

GLADSTONE INVESTMENT CORPORATION\DE  
Form 10-Q  
November 01, 2006

**UNITED STATES**

**SECURITIES AND EXCHANGE COMMISSION**

WASHINGTON, D.C. 20549

**FORM 10-Q**

**x** **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d)  
OF THE SECURITIES EXCHANGE ACT OF 1934**

**FOR THE QUARTER ENDED SEPTEMBER 30, 2006**

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

**COMMISSION FILE NUMBER: 000-51233**

**GLADSTONE INVESTMENT CORPORATION**

(Exact name of registrant as specified in its charter)

**DELAWARE**

(State or other jurisdiction of incorporation or organization)

**83-0423116**

(I.R.S. Employer Identification No.)

**1521 WESTBRANCH DRIVE, SUITE 200**

**MCLEAN, VIRGINIA 22102**

(Address of principal executive office)

**(703) 287-5800**

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(Registrant's telephone number, including area code)

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 and (2) has been subject to such filing requirements for the past 90 days. Yes  No .

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer  Accelerated filer  Non-accelerated filer

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12 b-2 of the Exchange Act).

Yes  No

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date. The number of shares of the issuer's Common Stock, \$0.001 par value, outstanding as of November 1, 2006 was 16,560,100.

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**GLADSTONE INVESTMENT CORPORATION**

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**GLADSTONE INVESTMENT CORPORATION**  
**STATEMENTS OF ASSETS AND LIABILITIES**  
**(UNAUDITED)**

	September 30, 2006	March 31, 2006
<b>ASSETS</b>		
Non-Control/Non-Affiliate investments (Cost 9/30/06: \$122,529,078; 3/31/06: \$97,423,004)	\$ 121,555,262	\$ 97,585,972
Control investments (Cost 9/30/06: \$56,746,318; 3/31/06: \$55,846,318)	56,491,805	55,796,318
Total investments at fair value (Cost 9/30/06: \$179,275,396; 3/31/06: \$153,269,322)	178,047,067	153,382,290
Cash and cash equivalents	48,446,618	75,672,605
Interest receivable	1,294,355	761,388
Prepaid directors fees	72,500	
Prepaid insurance	200,875	99,874
Due from Adviser		234,551
Other assets	74,732	173,099
<b>TOTAL ASSETS</b>	<b>\$ 228,136,147</b>	<b>\$ 230,323,807</b>
<b>LIABILITIES</b>		
Administration fee payable to Gladstone Administration	\$ 124,861	\$ 110,002
Base management fee payable to Gladstone Management	861,893	
Accrued expenses	154,285	367,031
Other liabilities	16,692	5,077
Total Liabilities	1,157,731	482,110
<b>NET ASSETS</b>	<b>\$ 226,978,416</b>	<b>\$ 229,841,697</b>
<b>ANALYSIS OF NET ASSETS:</b>		
Common stock, \$0.001 par value, 100,000,000 shares authorized and 16,560,100 shares issued and outstanding	\$ 16,560	\$ 16,560
Capital in excess of par value	230,196,151	230,229,279
Net unrealized (depreciation) appreciation of investment portfolio	(1,228,329	) 112,968
Distributions in excess of net investment income	(2,005,966	) (517,110
Total Net Assets	\$ 226,978,416	\$ 229,841,697
Net assets per share	\$ 13.71	\$ 13.88

*THE ACCOMPANYING NOTES ARE AN INTEGRAL PART OF THESE FINANCIAL STATEMENTS.*

**GLADSTONE INVESTMENT CORPORATION**  
**SCHEDULE OF INVESTMENTS**  
**September 30, 2006**

(UNAUDITED)

Company (1)	Industry	Investment (2)	Cost	Fair Value
<b>NON-CONTROL/NON-AFFILIATE INVESTMENTS</b>				
Activant	Service - enterprise software and services	Senior Term Debt (7.5%, Due 5/2013) (3)	\$ 4,003,707	\$ 3,940,200
American Safety Razor Company Inc.	Manufacturing - razors and blades	Senior Term Debt (7.9%, Due 7/2013) (3)	1,498,843	1,511,213
Aspect Software, Inc.	Service - call center software	Senior Term Debt (8.4%, Due 7/2011) (3)	3,004,076	3,015,000
Bankruptcy Management Solutions, Inc.	Service - software and service to bankruptcy trustees	Senior Term Debt (8.2%, Due 7/2012) (3)	1,003,597	1,010,000
Brock Holdings II, Inc.	Service - industrial specialty maintenance	Senior Term Debt (7.9%, Due 8/2013) (3)	3,008,279	3,015,000
Compsych	Service - independent employee assistance programs	Senior Term Debt (8.1%, Due 2/2012) (3) (7)	3,956,832	3,949,850
CRC Health Group, Inc.	Service - substance abuse treatment	Senior Term Debt (7.6%, Due 2/2016) (3)	7,850,634	7,731,896
CST Industries Acquisition, Inc.	Manufacturing - metal storage tanks	Senior Term Debt (10.0%, Due 8/2013) (3)	1,002,100	1,005,000
Graham Packaging Holdings Co.	Manufacturing - custom blow molded	Senior Term Debt (7.8%, Due 10/2011) (3)	10,778,850	10,672,062
J. Crew Operating Corp.	Retail - apparel	Senior Term Debt (7.2%, Due 5/2013) (3)	1,757,068	1,754,386
Latham Manufacturing Corp.	Manufacturing - swimming pool components accessories	Senior Term Debt (8.9%, Due 6/2012) (3)	4,438,762	4,356,524
Lexicon Marketing USA, Inc.	Service - marketing to Hispanic community	Senior Term Debt (7.8%, Due 5/2012) (3)	2,995,063	3,029,906
LVI Services, Inc.	Service - asbestos and mold remediation	Senior Term Debt (8.2%, Due 11/2010) (3)	6,475,871	6,193,200
Madison River Capital LLC	Service - communications and information	Senior Term Debt (7.7%, Due 7/2012) (3)	5,785,564	5,771,563
Maidenform, Inc.	Manufacturing - intimate apparel	Senior Term Debt (7.2%, Due 5/2010) (3)	2,803,017	2,789,500
MedAssets, Inc.	Service - pharmaceuticals and healthcare GPO	Senior Term Debt (8.9%, Due 7/2010) (3) (7)	2,276,561	2,273,684
National Mentor Holdings, Inc.	Service - home health care	Senior Term Debt (7.9%, Due 6/2013) (3)	1,996,572	2,005,251
NPC International Inc.	Service - Pizza Hut franchisee	Senior Term Debt (7.1%, Due 5/2013) (3)	3,078,749	3,039,959
Nutro Products, Inc.	Manufacturing - pet food	Senior Term Debt (7.4%, Due 4/2012) (3)	2,510,732	2,490,609
Ozburn-Hessey Holding Co. LLC	Service - third party logistics	Senior Term Debt (8.8%, Due 8/2012) (3)	6,558,933	6,480,840
Patriot Media & Communications CNJ, LLC	Service - telecommunications	Senior Term Debt (7.6%, Due 3/2013) (3)	4,294,954	4,259,764
RPG Holdings, Inc.	Manufacturing and design - greeting cards	Senior Term Debt (9.0%, Due 12/2011) (3)	5,001,216	4,987,500
SGS International, Inc.	Service - digital imaging and graphics	Senior Term Debt (8.1%, Due 12/2011) (3)	1,620,806	1,614,829
SunGard Data Systems, Inc.	Service & manufacturing - integrated software and	Senior Term Debt (8.0%, Due 2/2013) (3)	9,975,562	9,961,406

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	processing solutions and information availability services			
Survey Sampling, LLC	Service - telecommunications-based sampling	Senior Term Debt (8.6%, Due 5/2011) (3)	3,437,427	3,401,579
Triad Laboratory Alliance, LLC	Service - regional medical laboratories	Senior Term Debt (8.6%, Due 12/2011) (3) (7)	4,980,266	4,962,500
US Investigative Services, Inc.	Service - background investigations	Senior Term Debt (7.9%, Due 10/2012) (3)	10,946,785	10,900,586
Wastequip, Inc.	Manufacturing - waste removal equipment	Senior Term Debt (7.6%, Due 7/2011) (3)	5,488,252	5,431,456
<b>Total Non-Control/Non-Affiliate Investments</b>			<b>122,529,078</b>	<b>121,555,262</b>

