

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-K

(Mark One)

☒ ANNUAL REPORT UNDER SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934 (FEE REQUIRED)

For the fiscal period ended December 31, 1996

☐ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934 (NO FEE REQUIRED)

Commission File Number 0-19509

EQUUS II INCORPORATED
(Exact name of registrant as specified in its charter)

DELAWARE (State or other jurisdiction of incorporation or organization)	76-0345915 (I.R.S. Employer Identification No.)
2929 Allen Parkway, Suite 2500 HOUSTON, TEXAS	77019 (Zip Code)

Registrant's telephone number, including area code: (713) 529-0900

Securities registered pursuant to Section 12(b) of the Act:

Title of each class -----	Name of each exchange on which registered -----
COMMON STOCK	AMERICAN STOCK EXCHANGE

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

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 ☒ 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 the definitive proxy or information statement incorporated by reference in Part III of this 10-K. ☐

Approximate aggregate market value of common stock held by non-affiliates of the registrant: \$71,678,715, computed on the basis of \$17 per share, closing price of the common stock on the American Stock Exchange, Inc. on February 19, 1997. For purposes of calculating this amount only, all Directors and executive officers of the registrant have been treated as affiliates. There were 4,300,682 shares of the registrant's common stock, \$.001 par value, outstanding as of February 19, 1997. The net asset value of a share at December 31, 1996 was \$24.00.

Documents incorporated by reference: Proxy Statement for 1997 Annual Meeting of Stockholders is incorporated by reference in Part III.

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ITEM 1. BUSINESS.

Equus II Incorporated (the "Fund") is a Delaware corporation and the successor to Equus Investments II, L.P. (the "Partnership" or "Predecessor Entity") pursuant to a reorganization in which all assets and liabilities of the Partnership were transferred to the Fund on July 1, 1992, in exchange for shares of common stock of the Fund (the "Exchange"). References to the Fund are intended to include the Partnership where the context requires. The Fund seeks to achieve capital appreciation principally by making investments in equity and equity-oriented securities issued by privately-owned companies in transactions negotiated directly with such companies ("Portfolio Companies"). The Fund seeks to invest primarily in companies which intend to acquire other businesses, including leveraged buyouts. The Fund may also invest in recapitalizations of existing businesses or special situations from time to time. The Fund's investments in Portfolio Companies consist principally of equity securities such as common and preferred stock, but also include other equity-oriented securities such as debt convertible into common or preferred stock or debt combined with warrants, options or other rights to acquire common or preferred stock. Current income is not a significant factor in the selection of investments. The Fund has elected to be treated as a business development company under the Investment Company Act of 1940 (the "Investment Company Act").

On June 30, 1993, Equus Investments Incorporated ("EQI"), a Delaware corporation and business development company was merged with and into the Fund. Pursuant to the Agreement and Plan of Merger dated March 26, 1993, as amended, (the "Merger"), all outstanding shares of EQI were converted into 0.54 of a share of the Fund's common stock. The Fund issued 1,147,137 shares of common stock, net of 130 shares redeemed in lieu of fractional shares, in connection with the Merger. The Merger of EQI into the Fund was recorded as a "pooling of interests" for financial statement reporting purposes. Accordingly, the financial statements of the Fund included elsewhere herein were restated to include the selected per share data and ratios for the two years ended December 31, 1993.

The Fund has eight directors. Five of such directors are disinterested individuals (the "Independent Directors") as defined by the Investment Company Act. The directors are responsible for providing overall guidance and supervision of the Fund, approving the Fund's investments and valuation procedures and performing various duties imposed on directors of a business development company by the Investment Company Act. Among other things, the Independent Directors supervise the management arrangements for the Fund, the custody arrangements with respect to portfolio securities, the selection of independent public accountants, fidelity bonding and any transactions with affiliates.

The Fund has engaged Equus Capital Management Corporation, a Delaware corporation (the "Management Company"), to provide certain investment management and administrative services to the Fund. Subject to the supervision of the directors, the Management Company performs, or arranges for third parties to perform, the management, administrative, certain investment advisory and other services necessary for the operation of the Fund. The Management Company identifies, evaluates, structures, monitors and disposes of the Fund's investments. The Management Company also manages the Fund's cash and short-term, interest-bearing investments and provides the Fund, at the Management Company's expense, with the office space, facilities, equipment and personnel (whose salaries and benefits are paid by the Management Company) necessary to enable the Fund to conduct its business.

Equus Capital Corporation, a Delaware corporation (the "Sub-Adviser"), is the subordinate investment adviser to the Fund and is responsible for preparing the Fund's quarterly net asset valuations and providing certain investment advice to the Fund.

The Management Company, the Sub-Adviser, their officers and directors and the officers of the Fund are collectively referred to herein as "Management". The Fund's principal office is located at 2929 Allen Parkway, Suite 2500, Houston, Texas 77019-2120, and the telephone number is (713) 529-0900.

INVESTMENT PRACTICES

Substantially all of the net assets of the Fund are invested or committed to be invested in securities of Portfolio Companies. Substantially all amounts not invested in securities of Portfolio Companies are invested in short-term, highly liquid investments consisting of interest-bearing bank accounts, certificates of deposit or securities issued or guaranteed as to interest and principal by the United States or by a person or entity controlled or supervised by and acting as an instrumentality of the government of the United States that have maturities of less than one year from the date of investment or other short-term, highly liquid investments providing, in the opinion of the Management Company, appropriate safety of principal.

The Fund's investments in portfolio securities are usually structured in private transactions negotiated directly with the owner or issuer of the securities acquired. Such securities consist principally of common and preferred stock, but also include other equity-oriented securities such as debt convertible into common or preferred stock or debt combined with warrants, options or other rights to acquire common or preferred stock.

The Fund is concentrating its investment efforts on companies of a type and size that, in management's view, provide opportunities for significant capital appreciation, relative ease of acquisition and disposition, reduced competition for investments and prudent diversification of risk.

The enterprise value of a Portfolio Company typically ranges from \$15,000,000 to \$75,000,000, at the time of the Fund's initial investment. The Fund's initial investment in a Portfolio Company typically ranges from \$2,000,000 to \$7,000,000, depending on the investment. The balance of the purchase price of a Portfolio Company is supplied by debt financing and other equity investors, if necessary.

The Fund is attempting to reduce certain of the risks inherent in private equity-oriented investments by investing in a portfolio of companies involved in different industries. The Fund has limited its initial investment (whether in the form of equity or debt securities, commitments to purchase securities or debt guaranties) in any Portfolio Company to no more than 15% of the Fund's net assets. However, if a follow-on investment is available or required, as discussed below, the Fund's investment in a particular Portfolio Company may exceed these initial investment limitations. Also, investments in certain Portfolio Companies may be in excess of the Fund's initial investment limitations due to increases in the value of such investments.

The Fund may make investments as a sole investor, with other professional investors or with other persons. The Fund ordinarily will not be the sole investor in a Portfolio Company. Joint equity participants may include management of the Portfolio Company, other business development companies, small business investment companies, other institutional or individual investors or venture capital groups. The investment position of the Fund and its co-investors, if any, in Portfolio Companies will typically involve a substantial, and may constitute a controlling, interest in such companies.

The Fund may borrow funds to make new or follow-on investments, to maintain its pass through tax status, or to pay contingencies and expenses. See "Borrowing" and "Loss of Conduit Tax treatment" under "Factors that May Affect Future Results, the Market Price of Common Stock, and the Accuracy of Forward Looking Statements."

INVESTMENT CRITERIA

Prospective investments are evaluated by Management based upon criteria that may be modified from time to time. The criteria currently being used by Management in determining whether to make an investment in a prospective Portfolio Company include:

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1. The presence or availability of competent management;
2. The existence of a substantial market for the products or services of the company characterized by favorable growth potential, or a substantial market position in a stable industry;
3. The existence of a history of profitable operations or a reasonable expectation that operations can be conducted at a level of profitability acceptable in relation to the proposed investment; and
4. The willingness of the company to permit the Fund and its co-investors, if any, to take a substantial position in the company and have representation on its board of directors, so as to enable the Fund to influence the selection of management and basic policies of the company.

CO-INVESTMENTS

The Fund has coinvested in certain Portfolio Companies with Equus Capital Partners, L.P., a Delaware limited partnership and an affiliate of the Fund ("ECP"). The Fund and Management obtained an order from the Securities and Exchange Commission (the "SEC") exempting the Fund from certain prohibitions contained in the Investment Company Act relating to coinvestments by the Fund and ECP. Under the terms of the order, Portfolio Securities purchased by the Fund and ECP were required to meet certain guidelines or be approved in advance by the Independent Directors and were required to satisfy certain conditions established by the SEC.

INVESTMENT OPERATIONS

The investment operations of the Fund consist principally of the following basic activities:

IDENTIFYING INVESTMENTS. Investment opportunities are identified for the Fund by the Management Company, the Sub-Adviser and their respective officers and directors. Investment proposals may, however, come to the Fund from many other sources, and may include unsolicited proposals from the public and referrals from banks, lawyers, accountants and members of the financial community. Subject to the approval of the Board of Directors, the Fund may pay such persons (including affiliates of Management other than directors, officers and employees of the Sub-Adviser and the Management Company) finder's fees to the extent permissible under applicable law and consistent with industry practice.

EVALUATING INVESTMENT OPPORTUNITIES. Prior to committing funds to an investment opportunity, due diligence is conducted to assess the prospects and

risks of the potential investment. See "Investment Criteria" above.

STRUCTURING INVESTMENTS. Portfolio Company investments typically are negotiated directly with the prospective Portfolio Company or its affiliates. The Management Company structures the terms of a proposed investment, including the purchase price, the type of security to be purchased and the future involvement of the Fund and affiliates in the Portfolio Company's business (including representation on its board of directors). The Management Company seeks to structure the terms of the investment so as to provide for the capital needs of the Portfolio Company and at the same time maximize the Fund's opportunities for capital appreciation in its investment.

PROVIDING MANAGEMENT ASSISTANCE AND MONITORING OF INVESTMENTS. Successful private equity investments typically require active monitoring of, and significant participation in, major business decisions of Portfolio Companies. In most cases, officers of the Fund serve as members of the boards of directors of Portfolio Companies. Such management assistance is required of a business development company under the Investment Company Act and is intended to enable the Fund to

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provide guidance and management assistance with respect to such matters as capital structure, budgets, profit goals, diversification strategy, financing requirements, management additions or replacements and development of a public or private market for the securities of the Portfolio Company. In connection with their service as directors of Portfolio Companies, officers and directors of Management may receive and retain directors' fees or reimbursement for expenses incurred, and may participate in incentive stock option plans for non-employee directors, if any. When necessary, the Management Company, on behalf of the Fund, may also assign staff professionals with financial or management expertise to assist Portfolio Company management on specific problems.

CURRENT PORTFOLIO COMPANIES

A. C. LIQUIDATING CORPORATION

A. C. Liquidating Corporation ("ACL"), Houston, Texas, has disposed of its operating businesses and currently holds two parcels of real estate and a note receivable. ACL is offering the real estate for sale and intends to distribute the net proceeds from such sale, collections on the note receivable and its remaining cash to its shareholders as soon as possible. At December 31, 1996, the Fund's investment in ACL consisted of \$188,014 in 10% secured promissory notes and \$488,500 in 10% Series C cumulative preferred stock, and the investment was recorded at no value. Stock held by the Fund represents a 49% fully-diluted equity interest in ACL. Mr. Lehmann, President of the Fund, serves as a director of ACL.

ALLIED WASTE INDUSTRIES, INC. (NASDAQ: AWIN)

Allied Waste Industries, Inc. ("Allied"), Scottsdale, Arizona, is involved in the acquisition and management of solid waste disposal operations. The Company owns or operates 122 collection companies, 41 transfer stations, 53 landfills and 53 recycling facilities located in 22 states. At December 31, 1996, the Fund's investment in Allied, valued at \$11,876,548 with a cost of \$5,109,808, consisted of 1,351,449 shares of common stock valued at an average of \$8.69 per share, and warrants to buy up to 140,000 shares of common stock at prices ranging from \$5.00 to \$13.50 per share. The December 31, 1996 closing price of Allied's common stock on the NASDAQ National Market was \$9.25 per share. Due to restrictions on the Fund's ability to sell a portion of the common stock and warrants, the aggregate value recorded by the Fund was \$1,155,605 less than the aggregate value based on the market price at December 31, 1996. The Fund's investment in Allied represents an approximate 2% fully-diluted equity interest in Allied. Mr. Lehmann serves on Allied's Board of Directors.

AMERICAN RESIDENTIAL SERVICES, INC. (NYSE: ARS)

American Residential Services, Inc. ("ARS"), Houston, Texas, operates businesses which provide heating and air conditioning, plumbing and electrical services to the residential community. The December 31, 1996 closing price of ARS common stock on the New York Stock Exchange was \$27.125 per share. At December 31, 1996, the Fund's investment in ARS, valued at \$25,172,630 with a cost of \$3,057,100, consisted of 1,221,035 shares of restricted common stock valued at an average of \$20.61 per share, and warrants to buy up to 100,000 shares of common stock at \$15 per share. Due to restrictions on the Fund's ability to sell the common stock and warrants, the aggregate value recorded by the Fund was \$9,160,445 less than the aggregate value based on the market price at December 31, 1996. The Fund's investment in ARS represents an approximate 13% fully-diluted equity interest in ARS. Mr. Lehmann and Mr. Hale, a Vice President of the Fund, serve as directors of ARS.

BSI HOLDINGS, INC., AND RELATED ENTITIES

BSI Holdings, Inc. ("BSI"), Cincinnati, Ohio, is a licensed sportswear company with operating facilities in 11 states. BSI sells products to over 10,000 customers, including Wal-Mart, Target and

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JC Penney. At December 31, 1996, the Fund's investment in BSI, valued at \$13,478,500 with a cost of \$6,059,687, consisted of 284,909 shares of common stock, 1,200,000 shares of Series A preferred stock, 3,528,500 shares of 8%

Series B preferred stock and warrants to buy up to 3,991 shares of common stock for \$35 per share. In addition, the Fund has committed to invest, under certain circumstances, up to an additional \$1,000,000 in BSI in connection with its pending merger into Sun Sportswear, Inc. ("Sun"). The stock of Sun is traded on the NASDAQ National Market, and the Fund will receive shares of Sun stock in exchange for its investment in BSI if the merger is completed. The Fund's investment in BSI represents an approximate 49% fully-diluted equity interest. Mr. Lehmann and Mr. Hale serve as directors of BSI.

GCS RE, Inc. ("GCS"), Houston, Texas, was formed to be a general partner of a real estate partnership, which owns a warehouse that is leased to BSI. At December 31, 1996, the Fund's investment in GCS consisted of 1,000 shares of common stock that was valued at \$200,000, with a cost of \$132,910. The Fund owns 100% of the stock of GCS, and GCS owns 50% of the real estate partnership. In addition, the Fund has committed to invest up to an additional \$565,500 in GCS, under certain circumstances. Mr. Douglass, Chairman and CEO of the Fund, and Mr. Lehmann serve on the Board of Directors of GCS.

CARDIOVASCULAR VENTURES, INC.

Cardiovascular Ventures, Inc. ("CVI"), New Orleans, Louisiana, develops and operates freestanding clinics for cardiac catheterization procedures and manages one multi-specialty physicians practice group. CVI currently operates seven clinics in Florida, Louisiana, Maryland and Texas. At December 31, 1996, the Fund's investment in CVI consisted of 150,000, 214,286 and 56,717 shares of Series A, Series B and Series C convertible preferred stock, respectively, valued at \$1,373,138, its original cost. The Fund's investment represents an approximate 8% fully-diluted equity interest in CVI.

CARRUTH-DOGGETT INDUSTRIES, INC.

Carruth-Doggett Industries, Inc. ("CDI"), Houston, Texas, operates five Case Equipment dealerships in the Houston area, which are involved in the sale or rental of new and used equipment, parts and services. Case is the second largest manufacturer of farm equipment in North America and the largest manufacturer of light and medium-sized equipment in the world. At December 31, 1996, the Fund's investment in CDI, valued at its original cost of \$2,250,000, consisted of a \$2,250,000, 10% senior subordinated promissory note, a warrant to buy up to 33,333 shares of CDI for \$.01 per share and a warrant to buy up to 249 shares of CDE Corp., a sister company of CDI that owns the real property leased by CDI, for \$.01 per share. The Fund's investment in CDI represents a 25% fully-diluted equity interest. Mr. Forbes, a Vice President of the Fund, serves on CDI's Board of Directors.

