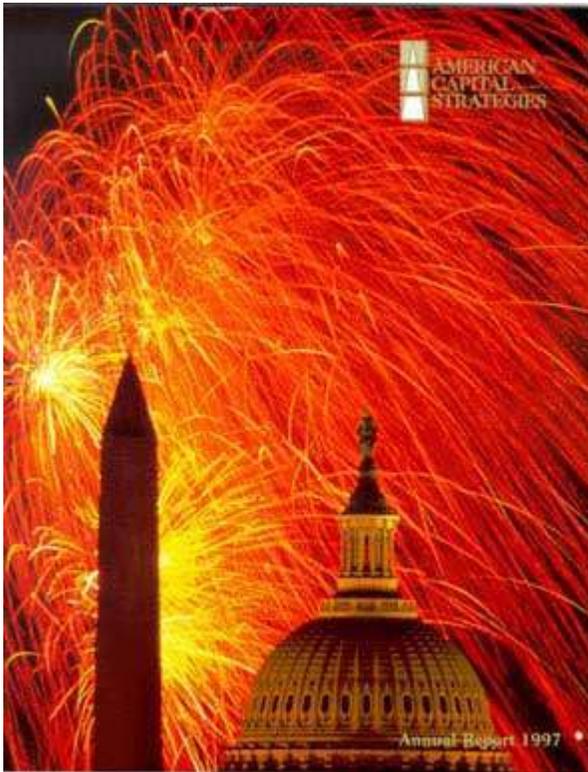


Excerpts from the 1997 Annual Report



DEAR SHAREHOLDERS...

We would to extend our warmest welcome to you as shareholders of American Capital. It has been a momentous year. You have entrusted us with \$150 million of your capital and we want to convey our commitment and responsibility to executing our business plan and rewarding your trust.

We wish each of you could be with us to share the excitement in our organization. It is an excitement bred of seeing long-cherished goals achieved., It is an excitement fed by the strong reception our capital strategies have had from the entrepreneurs, managers and employees who provide the vitality to America's economic heartland. And it is an excitement shared both by the many seasoned professionals who have devoted a decade or more to the development of American Capital, and by the select group of extraordinary people we have had the privilege of hiring since last August.

With the capital you have entrusted to us, American Capital is providing senior debt, subordinated debt and equity to some of the most dynamic small and medium sized businesses in America. In the seven months since our IPO, we have executed our strategy by:

- Reviewing nearly \$1 billion of financing opportunities,
- Investing and committing just under \$70 million in senior debt, subordinated debt and equity to nine outstanding companies, including:
 - Funding \$1,8 million for three add-on acquisitions,
 - Capitalizing three buyouts totaling \$32 million, and



David Gladstone
*Chairman of the
Board*

- Committing \$15 million to and raising additional financing for a major employee buyout.



Over the past thirteen years, American Capital has arranged funding for more than \$400 million of transactions, while becoming a national leader in structuring and funding employee and management buyouts. Over that time, we became acutely aware of a tremendous gap in the financial markets for sophisticated, flexible, long-term capital for the small and medium businesses who give the American economy its vibrancy and resilience.

We worked intimately with managers and employees who were tough, determined creative and tested. Often they were in industries that were out of favor--manufacturers in the so-called rust belt or in our large inner cities, or which had a unionized workforce. Sometimes they were corporate stepchildren, declared "noncore" for the grand corporate strategy du jour, but with a core of managers and employees who knew they could be dynamic independent businesses. Other situations were a solid and ambitious small fry seeking to eat a larger fish. Always, they were under the radar screen of the great liquidity and capital machine we refer to as "Wall Street."

For twelve years we solved financial problems for such companies. We invested in them and presented them to conventional capital markets. After financing them, we often became their partners, served on their boards, and saw them thrive. We became intimate with a gap in the capital markets so dramatic that it cried out to be filled. Our companies were dynamic. Their capital sources were moribund and often failed to provide adequate financing to fuel their growth. Regulations and industry consolidation make it uneconomical for banks to meet their needs. Pension funds and insurance companies are generally not sources of capital for this market due to the sophisticated structuring and uniqueness of each transaction coupled with an average funding requirement which is smaller than their appetite.

Venture capital firms are frequently established as finite-life organizations requiring quick exit strategies that do not mesh with the long-term plans of these businesses. Private equity funds tend to have an appetite for one specific tier of financing and cannot meet all of the needs of a small and medium sized business. Everywhere we turned, we saw structural problems and gaps in the availability of financing.

Our capital strategies fill the gaps and serve the needs of these dynamic companies. We approach our transactions with the mindset of a principal and underwrite it with a rigor unmatched in the industry because we believe in making strategic investments rather than simply churning capital. The companies we invest in work directly with our principals, who are talented individuals with exceptional achievements in finance and investment banking. As a result of this detailed diligence, we are willing to place long-term, patient capital, to take mezzanine or equity risks for appropriate returns, or to act quickly to finance an entire transaction--senior, subdebt, and equity--where speed and certainty are critical to closing.

Because of our ability to fill the gaps and our expertise in structuring transactions, many existing

financial institutions and financial advisors see us as partners. Commercial banks, venture capital firms and private equity funds come to us for capital, advice and expertise. Our organization is excited because the business plan that we talked to you about at the time of the IPO is being executed and well received. We now have seven months experience as a public company and are very pleased with our performance. We have quickly and very judiciously invested \$55 million and are working to finalize a \$15 million investment in the near future. Additionally, the pipeline of new investment opportunities continues to fill and we are confident in our ability to deliver outstanding results.

