American Capital Strategies

ANNUAL REPORT 1998

CORPORATE PROFILE

American Capital Strategies, founded in 1986, is a buyout and specialty finance company that is publicly traded (Nasdaq Symbol: "ACAS") with capital resources exceeding $250 million. American Capital provides senior debt, subordinated debt and equity to companies in need of capital for growth, acquisitions, employee buyouts, management buyouts, liquidity and restructuring. American Capital provides $3 to $20 million to middle market companies and is able to source substantial additional capital for much larger transactions. American Capital does not provide startup financing.

American Capital is headquartered in Bethesda, MD with offices in Boston, New York, Pittsburgh, San Francisco, Dallas and Chicago.

Companies interested in learning more about American Capital and its unique and flexible financing should contact John Hoffmire, Vice President of Sales and Marketing, at 781-862-4447 or visit its website at *www.American-Capital.com* or its shareholder site at *www.ACAS1.com*.

This annual report contains forward-looking statements that are made pursuant to the safe harbor provisions of the Private Securities Litigation Reform Act of 1995. The statements regarding expected results of American Capital are subject to various factors and uncertainties, including the uncertainties associated with the timing of transaction closings and national economic trends.

FINANCIAL HIGHLIGHTS

(In thousands except per share data)

	Year Ended December 31, 1998	Three Months Ended December 31, 1997
Per share data (1)		
Net asset value at beginning of the period	**$ 13.61**	$ 13.60
Net operating income	**1.34**	0.21
Increase in unrealized appreciation on investments	**0.19**	0.01
Net increase in shareholders' equity from operations	**$ 1.53**	$ 0.22
Distribution of net investment income	**1.34**	0.21
Net asset value at end of period	**$ 13.80**	$ 13.61
Per share market value at end of period	**$ 17.25**	$ 18.125
Total return (2)	**2.57%**	22.23%
Shares outstanding at end of period	**11,081**	11,069
Ratio/supplemental data		
Net assets at end of period	**$152,723**	$150,652
Ratio of operating expenses to average net assets (3)	**1.13%**	1.46%
Ratio of net operating income to average net assets (3)	**9.75%**	6.03%

(1) Basic per share data.
(2) Amounts were not annualized for the results of the three month period ended December 31, 1997.
(3) Amounts were annualized for the results of the three month period ended December 31, 1997.

See accompanying notes to the financial statements beginning on page 25.

SUMMARY OF INVESTMENTS

December 31, 1998	Industry		Cost	Fair Value
Centennial Broadcasting	Radio Stations	Debt	$ 15,040	$ 15,040
ConStar International	Electrical Contractor	Debt	12,839	12,839
		Equity	3,671	3,671
Euro-Caribe Packing Company	Sausage/Ham Producer	Debt	16,086	16,086
		Equity	1,110	1,110
Confluence Holdings	Kayak and Canoe Mfg.	Debt	14,376	14,376
		Equity	1,319	1,319
Cycle Gear	Motorcycle Parts and Accessories	Debt	1,383	1,383
		Equity	374	374
Electrolux	Vacuum Cleaners	Debt	7,264	7,264
		Equity	246	246
BIW Connector Systems	Specialty Connectors	Debt	10,114	10,114
		Equity	652	540
The New Piper Aircraft	Aircraft Mfg.	Debt	17,858	17,858
		Equity	2,231	2,231
Decorative Surfaces International	Wallcovering Mfg.	Debt	10,490	10,490
		Equity	5,217	6,242
The L.A. Studios	Audio Post Production	Debt	2,393	2,393
		Equity	902	857
Four S Baking	Bread Bakery	Debt	2,854	2,854
		Equity	4,184	4,360
Chance Coach	Bus Manufacturing	Debt	8,346	8,346
		Equity	7,937	8,753
Specialty Transportation Services	Municipal Solid Waste Transport	Debt	7,368	7,368
		Equity	1,194	1,568
JAG Industries, Inc.	Contract Metal Fabrication	Debt	3,535	3,535
		Equity	505	465
Westwind Group Holdings	Restaurants	Debt	2,932	2,932
		Equity	350	421
Totals			$162,770	$165,035

DEAR SHAREHOLDERS:

Last year we thanked you for entrusting us with your capital. This year we would like to report on the quality and performance of the investments we made with your capital and share with you our vision for 1999 and beyond.

1998 was a great year for American Capital. During 1998 we reviewed more than 1,500 opportunities to select the several hundred we investigated, and ultimately, the 14 that met our criteria for investment. As outlined in the following pages, we believe we have found companies with strong management teams, great businesses, dominant positions in their individual markets, established cash flows, long operating histories and the ability to weather periodic downturns in the economy. The businesses we have invested in are, on average, more than 35 years old with average sales of $57 million, and a debt service coverage in excess of 2 times cash flow. We also own an average of 27% of the equity of these businesses, primarily through the warrants to purchase common stock.

WHILE WE DO NOT HAVE CONTROL OVER MARKET FORCES, WE BELIEVE THAT THERE ARE AREAS THAT WE CAN AND HAVE ALREADY BEGUN TO IMPROVE TO MAXIMIZE THE CONDITIONS FOR THE TRADING OF OUR STOCK.

The quality and depth of our investment selection process is best demonstrated by the fact that during the year we closed, on average, one transaction for each principal officer in the company. That represents a tremendous amount of due diligence for every investment we make. These statistics are outstanding for the buyout and mezzanine finance industry. They reflect our mindset of investing as a principal, and our focus on creating value for our shareholders. It also shows that we have significant untapped capacity to make new investments without increasing the number of individuals making those investments.

Our staff of seasoned investment professionals made 1998 a successful year by providing experienced judgement which allowed us to efficiently choose among the opportunities presented to us and select the ones that met our high standards for investment. In total, we invested $150 million during the year and finished investing the proceeds from our IPO. We opened offices in Chicago and Dallas and hired five outstanding principals. These individuals have extensive equity underwriting experience and come from some of the finest private buyout firms in the country. To broaden our capabilities, we hired five associates in 1998 to support the principals. The associates are high-caliber men and women who have worked for two or more years in a Wall Street firm analyst program and distinguished themselves by being in the top ten percent of their peer group.

An important measure of our investment success is the current yield we generate from our investments because it is the driver of net operating income and the dividend we are able to declare and distribute. We are pleased to report that the current yield on our portfolio was 13.0% at year-end. That yield coupled with the fact that we invested the IPO proceeds ahead of schedule allowed us to exceed the expectations set at the time of our IPO and declare dividends totaling $1.34 for the year.

The pace of our investments was also enhanced by the flexibility of our capital. A key competitive advantage for us is our ability to invest in all elements of a company's capital structure. While we made 74% of our investments in subordinated debt, our ability to provide senior debt, and purchase preferred and common stock, proved to be a competitive advantage in several transactions this past year.

We believe the shareholder letter is a forum to report the company's performance and should include an assessment of the positives as well as the disappointments we faced, and our plans for addressing them. 1998 was a turbulent year in the capital markets. We saw investors flee from financial service companies and small cap stocks as international economic problems raised domestic concerns. We saw the cost of capital rise for small cap companies and we saw high volatility in our stock price.

American Capital, along with many other companies, suffered through periods of poor stock price performance even though we continued to deliver on the results promised to shareholders. For us and many other companies, the words of Benjamin Graham rang true: "Sometimes Mr. Market's idea of value appears plausible… Often, on the other hand, Mr. Market lets his enthusiasm or his fears run away with him, and the value he proposes seems to you a little short of silly." While we do not have control over market forces, we believe that there are areas that we can and have already begun to improve to maximize the conditions for the trading of our stock. First, we believe that research coverage of our stock is critical. We worked hard during the course of the year to obtain research coverage from four new investment banks; Scott & Stringfellow, Hilliard Lyons, BancBoston Robertson Stephens and Legg Mason, and from a well-respected independent analyst. We believe additional research coverage is needed, and we are working to attract that coverage.

In addition to the analyst coverage for our stock, we have initiated a focused effort to disseminate information to retail investors as well as institutional investors. We have developed one of the finest investor relations Internet sites (www.ACAS1.com) and have included leading edge information. We have opened our quarterly analyst calls to individual investors and created a slide presentation on our web site for all participants to follow during the call and review afterwards via the internet. We have developed meaningful statistics on portfolio quality, designed to allow investors to monitor the portfolio results on much the same basis as we do. We are committed to providing the market with as much meaningful information as we can and will continue to look for ways to expand and improve the communication of our results.

We have embarked on investor visits both institutionally and with retail brokers to continue to educate the market about American Capital. We are continuing those efforts in 1999 and believe that by adding research coverage and market makers for our stock, and providing meaningful portfolio statistics, we can improve the trading performance of our stock.

The disruption in the capital markets also provided a challenge for raising our first round of debt capital. During the peak of the liquidity problems in the capital markets in the early fall, we succeeded in obtaining an initial credit facility. We continued to work with a number of lenders and were extremely pleased to execute a commitment letter from First Union for a fully underwritten $100 million credit facility in early February and closed the facility in March. The fact that First Union fully underwrote the $100 million credit facility during a period of disruption in the capital markets makes a strong statement about our asset quality.

Turning to our plans for next year and beyond, we have developed a number of strategic objectives we want to share with you. First, our roots are founded in employee stock ownership plan (ESOP) transactions and we are one of the leading ESOP experts and sources of financing in the country. In 25% of our investments, we have served as the principal in a buyout that utilized an ESOP as part of the capital structure. We believe these

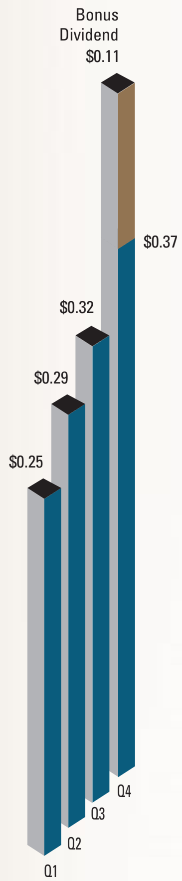
Malon Wilkus
Chairman and CEO
(Bottom Right)

David Gladstone
Vice Chairman
(Bottom Left)

Adam Blumenthal
Executive Vice President
(Top Right)

John Erickson
Chief Financial Officer
(Top Left)

1998 Quarterly Dividend



transactions, on a risk-adjusted basis, provide the best rate of return of any of our investments, and we intend to work to increase those opportunities. We plan to increase our marketing staff to target a greater number of buyout opportunities that can be structured with an ESOP.

We firmly believe that quality people are our most important asset and will continue to grow that resource. We will hire several new associates to support our principals and will consider adding principals and opening another strategically located regional office late in 1999. The associates we hire come from some of the best Wall Street firms and based on our experience this year our new hires in 1999 will be prepared to make an immediate contribution.

During 1999, we will strive to increase the ratio of transaction closings per principal year. We believe that we can achieve that goal by increasing our staff of associates and will absolutely not reduce our scope of due diligence to further this goal.

Capital is a precious resource. We intend to continue broadening our research coverage, increasing the market makers trading our stock, meeting new and existing shareholders, and developing effective measures of the quality and performance of our assets. Additionally, we will seek to find selected pieces of investments that can be sold at attractive returns to demonstrate the liquidity in our portfolio and begin building our track record of capital appreciation. We believe these goals will help us increase our ability to leverage and improve the performance of our stock.

In closing, we are extremely proud of the accomplishments of 1998 and look forward to continuing to execute our business model and deliver outstanding results to our shareholders. On behalf of all of the directors, management and employees at American Capital, we wish to thank you for your continued support.

Sincerely,

MALON WILKUS
Chairman and CEO

ADAM BLUMENTHAL
Executive Vice President

DAVID GLADSTONE
Vice Chairman

JOHN ERICKSON
Chief Financial Officer

ERIE FORGE & STEEL

American Capital's first equity investment was in Erie Forge & Steel, a majority employee-owned company based in Erie, Pennsylvania. Erie is a $60 million revenue manufacturer and is the dominant source of ship shafts for the U.S. Navy, having more than 90% market share. Under the leadership of CEO Allan Concoby, Erie has been held up as a national model for middle market manufacturing. Erie's labor-management cooperation program, facilitated by its Employee Stock Ownership Plan, has led to productivity improvements which helped the company weather severe economic cycles. Erie has also been successful at maintaining its commanding position in a key military technology while achieving growth and profitability as a diversified civilian producer. American Capital has been a long term equity partner for Erie and its employee and management owners, and looks forward to a long and mutually profitable continued association.

