MANUGISTICS GROUP INC
Form 10-Q
July 16, 2001

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q
(Mark One)
[X] QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended May 31, 2001
OR
[ ] TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from __________ to __________

Commission File Number 0-22154

MANUGISTICS GROUP, INC.
(Exact name of Registrant as specified in its charter)

Delaware	52-1469385
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification Number)

2115 East Jefferson Street, Rockville, Maryland 20852
(Address of principal executive office) (Zip code)
(301) 984-5000
(Registrant s telephone number, including area code)

Securities registered pursuant to Section 12(b) of the Act: None
Securities registered pursuant to Section 12(g) of the Act: Common Stock, $.002 par value per share
(Title of Class)
Name of each exchange on which registered: None

Indicate by check mark whether the Registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports) and (2) has been subject to such filing requirements for the past 90 days.

Yes X No __

Indicate the number of shares outstanding of each of the issuer s classes of common stock, as of the latest practicable date: 67.7 million shares of common stock, $.002 par value, as of July 10, 2001.

MANUGISTICS GROUP, INC. AND SUBSIDIARIES

TABLE OF CONTENTS

PART I FINANCIAL INFORMATION

Item 1. FINANCIAL STATEMENTS

MANUGISTICS GROUP, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS
(in thousands, except per share data)

	May 31, 2001	February 28, 2001
	(Unaudited)	
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	$210,349	$196,362
Marketable securities	52,241	103,946
Accounts receivable, net of allowance for doubtful accounts of $8,565 and $5,604 at May 31, 2001 and February 28, 2001, respectively	89,981	84,211
Deferred tax assets	8,929	9,175
Other current assets	12,232	12,536
Total current assets	373,732	406,230
NONCURRENT ASSETS:		
Property and equipment, net of accumulated depreciation	20,192	19,275
Software development costs, net of accumulated amortization	15,095	15,709
Goodwill, net of accumulated amortization	317,356	335,651
Other intangible assets and noncurrent assets, net of accumulated amortization	99,148	70,396
TOTAL ASSETS	$825,523	$847,261
LIABILITIES AND STOCKHOLDERS EQUITY		
CURRENT LIABILITIES:		
Accounts payable	$7,061	$9,923
Accrued compensation	14,140	19,539
Other accrued liabilities	28,665	34,371
Deferred revenue	47,028	41,729

Total current
liabilities96,894105,562 **NONCURRENT LIABILITES:**Long-term debt250,337250,133Deferred tax liabilities14,23916,062Other3,4295,183

Total noncurrent
liabilities268,005271,378 **COMMITMENTS AND CONTINGENCIES (Note 3) STOCKHOLDERS EQUITY:**Preferred stock Common stock, $.002 par value per share; 100,000 shares authorized; 68,355 and 67,518 issued, and 67,602 and 66,765 outstanding at May 31, 2001 and February 28, 2001, respectively136135Additional paid-in capital636,077621,824Treasury stock, 753 shares, at cost(717)(717)Deferred compensation(17,999)(19,316)Accumulated other comprehensive loss(3,166)(1,324)Accumulated deficit(153,707)(130,281)

460,624470,321

TOTAL LIABILITIES AND STOCKHOLDERS EQUITY$825,523$847,261

See accompanying notes to the condensed consolidated financial statements.

MANUGISTICS GROUP, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF OPERATIONS (UNAUDITED)
(in thousands, except per share data)

	Three Months Ended May 31,	
	2001	2000

REVENUE:
Software$45,056$25,973Services27,53311,968Support17,22112,578

Total revenue89,81050,519

OPERATING EXPENSES: Cost of software5,1354,785 Cost of services and support23,34011,538Non-cash stock compensation expense for cost of services and support1,729

25,06911,538 Sales and marketing33,99922,977Non-cash stock compensation expense for sales and marketing2,512

36,51122,977 Product development16,4357,770Non-cash stock compensation expense for product development1,186

17,6217,770 General and administrative7,7985,004Non-cash stock compensation expense for general and administrative480

8,2785,004 Amortization of intangibles21,508612

Total operating expenses114,12252,686

LOSS FROM OPERATIONS(24,312)(2,167)**OTHER INCOME, NET**682283

LOSS BEFORE INCOME TAXES(23,630)(1,884)**BENEFIT FROM INCOME TAXES**(204)(733)

NET LOSS$(23,426)$(1,151)

NET LOSS PER SHARE:BASIC(0.35)(0.02)**DILUTED**(0.35)(0.02) **SHARES USED IN LOSS PER SHARE CALCULATION:BASIC**67,04156,866**DILUTED**67,04156,866 See accompanying notes to the condensed consolidated financial statements.

4

MANUGISTICS GROUP, INC. AND SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)
(in thousands)

	Three Months Ended May 31,	
	2001	2000

CASH FLOWS FROM OPERATING ACTIVITIES
Net loss$(23,426)$(1,151)Adjustments to reconcile net loss to net cash used in operating activities:Depreciation and amortization26,7055,104Amortization of debt issuance costs283   Deferred income taxes(2,051)(833)Non-cash stock compensation expense5,907   Other(1,229)160Changes in assets and liabilities:Accounts receivable(3,946)(9,511)Other assets3872,357Accounts payable(3,134)(576)Accrued compensation(5,493)(1,882)Other liabilities(6,254)1,134Deferred revenue5,137181

Net cash used in operating activities(7,114)(5,017)

CASH FLOWS FROM INVESTING ACTIVITIES Acquisitions and investments in businesses, net of cash acquired(31,106)(1,000)Sales and purchases of marketable securities, net53,0131,110Purchases of property and equipment(2,335)(1,681)Capitalization and purchases of software(2,838)(2,608)

Net cash provided by (used in) investing activities16,734(4,179)

CASH FLOWS FROM FINANCING ACTIVITIES Payments of long-term debt and capital lease obligations(68)(48)Payments of debt issuance costs convertible debt(163) Proceeds from exercise of stock options and employee stock plan purchases4,4351,586

Net cash provided by financing activities4,2041,538

EFFECTS OF EXCHANGE RATES ON CASH BALANCES163169 **NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS**13,987(7,489)**CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD**196,36241,803

CASH AND CASH EQUIVALENTS, END OF PERIOD$210,349$34,314

See accompanying notes to the condensed consolidated financial statements.

MANUGISTICS GROUP, INC. AND SUBSIDIARIES
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)
May 31, 2001

1. Basis of Presentation

The accompanying unaudited condensed consolidated financial statements of Manugistics Group, Inc. (the Company) have been prepared in accordance with generally accepted accounting principles for interim reporting and in accordance with the instructions to the Quarterly Report on Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and notes required by generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments (consisting only of normal, recurring adjustments) which are necessary for a fair presentation of the unaudited results for the interim periods presented have been included. The results of operations for the period presented herein are not necessarily indicative of the results of operations for the entire fiscal year, which ends on February 28, 2002.

These financial statements should be read in conjunction with the financial statements and notes thereto for the fiscal year ended February 28, 2001 included in the Annual Report on Form 10-K of the Company for that year filed with the Securities and Exchange Commission.

2. Net Loss Per Share

Basic net loss per share is computed using the weighted average number of shares of common stock outstanding. Diluted net income (loss) per share is computed using the weighted average number of shares of common stock and, when dilutive, potential common shares from options and warrants to purchase common stock using the treasury stock method and the effect of the assumed conversion of the Company s convertible subordinated debt. The dilutive effect of options and warrants of 6.5 million shares and 6.4 million shares were excluded from the calculation of diluted net loss per share for the three month periods ended May 31, 2001 and May 31, 2000, respectively, as including them would have been anti-dilutive due to the Company s reported net loss. The assumed conversion of the Company s convertible debt was excluded from the computation of diluted net income (loss) per share for the three months ended May 31, 2001 since it was anti-dilutive. The Company s convertible debt may be exchanged for up to approximately 5.7 million shares of the Company s common stock in future periods.

3. Commitments and Contingencies

The Company is involved in disputes and litigation in the normal course of business. The Company does not believe that the outcome of any pending disputes or litigation will have a material effect on the Company s financial condition or operating results. However, an unfavorable outcome of legal matters could have a material effect on the Company s business, operating results, financial condition or cash flows. The Company has established accruals related to legal matters where a loss is probable and reasonably estimable.

The Company has previously reported its legal proceedings with Information Resources, Inc. (IRI) arising from the acquisition of certain assets in March 1997. A dispute over revenue streams that IRI alleges it is entitled to is being arbitrated. IRI seeks a total of $15.9 million in damages. The Company contends that the conditions to these amounts becoming due have not been satisfied and that no amounts are due IRI, because, among other reasons, of a failure of consideration in the overall transaction. Arbitration of this matter is scheduled to commence in early November. A related claim concerning the breach of a separate Non-Competition and Non-Solicitation Agreement filed in the Circuit Court of Cook County, Illinois is awaiting resolution of the abitration.

As previously reported, on November 29, 2000, the Company filed a lawsuit against VirtualFund.com, Inc., in the United States District Court for the District of Maryland alleging that VirtualFund.com, Inc. is in anticipatory breach of its obligations under a software license agreement among the Company and VirtualFund, Inc. and its affiliates. The Company sought at least $4.5 million in damages. VirtualFund.com, Inc. counterclaimed that the contract is invalid and sought return of $2.5 million in fees and other unspecified damages. In July 2001, the Company and VirtualFund.com, Inc. settled all claims. The settlement of these claims will not have a material impact on the Company s results of operations.

4. Comprehensive Loss

Other comprehensive loss relates primarily to foreign currency translation losses and unrealized losses on investments in marketable securities. The following table sets forth the comprehensive loss for the three month periods ended May 31, 2001 and 2000 (dollar amounts in thousands):

	Three Months Ended May, 31

	2001	2000
Net loss	$(23,426)	$(1,151)
Other comprehensive loss	(1,842)	(233)
Total comprehensive loss	$(25,268)	$(1,384)

5. Acquisitions and Investments in Businesses

On May 17, 2001, the Company acquired One Release, LLC and its affiliates (the One Release Acquisition), a software engineering services and systems business, for $4.3 million of common stock (135,793 shares). The Company may also pay up to an additional $1.0 million in contingent consideration if certain performance criteria are attained during the first year after the acquisition date. The One Release Acquisition was accounted for using the purchase method of accounting. The results of operations for One Release have been included in the Company s operations since the acquisition date. The Company allocated approximately $4.6 million of the purchase price to assembled workforce, which is included in other intangible assets and noncurrent assets in the condensed consolidated balance sheet as of May 31, 2001.

On May 30, 2001, the Company purchased preferred stock of Converge, Inc. (Converge Investment). Converge, Inc. is a private marketplace exchange for components used by electronics and high technology manufacturers whose founding investors include Hewlett-Packard Company, Compaq Computer Corporation and Agilent Technologies, Inc., among others. The Converge Investment is included in other intangible assets and noncurrent assets in the condensed consolidated balance sheet as of May 31, 2001 and will be accounted for under the cost method of accounting for investments. In a transaction approximately two weeks prior, the Company entered into a software license agreement with Converge, Inc. for various products for use in its marketplace exchange business.

On May 31, 2001, the Company acquired the collaborative sourcing and design assets of Partminer CSD, Inc. , as well as related assets from its parent, Partminer, Inc. and its affiliates (the CSD Acquisition) for cash. Partminer CSD, Inc. is a developer of product design and sourcing software. The CSD Acquisition included developed technology, existing customer contracts, personnel and other intangible assets. The CSD Acquisition was accounted for using the purchase method of accounting. The purchase price has been allocated to the assets acquired and liabilities assumed based on their estimated fair values at the acquisition date and is subject to adjustment. Total intangible assets related to the CSD Acquisition are included in other intangible assets and noncurrent assets in the condensed consolidated balance sheet as of May 31, 2001. Contemporaneously, in another transaction, the Company entered into a software license agreement with Partminer, Inc. for various products for use in its electronic components procurement and sourcing business.

Total aggregate cash consideration paid for the CSD acquisition and Converge Investment was $30.1 million.

6. New Accounting Pronouncements

On March 1, 2001, the Company adopted Statement of Financial Accounting Standards No. 133 (SFAS 133), *Accounting for Derivative Instruments and Hedging Activities* , as amended by SFAS 137 and 138. SFAS 133 requires all derivatives to be recorded at fair value. Unless designated as hedges, changes in these fair values will be recorded in the income statement. Fair value changes involving hedges will generally be recorded by offsetting gains and losses on the hedge and on the hedged item, even if the fair value of the hedged item is not otherwise recorded. Adoption of this standard had no impact on the Company s financial statements.

7. Subsequent Events

SpaceWorks Transaction

In June 2001, the Company reached an agreement to acquire certain intellectual property of SpaceWorks Inc., (SpaceWorks Transaction), a provider of order management software. On June 13, 2001, in connection with the SpaceWorks Transaction, the Company and SpaceWorks entered into an agreement pursuant to which SpaceWorks appointed the Company as a reseller of its products and authorized the Company to continue development of the SpaceWorks technology. On June 15, 2001, SpaceWorks filed a voluntary petition in bankruptcy under Chapter 11 of the Bankruptcy Code. On June 20, 2001, the Company and SpaceWorks entered into an Asset Purchase Agreement pursuant to which the Company would acquire certain intellectual property and other assets of SpaceWorks for cash, which is subject to the bankruptcy approval process and certain other conditions.

The Company will account for the SpaceWorks Transaction as a purchase of developed technology, if consummated. The Company expects the SpaceWorks Transaction to be consummated on or before August 31, 2001, subject to the conditions mentioned above.

Product Development Consolidation

During June 2001, the Company decided to centralize certain of its product development functions in Rockville, MD from two remote offices. This will result in the closure of one office and reduction of space occupied in another office, as well as the relocation or termination of approximately 60 employees. The Company expects to record a charge to operations of approximately $2.5 million to $3.0 million during the three months ended August 31, 2001 as a result of the product development consolidation. The charge will consist of remaining lease obligations, severance and related benefits, employee relocation costs incurred on or prior to August 31, 2001 and long-lived asset impairments. The Company may incur additional employee relocation costs subsequent to August 31, 2001, which would result in a charge to operations during periods after August 31, 2001.

Item 2. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS.

Overview:

We are a leading global provider of Enterprise Profit Optimization (EPO) solutions, which we believe is a new and important category of solutions for enterprise management. We are also a leading provider of solutions for supply chain management (SCM), pricing and revenue optimization (PRO) and electronic marketplaces (eMarketplaces). Our solutions help companies lower operating costs, increase revenues, enhance profitability and accelerate revenue and earnings growth. They do this by creating efficiencies in both how goods and services are brought to market (supply chain management) and how they are sold (pricing and revenue optimization). EPO solutions provide additional benefits by combining the proven cost-reduction power of supply chain management solutions and the revenue-enhancing capacity of pricing and revenue optimization solutions.

We help our clients monitor and streamline their own core internal operational processes involving the design, purchase, manufacture, storage, transportation, pricing, marketing and selling of their goods and services. Our solutions also help our clients integrate their own internal processes with those of their customers and suppliers to assist in providing collaboration and efficiencies across extended eMarketplaces. In addition, our solutions help our clients improve customer service and the allocation of resources by providing information and forecasts that allow them to make more effective operational decisions. We also provide strategic consulting and implementation services to our clients as part of our solutions.

Increasing global competition, shortening product life cycles and developing eMarketplace initiatives are forcing businesses to provide improved levels of customer service while shortening the time it takes to bring their products and services to market. We were an early innovator in solutions that allow collaboration among our clients and their customers and suppliers. Our first Internet ready products were commercially available in late 1997. We focus the development of our technology on meeting the changing needs of companies in the markets we serve,

including the need to do business in new electronic marketplaces. We offer solutions to companies in many industries including agriculture, apparel, automotive, chemical, consumer durables, consumer packaged goods, electronics & high technology, energy, food & beverage, government, logistics, metals, pharmaceuticals, pulp & paper, retail, services and transport, travel & hospitality. Our customer base of approximately 1,100 clients includes large, multinational enterprises such as 3Com; Cisco Systems Inc.; Coca-Cola Bottling Co. Consolidated; Emerson Electric Co.; Ford Motor Company; Fuji Photo Film, USA; Harley-Davidson, Inc.; Levi Strauss & Co.; Marriott; Texas Instruments; The Limited; and Unilever Home & Personal Care, USA; as well as mid-sized enterprises and emerging eMarketplaces.

Results of Operations:

The following table includes the consolidated statements of operations data for the three months ended May 31, 2001 and 2000 expressed as a percentage of revenue:

	Three Months Ended May 31,	
	2001	2000
REVENUE:		
Software	50.2%	51.4%
Services	30.6%	23.7%
Support	19.2%	24.9%
Total revenue	100.0%	100.0%
OPERATING EXPENSES:		
Cost of software	5.7%	9.5%
Cost of services and support	26.0%	22.8%
Sales and marketing	37.9%	45.5%
Product development	18.3%	15.4%
General and administrative	8.7%	9.9%
Amortization of intangibles	23.9%	1.2%
Non-cash stock compensation expense	6.6%	
Total operating expenses	127.1%	104.3%
Loss from operations	(27.1)%	(4.3%)
Other income, net	0.8%	0.6%

Loss before income taxes(26.3%)(3.7%)Benefit from income taxes(0.2)%(1.4%)

Net loss(26.1)%(2.3%)

The percentages shown above for cost of services and support, sales and marketing, product development and general and administrative expenses have been calculated, exclusive of non-cash stock compensation expense as follows (in thousands):

Cost of services and support	$1,729
Sales and marketing2,512Product development1,186General and administrative480	
	$5,907

See Non-Cash Stock Compensation Expense for further detail.

Revenue:

General. Our revenue is derived from three categories: software, services and support. Software revenue is generally recognized upon execution of a software license agreement and shipment of the software, provided the fees are fixed and determinable and collection is considered probable in accordance with the American Institute of Certified Public Accountants (AICPA) Statement of Position (SOP) 97-2, *Software Revenue Recognition"*, as modified by SOP 98-9, *Modification of SOP 97-2, Software Revenue Recognition with Respect to Certain*

Transactions, and Securities and Exchange Commission (SEC) Staff Accounting Bulletin 101 (SAB 101), *Revenue Recognition* . Fees are allocated to the various elements of software license agreements based on historical fair value experience. We generate the majority of our software revenue from our direct sales force with lesser amounts coming through indirect sales channels such as complementary software vendors, consulting firms, systems integrators and resellers. Services revenue is recognized as the services are performed. Support revenue is recognized ratably over the support period defined in the software license agreement.

