

ALLIED CAPITAL CORP

Form N-2/A

June 05, 2003

As filed with the Securities and Exchange Commission on June 5, 2003

Registration No. 333-104149

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM N-2

REGISTRATION STATEMENT

**UNDER
THE SECURITIES ACT OF 1933**

- Pre-Effective Amendment No. 1**
 Post-Effective Amendment No.

ALLIED CAPITAL CORPORATION

(Exact Name of Registrant as Specified in Charter)

1919 Pennsylvania Avenue, N.W.

**Washington, D.C. 20006-3434
(202) 331-1112**

(Address and Telephone Number, including Area Code, of Principal Executive Offices)

William L. Walton, Chairman and Chief Executive Officer

**Allied Capital Corporation
1919 Pennsylvania Avenue, N.W.
Washington, D.C. 20006-3434**
(Name and Address of Agent for Service)

Copies of information to:

**Steven B. Boehm, Esq.
Cynthia M. Krus, Esq.
Sutherland Asbill & Brennan LLP
1275 Pennsylvania Avenue, N.W.
Washington, D.C. 20004-2415**

Approximate Date of Proposed Public Offering:

From time to time after the effective date of the Registration Statement.

If any securities being registered on this form will be offered on a delayed or continuous basis in reliance on Rule 415 under the Securities Act of 1933, other than securities offered in connection with a dividend reinvestment plan, check the following box. x

The registrant hereby amends this registration statement on such date or dates as may be necessary to delay its effective date until the registrant shall file a further amendment which specifically states that this registration statement shall thereafter become effective in accordance with Section 8(a) of the Securities Act of 1933, as amended, or until this registration statement shall become effective on such date as the Commission, acting pursuant to Section 8(a), may determine.

**PROSPECTUS SUPPLEMENT
(TO PROSPECTUS DATED JUNE , 2003)**

This prospectus supplement supplements the prospectus dated June , 2003 relating to the offer and sale of up to 18,000,000 shares of common stock by providing certain information regarding our first quarter 2003 financial results. You should carefully read this prospectus supplement and the prospectus before investing in our common stock.

You should review the information, including the risk of leverage, set forth under Risk Factors on page 9 of the accompanying prospectus before investing in our common stock.

Neither the Securities and Exchange Commission nor any state securities commission has approved or disapproved of these securities or passed upon the adequacy or accuracy of this prospectus supplement. Any representations to the contrary is a criminal offense.

The information in this prospectus supplement is not complete and may be changed. We may not sell these securities until the registration statement filed with the Securities and Exchange Commission is effective. This prospectus supplement is not an offer to sell these securities and is not soliciting an offer to buy these securities in any state where the offer or sale is not permitted.

[THIS PAGE INTENTIONALLY LEFT BLANK]

You should rely only on the information contained in this prospectus supplement and the accompanying prospectus. We have not, and the underwriter has not, authorized any other person to provide you with different information. If anyone provides you with different or inconsistent information, you should not rely on it. We are not, and the underwriter is not, making an offer to sell these securities in any jurisdiction where the offer or sale is not permitted. You should assume that the information appearing in this prospectus supplement and the accompanying prospectus is accurate only as of their respective dates. Our business, financial condition, results of operations and prospects may have changed since those dates.

TABLE OF CONTENTS

Prospectus Supplement

| | Page Number |
|---|------------------------|
| Interim Management's Discussion and Analysis of Financial Condition and Results of Operations | S-1 |
| Interim Consolidated Financial Statements | S-28 |
| Notice Regarding Independent Public Accountants' Review Report | S-64 |

Prospectus

| | |
|---|-----|
| Prospectus Summary | 1 |
| Fees and Expenses | 5 |
| Selected Condensed Consolidated Financial Data | 6 |
| Where You Can Find Additional Information | 8 |
| Risk Factors | 9 |
| Use of Proceeds | 16 |
| Price Range of Common Stock and Distributions | 17 |
| Management's Discussion and Analysis of Financial Condition and Results of Operations | 18 |
| Senior Securities | 45 |
| Business | 49 |
| Legal Proceedings | 66 |
| Portfolio Companies | 67 |
| Determination of Net Asset Value | 74 |
| Management | 78 |
| Compensation of Executive Officers and Directors | 84 |
| Control Persons and Principal Holders of Securities | 89 |
| Certain Relationships and Related Party Transactions | 91 |
| Tax Status | 92 |
| Certain Government Regulations | 96 |
| Dividend Reinvestment Plan | 100 |
| Description of Capital Stock | 101 |
| Plan of Distribution | 105 |
| Legal Matters | 106 |
| Safekeeping, Transfer and Dividend Paying Agent and Registrar | 106 |
| Brokerage Allocation and Other Practices | 106 |
| Independent Public Accountants | 106 |
| Notice Regarding Arthur Andersen LLP | 107 |
| Index to Consolidated Financial Statements | F-1 |

**INTERIM MANAGEMENT'S DISCUSSION AND ANALYSIS
OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

The following analysis of our financial condition and results of operations should be read in conjunction with our Consolidated Financial Statements and the Notes thereto included herein and in the accompanying prospectus. The information herein contains certain forward-looking statements. These statements include the plans and objectives of management for future operations and financial objectives and can be identified by the use of forward-looking terminology such as may, will, expect, intend, anticipate, estimate, or continue or the negative thereof or variations thereon or comparable terminology. These forward-looking statements are subject to the inherent uncertainties in predicting future results and conditions. Certain factors that could cause actual results and conditions to differ materially from those projected in these forward-looking statements are set forth below in the Risk Factors. Other factors that could cause actual results to differ materially include:

the ongoing global economic downturn;

risks associated with possible disruption in our operations due to terrorism; and

future regulatory actions and conditions in our operating areas.

Financial or other information presented for private finance portfolio companies has been obtained from the portfolio company, and the financial information presented may represent unaudited, projected or pro forma financial information, and therefore may not be indicative of actual results. In addition, the private equity industry uses financial measures such as EBITDA or EBITDAM (Earnings Before Interest, Taxes, Depreciation, Amortization and, in some instances, Management fees) in order to assess a portfolio company's financial performance and to value a portfolio company. EBITDA and EBITDAM are not intended to represent cash flow from operations as defined by accounting principles generally accepted in the United States of America and such information should not be considered as an alternative to net income, cash flow from operations or any other measure of performance prescribed by accounting principles generally accepted in the United States of America.

OVERVIEW

We are a business development company that provides long-term debt and equity investment capital to support the expansion of companies in a variety of industries. Our lending and investment activity is generally focused on private finance and commercial real estate finance, primarily the investment in non-investment grade commercial mortgage-backed securities, which we refer to as CMBS. Our private finance activity principally involves providing financing through privately negotiated long-term debt and equity investment capital. Our private financing is generally used to fund growth, buyouts, acquisitions, recapitalizations, note purchases, and bridge financings. We generally invest in private companies though, from time to time, we may invest in public companies that lack access to public capital or whose securities may not be marginable.

Edgar Filing: ALLIED CAPITAL CORP - Form N-2/A

Our portfolio composition at March 31, 2003, and December 31, 2002, was as follows:

| | 2003 | 2002 |
|--------------------------------|------|------|
| Private Finance | 73% | 70% |
| Commercial Real Estate Finance | 27% | 30% |

Our earnings depend primarily on the level of interest and dividend income, fee income, and net gains or losses earned on our investment portfolio after deducting interest paid on borrowed capital and operating expenses. Interest income results from the stated interest rate earned on a loan and the amortization of loan origination points and discounts. The level of interest income is directly related to the balance of the interest-bearing investment portfolio multiplied by the weighted average yield. Our ability to generate interest income is dependent on economic, regulatory, and competitive factors that influence new investment activity, the amount of loans and debt securities for which interest is not accruing and our ability to secure debt and equity capital for our investment activities.

PORTFOLIO AND INVESTMENT ACTIVITY

Total portfolio investment activity, and yields at and for the three months ended March 31, 2003 and 2002, and at and for the year ended December 31, 2002, were as follows:

| | At and for the Three Months Ended March 31, | | At and for the Year Ended December 31, |
|--|---|-----------|--|
| | 2003 | 2002 | 2002 |
| (\$ in millions) | | | |
| Portfolio at value | \$2,376.9 | \$2,254.1 | \$2,488.2 |
| Investments funded | \$ 269.0 | \$ 80.0 | \$ 506.4 |
| Change in accrued or reinvested interest and dividends | \$ 11.1 | \$ 13.3 | \$ 44.7 |
| Principal repayments | \$ 76.0 | \$ 31.0 | \$ 143.2 |
| Sales | \$ 244.1 | \$ 125.1 | \$ 213.5 |
| Yield ⁽¹⁾ | 14.0% | 14.3% | 14.0% |

- (1) The weighted average yield on interest-bearing investments is computed as the (a) annual stated interest rate earned plus the annual amortization of loan origination fees, original issue discount, and market discount earned on accruing interest-bearing investments, divided by (b) total interest-bearing investments at value. The weighted average yield is computed as of the balance sheet date.

