

 GLADSTONE CAPITAL

2005 ANNUAL REPORT





Pictured here clockwise from above are David Gladstone, Terry Brubaker and Chip Stelljes.

GLADSTONE CAPITAL is a specialty finance company that pays monthly dividends to its stockholders. We provide financing through loans to small and medium-sized private businesses across the U.S. Our common stock is traded on the Nasdaq® under the trading symbol GLAD. We seek to invest in private companies with profitable operations and strong management teams. Gladstone Capital has invested in small and medium-sized businesses in the industries of food and paper products, home care equipment, equipment manufacturing and much more. To learn more about our company, visit our website for more information at: www.GladstoneCapital.com.

Our headquarters are located Washington, DC's suburb McLean, VA and we have satellite offices in Morristown, NJ, New York, NY, Pittsburgh, PA, Lexington, KY and Dallas, TX.



GLADSTONE CAPITAL CORPORATION

TO OUR STOCKHOLDERS

Fiscal 2005 produced positive results for our stockholders. This year, our net investment income increased to \$1.49 per fully diluted share from \$1.29 per fully diluted share, a 15.5% increase over last year. Net investment income is one of the critically important benchmarks because the growth in net investment income corresponds closely to the growth of the dividends and distributions we make to our stockholders. This year, the annual dividend increased 11% to \$1.515 from \$1.365 last year.

For the year ended September 30, 2005, we recorded nearly \$144 million of new loans to 23 companies. We sold two investments for a cumulative gain of \$30 thousand and received principal repayments of \$88 million, which included scheduled principal repayments. We also received \$1 million of success fees in connection with the repayment of one investment. We are proud of these results; however, our expectations are greater, and we hope to do even better in 2006.

Current debt markets are as frothy as they were in 1989 or 1998. Debt buyers are buying debt instruments that only an investment banker could love. We estimate that approximately 70% of the debt buyers are hedge funds. If the United States experiences an economic downturn, there may be a great opportunity for our fund similar to the one in the period after the 1990 recession.

The nation's trade deficit is at an all-time high, which means a flood of U.S. dollars ends up in foreign hands. Our country is highly dependent on a few nations that buy the majority of United States treasury securities. On a positive note, interest rates are now approaching their average rate for the past decade. If they maintain their historical average, we expect that the United States would have a stable economic environment. However, if interest rates rise much further, this could create an inflationary environment.

Short-term rates are under the control of our federal government. Over the last 18 months, the Federal Reserve has increased short-term rates to the point that they equal long-term rates. We hope that the Federal Reserve will not move short-term rates in excess of long-term rates, which would produce an inverted yield curve and which could potentially lead to a recession.

Given the risks we mention above, we believe that we have built a diversified portfolio that is well-positioned to weather the changes of the economy. Despite uncertainties in the marketplace, we are happy to report that, on the whole, small and medium-sized businesses are doing very well indeed. Many small and medium-sized businesses are seeing record profits and growth in revenues. As of the date of this report, all of our borrowers are current on their payments to us. Subsequent to fiscal year end, we sold two of our portfolio company loans at below par, but in each case, the loss at the time of disposition was relatively small compared to the profits we received from these investments in the early years, so that our total net returns on the investments were positive. At this time, we are very comfortable with our portfolio, to which we have assigned an average risk rating of 6.7 (as explained in the Form 10-K attached) and a weighted average yield on investments of 12.2%, excluding the small amount of paid-in-kind (PIK) interest.

In December 2005, we held a special stockholders meeting to ask our stockholders to approve an amended and restated investment advisory and management agreement with our Adviser, Gladstone Management Corporation. We are pleased to report that our stockholders approved the amended and restated investment advisory and management agreement. We currently expect to implement the new agreement effective October 1, 2006 (as described in more detail in the attached Form 10-K). The same individuals who manage our portfolio will continue to manage our portfolio under the new agreement, although administrative services will be provided pursuant to a separate administration agreement with Gladstone Administration LLC, a wholly-owned subsidiary of Gladstone Management. Our stockholders should not recognize any change or diminution in services because of this change.