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**GLADSTONE INVESTMENT CORPORATION**  
**SCHEDULE OF INVESTMENTS (Continued)**  
**September 30, 2006**  
**(UNAUDITED)**

<b>Company (1)</b>	<b>Industry</b>	<b>Investment (2)</b>	<b>Cost</b>	<b>Fair Value</b>
<b>CONTROL INVESTMENTS</b>				
Chase II Holdings Corp.	Manufacturing - Traffic doors	Revolving Credit Facility (5)		
		Senior Term Debt (9.8%, Due 3/2011) (7)	12,900,000	12,883,875
		Senior Term Debt (12.0% Due 3/2011) (7)	8,000,000	7,960,000
		Subordinated Term Debt (13% Due 3/2013) (7)	6,167,810	6,098,422
		Redeemable Preferred Stock (4) (8)	6,960,806	6,960,806
		Common Stock (4) (8)	61,384	61,384
			34,090,000	33,964,487
Hailey Transport Corporation	Retail and service - school buses and parts	Senior Subordinated Term Debt (12.0%, Due 1/2012) (7)	4,000,000	3,930,000
		Preferred Stock (4) (8)	2,500,000	2,500,000
			6,500,000	6,430,000
Quench Holdings Corp.	Service - sales, installation and service of water coolers	Revolving Credit Facility (9.3%, Due 3/2009) (6) (7)	900,000	891,000
		Senior Term Debt (9.3%, Due 3/2011) (7)	4,000,000	4,000,000
		Subordinated Term Debt (11.5%, Due 3/2011) (7)	8,000,000	7,950,000
		Common Stock (4) (8)	3,256,318	3,256,318
			16,156,318	16,097,318
<b>Total Control Investments</b>			<b>56,746,318</b>	<b>56,491,805</b>
<b>Total Investments</b>			<b>\$ 179,275,396</b>	<b>\$ 178,047,067</b>
<b>Cash equivalents</b>				
	Government	US Treasury Bill (4.7%, 10/5/2006)	4,082,155	4,082,155
	Government	US Treasury Bill (4.8%, 10/26/2006)	18,043,299	18,043,299
	Government	US Treasury Bill (4.7%, 11/24/2006)	7,882,236	7,882,236
<b>Total cash equivalents:</b>			<b>30,007,690</b>	<b>30,007,690</b>
<b>Total investments and cash equivalents:</b>			<b>\$ 209,283,086</b>	<b>\$ 208,054,757</b>

- (1) Certain of the listed securities are issued by affiliate(s) of the indicated portfolio company.
- (2) Percentage represents the weighted average interest rates in effect at September 30, 2006 and due date represents the contractual maturity date.
- (3) Marketable securities are valued based on the indicative bid price, as of September 30, 2006, from the respective originating syndication agent's trading desk.
- (4) Security is non-income producing.
- (5) Total available under the revolving credit facility is \$500,000 which was undrawn as of September 30, 2006.
- (6) Total available under the revolving credit facility is \$2,000,000, of which \$1,100,000 remains undrawn at September 30, 2006.
- (7) Valued using Standards & Poors Securities Evaluations, Inc. estimates at September 30, 2006.
- (8) Fair value is equal to cost due to recent acquisition.

*THE ACCOMPANYING NOTES ARE AN INTEGRAL PART OF THESE FINANCIAL STATEMENTS.*

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**GLADSTONE INVESTMENT CORPORATION**  
**SCHEDULE OF INVESTMENTS**  
**March 31, 2006**  
**(UNAUDITED)**

<b>Company (1)</b>	<b>Industry</b>	<b>Investment (2)</b>	<b>Cost</b>	<b>Fair Value</b>
<b>NON-CONTROL/NON-AFFILIATE INVESTMENTS</b>				
CRC Health Group, Inc	Service - substance abuse treatment	Senior Term Debt (6.9%, Due 2/2016) (3)	\$ 5,056,761	\$ 5,056,250
Graham Packaging Holdings Co	Manufacturing - custom blow molded	Senior Term Debt (7.0%, Due 10/2011) (3)	10,071,296	10,061,087
Hertz Equipment Rental Corporation	Service - car rentals	Senior Term Debt (6.7%, Due 12/2010) (3)	871,388	876,560
Latham Manufacturing Corp.	Manufacturing - swimming pool components accessories	Senior Term Debt (7.8%, Due 12/2010) (3)	4,454,333	4,461,188
Le-Natures, Inc.	Marketing & development - natural beverages	Senior Term Debt (7.7%, Due 6/2010) (3)	5,042,467	5,074,713
LVI Services, Inc.	Service - asbestos and mold remediation	Senior Term Debt (7.3%, Due 11/2010) (3)	6,511,390	6,540,483
Madison River Capital LLC	Service - communications and information information	Senior Term Debt (6.8%, Due 7/2012) (3)	5,788,660	5,829,062
Maidenform, Inc.	Manufacturing - intimate apparel	Senior Term Debt (6.5%, Due 5/2010) (3)	3,118,448	3,122,787
MedAssets, Inc.	Service - pharmaceuticals and healthcare GPO	Senior Term Debt (7.7%, Due 7/2010) (3) (7)	2,340,111	2,348,526
Ozburn-Hessey Holding Co. LLC	Service - third party logistics	Senior Term Debt (7.3%, Due 8/2012) (3)	6,382,673	6,376,646
Patriot Media & Communications CNJ, LLC	Service - telecommunications	Senior Term Debt (7.0%, Due 3/2013) (3)	4,360,777	4,359,125
Revere Industries, LLC	Manufacturing-plastic and metal components	Senior Term Debt (7.6%, Due 9/2010) (3)	3,508,831	3,504,546
RPG Holdings, Inc.	Manufacturing and design - greeting cards	Senior Term Debt (8.2%, Due 12/2011) (3)	5,001,332	5,000,000
SGS International, Inc.	Service - digital imaging and graphics	Senior Term Debt (7.2%, Due 12/2011) (3)	1,404,081	1,415,702
SunGard Data Systems, Inc.	Service & manufacturing - integrated software and processing	Senior Term Debt (7.2%, Due 2/2013) (3)	10,033,531	10,049,063
Triad Laboratory Alliance, LLC	Service - regional medical laboratories	Senior Term Debt (7.8%, Due 12/2011) (3) (7)	5,006,982	5,012,438
TexStar Operating, L.P.	Manufacturing - midstream natural gas processing	Senior Term Debt (8.3%, Due 12/2011) (3) (7)	3,000,161	2,999,981
US Investigative Services, Inc.	Service - background investigations	Senior Term Debt (7.4%, Due 10/2012) (3)	9,948,345	9,984,478

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Wastequip, Inc.	Manufacturing - waste removal equipment	Senior Term Debt (7.0%, Due 7/2011) (3)	5,521,437	5,513,337
<b>Total Non-Control/Non-Affiliate Investments</b>			<b>97,423,004</b>	<b>97,585,972</b>

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**GLADSTONE INVESTMENT CORPORATION**  
**SCHEDULE OF INVESTMENTS (Continued)**  
**March 31, 2006**  
**(UNAUDITED)**