COACH USA, INC. (NASDAQ: TOUR)

Coach USA, Inc. ("Coach"), Houston, Texas, is the largest provider of motor coach charter, tour and sight seeing services and one of the largest non-municipal providers of commuter and transit motor coach services in the United States. The December 31, 1996 closing price of Coach's common stock on the NASDAQ National Market was \$29 per share. At December 31, 1996, the Fund's investment in Coach, valued at \$3,422,503 with a cost of \$1,863,357, consisted of 143,112 shares of restricted common stock valued at an average of \$23.91 per share. Due to restrictions on the Fund's ability to sell the stock, the aggregate value recorded by the Fund was \$727,745 less than the aggregate value based on the market price at December 31, 1996. The Fund's investment in Coach represents an approximate 1% fully-diluted equity interest in Coach.

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DAVID'S SUPERMARKETS, INC.

David's Supermarkets, Inc. ("David's"), Grandview, Texas, operates a chain of twenty-one grocery stores located in small towns in North Central Texas. At December 31, 1996, the Fund's investment in David's, valued at \$3,784,450, with a cost of \$4,069,450, consisted of 735,000 shares of common stock, 333,445 shares of 3.5% junior preferred stock and warrants to buy up to 538,462 shares of common stock for \$1 per share. The Fund's investment in David's represents a 14% fully-diluted equity interest. Mr. Douglass and Mr. Forbes serve on David's Board of Directors.

DRYPERS CORPORATION (NASDAQ: DYPR)

Drypers Corporation ("Drypers"), Houston, Texas, manufactures and distributes disposable diapers and baby wipes sold under the trade name Drypers(R). Drypers is believed to be the third leading branded diaper manufacturer in the United States, and has manufacturing facilities in Marion, Ohio; Vancouver, Washington; Buenos Aires, Argentina; Guadalajara, Mexico; Sao Paulo, Brazil and Puerto Rico. The December 31, 1996 closing price of Drypers' common stock on the NASDAQ National Market was \$3.75 per share. At December 31, 1996, the Fund's investment in Drypers, valued at \$9,396,651 with a cost of \$8,900,132, consisted of 1,096,892 shares of restricted common stock, 25,000 shares of 7.5% convertible preferred stock which is convertible into 2,500,000 shares of common stock and warrants to buy 6,634 shares of common stock for \$4 per share. The common stock equivalents held by the Fund were valued at an average of \$2.61 per share due to restrictions on the Fund's ability to sell such stock, which resulted in an aggregate reduction in value from the market price on such date of \$4,091,694. The Fund's investment in Drypers represents an approximate 21% fully-diluted equity interest in Drypers. Mr. Lehmann and Mr. Forbes serve as directors of Drypers.

GARDEN RIDGE CORPORATION (NASDAQ: GRDG)

Garden Ridge Corporation ("GRDG"), Houston, Texas, is a specialty retailer of crafts and home decorative items. GRDG operates eighteen megastores in seven states and is continuing its expansion into other areas of the United States. The December 31, 1996 closing price of GRDG on the NASDAQ National Market was \$8.625 per share. At December 31, 1996, the Fund's investment in GRDG, valued at \$3,961,380 with a cost of \$685,030, consisted of 474,942 shares of common stock. The stock was valued at an average of \$8.34 per share due to restrictions on the Fund's ability to sell such stock, which resulted in an aggregate reduction in value from the market price on such date of \$134,995. The Fund's investment in GRDG represents an approximate 3% fully-diluted equity interest in GRDG. Mr. Lehmann serves on GRDG's Board of Directors.

HOT & COOL HOLDINGS, INC.

Hot & Cool Holdings, Inc. ("Hot & Cool"), Laredo, Texas, is a manufacturer and distributor of automotive radiators and other heat transfer products. At December 31, 1996, the Fund's investment in Hot & Cool, valued at its original cost of \$1,700,000, consisted of \$1,300,000 in a 9% increasing rate subordinated promissory note, \$400,000 in a 10% subordinated note and warrants to buy up to 14,942 shares of common stock for \$0.01 per share. The Fund's investment represents an approximate 12% fully-diluted equity interest in Hot & Cool. Mr. Lehmann serves on Hot & Cool's Board of Directors.

INDUSTRIAL EQUIPMENT RENTALS, INC.

Industrial Equipment Rentals, Inc. ("IER"), Houma, Louisiana, rents industrial equipment from locations in Texas, Louisiana, Alabama and Mississippi, primarily to refineries, petrochemical plants and oil and gas operations. At December 31, 1996, the Fund's investment in IER, valued at \$3,964,828 with a cost of \$2,366,700, consisted of 182,230 shares of common stock, 5,371 shares of junior preferred stock, 67,500 shares of Series B senior convertible preferred stock, \$1,077,778 in a 12% subordinated debenture and \$499,950 in a 9% senior subordinated debenture. The Fund's

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investment in IER represents a 16% fully-diluted equity interest. Mr. Lehmann and Mr. Hale serve on IER's Board of Directors.

MIDWAY AIRLINES CORPORATION

Midway Airlines Corporation ("Midway"), Chicago, Illinois, is a commercial airline which serves markets on the east coast of the U. S. from its home base at the Raleigh-Durham Airport. At December 31, 1996, the Fund's investment in Midway, valued at \$271,000 with a cost of \$4,214,226, consisted of 452,392 shares of Class C common stock, 274,761 shares of junior preferred stock, \$271,000 in a 12% subordinated note and warrants to buy up to 203,250 shares of Class C common stock for \$0.01 per share. The Fund's investment in Midway represents an approximate 1% fully-diluted equity interest in Midway. Subsequent to December 31, 1996, the Fund sold its investment in Midway for \$278,272 realizing a capital loss of \$3,935,954.

NCI BUILDING SYSTEMS, INC. (NASDAQ: BLDG)

NCI Building Systems, Inc. ("NCI"), Houston, Texas, manufactures and distributes pre-engineered metal buildings and components. NCI operates facilities in Alabama, Indiana, Mississippi, New Mexico, Tennessee and Texas. The December 31, 1996 closing price of NCI's common stock on the NASDAQ National Market was \$34.50 per share. At December 31, 1996, the Fund's investment in NCI consisted of 100,000 shares of common stock valued at \$3,450,000 with a cost of \$159,784, which represents an approximate 1% fully-diluted equity interest in NCI. Mr. Forbes serves as a director of NCI.

PARACELSUS HEALTHCARE CORPORATION (NYSE: PLS)

Paracelsus Healthcare Corporation ("PLS"), Houston, Texas, owns or operates, directly or through hospital partnerships, 31 hospitals and five skilled nursing facilities in 11 states. The December 31, 1996 closing price of PLS's common stock on the New York Stock Exchange was \$3.625 per share. At December 31, 1996, the Fund's investment in PLS, valued at \$4,249,455 with a cost of \$5,278,748, consisted of 1,263,058 shares of common stock. The common stock of PLS was valued by the Fund at an average of \$3.36 per share at December 31, 1996, due to restrictions on the Fund's ability to sell such stock, which resulted in an aggregate reduction in value from the market price on such date of \$329,130. The Fund's investment in PLS represents an approximate 2% fully-diluted equity interest in PLS.

RESTAURANT DEVELOPMENT GROUP, INC.

Restaurant Development Group, Inc. ("RDG"), Houston, Texas, was the South Florida franchisee of Rally's Inc., a drive-through restaurant chain. RDG sold its restaurants to Checkers Drive-in Restaurants, Inc. ("Checkers") in 1994 for 676,751 shares of common stock of Checkers (NASDAQ: CHKR) and a note receivable in the amount of \$1,693,225. During 1996, the Checkers stock was sold and RDG used the proceeds to reduce its debt payable to the Fund. RDG intends to distribute to its shareholders any proceeds from collections on the note receivable. At December 31, 1996, the Fund's investment in RDG, valued at \$908,000 with a cost of \$2,999,156, consisted of 610,909 shares of Class A common stock, \$108,000 in a prime +2% promissory note and warrants to buy up to 62,500 shares of common stock for \$3.00 per share. The Fund's investment represents a 50% fully-diluted equity interest in RDG. Mr. Douglass and Mr. Lehmann serve on RDG's Board of Directors.

SOVEREIGN BUSINESS FORMS, INC.

Sovereign Business Forms, Inc. ("Sovereign"), Houston, Texas, is a manufacturer of wholesale business forms in Texas and Massachusetts. At December 31, 1996, the Fund's investment in Sovereign, valued at its original cost of \$1,300,000, consisted of 7,500 shares of preferred stock,

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\$550,000 in a 15% promissory note and warrants to buy up to 551,894 shares of common stock at \$1 per share. The Fund's investment represents a 30% fully-diluted equity interest in Sovereign. Mr. Forbes serves on Sovereign's Board of Directors.

STRATEGIC HOLDINGS, INC. AND RELATED ENTITY

Strategic Holdings, Inc. ("SHI"), Houston, Texas, was formed to acquire Strategic Materials, Inc., formerly known as Allwaste Recycling, Inc., the glass recycling division of Allwaste, Inc. SHI receives and processes used glass, which is then sold to the container, fiberglass and bead industries as a raw material source. At December 31, 1996, the Fund's investment in SHI was valued at \$6,909,013, its original cost. The Fund's investment in SHI consists of 3,089,751 shares of common stock, 3,822,157 shares of Series B preferred stock, and warrants to buy 225,000 and 100,000 shares of SMI at \$0.4643 and \$1.50 per share, respectively. Mr. Lehmann and Mr. Hale serve as directors of SHI.

SMIP, Inc. ("SMIP"), Houston, Texas, was formed to be the general partner of a limited partnership which owns an 18% fully-diluted interest in SHI. Management personnel of Strategic Materials, Inc. are the limited partners of the partnership. At December 31, 1996, the Fund's investment in SMIP was valued at \$325,000, its original cost. The Fund's investment in SMIP consists of 1,000 shares of common stock and a \$175,000, 15% promissory note. SMIP is wholly-owned by the Fund. Mr. Lehmann and Mr. Hale serve as directors of SMIP.

The Fund's investments in SHI and SMIP represents an approximate 50% fully-diluted equity interest in SHI.

SUMMIT/DPC PARTNERS, L. P.

Summit/DPC Partners, L. P. ("DPC"), Houston, Texas, was formed to invest in DPC Acquisition Corp, which was created to acquire Doane Products Company, which is believed to be the largest manufacturer of private label dry pet food in the United States. At December 31, 1996, the Fund's investment in Summit/DPC was valued at \$2,600,000, its original cost. The Fund's investment consists of an approximate 36% limited partnership interest in DPC, which in turn owns an approximate 17% fully-diluted interest in DPC Acquisition Corp.

TRAVIS INTERNATIONAL, INC.

Travis International, Inc. ("Travis"), Houston, Texas, distributes specialty products for industrial and commercial use, including o-rings, gaskets and sealants, builders' hardware and various other products used in the construction industry. At December 31, 1996, the Fund's investment in Travis, valued at \$3,853,890 with a cost of \$560,290, consisted of 66,784 shares of common stock and 104,500 shares of Class A common stock, which represents an approximate 15% fully-diluted equity interest in Travis. Mr. Lehmann serves as a director of Travis.

VRPI SPIN OFF, INC. AND RELATED ENTITY

VRPI Spin Off, Inc. ("VRS"), Houston, Texas, owns the rights to receive over 50% of all general partner distributions from a limited partnership that has franchise rights to operate 12 BLOCKBUSTER Entertainment Corporation video cassette stores in the Pittsburgh, Pennsylvania area. At December 31, 1996, the Fund's investment in VRS, valued at \$625,000 with a cost of \$250,000, consisted of 100 shares of common stock. VRS is wholly-owned by the Fund. Messrs. Douglass, Lehmann and Dr. Williams, a director of the Fund, serve as directors of VRS and Video Rental of Pennsylvania, Inc. ("VRP"), the managing general partner of the limited partnership.

Equus Video Corporation ("Video"), Houston, Texas, owns an 80% limited partnership interest in a partnership whose sole general partner is a corporation owned by VRP. The limited

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partnership is developing additional BLOCKBUSTER Entertainment Corporation video cassette stores in and around Pittsburgh. At December 31, 1996, the Fund's investment in 10,000 shares of common stock of Video was valued at \$25,000, its original cost. In addition, the Fund has invested \$2,672,349 in a 10% secured promissory note and \$1,050,000 in a 12% promissory note of such partnership. The notes are guaranteed by VRP. Mr. Douglass and Mr. Lehmann serve as directors of Video.

WMW INDUSTRIES, INC.

WMW Industries, Inc. ("WMW"), Houston, Texas, manufactures and distributes wire cloth products and products used in industrial filtering and screening applications in oil and gas production and in water pollution monitoring wells. At December 31, 1996, the Fund's investment in WMW, valued at \$2,240,153 with a cost of \$2,800,632, consisted of 530,035 shares of common stock, \$763,747 in a 12% subordinated promissory note, \$1,012,576 junior participation in a prime +1.5% note and a warrant to buy 72,672 shares of common stock for \$0.01 per

share. The fund's investment in WMW represents an approximate 48% fully-diluted equity interest. Mr. Forbes serves on the Board of Directors of WMW.

TEMPORARY INVESTMENTS

Pending investment in Portfolio Companies, the Fund invests its available funds in interest-bearing bank accounts, money market mutual funds, U.S. Treasury securities and/or certificates of deposit with maturities of less than one year (collectively, "Temporary Investments"). Temporary Investments may also include commercial paper (rated or unrated) and other short-term securities. Temporary Investments constituting cash, cash items, securities issued or guaranteed by the U.S. Treasury or U.S. Government agencies and high quality debt securities (commercial paper rated in the two highest rating categories by Moody's Investor Services, Inc. or Standard & Poor's Corporation, or if not rated, issued by a company having an outstanding debt issue so rated with maturities of less than one year at the time of investment will qualify for determining whether the Fund has 70% of its total assets invested in Managed Companies (as hereafter defined) or in qualified Temporary Investments for purposes of the business development company provisions of the Investment Company Act. See "Regulation" below.

FOLLOW-ON INVESTMENTS

Following its initial investment in a Portfolio Company, the Fund may be requested to make follow-on investments in the company. Follow-on investments may be made to take advantage of warrants or other preferential rights granted to the Fund or otherwise to increase the Fund's position in a successful or promising Portfolio Company. The Fund may also be called upon to provide additional equity or loans needed by a Portfolio Company to implement fully its business plans, to develop a new line of business or to recover from unexpected business problems. The Fund may make follow-on investments in Portfolio Companies from funds on hand or may borrow all or a portion of the funds required to make such follow-on investments.

DISPOSITION OF INVESTMENTS

The method and timing of the disposition of the Fund's portfolio investments is critical to the realization of capital appreciation. The Fund expects to dispose of its portfolio securities through a variety of transactions, including sales of portfolio securities in underwritten public offerings, public sales of such securities pursuant to exemptions from registration requirements and negotiated private sales of such securities to the Portfolio Company itself or to other investors. In addition, the Fund may distribute its portfolio securities in-kind to its shareholders. In structuring investments, the Fund endeavors to reach such agreements or understandings with a prospective Portfolio Company as may be appropriate with respect to the method and timing of the disposition of the Fund's investment and, if appropriate, seeks to obtain registration rights at the expense of the Portfolio Company. The Fund bears the costs of disposing of investments to the extent not paid by the Portfolio Company.

OPERATING EXPENSES

The Management Company, at its expense, provides the Fund with office space, facilities, equipment and personnel (whose salaries and benefits are paid by the Management Company) necessary for the conduct of the Fund's business and pays all costs related to proposed acquisitions of portfolio securities that are not completed, unless such proposed acquisitions have been previously approved by the Board of Directors of the Fund.

The Fund is responsible for paying certain expenses relating to its operations, including: management fees and incentive compensation to the Management Company; fees and expenses of the Independent Directors; finder's fees; direct costs of proposed investments in Portfolio Companies, whether or not completed, if such proposed investments have been approved for acquisition by the Board of Directors of the Fund; depositary fees of unaffiliated depositaries; fees of unaffiliated transfer agents, registrars and disbursing agents; the administrative fee to the Management Company; portfolio transaction expenses; interest; legal and accounting expenses; costs of printing and mailing proxy materials and reports to shareholders; American Stock Exchange fees; custodian fees; litigation costs; costs of disposing of investments including brokerage fees and commissions; and other extraordinary or nonrecurring expenses and other expenses properly payable by the Fund.

VALUATION

On a quarterly basis, the Sub-Adviser performs a valuation of the investments in portfolio securities of the Fund, subject to the approval of the Board of Directors of the Fund. Valuations of portfolio securities are done in accordance with generally accepted accounting principles and the financial reporting policies of the SEC. The applicable methods prescribed by such principles and policies are described below.