Private Finance

The private finance portfolio, investment activity, and yields at and for the three months ended March 31, 2003 and 2002, and at and for the year ended December 31, 2002, were as follows:

| (\$ in millions) | At and for the Three Months Ended March 31, | | At and for the Year Ended December 31, |
|--|---|------------|--|
| | 2003 | 2002 | 2002 |
| Portfolio at value: | | | |
| Loans and debt securities | \$ 1,148.3 | \$ 1,105.8 | \$ 1,151.2 |
| Equity interests | 593.8 | 499.1 | 592.0 |
| Total portfolio | \$ 1,742.1 | \$ 1,604.9 | \$ 1,743.2 |
| Investments funded | \$ 110.1 | \$ 37.6 | \$ 297.2 |
| Change in accrued or reinvested interest and dividends | \$ 11.3 | \$ 12.1 | \$ 42.6 |
| Principal repayments | \$ 75.1 | \$ 28.8 | \$ 129.3 |
| Yield(1) | 14.0% | 14.3% | 14.4% |

- (1) The weighted average yield on loans and debt securities is computed as the (a) annual stated interest rate earned plus the annual amortization of loan origination fees, original issue discount, and market discount earned on accruing loans and debt securities, divided by (b) total loans and debt securities at value. The weighted average yield is computed as of the balance sheet date.

Investments funded for the three months ended March 31, 2003 and 2002, and for the year ended December 31, 2002, consisted of the following:

| (\$ in millions) | Loans and Debt Securities | Equity Interests | Total |
|---|---------------------------------|---------------------|----------|
| For the Three Months Ended March 31, 2003(1) | | | |
| Companies more than 25% owned | \$ 33.2 | \$ 25.0 | \$ 58.2 |
| Companies 5% to 25% owned | 7.9 | 1.0 | 8.9 |
| Companies less than 5% owned | 41.2 | 1.8 | 43.0 |
| Total | \$ 82.3 | \$ 27.8 | \$ 110.1 |
| For the Three Months Ended March 31, 2002(1) | | | |
| Companies more than 25% owned | \$ 4.8 | \$ 1.1 | \$ 5.9 |
| Companies 5% to 25% owned | | | |
| Companies less than 5% owned | 30.7 | 1.0 | 31.7 |
| Total | \$ 35.5 | \$ 2.1 | \$ 37.6 |

| (\$ in millions) | Loans and Debt Securities | Equity Interests | Total |
|--|---------------------------------|---------------------|-----------------|
| For the Year Ended December 31, 2002(1) | | | |
| Companies more than 25% owned | \$ 86.1 | \$ 18.7 | \$ 104.8 |
| Companies 5% to 25% owned | 22.3 | 0.4 | 22.7 |
| Companies less than 5% owned | 154.6 | 15.1 | 169.7 |
| Total | \$ 263.0 | \$ 34.2 | \$ 297.2 |

(1) The private finance portfolio is presented in three categories – companies more than 25% owned, which represent portfolio companies where we directly or indirectly own more than 25% of the outstanding voting securities of such portfolio company and, therefore, are deemed controlled by us under the Investment Company Act of 1940, or the 1940 Act; companies owned 5% to 25%, which represent portfolio companies where we directly or indirectly own 5% to 25% of the outstanding voting securities of such portfolio company or where we hold one or more seats on the portfolio company’s board of directors and, therefore, are deemed to be an affiliated person under the 1940 Act; and companies less than 5% owned, which represent portfolio companies where we directly or indirectly own less than 5% of the outstanding voting securities of such portfolio company and where we have no other affiliations with such portfolio company.

At March 31, 2003, we had outstanding funding commitments of \$90.8 million to portfolio companies, including \$23.9 million committed to private venture capital funds. At March 31, 2003, we also had total commitments to private finance portfolio companies in the form of standby letters of credit and guarantees of \$78.7 million.

We fund new investments using cash, through the issuance of our common equity, the reinvestment of previously accrued interest and dividends in debt or equity securities, or the current reinvestment of interest and dividend income through the receipt of a debt or equity security (payment-in-kind income). From time to time we may opt to reinvest accrued interest receivable in a new debt or equity security in lieu of receiving such interest in cash and providing a subsequent investment.

We may acquire more than 50% of the common stock of a company in a control buyout transaction. Control investments are generally structured such that we earn a current return through a combination of interest income on our senior loans and subordinated debt, dividends on our preferred and common stock, and management or transaction services fees to compensate us for the managerial assistance that we provide to a controlled portfolio company. In some cases for companies that are more than 50% owned, we may not accrue interest on loans and debt securities if such company is in need of additional working capital. In such cases, we may defer current debt service. Our most significant investments acquired through control buyout transactions at March 31, 2003, were Business Loan Express, LLC (BLX), acquired in 2000, and The Hillman Companies, Inc., acquired in 2001.

Business Loan Express, LLC. At March 31, 2003, our investment in BLX totaled \$266.0 million at cost and \$307.6 million at value, or 11.9% of our total assets, which includes unrealized appreciation of \$41.6 million.

BLX is the nation’s second largest non-bank government guaranteed lender utilizing the SBA’s 7(a) Guaranteed Loan Program and is licensed by the SBA as a Small Business Lending Company (SBLC). BLX is a preferred lender as designated by the SBA, and originates, sells, and services small business loans. In addition to the SBA 7(a) Guaranteed Loan Program, BLX originates conventional small business loans and originates loans under the USDA Business and Industry Guaranteed Loan Program. BLX

Edgar Filing: ALLIED CAPITAL CORP - Form N-2/A

has offices across the United States and is headquartered in New York, New York. Changes in the laws or regulations that govern SBLCs or the SBA 7(a) Guaranteed Loan Program or changes in government funding for this program could have a material impact on BLX or its operations.

During the quarter ended March 31, 2003, BLX completed two significant transactions, the purchase of loans and other assets from Amresco Independence Funding, Inc. (AIF) and the reorganization of BLX from a corporation to a limited liability company or LLC .

In January 2003, BLX completed the acquisition of \$128.0 million of performing loans and other assets from AIF. BLX purchased \$121.5 million of performing SBA 7(a) unguaranteed loans at par and \$6.5 million of other assets. The acquisition increased BLX s serviced portfolio and enhanced its nationwide loan origination platform. BLX believes that the acquisition positions the company to increase its competitiveness in the marketplace, as well as improve the economics of its business over time.

The AIF acquisition increased BLX s serviced portfolio to over \$2.0 billion, represented by over 2,900 small business borrowers. We provided \$50 million of the capital to fund this acquisition. Our \$50 million financing was in the form of a short-term revolving credit facility of \$25 million to fund the temporary capital needs of construction loans purchased and loans pending sale, as well as \$25 million of preferred equity to support the future growth potential of BLX post acquisition.

In February 2003, BLX completed a reorganization from a corporation to a limited liability company in order to simplify its corporate structure and provide certain income tax efficiencies. In connection with the reorganization, BLX s stated book equity increased by \$43 million because we converted \$43 million of our subordinated debt into preferred stock in BLX, Inc., which was exchanged for Class A equity interests in BLX, LLC. In addition, we exchanged our existing preferred stock and common equity investments in BLX, Inc. for similar classes of members equity in BLX, LLC represented by Class B and Class C equity interests, respectively.

Subsequent to the reorganization, BLX s taxable earnings will flow directly to its members and we represent approximately 95% of the economic interests in the LLC. In connection with the reorganization, BLX has changed its fiscal year end to September 30.