<b>Company (1)</b>	<b>Industry</b>	<b>Investment (2)</b>	<b>Cost</b>	<b>Fair Value</b>
<b>CONTROL INVESTMENTS</b>				
Chase II Holdings Corp.	Manufacturing - traffic doors	Revolving Credit Facility (5)		
		Senior Term Debt (9.1%, Due 3/2011)	12,900,000	12,900,000
		Senior Term Debt (12.0% Due 3/2011)	8,000,000	8,000,000
		Subordinated Term Debt (13% Due 3/2013)	6,167,810	6,167,810
		Redeemable Preferred Stock (4) (8)	6,960,806	6,960,806
		Common Stock (4) (8)	61,384	61,384
			34,090,000	34,090,000
Hailey Transport Corporation	Retail and Service - school buses and parts	Senior Subordinated Term Debt (12.0%, Due 1/2012) (7)	4,000,000	3,950,000
		Common Stock (4) (8)	2,500,000	2,500,000
			6,500,000	6,450,000
Quench Holdings Corp.	Service - sales, installation and service of water coolers	Revolving Credit Facility (6)		
		Senior Term Debt (9.1%, Due 3/2011)	4,000,000	4,000,000
		Subordinated Term Debt (11.5%, Due 3/2011)	8,000,000	8,000,000
		Common Stock (4) (8)	3,256,318	3,256,318
			15,256,318	15,256,318
<b>Total Control Investments</b>			<b>55,846,318</b>	<b>55,796,318</b>
<b>Total Investments</b>			<b>\$ 153,269,322</b>	<b>\$ 153,382,290</b>
<b>Cash equivalents</b>				
	Government	US Treasury Bill (4.2%, 4/20/2006)	3,989,800	3,989,800
	Government	US Treasury Bill (4.4%, 4/27/2006)	15,241,694	15,241,694
	Government	US Treasury Bill (4.4%, 5/4/2006)	35,132,347	35,132,347
	Government	US Treasury Bill (4.4%, 5/25/2006)	15,243,245	15,243,245
<b>Total cash equivalents:</b>			<b>69,607,086</b>	<b>69,607,086</b>
<b>Total investments and cash equivalents:</b>			<b>\$ 222,876,408</b>	<b>\$ 222,989,376</b>

(1) Certain of the listed securities are issued by affiliate(s) of the indicated portfolio company.

(2) Percentage represents the weighted average interest rates in effect at March 31, 2006 and due date represents the contractual maturity date.

(3) Marketable securities are valued based on the indicative bid price, as of March 31, 2006, from the respective originating syndication agent's trading desk.

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- (4) Security is non-income producing.
- (5) Total available under the revolving credit facility is \$500,000 which was undrawn as of March 31, 2006.
- (6) Total available under the revolving credit facility is \$2,000,000 which was undrawn as of March 31, 2006.
- (7) Valued using Standard & Poor's Securities Evaluations, Inc. estimates at March 31, 2006.
- (8) Fair value is equal to cost due to recent acquisition.

*THE ACCOMPANYING NOTES ARE AN INTEGRAL PART OF THESE FINANCIAL STATEMENTS.*

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**GLADSTONE INVESTMENT CORPORATION**  
**STATEMENTS OF OPERATIONS**  
**(UNAUDITED)**

	<b>For the three months ended September 30, 2006</b>	<b>For the three months ended September 30, 2005</b>
<b>INVESTMENT INCOME</b>		
Interest income		
Non-Control/Non-Affiliate investments	\$ 2,387,375	\$ 193,578
Control investments	1,256,303	
Cash and cash equivalents	569,580	1,613,012
Total interest income	4,213,258	1,806,590
Other income	670	
Total investment income	4,213,928	1,806,590
<b>EXPENSES</b>		
Administration fee	124,861	77,962
Base management fee	861,893	92,108
Directors fees	56,250	52,000
Insurance expense	67,626	42,478
Professional fees	88,040	66,302
Stockholder related costs	65,100	42,903
Taxes and licenses	41,337	
Other expenses	24,935	19,931
Total expenses	1,330,042	393,684
NET INVESTMENT INCOME	2,883,886	1,412,906
<b>REALIZED AND UNREALIZED GAIN (LOSS) ON INVESTMENTS</b>		
Realized loss on sale of Non-Control/Non-Affiliate investments	(1,934	)
Net unrealized (depreciation) appreciation of investment portfolio	(33,908	) 63,826
Net loss on investments	(35,842	) 63,826
<b>NET INCREASE IN NET ASSETS RESULTING FROM OPERATIONS (Refer to Note 5)</b>		
	\$ 2,848,044	\$ 1,476,732
<b>NET INCREASE IN NET ASSETS RESULTING FROM OPERATIONS PER COMMON SHARE:</b>		
Basic and Diluted	\$ 0.17	\$ 0.09
<b>SHARES OF COMMON STOCK OUTSTANDING:</b>		
Basic and diluted weighted average shares	16,560,100	16,231,404

*THE ACCOMPANYING NOTES ARE AN INTEGRAL PART OF THESE FINANCIAL STATEMENTS.*

**GLADSTONE INVESTMENT CORPORATION**  
**STATEMENTS OF OPERATIONS**  
**(UNAUDITED)**

	For the six months ended September 30, 2006	For the period June 22, 2005 (Commencement of Operations) to September 30, 2005
<b>INVESTMENT INCOME</b>		
Interest income		
Non-Control/Non-Affiliate investments	\$ 4,351,855	\$ 193,578
Control investments	2,446,605	
Cash and cash equivalents	1,277,920	1,661,210
Total interest income	8,076,380	1,854,788
Other income	986	
Total investment income	8,077,366	1,854,788
<b>EXPENSES</b>		
Administration fee	240,250	105,045
Base management fee	1,663,202	92,108
Directors fees	99,500	52,000
Insurance expense	140,237	42,478
Professional fees	167,788	66,302
Stockholder related costs	158,866	43,538
Interest expense		378
Taxes and licenses	98,444	
Other expenses	44,029	20,233
Total expenses	2,612,316	422,082
<b>NET INVESTMENT INCOME</b>	<b>5,465,050</b>	<b>1,432,706</b>
<b>REALIZED AND UNREALIZED GAIN (LOSS) ON INVESTMENTS</b>		
Net realized gain on sale of Non-Control/Non-Affiliate investments	1,339	
Net unrealized (depreciation) appreciation of investment portfolio	(1,341,297)	) 63,826
Net gain on investments	(1,339,958)	) 63,826
<b>NET INCREASE IN NET ASSETS RESULTING FROM OPERATIONS (Refer to Note 5)</b>	<b>\$ 4,125,092</b>	<b>\$ 1,496,532</b>
<b>NET INCREASE IN NET ASSETS RESULTING FROM OPERATIONS PER COMMON SHARE:</b>		
Basic and Diluted	\$ 0.25	\$ 0.09
<b>SHARES OF COMMON STOCK OUTSTANDING:</b>		
Basic and diluted weighted average shares	16,560,100	16,084,900

*THE ACCOMPANYING NOTES ARE AN INTEGRAL PART OF THESE FINANCIAL STATEMENTS.*



**GLADSTONE INVESTMENT CORPORATION**  
**STATEMENTS OF CHANGES IN NET ASSETS**  
**(UNAUDITED)**

	For the six months ended September 30, 2006	For the period June 22, 2005 (Commencement of Operations) to September 30, 2005
<i>Operations:</i>		
Net investment income	\$ 5,465,050	\$ 1,432,706
Realized gain on sale of investments	1,339	
Unrealized (depreciation) appreciation of portfolio	(1,341,297	) 63,826
Increase in net assets from operations	4,125,092	1,496,532
<i>Capital transactions:</i>		
Issuance of common stock		230,248,986
Shelf registration offering costs	(33,128	)
Dividends from net investment income	(6,955,245	) (993,606
Total change in net assets from capital transactions	(6,988,373	) 229,255,380
Total change in net assets	(2,863,281	) 230,751,912
<b>Net Assets</b>		
Beginning of period	229,841,697	1,500
End of period	\$ 226,978,416	\$ 230,753,412