We are pleased to report that our outlook for fiscal 2006 is optimistic. We begin with a strong portfolio. Standard & Poor's Loan Evaluation Service (which recommends values for many of the loans in the portfolio to our Board of Directors) depreciated a few of our loans, so that at our fiscal year end, we had a portfolio of \$205.4 million in cost and a fair value of \$200.8 million, a difference of \$4.6 million or approximately 2.3%.

Gladstone Capital is blessed to have the team of professionals we have who take their work seriously and contribute so much of themselves to the growth of our company. In the last four years, we have become an active lender and have established Gladstone Capital as a well-known and respected name in our markets. We believe in bringing an ethical approach to every business transaction. We are dedicated to our stockholders, customers and employees and appreciate their loyalty during the last four years. We look forward to the many opportunities that await us in our fifth year.

Thank you for your continued support.

David Gladstone, *Chairman of the Board of Directors and Chief Executive Officer*

Terry Brubaker, *Vice Chairman and Chief Operating Officer*

Chip Stelljes, *President and Chief Investment Officer*



GLADSTONE CAPITAL CORPORATION

BUSINESS STRATEGY



CASH DISTRIBUTIONS FOR 2005 WERE \$1.515 PER SHARE

We are a specialty finance company that makes loans to small and medium-sized private businesses. Businesses approach us because they do not have sufficient access to traditional lending sources. Borrowers need funds to finance growth, restructure their balance sheets or effect a change of control. We provide a variety of financing options to these private companies including:

- Senior term loans
- Last out senior term loans
- Second lien loans
- Senior subordinated loans
- Junior subordinated loans
- Mezzanine loans

Senior term loans and last out senior term loans are exposed to the least risk of default because they command a senior position with respect to scheduled interest payments, principal payments and collateral. However, these types of loans traditionally have lower returns and only pay interest on the loans.

Second lien loans and senior subordinated loans are typically subordinated in their rights to receive principal and interest payments from the borrower to the rights of the holders of senior debt. As a result, senior subordinated debt is a riskier loan instrument than senior debt. Second lien loans and senior subordinated loans sometimes entitle the lender to obtain additional income from success fees and other profit enhancements.

Junior subordinated loans and mezzanine loans are subordinated in their rights to receive principal and interest payments from the borrower to the rights of the holders of senior debt and senior subordinated debt, which permits the junior subordinated lender to obtain higher interest rates and warrants to purchase a portion of the borrower's stock and other profit enhancements.

Currently the company is emphasizing senior term loans, last out loans and second lien loans.

Our business strategy contemplates that:

- Interest income will be the primary source of our revenue and will be used to pay our monthly dividends and distributions,
- Net capital gains from the sale of the warrants or stock (as well as other profit enhancements) we receive in connection with our lending activities over the long term will exceed any losses we may experience from loans that are not repaid, and
- Fee income we derive from our lending will provide us with a source of revenue that will cover some of our general and administrative expenses (excluding interest expense from our lines of credit).

We believe we are well positioned to provide financing to small and medium-sized businesses undergoing a change of ownership, including management-led and third party leveraged buyouts, or those with good growth characteristics. We are not burdened with the regulatory requirements of the banking and savings and loan industries, and we have relatively low overhead and administrative expenses. Perhaps most importantly, we have the experience and expertise to satisfy the financing needs of such businesses.



GLADSTONE CAPITAL CORPORATION

OUR PORTFOLIO COMPANIES



NET INVESTMENT INCOME FOR THE FISCAL YEAR 2005 INCREASED 30% TO \$17.3 MILLION

We have identified certain characteristics that we believe are important to profitably lend to small and medium-sized businesses. The criteria listed below provide a general guideline for our lending and investment decisions.