When we provide services that are considered essential to the functionality of software products sold or if software sold requires significant production, modification or customization, we account for the software and services revenue in accordance with SOP 81-1, *Accounting for Performance of Construction Type and Certain Production Type Contracts* , which requires us to use the percentage-of-completion method of revenue recognition. Revenue is recognized based on labor hours incurred to date compared to total estimated labor hours for the contract.

Total revenue increased 77.8% during the three months ended May 31, 2001 compared to the same period in 2000. The increase resulted primarily from increased demand and market acceptance for our products and services, increased selling activities resulting from a larger and more effective sales force, increased average selling price (ASP) for our software and the acquisitions of Talus Solutions, Inc. (Talus) and STG Holdings, Inc. (STG). No single customer accounted for 10% or more of the Company s total revenue during the three months ended May 31, 2001 and

2000.

Software. Software revenue increased 73.5%, or $19.1 million. The increase in software revenue during the three months ended May 31, 2001 was primarily due to:

increased demand and market acceptance for our software products;

increased selling activities resulting from a larger and more effective sales force;

increased ASP and number of completed transactions;

expanded and enhanced product offerings; and

the acquisition of Talus and STG

We had 35 significant software license transactions during the three months ended May 31, 2001 compared to 26 during the prior year period. The average size of our significant software transactions was $1.3 million and $1.0 million during the three months ended May 31, 2001 and 2000, respectively. Significant transactions are those with a value of over $100,000. We had 12 software transactions of $1.0 million or greater during the three months ended May 31, 2001 compared to 9 during the prior year period.

Services. Services revenue increased 130.1%, or $15.6 million, during the three months ended May 31, 2001 compared to the same period in 2000. The increase in services revenue during the three months ended May 31, 2001 was due to an increased number of software transactions and related implementations, an increased customer base desiring training, consulting and implementation services and the Talus acquisition. Services revenue tends to track software license transactions in prior periods.

Support. Support revenue increased 36.9%, or $4.6 million, during the three months ended May 31, 2001 compared to the same period in 2000. The increase in support revenue during the three months ended May 31, 2001 and 2000 was due to the increase in the number of clients that have licensed our software products and entered into annual support arrangements. Support revenue tends to track software license transactions in prior periods. In the past, we have experienced a high rate of renewed annual support contracts. There can no assurance that this renewal rate will continue. See Forward Looking Statements and Factors That May Effect Future Results.

International Revenue. We market and sell our software and services internationally primarily in Europe, Asia, Canada and Latin America. Revenue outside of the United States was 25.6% and 22.8% of total revenue, or $23.0 million and $11.5 million during the three months ended May 31, 2001 and 2000, respectively. The increase in this revenue resulted from our efforts to expand our presence and selling efforts outside of the United States. We

believe increasing international revenue is critical to growth in both revenue and profitability and may lower our overall exposure to unfavorable economic conditions in specific regions.

Operating Expenses:

Cost of Software. Cost of software consists primarily of amortization of capitalized software development costs and royalty fees associated with third-party software embedded in our software. The following table sets forth amortization of capitalized software development costs and other costs of license fees for the three months ended May 31, 2001 and 2000 (in thousands):

	Three Months Ended May, 31	
	2001	2000
Amortization of capitalized software	$ 3,003	$ 2,628
Percentage of software revenue	6.7%	10.1%
Other costs of software	2,132	2,157
Percentage of software revenue	4.7%	8.3%
Total cost of software	$5,135	$4,785
Percentage of software revenue	11.4%	18.4%

The increase in cost of software during the three months ended May 31, 2001 compared to the same period in 2000 was primarily a result of increased amortization of capitalized software. The decrease in other costs of software as a percentage of software revenue resulted from the mix of software sold and related impact on royalties paid to third parties.

Cost of Services and Support. Cost of services and support includes primarily personnel and third party contractor costs. Cost of services and support increased 102.3%, or $11.8 million, during the three months ended May 31, 2001 compared to the same period in 2000. The increase in cost of services and support was primarily attributable to adding the personnel necessary to support the growth in revenue and installed customer base and the Talus acquisition.

Sales and Marketing. Sales and marketing expense consists primarily of personnel costs, sales commissions, promotional events such as trade shows and technical conferences, advertising and public relations programs. Sales and marketing expense increased 48.0%, or $11.0 million during the three months ended May 31, 2001 compared to the same period in 2000. The increase during the three months ended May 31, 2001 was primarily due to:

- increasing the number of direct sales representatives and sales management to 157 at May 31, 2001 compared to 95 at May 31, 2000, or an increase of 65.3%; and increasing the overall sales, marketing and business development employees to 435 at May 31, 2001 compared to 288 at May 31, 2000, or an increase of 51.0%;

- increased sales commissions due to higher software revenue; and

- increases in promotional spending, advertising and public relations spending.

We expect sales and marketing expense to increase in dollars in fiscal 2002 and remain the same or decrease as a percentage of total revenue as our revenue grows. See Forward Looking Statements and Factors That May Effect Future Results.

Product Development. Product development expenses include expenses associated with the development of new software products, enhancements of existing products and quality assurance activities. Such costs are primarily from personnel and third party contractors. We record product development costs net of capitalized software development costs for products that have reached technological feasibility in accordance with SFAS No. 86, *Accounting for the Costs of Computer Software to be Sold, Leased or Otherwise Marketed*. The following table sets forth product development costs for the three months ended May 31, 2001 and 2000 (in thousands):

	Three Months Ended May, 31	
	2001	2000
Gross product development costs	$ 18,871	$ 9,885
Percentage of total revenue	21.0%	19.6%
Less: Capitalized product development costs	2,436	2,115
Percentage of total revenue	2.7%	4.2%
Product development costs, as reported	$16,435	$7,770
Percentage of total revenue	18.3%	15.4%

Gross product development costs increased 90.9%, or $9.0 million, during the three months ended May 31, 2001 compared to the same period in 2000. The increase was due to:

- Increasing the number of product development employees to 432 at May 31, 2001 compared to 244 at May 31, 2000, an increase of 77.0%;
- Increased number of product development initiatives.

General and Administrative. General and administrative expenses include personnel and other costs of our legal, finance, accounting, human resources and information systems functions. General and administrative expenses increased 55.8%, or $2.8 million during the three months ended May 31, 2001 compared to the same period in 2000. The increase was due primarily to increased personnel to support our growth. The decrease in general and administrative expense as a percentage of total revenue reflects our ability to spread this expense over a larger revenue base.

Amortization of Intangibles. Our acquisitions of the CSD division of Partminer and One Release during fiscal 2002, Talus and STG during fiscal year 2001 and certain previous acquisitions were accounted for under the purchase method of accounting. As a result, we recorded goodwill and other intangible assets that represent the excess of the purchase price paid over the fair value of the net tangible assets acquired. Goodwill and other intangible assets are amortized over periods ranging from two to seven years.

Non-Cash Stock Compensation Expense. We recognized non-cash stock compensation expense of $5.9 million during the three months ended May 31, 2001 primarily associated with stock options that were repriced in January 1999 and unvested stock options assumed in the Talus acquisition. These amounts are included as a separate component of stockholders equity and are amortized by charges to operations in accordance with FASB Interpretation No. 44 (FIN 44) "*Accounting for Certain Transactions Involving Stock Compensation* .

Repriced Options:

In January 1999, we repriced employee stock options, other than those held by executive officers or directors. This resulted in approximately 3.0 million options being repriced and the four-year vesting period starting over. Under FIN 44, repriced options are subject to variable plan accounting, which requires compensation cost or benefit to be recorded each period based on changes in the Company s stock price until the repriced options are exercised, forfeited or expire. This resulted in a charge of $4.6 million during the three months ended May 31, 2001. The initial fair value used to measure the ongoing stock compensation charge or benefit was $22.19 based on the closing price of our common stock on June 30, 2000. As of May 31, 2001, 1.1 million repriced options were still outstanding with a remaining vesting period of approximately 21 months. In future periods, we will record additional charges or benefits related to the repriced stock options still outstanding based on the change in our common stock price compared to the last reporting period. If our stock price at the beginning and end of any reporting period is below $22.19, no charge or benefit will be recorded.

Unvested Stock Options -Talus Acquisition:

As part of the Talus acquisition, we assumed all outstanding stock options, which were converted into our stock options. Options to purchase approximately 631,000 shares of our common stock were unvested at the acquisition date. FIN 44 requires the acquiring company to measure the intrinsic value of unvested stock options assumed at the acquisition date in a purchase business combination and record a compensation charge over the remaining

---

vesting period of those options to the extent those options remain outstanding. This resulted in a charge of $1.3 million during the three months ended May 31, 2001.

Other Income, Net:

Other income, net, includes interest income from cash equivalents and marketable securities, interest expense from borrowings, foreign currency exchange gains or losses and other gains or losses. Other income increased to $682,000 during the three months ended May 31, 2001 from $283,000 in the prior year period. This increase relates primarily to an investment gain recorded during the three months ended May 31, 2001. Interest income and interest expense were approximately the same during the three months ended May 31, 2001. We expect interest income to decline in future quarters as a result of a general decline in interest rates. See Quantitative and Qualitative Disclosures about Market Risk Interest Rate Risk .

Benefit from Income Taxes:

We recorded an income tax benefit of $204,000 during the three months ended May 31, 2001. The effective tax rate differed from the U.S statutory rate primarily due to non-deductible goodwill along with non-cash stock compensation expense that did not result in an income tax benefit for financial reporting purposes. Excluding the effect of amortization of intangibles and non-cash stock compensation expense, our effective tax rate was approximately 41% for the three months ended May 31, 2001.

As of February 28, 2001, we had net operating loss carryforwards (NOLs) for federal, state and foreign tax purposes of $211.0 million, in aggregate. These carryforwards expire in various years between 2001 and 2021. We recorded deferred tax asset valuation allowances against NOLs where it is more likely than not that we will not be able to utilize these future tax benefits.

Net Loss:

We reported a net loss of $23.4 million and $1.2 million for the three months ending May 31, 2001 and 2000, respectively. The increased net loss in the three months ended May 31, 2001 compared to the same period a year ago was primarily due to the intangible amortization directly attributable to our acquisitions of Talus and STG and charges for non-cash stock compensation, offset by an increase in operating income (excluding the non-cash items previously mentioned). Excluding the impact of amortization of intangibles and non-cash stock compensation expense, and the related tax effect, we would have reported net income of $2.2 million for the three months ended May 31, 2001 and a net loss of $782,000 for the three months ended May 31, 2000.

Liquidity and Capital Resources:

Our cash, cash equivalents and marketable securities in aggregate decreased $37.7 million during the three months ended May 31, 2001 to $262.6 million. Working capital decreased $23.8 million to $276.8 million at May 31, 2001. The decrease in cash, cash equivalents, marketable securities and working capital was primarily the result of the CSD Acquisition, Converge Investment and our semi-annual interest payment on our convertible debt.

Cash used in operations was $(7.1) million and $(5.0) million for the three months ended May 31, 2001 and 2000, respectively. The increase in cash used in operations for the three months ended May 31, 2001 resulted primarily from (i) interest payment on convertible debt of $6.5 million during the three months ended May 31, 2001 and; (ii) increased commission payments as a result of the increases in software revenue, offset by increased profits from operations, before non-cash charges, of approximately $4.7 million and an increase in interest income of $3.0 million. Excluding the effect of acquisitions, accounts receivable and deferred revenue increased $3.9 million and $5.1 million, respectively, during the three months ended May 31, 2001, while days sales outstanding in accounts receivable increased to 88 days as of May 31, 2001 from 82 days as of May 31, 2000. These increases primarily reflects the impact of our revenue growth.

Cash provided by (used in) investing activities was $16.7 million and $(4.2) million during the three months ended May 31, 2001 and 2000, respectively. Investing activities consist primarily of the sales and purchases of

marketable securities, purchases of property and equipment, purchases and capitalization of software and acquisitions and investments in businesses. Sales of marketable securities, net of purchases, was $53.0 million during the three months ended May 31, 2001. Total purchases of property, equipment and software, including capitalized software, were $5.2 million during the three months ended May 31, 2001. We expect this amount to increase in fiscal 2002 and 2003 as we support our growth and build out our new corporate headquarters space. Acquisitions and investments in businesses, net of cash acquired, of $31.1 million during the three months ended May 31, 2001 relates primarily to the CSD Acquisition and the Converge Investment.

Cash provided by financing activities was $4.2 million and $1.5 million during the three months ended May 31, 2001 and 2000, respectively. Cash provided by financing activities consisted primarily of proceeds from the exercise of stock options and employee stock plan purchases. We had no balance outstanding under our line of credit at May 31, 2001.

As of May 31, 2001, we had $250.0 million in 5 % convertible subordinated notes outstanding (the Notes). Interest on the Notes bear interest at 5.0% per annum which is payable semi-annually. The Notes mature in November 2007 and are convertible into approximately 5.7 million shares of our common stock at a conversion price of $44.06, subject to adjustment under certain conditions. At any time on or after November 7, 2003, the Company may redeem the Notes in whole, or from time to time, in part, at our option. Redemption can be made on at least 30 days notice if the trading price of our common stock for 20 trading days in a period of 30 consecutive days ending on the day prior to the mailing of notice of redemption exceeds 120% of the conversion price of the Notes. The redemption price, expressed as a percentage of the principal amount, will be as follows:

Redemption Period	Redemption Price
November 7, 2003 through October 31, 2004	103%
November 1, 2004 through October 31, 2005	
102%November 1, 2005 through October 31, 2006	
101%November 1, 2006 through maturity 100%	

We have a one-year committed unsecured revolving credit facility with a commercial bank for $20.0 million. The current agreement is scheduled to expire in September 2001. Under its terms, we may request cash advances, letters of credit or both. We may make borrowings under the facility for short-term working capital purposes or for acquisitions. Acquisition-related borrowings are limited to $7.5 million per acquisition.

In December 2000, we entered into a ten-year lease agreement for a new headquarters facility in Gaithersburg, MD for approximately 210,000 square feet. This lease was amended in June 2001 to add approximately 70,000 square feet. We expect to incur $14.0 to $15.0 million in capital expenditures for leasehold improvements and furniture for the new space. We expect to move into our new headquarters space during the second calendar quarter of 2002.

On January 16, 2001, we acquired STG. We may be required to make additional contingent payments to the former stockholders of STG of up to $27.9 million during fiscal 2003 if certain revenue-based performance criteria are met during the 21-month period ending October 31, 2002. The additional contingent payments, if any, would be payable in cash, or in limited circumstances, in common stock at our sole election.

We are actively pursuing acquisitions of complementary businesses and technologies. In addition, we may make strategic investments in businesses and enter into joint ventures that complement our existing business. Any future acquisition or investment may result in a decrease to our liquidity and working capital to the extent we pay with cash.

We believe that our existing cash, cash equivalents and marketable securities, available borrowings under our credit facility and our anticipated cash flows from operations in future periods will satisfy our existing liquidity and capital requirements for the foreseeable future.

Factors that May Affect Future Results:

In addition to the other information in this Form 10-Q, the following factors should be considered in evaluating us and our business. The risks and uncertainties described below are not the only ones facing us. Additional risks and uncertainties, that we do not presently know or that we currently deem immaterial, may also impair our business, results of operations and financial condition.

Risks Related to our Business

As result of recent significant changes in our management, personnel and products, you may have difficulty evaluating our prospects based on our significant losses in recent fiscal years.

We experienced operational difficulties in fiscal 1999 and the first half of fiscal 2000. Problems with our direct sales operation and intense competition, among other factors, contributed to net losses in fiscal 1999 and fiscal 2000 and a decline in revenue in fiscal 2000. Since April 1999, we hired a new executive management team, enhanced our supply chain optimization and eMarketplace products and services, expanded the scope of our product and service offerings to include pricing and revenue optimization and improved our direct sales organization. Our ability to continue to achieve operational improvements and improve our financial performance will be subject to a number of risks and uncertainties, including the following:

- slower growth in the market for supply chain management, pricing/revenue optimization and eMarketplace solutions;
- weakening economic conditions;
- our ability to introduce new software products and services to respond to technological and client needs;
- our ability to manage our anticipated growth;
- our ability to hire, integrate and deploy our direct sales force effectively;
- our ability to expand our distribution capability through indirect sales channels;
- our ability to respond to competitive developments and pricing; and
- our dependence on our current executive officers and key employees.

If we fail to successfully address these risks and uncertainties, our business could be harmed and we could continue to incur significant losses.

We have experienced significant losses in recent fiscal years. Our future results will be adversely affected by several types of non-cash charges. If we do not achieve or maintain profitability in the future, our stock price may decline.

We have recently incurred significant losses, including net losses of $23.4 million for the quarter ended May 31, 2001, $28.1 million in fiscal 2001, $8.9 million in fiscal 2000 and $96.1 million in fiscal 1999. We will incur non-cash charges in the future related to the amortization of intangible assets and non-cash stock compensation expenses associated with our acquisition of Talus. We will also incur non-cash charges related to the amortization of intangible assets relating to the STG acquisition, One Release Acquisition and CSD Acquisition. In addition, we have incurred and may in the future incur non-cash stock compensation charges related to our stock option repricing. We cannot assure you that our revenue will grow or that we will achieve profitability in the future. Our ability to increase revenue and achieve profitability will be affected by the other risks and uncertainties described in this section. Our failure to achieve profitability could cause our stock price to decline, and our ability to finance our operations could be impaired.

Our operating results fluctuate, and if we fail to meet the expectations of the investment community in any period, our stock price could decline significantly.

Our revenue and operating results are difficult to predict, and we believe that period-to-period comparisons of our operating results will not necessarily be indicative of future performance. The factors that may cause fluctuations of our quarterly operating results include the following:

- the size, timing and contractual terms of licenses and sales of our products and services;

- customer financial constraints and credit-worthiness;
- the potentially long and unpredictable sales cycle for our products;
- technical difficulties in our software that could delay the introduction of new products or increase their costs;
- introductions of new products or new versions of existing products by us or our competitors;
- delay or deferral of customer purchases and implementations of our solutions due to weakening economic conditions;
- changes in prices or the pricing models for our products and services or those of our competitors;
- changes in the mix of our software services and support revenue;
- changes in the mix of sales channels through which our products and services are sold; and
- changes in rules relating to revenue recognition or in interpretations of those rules.