The fair value of investments for which no market exists (including most investments made by the Fund) is determined on the basis of procedures established in good faith by the Board of Directors of the Fund. As a general principle, the current "fair value" of an investment being valued by the directors would be the amount the Fund might reasonably expect to receive for it upon its current sale. There is a range of values that are reasonable for such investments at any particular time. Generally, cost is the primary factor used to determine fair value until significant developments affecting the Portfolio

Company (such as results of operations or changes in general market conditions) provide a basis for use of an appraisal valuation.

Appraisal valuations are based upon such factors as the Portfolio Company's earnings, cash flow and net worth, the market prices for similar securities of comparable companies and an assessment of the company's future financial prospects. In the case of unsuccessful operations, the appraisal may be based upon liquidation value. Appraisal valuations are necessarily subjective.

The Fund may also use, when available, third-party transactions in a Portfolio Company's securities as the basis of valuation (the "private market method"). The private market method will be used only with respect to completed transactions or firm offers made by sophisticated, independent investors. Securities with legal, contractual or practical restrictions on transfer may be valued at a discount from their value determined by the foregoing method to reflect such restrictions.

Fund investments for which market quotations are readily available and which are freely transferable are valued as follows: (i) securities traded on a securities exchange or the NASDAQ National Market are valued at the closing price on the date of valuation and (ii) securities traded in the over-the-counter market are valued at the average of the closing bid and asked prices on the date of valuation. For securities which are in a class of public securities but are restricted from free trading (such as Rule 144 stock), valuation is set by discounting the closing sales or bid price to reflect the illiquidity caused by such restrictions. The fair values of debt securities, which are generally held to maturity, are determined on the basis of the terms of the debt securities and the financial condition of

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the issuer. Certificates of deposit purchased by the Fund generally will be valued at their face value, plus interest accrued to the date of valuation.

The Directors review the valuation policies on a quarterly basis to determine their appropriateness and may also hire independent firms to review the Sub-Adviser's methodology of valuation or to conduct an independent valuation.

On a weekly basis, the Fund adjusts its net asset value for the changes in the value of its publicly held securities and material changes in the value of its private securities and reports those amounts to Lipper Analytical Services, Inc. Such weekly net asset values appear in various publications, including BARRON'S and THE WALL STREET JOURNAL.

CUSTODIAN

The Fund acts as the custodian of its securities to the extent permitted under the Investment Company Act and is subject to the restrictions imposed on self-custodians by the Investment Company Act and the rules and regulations thereunder. The Fund has entered into an agreement with NationsBank of Texas, Houston, Texas, with respect to the safekeeping of such securities. The principal business office of such company is 700 Louisiana Street, Suite 3200, Houston, Texas 77002.

TRANSFER AND DISBURSING AGENT

The Fund employs Chase Mellon Shareholders Services ("Chase Mellon") as its transfer agent to record transfers of the shares, maintain proxy records and to process distributions. The principal business office of Chase Mellon is 2323 Bryan Street, Suite 2300, Dallas, Texas 75201.

FACTORS THAT MAY AFFECT FUTURE RESULTS, THE MARKET PRICE OF COMMON STOCK, AND THE ACCURACY OF FORWARD LOOKING STATEMENTS

In the normal course of its business, the Fund, in an effort to keep its stockholders and the public informed about the Fund's operations and portfolio of investments, may from time-to-time issue certain statements, either in writing or orally, that contain or may contain forward-looking information. Generally, these statements relate to business plans or strategies of the Fund or companies in which it invests, projected or anticipated benefits or consequences of such plans or strategies, projected or anticipated benefits of new or follow-on investments made by or to be made by the Fund, or projections involving anticipated purchases or sales of securities or other aspects of the Fund's operating results. Forward looking statements are not guarantees of future performance and are subject to risks and uncertainties that could cause actual results to differ materially. As noted elsewhere in this report, the Fund's operations and portfolio of investments are subject to a number of uncertainties, risks, and other influences, many of which are outside the control of the Fund, and any one of which, or a combination of which, could materially affect the results of the Fund's operations or net asset value, the market price of its common stock, and whether forward-looking statements made by the Fund ultimately prove to be accurate.

The following discussion outlines certain factors that in the future could affect the Fund's results for 1997 and beyond and cause them to differ materially from those that may be set forth in any forward-looking statement made by or on behalf of the Fund:

LONG-TERM OBJECTIVE. The Fund is intended for investors seeking long-term capital growth. The Fund is not meant to provide a vehicle for those who wish to play short-term swings in the stock market. The portfolio securities acquired by

the Fund generally require four to seven years to reach maturity and generally are illiquid. An investment in shares of the Fund should not be considered a complete investment program. Each prospective purchaser should take into account his investment objectives as well as his other investments when considering the purchase of shares of the Fund.

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NON-DIVERSIFIED STATUS; NUMBER OF INVESTMENTS. The Fund is classified as a "non-diversified" investment company under the Investment Company Act, which means the Fund is not limited in the proportion of its assets that may be invested in the securities of a single issuer. Generally, the Fund does not intend to initially invest more than 15% of the value of its assets in a single portfolio company. However, follow-on investments or a disproportionate increase in the value of one portfolio company may result in greater than 15% of the Fund's assets being invested in a single portfolio company. While these restrictions limit the exposure of the capital of the Fund in any single investment, to the extent the Fund takes large positions in the securities of a small number of issuers, the Fund will be exposed to a greater risk of loss and the Fund's net asset value and the market price of its common stock may fluctuate as a result of changes in the financial condition, the stock price of, or in the market's assessment of any single portfolio company to a greater extent than would be the case if it were a "diversified" company holding numerous investments. The Fund currently has investments in 22 portfolio companies, of which three exceed 10% of the value of its net assets.

LEVERAGED PORTFOLIO INVESTMENTS. While leveraged buyout investments and investments in highly leveraged companies offer the opportunity for significant capital gains and current income, such investments involve a high degree of business and financial risk and can result in substantial losses. The Fund's portfolio companies incur substantial indebtedness in connection with leveraged buyout or other highly leveraged transactions. Such indebtedness generally represents from 66% to 90% of the capitalization of a portfolio company. In the event a portfolio company cannot generate adequate cash flow to meet the principal and interest payments on such indebtedness, the Fund's equity investment could be reduced or eliminated through foreclosure on the portfolio company's assets or the portfolio company's reorganization or bankruptcy. A substantial portion of the indebtedness incurred by portfolio companies may bear interest at rates that will fluctuate in accordance with a stated interest rate index or the prime lending rate. The cash flow of a portfolio company may not be sufficient to meet increases in interest payments on its indebtedness. Accordingly, the profitability of the Fund's portfolio companies, as well as appreciation of the investments in such companies, will depend in a significant part upon prevailing interest rates.

LACK OF LIQUIDITY OF PORTFOLIO INVESTMENTS. The portfolio investments of the Fund consist principally of securities that are subject to restrictions on sale because they were acquired from the issuer in "private placement" transactions or because the Fund is deemed to be an affiliate of the issuer. Generally, the Fund will not be able to sell these securities publicly without the expense and time required to register the securities under the Securities Act, and applicable state securities law or unless an exemption from such registration requirements is available. In addition, contractual or practical limitations may restrict the Fund's ability to liquidate its securities in portfolio companies since in most cases the securities of such companies will be privately held and the Fund may own a relatively large percentage of the issuer's outstanding securities. Sales may also be limited by securities market conditions, which may be unfavorable for sales of securities of particular issuers or issuers in particular industries. The above limitations on liquidity of the Fund's securities could preclude or delay any disposition of such securities or reduce the amount of proceeds that might otherwise be realized.

NEED FOR FOLLOW-ON INVESTMENTS IN PORTFOLIO COMPANIES. After its initial investment in a portfolio company, the Fund may be called upon from time to time to provide additional funds to such company or have the opportunity to increase its investment in a successful situation, e.g., the exercise of a warrant to purchase common stock. There is no assurance that the Fund will make, or have sufficient funds to make, follow-on investments. Any decision by the Fund not to make a follow-on investment or any inability on its part to make such an investment may have a negative impact on a portfolio company in need of such an investment or may result in a missed opportunity for the Fund to increase its participation in a successful operation and may dilute the Fund's equity interest in or reduce the expected yield on its investment.

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COMPETITION FOR INVESTMENTS. The Fund encounters competition from other persons or entities with similar investment objectives. These competitors include leveraged buyout partnerships, other business development companies, investment partnerships and corporations, small business investment companies, large industrial and financial companies investing directly or through affiliates, foreign investors of various types and individuals. Some of these competitors may have greater financial resources and more personnel than the Fund and may be subject to different and frequently less stringent regulation.

BORROWING. The Fund may borrow funds to make new or follow-on investments, to maintain its pass-through tax status as a regulated investment company under Subchapter M of the Code or to pay contingencies and expenses. The Fund is permitted under the Investment Company Act to borrow funds if, immediately after the borrowing, it will have an asset coverage of at least 200%. That is, the Fund may borrow funds in an amount up to 50% of the value of its assets (including investments made with borrowed funds). The amount and nature of any Fund borrows will depend upon a number of factors over which the Fund has no

control, including general economic conditions, conditions in the financial markets and the impact of the financing on the tax treatment of the stockholders. The use of leverage, even on a short-term basis, could have the effect of magnifying increases or decreases in the Fund's net asset value. While the "spread" between the current yield on the Fund's investments and the cost of any loan would augment the stockholders' return from the Fund, if the spread narrows (because of an increase in the cost of debt or insufficient income on the Fund's investments), distributions to the stockholders would be adversely affected. If the spread were reversed, the Fund might be unable to meet its obligations to its lenders, which might then seek to cause the Fund to liquidate some or all of its investments. There can be no assurance that the Fund would realize full value for its investments or recoup all of its capital if its portfolio investments were involuntarily liquidated.

The costs of borrowing money may exceed the income from the portfolio securities purchased by the Fund with the borrowed money. The Fund will suffer a decline in net asset value if the investment performance of the additional securities purchased with borrowed money fails to cover their cost to the Fund (including any interest paid on the money borrowed). A decline in net asset value could affect the ability of the Fund to make distributions on the Common Stock. Failure by the Fund to distribute a sufficient portion of its net investment income and net realized capital gains could result in a loss of pass-through tax status or subject the Fund to a 4% excise tax. See "Tax Matters." If the asset coverage for debt securities issued by the Fund declines to less than 200% (as a result of market fluctuations or otherwise), the Fund may be required to sell a portion of its investments when it may be disadvantageous to do so.

Because of the nature and size of its portfolio investments, the Fund borrows money from time to time to make qualifying investments to maintain its tax status under the Code. There can be no assurance that debt financing will be available on terms that the Fund considers to be acceptable and in the best interests of the Fund. If borrowing is unavailable, the Fund may be required to make an untimely disposition of an investment or lose its pass-through tax status. See "Loss of Conduit Tax Treatment" below.

LOSS OF CONDUIT TAX TREATMENT. The Fund may cease to qualify for conduit tax treatment if it is unable to comply with the diversification requirements contained in Subchapter M of the Code. Subchapter M requires that at the end of each quarter (i) at least 50% of the value of the Fund's assets must consist of cash, government securities and other securities of any one issuer that do not represent more than 5% of the value of the Fund's total assets and 10% of the outstanding voting securities of such issuer, and (ii) no more than 25% of the value of the Fund's assets may be invested in the securities of any one issuer (other than United States government securities), or of two or more issuers that are controlled by the Fund and are engaged in the same or similar or related trades or businesses. The Fund will borrow funds if necessary to make qualifying investments to satisfy the foregoing diversification requirements. If the Fund fails to satisfy such diversification requirements and ceases to qualify for conduit tax treatment, the Fund will be subject to income tax on its income and gains and stockholders will be subject to income tax on distributions. The Fund may also cease to qualify for

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conduit tax treatment, or be subject to a 4% excise tax, if it fails to distribute a sufficient portion of its net investment income and net realized capital gains.

MARKET VALUE AND NET ASSET VALUE. The shares of common stock are listed on the AMEX. Shares of closed-end investment companies frequently trade at a discount from net asset value. This characteristic of shares of a closed-end fund is a risk separate and distinct from the risk that the Fund's net asset value will decrease. The risk of purchasing shares of a closed-end fund that might trade at a discount is more pronounced for investors who wish to sell their shares in a relatively short period of time because for those investors, realization of a gain or loss on their investments is likely to be more dependent upon the existence of a premium or discount than upon portfolio performance. The Fund's shares have traded at a discount to net asset value since they began trading. Investors desiring liquidity may trade their shares of common stock on the AMEX at current market value, which may differ from the then current net asset value. For information concerning the trading history of the Fund's shares see "Market for Registrant's Common Stock and Related Stockholder Matters."

VALUATION OF INVESTMENTS. The Fund's net asset value is based on the value assigned to its portfolio investments. Investments in companies whose securities are publicly traded are valued at their quoted market price, less a discount to reflect the estimated effects of restrictions on the sale of such securities, if applicable. The Fund adjusts its net asset value for changes in the value of its publicly held securities on a weekly basis. The value of the Fund's investments in securities for which market quotations are not available is determined at the end of each calendar quarter. Cost is used to approximate fair value of such investments until significant developments affecting an investment provide a basis for use of an appraisal valuation. Thereafter, such portfolio investments are carried at appraised values as determined quarterly. Because of the inherent uncertainty of the valuation of portfolio securities which do not have readily ascertainable market values, the Fund's estimate of fair value may significantly differ from the fair value that would have been used had a ready market existed for the securities. At December 31, 1996, approximately 48% of the Fund's net assets were invested in securities for which market quotations were not readily available.

POSSIBLE VOLATILITY OF STOCK PRICE. The market price of the Fund's common stock could be subject to significant fluctuations in response to variations in the net asset value of the Fund, its quarterly operating results, and other factors. The market price of the common stock may be significantly affected by such factors as the announcement of new or follow-on investments in portfolio companies, the sale or proposed sale of a portfolio investment, the results of operations or fluctuations in the market prices or appraised value of one or more of the Fund's portfolio companies, changes in earnings estimates by market analysts, speculation in the press or analyst community and general market conditions or market conditions specific to particular industries. From time to time in recent years, the securities markets have experienced significant price and volume fluctuations that have often been unrelated or disproportionate to the operating performance of particular companies. These broad fluctuations may adversely affect the market price of the common stock. In addition, the Fund is subject to the risk of the securities markets in which the portfolio securities of the Fund are traded. Securities markets are cyclical and the prices of the securities traded in such markets rise and fall at various times. These cyclical periods may extend over significant periods of time.

REGULATION

The Investment Advisers Act generally prohibits investment advisers from entering into investment advisory contracts with an investment company that provide for compensation to the investment adviser on the basis of a share of capital gains or capital appreciation of the portfolio investments or any portion of the funds of the investment company. The Investment Advisers Act, however, does permit the payment of compensation based on capital gains in an investment advisory contract between an investment adviser and a business development company. The Fund has elected to be treated as a business development company under the Investment Company Act in order to provide for incentive compensation to the Management Company and the Sub-Adviser based on the capital appreciation of the Fund's investments.

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The Fund may not withdraw its election to be treated as a business development company without first obtaining the approval of a majority in interest of its shareholders. The following brief description of the Investment Company Act is qualified in its entirety by reference to the full text of the Investment Company Act and the rules thereunder.

A business development company must be operated for the purpose of investing in the securities of certain present and former "eligible Portfolio Companies" or certain bankrupt or insolvent companies and must make available significant managerial assistance to Portfolio Companies. An eligible Portfolio Company generally is a company that (i) is organized under the laws of, and has its principal place of business in, any state or states, (ii) is not an investment company and (iii) (a) does not have a class of securities registered on an exchange or included in the Federal Reserve Board's over-the-counter margin list, (b) is actively controlled by the business development company acting either alone or as part of a group acting together and an affiliate of the business development company is a member of the Portfolio Company's board of directors or (c) meets such other criteria as may be established by the SEC. Control is presumed to exist where the business development company owns more than 25% of the outstanding voting securities of a Portfolio Company.

"Making available significant managerial assistance" is defined under the Investment Company Act to mean (i) any arrangement whereby a business development company, through its directors, officers or employees, offers to provide and, if accepted, does provide significant guidance and counsel concerning the management, operations or business objectives or policies of a Portfolio Company or (ii) the exercise of a controlling influence over the management or policies of a Portfolio Company by the business development company acting individually or as part of a group of which the business development company is a member acting together which controls such company ("Managed Company"). A business development company may satisfy the requirements of clause (i) with respect to a Portfolio Company by purchasing securities of such a company as part of a group of investors acting together if one person in such group provides the type of assistance described in such clause. However, the business development company will not satisfy the general requirement of making available significant managerial assistance if it only provides such assistance indirectly through an investor group. A business development company need only extend significant managerial assistance with respect to Portfolio Companies which are treated as Qualifying Assets (as defined below) for the purpose of satisfying the 70% test discussed below.