Erie Forge & Steel
Portfolio Company of ACAS operating subsidiary since 1990

Business
Engineered and forged submarine ship shafting, and steel ingot for commercial production

MOBILE TOOL INTERNATIONAL

Technology and deregulation are twin forces which are changing the face of the world at an ever increasing rate. American Capital seeks to participate in growth driven by these changes, without taking risk on specific technologies which are unproven or subject to rapid change.

Mobile Tool exemplifies this strategy. American Capital teamed up with management and employees in 1995 to purchase the Apparatus Division of the General Cable Corporation. A manufacturer of lift trucks for the telecommunications, cable, and electric utility industries, Mobile Tool was positioned with large market share and a deep product line. Since the acquisition, sales have increased substantially as a result of the flood of capital expenditures set loose by telecommunications deregulation, by the installation of competing networks of coaxial and fiber optic cable, and by the removal of significant amounts of copper wire from the country's telecom infrastructure. With its initial acquisition debt largely retired, Mobile Tool has devoted capital to building its electric utility product line and international presence in the belief that energy deregulation will cause similar capital investment in the US electric distribution network, while the global telecommunications revolution will drive a demand for increasingly reliable telecom and electric infrastructure.

American Capital is a minority investor in Mobile Tool, alongside significant employee ownership through an ESOP, and direct management ownership. American Capital has played an active board and advisory role, helping Mobile Tool grow through several rounds of senior financing, two acquisitions, and the development of substantial leasing and rental options for its dynamic customer base. Mobile Tool is headquartered in Denver, CO, with additional manufacturing facilities in Indiana, California, Maryland, Pennsylvania, and Alabama.

Mobile Tool International
Portfolio Company of ACAS operating subsidiary since 1995

Business
Insulated and uninsulated lift trucks sold to the telecommunications and electric utility markets, and related services

Biddeford Textile Company
Portfolio Company of ACAS operating subsidiary since 1997

Business
Manufactures blankets and electric blankets

BIDDEFORD TEXTILE COMPANY

American Capital often seeks out strong business opportunities and exceptional value where corporate America sees only a "non-core" business. Biddeford Textile Company was a division of Sunbeam Corporation, which currently has 100% of the electric blanket market in North America. Biddeford, which makes the unwired blanket shells, was targeted to be sold or closed as part of Sunbeam's 1996 restructuring.

When Sunbeam announced that it would close or sell over 20 businesses as part of a restructuring, American Capital immediately researched each of these companies to determine whether an opportunity for a buyout existed. The research quickly identified an opportunity at the Biddeford, Maine plant. Where Sunbeam saw a non-core business, American Capital quickly saw the makings of an attractive company. Biddeford had experienced, in place management, a commanding market position, and a hard-working, skilled workforce. American Capital contacted local management, the union representing Biddeford employees, and a local investor group; negotiated a new labor contract establishing a tax-advantaged employee ownership plan; and approached Sunbeam with a purchase offer and a long term blanket supply contract.

Supported by the supply agreement, and led by its long-time manager Rene Boisvert, Biddeford has grown in customers, employees, revenues and profits since its buyout.

Biddeford exemplifies the entrepreneurial spirit of the employee-owned companies in which American Capital seeks to invest.

JAG Industries
ACAS Portfolio Company since 1998

Business
Metal fabrication

JAG INDUSTRIES

American Capital supports entrepreneurs willing to commit their personal efforts and net worth to a business opportunity. Eugne Stluka, the CEO of JAG Industries, came to JAG after a successful career as a general manager at General Electric and two senior management assignments at private, family-owned, small manufacturing companies. He was eager to own and run a business which he thought he could improve through his proven background in production, marketing, and finance. JAG Industries, a diversified manufacturer in Baltimore, Maryland, with both export and domestic sales from a single manufacturing facility, appeared to be positioned for growth with professional and committed management. Mr. Stluka approached American Capital having negotiated a letter of intent to purchase the business with the three founders who wished to retire from the company. American Capital supported the buyout with a one-stop-shop investment of subordinated debt with warrants and senior debt that allowed him to close his transaction quickly and efficiently, with a base of long term core capital which will allow him the freedom to grow his business without immediate cash flow demands for principal repayment.

WESTWIND HOLDINGS

American Capital often coinvests with other private equity firms to provide capital to growing businesses. Westwind Holdings is the third largest franchisee of Burger King restaurants in the U.S., with significant market share in North Carolina, Oregon, and Florida. Westwind has a proven ability to increase profitability in newly acquired stores through an intensely disciplined management approach, including pricing and menu management, media planning, employee training and retention, and information systems management. American Capital coinvested with Churchill ESOP Capital Partners of Minneapolis to provide the junior capital for this focused operator, which promises to be a growing force within the fast food community.

Westwind Holdings, Inc.
ACAS Portfolio Company since 1997

Business
Third largest franchisee of Burger Kings in the U.S.

BIW

American Capital will invest mezzanine debt in buyout transactions sponsored by experienced and sophisticated equity investors. Thurteen Investments, a Northbrook, Illinois investment firm, together with Peninsula Capital, sponsored the acquisition of BIW in 1997. BIW, an electrical connector manufacturer with multiple patents covering a range of proprietary applications, has a dominant position in a worldwide market. American Capital structured its investment to take account of potential cyclicality in oil field applications, which provide the demand for a material portion of BIW's product.

BIW
ACAS Portfolio Company since 1997

Business
Manufacturer of specialized electrical connectors

SPECIALTY TRANSPORTATION SERVICES

American Capital seeks to bring value to a transaction through creative structuring. In the case of STS, a management team led by Chief Executive Officer Gary Goldberg and Chief Operating Officer Barbara Milligan sought to purchase the division of the Portage, Indiana based trucking company at which they worked. They approached Asche Transportation, a public company, as a strategic partner and equity investor, and looked to American Capital as a provider of mezzanine financing.

American Capital responded enthusiastically to the opportunity. STS specializes in hauling waste from transfer stations to landfills, applying intense focus and nationwide reach to a segment of the waste industry.The experienced management team had the ability to contract with the major players in this rapidly consolidating industry and provide a high level of service with reliability and efficiency.

During the intense negotiations leading to the final transaction, American Capital supported the management team by offering a variety of investment structures, with varying levels of senior debt or equity features, to accommodate the changing commitments of STS's senior lenders and equity partners. Because of American Capital's exceptional ability to invest across a broad band of the risk/reward continuum, we were able to provide the seller with confidence that the full agreed-to purchase price would be paid on the day of closing.

Specialty Transportation Services
ACAS Portfolio Company since 1998

Business
Specialized waste hauler

Chance Coach
ACAS Portfolio Company since 1998

Business
Heavy duty small transit buses

CHANCE COACH

When the Wichita, Kansas based management of Chance Coach came to American Capital and described an opportunity to purchase their division from a parent company, we saw a tremendous opportunity for them and for ourselves. Chance Industries, an amusement ride manufacturer, had developed the bus business as a sideline, and wished to disentangle the two companies operations and focus on their core business. Meanwhile the bus company's management wanted the freedom to grow their business, which provides a preferred product to municipalities across the country.

American Capital's ability to finance an entire buyout transaction with a mixture of equity, subordinated debt, and senior debt financing assured both the management of Chance Coach and the owners of Chance Industries that a transaction could close in a timely fashion with few complications. Our familiarity with due diligence in a manufacturing setting allowed us to rapidly evaluate the business plan including separating two lines of business which had been manufactured in the same facility for many years,

Since its buyout transaction, Chance Coach has smoothly transitioned to life as an independent company. With a newly incentivized management team and a new stand-alone plant, its backlog and revenues are at record levels, and its management team and employees are building shareholder value for themselves and American Capital.

Cycle Gear
ACAS Portfolio Company since 1998

Business
Specialty motorcycle equipment and apparel retail chain

CYCLE GEAR

American Capital has special expertise in financing the growth requirements of employee-owned companies. Cycle Gear is an ESOP company that has grown into the largest multi-store retailer of general motorcycle parts and accessories in the U.S. To fund a strategy of growth and industry consolidation, American Capital committed a total of $6 million including an initial investment of $1,750,000.

Cycle Gear, operates seven motorcycle parts and accessories retail stores in Northern California, and a catalog division that serves the entire U.S. market. The motorcycle parts industry is a $1.7 billion market that is principally served by small non-franchised single store operations. Cycle Gear has developed a model store that outperforms many of these small operations and intends to open new stores to increase its penetration in existing markets, as well as to move into strategically located new markets. By phasing its investment of long term junior capital on an as-needed basis, American Capital met existing owners' concerns, while maximizing the potential for attractive returns on our investment.

THE NEW PIPER AIRCRAFT

Piper is a legendary name in American aviation, and American Capital is proud to be able to invest in its growth. Piper was founded in 1937 and became famous for its World War II "Cub" aircraft. Today, Piper offers eight models of piston-powered aircraft that service the personal, business and flight training markets. Piper has 95,000 aircraft in operation around the world, including 64,000 registered in the United States, representing 27% of all registered piston-powered aircraft in the United States.

The retail aircraft market suffered a setback during the 1980s and early 1990s, as regulatory conditions made the ongoing business uncertain. After federal legislation resolved outstanding regulatory issues, companies like Piper enjoyed a renewed opportunity to grow aggressively. American Capital responded to Piper's desire to restructure its balance sheet and obtain additional long-term core capital to support the introduction of a new plane, the Malibu Meridian. Attracted by Piper's unique combination of brand equity, market share, distribution channels and manufacturing expertise, we invested in subordinated debt with detachable warrants that allows us to participate in Piper's long-term growth.

The New Piper Aircraft
ACAS Portfolio Company since 1998

Business
Aircraft Manufacturer

THE LA STUDIOS

The LA Studios, Inc. is a Southern California based employee-owned company providing audio post-production services for the animation, television, radio, advertising and film trailer markets. The Company's clients include Disney, CBS Television, ABC, NBC, Saatchi & Saatchi, BBDO and Wieden & Kennedy. The company sought American Capital as a partner to provide growth financing to develop a new state-of-the-art facility in Santa Monica, California. American Capital, building on its long-term knowledge of ESOP financing, structured a subordinated debt investment that provided the highly skilled employee-owners of LA Studios the required capital to build their new facility, without altering an important element of their compensation, the ESOP.

The LA Studios
ACAS Portfolio Company since 1998

Business
The largest privately owned audio post-production operation in the Western United States

DECORATIVE SURFACES INTERNATIONAL

American Capital's nationally recognized leadership in employee buyouts is demonstrated by its structuring and financing of the majority ESOP buyout of a $110 million revenue subsidiary of Borden, Inc. Decorative Surfaces is a manufacturing company with an 80 year history and has substantial market share manufacturing and selling coated papers used in laminates such as Formica®, Wilsonart® and Congoleum®. American Capital teamed with management, the union, and salaried employees to win the bid for this classic industrial company. American Capital structured and implemented a complex transaction which included a bank commitment to fund construction of an entire new production facility. American Capital tapped its extensive experience to manage complex environmental and labor-related issues, and created a vibrant company which provides significant value to owners and employees.

Decorative Surfaces International, Inc.
ACAS Portfolio Company since 1998

Business
Manufacturer of printed and embossed papers and vinyls used in laminates and wallcoverings

Confluence Holdings
ACAS Portfolio Company since 1998

Business
Manufacturer of canoes and kayaks

CONFLUENCE HOLDINGS

American Capital looks for investment opportunities where quantifiable and immediate synergies can enhance the value of an investment in the weeks and months immediately following a transaction. Confluence Holdings, Inc., which resulted from the merger of Wilderness Systems, Inc., the third largest U.S. manufacturer of kayaks, and Mad River Canoe, Inc., the second largest U.S. manufacturer of canoes, represented such a situation. The transaction, led by management, Westbury Capital Partners, LP, and principals of Lochridge & Company, a management consulting firm, brought together two pioneers in the paddle sports business.

Wilderness Systems pioneered the development of the touring and recreational segments of the kayak market. The company continues to be innovative in its designs and development of kayaks featuring composite construction techniques and advanced combinations of materials. Mad River Canoe currently offers canoes in 24 models in four different materials. Its award-winning designs serve the touring, tripping and whitewater market segments.

The combined company, in its first season, has demonstrated an ability to bring to market the complementary product lines of its two component businesses in a more powerful way than either company had been able to do alone. With new product introductions, expanded manufacturing facilities, and increased market outlets for both brands, these two leading companies are positioned to be dominant forces in their markets for years to come.