Due to fluctuations from quarter to quarter, our operating results may not meet the expectations of securities analysts or investors. If this occurs, the price of our common stock could decline significantly.

Variations in the time it takes us to license our software may cause fluctuations in our operating results.

The time it takes to license our software to prospective clients varies substantially, but typically ranges between four and twelve months. Variations in the length of our sales cycles could cause our revenue to fluctuate widely from period to period. Because we typically recognize a substantial portion of our software revenue in the last month of a quarter, any delay in the license of our products could cause significant variations in our revenue from quarter to quarter. Furthermore, because our operating expenses are relatively fixed over the short term and we devote significant time and resources to prospective clients, these fluctuations could cause our operating results to suffer in some future periods. The length of our sales cycle depends on a number of factors, including the following:

- the complexities of the supply chain, pricing/revenue and eMarketplace problems our solutions address;
- the breadth of the solution required by the client, including the technical, organizational and geographic scope of the license;
- the evaluation and approval process employed by the client;
- the economic conditions in the U.S. and abroad;
- the sales channel through which the solution is sold; and
- any other delays arising from factors beyond our control.

The size and scope of our contracts with clients are increasing, which may cause fluctuations in our operating results.

Our clients and prospective clients are seeking to solve increasingly complex supply chain, pricing/revenue and eMarketplace problems. Further, we are focused on providing more comprehensive solutions for our clients, as opposed to only licensing software. As the complexity of the problems our clients seek to solve increases, the size and scope of our contracts with clients increase. As a result, our operating results could fluctuate due to the following factors:

the complexities of the contracting process of our clients;

contractual terms may vary widely, which may result in differing methods of accounting for revenue from each contract;

losses of, or delays in concluding larger contracts could have a proportionately greater effect on our revenue for a particular period; and

the sales cycles related to larger contracts may be longer and subject to greater delays.

Any of these factors could cause our revenue to decline or fluctuate significantly in any quarter and could cause a decline in our stock price.

We have experienced difficulties integrating acquisitions in the past and may experience problems with future acquisitions that could materially harm our business.

Acquisitions involve the integration of companies that have previously operated independently. In connection with any acquisition, there can be no assurance that we will:

effectively integrate employees, operations, products and systems;

realize the expected benefits of the transaction;

retain key employees;

effectively develop and protect key technologies and proprietary know-how;

avoid conflicts with our clients and business partners that have commercial relationships or compete with the acquired company;

avoid unanticipated operational difficulties or expenditures or both; and

effectively operate our existing business lines, given the significant diversion of resources and management attention required to successfully integrate acquisitions, including the acquisition of Talus in December 2000.

We experienced significant difficulties with the integration of the products and operations of ProMIRA Software, Inc. (ProMIRA) and TYECIN, which we acquired in fiscal 1998 and 1999, respectively. These difficulties included problems integrating the prior ProMIRA sales forces and the delayed releases of the in-process technology acquired as part of the transaction. In addition, as a result of the poor financial performance we experienced in fiscal 1999, the technology acquired in conjunction with the TYECIN acquisition was not integrated into our solutions and, therefore, revenue generated from this technology have been nominal. Similar difficulties with future acquisitions could materially and adversely affect our business, results of operations and financial condition.

We may encounter problems effectively integrating Talus.

On December 21, 2000, we completed the acquisition of Talus, a privately-held company that provides pricing and revenue optimization products and services. This acquisition is substantially larger than all of our prior acquisitions, not all of which have been successful. In addition to the risks described above in connection with acquisitions generally, the ultimate success of our acquisition of Talus is dependent on factors which include the following:

our ability to complete the commercial releases of our pricing and revenue optimization solutions;

our ability to protect and maintain Talus intellectual property rights;

our ability to successfully market and license the products Talus has developed and is developing for commercial release;

our ability to successfully integrate Talus technologies;

our ability to retain and motivate Talus employees;

market acceptance of the products Talus has commercially developed to date;

our ability to fulfill our strategic plan for the acquisition of Talus by integrating our supply chain and eMarketplace capabilities and products with Talus pricing and revenue optimization products;

---

market acceptance of EPO solutions;

our ability, together with Talus, to cross-sell products and services into our respective markets; and

the outcome of disputes and litigation which have arisen in the ordinary course of business.

Our acquisition of Talus will adversely affect our combined financial results.

We have incurred and will continue to incur substantial dilution to our earnings per share in accordance with generally accepted accounting principles for the foreseeable future as a result of the Talus acquisition. In connection with the acquisition, we will amortize approximately $22.8 million of deferred compensation related to unvested stock options over four years. Further, we expect to incur an annual amortization charge of approximately $82 million related to goodwill and other intangible assets.

We depend on sales of our supply chain management, pricing/revenue optimization and eMarketplace solutions, and our business will be materially and adversely affected if the market for our products does not continue to grow.

Substantially all of our software revenue, service revenue and support revenue have arisen from, or are related directly to, our supply chain management, pricing/revenue optimization and eMarketplace solutions. We expect to continue to be dependent upon these solutions in the future, and any factor adversely affecting the solutions or the markets for supply chain management, pricing/revenue optimization and eMarketplace solutions, in general, would materially and adversely affect our ability to generate revenue. While we believe the markets for supply chain management, pricing/revenue optimization and eMarketplace solutions will continue to expand, they may grow more slowly than in the past. If the markets for our solutions do not grow as rapidly as we expect, revenue growth, operating margins, or both, could be adversely affected.

Our markets are very competitive, and we may not be able to effectively compete.

The markets for our solutions are very competitive. The intensity of competition in our markets has significantly increased, and we expect it to increase in the future. Our current and potential competitors may make acquisitions of other competitors and may establish cooperative relationships among themselves or with third parties. Further, our current or prospective clients and partners may become competitors in the future. Increased competition could result in price reductions, lower gross margins, longer sales cycles and the loss of market share. Each of these developments could materially and adversely affect our growth and operating performance.

Many of our current and potential competitors have significantly more resources than we do and, therefore, we may be at a disadvantage in competing with them.

We directly compete with other application software vendors including: Adexa, Inc., Aspen Technology, Inc., The Descartes Systems Group Inc., i2 Technologies, Inc., Logility, Inc., Micros Systems, Inc., PROS Revenue Management, Sabre, Inc., SynQuest and YieldStar Technology. Some eMarketplace software companies that do not currently offer directly competitive products or solutions, such as Ariba, Inc. and Commerce One, may begin to compete directly with us. In addition, some ERP companies such as Invensys plc (which acquired Baan Company N.V.), J.D. Edwards & Company, Oracle Corporation, PeopleSoft, Inc. and SAP AG have acquired or developed and are developing supply chain planning, pricing/revenue optimization or eMarketplace solutions. Some of our current and potential competitors, particularly the ERP vendors, have significantly greater financial, marketing, technical and other competitive resources than us, as well as greater name recognition and a larger installed base of clients. In addition, many of our competitors have well-established relationships with our current and potential clients and have extensive knowledge of our industry. As a result, they may be able to adapt more quickly to new or emerging technologies and changes in client requirements or to devote greater resources to the development, promotion and sale of their products than we can. Any of these factors could materially impair our ability to compete and adversely affect our revenue growth and operating performance.

If the development of our products and services fails to keep pace with our industry s rapidly evolving technology, our future results may be materially and adversely affected.

The markets for supply chain management, pricing/revenue optimization and eMarketplace solutions are subject to rapid technological change, changing client needs, frequent new product introductions and evolving industry standards that may render existing products and services obsolete. Our growth and future operating results will depend, in part, upon our ability to enhance existing applications and develop and introduce new applications or capabilities that:

- meet or exceed technological advances in the marketplace;
- meet changing client requirements;
- comply with changing industry standards;
- achieve market acceptance;
- integrate third-party software effectively; and
- respond to competitive offerings.

Our product development and testing efforts have required, and are expected to continue to require, substantial investments. We may not possess sufficient resources to continue to make the necessary investments in technology. In addition, we may not successfully identify new software opportunities or develop and bring new software to market in a timely and efficient manner. If we are unable, for technological or other reasons, to develop and introduce new and enhanced software in a timely manner, we may lose existing clients and fail to attract new clients, which may adversely affect our performance.

Defects in our software or problems in the implementation of our software could lead to claims for damages by our clients, loss of revenue or delays in the market acceptance of our solutions.

Our software is complex and is frequently integrated with a wide variety of third-party software. We may license software that contains undetected errors or failures when new software is first introduced or as new versions are released. We may also be unable to meet client expectations in implementing our solutions. These problems may result in claims for damages suffered by our clients, a loss of, or delays in, the market acceptance of our solutions, client dissatisfaction and potentially lost revenue during the period required to correct these errors.

We are dependent on third-party software that we incorporate into and include with our products and solutions and impaired relations with these third parties, defects in third-party software or the inability to enhance their software over time could harm our business.

We incorporate and include third-party software into and with our products and solutions. We are likely to incorporate and include additional third-party software into and with our products and solutions as we expand our product offerings. The operation of our products would be impaired if errors occur in the third-party software that we utilize. It may be more difficult for us to correct any defects in third-party software because the software is not within our control. Accordingly, our business could be adversely affected in the event of any errors in this software. There can be no assurance that these third parties will continue to invest the appropriate levels of resources in their products and services to maintain and enhance the software capabilities.

Furthermore, it may be difficult for us to replace any third-party software if a vendor seeks to terminate our license to the software or ability to license the software to others. Any impairment in our relationship with these third parties could adversely impact our business, results of operations and financial condition.

We are substantially dependent on third parties to integrate our software with other software products and platforms.

We depend on companies such as Peregrine Systems, Inc.; Vignette Corporation; and webMethods, Inc. to integrate our software with software and platforms developed by third parties. If these companies are unable to develop or maintain software that effectively integrates our software and is free from errors, our ability to license

our products and provide solutions could be impaired. Further, we rely on these companies to maintain relationships with the companies that provide the external software that is vital to the functioning of our products and solutions. The loss of any company that we use to integrate our software products could adversely affect our business, results of operations and financial condition.

Our efforts to develop relationships with vendors such as software companies, consulting firms, resellers and others to implement and promote our software products may fail.

We are developing, maintaining and enhancing significant working relationships with complementary vendors, such as software companies, consulting firms, resellers and others, that we believe can play important roles in marketing our products and solutions. We are currently investing, and intend to continue to invest significant resources to develop and enhance these relationships, which could adversely affect our operating margins. We may be unable to develop relationships with organizations that will be able to market our products effectively. Our arrangements with these organizations are not exclusive and, in many cases, may be terminated by either party without cause. Many of the organizations with whom we are developing or maintaining marketing relationships have commercial relationships with our competitors. Therefore, there can be no assurance that any organization will continue its involvement with us and our products. The loss of relationships with important organizations could materially and adversely affect our business, results of operations and financial condition.

We have only recently entered into contracts with governmental agencies. These contracts often involve long purchase cycles and competitive procurement processes.

We have recently begun providing our solutions to government agencies and expect that a significant portion of our future revenue may be derived from government agency clients. Obtaining government contracts may involve long purchase cycles, competitive bidding, qualification requirements, performance bond requirements, delays in funding, budgetary constraints and extensive specification development and price negotiations. In order to facilitate doing business with the federal government, we have submitted a schedule of prices for our products and services to the General Services Administration. We are permitted to update our schedule of prices only on an annual basis. Each government agency maintains its own rules and regulations with which we must comply and which can vary significantly among agencies. Government agencies also often retain a significant portion of fees payable upon completion of a project and collection of such fees may be delayed for several months. Accordingly, our revenue could decline as a result of these government procurement processes. In addition, it is possible that, in the future, some of our government contracts may be fixed price contracts which may prevent us from recovering costs incurred in excess of our budgeted costs. Fixed price contracts may require us to estimate the total project cost based on preliminary projections of the project s requirements. The financial viability of any given project depends in large part on our ability to estimate such costs accurately and complete the project on a timely basis. In the event our actual costs exceed the fixed contract cost, we will not be able to recover the excess costs. If we fail to properly anticipate costs on fixed price contracts, our profit margins will decrease. Some government contracts are also subject to termination or renegotiation at the convenience of the government, which could result in a large decline in revenue in any given quarter. Multi-year contracts are contingent on overall budget approval by Congress and may be terminated due to lack of funds.

Increased sales through indirect channels may adversely affect our operating performance.

Even if our marketing efforts through indirect channels are successful and result in increased sales, our average selling prices and operating margins could be adversely affected because of the lower unit prices that we receive when selling through indirect channels.

If we fail to effectively expand our sales organization, our ability to grow will be limited.

Our continuing efforts to expand our sales organization will require significant resources. New sales personnel will require training and may take a long time to achieve full productivity. Further, the competition for qualified sales personnel is intense, and there is no assurance that we can attract and retain qualified sales people at levels sufficient to support our growth. Any failure to adequately sell and support our products could limit our growth and adversely affect our performance.

The limited ability of legal protections to safeguard our intellectual property rights could impair our ability to compete effectively.

Our success and ability to compete are substantially dependent on our internally developed technologies and trademarks, which we protect through a combination of confidentiality procedures, contractual provisions, patent, copyright, trademark and trade secret laws. Despite our efforts to protect our proprietary rights, unauthorized parties may copy aspects of our products or obtain and use information that we regard as proprietary. Policing unauthorized use of our products is difficult and, although we are unable to determine the extent to which piracy of our software products exists, we expect software piracy to be a problem. In addition, the laws of some foreign countries do not protect our proprietary rights to the same extent as the laws of the United States. Furthermore, our competitors may independently develop technology similar to ours.

Our products may infringe upon the intellectual property rights of others, which may cause us to incur unexpected costs or prevent us from selling our products.

The number of intellectual property claims in our industry may increase as the number of competing products grows and the functionality of products in different industry segments overlaps. In recent years, there has been a tendency by software companies to file substantially increasing numbers of patent applications, including those for business methods and processes. We have no way of knowing what patent applications third parties have filed until the application is filed or until a patent is issued. Patent applications are often published within 18 months of filing but it can take as long as three years or more for a patent to be granted after an application has been filed. Although we are not aware that any of our products infringe upon the proprietary rights of third parties, there can be no assurance that third parties will not claim infringement by us with respect to current or future products. Any of these claims, with or without merit, could be time-consuming to address, result in costly litigation, cause product shipment delays or require us to enter into royalty or license agreements. These royalty or license agreements might not be available on terms acceptable to us or at all, which could materially and adversely affect our business.

Our international operations pose risks for our business and financial condition.

We currently conduct operations in a number of countries around the world. These operations require significant management attention and financial resources and subject us to risks inherent in doing business internationally, such as:

- regulatory requirements;
- difficulties in staffing and managing foreign operations;
- longer collection cycles;
- foreign currency risk;
- legal uncertainties regarding liability, ownership and protection of intellectual property;
- tariffs and other trade barriers;
- seasonal reductions in business activities;
- potentially adverse tax consequences; and
- economic and political instability.

Any of the above factors could adversely affect the success of our international operations. One or more of these factors could have a material adverse effect on our business and operating results.

If we lose our key personnel, the success and growth of our business may suffer.

Our success depends significantly on the continued service of our executive officers. We do not have fixed-term employment agreements with any of our executive officers, and we do not maintain key person life insurance on our executive officers. The loss of services of any of our officers for any reason could have a material adverse effect on our business, operating results, financial condition and cash flows.

The failure to hire and retain qualified personnel would harm our business.

We believe that our success also will depend significantly on our ability to attract, integrate, motivate and retain additional highly skilled technical, managerial, sales, marketing and services personnel. Competition for skilled personnel is intense, and there can be no assurance that we will be successful in attracting, motivating and retaining the personnel required to grow and operate profitably. In addition, the cost of hiring and retaining skilled employees is high, and this reduces our profitability. Failure to attract and retain highly skilled personnel could materially and adversely affect our business. An important component of our employee compensation is stock options. A decline in our stock price could adversely affect our ability to attract and retain employees, as it has in the past.

We have recently experienced significant changes in our senior management team and there is no assurance the team will work together effectively.

Commencing in the first quarter of fiscal 2000, we have completely changed our senior management team. Gregory J. Owens, our Chief Executive Officer, joined us in April 1999. With one exception, all of our other present executive officers joined us after Mr. Owens. Our success depends on the ability of our management team to work together effectively. Our business, revenue and financial condition will be materially and adversely affected if our senior management team does not manage our company effectively or if we are unable to retain our senior management.

Expenses arising from our stock option repricing may have a material adverse impact on future performance.

In response to the poor performance of our stock price between May 1998 and January 1999, we offered to reprice employee stock options, other than those held by our executive officers or directors, effective January 29, 1999, to bolster employee retention. The effect of this repricing resulted in options to acquire approximately 3.0 million shares being repriced and the four-year vesting period starting over. The recently adopted FASB Interpretation No. 44 of Accounting Principles Board Opinion No. 25, Accounting for Stock Issued to Employees, requires us to record compensation expense or benefit associated with the change in the market price of these options. The increase in our common stock market price since the FASB-mandated measurement date of July 1, 2000 resulted in a non-cash stock compensation expense of $4.6 million for the three months ended May 31, 2001 and $11.1 million being recorded for the year ended February 28, 2001. In each future quarter, we will record the additional expense or benefit related to the repriced stock options still outstanding, to the extent that our stock price is greater than $22.19, based on the change in our common stock price as compared to the measurement date. As a result, the repricing may continue to have a material adverse impact on reported financial results and could therefore negatively affect our stock price.

We may be subject to future liability claims, and our company s and products reputation may suffer.

Many of our implementations involve projects that are critical to the operations of our clients businesses and provide benefits that may be difficult to quantify. Any failure in a client s system could result in a claim for substantial damages against us, regardless of our responsibility for the failure. We have entered into and plan to continue to enter into agreements with software vendors, consulting firms, resellers and others whereby they market our solutions. If these vendors fail to meet their clients expectations or cause failures in their clients systems, the reputation of our company and products could be materially and adversely affected even if our software products perform in accordance with their functional specifications.

Risks Related to our Industry

Lack of growth or decline in internet usage or electronic marketplaces could be detrimental to our future operating results.