- Experienced management team
- Significant sponsor
- Liquidation value of assets
- Profitable or near-profitable operations
- Growth
- Exit strategy

EXPERIENCED MANAGEMENT TEAM:

We generally require that each borrower have a management team that is experienced and properly incentivized through a significant ownership interest in the borrower. We generally will require that a borrower have, at a minimum, a strong chief executive officer and chief financial officer who have demonstrated the ability to accomplish the borrower's objectives and implement its business plan.

SIGNIFICANT SPONSOR:

We seek businesses in which buy-out funds or venture capital funds have invested. We believe a business in which a substantial equity sponsor has made a meaningful investment is a good borrowing candidate.

LIQUIDATION VALUE OF ASSETS:

Although we do not generally intend to operate as an asset-based lender, liquidation value of the assets collateralizing our loans is an important factor in each credit decision. Emphasis is placed both on tangible assets and intangible assets.

PROFITABLE OR NEAR PROFITABLE OPERATIONS:

We focus on borrowers that are profitable or near profitable at the operating level. We do not intend typically to lend to or invest in startup or other early stage companies, nor do we intend typically to lend to or invest in businesses that are experiencing operating problems.

GROWTH:

In addition to generating sufficient cash flow to service its debt, a potential borrower generally will be required to establish its ability to grow its cash flow. Anticipated growth will be a key factor in determining the value ascribed to any warrants we acquire in connection with our loans.

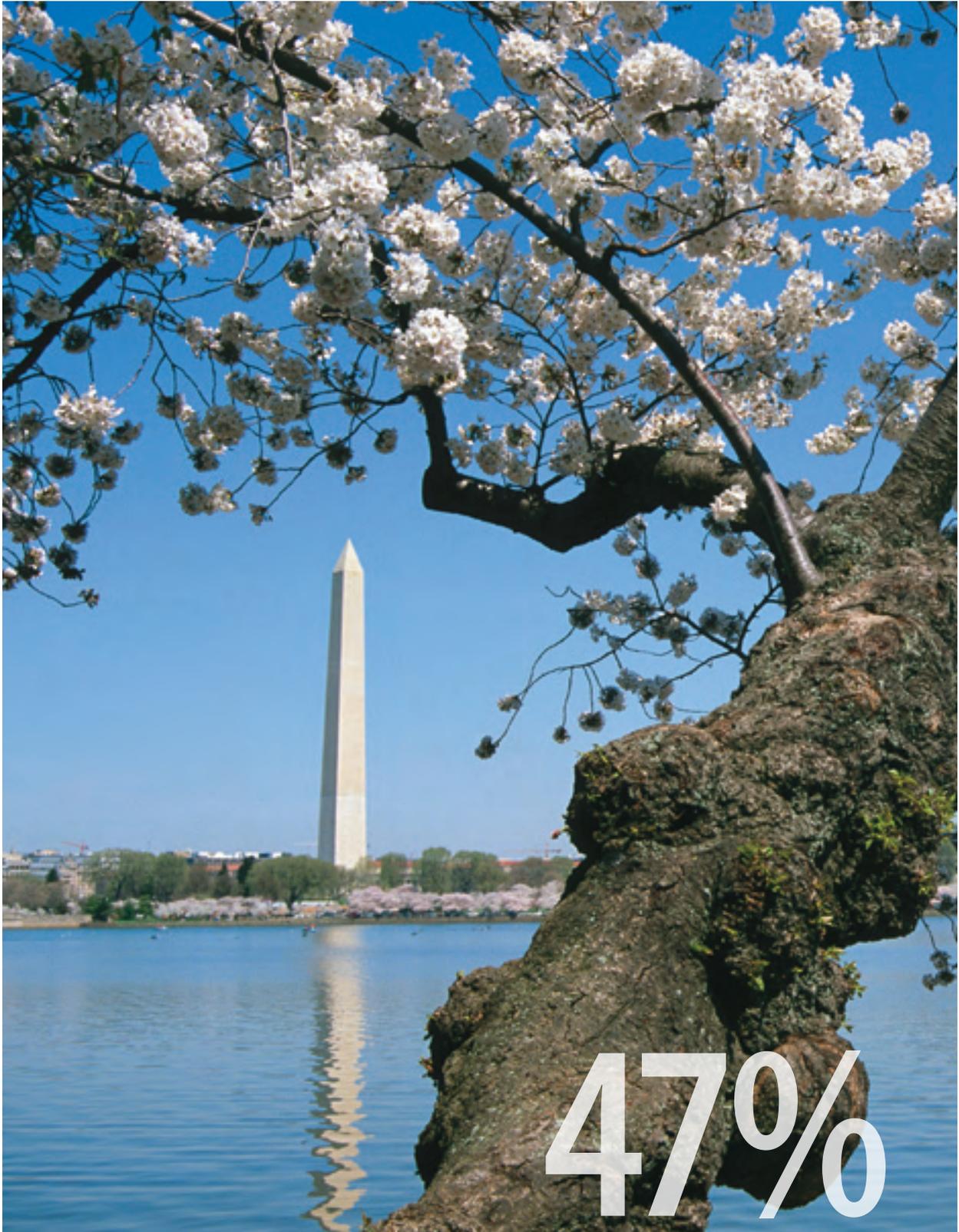
EXIT STRATEGY:

Prior to making a loan for which we receive a warrant to purchase stock of the borrower or other yield enhancement, we will analyze the potential for the borrower to experience a liquidity event that will allow us to realize value for our equity position. Liquidity events include, among other things, an initial public offering, a private sale of our financial interest, a merger or acquisition of the borrower or a purchase of our equity position by the borrower or one of its stockholders.



GLADSTONE CAPITAL CORPORATION

CHARACTERISTICS OF LOANS



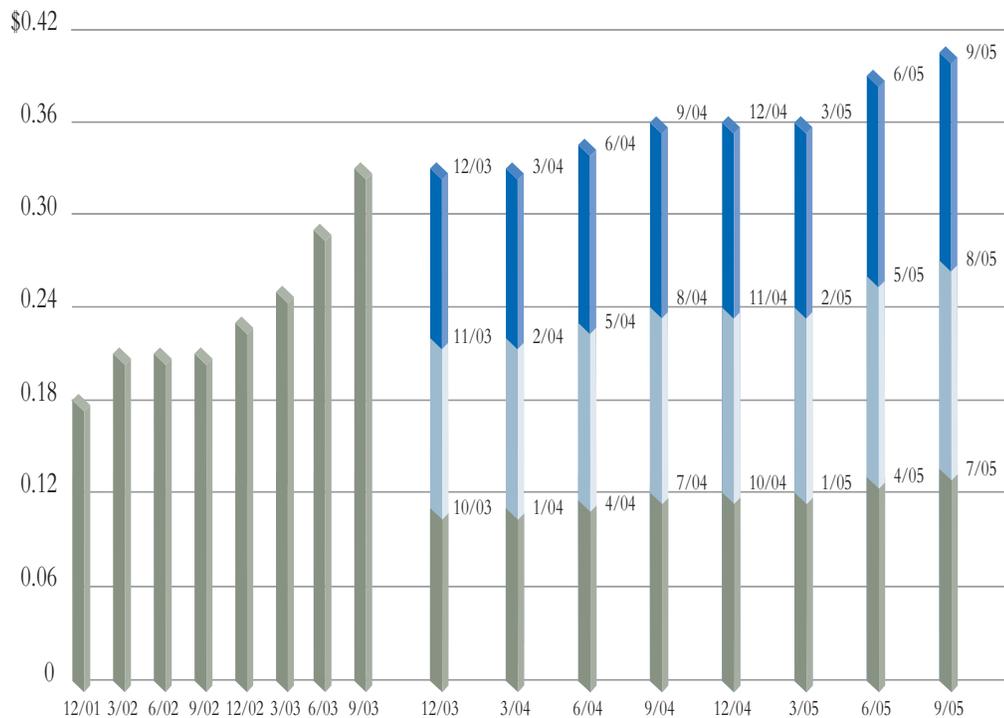
47%

NET INCREASE IN NET ASSETS RESULTING FROM OPERATIONS FOR THE FISCAL YEAR INCREASED NEARLY 47% TO \$15.5 MILLION

The loans we make to small and medium-sized private businesses generally exhibit many, if not all, of the following characteristics:

- Original principal amount from \$5 million to \$15 million
- Maturity of seven years or less
- Accrue interest at a fixed rate or a variable rate (sometimes with a minimum rate or floor)
- Interest payments made monthly with amortization of principal generally being deferred for some period
- Principal amount and any accrued but unpaid interest due at maturity
- Unrated by credit rating agencies—we use our own risk rating system
- May have conditional interest or success fees, payable if certain events occur
- May be accompanied by warrants that entitle us to purchase a modest percentage of the borrower’s stock

Gladstone Capital Dividend History
Dividend per Share (in dollars)

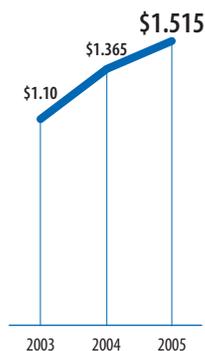


Beginning October 31, 2003, the Company started paying monthly dividends.



SELECTED FINANCIAL DATA

