth and have not yet attained profitability. The Company's venture investments often include securities which do not yield interest or dividends and are subject to legal or contractual restrictions on resale, which restrictions adversely affect the liquidity and marketability of such securities.

Because of the speculative nature of the Company's investments and the lack of any market for the securities initially purchased by the Company, there is a significantly greater risk of loss than is the case with traditional investment securities. The high-risk, long-term nature of the Company's venture investment activities may prevent shareholders of the Company from achieving price appreciation and dividend distributions.

Selected Consolidated Financial Data
(all figures in thousands except per share data)

| | 1987 | 1988 | 1989 | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 |
|---|-----------|-----------|-----------|-----------|-----------|-----------|-----------|-----------|-----------|-----------|-----------|
| Financial Position (as of March 31) | | | | | | | | | | | |
| Investments at cost..... | \$ 21,241 | \$ 28,478 | \$ 29,665 | \$ 32,212 | \$ 31,593 | \$ 34,929 | \$ 33,953 | \$ 41,993 | \$ 49,730 | \$ 58,544 | \$ 59,908 |
| Unrealized appreciation.... | 65,290 | 89,512 | 97,134 | 99,903 | 107,120 | 100,277 | 113,153 | 132,212 | 153,031 | 198,386 | 233,383 |
| Investments at market or fair value..... | 86,531 | 117,990 | 26,799 | 132,115 | 138,713 | 135,206 | 147,106 | 174,205 | 202,761 | 256,930 | 293,291 |
| Total assets..... | 137,520 | 83,941 | 31,365 | 185,231 | 149,975 | 208,871 | 176,422 | 270,874 | 213,811 | 326,972 | 310,760 |
| Subordinated debentures.... | 16,000 | 15,000 | 15,000 | 15,000 | 15,000 | 11,000 | 15,000 | 15,000 | 11,000 | 11,000 | 5,000 |
| Deferred taxes on unrealized appreciation. | 21,837* | 30,073 | 32,619 | 33,608 | 36,063 | 33,761 | 38,112 | 45,932 | 53,247 | 69,121 | 81,313 |
| Net assets..... | 66,367* | 78,376 | 83,124 | 94,610 | 97,139 | 07,522 | 121,455 | 133,053 | 147,370 | 189,048 | 218,972 |
| Shares outstanding**..... | 3,776 | 3,563 | 3,563 | 3,617 | 3,617 | 3,644 | 3,681 | 3,715 | 3,735 | 3,767 | 3,767 |
| Changes in Net Assets (years ended March 31) | | | | | | | | | | | |
| Net investment income..... | \$ 45 | \$ 22 | \$ 716 | \$ 1,737 | \$ 2,090 | \$ 2,363 | \$ 2,189 | \$ 2,870 | \$ 2,447 | \$ 2,855 | \$ 2,574 |
| Net realized gain (loss) on investments..... | 8,157 | 497 | 27 | 12,722 | (2,515) | 14,313 | 5,099 | (475) | 142 | 11,174 | 6,806 |
| Net increase (decrease) in unrealized appreciation before distributions.... | 10,105* | 15,986 | 5,075 | 1,780 | 4,762 | (4,541) | 8,524 | 11,160 | 13,584 | 38,746 | 22,804 |
| Increase in net assets from operations before distributions..... | 18,307* | 16,505 | 5,818 | 16,239 | 4,337 | 12,135 | 15,812 | 13,555 | 16,173 | 52,775 | 32,184 |
| Cash dividends paid.... | (425) | (378) | (1,069) | (5,197) | (1,809) | (2,181) | (2,202) | (2,228) | (2,241) | (2,270) | (2,260) |
| Securities dividends.... | - | - | - | - | - | - | - | - | - | (9,402) | - |
| Treasury stock acquired. | (2,563) | (4,118) | - | - | - | - | - | - | - | - | - |
| Employee stock options exercised..... | - | - | - | 444 | - | 429 | 322 | 272 | 385 | 575 | - |
| Increase in net assets.. | 15,319* | 12,009 | 4,749 | 11,486 | 2,528 | 10,383 | 13,932 | 11,599 | 14,317 | 41,678 | 29,924 |
| Per Share Data (as of March 31)** | | | | | | | | | | | |
| Deferred taxes on unrealized appreciation... | \$ 5.78* | \$ 8.44 | \$ 9.15 | \$ 9.29 | \$ 9.97 | \$ 9.27 | \$ 10.35 | \$ 12.36 | \$ 14.26 | \$ 18.35 | \$ 21.59 |
| Net assets..... | 17.58* | 22.00 | 23.33 | 26.16 | 26.86 | 29.51 | 32.99 | 35.81 | 39.46 | 50.18 | 58.13 |
| % Increase..... | 36.2% | 25.1% | 6.0% | 12.1% | 2.7% | 9.9% | 11.8% | 8.5% | 10.2% | 27.2% | 15.8% |
| Closing market price..... | 17.50 | 16.75 | 18.25 | 21.375 | 20.75 | 24.25 | 36.50 | 38.125 | 38.00 | 60.00 | 67.875 |
| Cash dividends paid..... | 0.1075 | 0.10 | 0.30 | 1.44 | .50 | .60 | .60 | .60 | .60 | .60 | .60 |
| Securities dividends..... | - | - | - | - | - | - | - | - | - | 2.50 | - |

* Restated on a pro forma basis to reflect a change in method of accounting for deferred income taxes.

** Shares outstanding and per share amounts have been restated to give effect to a two-for-one stock split in September 1987.