The Investment Company Act prohibits or restricts the Fund from investing in certain types of companies, such as brokerage firms, insurance companies, investment banking firms and investment companies. Moreover, the Investment Company Act limits the type of assets that the Fund may acquire to "Qualifying Assets" and certain assets necessary for its operations (such as office furniture, equipment and facilities) if, at the time of the acquisition, less than 70% of the value of the Fund's total assets consists of qualifying assets. Qualifying Assets include (i) securities of companies that were eligible Portfolio Companies at the time that the Fund acquired their securities; (ii) securities of companies that are actively controlled by the Fund; (iii) securities of bankrupt or insolvent companies that are not otherwise eligible Portfolio Companies; (iv) securities acquired as follow-on investments in companies that were eligible Portfolio Companies at the time of the Fund's initial acquisition of their securities but are no longer eligible Portfolio Companies, provided that the Fund has maintained a substantial portion of its initial investment in such companies; (v) securities received in exchange for or distributed on or with respect to any of the foregoing; and (vi) cash items,

government securities and high-quality, short-term debt. The Investment Company Act also places restrictions on the nature of the transactions in which, and the persons from whom, securities can be purchased in order for such securities to be considered Qualifying Assets. As a general matter, Qualifying Assets may only be purchased from the issuer or an affiliate in a transaction not constituting a public offering. The Fund may not purchase any security on margin, except such short-term credits as are necessary for the clearance of portfolio transactions, or engage in short sales of securities.

The Fund is permitted by the Investment Company Act, under specified conditions, to issue multiple classes of senior debt and a single class of preferred stock senior to the common stock if its asset coverage, as defined in the Investment Company Act, is at least 200% after the issuance of the

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debt or the senior stockholders' interests. In addition, provisions must be made to prohibit any distribution to common shareholders for the repurchase of any shares unless the asset coverage ratio is at least 200% at the time of the distribution or repurchase.

The Fund generally may sell its securities at a price that is below the prevailing net asset value per share only upon the approval of the policy by shareholders holding a majority of the shares issued by the Fund, including a majority of shares held by nonaffiliated shareholders. The Fund may in accordance with certain conditions established by the SEC sell shares below net asset value in connection with the distribution of rights to all of its stockholders.

Since the Fund is a closed-end business development company, stockholders have no right to present their shares to the Fund for redemption. Recognizing the possibility that the Fund's shares might trade at a discount, the Board of Directors of the Fund has determined that it would be in the best interest of stockholders for the Fund to be authorized to attempt to reduce or eliminate a market value discount from net asset value. Accordingly, the Fund from time to time may, but is not required to, repurchase its shares (including by means of tender offers) to attempt to reduce or eliminate any discount or to increase the net asset value of its shares, or both.

The Fund may repurchase its shares, subject to the restrictions of the Investment Company Act. On June 22, 1994, the Fund's Board of Directors approved a stock repurchase program pursuant to which the Fund repurchased and canceled 46,200 shares of its stock for \$640,159 in 1994. Such stock was repurchased at an average discount of 28.74% from its net asset value. From March 1995 until August 1995, pursuant to authorization from the Board of Directors, the Fund repurchased and canceled an additional 145,500 shares of its stock for \$1,993,642. The stock repurchased in 1995 was repurchased at an average discount of 33.61% from its net asset value. There was no stock repurchased in 1996.

Many of the transactions involving the Fund and its affiliates (as well as affiliates of such affiliates) require the prior approval of a majority of the Independent Directors and a majority of the Independent Directors having no financial interest in the transactions. However, certain transactions involving closely affiliated persons of the Fund, including its Sub-Adviser and the Management Company, require the prior approval of the SEC. In general (a) any person who owns, controls or holds with power to vote more than 5% of the outstanding shares, (b) any director or executive officer and (c) any person who directly or indirectly controls, is controlled by or is under common control with such person, must obtain the prior approval of a majority of the Independent Directors and, in some situations, the prior approval of the SEC, before engaging in certain transactions involving the Fund or any company controlled by the Fund. In accordance with the Investment Company Act, a majority of the directors must be persons who are not "interested persons" as defined in such act. Except for certain transactions which must be approved by the Independent Directors, the Investment Company Act generally does not restrict transactions between the Fund and its Portfolio Companies.

ITEM 2. PROPERTIES.

The Fund does not have an interest in any physical properties.

ITEM 3. LEGAL PROCEEDINGS.

The Fund, its affiliates and certain of the Portfolio Companies are involved in asserted claims and have the possibility for unasserted claims which may ultimately affect the net asset value of the Fund or the fair value of the Fund's portfolio investments. In the opinion of Management, the financial position or results of operations of the Fund will not be materially affected by these claims.

On April 1, 1996, an action was filed in federal district court in Houston, Texas by two stockholders of the Fund against the directors of the Fund, the Management Company, and the Fund, as nominal defendant ("Defendants"), asserting that by approving the rights offering the Management

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Company and the directors of the Fund violated their fiduciary duties to the Fund's stockholders under the Investment Company Act of 1940 and Delaware common law, and that the Management Company aided and abetted the breaches of fiduciary duties. The plaintiffs had attempted to have the action certified as a class action on behalf of all of the stockholders of the Fund but did not specify the amount of any damages that have been suffered. The suit was dismissed by the

court in December 1996. The plaintiffs have refiled their case as a derivative action alleging that the Defendants breached their fiduciary duties under Delaware common law and abetted the breaches of fiduciary duties and again did not specify the amount of any damages. The Fund, its directors and the Management Company intend to vigorously defend against this action, and management of the Fund believes that ultimate resolution of such complaint will not have a material adverse effect on the Fund's financial position or results of operations. Through December 31, 1996, the Fund had incurred \$92,336 in expenses related to such action.

ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS.

No matters were submitted to a vote of security holders during the fourth quarter of 1996.

ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY AND RELATED STOCKHOLDER MATTERS.

The Fund's shares of common stock trade on the American Stock Exchange under the symbol "EQS". The Fund had approximately 8,400 shareholders at February 18, 1997, 1,930 of which were registered holders. Registered holders do not include those shareholders whose stock has been issued in street name. The net asset value per share of the Fund's common stock at December 31, 1996, was \$24.00.

The following table reflects the high and low sales prices per share of the Fund's common stock on the American Stock Exchange for the two years ended December 31, 1996, by quarter.

QUARTER ENDED	HIGH	LOW
-----	-----	-----
03/31/95	\$13.125	\$12.250
06/30/95	14.750	12.250
09/30/95	16.000	13.875
12/31/95	15.875	13.000
03/31/96	16.375	13.125
06/30/96	16.250	14.250
09/30/96	16.750	12.250
12/31/96	17.750	15.125

Historically, net investment income and net realized gains from the sale of portfolio investments have been distributed at least annually, to the extent such amounts were not reserved for payment of contingencies or to make follow-on or new investments.

As a regulated investment company under Subchapter M of the Code, the Fund is required to distribute to its shareholders, in a timely manner, at least 90% of its taxable net investment income each year. If the Fund distributes in a timely manner, 98% of its taxable net capital gains and 98% of its taxable net investment income each year (as well as any portion of the respective 2% balances not distributed in the previous year), it will not be subject to the 4% non-deductible Federal excise tax on certain undistributed income of regulated investment companies. Under the Investment Company Act, the Fund is not permitted to pay dividends to shareholders unless it meets certain asset coverage requirements.

The Fund declared dividends of \$3,180,422 (\$0.76 per share), \$5,814,990 (\$2.00 per share) and \$763,268 (\$0.25 per share) during 1996, 1995 and 1994, respectively. The Fund adopted a policy

effective in 1995, to make dividend distributions of at least \$0.50 per share on an annual basis. In the event that taxable income, including realized capital gains, exceeds \$0.50 per share in any year, additional dividends may be declared to distribute such excess. The 1994 dividend was paid in cash and represented a return of capital. The 1996 and 1995 dividends, which represented the Fund's net income for tax purposes, were paid in additional shares of common stock or in cash by specific election of the shareholders in January 1997 and December 1995. The Fund paid \$1,209,850 and \$2,753,180 in cash and issued 115,916 and 231,080 additional shares of stock at \$17 and \$13.25 per share in January 1997 and December 1995, respectively, in connection with such dividends.

The Fund is investing in companies that it believes have a high potential for capital appreciation and the Fund intends to realize the majority of its profits upon the sale of its investments in Portfolio Companies. Consequently, most of the companies in which the Fund invests do not have established policies of paying annual dividends.

A portion of the investments in portfolio securities held by the Fund is comprised of interest-bearing subordinated debt securities or dividend-paying preferred stock. The Fund will continue to distribute taxable net investment income earned on these investments from time to time, to the extent not retained for follow-on investments, expenses and contingencies. If taxable net investment income is retained, the Fund will be subject to Federal income tax.

The Fund reserves the right to retain net long-term capital gains in excess of net short-term capital losses for reinvestment or to pay contingencies and expenses. Such retained amounts, if any, will be taxable to the Fund as long-term capital gains and shareholders will be able to claim their proportionate share of the federal income taxes paid by the Fund on such gains

as a credit against their own federal income tax liabilities. Stockholders will also be entitled to increase the adjusted tax basis of their Fund shares by the difference between their undistributed capital gains and their tax credit.

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ITEM 6. SELECTED FINANCIAL DATA.

Following is a summary of selected financial data and per share data of the Fund and its predecessors for the five years ended December 31, 1996. Amounts in thousands except per share data.

	1996	1995	1994	1993	1992
	-----	-----	-----	-----	-----
Total investment income	\$ 2,590	\$ 3,075	\$ 1,921	\$ 1,552	\$ 1,796
Net investment income (loss)	\$ (8,267)	\$ (668)	\$ 518	\$ (2,813)	\$ (1,403)
		Realized gain (loss) on sales			
of portfolio securities, net	\$ 4,037	\$ 7,669	\$ (350)	\$ (2,458)	\$ 10,744
		Increase (decrease) in			
		unrealized appreciation of			
portfolio securities, net	\$ 33,696	\$ (1,281)	\$ (2,563)	\$ 11,178	\$ (6,034)
		Total increase (decrease) in			
net assets from operations	\$ 29,467	\$ 5,720	\$ (2,395)	\$ 5,907	\$ 3,307
Dividends	\$ 3,180	\$ 5,815	\$ 763	\$ 2,049	\$ 3,228
Total assets at end of year	\$ 181,166	\$ 132,450	\$ 109,941	\$ 114,411	\$ 105,614
Net assets at end of year	\$ 103,223	\$ 61,853	\$ 60,880	\$ 64,679	\$ 59,436
		Net cash used by operating			
activities	\$ (2,494)	\$ (403)	\$ (186)	\$ (1,962)	\$ (325)
		Shares outstanding at end			
of year	4,301	3,139	3,053	3,099	3,013
		Average shares outstanding			
during year	3,819	2,968	3,084	3,013	2,880
Per Share Data:	1996	1995	1994	1993	1992
	-----	-----	-----	-----	-----
		Net investment			
income (loss)	\$ (2.16)	\$ (0.22)	\$ 0.17	\$ (0.93)	\$ (0.49)
		Realized gain (loss) on sales			
of portfolio securities, net ...	\$ 1.06	\$ 2.58	\$ (0.12)	\$ (0.82)	\$ 3.73
		Increase (decrease) in			
		unrealized appreciation of			
portfolio securities, net	\$ 8.82	\$ (0.43)	\$ (0.83)	\$ 3.71	\$ (2.10)
Dividends	\$ 0.76	\$ 2.00	\$ 0.25	\$ 0.68	\$ 1.12
		Net asset value (including			
		unrealized appreciation),			
end of year	\$ 24.00	\$ 19.71	\$ 19.94	\$ 20.87	\$ 19.72

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ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS.

LIQUIDITY AND CAPITAL RESOURCES

At December 31, 1996, the Fund had \$111,059,488 of its assets invested in portfolio securities of 22 companies, and has committed to invest up to an additional \$2,065,500 in four of such companies and \$16,900,000 in four new companies under certain conditions. Current temporary cash investments, anticipated future investment income, proceeds from borrowings, proceeds from the sale of existing portfolio securities and proceeds from future rights offerings of additional common stock are believed to be sufficient to finance these commitments. At December 31, 1996, the Fund had \$300,000 outstanding on a \$20,000,000 revolving line of credit loan from a bank. Subsequent to December 31, 1996, the Fund received a commitment to increase its revolving line of credit to \$30,000,000.

On March 5, 1996, the Fund filed a registration statement with the Securities and Exchange Commission for a rights offering. Under the rights offering, the Fund issued each shareholder of record as of April 10, 1996, one right for each share owned. One share of common stock could be acquired for every three rights. The exercise price for shares in the rights offering was \$12.75 per share, a 19.7% discount from the market price on April 10, 1996. On May 8, 1996, the Fund completed its rights offering, which was over-subscribed. The Fund issued a total of 1,046,191 shares at \$12.75 per share and raised \$13,112,953, net of \$225,982 in expenses. The proceeds from the rights offering were used to repay debt and to fund the commitments the Fund had made for new and follow-on investments.

Net cash used by operating activities was \$2,493,597, \$402,820 and \$185,849 for the three years ended December 31, 1996, respectively. Increased expenses paid during 1996 were primarily due to increases in the management fees and management incentive fees paid to the Management Company.

At December 31, 1996, the Fund had \$69,129,290 of its total assets of \$181,116,399 invested in temporary cash investments consisting of money market securities and commercial paper. This amount includes proceeds from a \$65,000,000 note payable to a bank that is utilized to enable the Fund to achieve adequate diversification to maintain its pass-through tax status as a regulated investment company. Such amount was repaid to the bank on January 2, 1997.

The Fund has the ability to borrow funds and issue forms of indebtedness,

subject to certain restrictions. Net investment income and net realized gains from the sales of portfolio investments are intended to be distributed at least annually, to the extent such amounts are not reserved for payment of contingencies or to make follow-on or new investments.

The Fund reserves the right to retain net long-term capital gains in excess of net short-term capital losses for reinvestment or to pay contingencies and expenses. Such retained amounts, if any, will be taxable to the Fund as long-term capital gains and stockholders will be able to claim their proportionate share of the federal income taxes paid by the Fund on such gains as a credit against their own federal income tax liabilities. Stockholders will also be entitled to increase the adjusted tax basis of their Fund shares by the difference between their undistributed capital gains and their tax credit.

RESULTS OF OPERATIONS

INVESTMENT INCOME AND EXPENSE

Net investment income (loss) after all expenses amounted to \$(8,266,606), \$(668,114) and \$518,473 for the three years ended December 31, 1996. Income from portfolio securities decreased to \$2,455,102 in 1996 as compared to \$2,859,707 in 1995, which increased from \$1,613,414 in 1994.

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Amounts invested in interest and dividend-bearing portfolio securities increased during 1996 and 1995, and the Fund also received a one-time payment of \$593,665 in dividends and payments to induce the Fund to convert preferred stock to common stock of Champion Healthcare Corporation in 1995. In addition, the Fund accrued \$185,850 of interest income on one portfolio security in 1995 which had been completely reserved in 1994 as uncollectible. Interest income from temporary cash investments was \$135,379 in 1996, \$215,527 in 1995 and \$307,722 in 1994. The steady decrease in 1996 and 1995 as compared to 1994 was a result of lower investable balances throughout the year.

The net investment losses in 1996 and 1995 were primarily attributable to the accrual of \$7,546,705 and \$1,277,595, respectively, in current and deferred management incentive fees due to the realized gains from the sales of portfolio securities in 1996 and 1995 and an increase in the net unrealized appreciation of portfolio securities during 1996.

Mailing, printing and other expenses decreased to \$218,982 during 1996 as compared to \$338,434 during 1995 and \$165,330 during 1994, due to the higher cost for the preparation and distribution of the annual report and proxy statement for the annual shareholder's meeting held in June 1995. Interest expense increased to \$582,884 in 1996 as compared to \$318,048 in 1995 and \$135,252 in 1994, due to the increase of the average daily balances outstanding on the lines of credit to \$5,956,570 in 1996, from \$2,839,315 in 1995 and \$994,520 in 1994.

The Management Company receives management fee compensation at an annual rate of 2% of the net assets of the Fund. Such fees amounted to \$1,848,253, \$1,237,775 and \$1,212,457 in 1996, 1995 and 1994, respectively. The increase in 1996 is due to the \$29,466,916 increase in net assets from operations during the year ended December 31, 1996 and the \$13,112,953 in net equity raised in the Fund's rights offering.