The growth of the Internet has increased demand for supply chain management, pricing/revenue optimization and eMarketplace solutions, as well as created markets for new and enhanced product offerings. Therefore, our

future sales and profits are substantially dependent upon the Internet as a viable medium for electronic marketplaces. The Internet may not succeed in becoming a viable marketplace for a number of reasons, including:

- potentially inadequate development of network infrastructure or delayed development of enabling technologies and performance improvements;

- delays in the development or adoption of new standards and protocols required to handle increased levels of internet activity;

- concerns that may develop among businesses and consumers about accessibility, security, reliability, cost, ease of use and quality of service;

- increased taxation and governmental regulation; or

- changes in, or insufficient availability of, communications services to support the Internet, resulting in slower Internet user response times.

The occurrence of any of these factors could require us to modify our technology and our business strategy. Any such modifications could require us to expend significant amounts of resources. In the event that the Internet does not become and remain a viable commercial marketplace, our business, financial condition and results of operations could be materially and adversely affected.

New laws or regulations affecting the Internet, electronic marketplaces or commerce in general could reduce our revenue and adversely affect our growth.

Congress and other domestic and foreign governmental authorities have adopted and are considering legislation affecting the use of the Internet, including laws relating to the use of the Internet for commerce and distribution. The adoption or interpretation of laws regulating the Internet, or of existing laws governing such things as consumer protection, libel, property rights and personal privacy, could hamper the growth of the Internet and its use as a communications and commercial medium. If this occurs, companies may decide not to use our products or services, and our business, operating results and financial condition could suffer.

The viability of electronic marketplaces is uncertain.

Electronic marketplaces that allow collaboration over the Internet among trading partners are relatively new and unproven. There can be no assurance that trading partners will adopt electronic marketplaces as a method of doing business. Trading partners may fail to participate in electronic marketplaces for a variety of reasons, including:

- concerns about the confidentiality of information provided electronically to electronic marketplaces;

- the inability of technological advances to keep pace with the volume of information processed by electronic marketplaces; and

- regulatory issues, including antitrust issues that may arise when trading partners collaborate through electronic marketplaces.

Any of these factors could limit the growth of electronic marketplaces as an accepted means of commerce. Slower growth or the abandonment of the electronic marketplace concept in one or more industries could have a material adverse affect on our results of operations and financial condition.

Risks Related to the Notes

Our indebtedness could adversely affect our financial condition.

In November 2000, we completed a convertible debt offering of $250.0 million in 5% subordinated convertible notes. Our indebtedness could have important consequences for investors. For example, it could:

increase our vulnerability to general adverse economic and industry conditions;

limit our ability to obtain additional financing;

---

require the dedication of a substantial portion of our cash flows from operations to the payment of principal of, and interest on, our indebtedness, thereby reducing the availability of capital to fund our growth strategy, working capital, capital expenditures, acquisitions and other general corporate purposes;

limit our flexibility in planning for, or reacting to, changes in our business and the industry; and

place us at a competitive disadvantage relative to our competitors with less debt.

Although we have no present plans to do so, we may incur substantial additional debt in the future. Neither the terms of our credit facility nor the terms of these Notes fully prohibit us from doing so. If a significant amount of new debt is added to our current levels, the related risks described above could intensify.

We may have insufficient cash flow to meet our debt service obligations.

We will be required to generate cash sufficient to pay all amounts due on the Notes and to conduct our business operations. We have net losses, and we may not be able to cover our anticipated debt service obligations. This may materially hinder our ability to make principal and interest payments on the Notes. Our ability to meet our future debt service obligations will be dependent upon our future performance, which will be subject to financial, business and other factors affecting our operations, many of which are beyond our control.

Risks Related to the Sale of our Common Stock

Resales of significant amounts of our common stock issued in connection with the acquisition of Talus may cause our stock price to decline.

In connection with the acquisition of Talus, we issued approximately 7.0 million new shares of our common stock. Of these shares, a total of approximately 6.0 million shares were delivered to Manugistics exchange agent for direct transfer to the former Talus stockholders and approximately 1.0 million shares were delivered to State Street Bank and Trust Company, as escrow agent, to secure potential indemnification claims of Manugistics. To the extent that the escrowed shares are not subject to indemnification claims, the escrowed shares will be released, subject to existing claims, in two installments, on October 31, 2001 and July 2, 2002. Of the 6.0 million shares delivered to the exchange agent, approximately 1.3 million shares were freely tradable upon completion of the acquisition. The remaining approximately 4.7 million shares are subject to share transfer restrictions and will become available for sale in three stages in accordance with the terms of the share transfer restriction agreements signed by certain principals of Talus. The first two release dates were January 18, 2001, and May 31, 2001, at which time approximately 1.4 million shares and 1.0 million shares were released, respectively. The balance of these shares will be released, in accordance with the terms of the share transfer restriction agreements, on October 31, 2001.

In addition, at closing, a total of approximately 1.4 million shares were reserved for issuance upon exercise of outstanding Talus stock options and warrants which were assumed by Manugistics. Options to purchase a total of approximately 700,000 shares were exercisable at the time of completion of the acquisition. In addition, a total of approximately 370,000 of these shares were subject to share transfer restrictions which expired January 18, 2001.

Scheduled sales of significant amounts of our common stock by our executive officers may cause our stock price to decline.

Certain of our executive officers have entered into pre-established trading plans pursuant to which they sold a total of approximately 515,000 shares of our common stock in January 2001 and approximately 253,000 shares in April 2001. They are scheduled to sell up to approximately 300,000 shares per quarter after each of the first, second and third quarters of fiscal 2002 pursuant to these trading plans. The quarterly sales will continue until the trading plans are modified or terminated. Certain of our other executive officers and directors may establish similar plans to sell shares on a quarterly basis. The sale of these shares may cause the market price of our stock to decline.

Our charter and bylaws and Delaware law contain provisions that could discourage a takeover even if beneficial to stockholders.

Our charter and our bylaws, in conjunction with Delaware law, contain provisions that could make it more difficult for a third party to obtain control of us even if doing so would be beneficial to stockholders. For example, our bylaws provide for a classified board of directors and allow our board of directors to expand its size and fill any vacancies without stockholder approval. In addition, our bylaws require a two-thirds vote of stockholders to remove a director from office. Furthermore, our board has the authority to issue preferred stock and to designate the voting rights, dividend rate and privileges of the preferred stock all of which may be greater than the rights of common stockholders.

Our stock price has been and is likely to continue to be volatile.

The trading price of our common stock has been and is likely to be highly volatile. Our stock price could be subject to wide fluctuations in response to a variety of factors, including the following:

- actual or anticipated variations in quarterly operating results;
- weakening economic conditions;
- announcements of technological innovations;
- new products or services offered by us or our competitors;
- changes in financial estimates by securities analysts;
- conditions or trends in the market for EPO, SCM, PRO and eMarketplace solutions;
- changes in the performance and/or market valuations of our current and potential competitors and the software industry in general;

our announcement of significant acquisitions, strategic partnerships, joint ventures or capital commitments;

adoption of industry standards and the inclusion of our technology in, or compatibility of our technology with, such standards;

adverse or unfavorable publicity regarding us or our products;

additions or departures of key personnel;

our sales of additional equity securities; and

other events or factors that may be beyond our control.

In addition, the stock markets in general, The NASDAQ National Market and the equity markets for software companies in particular, have recently experienced extraordinary price and volume volatility and a significant cumulative decline in recent months. Such volatility and decline have adversely affected the stock prices for many companies irrespective of or disproportionately to the operating performance of these companies. These broad market and industry factors may materially and adversely further affect the market price of our common stock, regardless of our actual operating performance.

Item 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISKS.

Foreign Currency Risk. Revenue outside of the United States was 25.6% during the three months ended May 31, 2001 and was 30.7%, 40.1% and 33.9% in fiscal 2001, 2000 and 1999, respectively. International sales are usually made by our foreign subsidiaries in local currencies and the expenses incurred by foreign subsidiaries are also denominated in local currencies.

Interest Rate Risk. Our marketable securities and certain cash equivalents are subject to interest rate risk. We manage this risk by maintaining an investment portfolio of available-for-sale instruments with high credit quality and relatively short average maturities. These instruments include, but are not limited to, commercial paper, money-market instruments, bank time deposits and taxable and tax-advantaged variable rate and fixed rate obligations of corporations, municipalities and national, state and local government agencies, in accordance with an investment policy approved by our Board of Directors. These instruments are denominated in U.S. dollars. The fair

market value of marketable securities held at May 31, 2001 was $52.2 million and $103.9 million at February 28, 2001.

We also hold cash balances in accounts with commercial banks in the United States and foreign countries. These cash balances represent operating balances only and are invested in short-term deposits of the local bank. Such operating cash balances held at banks outside of the United States are denominated in the local currency.

The United States Federal Reserve Board influences the general market rates of interest. The Federal Reserve Board has decreased the discount rate to 3.75% recently. This action has led to a general market decline in interest rates recently.

The weighted average yield on interest-bearing investments held as of May 31, 2001 was approximately 4.3%. Based on our investment holdings at May 31, 2001, a 100 basis point decline in the average yield would reduce our annual interest income by $2.4 million.

PART II OTHER INFORMATION

Item 1. LEGAL PROCEEDINGS.

We are involved from time to time in disputes (including those previously reported) and other litigation in the ordinary course of business. We do not believe that the outcome of any pending disputes or litigation will have a material adverse effect on our business, operating results, financial condition and cash flows. However, the ultimate outcome of these matters, as with litigation generally, is inherently uncertain and it is possible that some of these matters may be resolved adversely to us. The adverse resolution of any one or more of these matters could have a material adverse effect on our business, operating results, financial condition and cash flows.

The Company has previously reported its legal proceedings with Information Resources, Inc. (IRI) arising from the acquisition of certain assets in March 1997. A dispute over revenue streams that IRI alleges it is entitled to is being arbitrated. IRI seeks a total of $15.9 million in damages. The Company contends that the conditions to these amounts becoming due have not been satisfied and that no amounts are due IRI, because, among other reasons, of a failure of consideration in the overall transaction. Arbitration of this matter is scheduled to commence in early November. A related claim concerning the breach of a separate Non-Competition and Non-Solicitation Agreement filed in the Circuit Court of Cook County, Illinois is awaiting resolution of the abitration.

As previously reported, on November 29, 2000, the Company filed a lawsuit against VirtualFund.com, Inc., in the United States District Court for the District of Maryland alleging that VirtualFund.com, Inc. is in anticipatory breach of its obligations under a software license agreement among the Company and VirtualFund, Inc. and its affiliates. The Company sought at least $4.5 million in damages. VirtualFund.com, Inc. counterclaimed that the contract is invalid and sought return of $2.5 million in fees and other unspecified damages. In July 2001, the Company and VirtualFund.com, Inc. settled all claims. The settlement of these claims will not have a material impact on the Company s results of operations.

Item 2. CHANGES IN SECURITIES

(a) Recent sale of unregistered securities

One Release Acquisition. The Company acquired substantially all of the assets of One Release, LLC and its affiliates, pursuant to an Asset Purchase Agreement dated as of May 17, 2001, (the Purchase Agreement), which was privately negotiated among the parties thereto. At closing on May 17, 2001, the Company issued to One Release 135,793 shares of common stock valued at approximately $4.35 million. The Company also agreed to pay up to $1.0 million in contingent consideration (the Additional Consideration) if certain performance criteria are met during the 12- month period ended May 17, 2002. The Additional Consideration, if any, would be payable in the form of shares of the Company s common stock.

The Shares were not registered under the Securities Act of 1933, as amended (the Securities Act) in reliance upon Section 4 (2) of the Securities Act. The Purchase Agreement and a related Registration Rights Agreement imposed certain restrictions on the resale or other transfer of Shares necessary for the availability of the Section 4(2) exemption. No underwriters were involved in connection with the issuance and sale of the Shares under the Purchase Agreement. The Company has agreed to file a registration statement on Form S-3 under the Securities Act to register the Shares for resale by One Release or by certain permitted transferees. If the Company issues additional shares of its common stock as Additional Consideration, the Company is also obligated to register such shares for resale under the Securities Act.

26

Item 6. EXHIBITS AND REPORTS ON FORM 8-K.

(a) Exhibits

10 First Amendment to Lease Agreement, dated December 19, 2000, between the Company and DANAC Corporation.

(b) Reports on Form 8-K

1. On March 7, 2001, we filed a Current Report on Form 8-K reporting our issuance of a press release on March 2, 2001 announcing that we intended to report record revenue for the quarter ended February 28, 2001.

2. On March 8, 2001, we filed a Current Report on Form 8-K to file an updated description of our business.

27

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized, on July 13, 2001.

MANUGISTICS GROUP, INC.
(Registrant)

Date: July 13, 2001

/s/Raghavan Rajaji
Raghavan Rajaji
Executive Vice President and
Chief Financial Officer
(Principal financial officer)

/s/ Jeffrey T. Hudkins
Jeffrey T. Hudkins
Vice President, Controller and
Chief Accounting Officer
(Principal accounting officer)

28

"FONT-FAMILY: "Times New Roman", Times, serif; FONT-SIZE: 10pt">–

(1,765
)

(55
)

(68,646
)
Taxes incurred on deemed capital gain distribution

(3,787
)

(1,125
)

(3,787
)

(1,125
)
Net (increase) decrease in unrealized appreciation of investments

(53,308
)

(22,296
)

(109,315
)

5,904

Stock option expense

(2
)

62

347

334

Increase in dividend and interest receivable

(7,881
)

(5,586
)

(7,901
)

(6,462

)
Increase in receivables from affiliates

(136
)

(104
)

(365
)

(218
)
Decrease (Increase) in other assets

(13
)

22

31

32

Increase in taxes payable

4,110

1,125

4,110

1,125

Increase in other liabilities

1,295

1,687

724

1,591

(Decrease) Increase in deferred income taxes

(1,024
)

(43

)

(1,055
)

9

Net cash (used in) provided by operating activities

(1,808
)

9,230

(14,327
)

69,336

Cash flows from financing activities

Distributions from undistributed net investment income

(1,525
)

(1,520
)

(3,050
)

(3,025
)
Dividends paid from net realized capital gain

–

–

–

(66,826
)
Proceeds from exercise of employee stock options

868

226

1,327

3,243

Net cash used in financing activities

(657
)

(1,294
)

(1,723
)

(66,608
)
Net (decrease) increase in cash and cash equivalents

(2,465
)

7,936

(16,050
)

2,728

Cash and cash equivalents at beginning of period

68,182

59,687

81,767

64,895

Cash and cash equivalents at end of period

$
65,717

$
67,623

$
65,717

$
67,623

The accompanying Notes are an integral part of these Consolidated Financial Statements.

Table of Contents
CAPITAL SOUTHWEST CORPORATION AND SUBSIDIARIES

CONSOLIDATED SCHEDULE OF INVESTMENTS
(Unaudited)
December 31, 2013

Company	Equity (a)	Investment (b)	Cost	Value (c)
*†ALAMO GROUP INC. Seguin, Texas Tractor-mounted mowing and mobile excavation equipment for governmental, industrial and agricultural markets; street-sweeping and snow removal equipment for municipalities.	22.0 %	‡2,832,300 shares of common stock (acquired 4-1-73 thru 5-09-13)	$2,190,937	$171,831,597
ATLANTIC CAPITAL BANCSHARES, INC Atlanta, Georgia Holding company of Atlantic Capital Bank, a full service commercial bank.	1.9 %	300,000 shares of common stock (acquired 4-10-07)	3,000,000	3,656,000
¥BALCO, INC. Wichita, Kansas Specialty architectural products used in the construction and remodeling of commercial and institutional buildings.	95.7 %	445,000 shares of common stock and 60,920 shares Class B non-voting common stock (acquired 10-25-83 and 5-30-02)	624,920	4,600,000
*BOXX TECHNOLOGIES, INC. Austin, Texas Workstations for computer graphic imaging and design.	14.9 %	3,125,354 shares of Series B Convertible Preferred Stock, convertible into 3,125,354 shares of common stock at $0.50 per share (acquired 8-20-99 thru 8-8-01)	1,500,000	1,020,000
¥ CAPSTAR HOLDINGS CORPORATION Dallas, Texas Acquires holds and manages real estate for potential development and sale.	100 %	500 shares of common stock (acquired 6-10-10) and 1,000,000 shares of preferred stock (acquired 12-17-12)	4,703,619	7,572,000
	76.2 %	12% subordinated secured promissory note, due 5-9-16 (acquired 5-19-10 thru 10-20-10)	779,278	1
		12% subordinated secured promissory note, due 5-9-17 (acquired 5-9-11 thru 10-26-11)	2,285,700	1
		12% subordinated secured promissory note, due 3-31-17 (acquired 9-9-11 and 10-26-11)	1,523,800	1
		10% subordinated secured promissory note, due 5-9-17 (acquired 7-14-08 thru 4-28-10)	6,200,700	1
		12% subordinated secured promissory note, due 10-31-17	499,997	1

CINATRA CLEAN TECHNOLOGIES, INC

	(acquired 10-19-12)		
	12% subordinated secured promissory note, due 9-30-14 (acquired 7-25-13)	1,157,850	1
	3,033,410 shares of Series A Convertible Preferred Stock, convertible into 3,033,410 shares of common stock at $1.00 per share (acquired 7-14-08 thru 11-18-10)	3,033,410	1
	Warrants to purchase 1,436,499 shares of common stock at $1.00 per share, expiring 10-31-2027 (acquired 5-9-11 thru 10-19-12)	–	–
		15,480,735	7

†Publicly-owned company ¥ Control investment * Affiliated investment ‡Unrestricted securities as defined in Note (a)

The accompanying Notes are an integral part of these Consolidated Financial Statements.