Electrolux
ACAS Portfolio Company since 1998

Business
Vacuum Cleaners

ELECTROLUX

Electrolux is a leading manufacturer and direct marketer of high-end vacuums and floor cleaners sold throughout the United States and Canada. Electrolux was acquired on April 30, 1998 from the Sara Lee Corp. by the Dallas-based buyout firm, Engles Urso Follmer (EUF). American Capital supported the buyout with a mezzanine investment. We saw the potential for the creation of significant value through the focused, experienced management that EUF, (which had a current investment in the direct sales vacuum cleaner industry and a demonstrated track record), could bring to bear on a company that had been permitted to languish by a parent company that did not see it as a core interest.

Electrolux is a well-known brand name, having entered the U.S. market in 1924. Electrolux emerged as an industry sales leader based on its models, value and the strength of its direct distribution system. Since the acquisition led by EUF, this classic brand has been significantly reinvigorated, and we believe that the potential for value at this company is excellent.

EURO-CARIBE PACKING COMPANY

American Capital's financing can be particularly attractive to entrepreneurs who have built substantial equity in their operating companies, and who desire financing to acquire a complementary firm without giving up control of their business. Jose Casanova and Wolfgang Kell, the co-founders of Euro-Caribe, discovered this when they became aware of an opportunity to purchase Federal Packing Company. Euro-Caribe had a 25-year history as the manufacturer of the premier brand of sausage in Puerto Rico. When the opportunity arose to purchase Federal, a 32-year old family owned firm with leading market share in other processed meat products, Casanova and Kell saw it as a natural fit, with manufacturing, marketing and distribution synergies.

Despite Casanova and Kell's proven management skills, and two-decade long involvement in the Puerto Rican market, there was a gap between the amount they could borrow from local banks and Federal's purchase price. Filling the gap with a traditional third-party equity investment complemented by bank financing would have caused Casanova and Kell to lose control of the business to the equity investor. Jose Casanova and Wolfgang Kell chose American Capital as their financial partner because American Capital was able to develop a unique, "one-stop-shop" structure utilizing senior and subordinated debt instruments with warrants, which provided needed capital without taking a majority ownership position.

Euro-Caribe Packing Company
ACAS Portfolio Company since 1998

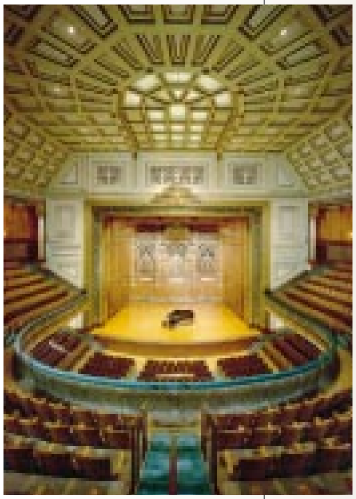
Business
Meat packing

CONSTAR

In a recapitalization, institutional capital is invested in a company which has been developed by entrepreneurial management. This provides for future growth, brings the talents of sophisticated investors to bear on a growing business, provides liquidity to the entrepreneurs, and aligns the interests of management and investors to take the company to a new level.

ConStar was an ideal candidate for a recapitalization. With roots in New England, ConStar is licensed in more than twenty-six states. Under the leadership of Stephen Bisson, who founded ConStar in 1976 and continues to serve as President after the recap, ConStar had a strong regional platform and a tremendous opportunity to grow into a number of new markets. Its outstanding design and build capability give it a competitive advantage over many firms in the industry. Recent representative projects include the computer networking design and installation at Denver's Coors Field, the rebuild of the Malden Mills textile plant in Massachusetts, and computer networking design and installation at the Foxwoods casino complex in Connecticut and other leading universities including Yale, the University of Boston and the University of Connecticut.

Growth beyond its 1998 base, however, required new capital resources and sophistication. Celerity Partners, an investor group based in Menlo Park, California, organized and led this group, which included American Capital and First Dominion Capital. The transaction injected enough capital into ConStar to provide Mr. Bisson and his colleagues with personal liquidity (while retaining their operating positions and incentives) and expanded the base of available capital for the Company. ConStar plans to grow both internally and externally, with two strategic acquisitions scheduled for closing early in the second quarter of 1999.



ConStar
ACAS Portfolio Company since 1998

Business
Design, integration, and installation of commercial electrical, telecommunications, and computer networking systems

Centennial Broadcasting
ACAS Portfolio Company since 1998

Business

Operator of 7 radio stations, 3 in Las Vegas, 3 in New Orleans, and 1 in Vero Beach, Florida

CENTENNIAL BROADCASTING

American Capital's approach to investing allows us to participate in a wide variety of industries, whenever we find opportunities with superb management, exceptional value, and a defensible market position with excellent growth potential. Centennial Broadcasting had all of these qualities. Led by Allen Shaw, the management of Centennial has over 50 years combined experience in the broadcasting industry and a proven track record of success in assembling and managing clusters of radio stations in top-50 markets. At Centennial, American Capital provided long term capital to replace the bridge financing that had been used, as well as a large equity investment, to assemble these clusters. The strong demographics of the markets, the profiles of the individual stations and a detailed business improvement plan made Centennial an attractive way for American Capital's shareholders to participate in the strong returns currently available from radio station buildups.

The Lion Brewery
ACAS Portfolio Company since 1999

Business

Brewed beverages, primarily non-alcoholic

THE LION BREWERY

For a company with stable, defensible cash flow, an entrepreneurial management team, and limited demands for growth capital in the near term, private ownership can be a more effective structure for a company than public ownership. With the public markets discounting smaller companies, American Capital believes there is excellent value and return potential for ourselves and for management teams in going-private transactions like this one.

In January 1999, American Capital teamed with the management of the Lion Brewery in a going private transaction that replaced a public shareholder base with ownership by American Capital and key management. American Capital's long-term subordinated debt investment provided sufficient capital to replace the existing public equity with a structure that left Lion's experienced management team with a very substantial equity interest in their business. Management now operates this 100-year old Wilkes-Barre, Pennsylvania based brewery with the extreme focus that concentrated management ownership brings, and with the opportunity for rewards that public markets have shown little willingness to provide to stable, profitable middle-market companies.

SELECTED FINANCIAL DATA

The selected financial data should be read in conjunction with the Company's financial statements and notes thereto. As discussed in Notes 1 and 2, the Company completed an initial public offering of its common stock on August 29, 1997 and on October 1, 1997 began to operate so as to qualify to be taxed as a RIC. As a result of the changes, the financial results of the Company for periods prior to October 1, 1997 are not comparable to periods commencing October 1, 1997, and are not expected to be representative of the financial results of the Company in the future.

(In thousands except per share data)

	Year Ended December 31, 1998	Three Months Ended December 31, 1997	Nine Months Ended September 30, 1997	Year Ended December 31, 1996	Year Ended December 31, 1995	Year Ended December 31, 1994
Total operating income	**$ 16,979**	$ 2,797	$ 2,901	$2,746	$2,706	$2,498
Total operating expenses	**1,709**	551	2,651	2,862	2,928	2,606
Operating income (loss) before equity in (loss) earnings of unconsolidated operating subsidiary	**15,270**	2,246	250	(116)	(222)	(108)
Equity in (loss) earnings of unconsolidated operating subsidiary	**(482)**	24	—	—	—	—
Net operating income (loss)	**14,788**	2,270	250	(116)	(222)	(108)
Increase in unrealized appreciation on investments	**2,127**	167	5,321	484	371	956
Realized gain (loss) on investments	**—**	—	—	—	66	(23)
Income before income taxes	**16,915**	2,437	5,571	368	215	825
Provision for income taxes	**—**	—	2,128	159	57	422
Net increase in shareholders' equity resulting from operations	**$ 16,915**	$ 2,437	$ 3,443	$ 209	$ 158	$ 403
Per share data:						
Net operating income:						
Basic	**$ 1.34**	$ 0.21				
Diluted	**$ 1.29**	$ 0.20				
Net increase in shareholders' equity resulting from operations:						
Basic	**$ 1.53**	$ 0.22				
Diluted	**$ 1.48**	$ 0.21				
Cash dividends	**$ 1.34**	$ 0.21				
Balance Sheet Data:						
Total assets	**$270,019**	$150,705	$154,322	$5,432	$4,382	$3,930
Total shareholders' equity	**152,723**	150,652	150,539	3,372	2,946	2,571
Other data:						
Number of portfolio companies at period end	**15**	3				
Principal amount of loan originations	**$116,864**	$ 16,817				
Principal amount of loan repayments	**$ 1,719**	$ 93				
Return on equity (1) (2)	**11.2%**	6.5%				
Weighted average yield on investments to date	**13.0%**	12.2%				

(1) Amounts are annualized for the three months ended December 31, 1997.

(2) Return represents net increase in shareholders' equity resulting from operations.

(In thousands except per share data)

All statements contained herein that are not historical facts including, but not limited to, statements regarding anticipated activity are forward looking in nature and involve a number of risks and uncertainties. Actual results may differ materially. Among the factors that could cause actual results to differ materially are the following: changes in the economic conditions in which the Company operates negatively impacting the financial resources of the Company; certain of the Company's competitors with substantially greater financial resources than the Company reducing the number of suitable investment opportunities offered to the Company or reducing the yield necessary to consummate the investment; increased costs related to compliance with laws, including environmental laws; general business and economic conditions and other risk factors described in the Company's reports filed from time to time with the Securities and Exchange Commission. The Company cautions readers not to place undue reliance on any such forward looking statements, which statements are made pursuant to the Private Securities Litigation Reform Act of 1995 and, as such, speak only as of the date made.

The following analysis of the financial condition and results of operations of the Company should be read in conjunction with the Company's financial statements and the notes thereto. As discussed in Notes 1 and 2, the Company completed an initial public offering ("IPO") of its common stock on August 29, 1997 and on October 1, 1997 began to operate so as to qualify to be taxed as a regulated investment company ("RIC"). After the IPO, the Company changed its primary business plan and format from structuring and arranging financing for buyout transactions on a fee for services basis to being a lender to and investor in middle market companies. As a result of the changes, the Company's predominant source of operating income has changed from financial performance and advisory fees to interest and dividends earned from investing the Company's assets in debt and equity of businesses. Additionally, pursuant to RIC accounting requirements, effective October 1, 1997, the Company's accounting for its operating subsidiary, ACS Capital Investments Corporation (CIC), changed from a consolidated basis to the equity method. The financial results of the Company for the periods through September 30, 1997 are not comparable to periods commencing October 1, 1997 and are not expected to be representative of the financial results of the Company in the future. Accordingly, those periods are discussed separately.

PORTFOLIO COMPOSITION

The Company's primary business is investing in and lending to privately-owned businesses through investments in senior debt, subordinated debt with detachable common stock warrants, preferred stock, and common stock. The total portfolio value of investments in non-publicly traded securities was $165,035 and $20,645 at December 31, 1998 and December 31, 1997, respectively. During the year ended December 31, 1998 and the three months ended December 31, 1997, the Company made investments totaling $150,249, including $7,384 in funds committed but undrawn under credit facilities, and $20,622, respectively. The weighted average effective interest rate on the investment portfolio was 13.0% and 12.2%, respectively, at December 31, 1998 and December 31, 1997. A summary of the composition of the Company's portfolio of non-publicly traded securities at December 31, 1998 and December 31, 1997 is shown in the following table:

December 31,	**1998**	1997
Senior debt	**15.0%**	27.7%
Subordinated debt	**65.5%**	53.5%
Convertible preferred stock	**3.3%**	11.2%
Common stock warrants	**13.5%**	7.6%
Common stock	**2.7%**	—

The Company expects its portfolio composition in 1999 to be similar to its portfolio composition at December 31, 1998. The Company will continue to heavily weight its portfolio composition toward investments in subordinated debt with detachable warrants.

The following table shows the portfolio composition by industry grouping:

December 31,	**1998**	1997
Manufacturing	**66.1%**	52.8%
Media	**9.1%**	—
Construction	**10.0%**	—
Wholesale & retail	**7.4%**	30.0%
Transportation	**5.4%**	—
Service	**2.0%**	17.2%

Management expects that the largest percentage of its investments will continue to be in manufacturing companies, however, the Company intends to continue to diversify its portfolio and will explore new investment opportunities in a variety of industries.