Edgar Filing: ALLIED CAPITAL CORP - Form N-2/A

Summary financial data for BLX at and for the nine months ended March 31, 2003, and the fiscal year ended June 30, 2002, is presented below. Data at and for the nine months ended March 31, 2003, includes the impact of the AIF asset purchase since the date of the acquisition as well as the reorganization transaction.

| (\$ in millions) | At and for the Nine Months Ended March 31, 2003(1) | At and for the Year Ended June 30, 2002 |
|---|--|---|
| Operating Data | | |
| Total revenue | \$ 79.5 | \$ 84.6 |
| Net income(4) | \$ 5.3 | \$ 2.3 |
| Earnings before interest, taxes and management fees (EBITM)(4) | \$ 34.4 | \$ 43.0 |
| Balance Sheet Data | | |
| Total assets(2) | \$ 351.4 | \$ 277.1 |
| Total debt | \$ 177.0 | \$ 183.0 |
| Total owners equity | \$ 140.8 | \$ 59.9 |
| Other Data | | |
| Total loan originations | \$ 569.4 | \$ 565.1 |
| Serviced loan portfolio | \$2,062.8 | \$1,372.6 |
| Number of loans | 2,928 | 2,083 |
| Loan delinquencies(3) | 7.8% | 9.4% |
| Serviced Loan Portfolio by Industry | | |
| Hotels | 25% | 27% |
| Gas stations/convenience stores | 18 | 16 |
| Professional and retail services | 12 | 10 |
| Restaurants | 9 | 10 |
| Manufacturing and industrial | 9 | 10 |
| Car wash/auto repair services | 7 | 3 |
| Shrimp/fishing vessels | 5 | 7 |
| Recreation | 5 | 5 |
| Child care and health care services | 5 | 4 |
| Other | 5 | 8 |
| Total | 100% | 100% |

- (1) The results of operations, changes in cash flows, and loan originations for the nine months ended March 31, 2003, are not necessarily indicative of the operating results to be expected for the full year. Post reorganization BLX's fiscal year end changed to September 30.
- (2) Included in total assets is \$6 million of goodwill at March 31, 2003, and June 30, 2002. There is no other goodwill on BLX's balance sheet. We acquired 94.9% of BLC Financial Services, Inc. on December 31, 2000. Push-down accounting was not required with respect to this transaction; accordingly, goodwill was not recorded by BLX.
- (3) Represents the percentage of loans in the total serviced loan portfolio that are greater than 30 days delinquent, which includes loans in workout status. Loans greater than 30 days delinquent for the SBA 7(a) loan portfolio only, which are included in the total serviced loan portfolio, were 7.5% at March 31, 2003. BLX will from time to time grant a 90-day deferment to borrowers experiencing short-term cash flow shortfalls. Loans that have been granted a deferment that perform as required are not considered delinquent consistent with SBA practice. The ability of small businesses to repay their loans may be adversely affected by numerous factors, including a downturn in their industry or negative economic conditions. Small businesses are also more vulnerable to customer preferences, competition, rising fuel prices and market conditions and, as a result, delinquencies in BLX's portfolio may increase. For instance, the shrimp and fishing industry has been affected by rising fuel costs and competition from imported shrimp. For these reasons, BLX focuses on collateral protection for each loan in addition to the cash flow of the small business and receives personal guarantees from the principal owners of the small business.
- (4) BLX incurred certain expenses that reduced net income and EBITM by approximately \$2.3 million for the nine months ended March 31, 2003, associated with the Amresco Independence Funding transaction and its reorganization to an LLC.

For the nine months ended March 31, 2003, BLX earned revenue of \$79.5 million and EBITM of \$34.4 million. EBITM was reduced by \$2.3 million due to costs associated with the AIF acquisition and the LLC reorganization. BLX's revenues consist of cash premiums from guaranteed loan sales, gain on sale income arising from loans sold at par or securitized where BLX will receive future cash flows representing the spread between loan interest and the interest paid on bonds issued including service fee income, interest income on loans remaining in BLX's portfolio, and other income. Gain on sale income is a non-cash source of income when recognized, and as future cash flows are received, the resulting cash reduces the receivable or residual interest that is recognized when the loan is sold. Cash loan sale premiums, cash interest income and cash received from residual interests and other cash income represented approximately 77% of BLX's revenue of \$79.5 million during the nine-months ended March 31, 2003.

BLX's business is to originate small business loans and then sell substantially all of the loans originated for cash proceeds. Loans originated during the nine-months ended March 31, 2003, totaled \$569.4 million, including loans purchased from AIF. Proceeds from loan sales during the nine months ended March 31, 2003, totaled approximately \$541 million. BLX funds the construction of commercial real estate projects, and as a result is unable to sell a construction loan until the loan is fully-funded and the construction is complete. In addition, BLX typically does not immediately receive the proceeds from the sale of its SBA 7(a) guaranteed and unguaranteed loan strips sold, but receives the cash upon settlement. Therefore until BLX sells construction loans or fully funded loans held for sale, it will finance the origination of the loans through funding on its revolving line of credit, or through financing provided by us.

BLX has a three-year \$149.0 million revolving credit facility that matures in March 2004. As the controlling equity owner in BLX, we have provided an unconditional guaranty to the revolving credit facility lenders in an amount of up to 50% of the total obligations (consisting of principal, accrued interest, and other fees) of BLX under the revolving credit facility. The amount guaranteed by us at March 31, 2003, was \$57.2 million. This guaranty can be called by the lenders only in the event of a default by BLX. BLX was in compliance with the terms of the revolving credit facility at March 31, 2003. We have provided two standby letters of credit in connection with two term securitization transactions completed by BLX totaling \$10.6 million.

BLX sells the guaranteed piece of guaranteed loans for cash premiums of up to 10% of the guaranteed loan amount plus a retained annual servicing fee generally between 1.0% and 2.0% of the guaranteed loan amount. Cash premiums received from guaranteed loans sales during the nine months ended March 31, 2003, were approximately \$22 million in total.

Alternatively, BLX may sell the guaranteed pieces of SBA 7(a) guaranteed loans at par and receive cash only for the face amount of the loan sold, and instead of receiving a cash premium, BLX will receive an annual servicing spread on the loans sold of between 4.0% and 4.8%. In addition, BLX will sell the unguaranteed pieces of the SBA 7(a) loans and conventional loans it originates into a conduit facility. The conduit loans are securitized and BLX retains an interest of up to 2.7% of the loan pool. BLX then receives the excess of loan interest payments on the loans sold over the interest cost on the securities issued in the securitization over the life of the loan pool. BLX generally receives between 4.3% and 4.9% annually on the loans sold into the securitization pools. During the nine months ended March 31, 2003, BLX received cash payments from securitization pools of approximately \$31 million.

When BLX sells a guaranteed piece of an SBA 7(a) loan at par, or when BLX securitizes a loan, it will record a residual interest and servicing asset together referred to as Residual Interest in order to account for the retained interest in the loans sold and the net present value of the future cash flows it will receive from the loans sold or securitized. In computing the Residual Interest BLX discounts for the present value of future cash flows, and also makes assumptions as to future loan losses and loan prepayments which may reduce future cash flows.

At March 31, 2003, BLX's Residual Interest totaled \$150.8 million, representing BLX's estimate of the net present value of future cash flows of scheduled loan payments, after estimated future loan losses and loan prepayments. If scheduled loan payments were to be received as stated in the loan agreements with no future losses or prepayments, BLX would receive future cash flows of \$658.8 million over time, with approximately \$46.3 million, \$48.1 million, \$47.0 million, and \$45.7 million (or \$187.1 million in the aggregate) scheduled to be received in the next four years ending on March 31, 2004, 2005, 2006, and 2007, respectively.

The Hillman Companies, Inc. At March 31, 2003, our investment in Hillman totaled \$93.1 million at cost and \$181.3 million at value, or 7.0% of total assets.

Hillman is a leading manufacturer of key making equipment and distributor of key blanks, fasteners, signage, and other small hardware components and operates in multiple channels of the retail marketplace such as hardware stores, national and regional home centers, and mass merchants. Hillman has certain patent-protected products, including key duplication technology, that is important to its business. Hillman's primary operations are located in Cincinnati, Ohio.

For the year ended December 31, 2002, Hillman had total revenue of \$286.8 million, earnings before interest, taxes, depreciation, amortization, and management fees, or EBITDAM, of \$50.2 million, and profits before taxes of \$10.0 million. For the three months ended March 31, 2003, Hillman had total revenue of \$70.0 million and EBITDAM of \$10.2 million. This EBITDAM is before the write-down of \$5.7 million of a note receivable related to an investment made by Hillman. Hillman had a loss before taxes of \$6.5 million, which includes the write-down of the note receivable. The total revenue, EBITDAM, and profits before taxes for the three months ended March 31, 2003, are not necessarily indicative of the operating results to be expected for the full year. Hillman had total assets of \$371.0 million and total debt of \$158.6 million at March 31, 2003.

Commercial Real Estate Finance

The commercial real estate finance portfolio, investment activity, and yields at and for the three months ended March 31, 2003 and 2002, and at and for the year ended December 31, 2002, were as follows:

| (\$ in millions) | At and for the Three Months Ended March 31, | | | | At and for the Year Ended December 31, 2002 | |
|--|--|--------|----------------|--------|--|--------|
| | 2003 | | 2002 | | Value | Yield* |
| | Value | Yield* | Value | Yield* | | |
| CMBS bonds | \$326.5 | 15.5% | \$456.4 | 15.7% | \$555.5 | 14.2% |
| CDO bonds and preferred shares | 172.0 | 16.4% | 47.3 | 17.3% | 52.8 | 17.2% |
| Commercial mortgage loans | 63.7 | 7.0% | 72.9 | 8.3% | 63.7 | 7.5% |
| Residual interest | 69.0 | 9.4% | 69.4 | 9.4% | 69.0 | 9.4% |
| Real estate owned | 3.6 | | 3.2 | | 4.0 | |
| Total portfolio | \$634.8 | | \$649.2 | | \$745.0 | |
| Investments funded | \$158.9 | | \$42.4 | | \$209.2 | |
| Change in accrued or reinvested interest | (0.2) | | 1.2 | | 2.1 | |
| Principal repayments | 0.9 | | 2.2 | | 13.9 | |
| CMBS and commercial real estate loan sales | 244.1 | | 125.1 | | 213.5 | |

* The weighted average yield on the interest-bearing investments is computed as the (a) annual stated interest rate earned plus the annual amortization of loan origination fees, original issue discount, and market discount earned on accruing interest-bearing investments, divided by (b) total interest-bearing investments at value. The weighted average yield is computed as of the balance sheet date. Interest-bearing investments for the commercial real estate finance portfolio include all investments except for real estate owned.