7

Table of Contents

CAPITAL SOUTHWEST CORPORATION AND SUBSIDIARIES

CONSOLIDATED SCHEDULE OF INVESTMENTS
(Unaudited)
December 31, 2013

Company	Equity (a)		Investment (b)	Cost	Value (c)
DEEPWATER CORROSION SERVICES, INC. Houston, Texas Full-service corrosion control company providing the oil and gas industry with expertise in cathodic protection and asset integrity management.	31.3	%	127,004 shares of Series A convertible preferred stock, convertible into 127,004 shares of common stock at $1.00 per shares (acquired 4-9-13)	8,000,000	8,000,000
¥DISCOVERY ALLIANCE, LLC Dallas, Texas Provides services related to intellectual property protection and development.	90	%	90.0% limited liability company interest (acquired 9-12-08 thru 10-15-12)	1,315,000	404,000
*†ENCORE WIRE CORPORATION McKinney, Texas Electric wire and cable for residential, commercial and industrial construction use.	6.2	%	‡1,312,500 shares of common stock (acquired 9-10-92 thru 10-15-98)	5,200,000	71,019,375
†HOLOGIC, INC. Bedford, Massachusetts Medical diagnostic products, imaging systems and surgical products serving the healthcare needs of women.	< 1	%	‡582,820 shares of common stock (acquired 8-27-99)	202,529	13,020,199
iMEMORIES, INC. Scottsdale, Arizona Enables online video and photo sharing and DVD creation for home movies and photos recorded in analog and digital formats.	23.3	%	17,391,304 shares of Series B Convertible Preferred Stock, convertible into 19,891,304 shares of common stock at $0.23 per share (acquired 7-10-09)	4,000,000	4,000,000
			4,684,967 shares of Series C Convertible Preferred Stock, convertible into 4,684,967 shares of common stock at $0.23 per share (acquired 7-20-11)	1,078,479	1,078,479
			Warrants to purchase 2,500,000 shares of common stock at $0.12 per share, expiring 1-21-21(acquired 9-13-10 thru 1-21-11)	–	–
			10% convertible notes, $308,000 principal due 7-31-14 (acquired 9-7-12)	308,000	308,000
				880,000	880,000

			10% convertible notes, $880,000 principal due 7-31-14 (acquired from 3-15-13 to 9-26-13)		
				6,266,479	6,266,479
INSTAWARES HOLDING COMPANY, LLC Atlanta, Georgia Provides services and distributes equipment and supplies to the restaurant industry via its five subsidiary companies.	4.3	%	3,846,154 Class D Convertible Preferred Stock (acquired 5-20-11)	5,000,000	3,652,000

†Publicly-owned company ¥ Control investment * Affiliated investment ‡Unrestricted securities as defined in Note (a)

The accompanying Notes are an integral part of these Consolidated Financial Statements.
8

Table of Contents

CAPITAL SOUTHWEST CORPORATION AND SUBSIDIARIES

CONSOLIDATED SCHEDULE OF INVESTMENTS
(Unaudited)
December 31, 2013

Company	Equity (a)		Investment (b)	Cost	Value (c)
KBI BIOPHARMA, INC.	17.1	%	10,204,082 shares of Series B-2 Convertible Preferred Stock, convertible into 10,204,802 shares of common stock at \$0.49 per share (acquired 9-08-09)	5,000,000	6,900,000
Durham, North Carolina Provides fully-integrated, outsourced drug development and bio-manufacturing services.			Warrants to purchase 94,510 shares of Series B preferred stock at \$ 0.70 per share, acquired 1-26-12	-	-
				5,000,000	6,900,000
¥MEDIA RECOVERY, INC. Dallas, Texas Distributor of computer datacenter and office automation supplies and accessories;	97.9	%	800,000 shares of Series A Convertible Preferred Stock, convertible into 800,000 shares of common stock at \$1.00 per share (acquired 11-4-97)	800,000	2,900,000
manufactures and distributes devices used to monitor and manage intransit inventory and			4,000,002 shares of common stock (acquired 11-4-97)	4,615,000	14,300,000
dunnage products for protecting shipments.				5,415,000	17,200,000
*PALLETONE, INC.	7.7	%	12.3% senior subordinated notes, \$2,000,000 principal due 12-18-15 (acquired 9-25-06)	1,553,150	2,000,000
Bartow, Florida Manufacturer of wooden pallets and			150,000 shares of common stock (acquired 10-18-01)	150,000	2
pressure-treated lumber.				1,703,150	2,000,002
¥THE RECTORSEAL CORPORATION Houston, Texas Specialty chemicals, tools and products for plumbing, HVAC, electrical, construction, industrial, and oil field; smoke containment systems for building fires; also owns 20% of The Whitmore Manufacturing Company.	100.0	%	27,907 shares of common stock (acquired 1-5-73 and 3-31-73)	52,600	257,900,000
	31.2	%	217,038 shares of Series A Convertible Preferred Stock convertible into 217,038 shares of Series A Preferred Stock at \$14.76 per share (acquired 6-29-12)	3,203,000	-
TITANLINER, INC. Midland, Texas			7% senior subordinated secured promissory note, due 6-30-17 (acquired 6-29-12)	2,747,000	2,536,000
Manufactures, installs and rents spill containment system for oilfield applications.				-	-

	Warrants to purchase 122,239 shares of Series A Preferred Stock at $ 0.01 per share, expiring 12-31-22		
		5,950,000	2,536,000

†Publicly-owned company ¥ Control investment * Affiliated investment ‡Unrestricted securities as defined in Note (a)

The accompanying Notes are an integral part of these Consolidated Financial Statements.
9

Table of Contents

CAPITAL SOUTHWEST CORPORATION AND SUBSIDIARIES

CONSOLIDATED SCHEDULE OF INVESTMENTS
(Unaudited)
December 31, 2013

Company	Equity (a)	Investment (b)	Cost	Value (c)
	28.4 %	475,430 shares of Series B convertible Preferred Stock convertible into 475,430 shares of common stock at $8.41 per share(acquired 12-5-12)	4,000,000	7,800,000
TRAX HOLDINGS, INC. Scottsdale, Arizona Provides a comprehensive set of solutions to improve the validation, accounting and payment of transportation-related invoices.		1,061,279 shares of Series A Convertible Preferred Stock, convertible into 1,061,279 shares of common stock at $4.71 per share (acquired 12-8-08 and 2-17-09)	5,000,000	13,500,000
			9,000,000	21,300,000
*WELLOGIX, INC. Houston, Texas Formerly a developer and supporter of business process software used by the oil and gas industry.	19.0 %	4,788,371 shares of Series A-1 Convertible Participating Preferred Stock, convertible into 4,788,371 shares of common stock at $1.04 per share (acquired 8-19-05 thru 6-15-08)	5,000,000	25,000
¥THE WHITMORE MANUFACTURING COMPANY Rockwall, Texas Specialized surface mining, railroad and industrial lubricants; coatings for automobiles and primary metals; fluid contamination control devices.	80.0 %	80 shares of common stock (acquired 8-31-79)	1,600,000	83,000,000
MISCELLANEOUS	–	Ballast Point Ventures II, L.P. 2.2% limited partnership interest (acquired 8-4-08 thru 2-15-13)	1,959,790	2,757,000
	–	BankCap Partners Fund I, L.P. 5.5% limited partnership interest (acquired 7-14-06 thru 11-16-12)	6,000,000	5,249,000
	–	†Capitala Finance Corporation 108,105 shares of common stock (acquired 9-25-13)	1,363,799	2,151,290
	–	CapitalSouth Partners Fund III, L.P. 1.9% limited partnership interest (acquired 1-22-08 and 11-16-11)	467,457	237,000
	–	Diamond State Ventures, L.P. 1.4% limited partnership interest (acquired 10-12-99 thru 8-26-05)	-	16,000
	–	First Capital Group of Texas III, L.P. 3.0% limited partnership interest (acquired 12-26-00 thru 8-12-05)	778,895	169,000
	100 %	¥Humac Company	–	203,000

1,041,000 shares of common stock
(acquired 1-31-75 and 12-31-75)

†Publicly-owned company ¥ Control investment * Affiliated investment ‡Unrestricted securities as defined in Note (a)

The accompanying Notes are an integral part of these Consolidated Financial Statements.

Table of Contents

CAPITAL SOUTHWEST CORPORATION AND SUBSIDIARIES

CONSOLIDATED SCHEDULE OF INVESTMENTS
(Unaudited)
December 31, 2013

Company	Equity (a)	Investment (b)	Cost	Value (c)
Miscellaneous (continued)		†North American Energy Partners, Inc.		
	–	77,194 shares of common stock (acquired 8-20-12)	236,986	448,498
		STARTech Seed Fund II		
	–	3.2% limited partnership interest (acquired 4-28-00 thru 2-23-05)	754,327	161,000
		TCI Holdings, Inc.		
	–	21 shares of 12% Series C Cumulative Compounding Preferred Stock (acquired 1-30-90)	–	708,000
TOTAL INVESTMENTS			$98,766,223	$694,002,447

†Publicly-owned company ¥ Control investment * Affiliated investment ‡Unrestricted securities as defined in Note (a)

The accompanying Notes are an integral part of these Consolidated Financial Statements.

11

Table of Contents

CAPITAL SOUTHWEST CORPORATION AND SUBSIDIARIES

CONSOLIDATED SCHEDULE OF INVESTMENTS

March 31, 2013

Company	Equity (a)	Investment (b)	Cost	Value (c)
*†ALAMO GROUP INC. Seguin, Texas Tractor-mounted mowing and mobile excavation equipment for governmental, industrial and agricultural markets; street-sweeping equipment for municipalities.	22.0 %	‡2,832,300 shares of common stock (acquired 4-1-73 thru 5-09-11)	$2,190,937	$108,278,100
ATLANTIC CAPITAL BANCSHARES, INC Atlanta, Georgia Holding company of Atlantic Capital Bank, a full service commercial bank.	1.9 %	300,000 shares of common stock (acquired 4-10-07)	3,000,000	2,950,000
¥BALCO, INC. Wichita, Kansas Specialty architectural products used in the construction and remodeling of commercial and institutional buildings.	95.7 %	445,000 shares of common stock and 60,920 shares Class B non-voting common stock (acquired 10-25-83 and 5-30-02)	624,920	4,500,000
*BOXX TECHNOLOGIES, INC. Austin, Texas Workstations for computer graphic imaging and design.	14.9 %	3,125,354 shares of Series B Convertible Preferred Stock, convertible into 3,125,354 shares of common stock at $0.50 per share (acquired 8-20-99 thru 8-8-01)	1,500,000	1,240,000
CINATRA CLEAN TECHNOLOGIES, INC. Houston, Texas Cleans above ground oil storage tanks with a patented, automated system.	73.4 %	12% subordinated secured promissory note, due 5-9-16 (acquired 5-19-10 thru 10-20-10)	779,278	81,000
		12% subordinated secured promissory note, due 5-9-17 (acquired 5-9-11 thru 10-26-11)	2,285,700	237,000
		12% subordinated secured promissory note, due 3-31-17 (acquired 9-9-11 and 10-26-11)	1,523,800	158,000
		10% subordinated secured promissory note, due 5-9-17 (acquired 7-14-08 thru 4-28-10)	6,200,700	643,000
		12% subordinated secured promissory note, due 10-31-17 (acquired 10-19-12)	499,997	52,000
		3,033,410 shares Series A Convertible Preferred Stock, convertible into 3,033,410 shares common stock at $1.00 per share (acquired 7-14-08 thru 11-18-10)	3,033,410	1

Warrants to purchase 1,436,499 shares of common stock at $1.00 per share, expiring 10-31-2027 (acquired 5-9-11 thru 10-19-12)	–	–
	14,322,885	1,171,001

†Publicly-owned company ¥ Control investment * Affiliated investment ‡Unrestricted securities as defined in Note (a)

The accompanying Notes are an integral part of these Consolidated Financial Statements.
12

Table of Contents

CAPITAL SOUTHWEST CORPORATION AND SUBSIDIARIES

CONSOLIDATED SCHEDULE OF INVESTMENTS

March 31, 2013

Company	Equity (a)		Investment (b)	Cost	Value (c)
*†ENCORE WIRE CORPORATION McKinney, Texas Electric wire and cable for residential, commercial and industrial construction use.	6.2	%	‡1,312,500 shares of common stock (acquired 9-10-92 thru 10-15-98)	5,200,000	45,950,625
†HOLOGIC, INC. Bedford, Massachusetts Medical instruments including bone densitometers, mammography devices and digital radiography systems.	< 1	%	‡582,820 shares of common stock (acquired 8-27-99)	202,529	13,165,904
iMEMORIES, INC. Scottsdale, Arizona Enables online video and photo sharing and DVD creation for home movies recorded in analog and new digital format.	23	%	17,391,304 shares of Series B Convertible Preferred Stock, convertible into 19,891,304 shares of common stock at $0.23 per share (acquired 7-10-09)	4,000,000	4,000,000
			4,684,967 shares of Series C Convertible Preferred Stock, convertible into 4,684,967 shares of common stock at $0.23 per share (acquired 7-20-11)	1,078,479	1,078,479
			Warrants to purchase 2,500,000 shares of common stock at $0.12 per share, expiring 1-21-21(acquired 9-13-10 thru 1-21-11)	–	–
			10% convertible notes, $308,000 principal due 7-31-14 (acquired 9-7-12)	308,000	308,000
			10% convertible notes, $400,000 principal due 7-31-14 (acquired 3-15-13	440,000	440,000
				5,826,479	5,826,479
INSTAWARES HOLDING COMPANY, LLC Atlanta, Georgia Provides services to the restaurant industry via its five subsidiary companies.	4.5	%	3,846,154 shares of Class D Convertible Preferred Stock (acquired 5-20-11)	5,000,000	5,975,000
KBI BIOPHARMA, INC. Durham, North Carolina Provides fully-integrated, outsourced drug development and bio-manufacturing services.	17.1	%	10,204,082 shares of Series B-2 Convertible Preferred Stock, convertible into 10,204,802 shares of common stock at $0.49 per share (acquired 9-08-09)	5,000,000	5,200,000
			Warrants to purchase 94,510 shares of Series B Preferred stock at $ 0.70 per	-	-

share, acquired 1-26-12		
	5,000,000	5,200,000

†Publicly-owned company ¥ Control investment * Affiliated investment ‡Unrestricted securities as defined in Note (a)

The accompanying Notes are an integral part of these Consolidated Financial Statements.
13

CAPITAL SOUTHWEST CORPORATION AND SUBSIDIARIES

CONSOLIDATED SCHEDULE OF INVESTMENTS

March 31, 2013

Company	Equity (a)	Investment (b)	Cost	Value (c)
¥MEDIA RECOVERY, INC. Dallas, Texas Computer datacenter and office automation supplies and accessories; impact, tilt monitoring and temperature sensing devices to detect mishandling shipments; dunnage for protecting shipments.	97.9 %	800,000 shares of Series A Convertible Preferred Stock, convertible into 800,000 shares of common stock at $1.00 per share (acquired 11-4-97)	800,000	2,000,000
		4,000,002 shares of common stock (acquired 11-4-97)	4,615,000	9,900,000
			5,415,000	11,900,000
*PALLETONE, INC. Bartow, Florida Manufacturer of wooden pallets and pressure-treated lumber.	7.7 %	12.3% senior subordinated notes, $2,000,000 principal due 12-18-15 (acquired 9-25-06)	1,553,150	1,900,000
		150,000 shares of common stock (acquired 10-18-01)	150,000	2
			1,703,150	1,900,002
¥THE RECTORSEAL CORPORATION Houston, Texas Specialty chemicals for plumbing, HVAC, electrical, construction, industrial, oil field and automotive applications; smoke containment systems for building fires; also owns 20% of The Whitmore Manufacturing Company.	100.0 %	27,907 shares of common stock (acquired 1-5-73 and 3-31-73)	52,600	238,900,000
TCI HOLDINGS, INC. Denver, Colorado Cable television systems and microwave relay systems.	–	21 shares of 12% Series C Cumulative Compounding Preferred Stock (acquired 1-30-90)	–	763,000
TITANLINER, INC. Midland, Texas Manufactures, installs and rents spill containment system for oilfield applications.	29.9 %	217,038 shares of Series A Convertible Preferred Stock convertible into 217,038 shares of Series A Preferred Stock at $14.76 per share (acquired 6-29-12)	3,203,000	3,203,000
		7% senior subordinated secured promissory note, due 6-30-17 (acquired 6-29-12)	2,747,000	2,747,000
		Warrants to purchase 122,239 shares of Series A preferred stock at $ 0.01 per share, expiring 12-31-22	-	-
			5,950,000	5,950,000

†Publicly-owned company ¥ Control investment * Affiliated investment ‡Unrestricted securities as defined in Note (a)

The accompanying Notes are an integral part of these Consolidated Financial Statements.
14

Table of Contents

CAPITAL SOUTHWEST CORPORATION AND SUBSIDIARIES

CONSOLIDATED SCHEDULE OF INVESTMENTS

March 31, 2013

Company	Equity (a)	Investment (b)	Cost	Value (c)
TRAX HOLDINGS, INC. Scottsdale, Arizona Provides a comprehensive set of solutions to improve the transportation validation, accounting, payment and information management process.	25.4 %	475,430 shares of Series B convertible Preferred Stock convertible into 475,430 shares of common stock at $8.41 per share(acquired 12-5-12)	4,000,000	7,000,000
		1,061,279 shares of Series A Convertible Preferred Stock, convertible into 1,061,279 shares of common stock at $4.71 per share (acquired 12-8-08 and 2-17-09)	5,000,000	12,400,000
			9,000,000	19,400,000
*WELLOGIX, INC. Houston, Texas Developer and supporter of software used by the oil and gas industry.	19.1 %	4,788,371 shares of Series A-1 Convertible Participating Preferred Stock, convertible into 4,788,371 shares of common stock at $1.04 per share (acquired 8-19-05 thru 6-15-08)	5,000,000	25,000
¥THE WHITMORE MANUFACTURING COMPANY Rockwall, Texas Specialized surface mining, railroad and industrial lubricants; coatings for automobiles and primary metals; fluid contamination control devices.	80.0 %	80 shares of common stock (acquired 8-31-79)	1,600,000	80,500,000
MISCELLANEOUS	–	Ballast Point Ventures II, L.P. 2.2% limited partnership interest (acquired 8-4-08 thru 2-15-13)	1,659,790	1,843,000
	–	BankCap Partners Fund I, L.P. 5.5% limited partnership interest (acquired 7-14-06 thru 11-16-12)	5,897,276	5,013,000
	–	CapitalSouth Partners Fund III, L.P. 1.9% limited partnership interest (acquired 1-22-08 and 11-16-11)	1,331,256	3,934,000
	100.0 %	¥CapStar Holdings Corporation 500 shares common stock (acquired 6-10-10); 1,000,000 shares of preferred stock (acquired 12-17-12)	4,703,619	7,846,000

†Publicly-owned company ¥ Control investment * Affiliated investment ‡Unrestricted securities as defined in Note (a)

The accompanying Notes are an integral part of these Consolidated Financial Statements.