RESULTS OF OPERATIONS

The Company's financial performance, as reflected in its Statements of Operations, is composed of four primary elements. The first element is "Net operating income (loss)," which for periods prior to October 1, 1997 ("Pre-RIC") is the difference between the Company's revenue earned from arranging financing for middle market companies and other financial advisory work and its total operating expenses including ESOP contributions, depreciation and interest expense. For periods prior to October 1, 1997, ESOP contributions represented a significant component of total operating expenses. All required contributions to the Company's ESOP have been made by the Company, and further contributions will be made at the discretion of the Company's Board of Directors. Net operating income (loss) for periods commencing October 1, 1997 ("Post-RIC") is primarily the interest and dividends earned from investing in debt and equity securities and the equity in earnings of its unconsolidated operating subsidiary less the operating expenses of the Company. The second element is "Change in unrealized appreciation of investments," which is the net change in the estimated fair value of the Company's portfolio assets at the end of the period compared with their estimated fair values at the beginning of the period or their stated costs, as appropriate. The third element is "Realized gain on investments," which reflects the difference between the proceeds from a sale or maturity of a portfolio investment and the cost at which the investment was carried on the Company's balance sheet. The fourth element is "Provision for income taxes," which reflects a statutory tax rate applied to the Company's GAAP pretax income for pre-RIC periods. Actual taxes paid have historically been lower than the provision primarily due to the temporary difference of the unrealized appreciation of investments which has resulted in a deferred tax liability on the pre-RIC balance sheet of CIC. For post-RIC periods, the Company intends to operate so as to qualify to be taxed as a RIC. As long as the Company qualifies as a RIC, it will be able to take a deduction against its otherwise taxable income for certain dividends it pays, allowing it to substantially reduce or eliminate its corporate-level tax liability. As a result, the provisions for income taxes for post-RIC periods are expected to be minimal.

As discussed above, as a RIC, the Company is required to account for investments in operating subsidiaries under the equity method, regardless of ownership interest. Accordingly, the Company's investment in CIC, which prior to RIC status was consolidated, is presented on the equity method effective October 1, 1997. Therefore, commencing on October 1, 1997, and consistent with the equity method of accounting, the portfolio companies owned by CIC are not reported separately by the Company.

The operating results for the year ended December 31, 1998 are as follows:

Year Ended December 31,	**1998**
Operating income	$16,979
Operating expenses	1,709
Equity in loss of unconsolidated operating subsidiary	(482)
Net operating income	14,788
Increase in unrealized appreciation of investments	2,127
Net increase in shareholders' equity resulting from operations	$16,915

Total operating income consisted of $2,549 in loan processing fees and $11,020 in interest and dividends on non-publicly traded securities and $3,410 in interest on government agency securities, bank deposits and repurchase agreements. The loan fees were earned as result of closing fourteen investments in private companies totaling $150 million during the year.

Operating expenses for the year consisted of $843 in salaries and benefits, $809 in general and administrative expenses, and $57 in interest expense.

Equity in loss of unconsolidated operating subsidiary represents CIC's results. For the year ended December 31, 1998, CIC's results included $5,227 of operating income, $6,451 of operating expenses, $481 of unrealized appreciation of investments, and $202 in other income.

The increase in unrealized appreciation of investments as discussed in Note 2 to the financial statements is based on portfolio asset valuations determined by the Company's Board of Directors. The increase in unrealized appreciation of investments for the year ended December 31, 1998 is $2,127, which consists of valuation increases of $2,324 at nine portfolio companies and valuation decreases of $197 at three portfolio companies.

The post-RIC operating results for the three months ended December 31, 1997 are summarized as follows:

Three Months Ended December 31,	1997
Operating income	$2,797
Operating expenses	551
Equity in earnings of unconsolidated operating subsidiary	24
Net operating income	2,270
Increase in unrealized appreciation of investments	167
Net increase in shareholders' equity resulting from operations	$2,437

Total operating income consisted of approximately $700 in loan processing fees and $200 in interest on non-publicly traded securities and $1,900 in interest on government agency securities and overnight repurchase agreements. The loan fees were earned as a result of closing three investments in private companies totaling $21 million during the period.

Operating expenses for the period consisted of $243 in salaries and benefits and $308 in general and administrative expenses.

Equity in earnings of unconsolidated operating subsidiary represents CIC's results including the portfolio companies. For the three months ended December 31, 1997, CIC's results included $414 of operating income, $987 of operating expenses, $605 of unrealized appreciation of investment and $8 in tax provisions.

The increase in unrealized appreciation of investments as discussed in Note 2 to the financial statements is determined by the Company's Board of Directors. The change in unrealized appreciation of investments for the three month period is $167 which consists of an increase of $52 in the valuation of the government agency securities and an increase of $115 in the valuation of the investments in private companies.

The operating results for the nine months ended September 30, 1997 compared to nine months ended September 30, 1996.

Nine Months Ended September 30,	1997	1996
Operating income	$2,901	$1,758
Operating expenses	2,651	1,921
Net operating income	250	(163)
Increase in unrealized appreciation of investments	5,321	441
Provision for income taxes	2,128	109
Net increase in shareholders' equity resulting from operations	$3,443	$ 169

Total operating income was $2,901 for the nine months ended September 30, 1997, compared to $1,758 for the nine months ended September 30, 1996, a 65.0% increase. Financial advisory fees were $1,122 and $1,300 for the nine months ended September 30, 1997 and 1996, respectively. The decline in financial advisory fees was attributable to a relative increase in management attention to engagements producing financial performance fees, and to the IPO. Financial performance fees were $798 and $241 for the nine months ended September 30, 1997 and 1996, respectively. The increase in financial performance fees was associated with the Company's successful completion of an engagement to advise the Allied Pilots Association on the structuring of an employee option plan at American

(In thousands except per share data)

Airlines. Other operating income was $428 and $265 for the nine months ended September 30, 1997 and 1996, respectively. The increase in other operating income was attributable to a higher level of expense reimbursement for the Company. Included in total operating revenue for the nine months ended September 30, 1997 was interest income earned on investment securities and overnight repurchase agreements of $553.

Total operating expenses for the nine months ended September 30, 1997 and 1996 were $2,651 and $1,921, respectively, an increase of 38.0%. Salaries and benefits for the nine months ended September 30, 1997 and 1996, were $1,221 and $935, respectively, a 30.6% increase which was predominantly associated with increased levels of staffing. General and administrative expenses for the nine months ended September 30, 1997 and 1996, were $1,514 and $772, respectively, a 96.1% increase primarily associated with the increased use of consultants by the Company. The increase in other expenses is attributable to a variety of expenses associated with potential transactions. For the nine months ended September 30, 1997 and 1996, interest expense was $60 and $21, respectively. The increase in interest expense relates to the Company's increased levels of working capital for the period in 1997 prior to the initial public offering.

During the nine months ended September 30, 1997, the Company changed its evaluation of collectibility of a receivable from Martino's Bakery, Inc. due to Martino's improved financial condition, restructuring of repayment terms, and subsequent payment history. Therefore, the Company recorded a reversal in its provision for doubtful accounts totaling $177. During the nine months ended September 30, 1996, the Company had accrued $164 as a provision for doubtful accounts related to two companies, one of which was Martino's Bakery, Inc.

For the nine months ended September 30, 1997 and 1996, the Company recorded net increases in unrealized appreciation of investments in its portfolio companies of $5,321 and $441, respectively. Included in unrealized appreciation of investments during the first nine months of 1997 was $4,400 associated with the acquisition of Biddeford Textile Company, formerly the blanket operation of the electric blanket manufacturing division of Sunbeam Products, Inc. Also included in unrealized appreciation of investments during the first nine months of 1997 was appreciation of $731 associated with the Company's investment in Mobile Tool International, Inc., appreciation of $356 associated with Four S Baking Company, Inc., and depreciation of $138 associated with Martino's Bakery, Inc.

The following table sets forth the components of the increase in unrealized appreciation of investments for the nine months ended September 30, 1997 and 1996:

Nine Months Ended September 30,	1997	1996
Government securities	$ (27)	$ —
Erie Forge and Steel, Inc	—	153
Four S Baking Company, Inc	355	(54)
Indiana Steel & Wire Corporation	—	7
Martino's Bakery, Inc.	(138)	143
Mobile Tool International, Inc.	731	192
Biddeford Textile Corporation	4,400	—
Increase in unrealized appreciation of investments	$5,321	$ 441

The Company recorded provisions for income taxes for the nine months ended September 30, 1997 and 1996 of $2,129 and $109, respectively. Unrealized appreciation (depreciation) of investments does not affect the actual tax paid by the Company. However, under GAAP, the Company provides for income taxes based on its GAAP pretax income, which includes unrealized appreciation (depreciation) of investments. Actual income taxes paid may differ substantially from the provision for income taxes. The Company accounted for this difference by recognition of a deferred tax liability in the Pre-RIC balance sheet of CIC.

Year Ended December 31,	1996
Operating income	$2,746
Operating expenses excluding ESOP contribution	2,645
Esop contribution	216
Total operating expenses	2,861
Net operating loss before investment activity	(115)
Increase in unrealized appreciation of investments	483
Provision for income taxes	159
Net increase in shareholders' equity resulting from operations	$ 209

Operating income consists predominantly of financial advisory fees and financial performance fees. During 1996, financial advisory fees and financial performance fees constituted 86.9% of total revenue.

Total operating expenses at the Company were $2,861 in 1996. Salaries and benefits, excluding ESOP contributions, were $1,067 in 1996. General and administrative and other expenses were $1,282 in 1996.

The Company's interest expense was $33 in 1996. Interest expense is primarily associated with credit facilities used by the Company to support its working capital requirements and to finance a portion of its investments in middle market companies. The Company's total borrowings under these facilities were approximately $430 at December 31, 1996. In addition, the Company had a note payable to its President in the amount of $74 at December 31, 1996. During 1996, the Company has paid interest on its debt obligations to unrelated parties at rates ranging from 1.5% above the lender's base rate of interest to 3% above such rate. The rate of interest on the Company's note payable to its President was 4% above the prime rate of interest.

The Company made ESOP contributions of $216 in 1996. These contributions represent an allocation of the preferred stock held by the ESOP to the Company's employees which preferred stock was converted into common stock on a one for one basis on July 28, 1997. As a result, these contributions did not result in a cash outflow from the Company. These contributions were deductible for tax purposes and served to reduce the Company's tax obligations. At December 31, 1996, unearned ESOP shares totaled $117, and the Company's obligation to make further contributions to the ESOP was limited to that amount.

For the year ended December 31, 1996, the Company recorded net increases in unrealized appreciation of investments of $483 as follows:

Year Ended December 31,	1996
Erie Forge and Steel, Inc.	$204
Four S Baking Company, Inc.	(81)
Indiana Steel & Wire Corporation	9
Martino's Bakery, Inc.	156
Mobile Tool International, Inc.	195
Increase in unrealized appreciation of investments	$483

During 1996, the Company was taxed as a C Corporation. Unrealized appreciation (depreciation) of investments does not affect the actual tax paid by the Company. However, under GAAP, the Company provides for income taxes based on its GAAP pretax income, which includes unrealized appreciation (depreciation) of investments. The Company accounted for this difference by recognition of a deferred tax provision of $159 in 1996.

FINANCIAL CONDITION, LIQUIDITY, AND CAPITAL RESOURCES

At December 31, 1998, the Company had $6,149 in cash and cash equivalents and $89,948 in investments in Federal agency securities. In addition, the Company had outstanding debt secured by assets of the Company of $30,000 in borrowings under credit facilities and $85,948 in short term notes payable. During 1998, the Company's primary source of funding was the proceeds received in connection with its IPO. The Company completed investing the proceeds of its IPO during 1998 and began funding its investments with proceeds from a line of credit and short term borrowings.

As of March 31, the Company closed a maximum $100,000 debt funding facility. In connection with the closing, the Company established ACS Funding Trust I (the "Trust"), an affiliated business trust and contributed or sold to the Trust approximately $157,000 in loans. Subject to certain conditions precedent, the Company will be required to contribute related equity warrants to the Trust in the future. The Company will remain servicer of the loans. Simultaneously with the initial contribution, the Trust entered in a loan agreement with First Union Capital Markets Corp., as deal agent, and certain other parties providing for loans in an amount up to 50% of the eligible loan balance subject to certain concentration limits. The loans to the Trust are expected to be funded primarily through a commercial paper conduit. The Company used initial proceeds under this facility to repay existing debt and expects to use future proceeds to continue making investments in the debt and equity securities of middle market companies. In order to manage interest rate risk associated with the floating rate borrowings, the Trust will enter into hedging agreements. The Trust intends to use derivative instruments for non-trading hedging agreements. The Trust intends to use derivative instruments for non-trading and non-speculative purposes only.

As a RIC, the Company is required to distribute annually 90% or more of its net operating income and net realized short-term capital gains to shareholders. While the Company provides shareholders with the option of reinvesting their distributions in the Company, the Company anticipates having to issue debt or equity securities in addition to the above borrowings to expand its investments in middle market companies. The terms of the future debt and equity issuances can not be determined and there can be no assurances that the debt or equity markets will be available to the Company on terms it deems favorable.