*THE ACCOMPANYING NOTES ARE AN INTEGRAL PART OF THESE FINANCIAL STATEMENTS.*

**GLADSTONE INVESTMENT CORPORATION**  
**STATEMENTS OF CASH FLOWS**  
**(UNAUDITED)**

	For the six months ended September 30, 2006	For the period June 22, 2005 (Commencement of Operations) to September 30, 2005
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>		
Net increase in net assets resulting from operations	\$ 4,125,092	\$ 1,496,532
Adjustments to reconcile net increase in net assets resulting from operations to net cash used in operating activities:		
Purchase of investments	(49,477,779	) (40,844,381
Principal repayments of investments	6,838,467	333,363
Proceeds from the sale of debt investments	16,549,229	
Net unrealized depreciation (appreciation) of investment portfolio	1,341,297	(63,826
Net realized gains on sales of investments	(1,339	)
Net amortization of premiums and discounts	85,348	3,134
Increase in interest receivable	(532,967	) (106,434
Increase in prepaid assets	(176,467	) (295,450
Decrease (increase) in other assets	101,333	(13,606
Decrease in other liabilities	11,615	
Increase in administration fee payable to Gladstone Administration	14,859	77,962
Increase in base management fee payable to Gladstone Management	1,096,444	67,434
Increase in accounts payable		32,071
(Decrease) increase in accrued expenses	(212,746	) 30,343
Net cash used in operating activities	(20,237,614	) (39,282,858
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>		
Net proceeds from the issuance of common stock		230,296,850
Shelf offering registration costs	(33,128	)
Distributions paid	(6,955,245	) (993,606
Decrease in loan payable to affiliate		(50,000
Net cash (used in) provided by financing activities	(6,988,373	) 229,253,244
<b>NET (DECREASE) INCREASE IN CASH AND CASH EQUIVALENTS (1)</b>	(27,225,987	) 189,970,386
<b>CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD</b>	75,672,605	3,636
<b>CASH AND CASH EQUIVALENTS, END OF PERIOD</b>	\$ 48,446,618	\$ 189,974,022
<b>CASH PAID DURING PERIOD FOR INTEREST TO AFFILIATE</b>	\$	\$ 378

(1) Cash and cash equivalents consist of demand deposits and highly liquid investments with original maturities of three months or less when purchased.

THE ACCOMPANYING NOTES ARE AN INTEGRAL PART OF THESE FINANCIAL STATEMENTS.

**GLADSTONE INVESTMENT CORPORATION**  
**FINANCIAL HIGHLIGHTS**  
**(UNAUDITED)**

	For the three months ended September 30, 2006	For the three months ended September 30, 2005
<u>Per Share Data (1)</u>		
Balance at beginning of period	\$ 13.75	\$ 13.90
<i>Income from investment operations:</i>		
Net investment income (2)	0.17	0.09
Realized gain on sale of investments (2)		
Net unrealized appreciation of investments (2)		
Total from investment operations	0.17	0.09
Distributions	(0.21	) (0.06 )
Net asset value at end of period	\$ 13.71	\$ 13.93
Per share market value at beginning of period	\$ 14.82	\$ 15.05
Per share market value at end of period	14.60	14.68
Total return (3)	-0.04	% -2.07 %
Shares outstanding at end of period	16,560,100	16,560,100
<u>Ratios/Supplemental Data</u>		
Net assets at end of period	\$ 226,978,416	\$ 230,753,412
Average net assets (4)	\$ 226,140,557	\$ 230,242,643
Ratio of expenses to average net assets (annualized)	2.35	% 0.68 %
Ratio of net investment income to average net assets (annualized)	5.10	% 2.45 %

(1) Based on actual shares outstanding.

(2) Based on weighted average basic per share data.

(3) Total return equals the change in the market value of the Company's common stock from the beginning of the period taking into account dividends reinvested in accordance with the terms of our dividend reinvestment plan.

(4) Calculated using the average of the ending monthly net assets for the respective periods.

*THE ACCOMPANYING NOTES ARE AN INTEGRAL PART OF THESE FINANCIAL STATEMENTS.*

**GLADSTONE INVESTMENT CORPORATION**  
**FINANCIAL HIGHLIGHTS**  
**(UNAUDITED)**

	For the six months ended September 30, 2006	For the period June 22, 2005 (Commencement of Operations) to September 30, 2005
<b>Per Share Data (1)</b>		
Balance at beginning of period	\$ 13.88	\$
Net proceeds from initial public offering (2)		13.95
Offering costs		(0.05 )
<i>Income from investment operations:</i>		
Net investment income (3)	0.33	0.09
Realized gain on sale of investments (3)		
Net unrealized appreciation of investments (3)	(0.08 )	
Total from investment operations	0.25	0.09
Distributions	(0.42 )	(0.06 )
Net asset value at end of period	\$ 13.71	\$ 13.93
Per share market value at beginning of period	\$ 14.90	\$ 15.00
Per share market value at end of period	14.60	14.68
Total return (4)	0.87	% -1.74 %
Shares outstanding at end of period	16,560,100	16,560,100
<b>Ratios/Supplemental Data</b>		
Net assets at end of period	\$ 226,978,416	\$ 230,753,412
Average net assets (5)	\$ 226,929,612	\$ 222,716,478
Ratio of expenses to average net assets (annualized)	2.30	% -0.57 %
Ratio of net investment income to average net assets (annualized)	4.82	% 1.93 %

(1) Based on actual shares outstanding.

(2) Net of initial underwriting discount of \$1.05 per share.

(3) Based on weighted average basic per share data.

(4) Total return equals the change in the market value of the Company's common stock from the beginning of the period taking into account dividends reinvested in accordance with the terms of our dividend reinvestment plan.

(5) Calculated using the average of the ending monthly net assets for the respective periods.

*THE ACCOMPANYING NOTES ARE AN INTEGRAL PART OF THESE FINANCIAL STATEMENTS.*

**GLADSTONE INVESTMENT CORPORATION**

**NOTES TO FINANCIAL STATEMENTS**

**SEPTEMBER 30, 2006**

**(UNAUDITED)**

**NOTE 1. ORGANIZATION**

Gladstone Investment Corporation (the "Company") was incorporated under the General Corporation Laws of the State of Delaware on February 18, 2005 and completed an initial public offering on June 22, 2005. The Company is a closed-end, non-diversified management investment company that has elected to be treated as a business development company under the Investment Company Act of 1940, as amended (the "1940 Act"). In addition, the Company has elected to be treated for tax purposes as a regulated investment company, or RIC, under the Internal Revenue Code of 1986, as amended (the "Code"). The Company's investment objectives are to achieve a high level of current income and capital gains by investing in debt and equity securities of established private businesses.

Gladstone Business Investment LLC, a wholly-owned subsidiary of the Company, was established on August 11, 2006 for the sole purpose of owning the Company's portfolio of investments in connection with the establishment of its line of credit facility with Deutsche Bank AG, which recently closed on October 19, 2006. The financial statements of the subsidiary are consolidated with those of the Company.

The Company is externally managed by Gladstone Management Corporation ("GMC"), an unconsolidated affiliate of the Company.

**NOTE 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

*Interim Financial Statements*

Interim financial statements of the Company are prepared in accordance with accounting principles generally accepted in the United States of America ("GAAP") for interim financial information and pursuant to the requirements for reporting on Form 10-Q and Article 10 of Regulation S-X. Accordingly, certain disclosures accompanying annual financial statements prepared in accordance with GAAP are omitted. In the opinion of management, all adjustments, consisting solely of normal recurring accruals, necessary for the fair statement of financial statements for the interim periods have been included. The current period's results of operations are not necessarily indicative of results that ultimately may be achieved for the year. The interim financial statements and notes thereto should be read in conjunction with the financial statements and notes thereto included in the Company's Form 10-K for the fiscal year ended March 31, 2006, as filed with the Securities and Exchange Commission on June 14, 2006.

*Use of Estimates*

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

*Classification of Investments*

The 1940 Act requires classification of the Company's investments by its respective level of control. As defined in the 1940 Act, "Control Investments" are investments in those portfolio companies that the Company is deemed to "Control". "Affiliate Investments" are investments in those portfolio companies that are "Affiliated Companies" of the Company, as defined in the 1940 Act, other than Control Investments.

"Non-Control/Non-Affiliate Investments" are those that are neither Control Investments nor Affiliate Investments. In general, the 1940 Act prescribes that the Company has control over a portfolio company if it owns greater than 25% of the voting securities of the portfolio company. The Company is deemed to be an affiliate of a portfolio company if it owns between 5% and 25% of the voting securities of such portfolio company or has one or more seats on the affiliated company's Board of Directors. However, if the Company holds 50% or more representation on a portfolio company's Board of Directors, the Company will be deemed to have control over the portfolio company.