The Management Company also receives or must reimburse a management incentive fee equal to 20% of net realized capital gains less unrealized capital depreciation, computed on a cumulative basis over the life of the Fund. Incentive fees of \$1,058,012 were paid during the year ended December 31, 1996. Deferred management incentive fee expense (income) for 1996, 1995 and 1994 totaled \$6,488,693, \$1,277,595 and \$(582,622), respectively. The deferred management incentive fee expense (income) relates to the increase (decrease) in net unrealized appreciation of portfolio securities and will not be paid until such appreciation is realized.

REALIZED GAINS AND LOSSES ON SALES OF PORTFOLIO SECURITIES

During the year ended December 31, 1996, the Fund realized net capital gains of \$4,037,326 from the sale or disposition of securities of seven portfolio companies. The Fund sold 233,044 shares of Allied Waste Industries, Inc. ("AWIN") common stock for \$1,563,678, realizing a capital gain of \$461,919; exchanged 5,000 shares of Enterprises Holding Company preferred stock for \$1,765,243 in cash and 238,933 shares of American Residential Services, Inc. common stock, realizing a capital gain of \$1,765,243; sold 96,000 shares of Garden Ridge Corporation common stock for \$4,719,360 realizing a capital gain of \$4,343,372; was repaid \$350,000 on a note receivable from Restaurant Development Group, Inc. which had a basis of \$275,000, realizing a capital gain of \$75,000; sold 32,789 shares of Tech-Sym Corporation for \$1,029,901, realizing a capital gain of \$911,656; and exchanged \$5,083,083 of notes receivable from Yellow Cab Service Corporation and \$63,601 in cash for 71,440 shares of Coach USA, Inc. common stock, valued at \$1,714,560, realizing a capital loss of \$3,432,124. In addition, the Fund realized a capital loss of \$87,740 on its investment in Sports & Leisure, Inc., which filed for Chapter 11 bankruptcy during February 1996.

During the year ended December 31, 1995, the Fund realized net capital gains of \$7,668,524 from the sale of securities of six Portfolio Companies. The Fund sold 116,590 shares of Allied Waste Industries, Inc. common stock for \$1,049,310, realizing a capital gain of \$490,032; 96,000 shares of Garden Ridge Corporation common stock for \$2,928,000, realizing a capital gain of \$2,906,667; 175,000 shares of NCI Building Systems, Inc. common stock for \$3,064,685,

realizing a capital gain of \$2,785,063; 30,000 shares of Tech-Sym Corporation for \$909,433, realizing a capital gain of

\$801,142 and 49,444 shares of USA Waste Services, Inc. for \$899,218, realizing a capital gain of \$685,620.

During the year ended December 31, 1994, the Fund realized \$350,309 of net capital losses from the sale of its investments in the securities of five Portfolio Companies. During 1994 the Fund sold 37,501 shares of NCI for \$637,517, realizing a net capital gain of \$577,596 on such sale. In addition, the Fund received \$213,944 from the escrow account related to the sale of Denver Technologies, Inc. and received a final payment of \$22,138 related to the sale of Gulf Coast Entertainment Corporation. Such amounts were recorded as capital gains. On July 19, 1994, the Fund sold its investment in MidCon Bottlers, L. P. for \$950,000, realizing a \$910,968 capital gain. The Fund also sold 28 shares of Travis International, Inc. preferred stock for \$28,000 and 5,855 shares of Garden Ridge Corporation common stock for \$5,855, in each case at the Fund's cost. During 1994, a loss of \$2,074,955 on the Fund's investment in Springtime, Inc. I, was realized when Springtime declared bankruptcy.

UNREALIZED APPRECIATION AND DEPRECIATION OF PORTFOLIO SECURITIES

Net unrealized appreciation on investments increased \$33,696,196 during the year ended December 31, 1996, from \$7,975,268 to \$41,671,464. Such net increase resulted from increases in the estimated fair value of securities of eleven of the Fund's Portfolio Companies aggregating \$42,748,672, decreases in the estimated fair value of the securities of four of the Fund's portfolio companies aggregating \$9,264,364, and the transfer of \$211,888 in net unrealized depreciation to net realized gains from the sale of investments in six companies.

Net unrealized appreciation on investments decreased \$1,280,549 during the year ended December 31, 1995, from \$9,255,817 to \$7,975,268. Such net decrease resulted from increases in the estimated fair value of securities of six of the Fund's Portfolio Companies aggregating \$13,601,466, decreases in the estimated fair value of securities of five portfolio Companies aggregating \$10,971,005 and the transfer of \$3,911,010 in net unrealized appreciation to net realized gains from the sale of investments in five companies.

Net unrealized appreciation on investments decreased \$2,562,801 during the year ended December 31, 1994, from \$11,818,618 to \$9,255,817. Such net decrease resulted from increases in the estimated fair value of securities of four of the Fund's Portfolio Companies aggregating \$5,432,740, decreases in the estimated fair value of securities of ten Portfolio Companies aggregating \$9,041,307 and a net transfer of \$1,045,766 from unrealized losses to realized losses from the disposition of investments in three companies.

DIVIDENDS

The Fund declared dividends of \$3,180,422 (\$0.76 per share), \$5,814,990 (\$2.00 per share) and \$763,268 (\$0.25 per share) during 1996, 1995 and 1994, respectively. The Fund has adopted a policy to make dividend distributions of at least \$0.50 per share on an annual basis. In the event that taxable income, including realized capital gains, exceeds \$0.50 per share in any year, additional dividends may be declared to distribute such excess. The 1994 dividend was paid in cash and represented a return of capital. The 1996 and 1995 dividends, which represented the Fund's net investment income and net capital gains for tax purposes, were paid in additional shares of common stock or in cash by specific election of the shareholders in January 1997 and December 1995. The Fund paid \$1,209,850 and \$2,753,180 in cash and issued 115,916 and 231,080 additional shares of stock at \$17 and \$13.25 per share, in January 1997 and December 1995, respectively, in connection with such dividends.

PORTFOLIO INVESTMENTS

During the year ended December 31, 1996, the Fund invested \$9,800,000 in three new Portfolio Companies and made follow-on investments in nine Portfolio Companies of \$10,274,910, including \$435,679 in accrued interest and dividends received in the form of additional portfolio securities and \$750,000 of common stock received through the net exercise of common stock warrants.

On January 2, 1996, the Fund exercised its warrants to acquire 163,044 shares of AWIN on a net exercise basis. This resulted in the Fund receiving 56,054 shares of AWIN valued at \$750,000, which were paid for by tendering the remaining 106,990 shares from such warrants to AWIN. In May 1995, the Fund received 23,751 shares of common stock of AWIN valued at \$144,733, as payment for dividends and inducement for the conversion of preferred stock to common stock.

In January 1996, in connection with the guaranty of \$5,000,000 of BSI Holdings, Inc. ("BSI") debt, the Fund received warrants to acquire up to 22,018 shares of BSI Holdings, Inc. common stock for \$0.01 per share. In 1996, the Fund exercised warrants to buy 118,659 shares of common stock of BSI Holdings, Inc. for \$1,187. On August 9, 1996, the Fund acquired 1,200,000 shares of Series A preferred stock of BSI for \$1,200,000. In connection with such investment, the Fund received warrants to buy up to 31,926 and 3,991 shares of BSI common stock for \$0.01 and \$35 per share, respectively, through August 2006. In addition, on August 9, 1996, the Fund converted its \$3,350,000 senior subordinated debenture and \$178,500 subordinated promissory note into 3,528,500 shares of 8%, Series B

preferred stock of BSI.

In January 1996, the Fund rolled \$86,497 of accrued interest along with \$677,250 from an existing note receivable from WMW Industries, Inc. ("WMW") into a new \$763,747, 12% subordinated promissory note. In addition, in May 1996, the Fund purchased 40,617 shares of Series B convertible preferred stock of WMW for \$67,830. In June 1996, the Fund converted its Series A and Series B convertible preferred stock of WMW into 4,642,452 shares of WMW common stock. WMW then effected a 10 for 1 reverse stock split leaving the Fund with 530,035 shares of WMW common stock.

In February 1996, the Fund acquired 25,000 shares of 7.5% convertible preferred stock of Drypers Corporation for \$2,500,000. The preferred stock is convertible into 2,500,000 shares of common stock of Drypers Corporation.

In March 1996, the Fund acquired 24,810 shares of Series A preferred stock and 190 shares of Series B preferred stock of Enterprises Holding Company ("EHC"), for \$2,481,000 and \$19,000, respectively. On June 30, 1996, the Fund received an additional 571 shares of Series A preferred stock of EHC as payment for \$57,100 in dividends. In addition, the Fund invested \$4,800,000 in a 12% promissory note of EHC. EHC was formed to acquire Crown Services, Inc., a company which provides plumbing, heating and air conditioning and electrical services in Houston, Texas.

During 1996 the Fund advanced an additional \$2,550,000 on a \$2,600,000 prime + 1/4% convertible promissory note to American Residential Services, Inc. ("ARS"), a company formed to acquire existing businesses which provide heating and air conditioning, plumbing and electrical services to the residential community. On September 25, 1996, ARS completed an initial public offering of its common stock. In connection with such offering, ARS acquired EHC and the Fund received \$1,765,243 in cash and 238,933 shares of ARS common stock in exchange for 5,000 shares of its EHC preferred stock. In addition, the Fund received 137,140 shares of ARS common stock in exchange for its remaining 20,571 shares of EHC Series A and B preferred stock. The \$4,800,000 promissory note due from EHC was also repaid in full. The Fund was repaid \$2,100,000 of the \$2,600,000 promissory note. The remaining \$500,000 was converted into 844,962 shares of ARS common stock.

During March 1996, the Fund invested \$1,300,000 in Hot & Cool Holdings, Inc. ("Hot & Cool"), in exchange for a 9% to 12% subordinated promissory note. In addition, the Fund received

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warrants to buy 14,942 shares of common stock of Hot & Cool for \$.01 per share through March 8, 2006. In December 1996, the Fund advanced an additional \$400,000 to Hot & Cool in exchange for a 10% subordinated promissory note. Hot & Cool manufactures automotive radiators and other heat transfer products in South Texas and Mexico.

In March 1996, the Fund committed to invest up to an additional \$1,200,000 in Video Rental of Pennsylvania ("VRP") in exchange for a 12% promissory note. The Fund had advanced \$1,050,000 on such note through December 31, 1996. In April 1996, the Fund rolled \$147,349 of accrued interest into a new \$2,672,349, 10% promissory note due from VRP.

In May 1996, the Fund exchanged \$342,541 of its note receivable from Champion Healthcare Corporation ("CHC") into common stock upon exercise of warrants to buy 45,000 and 5,246 shares of common stock of CHC for \$315,000 and \$27,541, respectively. In August 1996, CHC was merged into Paracelsus Healthcare Corporation ("PLS") and the Fund received one share of Paracelsus common stock for each share of common stock of CHC and two shares of PLS common stock for each share of CHC preferred stock.

On June 28, 1996, Garden Ridge Corporation completed a 2 for 1 split of its common stock.

On August 22, 1996, the Fund acquired 6,500 shares of common stock for \$650,000, invested \$550,000 in a 15% promissory note and obtained warrants to buy up to 551,894 shares of common stock of Sovereign Business Forms, Inc. ("Sovereign") for \$1 per share through August 2006. In October 1996, the Fund acquired an additional 1,000 shares of preferred stock of Sovereign for \$100,000 to enable Sovereign to acquire an additional company. Sovereign, located in Houston, Texas, is a business forms manufacturer.

On August 29, 1996, Coach USA, Inc. acquired Yellow Cab Services Corporation. The Fund received 143,112 shares of Coach USA, Inc. common stock for its investment in Yellow Cab Service Corporation.

In October 1996, the Fund acquired an additional 103,343 shares of common stock and 116,257 shares of Series B preferred stock of Strategic Holdings, Inc. for \$101,981 and \$114,727, respectively.

During the year ended December 31, 1995, the Fund invested \$11,917,308 in five new Portfolio Companies and made follow-on investments in seven Portfolio Companies of \$2,734,411, including \$865,909 in accrued interest and dividends and conversion inducement payments received in the form of additional portfolio securities.

During the year ended December 31, 1994, the Fund made follow-on investments of \$9,532,649 in nine Portfolio Companies.

For a description of the business of each Portfolio Company in which the

Fund has invested, see "Current Portfolio Companies".

Of the companies in which the Fund has investments at December 31, 1996, only ARS, AWIN, Coach USA, Inc., Drypers Corporation, GRDG, NCI Building Systems, Inc. and PLS are publicly-held. The others each have a small number of shareholders and do not generally make financial information available to the public. However, each company's operations and financial information are reviewed by Management to determine the proper valuation of the Fund's investment. See "Valuation".

SUBSEQUENT EVENTS

Subsequent to December 31, 1996, the Fund repaid \$65,300,000 of notes payable to the bank.

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On February 11, 1997, the Fund sold its investment in Midway Airlines Corporation for \$278,272 realizing a capital loss of \$3,935,954.

Subsequent to December 31, 1996, the Fund mailed a proxy statement pertaining to a special meeting of stockholders to be held on March 27, 1997 (the "Special Meeting"), to stockholders of record as of February 18, 1997. At the Special Meeting the stockholders of the Fund will be asked to vote on the following matters:

- (1) The stockholders have been asked to approve and adopt a new management agreement that eliminates any future management incentive fee.
- (2) The stockholders have been asked to authorize the payment to the Management Company of the deferred management incentive fee (\$10,784,028 as of December 31, 1996), in shares of restricted common stock, and
- (3) The stockholders have been asked to approve and adopt a stock incentive plan which permits the issuance of options to purchase common stock of the Fund to the Fund's officers and directors in amounts up to 20% of the outstanding shares of common stock of the Fund.

Implementation of the proposals is contingent on the approval of all three proposals by the stockholders. The adoption of the proposals also will be contingent upon receipt by the Fund and the Management Company of an exemptive order from the Securities and Exchange Commission that permits the proposed payment of the deferred management incentive fee in shares of common stock. The Fund and the Management Company filed an application for such exemptive order on October 10, 1996.

The Board of Directors of the Fund believes the implementation of the proposals will more closely align the interests of the Fund's management with those of the stockholders. In addition, the Fund's expense ratio in periods of net realized gains and unrealized appreciation on its investments will be reduced as a result of no further incentive fee accruals. The total net assets of the Fund would have been increased by \$10,784,028, and the net asset value per share would have been reduced by approximately \$1.05 if all the proposals had been implemented as of December 31, 1996.

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ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA.

Report of Independent Public Accountants

To the Board of Directors of
Equus II Incorporated:

We have audited the accompanying balance sheets of Equus II Incorporated (a Delaware corporation), including the schedules of portfolio securities, as of December 31, 1996 and 1995, and the related statements of operations, changes in net assets and cash flows for each of the three years in the period ended December 31, 1996, and the selected per share data and ratios for each of the five years in the period ended December 31, 1996. These financial statements, selected per share data and ratios are the responsibility of the management of Equus II Incorporated. Our responsibility is to express an opinion on these financial statements, selected 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 selected 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 physical verification or confirmation of securities owned as of December 31, 1996 and 1995. 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.

As discussed in Note 3, the financial statements include investment securities valued at \$107,609,488 (104% of net assets) and \$68,098,481 (110% of net assets) as of December 31, 1996 and 1995, respectively, whose values have been estimated by Equus Capital Corporation (the "Sub-Adviser") and approved by

the Board of Directors of Equus II Incorporated in the absence of readily ascertainable market values. We have reviewed the procedures used by the Sub-Adviser in arriving at their estimates of value of such securities and have inspected the underlying documentation, and in the circumstances we believe the procedures are reasonable and the documentation appropriate. However, because of the inherent uncertainty of valuation, the Sub-Adviser's estimates of values may differ significantly from the values that would have been used had a ready market existed for the securities and the differences could be material.

In our opinion, the financial statements and selected per share data and ratios referred to above present fairly, in all material respects, the financial position of Equus II Incorporated as of December 31, 1996 and 1995, the results of its operations, changes in net assets and cash flows for each of the three years in the period ended December 31, 1996, and the selected per share data and ratios for each of the five years in the period ended December 31, 1996, in conformity with generally accepted accounting principles.