PORTFOLIO CREDIT QUALITY

At December 31, 1998 and December 31, 1997, the Company's outstanding loans had estimated fair values of $132,878 and $16,763, respectively. All of the Company's outstanding loans are performing and paying as agreed.

The Company has implemented a system under which it grades all loans on a scale of 1 to 4. This system is intended to reflect the performance of the borrower's business, the collateral coverage of the loans and other factors considered relevant. Under this system, management believes that loans with a grade of 4 involve the least amount of risk in the Company's portfolio. The borrower is performing above expectations and the trends and risk factors are generally favorable. Management believes that loans graded 3 involve an acceptable level of risk that is similar to the risk at the time of origination. The borrower is performing as expected and the risk factors are neutral to favorable. All new loans are initially graded 3.

Loans graded 2 involve a borrower performing below expectations and the loan risk has increased since origination. The borrower may be out of compliance with debt covenants, however, loan payments are not more than 120 days past due. For loans graded 2, the Company's management will increase procedures to monitor the borrower and will write down the fair value of the loan if it is deemed to be impaired. A loan grade of 1 indicates that the borrower is performing materially below expectations and the loan risk has substantially increased since origination. Some or all of the debt covenants are out of compliance and payments are delinquent. Loans graded 1 are not anticipated to be repaid in full and the Company will reduce the fair market value of the loan to the amount it anticipates will be recovered.

To monitor and manage the investment portfolio risk, management tracks the weighted average portfolio grade. The weighted average portfolio grade was 3.2 and 3.0 at December 31, 1998 and December 31, 1997, respectively. In addition, at December 31, 1998 and December 31, 1997, all of the Company's loans were graded 3 or higher.

IMPACT OF THE YEAR 2000

The "Year 2000 Issue" is the result of computer programs being written using two digits rather than four to define the applicable year. Any of the Company's computer programs or hardware that have date-sensitive software or embedded chips may recognize a date using "00" as the year 1900 rather than the year 2000. This could result in a system failure or miscalculations causing disruption of operations, including, among other things, a temporary inability to process transactions, send invoices, or engage in similar normal business activities. The Company created a Year 2000 Compliance Committee to address the Year 2000 compliance of the Company's information technology and non-information technology systems, the systems of third parties, and the systems of the portfolio companies. The Company has also engaged outside technology consultants to assist with its Year 2000 project.

All of the software used by the Company in its information technology systems is provided by outside vendors. The Company has taken an inventory of all of its information technology systems and is in the process of obtaining Year 2000 compliance designation from the vendors and internally conducting compliance testing. Based on its assessment of its information technology systems, management has identified the general ledger software package as the significant system that is Year 2000 non-compliant. As such, the Company will replace its accounting software with a new, Year 2000 compliant software package. The new accounting software and all necessary modifications to other information technology systems will be completed by August, 1999.

The Company is also evaluating the Year 2000 compliance of its non-information technology systems, consisting of office equipment other than computers and communications equipment. The Company has contacted the office equipment vendors to obtain Year 2000 compliance designation. The Company believes it will complete the remediation, testing and implementation of these non-information technology systems by July, 1999.

The Company has contacted third parties that do not share information systems with the Company ("external agents"). These third parties include the Company's banks, landlords, utility companies, telecommunication providers and other vendors. To date, the Company is not aware of any external agent Year 2000 issue that would materially impact the Company's results of operations, liquidity, or capital resources. However, the Company has no means of ensuring that external agents will be Year 2000 ready. The inability of external agents to complete their Year 2000 resolution process in a timely fashion could materially impact the Company. The effect of non-compliance by external agents is not determinable.

The Company is also evaluating the Year 2000 readiness of its portfolio companies. Beginning in the summer of 1998, the Company has required that each portfolio company expressly warrant in its loan agreement that it is or will be Year 2000 compliant prior to December 31, 1999. The Company has also submitted questionnaires to all of its portfolio companies to determine their exposure to the Year 2000 problem and the adequacy of their plans to address the issues. Over 90% of the portfolio companies have responded to the questionnaire. Based on the correspondence received from the portfolio companies, management believes that over two-thirds of its portfolio companies have either no material exposure to the Year 2000 issue or are adequately carrying out their plans to address their exposure. The Company has either not received complete questionnaires from the remaining one third of the portfolio companies or has requested that the portfolio companies improve the scope and detail of their responses. The Company intends to follow up with the portfolio companies to ensure that they have executed their compliance plan by June 30, 1999.

Throughout 1999, the Company will continue to address any issues of Year 2000 non-compliance and further develop its contingency plan to ensure business operations in the event of systems failure in the Year 2000. The Company is utilizing both internal and external resources to reprogram or replace, test, and implement the software and other systems for Year 2000 modifications. The Company estimates that the cost of its Year 2000 project will be less than $125. This amount includes the cost of additional software, reviewing the portfolio companies' readiness, and outside systems professionals working on the Company's Year 2000 compliance.

The Company's plans to complete the Year 2000 modifications are based on management's best estimates, which were derived utilizing numerous assumptions of future events including the continued availability of certain resources, estimates on the status of completion and the total expected costs. However, there can be no guarantee that these estimates will be achieved and actual results could differ materially from those plans. Specific issues that might cause such material differences include, but are not limited to, the availability and cost of personnel trained in this area, the ability to locate and correct all relevant computer codes, and similar uncertainties. Significant systems failures at the Company, a third party, or the portfolio companies could have a materially adverse effect on the Company's business. While the Company believes that its portfolio companies are adequately addressing the Year 2000 issue, no assurance can be given that some of its portfolio companies will not suffer material adverse effects from Year 2000 issues. Management believes that the most likely worst case Year 2000 scenario is a material decrease in interest income and an impairment in the valuation of the Companies investment portfolio. The magnitude of these material adverse effects on the portfolio companies and the operating results and financial of the Company cannot be determined at this time.

IMPACT OF INFLATION

Management believes that inflation can influence the value of the Company's investments through the impact it may have on the capital markets, the valuations of business enterprises and the relationship of the valuations to underlying earnings.

RECENT DEVELOPMENTS

As of March 29, 1999, Four S Baking Company ("Four S") participated in a cash-out merger transaction, pursuant to which all of the Company's and ACS Partners L.P.'s notes and loans to Four S were repaid in full, the preferred stock of Four S held by the Company and the ACS Partners L.P.'s was converted into cash at its liquidation preference, and all of the common stock held by the Company, ACS Partners L.P. and CIC was converted into a right to receive cash, a portion of which is subject to an escrow. It is expected that ACS Partners L.P. will be liquidated shortly.

As of March 31, 1999, the Company closed a maximum $100,000 debt funding facility. In connection with the closing, the Company established ACS Funding Trust I (the "Trust"), an affiliated business trust and contributed or sold to the Trust approximately $157,000 in loans. Subject to certain conditions precedent, the Company will remain servicer of the loans. Simultaneously with the initial contribution, the Trust entered into a loan agreement with First Union Capital Markets Corp., as deal agent, and certain other parties providing for loans in an amount up to 50% of the eligible loan balance subject to certain concentration limits. The term of the facility is two years and interest on borrowings will be charged at LIBOR plus 2.50%. The full amount of principal is due at the end of the term and interest is payable monthly.

BALANCE SHEETS

(In thousands except per share data)

December 31,	**1998**	1997
Assets		
Investments at fair value (cost of $252,718 and $133,274, respectively)	**$254,983**	$133,415
Cash and cash equivalents	**6,149**	8,862
Investment in unconsolidated operating subsidiary	**6,386**	6,869
Due from unconsolidated operating subsidiary	**778**	861
Interest receivable	**1,561**	644
Other	**162**	54
Total assets	**$270,019**	$150,705
Liabilities and shareholders' equity		
Accounts payable and accrued liabilities	**$ 126**	$ 53
Accrued dividends payable	**1,222**	—
Notes payable	**85,948**	—
Revolving credit facility	**30,000**	—
Total liabilities	**117,296**	53
Shareholders' equity:		
Undesignated preferred stock, $0.01 par value, 5,000 shares authorized, 0 issued and outstanding	**—**	—
Common stock, $.01 par value, 20,000 shares authorized, and 11,081 and 11,069 issued and outstanding, respectively	**111**	111
Capital in excess of par value	**145,245**	144,940
Note receivable from sale of common stock	**(300)**	—
Distributions in excess of net realized earnings	**(116)**	(55)
Unrealized appreciation of investments	**7,783**	5,656
Total shareholders' equity	**152,723**	150,652
Total liabilities and shareholders' equity	**$270,019**	$150,705

See accompanying notes.

(In thousands except per share data)

December 31, 1998	Industry	Cost	Fair Value
Senior Debt—9.47%			
Four S Baking Company	Baking	$ 1,266	$ 1,266
BIW Connector Systems, LLC	Manufacturing	3,404	3,404
Chance Coach, Inc.	Bus Manufacturer	1,286	1,286
JAG Industries, Inc.	Manufacturing	1,200	1,200
Wilderness Systems, Inc.	Canoes & Kayaks	9,675	9,675
Cycle Gear, Inc.	Motorcycle Accessories	750	750
Euro-Caribe, Inc.	Meat Processing	7,181	7,181
Subtotal		24,762	24,762
Subordinated Debt—41.37%			
Four S Baking Company	Baking	1,588	1,588
BIW Connector Systems, LLC	Manufacturing	6,710	6,710
Westwinds Group Holdings, Inc.	Restaurant	2,932	2,932
JAG Industries, Inc.	Manufacturing	2,335	2,335
Specialty Transportation Services, Inc.	Waste Hauler	7,368	7,368
Chance Coach, Inc.	Bus Manufacturer	7,060	7,060
The L.A. Studios, Inc.	Audio Production	2,393	2,393
Decorative Surfaces International, Inc.	Decorative Paper & Vinyl Mfg.	10,490	10,490
New Piper Aircraft, Inc.	Aircraft Manufacturing	17,858	17,858
Electrolux, LLC	Vacuum Cleaner	7,264	7,264
Cycle Gear, Inc.	Motorcycle Accessories	633	633
Wilderness Systems, Inc.	Canoes & Kayaks	4,701	4,701
Euro-Caribe, Inc.	Meat Processing	8,905	8,905
ConStar International, Inc.	Electrical	12,839	12,839
Centennial Broadcasting, Inc.	Radio Stations	15,040	15,040
Subtotal		108,116	108,116
Convertible Preferred Stock—2.10%			
Four S Baking Company (2) 15% dividend convertible into 51,390 shares of common stock or 10.89% of Co.	Baking	2,756	2,756
Chance Coach, Inc. (2) 12% dividend convertible into 20% of Co.	Bus Manufacturer	2,000	2,079
Decorative Surfaces International, Inc. (2) prime rate plus 4% dividend convertible into 2.9% of Co.	Decorative Paper & Vinyl Mfg.	646	646
Subtotal		5,402	5,481
Common Stock Warrants(1)—8.52%			
Four S Baking Company (2) 3.26% of Co.	Baking	462	600
BIW Connector Systems, LLC 8% of LLC	Manufacturing	652	540
Westwinds Group Holdings, Inc. 5% of Co.	Restaurant	350	421
JAG Industries, Inc. (2) 75% of Co.	Manufacturing	505	465
Specialty Transportation Services, Inc. 9.1% of Co.	Waste Hauler	694	784
Chance Coach, Inc. (2) 43.7% of Co.	Bus Manufacturer	4,041	4,543
The L.A. Studios, lnc. 17% of Co.	Audio Production	902	857
Decorative Surfaces International, Inc. (2) 42.3% of Co.	Decorative Paper & Vinyl Mfg.	4,571	5,596
New Piper Aircraft, Inc. 4% of Co.	Aircraft Manufacturing	2,231	2,231
Electrolux, LLC 2.5% of Co.	Vacuum Cleaner	246	246
Cycle Gear, Inc. 16.5% of Co.	Motorcycle Accessories	374	374
Wilderness Systems, Inc. 18% of Co.	Canoes & Kayaks	1,319	1,319
Euro-Caribe, Inc. (2) 37% of Co.	Meat Processing	1,110	1,110
ConStar International, Inc. 17.5% of Co.	Electrical	3,171	3,171
Subtotal		20,628	22,257
Common Stock(1)—1.69%			
Four S Baking Company (2) 5.5% of Co.	Baking	966	1,004
Specialty Transportation Services, Inc. 9.1% of Co.	Waste Hauler	500	784
Chance Coach, Inc. (2) 18.3% of Co.	Bus Manufacturer	1,896	2,131
ConStar International, Inc. 2.8%	Electrical	500	500
Subtotal		3,862	4,419
Subtotal—non-publicly traded securities—63.15%		162,770	165,035
Government Securities—34.41%			
FHLB Discount Note due l/4/99		89,948	89,948
Total Investments		252,718	254,983
Investment in Unconsolidated Operating Subsidiary—2.44%			
ACS Capital Investments Corporation(1)(2)—100% of Co.	Investment Banking	403	6,386
Totals		$253,121	$261,369

(1) Non-income producing

(2) Affiliate

See accompanying notes.