### *Investment Valuation*

The Company carries its investments at fair value, as determined by its Board of Directors. Securities that are publicly traded are valued at the closing price on the valuation date. Securities for which a limited market exists, such as participations in syndicated loans, are valued at the indicative bid price on the valuation date from the respective originating syndication agent's trading desk. Debt and equity securities that are not publicly traded are valued at fair value as determined in good faith by the Board of Directors. The Company currently engages Standard & Poor's Securities Evaluations, Inc. ( SPSE ) to perform independent valuations of some of its investments. The Board of Directors uses opinions of value submitted by SPSE as a component of the foundation for the final fair value determination of such investments. In making fair value determinations, the Board of Directors values non-convertible debt securities at cost plus amortized original issue discount plus payment in kind ( PIK ) interest, if any, unless adverse factors lead to a determination of a lesser valuation. In valuing convertible debt, equity, success or exit fees or other equity-like securities, the Board of Directors determines the fair value based on the collateral, the issuer's ability to make payments, the earnings of the issuer, sales to third parties of similar securities, the comparison to publicly traded securities, discounted cash flow and other pertinent factors. Due to the uncertainty inherent in the valuation process, such estimates of fair value may differ significantly from the values that would have resulted had a ready market for the securities existed, and the differences could be material. Additionally, changes in the market environment and other events that may occur over the life of the investments may cause the gains ultimately realized on these investments to be different than the valuation currently assigned. Because there is a delay between when the Company closes a loan and when the loan can be evaluated by SPSE, new loans are not evaluated immediately by SPSE; rather, the Board of Directors makes its own independent determination about the value of the loan in accordance with the Company's valuation policy without the input of SPSE. Because SPSE does not perform independent valuations of the Company's equity securities, the Board of Directors also determines the fair value of these investments without the input of SPSE. The Board of Directors considers a number of qualitative and quantitative factors in current market conditions when performing valuations and is ultimately responsible for the fair value and disclosure of investments in the financial statements.

### *Interest Income Recognition*

Interest income, adjusted for amortization of premiums and acquisition costs and for the accretion of discounts, is recorded on the accrual basis to the extent that such amounts are expected to be collected. The Company stops accruing interest on its investments when it is determined that interest is no longer collectible. Conditional interest or a success fee is recorded upon full repayment of a loan investment.

### *Fee Income*

The 1940 Act requires that a business development company make available managerial assistance to its portfolio companies by providing significant guidance and counsel concerning the management, operations, or business objectives and policies of the respective portfolio company. The Company provides these and other services through its adviser, GMC. Currently, neither the Company nor GMC receives fees in connection with managerial assistance. However, GMC receives fees for the other services it provides, and 50% of those fees for other services are credited to the investment advisory fees due to GMC. These other fees are generally paid to GMC upon the closing of the investment. These fees are generally non-recurring, are recognized as revenue when earned and are paid directly to GMC by the borrower or potential borrower upon closing of the investment. The services GMC provides vary by investment, but generally include a wide variety of services to the portfolio companies such as investment banking services, arranging bank financing, arranging equity financing, structuring financing from multiple lenders and investors, reviewing existing credit facilities, restructuring existing loans, raising equity and debt capital, turnaround management, merger and acquisition services and recruiting new management personnel. Any services of this nature subsequent to the closing would generally generate a separate fee at the time of completion. From time to time, the Company is invited to participate as a co-lender in a transaction. In the event that the Company does not provide significant services in connection with our investment, loan fees paid directly to GMC in such situations are deferred and amortized over the life of the loan.

### *Cash and Cash Equivalents*

The Company considers all short-term, highly liquid investments that are both readily convertible to cash and have a maturity of three months or less at the time of purchase to be cash equivalents. Items classified as cash equivalents include temporary investments in U.S. Treasury bills and can also include commercial paper and money-market funds. All of the Company's cash at September 30, 2006 was deposited with two financial institutions, and the Company's balances exceed federally insurable limits. The Company seeks to mitigate this risk by depositing funds with major financial institutions.



*Realized Gain or Loss and Unrealized Appreciation or Depreciation of Portfolio Investments*

Realized gain or loss is recognized when an investment is sold and is computed as the difference between the Company's cost basis in the investment at the date of sale and the net proceeds received from such sale. Unrealized appreciation or depreciation reflects the difference between the fair market value of the investment and the cost basis of such investment.

*Income Taxes*

The Company intends to continue to qualify for treatment as a RIC under subchapter M of the Code. As a RIC, the Company will not be subject to federal income tax on the portion of its taxable income and gains distributed to stockholders. To qualify as a RIC, the Company is required to distribute at least 90% of investment company taxable income, as defined by the Code. The Company intends to distribute at least 90% of its ordinary income, and as a result, no income tax provisions have been recorded. The Company may, but does not intend to, pay out a return of capital.

*New Accounting Pronouncements*

In September 2006, the FASB issued Statement of Financial Accounting Standards No. 157, *Fair Value Measurements* (SFAS 157). SFAS 157 defines fair value, establishes a framework for measuring fair value in GAAP and expands disclosures about fair value measurements. SFAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. The Company is required to adopt the provisions of SFAS 157 beginning with the fiscal year ended March 31, 2009. The Company does not expect this pronouncement to have a material impact on the Company's financial position or net increase to net assets resulting from operations.

NOTE 3. RELATED PARTY TRANSACTIONS

**Investment Advisory and Management Agreement**

We have entered into an investment advisory and management agreement with GMC (the *Advisory Agreement*), which is controlled by our chairman and chief executive officer. In accordance with the *Advisory Agreement*, we pay GMC a fee, as compensation for its services, consisting of a base management fee and an incentive fee.

The base management fee is assessed at an annual rate of 2% computed on the basis of the average value of the Company's gross invested assets at the end of the two most recently completed quarters, which are total assets less the cash proceeds and cash and cash equivalents from the proceeds of the Company's initial public offering that are not invested in debt and equity securities of portfolio companies. Through September 30, 2006, the base management fee was computed and payable quarterly. Beginning in periods subsequent to December 31, 2006, the base management fee will be assessed at an annual rate of 2% computed on the basis of the average value of the Company's average gross assets at the end of the two most recently completed quarters, which are total assets, including investments made with proceeds of borrowings, less any uninvested cash or cash equivalents resulting from borrowings. This new calculation was originally scheduled to begin in periods after March 31, 2006; however, on April 11, 2006 and July 11, 2006, the Company's Board of Directors accepted a voluntary waiver from GMC that allowed the current calculation of the base management fee to be effective through June 30, 2006 and September 30, 2006, respectively. Further, on October 10, 2006, the Company's Board of Directors accepted another voluntary waiver from GMC that will allow the current calculation of the base management fee to be effective through December 31, 2006.

When GMC receives fees from the Company's portfolio companies, such as investment banking fees, structuring fees or executive recruiting services fees, one half of these fees will be credited against the base management fee that the Company would otherwise be required to pay to GMC. For the three and six months ended September 30, 2006, the Company recognized a base management fee of \$861,893 and \$1,663,202, respectively, of which \$861,893 remained unpaid at September 30, 2006 and is reflected in the accompanying statements of assets and liabilities as a base management fee payable to GMC. The Company recognized a base management fee of \$92,108 for the three months ended September 30, 2005 and for the period June 22, 2005 (commencement of operations) to September 30, 2005.

The incentive fee consists of two parts: an income-based incentive fee and a capital gains incentive fee. The income-based incentive fee is calculated and payable quarterly in arrears based on the Company's pre-incentive fee net investment income for the immediately preceding calendar quarter. The capital gains incentive fee is determined and payable annually in arrears as of the end of each fiscal year (or upon termination of the *Advisory Agreement*, as of the termination date) and equals 20.0% of the realized capital gains since inception through the end of the current fiscal year, if any, computed net of all realized capital losses, and net unrealized capital





depreciation since inception at the end of each fiscal year. Refer to the Company's Form 10-K for the fiscal year ended March 31, 2006 for more information regarding the calculation of the incentive fee.

Because pre-incentive fee net investment income was below the hurdle rate of 1.75% of net assets, no income-based incentive fee was recorded for the three or six months ended September 30, 2006, the three months ended September 30, 2005 or the period June 22, 2005 (Commencement of operations) to September 30, 2005.