/s/ ARTHUR ANDERSEN LLP
ARTHUR ANDERSEN LLP

Houston, Texas
February 14, 1997

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EQUUS II INCORPORATED
BALANCE SHEETS
DECEMBER 31, 1996 AND 1995

	1996	1995
	-----	-----
ASSETS		
Investments in portfolio securities at fair value (cost of \$69,388,024 and \$63,635,092, respectively)	\$111,059,488	\$ 71,610,360
Temporary cash investments, at cost		
which approximates fair value	69,129,290	60,232,594
Cash	--	7,267
Accounts receivable	1,326	1,326
Accrued interest receivable	897,065	525,939
Commitment fees, net	17,500	37,500
Deferred reorganization costs, net	11,730	35,190
	-----	-----
Total assets	\$181,116,399	\$132,450,176
	-----	-----
LIABILITIES AND NET ASSETS		
Liabilities:		
Accounts payable	\$ 208,231	\$ 242,286
Dividend payable	1,209,850	--
Due to management company	390,982	309,266
Deferred management incentive fees	10,784,028	4,295,335
Notes payable to bank	65,300,000	65,750,000
	-----	-----
Total liabilities	\$ 77,893,091	\$ 70,596,887
	-----	-----
Commitments and contingencies		
Net assets:		
Preferred stock, \$.001 par value, 5,000,000 shares authorized, no shares outstanding	--	--
Common stock, \$.001 par value, 10,000,000 shares authorized, 4,300,682 and 3,138,575 shares		
outstanding, respectively	4,301	3,139
Additional paid-in capital	57,934,306	51,291,676
Undistributed net investment income	--	--
Undistributed net capital gains	3,613,237	2,583,206
Unrealized appreciation of portfolio securities, net	41,671,464	7,975,268
	-----	-----
Total net assets	\$103,223,308	\$ 61,853,289
	=====	=====
Net assets per share	\$ 24.00	\$ 19.71
	=====	=====

The accompanying notes are an integral part of these financial statements.

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EQUUS II INCORPORATED
STATEMENTS OF OPERATIONS
FOR THE YEARS ENDED DECEMBER 31, 1996, 1995 AND 1994

	1996	1995	1994
	-----	-----	-----
Investment income:			
Income from portfolio securities	\$ 2,455,102	\$ 2,859,707	\$ 1,613,414
Interest from temporary cash investments	135,379	215,527	307,722
	-----	-----	-----
Total investment income	2,590,481	3,075,234	1,921,136
	-----	-----	-----
Expenses:			
Management fee	1,848,253	1,237,775	1,212,457
Management incentive fees	1,058,012	--	--
Deferred management incentive fee	6,488,693	1,277,595	(582,622)
Director fees and expenses	203,324	206,124	157,327
Professional fees	303,545	251,770	209,845
Administrative fees	50,000	50,000	50,000
Mailing, printing and other expenses	218,982	338,434	165,330
Interest expense	582,884	318,048	135,252
Franchise taxes	79,934	40,142	31,614
Amortization	23,460	23,460	23,460
	-----	-----	-----
Total expenses	10,857,087	3,743,348	1,402,663
	-----	-----	-----
Net investment income (loss)	(8,266,606)	(668,114)	518,473
	-----	-----	-----
Realized gain (loss) on sales of portfolio securities, net	4,037,326	7,668,524	(350,309)
	-----	-----	-----
Unrealized appreciation of portfolio securities, net:			
End of year	41,671,464	7,975,268	9,255,817
Beginning of year	7,975,268	9,255,817	11,818,618
	-----	-----	-----
Increase (decrease) in unrealized appreciation of portfolio securities, net	33,696,196	(1,280,549)	(2,562,801)
	-----	-----	-----
Total increase (decrease) in net assets from operations	\$ 29,466,916	\$ 5,719,861	\$ (2,394,637)
	=====	=====	=====

The accompanying notes are an integral part of these financial statements.

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EQUUS II INCORPORATED
STATEMENTS OF CHANGES IN NET ASSETS
FOR THE YEARS ENDED DECEMBER 31, 1996, 1995 AND 1994

	1996	1995	1994
	-----	-----	-----
Operations:			
Net investment income (loss)	\$ (8,266,606)	\$ (668,114)	\$ 518,473
Realized gain (loss) on sales of portfolio securities, net	4,037,326	7,668,524	(350,309)
Increase (decrease) in unrealized appreciation of portfolio securities, net ...	33,696,196	(1,280,549)	(2,562,801)
	-----	-----	-----
Increase (decrease) in net assets from operations	29,466,916	5,719,861	(2,394,637)
	-----	-----	-----
Capital transactions:			
Proceeds from rights offering	13,338,935	--	--
Rights offering expenses	(225,982)	--	--
Redemptions of fractional shares	--	(114)	(897)
Stock repurchased and retired under common stock repurchase plan	--	(1,193,642)	(640,159)
Dividends	(3,180,422)	(5,814,990)	(763,268)
Stock issued in common stock dividend	1,970,572	3,061,810	--
	-----	-----	-----
Decrease in net assets from capital share transactions	11,903,103	(4,746,936)	(1,404,324)
	-----	-----	-----
Increase (decrease) in net assets	41,370,019	972,925	(3,798,961)
Net assets, at beginning of year	61,853,289	60,880,364	64,679,325
	-----	-----	-----
Net assets, at end of year	\$ 103,223,308	\$ 61,853,289	\$ 60,880,364
	=====	=====	=====

The accompanying notes are an integral part of these financial statements.

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EQUUS II INCORPORATED
STATEMENTS OF CASH FLOWS
FOR THE YEARS ENDED DECEMBER 31, 1996, 1995 AND 1994

	1996	1995	1994
	-----	-----	-----
Cash flows from operating activities:			
Interest received	\$ 1,783,676	\$ 1,940,403	\$ 1,801,962
Cash paid to management company, directors, a bank and suppliers	(4,277,273)	(2,343,223)	(1,987,811)
Net cash used by operating activities	(2,493,597)	(402,820)	(185,849)
Cash flows from investing activities:			
Purchase of portfolio securities	(18,889,231)	(13,785,810)	(9,512,649)
Proceeds from sales of portfolio securities	8,328,182	8,850,646	1,857,460
Principal payments from portfolio securities	9,281,122	4,698,814	156,582
Purchase of temporary cash investments with original maturities of greater than three months	--	--	(300,000)
Maturity of temporary cash investments with original maturities of greater than three months	--	300,000	200,000
Net cash provided (used) by investing activities	(1,279,927)	63,650	(7,598,607)
Cash flows from financing activities:			
Advances from bank	261,250,000	273,650,000	152,600,000
Repayments to bank	(261,700,000)	(253,500,000)	(152,000,000)
Proceeds from rights offering	13,338,935	--	--
Rights offering expenses	(225,982)	--	--
Dividends paid	--	(2,753,180)	(1,425,862)
Repurchase of common stock	--	(1,993,642)	(640,159)
Redemptions of fractional shares	--	(114)	(897)
Net cash provided (used) by financing activities	12,662,953	15,403,064	(1,466,918)
Net increase (decrease) in cash and cash equivalents	8,889,429	15,063,894	(9,251,374)
Cash and cash equivalents at beginning of year	60,239,861	45,175,967	54,427,341
Cash and cash equivalents at end of year	\$ 69,129,290	\$ 60,239,861	\$ 45,175,967
	=====	=====	=====

The accompanying notes are an integral part of these financial statements.

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EQUUS II INCORPORATED
STATEMENTS OF CASH FLOWS
FOR THE YEARS ENDED DECEMBER 31, 1996, 1995 AND 1994
(Continued)

	1996	1995	1994
	----	----	----
Reconciliation of increase (decrease) in net assets from operations to net cash used by operating activities:			
Increase (decrease) in net assets from operations	\$ 29,466,916	\$ 5,719,861	\$ (2,394,637)
Adjustments to reconcile increase (decrease) from operations to net cash used by operating activities:			
Realized (gain) loss on sales of portfolio securities, net	(4,037,326)	(7,668,524)	350,309
Decrease (increase) in unrealized appreciation, net	(33,696,196)	1,280,549	2,562,801
Fees received in stock	--	--	(20,000)
Decrease (increase) in accounts receivable	--	(886)	1,464
Increase in accrued interest receivable	(371,126)	(268,036)	(100,638)
Accrued interest or dividends exchanged for portfolio securities	(435,679)	(865,909)	--
Commitment fees paid	(70,000)	(75,000)	(56,250)
Amortization of commitment fee	90,000	65,625	56,250
Amortization of deferred reorganization costs	23,460	23,460	23,460
Increase (decrease) in accounts payable ..	(34,055)	105,111	(5,925)
Increase (decrease) in due to management company	6,570,409	1,280,929	(602,683)
Net cash used by operating activities	\$ (2,493,597)	\$ (402,820)	\$ (185,849)
	=====	=====	=====

The accompanying notes are an integral part of these financial statements.

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	1996	1995	1994	1993	1992
	-----	-----	-----	-----	-----
SELECTED PER SHARE DATA:					
Investment income	\$ 0.68	\$ 1.04	\$ 0.62	\$ 0.52	\$ 0.62
Expenses	2.84	1.26	0.45	1.45	1.11
	-----	-----	-----	-----	-----
Net investment income (loss)	(2.16)	(0.22)	0.17	(0.93)	(0.49)
Realized gain (loss) on sales of portfolio securities, net	1.06	2.58	(0.12)	(0.82)	3.73
Increase (decrease) in unrealized appreciation of portfolio securities, net	8.82	(0.43)	(0.83)	3.71	(2.10)
	-----	-----	-----	-----	-----
Increase (decrease) in net assets from operations	7.72	1.93	(0.78)	1.96	1.14
Capital transactions:					
Dividends	(0.76)	(2.00)	(0.25)	(0.68)	(1.12)
Effect of common stock repurchases	--	0.35	0.10	--	--
Dilutive effect of shares issued					
in common stock dividend	(0.20)	(0.51)	--	(0.13)	(0.35)
Effect of rights offering	(2.47)	--	--	--	--
	-----	-----	-----	-----	-----
Net decrease in assets from capital transactions	(3.43)	(2.16)	(0.15)	(0.81)	(1.47)
	-----	-----	-----	-----	-----
Net increase (decrease) in net assets	4.29	(0.23)	(0.93)	1.15	(0.33)
Net assets at beginning of year	19.71	19.94	20.87	19.72	20.05
	-----	-----	-----	-----	-----
Net assets at end of year	\$ 24.00	\$ 19.71	\$ 19.94	\$ 20.87	\$ 19.72
	=====	=====	=====	=====	=====
Weighted average number of shares					
outstanding during year, in thousands	3,819	2,968	3,083	3,013	2,880
SELECTED RATIOS:					
Ratio of expenses to average					
net assets	13.15%	6.10%	2.23%	7.03%	5.46%
Ratio of net investment income					
(loss) to average net assets	(10.02)%	(1.09)%	0.83%	(4.53)%	(2.40)%
Ratio of increase (decrease) in net					
assets from operations to average					
net assets	35.70%	9.32%	(3.81)%	9.52%	5.64%

The accompanying notes are an integral part of these financial statements.

EQUUS II INCORPORATED
SCHEDULE OF PORTFOLIO SECURITIES
DECEMBER 31, 1996

PORTFOLIO COMPANY	INITIAL INVESTMENT	DATE OF COST	FAIR VALUE
-----	-----	-----	-----
A. C. Liquidating Corporation		February 1985	
-4,885 shares of 10% Series C		\$ 488,500	\$ -
cumulative preferred stock			
-10% secured promissory notes		188,014	-
Allied Waste Industries, Inc. (NASDAQ - AWIN)		March 1989	
-1,351,449 shares of common stock		5,109,808	11,749,985
-Warrants to buy up to 125,000 and 15,000 shares of common stock at \$5.00 and \$13.50 per share through August 1999			
and February 1997, respectively		-	126,563
American Residential Services, Inc. (NYSE - ARS)			
-1,221,035 shares of common stock		December 1995	3,057,100
-Warrants to buy up to 100,000 shares of common stock at \$15 per share through			
September 2001		-	263,125
BSI Holdings, Inc.		February 1989	
-284,909 shares of common stock		1,331,187	8,750,000
-1,200,000 shares of Series A preferred stock		1,200,000	1,200,000
-3,528,500 shares of 8% Series B preferred stock		3,528,500	3,528,500
-Warrants to buy up to 3,991 shares of common stock at \$35 per share through August 2006		-	-
-1,000 shares of common stock of GCS RE, Inc.		132,910	200,000
Cardiovascular Ventures, Inc.		November 1991	
-150,000 shares of Series A convertible preferred stock		375,000	375,000
-214,286 shares of Series B convertible preferred stock		750,001	750,001
-56,717 shares of Series C convertible preferred stock		248,137	248,137

The accompanying notes are an integral part of these financial statements.

EQUUS II INCORPORATED
SCHEDULE OF PORTFOLIO SECURITIES
DECEMBER 31, 1996
(Continued)

Portfolio Company -----	Initial Investment -----	Date of Cost -----	Fair Value -----
Carruth-Doggett Industries, Inc.		December 1995	
-10% senior subordinated promissory note			
-Warrant to buy up to 33,333 shares		\$2,250,000	\$2,250,000
of common stock at \$0.01 per share			
through December 14, 2005		-	-
-Warrant to buy up to 249 shares of			
common stock of CDE Corp. at \$0.01 per			
share through December 2005		-	-
Coach USA, Inc. (NASDAQ - TOUR)			
-143,112 shares of common stock	August 1996	1,863,357	3,422,503
David's Supermarkets, Inc.			
-735,000 shares of common stock	February 1990	735,000	450,000
-333,445 shares of 3.5% junior preferred stock		3,334,450	3,334,450
-Warrants to buy up to 538,462			
shares of common stock at \$1 per			
share through April 2000		-	-
Drypers Corporation (NASDAQ - DYPR)			
-1,096,892 shares of common stock	July 1991	6,400,132	3,299,289
-25,000 shares of 7.5% convertible			
preferred stock		2,500,000	6,097,362
-Warrants to buy up to 6,634 shares of common			
stock at \$4 per share through June 1998		-	-
Garden Ridge Corporation (NASDAQ - GRDG)			
-474,942 shares of common stock		July 1992	
		685,030	3,961,380
Hot & Cool Holdings, Inc.			
-9% increasing rate subordinated promissory note		March 1996	
-10% subordinated note		1,300,000	1,300,000
		400,000	400,000
-Warrants to buy up to 14,942 shares of common			
stock at \$.01 per share through March 2006		-	-

The accompanying notes are an integral part of these financial statements.

EQUUS II INCORPORATED
SCHEDULE OF PORTFOLIO SECURITIES
DECEMBER 31, 1996
(Continued)

Portfolio Company -----	Initial Investment -----	Date of Cost -----	Fair Value -----
Industrial Equipment Rentals, Inc.		June 1993	
-182,230 shares of common stock		\$ 1,822	\$1,349,960
-5,371 shares of junior preferred stock		537,100	537,100
-67,500 shares of Series B convertible			
preferred stock		250,050	500,040
-12% subordinated debenture		1,077,778	1,077,778
-9% senior subordinated debenture		499,950	499,950
Midway Airlines Corporation		August 1993	
-452,392 shares of Class C common stock		1,195,616	-
-274,761 shares of junior preferred stock		2,747,610	-
-12% subordinated note		271,000	271,000
-Warrants to buy up to 203,250 shares			
of Class C common stock at \$.01 per share			
through April 2002		-	-
NCI Building Systems, Inc. (NASDAQ - BLDG)		April 1989	
-100,000 shares of common stock		159,784	3,450,000
Paracelsus Healthcare Corporation (NYSE - PLS)		December 1990	
-1,263,058 shares of common stock		5,278,748	4,249,455
Restaurant Development Group, Inc.		June 1987	
-610,909 shares of Class A common stock		2,891,156	700,000
-Prime +2% promissory note		108,000	108,000
-Warrants to buy up to 62,500			
shares of common stock at \$3 per			
share through April 1998		-	-
Sovereign Business Forms, Inc.		August 1996	
-7,500 shares of preferred stock		750,000	750,000
-15% promissory note		550,000	550,000
-Warrant to buy 551,894 shares of common			
stock at \$1 per share through August 2006		-	-

The accompanying notes are an integral part of these financial statements.