SCHEDULE OF INVESTMENTS

(In thousands except per share data)

December 31, 1997	Industry	Cost	Fair Value
Senior Debt—4.07%			
Four S Baking Company	Baking	$ 1,825	$ 1,825
BIW Connector Systems, LLC	Manufacturing	3,890	3,890
Subtotal		5,715	5,715
Subordinated Debt—7.88%			
Four S Baking Company	Baking	1,492	1,492
BIW Connector Systems, LLC	Manufacturing	6,350	6,350
Westwinds Group Holdings, Inc.	Restaurant	3,206	3,206
Subtotal		11,048	11,048
Convertible Preferred Stock(2)—1.64%			
Four S Baking Company 15% dividend convertible into 51,390 shares of common stock or 10.89% of Co.	Baking	2,303	2,303
Common Stock Warrants(1)(2)—1.13%			
Four S Baking Company 3.26% of Co.	Baking	461	577
BIW Connector Systems, LLC 8% of LLC	Manufacturing	652	652
Westwinds Group Holdings, Inc. 5% of Co.	Restaurant	350	350
Subtotal		1,463	1,579
Subtotal—non-publicly traded securities—14.72%		20,529	20,645
Government Securities—80.38%			
FHLB Discount Note due 2/4/98		20,969	20,981
FHLB Discount Note due 3/6/98		10,893	10,898
FHLB Discount Note due 4/1/98		9,865	9,868
FNMA Discount Note due 4/24/98		6,877	6,883
FFCB 5.90% due 6/2/98		20,017	20,016
FHLB Discount Note due 6/8/98		14,646	14,644
FHLB Discount Note due 8/20/98		14,483	14,480
FNMA 5.71% due 9/9/98		14,995	15,000
Subtotal		112,745	112,770
Total Investments		133,274	133,415
Investment in Unconsolidated Operating Subsidiary—4.90%			
ACS Capital Investments Corporation(1)(2)—100% of Co.	Investment Banking	403	6,869
Totals		$133,677	$140,284

(1) Non-income producing
(2) Affiliate

See accompanying notes.

STATEMENTS OF OPERATIONS

(In thousands except per share data)

		Year Ended December 31, 1998	Three Months Ended December 31, 1997	Nine Months Ended September 30, 1997	Year Ended December 31, 1996
Operating income:					
Financial advisory fees		$ —	$ —	$1,122	$1,738
Financial performance fees		—	—	798	649
Interest and dividend income		14,430	2,123	553	—
Loan processing fees		2,549	654	—	—
Other		—	20	428	359
Total operating income		16,979	2,797	2,901	2,746
Operating expenses:					
Salaries and benefits		843	243	1,221	1,283
General, administrative and other		809	308	1,514	1,282
Provision for (reversal of) doubtful accounts		—	—	(177)	224
Interest		57	—	60	33
Depreciation and amortization		—	—	33	39
Total operating expenses		1,709	551	2,651	2,861
Operating income (loss) before equity in earnings of unconsolidated operating subsidiary		15,270	2,246	250	(115)
Equity in (loss) earnings of unconsolidated operating subsidiary		(482)	24	—	—
Net operating income (loss)		14,788	2,270	250	(115)
Increase in unrealized appreciation of investments		2,127	167	5,321	483
Income before income taxes		16,915	2,437	5,571	368
Provision for income taxes		—	—	2,128	159
Net increase in shareholders' equity resulting from operations		$16,915	$ 2,437	$3,443	$ 209
Net operating income per share	Basic	$ 1.34	$ 0.21		
	Diluted	$ 1.29	$ 0.20		
Net increase in shareholders' equity resulting from operations per share	Basic	$ 1.53	$ 0.22		
	Diluted	$ 1.48	$ 0.21		
Weighted average shares of common stock outstanding	Basic	11,068	11,069		
	Diluted	11,424	11,405		

See accompanying notes.

STATEMENTS OF SHAREHOLDERS' EQUITY

(In thousands except per share data)

	Preferred Stock	Unearned ESOP Shares	Shares	Amount	Capital in Excess of Par Value	Retained Earnings	Note Receivable From Sale of Common Stock	Undistributed Net Realized Earnings	Unrealized Appreciation of Investments	Total Shareholders' Equity
Balance at December 31, 1995	$ 1,419	$(333)	480	$ 5	$ 10	$ 1,845	—	—	—	$ 2,946
Net increase in shareholders' equity resulting from operations	—	—	—	—	—	209	—	—	—	209
Options exercised	—	—	1	—	1	—	—	—	—	1
ESOP shares earned	—	216	—	—	—	—	—	—	—	216
Balance at December 31, 1996	$ 1,419	$(117)	481	$ 5	$ 11	$ 2,054	—	—	—	$ 3,372
Net increase in shareholders' equity resulting from operations	—	—	—	—	—	3,443	—	—	—	3,443
Contribution of common stock to ESOP	—	—	1	—	8	(8)	—	—	—	—
Conversion of preferred stock to common stock	(1,419)	—	205	2	1,417	—	—	—	—	—
Issuance of common stock	—	—	10,382	104	143,504	—	—	—	—	143,608
ESOP shares earned	—	117	—	—	—		—	—	—	117
Balance at September 30, 1997	$ —	$ —	11,069	$111	$144,940	$ 5,489	$ —	$ —	$ —	$150,540
Effect of reorganization as a RIC	—	—	—	—	—	(5,489)	—	—	5,489	—
Net increase in shareholders' equity resulting from operations	—	—	—	—	—	—	—	2,269	167	2,436
Distributions	—	—	—	—	—	—	—	(2,324)	—	(2,324)
Balance at December 31, 1997	$ —	$ —	11,069	$111	$144,940	$ —	$ —	$ (55)	$5,656	$150,652
Issuance of common stock under the 1997 Stock Option Plan	—	—	28	—	396	—	—	—	—	396
Issue of common stock under the the Dividend Reinvestment	—	—	7	—	128	—	—	—	—	128
Repurchase of outstanding shares	—	—	(23)	—	(219)	—	—	—	—	(219)
Issuance of note receivable from sale of common stock	—	—	—	—	—	—	(300)	—	—	(300)
Net increase in shareholders' equity resulting from operations	—	—	—	—	—	—	—	14,788	2,127	16,915
Distributions	—	—	—	—	—	—	—	(14,849)	—	(14,849)
Balance at December 31, 1998	$ —	$ —	11,081	$111	$145,245	$ —	$(300)	$ (116)	$7,783	$152,723

See accompanying notes.

STATEMENTS OF CASH FLOWS

(In thousands except per share data)

	Year Ended December 31, 1998	Three Months Ended December 31, 1997	Nine Months Ended September 30, 1997	Year Ended December 31, 1996
Operating activities				
Net increase in shareholders' equity resulting from operations	$ 16,915	$ 2,437	$ 3,443	$ 209
Adjustments to reconcile net increase in shareholders' equity resulting from operations to net cash provided by (used in) operating activities:				
Depreciation and amortization	—	—	33	38
Unrealized appreciation of investments	(2,127)	(167)	(5,321)	(483)
Net amortization of securities	(1,336)	(1,234)	(337)	—
Amortization of loan discounts	(913)	—	—	—
Amortization of deferred finance costs	—	—	3	11
Provision for deferred income taxes	—	—	2,102	121
Contribution of stock to ESOP	—	—	117	216
Increase in interest receivable	(917)	(207)	(122)	—
Provision for doubtful accounts	—	—	(177)	224
Increase in accrued payment-in-kind dividend and interest	(478)	—	—	—
Decrease (increase) in due from unconsolidated subsidiary	83	(526)	—	—
Decrease (increase) in accounts receivable	—	—	486	(865)
Decrease in income taxes receivable	—	—	24	101
(Increase) decrease in other assets	(71)	62	(113)	6
Increase (decrease) in accounts payable and accrued liabilities	73	(328)	128	228
Loss (earnings) of unconsolidated operating subsidiary	482	(24)	—	—
Net cash provided by (used in) operating activities	11,711	13	266	(194)
Investing activities				
Proceeds from sale or maturity of investments	231,580	35,000	60	—
Principal repayments	1,719	93	—	—
Purchase of investments	(142,865)	(20,622)	(483)	(75)
Purchase of securities	(207,146)	(16,593)	(129,896)	—
Purchases of property and equipment, net of disposals	—	—	(29)	(39)
Net cash used in investing activities	(116,712)	(2,122)	(130,348)	(114)
Financing activities				
Proceeds from short term notes payable, net	85,948	—	(430)	269
Drawings on revolving credit facilities, net	30,000	—	—	—
Increase in deferred financing costs	(37)	—	—	(4)
(Decrease) increase in due to related parties, net	—	—	(78)	6
Repurchase of common stock	(219)	—	—	—
Issuance of common stock	224	—	143,608	—
Options exercised	—	—	—	1
Distributions paid	(13,628)	(2,325)	—	—
Net cash provided by (used in) financing activities	102,288	(2,325)	143,100	272
Net (decrease) increase in cash and cash equivalents	(2,713)	(4,434)	13,018	(36)
Cash and cash equivalents at beginning of period	8,862	13,296	323	359
Cash and cash equivalents at end of period	$ 6,149	$ 8,862	$ 13,341	$ 323
Non-cash financing activities:				
Note receivable issued in sale of common stock	$ 300	$ —	$ —	$ —

See accompanying notes.

(In thousands except per share data)

NOTE 1. ORGANIZATION

American Capital Strategies, Ltd., a Delaware corporation (the "Company"), was incorporated in 1986 to provide financial advisory services to and invest in middle market companies. On August 29, 1997, the Company completed an initial public offering ("IPO") of 10,382 shares of common stock ("Common Stock"), and became a non-diversified closed end investment company that has elected to be treated as a business development company ("BDC") under the Investment Company Act of 1940, as amended ("1940 Act"). On October 1, 1997, the Company began operations so as to qualify to be taxed as a regulated investment company ("RIC") as defined in Subtitle A, Chapter 1, under Subchapter M of the Internal Revenue Code of 1986 as amended (the "Code"). As contemplated by these transactions, the Company materially changed its business plan and format from structuring and arranging financing for buyout transactions on a fee for services basis to primarily being a lender to and investor in middle market companies. As a result of the changes, the Company is operating as a holding company whose predominant source of operating income has changed from financial performance and advisory fees to interest and dividends earned from investing the Company's assets in debt and equity of businesses. The Company's investment objectives are to achieve current income from the collection of interest and dividends, as well as long-term growth in its shareholders' equity through appreciation in value of the Company's equity interests. The Company continues to provide financial advisory services to businesses through ACS Capital Investments Corporation ("CIC"), a wholly-owned subsidiary. The Company is headquartered in Bethesda, Maryland, and has offices in New York, Boston, Pittsburgh, San Francisco, Chicago, and Dallas.

NOTE 2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

The accompanying financial statements have been prepared in accordance with generally accepted accounting principles and for periods commencing with the Company's election to be treated as a RIC, in accordance with Article 6 of Regulation S-X of the Code of Federal Regulations. For the nine months ended September 30, 1997 and the year ended December 31, 1996 the financial statements are prepared on a consolidated basis with the accounts of CIC, the Company's wholly owned subsidiary. All intercompany transactions and balances were eliminated. Effective October 1, 1997, pursuant to RIC accounting requirements, CIC was deconsolidated, and, as a result, for the year ended December 31, 1998 and the three months ended December 31, 1997 the Company accounted for its investment in CIC under the equity method. In connection with this change, the Company contributed the following assets and liabilities to CIC:

Investment in Erie Forge and Steel	$2,736
Other assets	791
Other liabilities	69
Deferred tax liability	3,333

As a result of these changes, the Company's financial statements for periods through September 30, 1997 ("pre-RIC") are not comparable with the financial statements for periods commencing after October 1, 1997 ("post-RIC").

Valuation of Investments

Investments are carried at fair value, as determined by the Board of Directors.

Securities which are publicly traded are valued at the closing bid price on the valuation date.

Debt and equity securities which are not publicly traded are valued at fair value as determined in good faith by the Board of Directors. In making such determination, the Board of Directors will value non-convertible debt securities at cost plus amortized original issue discount, if any, unless adverse factors lead to a determination of a lesser valuation. In valuing convertible debt, equity or other securities, the Board of Directors determines the fair value based on the collateral, the issuer's ability to make payments, the earnings of the issuer, sales to third parties of similar securities, the comparison to publicly traded securities and other pertinent factors. Due to the uncertainty inherent in the valuation process, such estimates of fair value may differ significantly from the values that would have been used had a ready market for the securities existed, and the differences could be material.