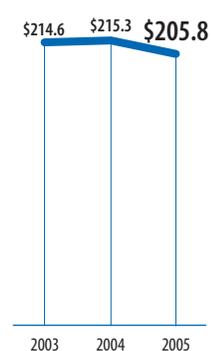
Cash Distributions Declared per Share



Net Investment Income
(dollars in millions)



Total Assets
(dollars in millions)



	Year Ended September 30, 2005	Year Ended September 30, 2004	Year Ended September 30, 2003	Year Ended September 30, 2002	Period May 30, 2001 (Inception) Through September 30, 2001
Total Investment Income	\$ 23,949,759	\$ 20,395,968	\$ 15,154,874	\$ 10,455,703	\$ 394,855
Total Expenses	\$ 7,531,436	\$ 7,103,193	\$ 3,858,953	\$ 2,839,102	\$ 487,499
Net Investment Income (Loss)	\$ 17,286,145	\$ 13,292,775	\$ 11,295,921	\$ 7,616,601	\$ (92,644)
Net Increase (Decrease) in Net Assets Resulting from Operations	\$ 15,490,682	\$ 10,570,290	\$ 11,073,581	\$ 7,616,601	\$ (92,644)
Per Share Data:					
Net Increase (Decrease) in Net Assets Resulting from Operations:					
Basic	\$ 1.37	\$ 1.05	\$ 1.10	\$ 0.76	\$ (0.03)
Diluted	\$ 1.33	\$ 1.02	\$ 1.09	\$ 0.75	\$ (0.03)
Cash Distributions Declared per Share	\$ 1.515	\$ 1.365	\$ 1.10	\$ 0.81	\$ —
Statement of Assets and Liabilities Data:					
Total Assets	\$205,793,094	\$215,333,727	\$214,566,663	\$172,922,039	\$132,205,486
Total Net Assets	\$151,610,683	\$152,226,655	\$130,802,382	\$130,663,273	\$131,249,144
Other Data:					
Number of Portfolio Companies at Period End	28	16	11	7	NONE
Principal Amount of Loan Originations ⁽¹⁾	\$143,794,006	\$ 86,267,500	\$ 47,011,278	\$ 97,705,054	NONE
Principal Amount of Loan Repayments ⁽¹⁾	\$ 88,019,136	\$ 47,158,995	\$ 18,005,827	\$ 18,387,191	NONE
Total Return ⁽²⁾	5.93%	24.40%	21.74%	9.60%	7.60%
Weighted Average Yield on Investments ⁽³⁾ :					
With PIK Interest ⁽⁴⁾	12.36%	13.78%	13.86%	14.79%	N/A
Without PIK Interest ⁽⁴⁾	12.23%	13.44%	13.14%	13.82%	N/A