15

Table of Contents

CAPITAL SOUTHWEST CORPORATION AND SUBSIDIARIES

CONSOLIDATED SCHEDULE OF INVESTMENTS

March 31, 2013

Company	Equity (a)	Investment (b)	Cost	Value (c)
Miscellaneous (continued)	–	Diamond State Ventures, L.P. 1.4% limited partnership interest (acquired 10-12-99 thru 8-26-05)	-	120,000
	–	¥Discovery Alliance, LLC 90.0% limited liability company interest (acquired 9-12-08 thru 10-15-12)	1,315,000	956,000
	–	First Capital Group of Texas III, L.P. 3.0% limited partnership interest (acquired 12-26-00 thru 8-12-05)	778,895	190,000
	100 %	¥Humac Company 1,041,000 shares common stock (acquired 1-31-75 and 12-31-75)	–	188,000
	–	†North American Energy Partners, Inc. 77,194 shares of common stock (acquired 8-20-12)	236,986	350,461
	–	STARTech Seed Fund II 3.2% limited partnership interest (acquired 4-28-00 thru 2-23-05)	754,327	151,000
TOTAL INVESTMENTS			$88,265,649	$574,186,572

†Publicly-owned company ¥ Control investment * Affiliated investment ‡Unrestricted securities as defined in Note (a)

The accompanying Notes are an integral part of these Consolidated Financial Statements.

Table of Contents

Notes to Consolidated Schedule of Investments

a) Equity

The percentages in the “Equity” column express equity interests held collectively by Capital Southwest Corporation and Capital Southwest Venture Corporation (together, the “Company”) in each issuer. Each percentage represents the amount of the issuer’s common stock owned by the Company, or which the Company has the right to acquire, as a percentage of the issuer’s total outstanding common stock, plus stock reserved for all warrants, convertible securities and employee stock options.

(b) Investments

Unrestricted securities (indicated by ‡) are freely marketable securities having readily available market quotations. All other securities are restricted securities, which are subject to one or more restrictions on resale and are not freely marketable. At December 31, 2013, restricted securities represented approximately 63.1% of the value of the consolidated investment portfolio and unrestricted securities represented 36.9% of the value of the consolidated investment portfolio. At March 31, 2013, restricted securities represented approximately 70.8% of the value of the consolidated investment portfolio and unrestricted securities represented 29.2% of the value of the consolidated investment portfolio.

Our investments are carried at fair value in accordance with the Investment Company Act of 1940 (the “1940 Act”) and FASB Accounting Standards Codification (ASC) 820, Fair Value Measurements and Disclosures. In accordance with the 1940 Act, unrestricted minority-owned publicly traded securities, for which the market quotations are readily available, are valued at the closing sale price for the NYSE listed securities and the lower of the closing bid price or the last sale price for NASDAQ securities on the valuation date; privately held securities are valued as determined in good faith by our Board of Directors.

ASC 820 defines fair value in terms of the price that would be received upon the sale of an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date (the “exit price”) and excludes transaction costs. Under ASC 820, the fair value measurement also assumes that the transaction to sell an asset occurs in the principal market for the asset or, in the absence of a principal market, the most advantageous market for the asset. The principal market is the market in which the reporting entity would sell or transfer the asset with the greatest volume and level of activity for the asset. In determining the principal market for an asset or liability under ASC 820, it is assumed that the reporting entity has access to the market as of the measurement date.

(c) Value

Debt Securities are generally valued on the basis of the price the security would command in order to provide a yield-to-maturity equivalent to the present yield of comparable debt instruments of similar quality. Issuers whose debt securities are judged to be of poor quality and doubtful collectability may instead be valued by assigning percentage discounts commensurate with the quality of such debt securities. Debt securities may also be valued based on the resulting value from the sale of the business at the estimated fair market value.

Partnership Interests, Preferred Equity and Common Equity, including unrestricted marketable securities, are valued at the closing sale price for the NYSE listed securities and the lower of the closing bid price or the last sale price for NASDAQ securities on the valuation date. For those securities without a principal market, our Board of Directors considers the financial condition and operating results of the issuer; the long-term potential of the business of the issuer; the market for and recent sales prices of the issuer’s securities; the values of similar securities issued by companies in similar businesses; and the proportion of the issuer’s securities owned by the Company. Investments in certain entities that calculate net asset value per share (or its equivalent) and for which fair market value is not readily determinable are valued using the net asset value per share (or its equivalent, such as member units or ownership interest in partners' capital to which a proportionate share of net assets is attributed) of the investment.

Table of Contents

Equity warrants are valued on the basis of the Black-Scholes model which defines the market value of a warrant in relation to the market price of the underlying common stock, share price volatility, and time to maturity.

(d) Agreements between Certain Issuers and the Company

Agreements between certain issuers and the Company provide that the issuer will bear substantially all costs in connection with the Company disposing of such common stock, including those costs involved in registration under the Securities Act of 1933, but excluding underwriting discounts and commissions. These agreements cover common stock owned at December 31, 2013 and common stock which may be acquired thereafter through the exercise of warrants and conversion of debentures and preferred stock. They apply to restricted securities of all issuers in the investment portfolio of the Company, except securities of Humac Company and The Whitmore Manufacturing Company which are not obligated to bear registration costs.

(e) Descriptions and Ownership Percentages

The descriptions of the companies and ownership percentages shown in the Consolidated Schedule of Investments were obtained from published reports and other sources believed to be reliable. Acquisition dates indicated are the dates specific securities were acquired, which may differ from the original investment dates. Certain securities were received in exchange for or upon conversion or exercise of other securities previously acquired.

Table of Contents
Notes to Consolidated Financial Statements

1. ORGANIZATION AND BASIS OF PRESENTATION

Organization

Capital Southwest Corporation ("CSW") was organized as a Texas corporation on April 19, 1961. Until September 1969, CSW operated as a licensee under the Small Business Investment Act of 1958. At that time, we transferred to our wholly-owned subsidiary, Capital Southwest Venture Corporation ("CSVC"), certain assets and our license as a small business investment company ("SBIC"). CSVC is a closed-end, non-diversified investment company registered under the Investment Company Act of 1940, as amended (the "1940 Act"). Prior to March 30, 1988, CSW was registered as a closed-end, non-diversified investment company under the 1940 Act. On that date, CSW elected to become a Business Development Company ("BDC") subject to the provisions of the 1940 Act, as amended by the Small Business Incentive Act of 1980. Because CSW wholly owns CSVC, the portfolios of both CSW and CSVC are referred to collectively as "our," "we" and "us." Capital Southwest Management Company ("CSMC"), a wholly-owned subsidiary of CSW, is the management company for CSW and CSVC. CSMC generally incurs all normal operating and administrative expenses, including, but not limited to, salaries and related benefits, rent, equipment and other administrative costs required for its day-to-day operations.

Our portfolio is a composite of companies, consisting of controlled affiliates, fund holdings, publicly-traded holdings, and other non-control holdings. We make available significant managerial assistance to the companies in which we invest and believe that providing managerial assistance to such investee companies is critical to their business development activities. CSMC receives a monthly fixed fee for management services provided to certain of its control portfolio companies.

Basis of Presentation

The consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America ("GAAP"). Under the rules and regulations applicable to investment companies, we are precluded from consolidating any entity other than another investment company. An exception to this general principle occurs if the investment company has an investment in an operating company that provides services to the investment company. Accordingly, consolidated financial statements include CSMC, our management company.

On July 15, 2013, a four-for-one split of our common stock was approved by our shareholders. The stock split was payable on August 15, 2013 to shareholders of record at the close of business on July 31, 2013. Our common stock began trading at the split-adjusted price on August 16, 2013. All share numbers and per share amounts presented herein reflect the stock split.

Portfolio Investment Classification

We classify our investments in accordance with the requirements of the 1940 Act. Under the 1940 Act, "Control Investments" are defined as investments in which we own more than 25% of the voting securities or have rights to maintain greater than 50% of the board representation; "Affiliated Investments" are defined as investments in which we own between 5% and 25% of the voting securities; and "Non-Control/Non-Affiliated Investments" are defined as investments that are neither "Control Investments" nor "Affiliated Investments."

Table of Contents

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The following is a summary of significant accounting policies followed in the preparation of the consolidated financial statements of CSW, CSVC and CSMC.

Fair Value Measurements. We adopted FASB ASC Topic 820 on April 1, 2008. ASC Topic 820 (1) creates a single definition of fair value, (2) establishes a framework for measuring fair value, and (3) expands disclosure requirements about items measured at fair value. This topic applies to both items recognized and reported at fair value in the financial statements and items disclosed at fair value in the notes to the financial statements. This topic does not change existing accounting rules governing what can or what must be recognized and reported at fair value in our financial statements, or disclosed at fair value in our notes to financial statements. Additionally, ASC Topic 820 does not eliminate practicability exceptions that exist in accounting pronouncements amended by this Statement when measuring fair value.

Fair value is generally determined based on quoted market prices in the active markets for identical assets or liabilities. If quoted market prices are not available, we use valuation techniques that place greater reliance on observable inputs and less reliance on unobservable inputs. Due to the inherent uncertainty in the valuation process, our estimate of fair value may differ materially from the values that would have been used had a ready market for the securities existed. In addition, changes in the market environment, portfolio company performance and other events may occur over the lives of the investments that may cause the gains or losses ultimately realized on these investments to be materially different than the valuations currently assigned. We determine the fair value of each individual investment and record changes in fair value as unrealized appreciation or depreciation.

Pursuant to our internal valuation process, each portfolio company is valued once a quarter. In addition to our internal valuation process, our Board of Directors retains a nationally recognized firm to provide limited scope third party valuation services on certain portfolio investments. Our Board of Directors retained Duff & Phelps to provide limited scope third party valuation services on three investments comprising 57.7% of our net asset value at March 31, 2013.

We believe our investments at December 31, 2013 and March 31, 2013 approximate fair value as of those dates based on the markets in which we operate and other conditions in existence at those reporting periods.

Investments. Investments are stated at fair value determined by our Board of Directors as described in the Notes to the Consolidated Schedule of Investments and Note 3 below. The average cost method is used in determining cost of investments sold. Investments are recorded on a trade date basis.

Cash and Cash Equivalents. Cash and cash equivalents consist of highly liquid investments with an original maturity of three months or less at the date of purchase. Cash and cash equivalents are carried at cost, which approximates fair value.

Segment Information. We operate and manage our business in a singular segment. As an investment company, we invest in portfolio companies in various industries and geographic areas as presented in the Consolidated Schedule of Investments.

Use of Estimates. The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates.

Table of Contents

Interest and Dividend Income. Interest and dividend income is recorded on an accrual basis to the extent amounts are expected to be collected. Dividend income is recorded at the ex-dividend date for marketable securities and restricted securities. In accordance with our valuation policy, accrued interest and dividend income is evaluated periodically for collectability. When a debt or loan becomes 90 days or more past due, and if we otherwise do not expect the debtor to be able to service all of its debt or other obligations, we generally will establish a reserve against the interest income. At that point, the loan or debt security's status is on non-accrual basis, and we cease recognizing interest income on that loan or debt security until the borrower has demonstrated the ability and intent to pay contractual amounts due. If a loan or debt security's status significantly improves regarding its ability to service debt or, pay other obligations, it will be restored to accrual basis.

Federal Income Taxes. CSW and CSVC have elected and intend to comply with the requirements of the Internal Revenue Code ("IRC") necessary to qualify as regulated investment companies ("RIC"s). By meeting these requirements, we will not be subject to corporate federal income taxes on ordinary income distributed to shareholders. In order to comply as a RIC, each company is required to timely distribute to its shareholders at least 90% of investment company taxable income, as defined by the IRC, each year. Investment company taxable income generally differs from net income for financial reporting purposes due to temporary and permanent differences in the recognition of income and expenses. Investment company taxable income generally excludes net unrealized appreciation or depreciation, as investment gains and losses are not included in investment company taxable income until they are realized.

In addition to the requirement that we must annually distribute at least 90% of our investment company taxable income, we may either distribute or retain our realized net capital gains from investments, but any net capital gains not distributed may be subject to corporate level tax. When we retain the capital gains, they are classified as a "deemed distribution" to our shareholders and are subject to our corporate tax rate of 35%. As an investment company that qualifies as a RIC under the IRC, federal income taxes payable on security gains that we elect to retain are accrued only on the last day of our tax year, December 31. Any capital gains actually distributed to shareholders are generally taxable to the shareholders as long-term capital gains. See Note 4 for further discussion.

CSMC, a wholly owned subsidiary of CSW, is not a RIC and is required to pay taxes at the current corporate rate.

We account for interest and penalties as part of operating expenses. There were no interest or penalties incurred during the nine months ended December 31, 2013 and 2012.

Deferred Taxes. CSMC sponsors a qualified defined benefit pension plan which covers its employees and employees of certain wholly owned portfolio companies. In addition, CSMC records phantom stock option and bonus accruals on a quarterly basis. Deferred taxes related to the qualified defined pension plan and phantom stock option and bonus accruals are recorded as incurred.

Stock-Based Compensation. We account for our stock-based compensation using the fair value method, as prescribed by ASC 718, Compensation – Stock Compensation. Accordingly, we recognize stock-based compensation expense over the straight-line method for all share-based payment awards granted to employees. The fair value of stock options is determined on the date of grant using the Black-Scholes pricing model and is expensed over the vesting period of the related stock options. For restricted stock unit awards, we measured the grant date fair value based upon the market price of our common stock on the date of the grant and will amortize this fair value to shared-based compensation expense over the vesting term. For phantom stock options, the option value of phantom stock awards is calculated based on the last available net asset value of the Company. We value phantom stock awards each quarter and either increase or decrease the liability based on the phantom option value. See Note 6 for further discussion.

Table of Contents

Defined Pension Benefits and Other Postretirement Plans. We record annual amounts relating to our defined benefit pension plan based on calculations, which include various actuarial assumptions such as discount rates and assumed rates of return. Material changes in pension costs could occur due to changes in the discount rate, in the expected long-term rate of return, or in the level of contributions to the plans and other factors. The funded status is the difference between the fair value of plan assets and the benefit obligation. We recognize changes in the funded status of our defined benefit plan in the Statement of Assets and Liabilities in the year in which the changes occur and measure defined benefit plan assets and obligations as of the date of our fiscal year-end, which is March 31.

Concentration of Risk. We place our idle cash in financial institutions, and at times, such balances may be in excess of the federally insured limits. We have not experienced any losses in such accounts and do not believe we are subject to any significant credit risk.

3. INVESTMENTS

We record our investments at fair value as determined in good faith by our Board of Directors in accordance with GAAP. When available, we base the fair value of our investments on directly observable market prices or on market data derived for comparable assets. For all other investments, inputs used to measure fair value reflect management's best estimate of assumptions that would be used by market participants in pricing the investments in a hypothetical transaction.

The levels of fair value inputs used to measure our investments are characterized in accordance with the fair value hierarchy established by ASC. We use judgment and consider factors specific to the investment in determining the significance of an input to a fair value measurement. While we believe our valuation methodologies are appropriate and consistent with market participants, the use of different methodologies or assumptions to determine the fair value of certain financial instruments could result in a different estimate of fair value at the reporting date. The three levels of the fair value hierarchy and investments that fall into each of the levels are described below:

- Level 1: Investments whose values are based on unadjusted quoted prices in active markets for identical assets or liabilities that we have the ability to access. We use Level 1 inputs for publicly traded unrestricted securities. Such investments are valued at the closing price for listed securities and at the lower of the closing bid price or the closing sale price for NASDAQ securities on the valuation date.

- Level 2: Investments whose values are based on observable inputs other than quoted prices included in Level 1 that are observable for the asset or liability, either directly or indirectly. These inputs may include quoted prices for the identical instrument in non-active markets, quoted prices for similar instruments in active markets and similar data.

- Level 3: Investments whose values are based on prices or valuation techniques that require inputs that are both unobservable and significant to the overall fair value measurement. These inputs reflect management's own assumptions about the assumptions a market participant would use in pricing the investment. We used Level 3 inputs for measuring the fair value of approximately 62.8% of our investments as of December 31, 2013.

Table of Contents

As required by ASC 820, when the inputs used to measure fair value fall within different levels of the hierarchy, the level within the fair value measurement is categorized based on the lowest level input that is significant to the fair value measurement which may include inputs that are observable (Levels 1 and 2) and unobservable (Level 3). Therefore, gains and losses for such investments categorized within the Level 3 table below may include changes in fair value that are attributable to both observable inputs (Levels 1 and 2) and unobservable inputs (Level 3). We conduct reviews of fair value hierarchy classifications on a quarterly basis. Changes in the observability of valuation inputs may result in a reclassification of certain investments.

Unobservable inputs are those inputs for which little or no market data exists and, therefore, require an entity to develop its own assumptions. The fair value determination of each portfolio company requires one or more of the following unobservable inputs:

- Financial information obtained from each portfolio company, including audited and unaudited statements of operations and balance sheets for the most recent period available as compared to budgeted numbers;
- Current and projected financial condition of the portfolio company;
- Current and projected ability of the portfolio company to service its debt obligations;
- Projected operating results of the portfolio company;
- Current information regarding any offers to purchase the investment or recent private sales transactions;
- Current ability of the portfolio company to raise any additional financing as needed;
- Change in the economic environment which may have a material impact on the operating results of the portfolio company;
- Qualitative assessment of key management;
- Contractual rights, obligations or restrictions associated with the investment; and
- Other factors deemed relevant.

Preferred Stock and Common Stock

The significant unobservable inputs used in the fair value measurement of our equity securities are EBITDA multiples, revenue multiples, net book values, and tangible book value multiples. Generally, increases or decreases in EBITDA or revenue multiple inputs result in a higher or lower fair value measurement, respectively. However, due to the nature of certain investments, fair value measurements may be based on other criteria, such as third party-appraisals. For recent investments, we generally rely on our cost basis to determine the fair value unless fair value is deemed to have departed from this level.

Table of Contents

Debt Securities

The significant unobservable inputs used in the fair value measurement of our debt securities are risk adjusted discount factors used in the yield valuation technique and probability of principal recovery. Significant increases or decreases in any of these valuation inputs in isolation would result in a significantly lower or higher fair value measurement. However, due to the nature of certain investments, fair value measurements may be based on other criteria, such as third party inputs.

Limited Partnership or Limited Liability Company Interests

For recent investments, we generally evaluate limited partnership or limited liability company interests at cost, which is deemed to represent fair value, unless or until there is substantive evidence that cost does not correspond to fair value. Thereafter, these securities are generally valued at our percentage interest of the fund or the company's calculated net asset value, unless there is substantive evidence that the net asset value does not correspond to fair value. All investments of each fund are valued by each fund in accordance with ASC 820.