Cash and Cash Equivalents

Cash and cash equivalents consist of demand, deposits and highly liquid investments with original maturities of three months or less. Cash and cash equivalents are carried at cost which approximates fair value.

Interest and Dividend Income Recognition

Interest income is recorded on the accrual basis to the extent that such amounts are expected to be collected. Original issue discount is amortized into interest income using the effective interest method. Dividend income is recognized on the ex-dividend date.

Financial Advisory and Performance Fee Recognition

Financial advisory fees represent amounts received for providing advice and analysis to middle market companies and are recognized as earned based on hours incurred. Financial performance fees represent amounts received for structuring, financing, and executing transactions and are generally payable only if the transaction closes and are recognized as earned when the transaction is completed. Financial advisory and performance fees are for services provided by CIC.

Loan Fee and Loan Processing Fee Recognition

The Company records loan fees as income on the closing date of the related loan. Loan processing fees are recorded by the Company's wholly owned subsidiary, CIC, as income on the closing date of the related loan.

Realized Gain or Loss and Unrealized Appreciation or Depreciation on Investments

Realized gain or loss is recorded at the disposition of an investment and is the difference between the net proceeds from the sale and the cost basis of the investment using the specific identification method. Unrealized appreciation or depreciation reflects the difference between the Board of Directors' valuation of the investments and the cost basis of the investments.

Distributions to Shareholders

Distributions to shareholders are recorded on the ex-dividend date.

Federal Income Taxes

The Company operates so as to qualify to be taxed as a RIC under the Internal Revenue Code. Generally, a RIC is entitled to deduct dividends it pays to its shareholders from its income to determine "taxable income." The Company has distributed and currently intends to distribute sufficient dividends to eliminate taxable income. Therefore, the statement of operations contains no provision for income taxes for the year ended December 31, 1998 and the three months ended December 31, 1997.

During the pre-RIC periods, the Company operated under Subchapter C of the Internal Revenue Code and calculated its tax provision pursuant to Statement of Financial Accounting Standards No. 109. Deferred income taxes were determined based on the differences between financial reporting and tax basis of assets and liabilities.

Use of Estimates in Preparation of Financial Statements

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses and disclosure of contingent assets and liabilities. Actual results could differ from those estimates.

Property and Equipment

Property and equipment are carried at cost and are depreciated using the straight-line method over the estimated useful lives of the related assets ranging from five to seven years.

Management Fees

The company is self-managed and therefore does not incur management fees payable to third parties.

Reclassifications

Certain previously reported amounts have been reclassified to conform with the current financial statement presentation.

Recent accounting pronouncements

As of January 1, 1998, the Company adopted Statement of Financial Accounting Standards ("SFAS") No. 130, "Reporting Comprehensive Income" ("SFAS 130"). SFAS 130 established new rules for the reporting and display of comprehensive income and its components; however, the adoption of this statement had no impact on the Company's net increase in shareholders' equity resulting from operations or shareholders' equity.

As of January 1, 1998, the Company adopted SFAS No. 131, "Disclosures about Segments of an Enterprise and Related Information" ("SFAS 131"). SFAS 131 established standards for determining an entity's operating segments and the type and level of financial information to be disclosed in both annual and interim financial statements. It also established standards for related disclosures about products and services, geographic areas and major customers. Accordingly, the Company's reportable segments are its investing operations as a business development company and the financial advisory operations of its wholly-owned subsidiary, CIC (see Note 4).

As of January 1, 1998, the Company adopted SFAS No. 132, "Employers' Disclosures about Pensions and Other Postretirement Benefits - an amendment of FASB Statements No. 87, 88, and 106" ("SFAS 132"). SFAS 132 revises employers' disclosures about pension and other postretirement benefit plans. Adoption of SFAS 132 does not have a material impact on the financial statements of the Company.

In June 1998, the Financial Accounting Standards Board (FASB) issued SFAS No. 133, "Accounting for Derivative Instruments and Hedging Activities" ("SFAS 133"). SFAS 133 establishes accounting and reporting standards for derivative instruments. The statement requires an entity to recognize all derivatives as either assets or liabilities in the statement of financial position and measure those instruments at fair value. This statement is effective for all fiscal quarters of fiscal years beginning after June 15, 1999. Adoption of SFAS 133 is not expected to have a material impact on the Company's financial statements or disclosures.

NOTE 3. INVESTMENTS

Investments consists of securities issued by various agencies of the Federal government valued at $89,948 with maturities of less than one year from the date of purchase and securities issued by privately-held companies valued at $165,035. The securities issued by privately-held companies consist of senior debt, subordinated debt with equity warrants, convertible preferred stock and common stock. The debt securities have effective interest rates ranging from 8.8% to 22.4% and are payable in installments with final maturities from 5 to 10 years and are generally collateralized by assets of the borrower. The Company's investments in equity warrants and common stock are non-income producing. The net unrealized appreciation in investments for Federal income tax purposes is the same as for book purposes and none of the Company's investments are on non-accrual status.

NOTE 4. INVESTMENT IN UNCONSOLIDATED OPERATING SUBSIDIARY

As discussed in Note 2, CIC is an operating subsidiary of the Company and is accounted for under the equity method effective October 1, 1997. The investment in CIC is carried at fair value as determined by the Board of Directors.

Condensed financial information for CIC is as follows:

December 31,	**1998**	1997
Assets		
Investments in portfolio companies, at fair value	**$10,837**	$10,361
Other assets, net	**1,359**	991
Total assets	**$12,196**	$11,352
Liabilities and shareholder's equity		
Deferred income taxes	**$ 2,921**	$ 3,323
Due to parent	**778**	861
Other liabilities	**2,111**	299
Shareholder's equity	**6,386**	6,869
Total liabilities and shareholder's equity	**$12,196**	$11,352

	Year Ended December 31,	Three Months Ended December 31,
	1998	1997
Operating income	**$ 5,227**	$ 532
Operating expense	**6,451**	1,084
Net operating loss	**(1,224)**	(552)
Increase in unrealized appreciation of investments	**481**	605
Other	**261**	(29)
Net (loss) income	**$ (482)**	$ 24

NOTE 5. STOCK OPTION PLAN

The Company applies APB No. 25, "Accounting for Stock Issued to Employees" (APB 25), and related interpretations in accounting for its stock-based compensation plan. In accordance with SFAS 123, "Accounting for Stock-Based Compensation" (SFAS 123), the Company elected to continue to apply the provisions of APB 25 and provide pro forma disclosure of the Company's net operating income and net increase in shareholders' equity resulting from operations calculated as if compensation costs were computed in accordance with SFAS 123. The Company is providing this information for the post-RIC period as discussed in Notes 1 and 2 and from the time the 1997 Stock Option Plan (the 1997 Plan) was established by the Company. The 1997 Plan provides for the granting of options to purchase up to 1,328 shares of common stock at a price of not less than the fair market value of the common stock on the date of grant to employees of the Company. On May 14, 1998, the Company authorized 500 additional shares to be granted under the 1997 Plan. As of December 31, 1998, there are 195 shares available to be granted under the 1997 Plan.

Options granted under the 1997 Plan may be either incentive stock options within the meaning of Section 422 of the Code or nonstatutory stock options. Only employees of the Company and its subsidiaries are eligible to receive incentive stock options under the 1997 Plan; such options generally vest over a three year period. Incentive stock options must have a per share exercise price of no less than the fair market value on the date of the grant. Nonstatutory stock options granted under the 1997 Plan must have a per share exercise price of no less than the fair market value on the date of the grant. Options granted under the 1997 Plan may be exercised for a period of no more than ten years from the date of grant.

	Year Ended December 31,	Three Months Ended December 31,
	1998	1997
Net operating income		
As reported	**$14,788**	$2,270
Pro forma	**$13,609**	$2,030
Net increase in shareholders' equity resulting from operations		
As reported	**$16,915**	$2,437
Pro forma	**$15,737**	$2,197

The effects of applying SFAS 123 for providing pro forma disclosures are not likely to be representative of the effects on reported net operating income and net increase in shareholders' equity resulting from operations for future years.

For options granted during the year ended December 31, 1998, the Company estimated a fair value per option on the date of grant of $4.72 using a Black-Scholes option pricing model and the following assumptions: dividend yield 7.9%, risk free interest rate 5.1%, expected volatility factor .51, and expected lives of the options of 7 years.

For options granted during the three months ended December 31, 1997, the Company estimated a fair value per option on the date of grant of $2.44 using a Black-Scholes option pricing model and the following assumptions; dividend yield 6.5%, risk free interest rate 6.5%, expected volatility factor .25, and expected lives of the options of 7 years.

(In thousands except per share data)

A summary of the status of the Company's stock option plans as of and for the year ended December 31, 1998 and as of and for the three months ended December 31, 1997 is as follows:

	Year Ended December 31,		Three Months Ended December 31,	
	1998		1997	
	Shares	Weighted-Average Exercise Price	Shares	Weighted-Average Exercise Price
Options outstanding, beginning of period	**1,297**	**$15.00**	—	—
Granted	**692**	**$18.42**	1,303	$15.00
Exercised	**(28)**	**$15.00**	—	—
Canceled	**(328)**	**$22.38**	(6)	$15.00
Options outstanding, end of year	**1,633**	**$14.96**	1,297	$15.00
Options exercisable at year end	**1,633**		1,297	

The following table summarizes information about stock options outstanding at December 31, 1998:

	Options Outstanding			Options Exercisable	
	Number Outstanding at December 31, 1998	Weighted-Average Remaining Contractual Life	Weighted-Average Exercise Price	Number Exercisable at December 31, 1998	Weighted-Average Exercisable Price
Less than $14.01	**62**	**9.7 years**	**$14.00**	**62**	**$14.00**
$14.01 to $15.00	**1,571**	**8.9 years**	**$15.00**	**1,571**	**$15.00**
$14.00 to $15.00	**1,633**	**8.9 years**	**$14.96**	**1,633**	**$14.96**

In 1998, the Company issued 20 shares of common stock to an officer of the Company in exchange for a note receivable in the amount of $300. The transaction was executed pursuant to the 1997 Stock Option Plan, which allows the Company to lend to its employees funds to pay for the exercise of stock options. All loans made under this arrangement are fully secured by the value of the common stock purchased. Interest is charged and paid on such loans at the Applicable Federal Rate as defined in the Internal Revenue Code.

On November 6, 1997, the Board of Directors authorized the establishment of a stock option plan for the non-employee directors. The plan was approved by shareholders at the annual meeting held on May 14, 1998. The Company is awaiting approval of the plan by the Securities and Exchange Commission (SEC). Pending SEC approval, the Board of Directors has authorized the Company to issue 15 options to each of the six non-employee directors.

NOTE 6. RELATED PARTIES

Pursuant to a commitment entered into prior to the Company's IPO, ACS Partners I, L.P., a Delaware Partnership, was formed in 1997 with a wholly-owned subsidiary of the Company as sole general partner and two principals of the Company as limited partners to allow the principals the opportunity to co-invest in a transaction with the Company. Pursuant to the terms of the partnership agreement of ACS Partners I, L.P. the Company, through its wholly-owned subsidiary, as sole general partner, has all discretion over the purchase, sale, restructuring and disposition of the assets of ACS Partners I, L.P. Upon completion of its IPO, the Company became subject to the 1940 Act and an application was made to the SEC for an exemption from those provisions of the 1940 Act that could be construed to prohibit an investment of the type made by ACS Partners I, L.P. To date, the SEC has not acted on such exemption request. As of December 31, 1998 and December 31, 1997, principals of the Company had invested $260 in ACS Partners I, L.P. for investment commitments issued prior to the Company's IPO.

The Company and CIC have entered into an expense sharing agreement whereby CIC reimburses the Company for expenses paid by the Company on CIC's behalf.

NOTE 7. NOTES PAYABLE

During December, 1998, the Company borrowed $80,948 secured by government agency securities with a fair value of $89,948. The interest rate on the Note was 4.25% and the note was fully repaid on January 4, 1999.

During November, 1998, the Company entered into a credit agreement with two banks under which the Company has the ability to borrow up to $30 million. Interest on borrowings is accrued and paid monthly at the prime rate (7.75% at December 31, 1998). At December 31, 1998, the outstanding balance was $30 million, which is due in October, 2000. The credit facility is secured by the certain investments of the Company.