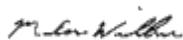
We have expanded our Bethesda, New York City and San Francisco offices and are planning to open additional offices and staff them with highly dedicated and experienced principals and associates. We strongly believe that the success of our business starts with our people and that we offer an exciting opportunity for everyone at American Capital.

In closing, we would like to thank all of the employee owners of American Capital whose energy and efforts have made this fine organization, our outstanding board of directors for their advice and counsel, and of course we want to thank you, our shareholders, for the support and confidence you have in us.

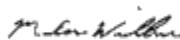
Sincerely,



David Gladstone
Chairman of the Board



Malon Wilkus
President



Adam Blumenthal
Executive Vice President

STATEMENTS OF OPERATIONS

	Three Months Ended December 31, 1997	Nine Months Ended September 30, 1997	Year Ended	
			December 31, 1996	December 31, 1995
Operating Income	(Note 2)			
Financial advisory fees	--	\$1,122,357	\$1,738,295	1,148,752
Financial performance fees		797,600	649,030	1,288,797
Interest income	\$2,122,876	553,267	--	--
Loan processing fees	653,568	--	--	--
Other	20,223	427,577	359,097	268,083
Total operating income	2,796,667	2,900,801	2,746,422	2,705,632
Operating Expenses				
Salaries and benefits	243,142	1,220,907	1,283,198	1,701,660
General, administrative and other	307,919	1,514,122	1,282,195	851,314

Provision for (reversal of) doubtful accounts	--	(177,198)	224,329	302,283
Interest		60,034	32,959	37,037
Depreciation and amortization	--	33,164	39,016	35,415
Total operating expenses	551,061	2,651,029	2,861,697	2,927,709
Operating income (loss) before equity in earnings of unconsolidated operating subsidiary	2,245,606	249,772	(115,275)	(222,077)
Equity in earnings of unconsolidated operating subsidiary	24,213			
Net operating income (loss)	2,269,819	249,772	(115,275)	(222,077)
Realized gain on investments	--	--	--	66,148
Change in unrealized appreciation of investments	167,573	5,321,421	483,665	370,696
Income before income taxes	2,437,392	5,571,193	368,390	214,767
Provision for income taxes	--	2,128,610	159,251	57,381
Net increase in shareholders equity resulting from operations	\$2,437,392	\$3,442,583	\$209,139	\$157,386
Net operating income per share:				
Basic	\$0.21			
Diluted	\$0.20			
Net increase in shareholders' equity resulting from operations per share:				
Basic	\$0.22			
Diluted	\$0.21			
Weighted average shares of common stock outstanding:				
Basic	11,068,767			
Diluted	11,405,385			

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 years ended December 31, 1996 and 1995, the financial statements are prepared on a consolidated basis with the accounts of the 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 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 Eric Forge and Steel	\$2,736,418
Other assets	791,228
Other liabilities	68,996
Deferred tax liability	3,332,771

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

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 small and medium sized businesses 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. For post-RIC periods, financial advisory and performance fees are for services provided by CIC.

Loan Processing Fee Recognition

Loan processing fees are recorded 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. 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 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 is carried at cost and is 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

In February 1997, the Financial Accounting Standards Board issued Statement No. 128, "Earnings Per Share," (SFAS 128). The Company adopted SFAS 128 for the three months ended December 31, 1997. The Company has not restated the earnings per share for prior periods since it is not meaningful due to the significant change in the Company's capital structure as a result of the IPO, and its change in operating activities to a RIC on October 1, 1997.

In June 1997, Statement of Financial Accounting Standards No. 130, "Reporting Comprehensive Income" (SFAS 130) was issued and is effective for fiscal years beginning after December 15, 1997. SFAS 130 establishes standards for the reporting and display of comprehensive income and its components (revenues, expenses, gains, losses) in a full set of general purpose financial statements. SFAS 130 requires the disclosure of an amount that represents total comprehensive income and the components of comprehensive income in a financial statement. The adoption of SFAS 130 is not expected to have a material impact on the financial statements of the Company.

In June 1997, Statement of Financial Accounting Standards No. 131, "Disclosures about Segments of an Enterprise and Related Information" (SFAS 131) was issued and is effective for fiscal years beginning after December 15, 1997. SFAS 131 establishes 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 establishes standards for related disclosures about products and services, geographic areas and major customers. The adoption of SFAS 131 is not expected to have a material impact on the financial statements of the Company.

FINANCIAL HIGHLIGHTS

	Three Months Ended December 31, 1997
<hr/>	
Per Share Data ⁽¹⁾	
Net asset value at beginning of the period	\$13.60
Net operating income	0.21
Net realized and unrealized gains on investments	0.01
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Net increase in shareholders' equity from operations	0.22
Distribution of net investment income	0.21
<hr/>	
Net asset value at end of period	\$13.61
Per share market value at end of period	\$18.125
Shares outstanding at end of period	11,068,767
Ratio/Supplemental Data	

Net assets at end of period	\$150,651,900
Ratio of operating expenses to average net assets ⁽²⁾	1.46%
Ratio of net operating income to net assets ⁽²⁾	6.03%

(1) Basic per share data

(2) Amounts were annualized since the results are for a three-month period.

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