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EQUUS II INCORPORATED
SCHEDULE OF PORTFOLIO SECURITIES
DECEMBER 31, 1996
(Continued)

PORTFOLIO COMPANY -----	INITIAL INVESTMENT -----	DATE OF COST -----	FAIR VALUE -----
Strategic Holdings, Inc.		September 1995	
-3,089,751 shares of common stock		\$ 3,088,389	\$ 3,088,389
-3,822,157 shares of Series B preferred stock		3,820,624	3,820,624
-Warrants to buy 225,000 and 100,000 shares of common stock at \$0.4643 and \$1.50 per share, respectively, through August 2005		-	-
-1,000 shares of SMIP, Inc. common stock		150,000	150,000
-15% promissory note of SMIP, Inc.		175,000	175,000
Summit/DPC Partners, L.P.		October 1995	
-36.11% limited partnership interest		2,600,000	2,600,000
Travis International, Inc.		December 1986	
-66,784 shares of common stock		534,589	1,502,640
-104,500 shares of Class A common stock		25,701	2,351,250
VRPI Spin Off, Inc.		January 1988	
-100 shares of common stock		250,000	625,000
-10% secured promissory note		2,672,349	2,672,349
-12% secured promissory note		1,050,000	1,050,000
-10,000 shares of common stock of Equus Video Corporation		25,000	25,000
WMW Industries, Inc.		October 1989	
(formerly Williams & Mettle Co.)			
-530,035 shares of common stock		1,024,309	463,830
-12% subordinated promissory note		763,747	763,747
-Junior participation in prime + 1.75% note		1,012,576	1,012,576
-Warrant to buy 72,672 shares of common stock at \$0.01 per share through December 1999		-	-
Total		\$69,388,024	\$111,059,488

The accompanying notes are an integral part of these financial statements.

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EQUUS II INCORPORATED
SCHEDULE OF PORTFOLIO SECURITIES
DECEMBER 31, 1996
(Continued)

Substantially all of the Fund's portfolio securities are restricted from public sale without prior registration under the Securities Act of 1933. The Fund negotiates certain aspects of the method and timing of the disposition of the Fund's investment in each portfolio company, including registration rights and related costs.

In connection with the investments in Allied Waste Industries, Inc., American Residential Services, Inc., BSI Holdings, Inc., Cardiovascular Ventures, Inc., Coach USA, Inc., Drypers Corporation, Hot & Cool Holdings, Inc., Industrial Equipment Rentals, Inc., Paracelsus Healthcare Corporation, Sovereign Business Forms, Inc. and Strategic Holdings, Inc., rights have been obtained to demand the registration of such securities under the Securities Act of 1933, providing certain conditions are met. The Fund does not expect to incur significant costs, including costs of any such registration, in connection with the future disposition of its portfolio securities.

As defined in the Investment Company Act of 1940, the Fund is considered to have a controlling interest in A.C. Liquidating Corporation, BSI Holdings, Inc., Industrial Equipment Rentals, Inc., Restaurant Development Group, Inc., Strategic Holdings, Inc., Video Rental of Pennsylvania, Inc. and WMW Industries, Inc. In addition, American Residential Services, Inc., Cardiovascular Ventures, Inc., David's Supermarkets, Inc., Drypers Corporation and Travis International, Inc. are considered to be affiliated entities of the Fund. The fair value of the Fund's investments in publicly traded securities include discounts from the closing market prices to reflect the estimated effects of restrictions on the sale of such securities at December 31, 1996. Such discounts, as detailed below, total \$15,599,614 or \$3.63 per share as of December 31, 1996.

Allied Waste Industries, Inc.	\$ 1,155,605
American Residential Services, Inc.	9,160,445
Coach USA, Inc.	727,745
Drypers Corporation	4,091,694
Garden Ridge Corporation	134,995
Paracelsus Healthcare Corporation	329,130

Total discount \$15,599,614
=====

Income was earned in the amount of \$1,577,564, \$1,349,420 and \$1,213,320 for the years December 31, 1996, 1995 and 1994, respectively, on portfolio securities of companies in which the Fund has a controlling interest.

As defined in the Investment Company Act of 1940, all of the Fund's investments are in eligible portfolio companies. The Fund provides significant managerial assistance to all of the portfolio companies in which it has invested except Cardiovascular Ventures, Inc., Coach USA, Inc., Midway Airlines Corporation, Paracelsus Healthcare Corporation and Summit/DPC Partners, L.P. The Fund provides significant managerial assistance to portfolio companies that comprise 89% of the total value of the investments in portfolio companies at December 31, 1996.

The accompanying notes are an integral part of these financial statements.

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EQUUS II INCORPORATED
SCHEDULE OF PORTFOLIO SECURITIES
DECEMBER 31, 1995

Portfolio Company -----	Initial Investment -----	Date of Cost -----	Fair Value -----
A.C. Liquidating Corporation		February 1985	
-4,885 shares of 10% Series C cumulative preferred stock		\$ 488,500	\$ -
-10% secured promissory notes		188,014	188,014
Allied Waste Industries, Inc.		March 1989	
(NASDAQ - AWIN)			
-1,397,698 shares of common stock		5,316,834	8,763,730
-Warrants to buy up to 163,044, 125,000 and 15,000 shares of common stock at \$4.60, \$5.00 and \$13.50 per share, through May 1998, August 1999 and February 1997, respectively		-	-
American Residential Services, Inc.		December 1995	
-Prime rate promissory note		50,000	50,000
BSI Holdings, Inc.		February 1989	
(formerly Brazos Sportswear, Inc.)			
-166,250 shares of common stock		1,330,000	1,800,000
-12% senior subordinated debenture		3,350,000	3,350,000
-10% subordinated promissory note		178,500	178,500
-Warrants to buy up to 64,715 shares of common stock at \$0.01 per share through December 2004		-	700,000
-1,000 shares of common stock of GCS RE, Inc.		132,910	132,910
-87,632 shares of common stock of Sports/Leisure, Inc.		82,734	876
-8% unsecured promissory note, due from Sports/Leisure, Inc.		5,005	5,005
Cardiovascular Ventures, Inc.		November 1991	
-150,000 shares of Series A convertible preferred stock		375,000	375,000
-214,286 shares of Series B convertible preferred stock		750,001	750,001
-56,717 shares of Series C convertible preferred stock		248,137	248,137

The accompanying notes are an integral part of these financial statements.

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EQUUS II INCORPORATED
SCHEDULE OF PORTFOLIO SECURITIES
DECEMBER 31, 1995
(Continued)

Portfolio Company	Initial Invest	Date of Cost	Fair Value
Carruth-Doggett Industries, Inc.		December 1995	
-10% senior subordinated promissory note		\$ 2,250,000	\$ 2,250,000
-Warrant to buy up to 33,333 shares of common stock at \$0.01 per share through December 14, 2005		-	-
-Warrant to buy up to 333 shares of common stock of CDE Corp. at \$0.01 per share through December 14, 2005		-	-
Champion Healthcare Corporation (AMEX - CHC)		December 1990	
-1,038,944 shares of common stock		3,371,395	4,292,535
-3,601 shares of Series C convertible preferred stock		64,818	64,815
-83,333 shares of Series D convertible preferred stock		1,499,994	1,499,994
-11% senior subordinated note		1,500,000	1,500,000
-Warrants to buy up to 5,246 shares of common stock at \$5.90 per share through June 1, 1999		-	-
-Warrants to buy up to 45,000 shares of common stock at \$9 per shares through December 31, 2003		-	-
David's Supermarkets, Inc.		February 1990	
-735,000 shares of common stock		735,000	-
-333,445 shares of 3.5% junior preferred stock		3,334,450	3,334,450
-Warrants to buy up to 538,462 shares of common stock at \$1 per share through April 21, 2000		-	-
Drypers Corporation (NASDAQ - DYPR)		July 1991	
-1,096,892 shares of common stock		6,400,132	2,838,162
-Warrants to buy up to 6,634 shares of common stock at \$4 per share through June 30, 1998		-	-
Garden Ridge Corporation (NASDAQ - GRDG)		July 1992	
-333,471 shares of common stock		1,061,018	10,963,284

The accompanying notes are an integral part of these financial statements.

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EQUUS II INCORPORATED
SCHEDULE OF PORTFOLIO SECURITIES
DECEMBER 31, 1995
(Continued)

Portfolio Company	Initial Investment	Date of Cost	Fair Value
Industrial Equipment Rentals, Inc.		June 1993	
-182,230 shares of common stock		\$ 1,822	\$ 1,822
-5,371 shares of junior preferred stock		537,100	537,100
-67,500 shares of Series B senior convertible preferred stock		250,050	250,050
-12% subordinated debenture		1,077,778	1,077,778
-9% senior subordinated debenture		499,950	499,950
Midway Airlines Corporation		August 1993	
-452,392 shares of Class C common stock		1,195,616	-
-274,761 shares of junior preferred stock		2,747,610	500,000
-12% subordinated note		271,000	271,000
-Warrants to buy up to 203,250 shares of Class C common stock at \$.01 per share through April 2002		-	-
NCI Building Systems, Inc. (NASDAQ - BLDG)		April 1989	
-100,000 shares of common stock		159,783	2,475,000
Restaurant Development Group, Inc.		June 1987	
-610,909 shares of Class A common stock		2,891,156	700,000
-14% promissory note, face amount \$350,000		275,000	350,000
-Prime +2% promissory note		639,122	639,122
-Warrants to buy up to 150,000 and 62,500 shares of common stock at \$2.80 and \$3 per share through November 1996 and April 1998, respectively		-	-
Strategic Holdings, Inc.		September 1995	
-2,986,408 shares of common stock		2,986,408	2,986,408
-3,705,900 shares of Series B preferred stock		3,705,900	3,705,900
-1,000 shares of SMIP, Inc. common stock		150,000	150,000
-15% promissory note of SMIP, Inc.		175,000	175,000

The accompanying notes are an integral part of these financial statements.

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SCHEDULE OF PORTFOLIO SECURITIES
DECEMBER 31, 1995
(Continued)

PORTFOLIO COMPANY	INITIAL INVESTMENT -----	DATE OF COST -----	FAIR VALUE -----
Summit/DPC Partners, L.P. -36.11% limited partnership interest		October 1995 \$ 2,600,000	\$ 2,600,000
Tech-Sym Corporation (NYSE - TSY) -32,759 shares of common stock		March 1987 118,245	1,036,003
Travis International, Inc. -171,284 shares of common stock		December 1986 560,290	3,853,890
Video Rental of Pennsylvania, Inc. -125,000 shares of common stock		January 1988 125,000	500,000
-125,000 shares of 9% redeemable preferred stock		125,000	125,000
-10% secured promissory note		2,525,000	2,525,000
-10,000 shares of common stock of Equus Video Corporation		25,000	25,000
Williams & Mettle Co. -657,895 shares of common stock		October 1989 6,579	-
-138,475 shares of Series A convertible preferred stock		553,900	-
-237,126 shares of Series B convertible preferred stock		396,000	396,000
-12% subordinated promissory note		677,250	677,250
-Junior participation in prime + 1.75% note		512,576	512,576
-Warrant to buy 456,718 shares of common stock at \$0.01 per share			
through December 21, 1999		-	-
Yellow Cab Service Corporation -1,006,701 shares of common stock		December 1985 51,432	-
-3% subordinated promissory note, face amount aggregating \$1,655,014		1,566,000	-
-3% subordinated promissory note		3,517,083	1,750,000
Total		=====	=====
		\$63,635,092	\$71,610,360
		=====	=====

The accompanying notes are an integral part of these financial statements.

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EQUUS II INCORPORATED
NOTES TO FINANCIAL STATEMENTS
DECEMBER 31, 1996, 1995 AND 1994

(1) ORGANIZATION AND BUSINESS PURPOSE

Equus II Incorporated (the "Fund"), a Delaware corporation with perpetual existence, was formed by Equus Investments II, L.P. (the "Partnership") on August 16, 1991. On July 1, 1992, the Partnership was reorganized and all of the assets and liabilities of the Partnership were transferred to the Fund in exchange for shares of common stock of the Fund. The shares of the Fund trade on the American Stock Exchange under the symbol EQS.

The Fund seeks to achieve capital appreciation by making investments in equity and equity-oriented securities issued by privately-owned companies in transactions negotiated directly with such companies. The Fund seeks to invest primarily in companies which intend to acquire other businesses, including leveraged buyouts. The Fund may also invest in recapitalizations of existing businesses or special situations from time to time. The Fund's investments in Portfolio Companies consist principally of equity securities such as common and preferred stock, but also include other equity-oriented securities such as debt convertible into common or preferred stock or debt combined with warrants, options or other rights to acquire common or preferred stock. Current income is not a significant factor in the selection of investments. The Fund elected to be treated as a business development company under the Investment Company Act of 1940, as amended.

(2) MANAGEMENT

The Fund has entered into a management agreement with Equus Capital Management Corporation, a Delaware corporation (the "Management Company"). Pursuant to such agreement, the Management Company performs certain services, including certain management and administrative services necessary for the operation of the Fund. The Management Company entered into a Sub-Adviser Agreement with Equus Capital Corporation, a Delaware corporation (the "Sub-Adviser"), pursuant to which the Sub-Adviser provides certain investment advisory services for the Fund, including preparing the Fund's quarterly net asset valuations. The Management Company receives a management fee at an annual rate of 2% of the net assets of the Fund, paid quarterly in arrears. The Management Company also receives compensation for providing certain investor communication services, of which \$50,000 is included in the accompanying Statements of Operations for each of the three years ended December 31, 1996.

The Management Company also receives or must reimburse a management incentive fee equal to 20% of net realized capital gains less unrealized capital depreciation, computed on a cumulative basis over the life of the Fund. The Sub-Adviser receives a fee from the Management Company equal to 50% of the Management Company's net management incentive fee. The management incentive fee is paid or reimbursed quarterly in arrears.

"Deferred management incentive fees" in the accompanying Balance Sheets of \$10,784,028 and \$4,295,335 at December 31, 1996 and 1995, respectively, were calculated on the unrealized appreciation of investments in portfolio securities and will not be paid until such appreciation is realized. See Note 13. Deferred management incentive fee expense (income) of \$6,488,693, \$1,277,595 and \$(582,622) related to increases (decreases) in unrealized appreciation on portfolio securities are included in the accompanying Statements of Operations for the three years ended December 31, 1996. Current management incentive fees of \$1,058,012 are included in the accompanying Statement of Operations for the year ended December 31, 1996. At December 31, 1996, \$125,135 of incentive fees to be reimbursed by the Management Company to the Fund are netted in "Due to Management Company", against \$516,117 of management fees due to the Management Company.

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The Sub-Adviser is a wholly-owned subsidiary of the Management Company and the Management Company is controlled by a privately-owned corporation.

As compensation for services rendered to the Fund, each director who is not an officer of the Fund receives an annual fee of \$20,000 paid quarterly in arrears, a fee of \$2,000 for each meeting of the Board of Directors attended in person, a fee of \$1,000 for participation in each telephonic meeting of the Board of Directors and for each committee meeting attended (\$500 for each committee meeting if attended on the same day as a Board Meeting), and reimbursement of all out-of-pocket expenses relating to attendance at such meetings. Certain officers and directors of the Fund serve as directors of Portfolio Companies, and receive and retain fees in consideration for such service.

(3) SIGNIFICANT ACCOUNTING POLICIES

Valuation of Investments - Portfolio investments are carried at fair value with the net change in unrealized appreciation or depreciation included in the determination of net assets. Investments in companies whose securities are publicly traded are valued at their quoted market price, less a discount to reflect the estimated effects of restrictions on the sale of such securities ("Valuation Discount"), if applicable. Cost is used to approximate fair value of other investments until significant developments affecting an investment provide a basis for use of an appraisal valuation. Thereafter, portfolio investments are carried at appraised values as determined quarterly by the Sub-Adviser, subject to the approval of the Board of Directors. The fair market values of debt securities, which are generally held to maturity, are determined on the basis of the terms of the debt securities and the financial conditions of the issuer. Because of the inherent uncertainty of the valuation of portfolio securities which do not have readily ascertainable market values, \$107,609,488 (including \$58,079,167 in publicly-traded securities, net of a \$15,599,614 Valuation Discount) and \$68,098,481 (including \$26,862,806 in publicly-traded securities, net of a \$5,642,282 Valuation Discount) at December 31, 1996 and 1995, respectively, the Sub-Adviser's estimate of fair value may significantly differ from the fair value that would have been used had a ready market existed for the securities. Appraised values do not reflect brokers' fees or other normal selling costs or management incentive fees which might become payable on disposition of such investments. Such management incentive fees are recorded in total on the Fund's Balance Sheets. See Note 2 above.

On a weekly basis, the Fund adjusts its net asset value for changes in the value of its publicly held securities and material changes in the value of its private securities and reports those amounts to Lipper Analytical Services, Inc. Such weekly net asset values appear in various publications, including BARRON'S and THE WALL STREET JOURNAL.

Investment Transactions - Investment transactions are recorded on the accrual method. Realized gains and losses on investments sold are computed on a specific identification basis.

Cash Flows - For purposes of the Statements of Cash Flows, the Fund considers all highly liquid temporary cash investments purchased with an original maturity of three months or less to be cash equivalents.