#### Administration Agreement

The Company has entered into an administration agreement (the Administration Agreement) with Gladstone Administration, LLC (Gladstone Administration), a wholly owned subsidiary of GMC, which is controlled by the Company's chairman and chief executive officer. Pursuant to the Administration Agreement, Gladstone Administration furnishes the Company with office facilities, equipment and clerical, bookkeeping and record keeping services at such facilities and performs, or oversees the performance of the Company's required administrative services. Such required administrative services include, among other things, being responsible for the financial records which we are required to maintain and preparing reports to our stockholders and reports filed with the Securities and Exchange Commission (the SEC).

The Administration Agreement requires the Company to reimburse Gladstone Administration for the performance of its obligations under the Administration Agreement. The reimbursement is based upon the allocable portion of Gladstone Administration's overhead, including, but not limited to, rent and the allocable portion of salaries and benefits of the Company's chief financial officer, controller, chief compliance officer, treasurer and their respective staff. The Company recorded fees to Gladstone Administration on the statement of operations of \$124,861 and \$77,962 for the three months ended September 30, 2006 and 2005, respectively. The Company recorded fees to Gladstone Administration on the statement of operations of \$240,250 and \$105,045 for the six months ended September 30, 2006 and the period June 22, 2005 (Commencement of operations) to September 30, 2005, respectively. As of September 30, 2006, \$124,861 was unpaid and included in the administration fee payable to Gladstone Administration in the accompanying statements of assets and liabilities.

#### Loan Payable to Affiliate

On June 30, 2005, the Company repaid a \$50,000 loan payable to its chairman and chief executive officer. The demand recourse promissory note accrued interest at the rate of 3% per annum and was repaid with accrued interest of \$378 using a portion of the net proceeds from the Company's initial public offering.

#### NOTE 4. COMMON STOCK

As of September 30, 2006 and March 31, 2006, 100,000,000 shares of \$0.001 par value common stock were authorized and 16,560,100 shares were outstanding.

#### NOTE 5. INCREASE IN NET ASSETS PER SHARE RESULTING FROM OPERATIONS

The following table sets forth the computation of basic and diluted net increase in net assets per share resulting from operations:

	For the three months ended September 30, 2006	For the three months ended September 30, 2005	For the six months ended September 30, 2006	For the period June 22, 2005 (Commencement of Operations) to September 30, 2005
Numerator for basic and diluted net increase in net assets resulting from operations per share	\$ 2,848,044	\$ 1,476,732	\$ 4,125,092	\$ 1,496,532
Denominator for basic and diluted shares	16,560,100	16,231,404	16,560,100	16,084,900
Basic and diluted net increase in net assets per share resulting from operations	\$ 0.17	\$ 0.09	\$ 0.25	\$ 0.09



## NOTE 6. DIVIDENDS

The Company is required to pay out as a dividend, 90% of its ordinary income and realized net short-term capital gains in excess of realized net short-term capital losses, if any, for each taxable year in order to maintain its status as a RIC under Subtitle A, Chapter 1 of Subchapter M of the Code. It is the policy of the Company to pay out as a dividend up to 100% of those amounts. The amount to be paid out monthly as a dividend is determined by the Board of Directors each quarter and is based on the annual earnings estimated by the management of the Company. At year-end the Company may pay a bonus dividend, in addition to the monthly dividends, to ensure that it has paid out at least 90% of its ordinary income and realized net short-term capital gains for the year. The Company's Board of Directors declared the following monthly dividends for the six months ended September 30, 2006 and the period June 22, 2005 (Commencement of operations) to September 30, 2005:

**FY 2007**

Declaration Date	Record Date	Payment Date	Dividend per Share
July 11, 2006	September 21, 2006	September 29, 2006	\$ 0.07
July 11, 2006	August 21, 2006	August 31, 2006	\$ 0.07
July 11, 2006	July 19, 2006	July 31, 2006	\$ 0.07
April 11, 2006	June 22, 2006	June 30, 2006	\$ 0.07
April 11, 2006	May 22, 2006	May 31, 2006	\$ 0.07
April 11, 2006	April 20, 2006	April 28, 2006	\$ 0.07

**FY 2006**

Declaration Date	Record Date	Payment Date	Dividend per Share
July 7, 2005	September 22, 2005	September 30, 2005	\$ 0.02
July 7, 2005	August 23, 2005	August 31, 2005	\$ 0.02
July 7, 2005	July 21, 2005	July 29, 2005	\$ 0.02

## NOTE 7. SUBSEQUENT EVENTS

*Line of Credit*

Through the Company's wholly-owned subsidiary Gladstone Business Investment, LLC ( *Business Investment* ), the Company has obtained a \$100 million revolving credit facility (the *Credit Facility* ). On October 19, 2006, the Company executed a Purchase and Sale Agreement pursuant to which it agreed to sell certain loans to Business Investment in consideration of a membership interest therein. Simultaneously, Business Investment executed a Credit Agreement (the *Credit Agreement* ) with Deutsche Bank AG, New York Branch ( *Deutsche Bank* ), as administrative agent, pursuant to which Business Investment pledged the loans purchased from the Company to secure future advances by certain institutional lenders. Availability under the Credit Facility will terminate on October 18, 2007, unless extended in the discretion of the lenders, at the request of Business Investment. Interest will be payable monthly during the term of the Credit Facility and principal will be payable out of collections on loans purchased from the Company during the period following the date of which availability for advances has terminated through maturity. The Credit Facility will mature two years following the date on which availability for advances has terminated and on such date, all principal, interest and other amounts owing under the Credit Facility will be due and payable. Interest rates charged on the advances under the facility are based on the rate paid by the lenders on commercial paper notes issued by such lenders to fund some or all of the advances, the London Interbank Offered Rate ( *LIBOR* ), the Prime Rate or the Federal Funds Rate, depending on market conditions, and adjusts periodically. As of October 31, 2006, there was no outstanding principal balance under the Credit Facility. Available borrowings are subject to various constraints imposed under the Credit Agreement, based on the aggregate loan balance pledged by Business Investment, which varies as loans are added and repaid, regardless of whether such repayments are early prepayment or are made as contractually required. At October 31, 2006, the remaining borrowing capacity available under the Credit Facility was approximately \$100 million.

The Credit Facility contains covenants that require Business Investment to maintain its status as a separate entity; prohibit certain significant corporate transactions (such as mergers, consolidations, liquidations or dissolutions); and restrict material changes to the Company's credit and collection policies. The facility also restricts some of the terms and provisions (including interest rates, terms to maturity and payments schedules) and limits the borrower and industry concentrations of loans that are eligible to secure advances. As of October 31, 2006, Business Investment was in compliance with all of the facility covenants. The Company currently intends to securitize some or all of the loans held by Business Investment and if it is able to do so, it will use the proceeds from the securitization to pay down any amounts then outstanding under

the revolving credit facility.

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The administrative agent also requires that any interest or principal payments on pledged loans be remitted directly by the borrower into lockbox accounts controlled by Deutsche Bank. Once a month, Deutsche Bank remits the collected funds to the Company after payment of any interest and expenses provided for under the Credit Agreement.

GMC, the Company's affiliated external adviser, services the loans pledged under the Credit Facility. As a condition to this servicing arrangement, the Company executed a performance guaranty pursuant to which it guaranteed that GMC would comply fully with all of its obligations under the Credit Facility. The performance guaranty requires the Company to maintain a minimum net worth of \$100 million and to maintain asset coverage with respect to senior securities representing indebtedness of at least 200%, in accordance with Section 18 of the 1940 Act. As of October 31, 2006, the Company was in compliance with its covenants under the performance guaranty.

#### *Loan Participations*

In October 2006, the Company purchased additional loan participations of three new portfolio companies of approximately \$4.0 million and received principal repayments of approximately \$2.4 million on its loan participations. In addition, the Company sold two of its loan participations realizing a net loss of \$8,491 on the transactions.