Our commercial real estate investment activity for the three months ended March 31, 2003 and 2002, and for the year ended December 31, 2002, was as follows:

| (\$ in millions) | Face Amount | Discount | Amount Funded |
|--|----------------|------------------|------------------|
| For the Three Months Ended March 31, 2003 | | | |
| CMBS bonds | \$ 90.4 | \$ (49.6) | \$ 40.8 |
| CDO bonds and preferred shares | 118.4 | (0.3) | 118.1 |
| Total | \$208.8 | \$ (49.9) | \$158.9 |
| For the Three Months Ended March 31, 2002 | | | |
| CMBS bonds | \$ 45.6 | \$ (26.3) | \$ 19.3 |
| CDO preferred shares | 23.1 | | 23.1 |
| Total | \$ 68.7 | \$ (26.3) | \$ 42.4 |
| For the Year Ended December 31, 2002 | | | |
| CMBS bonds | \$302.5 | \$(140.2) | \$162.3 |
| CDO preferred shares | 29.0 | | 29.0 |
| Commercial mortgage loans | 11.7 | (1.7) | 10.0 |

Edgar Filing: ALLIED CAPITAL CORP - Form N-2/A

| | | | |
|-------------------|-------------------|-------------------|-------------------|
| Real estate owned | 7.9 | | 7.9 |
| | <u> </u> | <u> </u> | <u> </u> |
| Total | \$351.1 | \$(141.9) | \$209.2 |
| | <u> </u> | <u> </u> | <u> </u> |

S-9

Edgar Filing: ALLIED CAPITAL CORP - Form N-2/A

CMBS Bonds. The yield on our CMBS bond portfolio at March 31, 2003, and December 31, 2002, was 15.5% and 14.2%, respectively. The yield on the CMBS bond portfolio at any point in time will vary depending on the concentration of lower yielding BB+, BB, and BB- CMBS bonds held in the portfolio.

During the three months ended March 31, 2003 and 2002, we invested \$40.8 million in two CMBS bond issuances and \$19.3 million in one CMBS bond issuance, respectively. During the year ended December 31, 2002, we invested \$162.3 million in three CMBS bond issuances.

The underlying pools of mortgage loans that are collateral for our new investments in CMBS bonds for the three months ended March 31, 2003 and 2002, and for the year ended December 31, 2002, had respective underwritten loan to value and underwritten debt service coverage ratios as follows:

| Loan to Value Ranges (\$ in millions) | For the Three Months Ended March 31, | | | | For the Year Ended December 31, 2002 | |
|--|---|-------------|-----------------|-------------|--|-------------|
| | 2003 | | 2002 | | Amount | Percentage |
| | Amount | Percentage | Amount | Percentage | | |
| Less than 60% | \$ 1,217.0 | 41% | \$ 139.9 | 19% | \$ 909.3 | 20% |
| 60-65% | 400.0 | 13 | 37.5 | 5 | 287.3 | 6 |
| 65-70% | 237.7 | 8 | 45.3 | 6 | 587.9 | 13 |
| 70-75% | 323.4 | 11 | 207.9 | 29 | 1,214.5 | 27 |
| 75-80% | 795.1 | 27 | 291.6 | 40 | 1,477.5 | 33 |
| Greater than 80% | 9.5 | | 5.3 | 1 | 47.8 | 1 |
| Total | \$ 2,982.7 | 100% | \$ 727.5 | 100% | \$ 4,524.3 | 100% |
| Weighted average loan to value | 63.4% | | 71.1% | | 68.5% | |

| Debt Service Coverage Ratio(1) Ranges (\$ in millions) | For the Three Months Ended March 31, | | | | For the Year Ended December 31, | |
|--|---|-------------|-----------------|-------------|------------------------------------|-------------|
| | 2003 | | 2002 | | Amount | Percentage |
| | Amount | Percentage | Amount | Percentage | | |
| Greater than 2.00 | \$ 1,323.4 | 45% | \$ 4.0 | 1% | \$ 366.9 | 8% |
| 1.76-2.00 | 368.7 | 12 | 4.7 | 1 | 229.6 | 5 |
| 1.51-1.75 | 515.8 | 17 | 87.4 | 12 | 477.4 | 11 |
| 1.26-1.50 | 741.5 | 25 | 460.4 | 63 | 2,739.6 | 60 |
| Less than 1.25 | 33.3 | 1 | 171.0 | 23 | 710.8 | 16 |
| Total | \$ 2,982.7 | 100% | \$ 727.5 | 100% | \$ 4,524.3 | 100% |
| Weighted average debt service coverage ratio | 1.91 | | 1.35 | | 1.41 | |

(1) Defined as annual net cash flow before debt service divided by annual debt service payments.

Edgar Filing: ALLIED CAPITAL CORP - Form N-2/A

From time to time, we will sell lower yielding CMBS bonds rated BB+ through B in order to maximize the return on our CMBS bond portfolio. The cost basis of and proceeds from CMBS bonds sold, the related net realized gains from these sales, and the weighted average yield on the CMBS bonds sold for the three months ended March 31, 2003 and 2002, and for the year ended December 31, 2002, were as follows:

| | For the Three Months Ended March 31, | | For the Year Ended December 31, |
|---|--|---------|---------------------------------------|
| | 2003 | 2002 | 2002 |
| | (\$ in millions) | | |
| Cost basis | \$244.1 | \$123.3 | \$205.9 |
| Sales proceeds | 275.1 | 128.8 | 225.6 |
| Net realized gains (net of related hedge gains or losses) | 24.6 | 7.1 | 19.1 |
| Weighted average yield | 11.9% | 11.2% | 11.5% |

The non-investment grade and unrated tranches of the CMBS bonds in which we invest are junior in priority for payment of interest and principal to the more senior tranches of the related CMBS bond issuance. Cash flow from the underlying mortgages generally is allocated first to the senior tranches, with the most senior tranches having a priority right to the cash flow. Then, any remaining cash flow is allocated, generally, among the other tranches in order of their relative seniority. To the extent there are defaults and unrecoverable losses on the underlying mortgages resulting in reduced cash flows, our most subordinate tranche will bear this loss first. At March 31, 2003, our CMBS bonds were subordinate to 91% to 99% of the tranches of bonds issued in various CMBS transactions. Given that the non-investment grade CMBS bonds in which we invest are junior in priority for payment of principal and interest, we invest in these CMBS bonds at a discount from the face amount of the bonds. The discount increases with the decrease in the seniority of the CMBS bonds. For the three months ended March 31, 2003, and 2002, and for the year ended December 31, 2002, the average discount for the CMBS bonds in which we invested was 55%, 58%, and 46%, respectively.

At March 31, 2003, and December 31, 2002, the unamortized discount related to the CMBS bond portfolio was \$518.0 million and \$649.5 million, respectively. At March 31, 2003, the CMBS bond portfolio had a fair value of \$326.5 million, which included net unrealized appreciation on the CMBS bonds of \$4.7 million.

At March 31, 2003, and December 31, 2002, the underlying collateral for our CMBS bonds consisted of approximately 4,600 and 4,500 commercial mortgage loans and real estate properties owned with a total outstanding principal balance of \$27.8 billion and \$25.0 billion, respectively. At March 31, 2003, and December 31, 2002, 0.9% and 1.0%, respectively, of the loans in the underlying collateral pool for our CMBS bonds were over 30 days delinquent or were classified as real estate owned.