Warrants

We generally use the Black-Scholes option pricing model to determine the fair value of warrants held in our portfolio. Option pricing models, including the Black-Scholes model, require the use of subjective inputs, including expected volatility, expected life, expected dividend rate, and expected risk-free rate of return. In the Black-Scholes model, variation in the expected volatility or expected term assumptions has a significant impact on fair value.

The table below presents the valuation technique and quantitative information about the significant unobservable inputs utilized by the Company to value our Level 3 investments as of December 31, 2013 and March 31, 2013. Unobservable inputs are those inputs for which little or no market data exists and therefore require an entity to develop its own assumptions. The table is not intended to be all inclusive, but instead captures the significant unobservable inputs relevant to our determination of fair value.

Type	Valuation Technique	Fair Value at 12/31/2013 (in millions)	Unobservable Input	Range		Weighted Average	
Preferred & Common Equity	Market Approach	$ 374.2	EBITDA Multiple	3.50x – 7.78	x	6.92	x
	Market Approach	$ 26.3	Revenue Multiple	2.50x – 2.98	x	2.59	x
	Market Approach	$ 7.6	Cash and Asset Value	NA		NA	
	Income Approach	$ 0.7	Discount Rate	2.86	%	2.86	%
	Market Approach	$ 3.7	Multiple of Tangible Book Value	1.47	x	1.47	x
	Market Approach	$ 8.0	Recent Transaction Price	NA		NA	
	Market Approach	$ 0.2	Market Value of Held Securities	NA		NA	
		$ 420.7					
Debt	Income Approach	$ 4.6	Discount Rate	11.69% -13.02	%	12.28	%
	Recent Transaction Price	$ 1.2	Recent Transaction Price	NA		NA	

		$ 5.8			
Partnership Interests	Net Asset Value*	$ 9.0	Fund Value	NA	NA
	Total	$ 435.5			

24

Table of Contents

Type	Valuation Technique	Fair Value at 3/31/2013 (in millions)	Unobservable Input	Range	Weighted Average
Preferred & Common Equity	Market Approach	$ 342.2	EBITDA Multiple	3.25x – 7.00 x	6.45 x
	Market Approach	$ 11.1	Revenue Multiple	0.25x – 1.82 x	0.97 x
	Market Approach	$ 7.9	Cash and Asset Value	NA	NA
	Income Approach	$ 0.7	Discount Rate	1.75 %	1.75 %
	Market Approach	$ 3.0	Multiple of Tangible Book Value	1.22 x	1.22 x
	Market Approach	$ 22.6	Recent Transaction Price	NA	NA
	Market Approach	$ 0.2	Market Value of Held Securities	NA	NA
		$ 387.7			
Debt	Income Approach	$ 3.1	Discount Rate	10.02% -12.00 %	10.77 %
	Recent Transaction Price	$ 3.5	Recent Transaction Price	NA	NA
		$ 6.6			
Partnership Interests	Net Asset Value*	$ 12.2	Fund Value	NA	NA
	Total	$ 406.5			

*All funds are valued in accordance with ASC 820.

As of December 31, 2013 and March 31, 2013, 62.8% and 70.8%, respectively, of our portfolio investments were categorized as Level 3.

The following fair value hierarchy tables set forth our investment portfolio by level as of December 31, 2013 and March 31, 2013 (in millions):

		Fair Value Measurements at 12/31/13 Using		
Asset Category	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Debt	$5.8	$–	$ –	$ 5.8
Partnership Interests	9.0	–	–	9.0
Preferred Equity	51.2	–	–	51.2
Common Equity	628.0	256.3	2.2	369.5
Total Investments	$694.0	$256.3	$ 2.2	$ 435.5

Fair Value Measurements

Asset Category	Total	at 3/31/13 Using Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Debt	$6.6	$–	$ –	$ 6.6
Partnership Interests	12.2	–	–	12.2
Preferred Equity	44.6	–	–	44.6
Common Equity	510.8	167.7	–	343.1
Total Investments	$574.2	$167.7	$ –	$ 406.5

25

Table of Contents

The following table provides a summary of changes in the fair value of investments measured using Level 3 inputs during the nine months ended December 31, 2013 (in millions):

	Fair Value 3/31/13	Net Unrealized Appreciation (Depreciation)	New Investments	Distribution	Net Changes from Unrealized to Realized	Conversion of Security from Debt to Equity	Fair Value at 12/31/13
Debt	$ 6.6	$ (2.4)	$ 1.6	$ –	$ –	$ –	$ 5.8
Partnership Interests	12.2	(2.7)	0.9	(1.4)	–	–	9.0
Preferred Equity	44.6	(1.4)	8.0	–	–	–	51.2
Common Equity	343.1	26.4	–	–	–	–	369.5
Total Investments	$ 406.5	$ 19.9	$ 10.5	$ (1.4)	$ –	$ –	$ 435.5

4. INCOME TAXES

We operate to qualify as a RIC under Subchapter M of the IRC and have a calendar tax year end of December 31. In order to qualify as a RIC, we must annually distribute at least 90% of our investment company taxable ordinary income, based on our tax year, to our shareholders in a timely manner. Investment company ordinary income includes net short-term capital gains but excludes net long-term capital gains. A RIC is not subject to federal income tax on the portion of its ordinary income and long-term capital gains that are distributed to its shareholders. As permitted by the IRC, a RIC can designate dividends paid in the subsequent tax year as dividends of current year ordinary income and net long-term gains if those dividends are both declared by the extended due date of the RIC’s federal income tax return and paid to shareholders by the last day of the subsequent tax year.

We have distributed or intend to distribute sufficient dividends to eliminate any taxable income for our completed tax years. If we fail to satisfy the 90% distribution requirement or otherwise fail to qualify as a RIC in any tax year, we would be subject to tax in such year on all of our taxable income, regardless of whether we made any distributions to our shareholders. For the tax years ended December 31, 2013 and 2012, we declared and paid ordinary dividends in the amounts of $3,049,614 and $3,025,032, respectively.

Additionally, we are subject to a nondeductible federal excise tax of 4% if we do not distribute at least 98% of our investment company ordinary taxable income before the end of our tax year. For the tax years ended December 31, 2013 and 2012, we distributed 100% of our investment company ordinary taxable income. As a result, we have made no tax provisions for income taxes on ordinary taxable income for the tax years ended December 31, 2013 and 2012.

A RIC may elect to retain its long-term capital gains by designating them as a “deemed distribution” to its shareholders and paying a federal tax rate of 35% on the long-term capital gains for the benefit of its shareholders. Shareholders then report their share of the retained capital gains on their income tax returns as if they had been received and report a tax credit for tax paid on their behalf by the RIC. Shareholders then add the amount of the “deemed distribution” net of such tax, to the basis of their shares.

Table of Contents

During our tax year ended December 31, 2013, we sold 9,317,310 shares of common stock of Heelys, Inc. to Sequential Brands Group, Inc. and generated cash proceeds of $20,963,948 and a capital gain of $20,861,458. Subsequently, we distributed and paid $0.69 per share or $10,474,932 of Heely's gain to our shareholders on March 28, 2013. For the tax year ended December 31, 2013, we had net long-term capital gains of $10,819,079 for tax purposes and $10,491,526 for book purposes, which we elected to retain and treat as deemed distributions to our shareholders. During the tax year ended December 31, 2012, we distributed capital gains dividends in the amount of $4.40 per share or $66,825,782 to our shareholders; we also had net long-term capital gains of $3,214,547 for tax purposes and $2,319,012 for book purposes, which we elected to retain and treat as deemed distributions to our shareholders.

In order to make the election to retain capital gains, we incurred federal taxes on behalf of our shareholders in the amount of $3,786,678 for the tax year ended December 31, 2013. For the tax year ended December 31, 2012, we incurred federal taxes on behalf of our shareholders in the amount of $1,125,092.

For the quarter ended December 31, 2013 and 2012, CSW and CSVC qualified to be taxed as RICs. We intend to continue meet the applicable qualifications to be taxed as a RIC. However, either company's ability to meet certain portfolio diversification requirements of RICs in future years may not be controllable by such company.

CSMC, a wholly owned subsidiary of CSW, is not a RIC and is required to pay taxes at the current corporate rate. CSMC sponsors a qualified defined benefit pension plan which covers its employees and employees of certain wholly owned portfolio companies. In addition, CSMC records phantom stock option and bonus accruals on a quarterly basis. Deferred taxes related to the qualified defined benefit pension plan and phantom stock option and bonus accruals are recorded as incurred. As of December 31, 2013, CSMC has a net deferred tax liability of $1,087,981.

5. ACCUMULATED NET REALIZED GAINS (LOSSES) ON INVESTMENTS

Distributions made by RICs often differ from aggregate GAAP-basis undistributed net investment income and accumulated net realized gains (total GAAP-basis net realized gains). The principal cause of the difference is that required minimum fund distributions are based on income and gain amounts determined in accordance with federal income tax regulations, rather than GAAP. The differences created can be temporary, meaning that they will reverse in the future, or they can be permanent. In subsequent periods, when all or a portion of a temporary difference becomes a permanent difference, the amount of the permanent difference will be reclassified to "additional capital."

We incur federal taxes on behalf of our shareholders as a result of our election to retain long-term capital gains. We had $10,491,526 and $10,436,526 of accumulated long term capital gains, as of December 31, 2013 and March 31, 2013, respectively. In accordance with the RIC rules, we elected to retain our long-term capital gains for the tax year ended December 31, 2013, incur the applicable income taxes of $3,786,678, and designate the after-tax gain as "deemed distributions" to shareholders. "Deemed distributions" are reclassified from accumulated net realized gains into additional paid in capital at the end of December.

Table of Contents

6. EMPLOYEE STOCK BASED COMPENSATION PLANS

On July 15, 2013, a four-for-one split of our common stock was approved by our shareholders. The stock split was payable on August 15, 2013 to shareholders of record at the close of business on July 31, 2013. Our common stock began trading at the split-adjusted price on August 16, 2013. All share numbers and per share amounts presented herein reflect the stock split.

Stock Options

On July 20, 2009, shareholders approved our 2009 Stock Incentive Plan (the "2009 Plan"), which provides for the granting of stock options to employees and officers and authorizes the issuance of common stock upon exercise of such options for up to 560,000 shares. All options are granted at or above market price, generally expire up to 10 years from the date of grant and are generally exercisable on or after the first anniversary of the date of grant in five annual installments. Options to purchase 155,000 shares at a price of $19.19 per share (market price at the time of grant) were granted on October 19, 2009. Additionally, options to purchase 80,000 shares at a price of $23.95 per share (market price at time of grant) were granted on March 22, 2010, options to purchase 60,000 shares at a price of $22.05 per share were granted on July 19, 2010 and options to purchase 40,000 shares at a price of $24.23 per share were granted on July 18, 2011. During the nine months ended December 31, 2013, options to purchase 30,000 shares at a price of $37.02 per share (market price at the time of grant) were granted on July 15, 2013. Additionally, 13,720 options were exercised and 47,000 options were forfeited during the nine months ended December 31, 2013 and thus leaving 140,188 options outstanding and 298,000 options available to grant under the 2009 Plan as of December 31, 2013.

We previously granted stock options under our 1999 Stock Option Plan (the "1999 Plan"), as approved by shareholders on July 19, 1999. The 1999 Plan expired on April 19, 2009. Options previously made under our 1999 Stock Option Plan and outstanding on July 20, 2009 continue in effect governed by provisions of the 1999 Plan. All options granted under the 1999 Plan were granted at or above market price, generally expire up to 10 years from the date of grant and are generally exercisable on or after the first anniversary of the date of grant in five to ten annual installments. During the nine months ended December 31, 2013, 38,000 options were exercised, thus leaving 208,000 options outstanding under the 1999 Plan.

We recognize compensation expense over the straight-line method for all share-based payments granted on or after that date and for all awards granted to employees prior to April 1, 2006 that remain unvested on that date. The fair value of stock options is determined on the date of grant using the Black-Scholes pricing model and are expensed over the vesting period of the related stock options. Share-based compensation cost for restricted stock is measured based on the closing fair market value of our Company's common stock on the date of the grant. Accordingly, for the quarters ended December 31, 2013 and 2012, we recognized stock option compensation expense of $8,044 and $33,769, respectively. For the nine months ended December 31, 2013 and 2012, we recognized stock option compensation expense of $283,341 and $ 262,785, respectively. Changes in stock option compensation expense for 2013 versus 2012 is due to forfeitures of unexercised stock options that occurred with the departures of employees during the quarter ended December 31, 2013.

As of December 31, 2013, the total remaining unrecognized compensation expense related to non-vested stock options was $691,754, which will be amortized over the weighted-average service period of approximately 0.9 years.

Table of Contents

The following table summarizes the 2009 Plan and the 1999 Plan price per option at grant date using the Black-Scholes pricing model:

		Black-Scholes Pricing Model Assumptions			
Date of Issuance	Weighted Average Fair Value	Expected Dividend Yield	Risk-Free Interest Rate	Expected Volatility	Expected Life (in years)
2009 Plan					
July 18, 2011	$ 8.27	0.83 %	1.45 %	40.0 %	5
July 19, 2010	$ 7.15	0.91 %	1.73 %	37.5 %	5
March 22, 2010	$ 8.14	0.84 %	2.43 %	37.8 %	5
October 19, 2009	$ 6.34	1.04 %	2.36 %	37.6 %	5
July 15, 2013	$ 14.80	0.54 %	1.40 %	46.6 %	5
1999 Plan					
July 30, 2008	$ 7.48	0.62 %	3.36 %	20.2 %	5
July 21, 2008	$ 6.84	0.67 %	3.41 %	20.2 %	5
July 16, 2007	$ 10.44	0.39 %	4.95 %	19.9 %	5
July 17, 2006	$ 8.26	0.61 %	5.04 %	21.2 %	7
May 15, 2006	$ 7.82	0.64 %	5.08 %	21.1 %	7

The following table summarizes activity in the 2009 Plan and the 1999 Plan as of December 31, 2013:

	Number of Shares	Weighted Average Exercise Price
2009 Plan		
Balance at March 31, 2011	295,000	$ 21.06
Granted	40,000	24.23
Exercised	–	–
Canceled/Forfeited	–	–
Balance at March 31, 2012	335,000	21.44
Granted	–	–
Exercised	(108,092)	19.96
Canceled/Forfeited	(56,000)	21.44
Balance at March 31, 2013	170,908	22.37
Granted	30,000	37.02
Exercised	(13,720)	22.71
Canceled/Forfeited	(47,000)	22.10
Balance at December 31, 2013	140,188	$ 25.55

Table of Contents

1999 Plan		
Balance at March 31, 2011	386,000	$28.70
Granted	–	–
Exercised	(6,000)	16.43
Canceled/Forfeited	–	–
Balance at March 31, 2012	380,000	28.41
Granted	–	–
Exercised	(76,420)	23.83
Canceled/Forfeited	(57,580)	27.79
Balance at March 31, 2013	246,000	33.00
Granted	–	–
Exercised	(38,000)	26.69
Canceled/Forfeited	–	–
Balance at December 31, 2013	208,000	$34.16
Combined Balance at December 31, 2013	348,188	$30.69

December 31, 2013	Weighted Average Remaining Contractual Term	Aggregate Intrinsic Value
Outstanding	0.9 years	$3,068,087
Exercisable	0.3 years	$2,260,194

At December 31, 2013, the range of exercise prices was $19.19 to $38.25 and the weighted-average remaining contractual life of outstanding options was 0.9 years. The total number of options exercisable under both the 2009 Plan and the 1999 Plan at December 31, 2013 and 2012, was 264,188 shares with a weighted-average exercise price of $31.58 and 272,600 shares with a weighted-average exercise price of $31.10, respectively. During the nine months ended December 31, 2013, 47,000 options were forfeited and 51,720 options were exercised. During the nine months ended December 31, 2012, 113,580 options were forfeited, and 148,820 options were exercised.

Stock Awards

Pursuant to the Capital Southwest Corporation 2010 Restricted Stock Award Plan, our Board of Directors reserved for issuance 188,000 shares of restricted stock to certain key employees. A restricted stock award is an award of shares of our common stock (which have full voting and dividend rights but are restricted with regard to sale or transfer), the restrictions on which lapse ratably over a specified period of time (generally five years). Restricted stock awards are independent of stock grants and are subject to forfeiture if employment terminates prior to these restrictions lapsing. These shares vest over a five-year period from the grant date and are expensed over the five-year service period starting on the grant date. On January 16, 2012, the Board of Directors granted 38,600 shares of restricted stock to key employees of the Company. On January 22, 2013, the Board of Directors granted 8,000 shares of restricted stock to officers of the Company. On July 15, 2013, The Board of Directors granted 5,000 shares of restricted stock to a key officer of the Company. During the nine months ended December 31, 2013, 13,240 shares of restricted stock were forfeited. The following table summarizes the restricted stock available for issuance as of December 31 2013:

Restricted stock available for issuance as of March 31, 2013	153,400
Restricted stock granted during the nine Months ended December 31, 2013	(5,000)
Restricted stock forfeited during the nine Months ended December 31, 2013	13,240
Restricted stock available for issuance as of December 31, 2013	161,640

Table of Contents

We expense the cost of the restricted stock awards, which is determined to equal the fair value of the restricted stock award at the date of grant on a straight-line basis over the vesting period in which the restrictions on these stock awards lapse. For these purposes, the fair value of the restricted stock award is determined based on the closing price of our common stock on the date of grant. For the quarters ended December 2013 and 2012, we recognized total share based compensation expense of $(9,930) and $27,797, respectively, related to the restricted stock issued to our employees and officers. For the nine months ended December 31, 2013 and 2012, we recognized share based compensation expense of $64,050 and $70,851, respectively, related to restricted stock issued to employees and officers. Changes in stock option compensation expense for 2013 versus 2012 are due to forfeitures of unvested restricted stock that occurred with the departures of employees during the quarter ended December 31, 2013.

As of December 31, 2013, the total remaining unrecognized compensation expense related to non-vested restricted stock awards was $443,979, which will be amortized over the weighted-average service period of approximately 3.6 years.