#### *Dividends*

On October 10, 2006, the Company's Board of Directors declared the following monthly dividends which it believes were and will be paid, as applicable, from ordinary income:

Declaration Date	Record Date	Payment Date	Dividend per Share
October 10, 2006	October 23, 2006	October 31, 2006	\$ 0.07
October 10, 2006	November 21, 2006	November 30, 2006	\$ 0.07
October 10, 2006	December 20, 2006	December 29, 2006	\$ 0.07

## ITEM 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS.

All statements contained herein, other than historical facts, may constitute **forward-looking statements** within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. These statements may relate to, among other things, future events or our future performance or financial condition. In some cases, you can identify forward-looking statements by terminology such as **may, might, believe, will, provided, anticipate, future, could, growth, plan, intend, expect, possible, potential, likely** or the negative of such terms or comparable terminology. These forward-looking statements involve known and unknown risks, uncertainties and other factors that may cause our actual results, levels of activity, performance or achievements to be materially different from any future results, levels of activity, performance or achievements expressed or implied by such forward-looking statements. Such factors include, among others: (1) our future operating results as we are a company with a limited operating history; (2) the loss of one or more of our executive officers, in particular, David Gladstone, Terry Lee Brubaker, or George Stelljes III; (3) the impact of the investments that we make and the ability of these investments to achieve their objectives; (4) our contractual relationships with third parties; (5) the adequacy of our cash resources and working capital; (6) our ability to obtain future financing, if at all; and (7) those factors listed under the caption **Risk Factors** of the Company's Annual Report on Form 10-K dated March 31, 2006, as filed with the Securities and Exchange Commission on June 14, 2006, and in the Company's registration statement on Form N-2 as filed with the Securities and Exchange Commission on October 13, 2006. We caution readers not to place undue reliance on any such forward-looking statements, which are made pursuant to the

**Private Securities Litigation Reform Act of 1995 and, as such, speak only as of the date made. We undertake no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events or otherwise, after the date of this Form 10-Q.**

*The following analysis of our financial condition and results of operations should be read in conjunction with our financial statements and the notes thereto contained elsewhere in this report and our annual report on Form 10-K for the fiscal year ended March 31, 2006.*

## OVERVIEW

We were incorporated under the General Corporation Laws of the State of Delaware on February 18, 2005. We were primarily established for the purpose of investing in subordinated loans, mezzanine debt, preferred stock and warrants to purchase common stock of small and medium-sized companies in connection with buyouts and recapitalizations. We also may invest in common stock and from time to time, we also may invest in senior and subordinated syndicated loans. Our investment objective is to generate both current income and capital gains through these debt and equity instruments. We operate as a closed-end, non-diversified management investment company, and have elected to be treated as a business development company under the Investment Company Act of 1940, as amended (the "1940 Act").

Our primary investment focuses are situations involving buyouts and recapitalizations of small and mid-sized companies with established management teams. We expect that our investments will generally range between \$10 million and \$30 million each, although this investment size may vary proportionately as the size of our capital base changes. We intend to invest either by ourselves or jointly with other buyout funds, depending on the opportunity. If we are participating in an investment with one or more co-investors, then our investment is likely to be smaller than if we were to be investing alone.

Following the completion of our initial public offering in June 2005, we began investing the proceeds of our initial public offering in senior secured syndicated loans because these investments typically may be originated more quickly than investments in companies undergoing a buyout or recapitalization. We employed this strategy in order to more quickly invest our initial capital to generate current income. Senior secured syndicated loans typically involve a number of banks or other financial institutions and are generally more marketable than loans that are not syndicated. We believe we will be able to sell our interests in senior secured syndicated loans and reinvest the proceeds in subordinated debt, mezzanine debt, preferred stock and other higher yielding investments when such investment opportunities are more readily available. In order to invest in certain senior secured syndicated loans, we may purchase these investments at a premium or discount. We amortize premiums and discounts over the contractual life of the investment. In the event that an investment is sold prior to its contractual maturity date, we recognize a loss on any unamortized premium or a gain on any unamortized discount. While the majority of our portfolio currently consists of senior secured loans, over time we expect that it will consist primarily of subordinated debt, mezzanine debt and preferred stock that we receive when making investments in connection with buyouts and recapitalizations. To date, we have acquired interests in 28 such syndicated loans in the aggregate principal amount, net of any repayments, of approximately \$121.7 million. We expect to continue purchasing syndicated loans using the proceeds from our initial public offering and borrowings from our credit facility.

Through our wholly-owned subsidiary, Gladstone Business Investment, LLC, we recently entered into a \$100 million line of credit with Deutsche Bank AG, New York Branch as administrative agent. We intend to use this line of credit to borrow funds to facilitate financing of future investments. The line of credit is at a variable interest rate below the average variable interest rate of our senior syndicated loans.

At September 30, 2006, we have investments of approximately \$44.0 million in revolving credit facilities, senior and subordinated debt of three portfolio companies, including borrowings under revolving credit facilities. In addition, at September 30, 2006 we have invested approximately \$12.8 million in preferred and common equity of those companies. These investments are the result of buyout and recapitalization transactions and represent our primary investment focus. We intend to continue to invest in such investments using the remaining proceeds from our initial public offering or by the potential future sale of our existing senior syndicated loans, however, from time to time we may continue to invest in syndicated loans.

Certain loan investments may have a form of interest that is not paid currently but is accrued and added to the loan balance and paid at the end of the term. This interest is called "paid in kind" interest or "PIK". We will generally seek investments that do not generate PIK interest as we have to pay out this accrued interest as dividends to our stockholders and we may have to borrow money or raise additional capital in order to meet the tax test for a regulated investment company ("RIC") by having to pay out at least 90% of our income. As of September 30, 2006, none of our investments bear PIK interest.

We may also encounter "original issue discount" income, or "OID" income, which arises when an investor simultaneously purchases a warrant and a note from a company. This transaction requires an allocation of a portion of the purchase price to the warrant and reduces the note by the same amount. This would cause us to have to record the note as if we paid less than the face amount of the note and, therefore, we would have to amortize the OID over the life of the loan. This would create income that would be required to be paid out as dividends to our stockholders in accordance with the tax test for RICs to pay out at least 90% of our income. We will seek to purchase warrants from the issuer at fair market value in order to avoid OID income.





As a business development company under the 1940 Act, we are required to make available significant managerial assistance to our portfolio companies. We provide these services through Gladstone Management Corporation (the Adviser or GMC), who provides these services on our behalf through its officers who are also our officers. If a portfolio company is charged for managerial assistance then GMC will credit all such non-managerial assistance fees against the base management fee. In addition, GMC provides additional services to our portfolio companies, for which it receives fees, in connection with our investments. These fees are generally non-recurring, however in some instances they may have a recurring component that is also paid to GMC. One half of any such non-recurring fees received by GMC are credited against the base management advisory fee payable to GMC pursuant to the terms of our advisory agreement, which has the effect of reducing our expenses to the extent of any such fees received by GMC. The specific services GMC provides vary by portfolio company, but generally include a wide variety of services such as investment banking, arranging bank financing and equity financing, structuring financing from multiple lenders and investors, reviewing existing credit facilities, restructuring existing loans, raising equity and debt capital, turnaround management, merger and acquisition services and recruiting new management personnel.

In the event that we expend significant effort in considering and negotiating a potential investment that ultimately is not consummated, we generally will seek reimbursement from the proposed borrower for our reasonable expenses incurred in connection with the proposed transaction. Any amounts collected for expenses incurred by GMC in connection with unconsummated investments will be reimbursed to GMC. Amounts collected for these expenses incurred by us will be reimbursed to us and will be recognized in the period in which such reimbursement is received. Also, in the event that we have incurred significant legal fees in connection with the transaction, we will typically seek reimbursement for these expenses from the proposed borrower. However, there can be no guarantee that we will be successful in collecting any such reimbursements.

#### **Our Adviser**

Our affiliate, GMC, is our investment adviser and is led by a management team which has extensive experience in our lines of business. GMC is controlled by David Gladstone, our chairman and chief executive officer. Mr. Gladstone is also the chairman and chief executive officer of GMC. Terry Lee Brubaker, our vice chairman, chief operating officer, secretary and director, is a member of the Board of Directors of GMC and is its vice chairman and chief operating officer. George Stelljes III, our president, chief investment officer and director, is a member of the Board of Directors of GMC and is its president and chief investment officer. Harry Brill, our chief financial officer, is the chief financial officer of GMC.