Income Taxes - No provision for Federal income taxes has been made in the accompanying financial statements as the Fund has qualified for pass-through treatment as a "regulated investment company" under Subchapter M of the Internal Revenue Code of 1986. As such, all net income is allocable to the stockholders for inclusion in their respective tax returns. Net capital losses are not allocable to the shareholders but can be carried over to offset future earnings of the Fund.

(4) BOOK TO TAX RECONCILIATION

The Fund accounts for dividends in accordance with Statement of Position 93-2 which relates to the amounts distributed by the Fund as net investment income or net capital gains, which are often not equal to the corresponding income or gains shown in the Fund's financial statements. The Fund

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had undistributed net investment income and capital gains during 1995 of \$173,128 and \$9,995, respectively. A dividend of such income was declared and distributed during 1996 (see Note 5). The Fund had a net investment loss for tax purposes for the years ended December 31, 1996 and 1994, and therefore distributed no net investment income. The Fund, for book purposes, has undistributed net capital gains of \$3,613,237 in the accompanying Balance Sheet at December 31, 1996. However, for tax purposes, the Fund has distributed all of its net realized capital gains.

The following is a reconciliation of the difference in the Fund's net realized gain (loss) on the sale of portfolio securities for book and tax purposes.

	1996	1995	1994
	-----	-----	-----
Net realized gain (loss) on the sales			
of portfolio securities, book	\$ 4,037,326	\$ 7,668,524	\$(350,309)
Management incentive fee	(1,058,012)	--	--
Reversal of amounts previously written off	--	48,838	--
Utilization of capital loss carryforwards	--	(1,892,377)	--
	-----	-----	-----
Net realized gain (loss) on the sales of			
portfolio securities, tax	\$ 2,979,314	\$ 5,824,985	\$(350,309)
	=====	=====	=====

(5) DIVIDENDS

The Fund declared dividends of \$3,180,422 (\$0.76 per share), \$5,814,990 (\$2.00 per share) and \$763,268 (\$0.25 per share) during 1996, 1995 and 1994, respectively. The Fund has adopted a policy to make dividend distributions of at least \$0.50 per share on an annual basis. In the event that taxable income, including realized capital gains, exceeds \$0.50 per share in any year, additional dividends may be declared to distribute such excess. The 1994 dividend was paid in cash and represented a return of capital. The 1996 and 1995 dividends, which represented the Fund's net investment income and net capital gains for tax purposes, were paid in additional shares of common stock or in cash by specific election of the shareholders in January 1997 and December 1995. The Fund paid \$1,209,850 and \$2,753,180 in cash and issued 115,916 and 231,080 additional shares of stock at \$17 and \$13.25 per share, in January 1997 and December 1995, respectively, in connection with such dividends. The stock issued in January 1997 is reflected as outstanding as of December 31, 1996 in the accompanying financial statements.

(6) TEMPORARY CASH INVESTMENTS

Temporary cash investments, which represent the short-term utilization of cash prior to investment in securities of portfolio companies, distributions to the shareholders or payment of expenses, consist of money market accounts earning interest at rates ranging from 3.50% to 5.30% at December 31, 1996. The following is a list of temporary cash investments at December 31, 1996 and 1995:

	1996	1995
	-----	-----
Broadcort Money Plus	\$ --	\$ 1,338
Dreyfus Cash Management Fund	--	58,141
Dreyfus Treasury Cash Management Fund	--	60,026,074
First Interstate Bank of Texas, N.A	--	85,353
Great Hall Money Market	11	8,211
NationsBank of Texas, N.A	69,129,279	--
Pitkin County Bank	--	53,477
	-----	-----
Total money market accounts	\$69,129,290	\$60,232,594

(7) PORTFOLIO SECURITIES

During the year ended December 31, 1996, the Fund invested \$9,800,000 in three new companies and made follow-on investments of \$10,274,910 in nine portfolio companies, including \$435,679 in dividends and accrued interest received in the form of additional portfolio securities and \$750,000 of common stock received through the net exercise of common stock warrants. In addition, the Fund realized net capital gains of \$4,037,326 during the year ended December 31, 1996.

During the year ended December 31, 1995, the Fund invested \$11,917,308 in five new companies and made follow-on investments of \$2,734,411 in seven portfolio companies, including \$865,909 in accrued interest, dividends and conversion inducement payments received in the form of additional portfolio securities. In addition, the Fund realized capital gains of \$7,668,524 during the year ended December 31, 1995.

During the year ended December 31, 1994, the Fund made follow-on investments of \$9,532,649 in nine portfolio companies, and realized \$350,309 of net capital losses from the sale of a portion of its investment in five portfolio companies.

(8) DEFERRED REORGANIZATION COSTS

The Fund paid \$117,300 in expenses related to the formation of the Fund and is amortizing such amount over 5 years. Accumulated amortization of such

expenses totaled \$105,570 and \$82,110 at December 31, 1996 and 1995, respectively.

(9) NOTES PAYABLE TO BANK

The Fund had a \$60,000,000 line of credit promissory note with a bank, with interest payable at the prime rate, at December 31, 1995. The Fund had \$60,000,000 outstanding on such note at December 31, 1995 that was secured by \$60,000,000 of the Fund's temporary cash investments. The Fund paid \$75,000 and \$56,250 in commitment fees on such notes in 1995 and 1994, respectively, which were deferred and are being amortized over the twelve month commitment period. Amortization expense related to such fees is included in "Interest expense" in the accompanying Statements of Operations for each of the two years ended December 31, 1995.

In March 1996, the Fund entered into a new \$65,000,000 line of credit promissory note with a bank, with interest payable at 1% over the rate earned in its money market account. The Fund had \$65,000,000 outstanding on such note at December 31, 1996, that was secured by \$65,000,000 of the Fund's temporary cash investments. The Fund paid a \$50,000 commitment fee in 1996, which was deferred and is being amortized over the commitment period. The note matures on April 4, 1997. Subsequent to December 31, 1996, the Fund received a commitment from the bank to extend the maturity to April 1, 1998.

The Fund also had a \$13,000,000 revolving line of credit from a bank, with interest payable at prime, of which \$5,750,000 was outstanding at December 31, 1995. The Fund paid facility fees of \$3,125 and \$6,250 to the bank for such revolving line of credit during 1995 and 1994, respectively, which are included in interest expense for the years ended December 31, 1995 and 1994. The line of credit was secured by a portion of the Fund's investment in portfolio securities.

On March 18, 1996, the Fund entered into a new \$20,000,000 revolving line of credit with another bank which replaced its \$13,000,000 line of credit. The Fund had \$300,000 outstanding under such line of credit at December 31, 1996. The line is secured by the Fund's investments in portfolio securities. The Fund paid a \$20,000 commitment fee in connection with such loan which was deferred and is being amortized over the commitment period which ends April 4, 1997. The outstanding balance on the loan bears interest at prime + 1/4% to 3/4%. The fund also pays 1/4% per annum as a commitment fee on the unused portion of the line of credit. Subsequent to December 31, 1996, the

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Fund received a commitment to increase the line of credit to \$30,000,000 and extended the maturity to April 1, 1998.

The average daily balances outstanding on the Fund's notes payable during the years ended December 31, 1996 and 1995, were \$5,956,570 and \$2,839,315, respectively.

(10) STOCK REPURCHASE PLAN

From June through December 31, 1994, the Fund repurchased on the open market and canceled 46,200 shares of its stock for \$640,159. Such stock was repurchased at an average discount of 28.74% from its net asset value. During 1995, the Board of Directors of the Fund authorized the repurchase of additional stock, and the Fund repurchased and canceled 145,500 shares of its stock for \$1,993,642. The stock repurchased in 1995 was repurchased at an average discount of 33.61% from its net asset value.

(11) RIGHTS OFFERING

On March 5, 1996, the Fund filed a registration statement with the Securities and Exchange Commission for a rights offering. Under the rights offering, the Fund issued each shareholder of record as of April 10, 1996, one right for each share owned. One share of common stock could be acquired for every three rights. The exercise price for shares in the rights offering was \$12.75 per share, a 19.7% discount from the market price on April 10, 1996. On May 8, 1996, the Fund completed its rights offering, which was over-subscribed. The Fund issued a total of 1,046,191 shares at \$12.75 per share and raised \$13,112,953, net of \$225,982 in expenses. The proceeds from the rights offering were used to repay debt and to fund the commitments the Fund had made for new and follow-on investments.

(12) COMMITMENTS AND CONTINGENCIES

The Fund has made commitments to invest, under certain circumstances, up to an additional \$1,000,000 in BSI Holdings, Inc., \$565,500 in GCS RE, Inc. and \$350,000 in Sovereign Business Forms, Inc. In connection with its commitment to GCS RE, Inc., the Fund has committed to a bank to maintain at least \$380,000 in temporary cash investments to fund such commitment. In addition, the Fund has committed to invest up to \$16,900,000 in four new companies.

On April 1, 1996, an action was filed in federal district court in Houston, Texas by two stockholders of the Fund against the directors of the Fund, the Management Company, and the Fund, as nominal defendant ("Defendants"), asserting that by approving the rights offering the Management Company and the directors of the Fund violated their fiduciary duties to the Fund's stockholders under the Investment Company Act of 1940 and Delaware common law, and that the Management Company aided and abetted the breaches of fiduciary duties. The plaintiffs had attempted to have the action certified as a class action on behalf of all of the stockholders of the Fund but did not specify the amount of

any damages that have been suffered. The suit was dismissed by the court in December 1996. The plaintiffs have refiled their case as a derivative action alleging that the Defendants breached their fiduciary duties under Delaware common law and abetted the breaches of fiduciary duties and again did not specify the amount of any damages. The Fund, its directors and the Management Company intend to vigorously defend against this action, and management of the Fund believes that ultimate resolution of such complaint will not have a material adverse effect on the Fund's financial position or results of operations. Through December 31, 1996, the Fund had incurred \$92,336 in legal expenses related to such action.

The Fund and certain of the portfolio companies are involved in asserted claims and have the possibility for unasserted claims which may ultimately affect the fair value of the Fund's portfolio investments. In the opinion of Management, the financial position or operating results of the Fund will not be materially affected by these claims.

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(13) SUBSEQUENT EVENTS

On February 11, 1997, the Fund sold its investment in Midway Airlines Corporation for \$278,272 realizing a capital loss of \$3,935,954.

Subsequent to December 31, 1996, the Fund repaid \$65,300,000 of notes payable to the bank.

Subsequent to December 31, 1996, the Fund mailed a proxy statement pertaining to a special meeting of stockholders to be held on March 27, 1997 (the "Special Meeting"), to stockholders of record as of February 18, 1997. At the Special Meeting the stockholders of the Fund will be asked to vote on the following matters:

- (1) The stockholders have been asked to approve and adopt a new management agreement that eliminates any future management incentive fee.
- (2) The stockholders have been asked to authorize the payment to the Management Company of the deferred management incentive fee (\$10,784,028 as of December 31, 1996), in shares of restricted common stock, and
- (3) The stockholders have been asked to approve and adopt a stock incentive plan which permits the issuance of options to purchase common stock of the Fund to the Fund's officers and directors in amounts up to 20% of the outstanding shares of common stock of the Fund.

Implementation of the proposals is contingent on the approval of all three proposals by the stockholders. The adoption of the proposals also will be contingent upon receipt by the Fund and the Management Company of an exemptive order from the Securities and Exchange Commission that permits the proposed payment of the deferred management incentive fee in shares of common stock. The Fund and the Management Company filed an application for such exemptive order on October 10, 1996.

The Board of Directors of the Fund believes the implementation of the proposals will more closely align the interests of the Fund's management with those of the stockholders. In addition, the Fund's expense ratio in periods of net realized gains and unrealized appreciation on its investments will be reduced as a result of no further incentive fee accruals. The total net assets of the Fund would have been increased by \$10,784,028, and the net asset value per share would have been reduced by approximately \$1.05 if all the proposals had been implemented as of December 31, 1996.

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ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE.

None.

ITEM 10. DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT.

Information about the Directors and Executive Officers of the Registrant is incorporated by reference to the Fund's Definitive Proxy Statement for the 1997 Annual Meeting of Stockholders, to be filed pursuant to Regulation 14A under the Securities and Exchange Act of 1934, as amended, prior to April 30, 1997 (the "1997 Proxy Statement").

ITEM 11. EXECUTIVE COMPENSATION.

Information regarding Executive Compensation is incorporated by reference to the Fund's 1997 Proxy Statement.

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT.

Information regarding Security Ownership of Certain Beneficial Owners and Management is incorporated by reference to the Fund's 1997 Proxy Statement.

ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS.

Information regarding Certain Relationships and Related Transactions is

incorporated by reference to the Fund's 1997 Proxy Statement.

ITEM 14. EXHIBITS, FINANCIAL STATEMENT SCHEDULES AND REPORTS ON FORM 8-K.

(a) (1)	FINANCIAL STATEMENTS	PAGES
Report of Independent Public Accountants		26
Balance Sheets at December 31, 1996 and 1995		27
Statements of Operations for the years ended December 31, 1996, 1995 and 1994		28
Statements of Changes in Net Assets for the years ended December 31, 1996, 1995 and 1994		29
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Supplemental Information-Selected Per Share Data and Ratios for the five years ended December 31, 1996		32
Schedule of Portfolio Securities at December 31, 1996		33
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Notes to Financial Statements		42

All other information required in the financial statement schedules has been incorporated in the financial statements or notes thereto or has been omitted since the information is not applicable, not present or not present in amounts sufficient to require submission of the schedule.

(a) (3) EXHIBITS

3. Articles of Incorporation and by-laws

- (a) Restated Certificate of Incorporation of the Fund dated March 4, 1992. [Exhibit 3(a) to Registrant's Annual Report on Form 10-K for the year ended December 31, 1991]
- (b) Certificate of Merger dated June 30, 1993, between the Fund and Equus Investments Incorporated [Exhibit 3(c) to Registrant's Annual Report on Form 10-K for the year ended December 31, 1993]
- (c) Amended and Restated Bylaws of the Fund. [Exhibit 3(c) to Registrant's Annual report on Form 10-K for the year ended December 31, 1995]

10. Material Contracts

- (a) Form of Management Agreement between the Fund and Equus Capital Management Corporation. [Form N-14, Exhibit 6(c) to the Registration Statement file number 33-60118]
- (b) Form of Sub-Adviser Agreement between Equus Capital Management Corporation and Equus Capital Corporation. [Form N-14, Exhibit 5(c) to the Registration Statement, file number 33-42621]
- (c) Agreement and Plan of Merger dated March 26, 1993 [Form N-14, Exhibit A to the Joint Proxy Statement and Prospectus, file number 33-60118]
- (d) First Amendment to Agreement and Plan of Merger, dated May 5, 1993 [Form N-14, Exhibit B to the Registration Statement, file number 33-60118]
- (e) Second Amendment to Agreement and Plan of Merger, dated June 15, 1993 [Exhibit 10(e) to Registrant's Annual Report on Form 10-K for the year ended December 31, 1993]
- (f) Form of Safekeeping Agreement with Southwest Guaranty Trust Company. [Form N-14, exhibit 6 to the Registration Statement, file number 33-42621]
- (g) Amended and restated loan agreement by and between Equus II Incorporated and NationsBank of Texas, N.A., dated March 29, 1996 [Exhibit 10(g) to Registrant's Quarterly Report on Form 10-Q for the quarter ended March 31, 1996.]

(b) REPORTS ON FORM 8-K

No reports on Form 8-K were filed by the Fund during the last quarter of the period covered by this report.

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

EQUUS II INCORPORATED

Date: February 26, 1997 /s/ NOLAN LEHMANN
Nolan Lehmann, President

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 dates indicated.

SIGNATURE -----	TITLE -----	DATE ----
/s/ GREGORY J. FLANAGAN (Gregory J. Flanagan)	Director	February 26, 1997
/s/ ROBERT L. KNAUSS (Robert L. Knauss)	Director	February 26, 1997
/s/ GARY R. PETERSEN (Gary R. Petersen)	Director	February 26, 1997
/s/ JOHN W. STORMS (John W. Storms)	Director	February 26, 1997
/s/ FRANCIS D. TUGGLE (Francis D. Tuggle)	Director	February 26, 1997
/s/ EDWARD E. WILLIAMS (Edward E. Williams)	Director	February 26, 1997
/s/ NOLAN LEHMANN (Nolan Lehmann)	President and Director (principal financial and accounting officer)	February 26, 1997
/s/ SAM P. DOUGLASS (Sam P. Douglass)	Chairman of the Board and Chief Executive Officer (principal executive officer)	February 26, 1997

EX-27
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DEC-31-1996
JAN-01-1996
DEC-31-1996
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