The following table represents a summary of the activity for our restricted stock awards for the nine months ended December 31, 2013:

Restricted Stock Awards	Number of Shares	Weighted Average Fair Value Per Share	Weighted Average Remaining Vesting Term (in Years)
Unvested at March 31, 2013	29,280	$ 22.32	4.1
Granted	5,000	37.02	4.5
Vested	–	–	–
Forfeited	(13,240)	22.08	–
Unvested at December 31, 2013	21,040	$ 25.96	3.6

Phantom Stock Plan

On January 16, 2012, our Board of Directors approved the issuance of 104,000 phantom stock options at an exercise price of $36.74 (Net Asset Value at December 31, 2011) pursuant to the Capital Southwest Corporation Phantom Stock Option Plan to provide deferred compensation to certain key employees. On January 22, 2013, the Board of Directors granted 16,200 shares of phantom stock options at an exercise price of $41.34 per share (Net Asset Value at December 31, 2012) to officers of the Company. On July 15, 2013, the Board of Directors granted 24,000 shares of phantom stock options at an exercise price of $43.80 per share (Net Asset Value at June 30, 2013) to a key officer of the Company. Under the plan, awards vest on the fifth anniversary of the award date. Upon exercise of the phantom option, a cash payment in an amount for each phantom share equal to estimated fair market value minus the phantom option exercise price, adjusted for capital gain dividends declared, will be distributed to plan participants. For the nine months ended December 31, 2013, we recognized estimated liability for phantom stock options in the amount of $605,822. The estimated liability for phantom stock awards was $541,865 for the nine months ended December 31, 2012.

Table of Contents

The following table represents a summary of the activity for our phantom stock plan for the fiscal year ended December 31, 2013:

Phantom Stock Awards	Number of Shares	Weighted Average Grant Price Per Share	Weighted Average Remaining Vesting Term (in Years)
Unvested at March 31, 2013	90,200	$ 37.26	4.0
Granted	24,000	43.80	4.5
Vested	–	–	–
Forfeited or expired	(19,200)	41.34	–
Unvested at December 31, 2013	95,000	$ 39.00	3.5

7. COMMITMENTS

From time to time the Company may be liable for claims against its portfolio companies. We do not believe the effects of such claims would have a material impact on our results of operations and financial condition.

CSC has agreed, subject to certain conditions, to invest up to $4,817,576 in five portfolio companies as of December 31, 2013.

8. SUMMARY OF PER SHARE INFORMATION

The following presents a summary of per share data for the three and nine months ended December 31, 2013 and 2012.

On July 15, 2013, a four-for-one split of our issued common stock was approved by our shareholders. The stock split was payable on August 15, 2013 to shareholders of record at the close of business July 31, 2013. Our common stock began trading at the split-adjusted price on August 16, 2013. All share numbers and per share amounts presented herein reflect the stock split.

	Three Months Ended December 31		Nine Months Ended December 31	
Per Share Data	2013	2012	2013	2012
Investment income	$ .55	$ .46	$ .68	$ .64
Operating expenses	(.18)	(.18)	(.48)	(.37)
Income taxes	.04	(.01)	.05	(.01)
Net investment income	.41	.27	.25	.26
Distributions from undistributed net investment income	(.10)	(.10)	(.20)	(.20)
Net realized gain/(loss) net of tax	(.25)	.04	(.25)	4.45
Net increase (decrease) in unrealized appreciation of investments	3.49	1.47	7.16	(.39)
Dividends from capital gains	–	–	–	(4.40)
Exercise of employee stock options	(.04)	(.01)	(.07)	(.19)
Stock option expense	–	.01	.02	.02
Forfeiture (Issuance) of restricted stock	.03	–	.04	(.07)
Increase (decrease) in net asset value	3.54	1.68	6.95	(.52)
Net asset value				

Beginning of period	46.71	39.66	43.30	41.86
End of period	$50.25	$41.34	$50.25	$41.34

Table of Contents

Item 2. – Management's Discussion and Analysis of Financial Condition and Results of Operations

The following discussion should be read in conjunction with our financial statements and the notes thereto included elsewhere in our Annual Report on Form 10-K for the fiscal year ended March 31, 2013 (the "Form 10-K").

The information contained herein may contain "forward-looking statements" based on our current expectations, assumptions and estimates about us and our industry. These forward-looking statements involve risks and uncertainties. Words such as "believe," "anticipate," "estimate," "expect," "intend," "plan," "will," "may," "might," "could," " other similar expressions identify forward-looking statements. In addition, any statements that refer to expectations, projections or other characterizations of future events or circumstances are forward-looking statements. Our actual results could differ materially from those anticipated in the forward-looking statements as a result of several factors more fully described in "Risk Factors" and elsewhere in this Form 10-Q, and in our Form 10-K for the year ended March 31, 2013. The forward-looking statements made in this Form 10-Q related only to events as of the date on which the statements are made. You should read the following discussion in conjunction with the consolidated financial statements and related footnotes and other financial information included in our Form 10-K for the year ended March 31, 2013. We undertake no obligation to update publicly any forward-looking statements for any reason, even if new information becomes available or other events occur in the future.

General

On July 15, 2013, a four-for-one split of our issued common stock was approved by our shareholders. The stock split was payable on August 15, 2013 to shareholders of record at the close of business July 31, 2013. Our common stock began trading at the split-adjusted price on August 16, 2013. All share numbers and per share amounts presented herein reflect the stock split.

On November 20, 2013, Kelly Tacke was appointed as the Company's Senior Vice President, Chief Financial Officer, Chief Compliance Officer, Secretary and Treasurer, effective November 18, 2013. Ms. Tacke replaced Tracy Morris, who resigned as the Company's Chief Financial Officer, Chief Operating Officer and Secretary, effective November 15, 2013, to pursue other opportunities.

Ms. Tacke was with Palm Harbor Homes, Inc., a publicly traded manufacturer and marketer of factory-built homes for 18 years, where she served as Executive Vice President, Chief Financial Officer and Corporate Secretary. The Company was a long-time investor in Palm Harbor Homes. Ms. Tacke began her career with PricewaterhouseCoopers, where she was a Senior Audit Manager. She holds a Bachelors of Business Administration degree from the University of Texas at Austin and is a Certified Public Accountant.

On January 20, 2014, the Board of Directors of the Company elected Joseph B. Armes as Chairman of the Board and appointed David R. Brooks and William R. Thomas III to the Board. The Board increased its size from six to seven members and appointed Messrs. Brooks and Thomas to fill the vacancies created by the resignation of Richard F. Strup in November 2013 and the increase in the size of the Board.

Mr. Armes has served as a director and President and Chief Executive Officer of the Company since June 2013. Mr. Brooks has been the Chairman of the Board and Chief Executive Officer of Independent Bank Group, Inc., a publicly-traded bank holding company with approximately $2.0 billion in assets, since its founding in 2002. Mr. Thomas is a private investor and has served as the President of the Thomas Heritage Foundation, a non-profit grant-making corporation, since 2008. Mr. Thomas worked for the Company from July 2006 to September 2012, most recently as a Vice President. Mr. Thomas currently serves as a director of Encore Wire Corporation.

Table of Contents

Results of Operations

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

Net Investment Income

For the three months ended December 31, 2013, total investment income was $8,363,469, a $1,390,797, or 19.9% increase from $6,972,672 for the three months ended December 31, 2012. For the nine months ended December 31, 2013, total investment income was $10,395,126, a $627,654, or a 6.4% increase from $9,767,472, total investment income for the nine months ended December 31, 2012. This comparable period increase was primarily attributable to a $1,364,628 and a $350,000 increase in third quarter dividend income from The Rectorseal Corporation and Capstar Corporation, respectively, offset by Cinatra Clean Technologies, Inc.'s current year's fully reserved interest income.

The Company's principal objective is to achieve capital appreciation. Therefore, a significant portion of the investment portfolio is structured to maximize the potential return from equity participation and provides minimal current yield in the form of interest or dividends. The Company also earns interest income from the short-term investment of cash funds, and the annual amount of such income varies based upon the average level of funds invested during the year and fluctuations in short-term interest rates. The Company received interest income from temporary cash investments of $16,599 and $14,772 during the quarters ended December 31, 2013 and 2012, respectively. During the nine months ended December 31, 2013 and 2012, the Company had interest income from temporary cash investments of $51,729 and $50,400, respectively.

The Company's management fees, received primarily from its controlled affiliates, totaled $419,850 and $456,850 for the nine months ended December 31, 2013 and 2012, respectively. During the quarters ended December 31, 2013 and 2012, the Company received management fees of $139,950 and $156,450, respectively.

Table of Contents

During the three and nine months ended December 31, 2013 and 2012, the Company recorded dividend income from the following sources:

	Three Months Ended December 31,		Nine Months Ended December 31,	
	2013	2012	2013	2012
Alamo Group, Inc.	$198,311	$169,938	$594,882	$509,814
CapitalSouth Partners Fund III	–	47,297	–	198,647
Capitala Finance Corporation	50,809		50,809	–
Capstar Holdings Corporation	350,000		350,000	–
Encore Wire Corporation	52,500	26,250	105,000	134,235
The RectorSeal Corporation	6,200,000	4,835,372	6,680,000	5,315,372
TCI Holdings, Inc.	20,318	20,318	60,953	60,953
The Whitmore Manufacturing Company	1,200,000	1,208,842	1,320,000	1,328,842
	$8,071,938	$6,308,017	$9,161,644	$7,547,863

Due to the nature of its business, the majority of the Company's operating expenses are related to officer and employee compensation, office expenses, and legal, professional and accounting fees. Total operating expenses decreased by $70,158 or 2.4% for the three months ended December 31, 2013 as compared to the three months ended December 31, 2012. This decrease is primarily due to $61,411, or 32.3%, decrease in professional fees during the three months ended December 31, 2013. Total operating expenses increased by $1,579,052 or 27.6% for the nine months ended December 31, 2013 as compared to the nine months ended December 31, 2012. This increase is primarily due to $1,382,507, or 37.2%, increase in salaries related to bonus and phantom option accruals recorded as well as the expense associated with certain staffing changes incurred during the nine months ended December 31, 2013.

Net Realized Gain (Loss) on Investments

During the nine months ended December 31, 2013, we received a capital gain dividend in the amount of $55,000 from Diamond State Venture, L.P.

During the nine months ended December 31, 2012, we sold 2,774,250 shares of common stock in Encore Wire Corporation held by our subsidiary, CSVC, to Encore Wire, generating a capital gain of $66,037,485. We also sold 50,000 shares of common stock of Hologic, Inc., generating a capital gain of $850,548. In addition, we sold all investment ownership in Extreme International, Inc., generating net cash proceeds of $11,890,630 and a realized gain of $7,600,125. We also received cash proceeds in the amount of $2,823 from Palm Harbor Home Liquidating Trust. These gains were offset by a $4,926,289 realized loss associated with sales of all investment ownership in VIA Holdings., a $760,742 realized loss related to liquidation of Sterling Group Partners, L.P., a $150,594 realized loss related to liquidation of StarTech Seed Fund I, L.P., and a $7,000 capital loss adjustment related to a final true-up of the Lifemark Group, Inc. divesture from June 2010. The net realized gain for the nine months ended December 31, 2012 was $68,646,356. We declared and paid a cash dividend in the amount of $66,825,782 or $17.59 per share of common stock in June 2012. In total, we recognized net realized gains of $1,820,574 for the nine months ended December 31, 2012.

Management does not attempt to maintain a consistent level of realized gains from year to year, but instead attempts to maximize total investment portfolio appreciation. This strategy often dictates the long-term holding of portfolio securities in pursuit of increased values and increased unrealized appreciation, but may at opportune times dictate realizing gains or losses through the disposition of certain portfolio investments.

Table of Contents

Net Increase/(Decrease) in Unrealized Appreciation of Investments

For the nine months ended December 31, 2013, we recognized a $109,315,301 increase in net change in unrealized appreciation of investments. The increases in unrealized appreciation are attributable to Alamo Group, Inc. and Encore Wire Corporation, which increased by $63,553,497 and $25,068,750, respectively, due to increases in their stock price at December 31, 2013, while The Rectorseal Corporation increased by $19,000,000; The Whitmore Manufacturing Company increased by $2,500,000; Media Recovery, Inc. increased by $5,300,000; and Trax Holdings, Inc. increased by $1,900,000 due to increases in each entity's respective earnings. Offsetting these increases were Cinatra Clean Technologies, Inc., TitanLiner Inc., and Instawares Holding Company, LLC., which decreased by $2,328,844, $3,414,000, and $2,323,000, respectively, due to each entity's under performance in their respective markets. In addition, CapitalSouth Partners Fund III, L.P. decreased by $2,833,201; during the nine months ended December 31, 2013 due to a distribution of 108,105 shares of Capitala Finance Corporation (CPTA) valued at $2,151,290, which represented 71% of our interest in Capital South Partners Fund III, L.P.

Set forth in the following table are the significant increases and decreases in unrealized appreciation by portfolio company:

	Nine Months Ended December 31, 2013	2012
Alamo Group, Inc.	$63,553,497	$7,258,374
Capital South Partners Fund III, L.P.	(2,833,201)	378,000
Cinatra Clean Technologies, Inc.	(2,328,844)	(4,107,390)
Encore Wire Corporation	25,068,750	(81,089,460)*
Instawares Holding Company LLC.	(2,323,000)	829,000
Media Recovery, Inc.	5,300,000	(5,400,000)
The RectorSeal Corporation	19,000,000	63,300,000
The Whitmore Manufacturing Company	2,500,000	4,200,000
TitanLiner, Inc.	(3,414,000)	-
Trax Holdings, Inc.	1,900,000	8,800,000

* During the nine months ended December 31, 2012, we sold 2,774,250 shares of common stock in Encore Wire Corporation held by our subsidiary, CSVC, to Encore Wire generating a capital gain of $66,037,485.

A description of the investments listed above and other material components of the investment portfolio are included elsewhere in this report under the caption "Consolidated Schedule of Investments – December 31, 2013 and March 31, 2013.

Portfolio Investments

During the nine months ended December 31, 2013, we invested $8,000,000 in Deepwater Corrosion Services, Inc., a full service corrosion control company providing the oil and gas industry with expertise in cathodic protection and asset integrity management. Deepwater's products and services provide life extension to and support regulatory compliance of mission-critical, energy production assets. In addition, we funded $2,500,574 in commitments to existing portfolio companies.

We have commitments, subject to certain conditions, to invest up to $4,817,576 in five portfolio companies as of December 31, 2013.

Table of Contents

Financial Liquidity and Capital Resources

At December 31, 2013, the Company had cash and cash equivalents of approximately $65.7 million.

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

Application of Critical Accounting Policies and Accounting Estimates

There have been no changes during the nine months ended December 31, 2013 to the critical accounting policies or the areas that involve the use of significant judgments or estimates we described in our Annual Report on Form 10-K for the fiscal year ended March 31, 2013.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

We are subject to financial market risks, including changes in marketable equity security prices. We do not use derivative financial instruments to mitigate any of these risks.

Our investment performance is a function of our portfolio companies' profitability, which may be affected by economic cycles, competitive forces, foreign currency fluctuations and production costs including labor rates, raw material prices and certain basic commodity prices. While the portfolio company with the most significant exposure to foreign currency fluctuations generally hedges its exposure, most of the companies in our investment portfolio do not hedge their exposure to raw material and commodity price fluctuations. All of these factors may have an adverse effect on the value of our investments and on our net asset value.

Our investment in portfolio securities includes fixed-rate debt securities which totaled $5,724,007 at December 31 2013, equivalent to 0.82% of the value of our total investments. Generally, these debt securities are below investment grade and have relatively high fixed rates of interest; therefore, minor changes in market yields of publicly traded debt securities have little or no effect on the values of debt securities in our portfolio and no effect on interest income. Our investments in debt securities are generally held to maturity and their fair values are determined on the basis of the terms of the debt security and the financial condition of the issuer.

A portion of our investment portfolio consists of debt and equity securities of private companies. We anticipate little or no effect on the values of these investments from modest changes in public market equity valuations. Should significant changes in market valuations of comparable publicly traded companies occur, there may be a corresponding effect on valuations of private companies, which would affect the value and the amount and timing of proceeds eventually realized from these investments. A portion of our investment portfolio also consists of unrestricted, freely marketable common stock of publicly traded companies. These freely marketable investments, which are valued at the public market price, are directly exposed to equity price risks because a change in an issuer's public market equity price would result in an identical change in the value of our investment in such security.

Table of Contents

Item 4. Controls and Procedures

As of the end of the period covered by this report, an evaluation was performed under the supervision and with the participation of our management, including the President and Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rule 13a-15 of the Securities Exchange Act of 1934). Based upon this evaluation, our President and Chief Executive Officer and our Chief Financial Officer have concluded that our current disclosure controls and procedures are effective in timely alerting them of material information relating to us that is required to be disclosed in the reports we file or submit under Securities Exchange Act of 1934.

During the fiscal quarter ended December 31, 2013, there have been no changes in our internal controls over financial reporting that have materially affected, or are reasonably likely to materially affect our internal controls over financial reporting.

PART II. – OTHER INFORMATION

Item 1. Legal Proceedings

We may, from time to time, be involved in litigation arising out of our operations in the normal course of business or otherwise. Furthermore, third parties may try to seek to impose liability on us in connection with the activities of our portfolio companies. We have no current pending legal proceedings to which we are party or to which any of our assets is subject.

Item 1A. Risk Factors

There have been no material changes to our risk factors disclosed in Item 1A. "Risk Factors" in our Annual Report on Form 10-K for the fiscal year ended March 31, 2013.

Item 6. Exhibits

Exhibit No.	Description
31.1	Certification of President and Chief Executive Officer required by Rule 13a-14(a) of the Securities Exchange Act of 1934, as amended (the "Exchange Act"), filed herewith.
31.2	Certification of Chief Financial Officer required by Rule 13a-14(a) of the Exchange Act, filed herewith.
32.1	Certification of President and Chief Executive Officer required by Rule 13a-14(b) of the Exchange Act and Section 1350 of Chapter 63 of Title 18 of the United States Code, furnished herewith.
32.2	Certification of Chief Financial Officer required by Rule 13a-14(b) of the Exchange Act and Section 1350 of Chapter 63 of Title 18 of the United States Code, furnished herewith.

Table of Contents

SIGNATURES

Pursuant to the requirements the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

	CAPITAL SOUTHWEST CORPORATION	
February 6, 2014	By:	/s/ Joseph B. Armes
Date		Joseph B. Armes Chairman of the Board President and Chief Executive Officer
February 6, 2014	By:	/s/ Kelly Tacke
Date		Kelly Tacke Chief Financial Officer