Shareholder Information

Stock Transfer Agent

American Stock Transfer & Trust Company, 40 Wall Street, New York, NY 10005 (telephone 800-937-5449) serves as transfer agent for the Company's common stock. Certificates to be transferred should be mailed directly to the transfer agent, preferably by registered mail.

Shareholders

The Company had approximately 900 record holders of its common stock at March 31, 1997. This total does not include an estimated 1,600 shareholders with shares held under beneficial ownership in nominee name or within clearinghouse positions of brokerage firms or banks.

Market Prices

The common stock of Capital Southwest Corporation is traded in the over-the-counter market through the National Association of Securities Dealers Automated Quotation ("Nasdaq") National Market System under the symbol CSWC. The following high and low selling prices for the shares during each quarter of the last two fiscal years were taken from quotations provided to the Company by the National Association of Securities Dealers, Inc.

| Quarter Ended | High | Low |
|-------------------------|--------|----------|
| June 30, 1995..... | \$45 | \$37 3/4 |
| September 30, 1995..... | 45 3/4 | 41 1/2 |
| December 31, 1995..... | 51 1/2 | 44 1/4 |
| March 31, 1996..... | 60 | 50 1/2 |

| Quarter Ended | High | Low |
|-------------------------|--------|----------|
| June 30, 1996..... | \$66 | \$57 1/2 |
| September 30, 1996..... | 73 | 63 1/2 |
| December 31, 1996..... | 72 1/2 | 67 1/4 |
| March 31, 1997..... | 72 | 65 3/8 |

Dividends

The payment dates and amounts of cash dividends per share since April 1, 1995, are as follows:

| Payment Date | Cash Dividend |
|------------------------|---------------|
| May 31, 1995..... | \$0.20 |
| November 30, 1995..... | 0.40 |
| May 31, 1996..... | 0.20 |
| November 29, 1996..... | 0.40 |
| May 30, 1997..... | 0.20 |

The amounts and timing of cash dividend payments have generally been dictated by requirements of the Internal Revenue Code regarding the distribution of taxable net investment income of regulated investment companies.

A dividend of one share of Palm Harbor Homes, Inc. common stock for each five shares of Capital Southwest common stock was paid on July 31, 1995. 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.

Automatic Dividend Reinvestment and Optional Cash Contribution Plan

As a service to its shareholders, the Company offers an Automatic Dividend Reinvestment and Optional Cash Contribution Plan for shareholders of record who own a minimum of 25 shares. The Company pays all costs of administration of the Plan except brokerage transaction fees. Upon request, shareholders may obtain information on the Plan from the Company, 12900 Preston Road, Suite 700, Dallas, Texas 75230 (telephone 972-233-8242).

Annual Meeting

The Annual Meeting of Shareholders of Capital Southwest Corporation will be held on Monday, July 21, 1997, at 10:00 a.m. in the North Dallas Bank Tower Meeting Room (first floor), 12900 Preston Road, Dallas, Texas.

INDEPENDENT AUDITORS' CONSENT

The Board of Directors
Capital Southwest Corporation:

We consent to incorporation by reference in the registration statement (No. 33-43881) on Form S-8 of Capital Southwest Corporation of our report dated April 25, 1997, relating to the consolidated statements of financial condition of Capital Southwest Corporation and subsidiary as of March 31, 1997 and 1996, the portfolio of investments as of March 31, 1997, and the related consolidated statements of operations, changes in net assets and cash flows for each of the years in the three-year period ended March 31, 1997 and the selected per share data and ratios for each of the years in the five-year period ended March 31, 1997, which report appears in the annual report to shareholders for the year ended March 31, 1997 and is incorporated by reference in the annual report on Form 10-K of Capital Southwest Corporation.

KPMG Peat Marwick LLP

Dallas, Texas
June 26, 1997

This schedule contains summary financial information extracted from the Consolidated Statement of Financial Condition at Mach 31, 1997 and the Consolidatd Statement of Operations for the year ended March 31, 1997 and is qualified in its entirety by reference to such financial statements.

0000017313

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USD

| YEAR | MAR-31-1997 | APR-01-1996 | MAR-31-1997 |
|------|-------------|-------------|-------------|
| | | | 1 |
| | 59,907,915 | | |
| | 293,291,026 | | |
| | | 279,815 | |
| | | 3,180,171 | |
| | 14,009,481 | | |
| | | 310,760,493 | |
| | | 0 | |
| | 5,000,000 | | |
| | 86,788,373 | | |
| | | 91,788,373 | |
| | | 0 | |
| | 1,984,235 | | |
| | | 3,767,051 | |
| | | 3,797,051 | |
| | 4,804,205 | | |
| | | 0 | |
| | 60,113,568 | | |
| | | 0 | |
| | 152,070,112 | | |
| | | 218,972,120 | |
| | | 2,774,321 | |
| | | 1,371,802 | |
| | | 586,900 | |
| | | 2,031,636 | |
| | 2,574,062 | | |
| | 6,805,786 | | |
| | 22,804,750 | | |
| | | 32,184,598 | |
| | | 0 | |
| | 2,260,231 | | |
| | | 0 | |
| | | 0 | |
| | | 0 | |
| | | 0 | |
| | 29,924,367 | | |
| | 4,490,374 | | |
| | 53,307,782 | | |
| | | 0 | |
| | | 0 | |
| | | 634,667 | |
| | | 2,031,636 | |
| | | 0 | |
| | 50.18 | | |
| | | .69 | |
| | 7.86 | | |
| | (.60) | | |
| | 0 | | |
| | | 0 | |
| | 58.13 | | |
| | | 0 | |
| | | 0 | |