During December, 1998, the Company borrowed $5 million from a corporation. Interest is accrued and paid monthly at 7.75% and the principal of the note is due on March 31, 1999.

During the year ended December 31, 1998, the nine months ended September 30, 1997 and the year ended December 31, 1996, the cash paid for interest was approximately $56, $88, and $43, respectively. The weighted average interest rates, including amortization of deferred finance costs, for the year ended December 31, 1998, the nine months ended September 30, 1997 and the year ended December 31, 1996 and 1995 were 5.9%, 16.9%, and 17.3%, respectively.

Due to the short term of the borrowings, the fair value of the notes payable approximates cost.

NOTE 8. INCOME TAXES

The Company operates so as to qualify to be taxed as a RIC under the Internal Revenue Code. Generally, a RIC is entitled to deduct dividends it pays to its shareholders from its income to determine taxable income." The Company has distributed and currently intends to distribute sufficient dividends to eliminate taxable income. Therefore, the statement of operations contains no provision for income taxes for the year ended December 31, 1998 and the three months ended December 31, 1997.

During the pre-RIC periods, the Company operated under Subchapter C of the Internal Revenue Code and calculated its tax provision pursuant to Statement of Financial Accounting Standards No. 109. Deferred income taxes were determined based on the differences between financial reporting and tax basis of assets and liabilities.

The components of the income tax provision were as follows:

	Nine Months Ended September 30, 1997	Year Ended December 31, 1996
Current provision	$ 2	$ 39
Deferred provision	2,126	120
	$2,128	$159

The differences between taxes at the Federal statutory tax rate and the effective tax rate were as follows:

	Nine Months Ended September 30, 1997	Year Ended December 31, 1996
Statutory rate	$1,803	$125
State taxes	342	15
Change in valuation Allowance	—	(26)
Other	(17)	45
Effective rate	$2,128	$159

(In thousands except per share data)

During the nine months ended September 30, 1997 and the year ended December 31, 1996, cash paid for income taxes was approximately $2 and $1, respectively.

The aggregate gross and net unrealized appreciation over the cost for Federal income tax purposes was $2,265, $7,414, and $3,399 as of December 31, 1998, December 31, 1997 and 1996, respectively. The aggregate cost of securities for Federal income tax purposes was $252,718, $132,870 and $581, as of December 31, 1998, December 31,1997 and 1996, respectively.

As discussed in Note 1, the Company had been taxed under subchapter C prior to October 1, 1997, when the Company converted to a subchapter M corporation for Federal income tax purposes. As a subchapter M corporation, the Company is entitled to deduct dividends it pays to shareholders from its income to determine taxable income. The Company has distributed and intends to distribute sufficient dividends to eliminate taxable income. As a result, the Company does not have a provision for income taxes for the year ended December 31, 1998 and the three months ended December 31, 1997.

The Company requested a ruling in June 1997 from the IRS seeking to clarify the tax consequences of the conversion from taxation under subchapter C to subchapter M. The Company was seeking to avoid having to incur a tax liability associated with the unrealized appreciation of assets whose fair market value exceeded their basis upon the ruling from the IRS in regards to the treatment of the unrecognized gain. Provided the Company meets all the requirements to be taxed as a RIC, it will be permitted to elect to be subject to rules similar to the rules of Section 1374 of the Internal Revenue Code with respect to any unrealized gain inherent in its assets, upon its conversion to RIC status ("built-in gain"). Generally, this treatment allows the deferring of recognition of the built-in gain. If the Company were to divest itself of any assets in which it had built-in gains prior to the end of a ten year recognition period, the Company would then be subject to the extent of its built-in gain.

NOTE 9. COMMITMENTS AND CONTINGENCIES

The Company has non-cancelable operating leases for office space and office equipment. The leases expire over the next seven years and contain provisions for certain annual rental escalations. Rent expense for operating leases for the year ended December 31, 1998, the three months ended December 31, 1997, the nine months ended September 30, 1997 and the year ended December 31, 1996 was approximately $60, $73, $97, and $101, respectively.

Future minimum lease payments under non-cancelable operating leases at December 31, 1998 were as follows:

1999	$ 240
2000	241
2001	248
2002	236
2003 and thereafter	374
Total	1,339

In addition, at December 31, 1998, the Company had commitments of $7.4 million to three portfolio companies. These commitments are composed of two working capital credit facilities and one acquisition credit facility. The commitments are subject to the borrowers meeting certain criteria. The terms of the borrowings subject to commitment are comparable to the terms of other debt securities in the Company's portfolio.

NOTE 10. EMPLOYEE STOCK OWNERSHIP PLAN

The Company maintains an ESOP, which includes all employees and is fully funded on a pro rata basis by the Company and its wholly owned subsidiary, CIC. Contributions are made at the Company's discretion up to the lesser of $30 or 25% of annual compensation expense for each employee. Employees are not fully vested until completing five years of service. For the year ended December 31, 1998, the Company and CIC contributed $97 to the ESOP, or 3% of total eligible employee compensation.

The Company sponsors an employee stock ownership trust to act as the depository of employer contributions to the ESOP as well as to administer and manage the actual trust assets which are deposited into the ESOP.

NOTE 11. CAPITAL STOCK

In July, 1997, all unearned ESOP shares became earned and were allocated to the ESOP accounts of the Company's employees. Pursuant to the Company's Class A preferred stock declaration, the Class A preferred stock held by the ESOP was converted into common stock on a one share to one share basis. The Company also contributed an additional 529 shares of common stock to the ESOP.

In August 1997, the Company increased its authorized shares of unallocated preferred stock to 5,000 and increased its authorized shares of common stock to 20,000.

On August 27, 1997, the Company declared a stock split effective August 29, 1997, effected in the form of a stock dividend pursuant to which each outstanding share of common stock was effectively converted into 29.859 shares. Outstanding shares and per share amounts for all periods presented have been restated to reflect this stock split.

On August 29, 1997, the Company completed its IPO and sold 10,382 shares of its common stock at a price of $15.00 per share. Pursuant to the terms of the Company's agreement with the underwriter of the offering, the Company issued 443 common stock warrants ("Warrants") to the underwriter. The Warrants have a term of five years from the date of issuance and may be exercised at a price of $15.00 per share.

The Company declared dividends of $14,849, or $1.34 per share for the year ended December 31, 1998; at year end, $1,222 remained accrued and undistributed to shareholders. For the three months ended December 31, 1997, the Company distributed $2,324, or $0.21 per share, to its shareholders. For Federal income tax purposes, the distributions were 100% from ordinary income. In addition, in accordance with regulations governing RIC's, the Company notified shareholders of its intention to periodically repurchase its outstanding common stock. Following release of this notification, the Company repurchased 23 shares of it common stock at a weighted average price of $10.12 per share.

NOTE 12. EARNINGS PER SHARE

The following table sets forth the computation of basic and diluted earnings per share for the year ended December 31, 1998 and the three months ended December 31, 1997. For all other periods, earnings per share is not presented since it is not considered meaningful due to the IPO and reorganization of the Company as a RIC.

	Year Ended December 31, 1998	Three Months Ended December 31, 1997
Numerator for basic and diluted net increase in shareholders' equity resulting from operations	$16,915	$ 2,437
Denominator for basic-weighted average shares	11,068	11,069
Employee stock options	269	251
Warrants	87	85
Dilutive potential shares	356	334
Denominator for diluted	11,424	11,405
Basic earnings per share	$ 1.53	$ 0.22
Diluted earnings per share	$ 1.48	$ 0.21

NOTE 13. SUBSEQUENT EVENTS

During February 1999, the Company obtained a commitment for a $100,000 credit facility. The credit facility is funded by a commercial paper conduit and requires the Company to create ACAS Funding, a bankruptcy remote wholly-owned subsidiary. The Company is required to make a capital contribution of $115,000 consisting of loans and any related equity warrants to ACAS Funding. ACAS Funding will then acquire loans and related equity warrants originated by the Company and may borrow up to 50% of the eligible loan balance subject to certain concentration limits. The term of the facility is two years and interest on borrowings will be charged at LIBOR plus 2.50%. The full amount of principal is due at the end of the term and interest is payable monthly.

BOARD OF DIRECTORS
AMERICAN CAPITAL STRATEGIES, LTD.

We have audited the accompanying balance sheets of American Capital Strategies, Ltd., including the schedules of investments, as of December 31, 1998 and 1997, the related statements of operations, shareholders' equity and cash flows for the year ended December 31, 1998, the three months ended December 31, 1997, the nine months ended September 30, 1997, and the year ended December 31, 1996, and the financial highlights (on page 1) for the year ended December 31, 1998 and the three months ended December 31, 1997. These financial statements and the financial highlights are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material aspects, the financial position of American Capital Strategies, Ltd. at December 31, 1998 and 1997, and the results of its operations and its cash flows for the year ended December 31, 1998, the three months ended December 31, 1997, the nine months ended September 30, 1997, and the year ended December 31, 1996, and the financial highlights for the year ended December 31, 1998 and the three months ended December 31, 1997 in conformity with generally accepted accounting principles.

Ernst + Young LLP

Washington, D.C.
February 2, 1999

CORPORATE INFORMATION

Corporate Officers

MALON WILKUS
President, Chief Executive Officer, Chairman of the Board

DAVID GLADSTONE
Vice Chairman

ADAM BLUMENTHAL
Executive Vice President, Secretary and Director

JOHN ERICKSON
Vice President and Chief Financial Officer

ROLAND CLINE
Vice President

STEPHEN L. HESTER
Vice President and General Counsel

JOHN HOFFMIRE
Vice President, Marketing

Board of Directors

ROBERT L. ALLBRITTON
President, Allbritton Communications

ADAM BLUMENTHAL
Executive Vice President, Secretary and Director American Capital Strategies

DAVID GLADSTONE
Vice Chairman American Capital Strategies

NEIL M. HAHL
President, The Weitling Group

STAN LUNDINE
Of Counsel, Sotir and Goldman

PHILIP R. HARPER
Chairman and Chief Executive Officer, U.S. Investigations Services, Inc.

ALVIN N. PURYEAR
Professor of Management, Baruch College of the City University of New York

STEPHEN P. WALKO
President, Decorative Surfaces International, Inc.

MALON WILKUS
President, Chief Executive Officer, Chairman of the Board American Capital Strategies

Corporate Headquarters

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San Francisco, CA 94111

One Oxford Center
301 Grant Street
Suite 1500
Pittsburgh, PA 15214

105 Kendall Road
Lexington, MA 02421

311 South Wacker Drive
Suite 4550
Chicago, IL 60606

2626 Cole Avenue
Suite 400
Dallas, TX 75204

Stock Exchange Listing

American Capital Strategies common stock trades on the Nasdaq Stock Market under the symbol ACAS. Price information for the common stock appears daily in major newspapers.

Transfer Agent and Registrar

State Street Bank and Trust Company
c/o Boston EquiServe, LP
150 Royall Street
Canton, MA 02021
(781) 575-2393

Financial Publications

Shareholders may receive a copy of the 1998 Form 10-K, annual report and quarterly reports filed with the Securities and Exchange Commission in Washington, D.C., by writing to:

American Capital Strategies
Investor Relations Office
Three Bethesda Metro Center
Suite 860
Bethesda, MD 20814

Dividend Reinvestment and Stock Purchase Plan

The Company offers a dividend reinvestment plan to its shareholders. Shareholders whose shares are held in their name should contact the transfer agent to enroll in the plan. Shareholders whose shares are held by a nominee or in "street name" must contact their broker in order to participate in the plan.

Investor Inquiries

Securities analysts, portfolio managers and others seeking information about the Company's business operations and financial performance are invited to contact the Investor Relations Office at (301) 951-6122.

Auditors

Ernst & Young LLP
Washington, D.C.

Legal Counsel

Arnold & Porter
Washington, D.C.

Price Range of Common Stock & Dividends

The common stock has been quoted on the Nasdaq Stock Market since August 1997. The following table sets forth the range of high and low bid prices on the Nasdaq Stock Market for the applicable periods.

1998	High	Low	Dividends Declared
First Quarter	$22.50	$17.25	$0.25
Second Quarter	$24.63	$21.25	$0.29
Third Quarter	$24.25	$10.13	$0.32
Fourth Quarter	$18.44	$ 9.19	$0.48
1997			
Third Quarter (beginning August 29, 1997)	$20.25	$18.50	—
Fourth Quarter	$20.75	$16.50	$0.21

As of March 16, 1999 , there were 163 shareholders of record of the common stock. Included in this number are shares held by nominees or in "street name" for approximately 4,500 shareholders.

Designed by Curran & Connors, Inc. / www.curran-connors.com

American Capital Strategies

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