Collateralized Debt Obligation Bonds and Preferred Shares. The yield on our CDO bonds and preferred shares at March 31, 2003, and December 31, 2002, was 16.4% and 17.2%, respectively. The yield on the CDO portfolio at any point in time will vary depending on the amount of lower yielding BBB CDO bonds held in the portfolio. During the three months ended March 31, 2003 and 2002, and the year ended December 31, 2002, we invested in the BBB bonds and preferred shares of one, one, and three collateralized debt obligations, respectively, which are secured by investment grade unsecured debt issued by various real estate investment trusts, or REITs, and investment

and non-investment grade CMBS bonds. The investment grade REIT collateral consists of debt with a cut-off balance of \$1.2 billion and was issued by 44 REITs. The investment grade CMBS collateral consists of CMBS bonds with a face amount of \$496.0 million issued in 41 separate CMBS transactions and the non-investment grade CMBS collateral consists of BB+, BB, BB-, B+, and B rated CMBS bonds with a face amount of \$873.7 million issued in 42 separate CMBS transactions. Included in the CMBS collateral for the CDOs are \$793.7 million of CMBS bonds that are senior in priority of repayment to certain lower rated CMBS bonds held by us, which were issued in 27 separate CMBS transactions.

The BBB rated bonds and the preferred shares that we own are junior in priority for payment of principal and interest to the more senior tranches of debt issued by the CDOs. To the extent there are defaults and unrecoverable losses on the underlying collateral resulting in reduced cash flows, the preferred shares will bear this loss first and then the BBB rated bonds would bear any loss after the preferred shares. At March 31, 2003, our BBB bonds and preferred shares in the CDOs were subordinate to 61% to 98% of the more senior tranches of debt issued in various CDO transactions.

Portfolio Asset Quality

Portfolio by Grade. We employ a standard grading system for the entire portfolio. Grade 1 is used for those investments from which a capital gain is expected. Grade 2 is used for investments performing in accordance with plan. Grade 3 is used for investments that require closer monitoring; however, no loss of investment return or principal is expected. Grade 4 is used for investments that are in workout and for which some loss of current investment return is expected, but no loss of principal is expected. Grade 5 is used for investments that are in workout and for which some loss of principal is expected.

At March 31, 2003, and December 31, 2002, our portfolio was graded as follows:

| Grade | At March 31, 2003 | | At December 31, 2002 | |
|------------------|--------------------|-------------------------------|----------------------|-------------------------------|
| | Portfolio at Value | Percentage of Total Portfolio | Portfolio at Value | Percentage of Total Portfolio |
| (\$ in millions) | | | | |
| 1 | \$ 762.2 | 32.1% | \$ 801.0 | 32.1% |
| 2 | 1,346.3 | 56.6 | 1,400.8 | 56.3 |
| 3 | 133.3 | 5.6 | 166.0 | 6.7 |
| 4 | 23.1 | 1.0 | 23.6 | 1.0 |
| 5 | 112.0 | 4.7 | 96.8 | 3.9 |
| | <u>\$2,376.9</u> | <u>100.0%</u> | <u>\$2,488.2</u> | <u>100.0%</u> |

Total Grade 4 and 5 assets as a percentage of the total portfolio at value at March 31, 2003, and December 31, 2002, were 5.7% and 4.9%, respectively. Included in Grade 4 and 5 assets at March 31, 2003 and December 31, 2002, were assets totaling \$27.2 million and \$24.1 million, respectively, that are secured by commercial real estate. Grade 4 and 5 assets include loans, debt securities, and equity securities. We expect that a number of portfolio companies will be in the Grade 4 or 5 categories from time to time. Part of the business of private finance is working with troubled portfolio companies to improve their businesses and protect our investment. The number of portfolio companies and related investment amount included in Grade 4 and 5 may fluctuate from period to period. We

continue to follow our historical practice of working with a troubled portfolio company in order to recover the maximum amount of our investment, but record unrealized depreciation for the expected amount of the loss when such exposure is identified.

Loans and Debt Securities on Non-Accrual Status. Loans and debt securities on non-accrual status for which we have doubt about interest collection and are in workout status are classified as Grade 4 or 5 assets. In addition, we may not accrue interest on loans and debt securities to companies that are more than 50% owned by us from time to time if such companies are in need of additional working capital. In these situations we may choose to defer current debt service.

For the total investment portfolio, workout loans and debt securities (which excludes equity securities that are included in the total Grade 4 and 5 assets above) not accruing interest that were classified in Grade 4 and 5 were \$98.4 million and \$89.1 million at value at March 31, 2003, and December 31, 2002, respectively. Included in this category were loans of \$16.3 million and \$13.0 million, respectively, that were secured by commercial real estate. In addition to Grade 4 and 5 assets that are in workout, loans and debt securities to companies that are more than 50% owned by us that were not accruing interest totaled \$58.5 million and \$63.6 million at value at March 31, 2003, and December 31, 2002, respectively, and loans and debt securities to companies that are less than 50% owned by us and were not in workout but were not accruing interest totaled \$21.6 million and \$7.2 million at value at March 31, 2003, and December 31, 2002, respectively.

Loans and Debt Securities Over 90 Days Delinquent. Loans and debt securities greater than 90 days delinquent were \$99.6 million and \$103.1 million at value at March 31, 2003, and December 31, 2002, respectively, or 4.2% and 4.1% of the total portfolio. Included in this category were loans valued at \$36.2 million and \$26.0 million, respectively, that were secured by commercial real estate.

As a provider of long-term privately negotiated investment capital, we may defer payment of principal or interest from time to time. As a result, the amount of the portfolio that is greater than 90 days delinquent or on non-accrual status may vary from quarter to quarter. The nature of our private finance portfolio company relationships frequently provide an opportunity for portfolio companies to amend the terms of payment to us or to restructure their debt and equity capital. During such restructuring, we may not receive or accrue interest or dividend payments. The investment portfolio is priced to provide current returns for shareholders assuming that a portion of the portfolio at any time may not be accruing interest currently. We also price our investments for a total return including interest or dividends plus capital gains from the sale of equity securities. Therefore, the amount of loans greater than 90 days delinquent or on non-accrual status is not necessarily an indication of future principal loss or loss of anticipated investment return. Our portfolio grading system is used as a means to assess loss of investment return or investment principal.

Hedging Activities

Because we invest in BB+ through B rated CMBS bonds, which were purchased at prices based in part on comparable Treasury rates, we have entered into transactions with financial institutions to hedge against movement in Treasury rates on certain of these CMBS bonds. These transactions, referred to as short sales, involved receiving the proceeds from the short sales of borrowed Treasury securities, with the obligations to

replenish the borrowed Treasury securities at a later date based on the then current market price, whatever that price may be. Risks in these contracts arise from movements in the value of the borrowed Treasury securities due to changes in interest rates and from the possible inability of counterparties to meet the terms of their contracts. If the value of the borrowed Treasury securities increases, we will incur losses on these transactions, which are limited only by the increase in value of the borrowed Treasury securities; conversely, the value of the CMBS bonds would likely increase. If the value of the borrowed Treasury securities decreases, we will incur gains on these transactions which are limited only by the decline in value of the borrowed Treasury securities; conversely, the value of the CMBS bonds would likely decrease. We do not anticipate nonperformance by any counterparty in connection with these transactions.

The total obligations to replenish borrowed Treasury securities, including accrued interest payable on the obligations, were \$100.3 million and \$197.0 million at March 31, 2003, and December 31, 2002, respectively, which included unrealized depreciation on the obligations of \$0.2 million and \$7.1 million, respectively, due to changes in the yield on the borrowed Treasury securities. The net proceeds related to the sales of the borrowed Treasury securities were \$99.4 million and \$189.3 million at March 31, 2003, and December 31, 2002, respectively. Under the terms of the transactions, we have provided additional cash collateral of \$17 thousand and \$5.4 million at March 31, 2003, and December 31, 2002, respectively, for the difference between the net proceeds related to the sales of the borrowed Treasury securities and the obligations to replenish the securities on the weekly settlement date, which is included in deposits of proceeds from sales of borrowed Treasury securities in the accompanying financial statements. The amount of the hedge will vary from period to period depending upon the amount of BB+ through B rated CMBS bonds that we own and have hedged on the balance sheet date.

RESULTS OF OPERATIONS**Comparison of Three Months Ended March 31, 2003 and 2002**

The following table summarizes the Company's operating results for the three months ended March 31, 2003 and 2002.

| (\$ in thousands, except per share amounts) | For the Three Months Ended March 31, | | Change | Percent Change |
|---|--------------------------------------|------------------|--------------------|----------------|
| | 2003 | 2002 | | |
| | (unaudited) | | | |
| Interest and Related Portfolio Income | | | | |
| Interest and dividends | \$ 65,521 | \$ 64,973 | \$ 548 | 1% |
| Premiums from loan dispositions | 1,121 | 1,613 | (492) | (31)% |
| Fees and other income | 6,488 | 15,805 | (9,317) | (59)% |
| Total interest and related portfolio income | 73,130 | 82,391 | (9,261) | (11)% |
| Expenses | | | | |
| Interest | 17,922 | 17,469 | 453 | 3% |
| Employee | 8,121 | 8,035 | 86 | 1% |
| Administrative | 4,417 | 3,018 | 1,399 | 46% |
| Total operating expenses | 30,460 | 28,522 | 1,938 | 7% |
| Net investment income | 42,670 | 53,869 | (11,199) | (21)% |
| Net Realized and Unrealized Gains (Losses) | | | | |
| Net realized gains | 48,339 | 9,605 | 38,734 | * |
| Net change in unrealized appreciation or depreciation | (71,136) | (7,513) | (63,623) | * |
| Total net gains (losses) | (22,797) | 2,092 | (24,889) | * |
| Net income | \$ 19,873 | \$ 55,961 | \$ (36,088) | (64)% |
| Diluted earnings per common share | \$ 0.18 | \$ 0.55 | \$ (0.37) | (67)% |
| Weighted average common shares outstanding diluted | 110,098 | 102,364 | 7,734 | 8% |

* Net gains and losses can fluctuate significantly from period to period. As a result, quarterly comparisons of net gains and losses may not be meaningful.