(1) Includes all originations/prepayments related to a line of credit to one of our portfolio companies during the fiscal year ended September 30, 2002.

(2) For the fiscal years ended September 30, 2005 and September 30, 2004, the total return equals the increase of the ending market value over the beginning market value plus monthly dividends divided by the monthly beginning market value. For the fiscal year ended September 30, 2003 and prior periods, total return equals the increase of the ending market value over the beginning market value, plus distributions, divided by the beginning market value. The return for 2001 has not been annualized.

(3) Weighted average yield on investments equals interest income on investments divided by the average investment balance throughout the year.

(4) Refer to Note 2 of the "Notes to Consolidated Financial Statements" for an explanation of PIK, or "Paid-in-Kind," interest.



GLADSTONE CAPITAL CORPORATION

CORPORATE INFORMATION

Board of Directors and Executive Officers

David Gladstone

Chief Executive Officer and
Chairman of the Board

Terry Brubaker

Chief Operating Officer,
Vice Chairman and Director

George Stelljes, III

Chief Investment Officer,
President and Director

Harry Brill

Chief Financial Officer and Treasurer

Paul Adelgren

Director and Pastor of
Missionary Alliance Church

Maurice Coulon

Director and Private
Real Estate Investor

David A.R. Dullum

Director and Partner of
New England Partners

Michela English

Director and Private Investor

John Outland

Director and Vice President of
Genworth Financial, Inc.

Anthony W. Parker

Director and Founder and
Chairman of Medical Funding Corp.

Gladstone Team Members

Michael Brown

Managing Director

Joseph Bute

Managing Director

Buzz Cooper

Managing Director

Robert Corry

Managing Director

John Freal

Managing Director

Laura Gladstone

Managing Director

Paul Guisti

Managing Director

Clifford Gookin

Managing Director

Chris Massey

Managing Director

Robert Pierce

Managing Director

Virginia Rollins

Managing Director

Donya Kolcio

Controller

Paula Novara

Chief Compliance Officer

Allyson Williams

Compliance Officer

Kelly Sargent

Investor Relations

Stock Exchange Listing

The common stock of the company trades on The Nasdaq National Stock Market under the symbol GLAD.

Transfer Agent

The Bank of New York
Shareholder Relations Department
P.O. Box 11258
Church Street Station
New York, NY 10286, USA

Stockholder Inquiries:

Email:

shareowners@bankofny.com

Web site: www.stockbny.com

Inside the US:

1 (800) 524-4458 (toll-free)

Outside the US:

1 (610) 382-7833

(collect calls accepted)

Dividend Reinvestment Plan

The company offers a dividend reinvestment plan to its shareholders. Shareholders whose shares are held in their names should contact the transfer agent to enroll. Shareholders whose shares are held by a brokerage firm should contact their broker to enroll.

Financial Information

Shareholders may receive a copy of the company's Annual Report on Form 10-K and Quarterly Reports on Form 10-Q by contacting the company or going to the company's website at www.GladstoneCapital.com, the SEC website at www.SEC.gov or by visiting the SEC at 100 F Street NE, Washington, DC 20549.

Auditors and Tax Consultants

PricewaterhouseCoopers LLP

Legal Counsel

Cooley Godward, LLP

Kirkpatrick & Lockhart
Nicholson Graham LLP

Company Website

www.GladstoneCapital.com

 GLADSTONE CAPITAL

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