GMC also provides investment advisory and administrative services to our affiliates Gladstone Commercial Corporation, a publicly traded real estate investment trust; Gladstone Capital Corporation, a publicly traded business development company; and Gladstone Land Corporation, an agricultural real estate company owned by Mr. Gladstone. All of our directors and executive officers serve as either directors or executive officers, or both, of Gladstone Commercial Corporation and Gladstone Capital Corporation. In the future, GMC may provide investment advisory and administrative services to other funds, both public and private, of which it is the sponsor.

We have been externally managed by GMC pursuant to an advisory agreement since our inception. GMC was organized as a corporation under the laws of the State of Delaware on July 2, 2002, and is a registered investment adviser under the 1940 Act. GMC is headquartered in McLean, Virginia, a suburb of Washington, DC, and has offices in New York, New York, Chicago, Illinois, Pittsburgh, Pennsylvania, Morristown, New Jersey, Lexington, Kentucky and Dallas, Texas.

#### **Investment Advisory and Management Agreement**

Pursuant to the advisory agreement with GMC we pay GMC a fee, as compensation for its services, consisting of a base management fee and an incentive fee.

The base management fee is assessed at an annual rate of 2% computed on the basis of the average value of our gross invested assets at the end of the two most recently completed quarters, which are total assets less the cash proceeds and cash and cash equivalent investments from the proceeds of our initial public offering that are not invested in debt and equity securities of portfolio companies. Through September 30, 2006, the base management fee was computed and payable quarterly. Beginning in periods subsequent to December 31, 2006, the base management fee will be assessed at an annual rate of 2% computed on the basis of the average value of our gross assets at the end of the two most recently completed quarters, which are total assets, including investments made with proceeds of borrowings, less any uninvested cash or cash equivalents resulting from borrowings. This calculation was originally scheduled to begin in periods after March 31, 2006; however, on April 11, 2006 and July 11, 2006, our board of directors accepted voluntary waivers from GMC that allowed the current calculation of the base management fee to be effective through June 30, 2006 and September 30, 2006, respectively. Further, on October 10, 2006, our board of directors accepted another voluntary waiver from GMC that will allow the current calculation of the base management fee to be effective through December 31, 2006. When GMC



also receives fees from our portfolio companies, such as investment banking fees, structuring fees or executive recruiting services fees, one half of these fees will be credited against the base management fee that we would otherwise be required to pay to GMC. The incentive fee consists of two parts: an income-based incentive fee and a capital gains incentive fee.

The income-based incentive fee will reward GMC if our quarterly net investment income (before giving effect to the incentive fee) exceeds 1.75% of our net assets. GMC will receive a capital gains incentive fee of 20% of our realized capital gains (net of realized capital losses and unrealized capital depreciation).

#### **Administration Agreement**

We have entered into an administration agreement with Gladstone Administration, LLC ( Gladstone Administration ), a wholly owned subsidiary of GMC. Pursuant to the administration agreement, Gladstone Administration furnishes us with office facilities, equipment and clerical, bookkeeping and record keeping services at such facilities and performs, or oversees the performance of our required administrative services. Such required administrative services include, among other things, being responsible for the financial records which we are required to maintain and preparing reports to our stockholders and reports filed with the Securities and Exchange Commission.

The administration agreement requires us to reimburse Gladstone Administration for the performance of its obligations under the administration agreement based upon our allocable portion of Gladstone Administration's overhead, including, but not limited to, rent and our allocable portion of the salaries and benefits of our chief financial officer, chief compliance officer, controller, treasurer and their respective staffs. Our allocable portion of expenses is derived by multiplying Gladstone Administration's total expenses by the percentage of our average total assets (the total assets at the beginning and end of each quarter) in comparison to the average total assets of all companies managed by GMC.

#### **Our Investment Strategy**

We seek to achieve returns from current income and capital gains from senior, subordinated and mezzanine debt, as well as preferred stock and warrants to purchase common stock, representing controlling investments that we make in connection with buyouts and recapitalizations of small and mid-sized companies. We expect that our target portfolio over time will include mostly subordinated loans, mezzanine debt, preferred stock, and warrants to buy common stock. Structurally, subordinated loans and mezzanine loans usually rank lower in priority of payment to senior debt, such as senior bank debt, and may be unsecured. However, subordinated debt and mezzanine loans rank senior to common and preferred equity in a borrower's capital structure. Typically, subordinated debt and mezzanine loans have elements of both debt and equity instruments, offering the returns in the form of interest payments associated with senior debt, while providing lenders an opportunity to participate in the capital appreciation of a borrower, if any, through an equity interest. This equity interest typically takes the form of warrants. Due to its higher risk profile and often less restrictive covenants as compared to senior debt, mezzanine debt generally earns a higher return than senior secured debt. The warrants associated with mezzanine loans are typically detachable, which allows lenders to receive repayment of their principal on an agreed amortization schedule while retaining their equity interest in the borrower. Mezzanine debt also may include a put feature, which permits the holder to sell its equity interest back to the borrower at a price determined through an agreed formula. We believe that mezzanine loans offer an alternative investment opportunity based upon their historic returns and resilience during economic downturns.

#### **Critical Accounting Policies**

The preparation of financial statements and related disclosures in conformity with accounting principles generally accepted in the United States ( GAAP ) requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, and disclosure of contingent assets and liabilities at the date of the financial statements, and revenues and expenses during the period reported. Actual results could differ materially from those estimates. Our accounting policies are more fully described in the Notes to Financial Statements contained elsewhere in this report. We have identified our investment valuation process as our most critical accounting policy.

#### **Investment Valuation**

The most significant estimate inherent in the preparation of our consolidated financial statements is the valuation of investments and the related amounts of unrealized appreciation and depreciation of investments recorded.

*General Valuation Policy:* Using procedures established by our board of directors, we value our investment portfolio each quarter. We carry our investments at fair value, as determined in good faith by or under the direction of our board of directors. Securities that are publicly traded, if any, are valued at the closing price of the exchange or securities market on which they are listed on the valuation date. Securities that are not traded on a public exchange or securities market, but for which a limited market exists and that have been rated by a nationally recognized statistical rating organizations, which we refer to as a NRSRO, (such as certain participations in syndicated loans) are valued at the indicative bid price offered by the syndication agent on the valuation date.

Debt and equity securities that are not publicly traded, for which a limited market does not exist, or for which a limited market exists but that have not been rated by a NRSRO (or for which we have various degrees of trading restrictions) are valued at fair value as determined in good faith by or under the direction of our board of directors. In making the good faith determination of the value of these securities, we start with the cost basis of the security, which includes the amortized OID and PIK interest, if any. We then apply the methods set out below in Valuation Methods. Members of our GMC's portfolio management team prepare the valuations of our investments in portfolio companies using the most recent portfolio company financial statements and forecasts. These individuals also consult with portfolio company senior management and ownership to obtain further updates on the portfolio company's performance, including information such as industry trends, new product development, and other operational issues. Due to the uncertainty inherent in the valuation process, such estimates of fair value may differ significantly from the values that would have been obtained had a ready market for the securities existed, and the differences could be material. Additionally, changes in the market environment and other events that may occur over the life of the investments may cause the gains or losses ultimately realized on these investments to be different than the valuations currently assigned. There is no single standard for determining fair value in good faith, as fair value depends upon circumstances of each individual case. In general, fair value is the amount that we might reasonably expect to receive upon the current sale of the security.

At September 30, 2006, we engaged SPSE to submit opinions of value for six of our loan securities. We request that SPSE also evaluate and assign values to success fees (conditional interest included in some loan securities) when we determine that the probability of receiving a success fee on a given loan is above 6-8%, a threshold of significance. Upon completing our collection of data with respect to the investments (including the information described under Credit Information, the risk ratings of the loans described under Loan Grading and Risk Rating and the factors described under Valuation Methods ), this valuation data is presented to SPSE. SPSE makes its independent assessment of the data that we have assembled and assesses its own data to form an opinion as to what they consider to be the market values for the securities. With regard to its work, SPSE has issued the following paragraph:

SPSE provides evaluated price opinions which are reflective of what SPSE believes the bid side of the market would be for each loan after careful review and analysis o