Net income results from total interest and related portfolio income earned, less total expenses incurred in our operations, plus or minus net gains (losses).

Total Interest and Related Portfolio Income. Total interest and related portfolio income includes interest and dividend income, premiums from loan dispositions, and fees and other income.

The level of interest income is directly related to the balance of the interest-bearing investment portfolio multiplied by the weighted average yield. The weighted average yield varies from period to period based on the current stated interest rate earned on interest-bearing investments and the amount of loans and debt securities for which interest is not accruing. Our interest-bearing investments in the portfolio increased by

1.4% to \$1,779.5 million at March 31, 2003, from \$1,755.0 million at March 31, 2002. The

S-15

Edgar Filing: ALLIED CAPITAL CORP - Form N-2/A

weighted average yield on the interest-bearing investments in the portfolio at March 31, 2003 and 2002, was as follows:

| (\$ in millions) | 2003 | 2002 |
|----------------------------|------------|------------|
| Interest-bearing portfolio | \$ 1,779.5 | \$ 1,755.0 |
| Portfolio yield | 14.0% | 14.3% |

Included in premiums from loan dispositions are prepayment premiums of \$1.1 million and \$1.6 million for the three months ended March 31, 2003 and 2002, respectively. While the scheduled maturities of private finance and commercial real estate loans range from five to ten years, it is not unusual for our borrowers to refinance or pay off their debts to us ahead of schedule. Because we seek to finance primarily seasoned, performing companies, such companies at times can secure lower cost financing as their balance sheets strengthen, or as more favorable interest rates become available, or a company may enter into a transaction that triggers the early repayment of their debt to us. Therefore, we generally structure our loans to require a prepayment premium for the first three to five years of the loan.

Fees and other income primarily include fees related to financial structuring, diligence, transaction services, management services to portfolio companies, guarantees, and other advisory services. As a business development company, we are required to make significant managerial assistance available to the companies in our investment portfolio. Managerial assistance includes management and consulting services including, but not limited to, information technology, web site development, marketing, human resources, personnel recruiting, board recruiting, corporate governance, and risk management.

Fees and other income for the quarter ended March 31, 2003, primarily included fees of \$0.3 million related to structuring and diligence, fees of \$0.3 million related to transaction services provided to portfolio companies, and fees of \$5.7 million related to management services provided to portfolio companies, other advisory services, and guaranty fees. Fees and other income for the quarter ended March 31, 2002, primarily included fees of \$8.0 million related to structuring and diligence, fees of \$2.0 million related to transaction services provided to portfolio companies, and fees of \$5.7 million related to management services provided to portfolio companies, other advisory services, and guaranty fees. Fees and other income are generally related to specific transactions or services, and therefore may vary substantially from period to period. Points or loan origination fees that represent yield enhancement on a loan are capitalized and amortized into interest income over the life of the loan. Fees and other income may vary from period to period depending on the level and types of services provided.

BLX and Hillman are our most significant portfolio investments and together represented 18.9% of our total assets at March 31, 2003. Total interest and related portfolio income earned from these investments for the three months ended March 31, 2003 and 2002, were \$15.3 million and \$12.3 million, respectively. In July 2002, we sold WyoTech Acquisition Corporation, which was a significant portfolio investment during 2002. Total interest and related portfolio income earned on this investment for the three months ended March 31, 2002, was \$1.8 million.

Operating Expenses. Operating expenses include interest, employee, and administrative expenses. Our single largest expense is interest on our indebtedness. The fluctuations in interest expense during the three months ended March 31, 2003 and 2002, are attributable to changes in the level of our borrowings under various notes payable and

debentures and our revolving line of credit. Our borrowing activity and weighted average interest cost, including fees and closing costs, were as follows:

| | At and for the Three Months Ended March 31, | |
|--------------------------|--|----------|
| | 2003 | 2002 |
| (\$ in millions) | | |
| Total Outstanding Debt | \$ 856.0 | \$ 933.1 |
| Average Outstanding Debt | \$ 891.3 | \$ 938.3 |
| Weighted Average Cost | 7.6% | 7.4% |
| BDC Asset Coverage* | 307% | 264% |

* As a BDC, the Company is generally required to maintain a minimum ratio of 200% of total assets to total borrowings.

Employee expenses include salaries and employee benefits. The change in employee expenses reflects the effect of wage increases and the change in mix of employees given their area of responsibility and relevant experience level. Total employees were 110 and 101 at March 31, 2003 and 2002, respectively.

Administrative expenses include the leases for our headquarters in Washington, DC, and our regional offices, travel costs, stock record expenses, directors' fees, legal and accounting fees, insurance premiums, and various other expenses. The increase in administrative expenses as compared to the three months ended March 31, 2002, includes approximately \$0.6 million from directors' fees, legal and accounting fees, and consulting fees, and \$0.4 million due to increased costs for corporate liability insurance.

Realized Gains and Losses. Net realized gains result from the sale of equity securities associated with certain private finance investments, the sale of CMBS bonds, and the realization of unamortized discount resulting from the sale and early repayment of private finance loans and commercial mortgage loans, offset by losses on investments. Net realized gains and losses for the three months ended March 31, 2003 and 2002, were as follows:

| | For the Three Months Ended March 31, | |
|--------------------|---|--------|
| | 2003 | 2002 |
| (\$ in millions) | | |
| Realized gains | \$48.5 | \$12.9 |
| Realized losses | (0.2) | (3.3) |
| Net realized gains | \$48.3 | \$ 9.6 |

Realized gains and losses for the three months ended March 31, 2003, resulted from various private finance and commercial real estate finance transactions. Realized gains for the three months ended March 31, 2003, primarily resulted from transactions involving five private finance portfolio companies, including Morton Grove Pharmaceuticals, Inc. (\$8.4 million), CyberRep (\$8.3 million), Blue Rhino Corporation (\$3.9 million), GC-Sun Holdings II, LP (\$2.0 million), and Kirkland's, Inc. (\$1.2 million). In addition, gains were also realized on CMBS bonds (\$24.6 million, net of a realized loss of \$6.4 million from hedges related to the CMBS bonds sold). For the three months ended March 31, 2003,

and 2002, we reversed previously recorded unrealized appreciation totaling \$43.0 million and \$5.2 million, respectively, when gains were realized. When we exit an investment and realize a gain, we make an accounting entry to reverse any unrealized appreciation we had previously recorded to reflect the appreciated value of the investment.

For the three months ended March 31, 2003 and 2002, we reversed previously recorded unrealized depreciation totaling \$0.2 million and \$3.2 million, respectively, when losses were realized. When we exit an investment and realize a loss, we make an accounting entry to reverse any unrealized depreciation we had previously recorded to reflect the depreciated value of the investment.

Change in Unrealized Appreciation or Depreciation. We determine the value of each investment in our portfolio on a quarterly basis, and changes in value result in unrealized appreciation or depreciation being recognized. At March 31, 2003, approximately 92% of our total assets represented portfolio investments recorded at fair value. Value, as defined in Section 2(a)(41) of the Investment Company Act of 1940, is (i) the market price for those securities for which a market quotation is readily available and (ii) for all other securities and assets, fair value is as determined in good faith by the board of directors. Since there is typically no readily available market value for the investments in our portfolio, we value substantially all of our portfolio investments at fair value as determined in good faith by the board of directors pursuant to a valuation policy and a consistently applied valuation process. Because of the inherent uncertainty of determining the fair value of investments that do not have a readily available market value, the fair value of our investments determined in good faith by the board of directors may differ significantly from the values that would have been used had a ready market existed for the investments, and the differences could be material.

There is no single standard for determining fair value in good faith. As a result, determining fair value requires that judgment be applied to the specific facts and circumstances of each portfolio investment while employing a consistently applied valuation process for the types of investments we make. Unlike banks, we are not permitted to provide a general reserve for anticipated loan losses. Instead, we are required to specifically value each individual investment on a quarterly basis. We will record unrealized depreciation on investments when we believe that an investment has become impaired, including where collection of a loan or realization of an equity security is doubtful, or when the enterprise value of the company does not currently support the cost of our debt or equity investment. Enterprise value means the entire value of the company to a potential buyer, including the sum of the values of all debt and equity securities used to capitalize the enterprise at a point in time. We will record unrealized appreciation if we believe that the underlying portfolio company has appreciated in value and, therefore, our equity security has also appreciated in value. Changes in fair value are recorded in the statement of operations as net change in unrealized appreciation or depreciation.

As a business development company, we invest in illiquid securities including debt and equity securities of companies and non-investment grade CMBS. The structure of each private finance debt and equity security is specifically negotiated to enable us to protect our investment and maximize our returns. We include many terms governing interest rate, repayment terms, prepayment penalties, financial covenants, operating covenants, ownership parameters, dilution parameters, liquidation preferences, voting rights, and put or call rights. Our investments are generally subject to restrictions on resale and generally have no established trading market. Because of the type of investments that we make and the nature of our business, our valuation process requires an analysis of various factors. Our

fair value methodology includes the examination of, among other things, the underlying investment performance, financial condition, and market changing events that impact valuation.

Valuation Methodology Private Finance Our process for determining the fair value of a private finance investment begins with determining the enterprise value of the portfolio company. The fair value of our investment is based on the enterprise value at which the portfolio company could be sold in an orderly disposition over a reasonable period of time between willing parties other than in a forced or liquidation sale. The liquidity event whereby we exit a private finance investment is generally the sale, the recapitalization or, in some cases, the initial public offering of the portfolio company.

There is no one methodology to determine enterprise value and, in fact, for any one portfolio company, enterprise value is best expressed as a range of fair values, from which we derive a single estimate of enterprise value. To determine the enterprise value of a portfolio company, we analyze its historical and projected financial results. We generally require portfolio companies to provide annual audited and monthly unaudited financial statements, as well as annual projections for the upcoming fiscal year. Typically in the private equity business, companies are bought and sold based on multiples of EBITDA, cash flow, net income, revenues or, in limited instances, book value. The private equity industry uses financial measures such as EBITDA or EBITDAM (Earnings Before Interest, Taxes, Depreciation, Amortization and, in some instances, Management fees) in order to assess a portfolio company's financial performance and to value a portfolio company. EBITDA and EBITDAM are not intended to represent cash flow from operations as defined by accounting principles generally accepted in the United States of America and such information should not be considered as an alternative to net income, cash flow from operations, or any other measure of performance prescribed by accounting principles generally accepted in the United States of America. When using EBITDA to determine enterprise value, we may adjust EBITDA for non-recurring items. Such adjustments are intended to normalize EBITDA to reflect the portfolio company's earnings power. Adjustments to EBITDA may include compensation to previous owners, acquisition, recapitalization, or restructuring related items or one-time non-recurring income or expense items.

In determining a multiple to use for valuation purposes, we look to private merger and acquisition statistics, discounted public trading multiples or industry practices. In estimating a reasonable multiple, we consider not only the fact that our portfolio company may be a private company relative to a peer group of public comparables, but we also consider the size and scope of our portfolio company and its specific strengths and weaknesses. In some cases, the best valuation methodology may be a discounted cash flow analysis based on future projections. If a portfolio company is distressed, a liquidation analysis may provide the best indication of enterprise value.

If there is adequate enterprise value to support the repayment of our debt, the fair value of our loan or debt security normally corresponds to cost unless the borrower's condition or other factors lead to a determination of fair value at a different amount. The fair value of equity interests in portfolio companies are determined based on various factors, including the enterprise value remaining for equity holders after the repayment of the portfolio company's debt and other pertinent factors such as recent offers to purchase a portfolio company's equity interest or other potential liquidity events. The determined equity values are generally discounted when we have a minority position, restrictions on

resale, specific concerns about the receptivity of the capital markets to a specific company at a certain time, or other factors.

Valuation Methodology CMBS Bonds and CDO Bonds and Preferred Shares CMBS bonds and CDO bonds and preferred shares are carried at fair value, which is based on a discounted cash flow model, which utilizes prepayment and loss assumptions based on historical experience and projected performance, economic factors, the characteristics of the underlying cash flow and comparable market yields for similar CMBS bonds and CDO bonds and preferred shares. Our assumption with regard to discount rate is based on the yield of comparable securities. We recognize income from the amortization of original issue discount using the effective interest method, using the anticipated yield over the projected life of the investment. Yields are revised when there are changes in estimates of future credit losses, actual losses incurred, or actual and estimated prepayment speeds. Changes in estimated yield are recognized as an adjustment to the estimated yield over the remaining life of the CMBS bonds and CDO bonds and preferred shares from the date the estimated yield is changed. We recognize unrealized appreciation or depreciation on our CMBS and CDO bonds and preferred shares bonds as comparable yields in the market change and based on changes in estimated cash flows resulting from changes in prepayment or loss assumptions in the underlying collateral pool.

For the portfolio, net change in unrealized appreciation or depreciation for the three months ended March 31, 2003 and 2002, consisted of the following:

| (\$ in millions) | <u>2003</u> | <u>2002</u> |
|---|-------------------|-------------------|
| Net unrealized appreciation or depreciation | \$(28.3) | \$(5.5) |
| Reversal of previously recorded unrealized appreciation associated with realized gains | (43.0) | (5.2) |
| Reversal of previously recorded unrealized depreciation associated with realized losses | 0.2 | 3.2 |
| | <u> </u> | <u> </u> |
| Net change in unrealized appreciation or depreciation | <u>\$ (71.1)</u> | <u>\$ (7.5)</u> |

Our two most significant portfolio investments are in BLX and Hillman. The following is a simplified summary of the methodology that we used to determine the fair value of these investments.

Business Loan Express, LLC. To determine the value of our investment in BLX at March 31, 2003, we performed four separate valuation analyses to determine its enterprise value: (1) analysis of comparable public company trading multiples, (2) analysis of BLX's value assuming an initial public offering, (3) analysis of merger and acquisition transactions for financial services companies, and (4) a discounted dividend analysis. The range of enterprise values resulting from these analyses was between \$360 million and \$530 million. We used an enterprise value of \$407 million to value our equity investment in BLX. This enterprise value is based on a pro forma equity value of 7.5 times trailing pro forma BLX net income adjusted for certain capital structure changes that would likely occur should the company be sold. Given an enterprise value of \$407 million, the fair value of our equity investment in BLX is \$244.7 million with a cost of \$203.1 million for total unrealized appreciation of \$41.6 million at March 31, 2003. Our valuation analysis also supports our newly invested capital to fund the Amresco Independence Funding purchase.

The Hillman Companies, Inc. Hillman achieved several milestones in 2002, including the completion of two acquisitions, the reduction of excess corporate overhead, and significant improvements to its operating structure. In performing our valuation analysis of Hillman at March 31, 2003, we quantified the impact of these milestones in order to determine normalized 2002 EBITDAM of approximately \$60.1 million.

We believe the current enterprise value for Hillman is approximately \$420.5 million, or 7.0 times 2002 normalized EBITDAM of \$60.1 million. The multiple was determined by obtaining a range of multiples representing the multiple of enterprise value to EBITDA for comparable public companies and the multiple of enterprise value to EBITDA for acquisition transactions involving companies in Hillman's peer group. From this market comparable analysis, we selected a 7.0 times multiple for our valuation. Using an enterprise value of \$420.5 million, the value of our equity investment in Hillman is approximately \$138.8 million, or \$88.2 million greater than our cost basis of \$50.6 million at March 31, 2003.

OTHER MATTERS

Per Share Amounts. All per share amounts included in Management's Discussion and Analysis of Financial Condition and Results of Operations section have been computed using the weighted average shares used to compute diluted earnings per share, which were 110.1 million and 102.4 million for the three months ended March 31, 2003 and 2002, respectively.

Regulated Investment Company Status. We have elected to be taxed as a regulated investment company under Subchapter M of the Internal Revenue Code of 1986. As long as we qualify as a regulated investment company, we are not taxed on our investment company taxable income or realized capital gains, to the extent that such taxable income or gains are distributed, or deemed to be distributed, to shareholders on a timely basis. Annual tax distributions generally differ from net income for the fiscal year due to temporary and permanent timing differences in the recognition of income and expenses, returns of capital and net unrealized appreciation or depreciation, which are not included in taxable income.

In order to maintain our status as a regulated investment company, we must, in general, (1) continue to qualify as a business development company; (2) derive at least 90% of our gross income from dividends, interest, gains from the sale of securities and other specified types of income; (3) meet investment diversification requirements as defined in the Internal Revenue Code; and (4) distribute annually to shareholders at least 90% of our investment company taxable income as defined in the Internal Revenue Code. We intend to take all steps necessary to continue to qualify as a regulated investment company. However, there can be no assurance that we will continue to qualify for such treatment in future years.

FINANCIAL CONDITION, LIQUIDITY AND CAPITAL RESOURCES

Cash and Cash Equivalents

At March 31, 2003, we had \$8.1 million in cash and cash equivalents. We invest otherwise uninvested cash in U.S. government- or agency-issued or guaranteed securities that are backed by the full faith and credit of the United States, or in high quality, short-term repurchase agreements fully collateralized by such securities. Our objective is to manage to a low cash balance and fund new originations with our revolving line of credit.

Debt

At March 31, 2003, we had outstanding debt as follows:

| (\$ in millions) | Facility Amount | Amount Outstanding | Annual Interest Cost(1) |
|------------------------------------|--------------------|-----------------------|-------------------------------|
| Notes payable and debentures: | | | |
| Unsecured long-term notes | \$ 694.0 | \$694.0 | 7.7% |
| SBA debentures | 101.8 | 94.5 | 8.1% |
| OPIC loan | 5.7 | 5.7 | 6.6% |
| | <u> </u> | <u> </u> | |
| Total notes payable and debentures | \$ 801.5 | \$794.2 | 7.8% |
| | <u> </u> | <u> </u> | |
| Revolving line of credit | 527.5(3) | 61.8 | 3.1%(2) |
| | <u> </u> | <u> </u> | |
| Total debt | \$1,329.0 | \$856.0 | 7.6% |
| | <u> </u> | <u> </u> | |

- (1) The annual interest cost includes the cost of commitment fees and other facility fees that are recognized into interest expense over the contractual life of the respective borrowings.
- (2) The current interest rate payable on the revolving line of credit is 2.8%, which excludes the annual cost of commitment fees and other facility fees of \$1.9 million.
- (3) On April 18, 2003, we renewed the revolving line of credit and the committed amount under the renewed facility is \$462.5 million.

Unsecured Long-Term Notes. We have issued long-term debt to institutional lenders, primarily insurance companies. The notes have five- or seven-year maturities, with maturity dates beginning in 2003. The notes require payment of interest only semi-annually, and all principal is due upon maturity. On May 14, 2003, we issued \$153 million of five-year and \$147 million of seven-year unsecured long-term notes, primarily to insurance companies. The five- and seven-year notes have fixed interest rates of 5.45% and 6.05%, respectively, and have substantially the same terms as our existing unsecured long-term notes. On May 30, 2003, \$140 million of our existing unsecured long-term notes will mature and we will use that the proceeds from the new long-term note issuance to repay this amount.

Small Business Administration Debentures. We, through our small business investment company subsidiary, have debentures payable to the Small Business Administration with contractual maturities of ten years. The notes require payment of interest only semi-annually, and all principal is due upon maturity. Under the small business investment company program, we may borrow up to \$113.4 million from the Small Business Administration. At March 31, 2003, we had a commitment from the Small Business Administration to borrow up to an additional \$7.3 million above the current amount outstanding. The commitment expires on September 30, 2005.

Revolving Line of Credit. On April 18, 2003, we renewed our unsecured revolving line of credit under substantially similar terms with a committed amount under the renewed facility of \$462.5 million. The revolving line of credit may be expanded through new or additional commitments up to \$600 million at our option. As of March 31, 2003, \$61.8 million was drawn on the line of credit and \$4.6 million was committed for standby letters of credit issued under the credit facility. The renewed line of credit expires in April 2005 and may be extended under substantially similar terms for one additional year at our sole option. The credit facility bears interest at a rate equal to (i) the one-month LIBOR plus 1.25%, (ii) the Bank of America, N.A. prime rate, or (iii) the Federal Funds rate plus 0.50% at our option. The line of credit generally requires monthly payments of interest, and all principal is due upon maturity.

Edgar Filing: ALLIED CAPITAL CORP - Form N-2/A

We have various financial and operating covenants required by the revolving line of credit and notes payable and debentures. These covenants require us to maintain certain financial ratios, including debt to equity and interest coverage, and a minimum net worth. Our credit facilities limit our ability to declare dividends if we default under certain provisions. As of March 31, 2003, we were in compliance with these covenants.

Auction Rate Reset Note. We repaid a \$75.0 million Auction Rate Reset Note Series A in December 2002. We have entered into an agreement with the placement agent of this note to serve as the placement agent on a future offering of \$75.0 million of debt, equity or other securities in one or more public or private transactions. If we do not conduct a capital raise, we will incur additional expenses of approximately \$3.2 million.

The following table shows our significant contractual obligations as of March 31, 2003.

| (\$ in millions) | Payments Due By Year | | | | | | |
|--|----------------------|----------------|----------------|----------------|----------------|--------------|---------------|
| | Total | 2003 | 2004 | 2005 | 2006 | 2007 | After 2007 |
| Notes payable and debentures: | | | | | | | |
| Unsecured long-term notes | \$694.0 | \$140.0 | \$214.0 | \$165.0 | \$175.0 | \$ | \$ |
| Small Business Administration debentures | 94.5 | | 7.0 | 14.0 | | | 73.5 |
| Overseas Private Investment Corporation loan | 5.7 | | | | 5.7 | | |
| Revolving line of credit(1) | 61.8 | | 61.8 | | | | |
| Operating Leases | 20.4 | 2.0 | 2.7 | 2.7 | 2.6 | 2.5 | 7.9 |
| Total contractual obligations | \$876.4 | \$142.0 | \$285.5 | \$181.7 | \$183.3 | \$2.5 | \$81.4 |

(1) As of March 31, 2003, the revolving line of credit had a committed amount of \$527.5 million and was to expire in August 2003, and could have been extended under substantially similar terms for one additional year at our sole option. We assumed that we would exercise our option to extend the revolving line of credit resulting in an assumed maturity of August 2004. At March 31, 2003, \$61.8 million was drawn on the line of credit and \$4.6 million was committed for standby letters of credit issued under the credit facility. On April 18, 2003, we renewed the revolving line of credit under substantially similar terms with a commitment amount under the renewed facility of \$462.5 million. The renewed line of credit expires in April 2005 and may be extended under substantially similar terms for one additional year at our sole option. Assuming that we would exercise our option to extend the revolving line of credit, the assumed maturity is April 2006.

The following table shows our contractual commitments that may have the effect of creating, increasing, or accelerating our liabilities as of March 31, 2003.

| (\$ in millions) | Amount of Commitment Expiration Per Year | | | | | | |
|---------------------------|--|--------------|---------------|--------------|--------------|--------------|--------------|
| | Total | 2003 | 2004 | 2005 | 2006 | 2007 | After 2007 |
| Standby letters of credit | \$17.6 | \$ | \$ 4.6 | \$ | \$7.0 | \$ | \$6.0 |
| Guarantees | 61.1 | 1.5 | 58.0 | 0.3 | 0.1 | 0.1 | 1.1 |
| Total commitments | \$78.7 | \$1.5 | \$62.6 | \$0.3 | \$7.1 | \$0.1 | \$7.1 |

Equity Capital and Dividends

Because we are a regulated investment company, we distribute our income and require external capital for growth. Because we are a business development company, we are limited in the amount of debt capital we may use to fund our growth, since we are generally required to maintain a minimum ratio of 200% of total assets to total borrowings, or approximately a 1 to 1 debt to equity ratio. At March 31, 2003, our asset coverage for senior indebtedness was 307% and our debt to equity ratio was 0.54 to 1.00.

To support our growth during the three months ended March 31, 2003 and 2002, we raised \$82.4 million and \$20.0 million, respectively, in new equity capital. We issue equity from time to time when we have attractive investment opportunities. In addition, we raised \$1.7 million and \$1.6 million in new equity capital through the issuance of shares through our dividend reinvestment plan during the three months ended March 31, 2003 and 2002, respectively. During the quarter ended March 31, 2003, total shareholders' equity had increased \$42.2 million to \$1,588.3 million.

Our Board of Directors reviews the dividend rate quarterly, and may adjust the quarterly dividend throughout the year. For the first and second quarters of 2003, the Board of Directors declared a dividend of \$0.57 per common share. The second quarter dividend is payable on June 27, 2003, with a record date of June 13, 2003. Dividends are paid based on our taxable income, which includes our taxable interest and fee income as well as taxable net realized capital gains. Our Board of Directors evaluates whether to retain or distribute capital gains on an annual basis. Our dividend policy allows us to continue to distribute capital gains, but will also allow us to retain gains to support future growth.

Liquidity and Capital Resources. We plan to maintain a strategy of financing our business and related debt maturities with cash from operations, through borrowings under short- or long-term credit facilities or other debt securities, through asset sales, or through the sale or issuance of new equity capital. We anticipate an increased level of new investment activity during 2003 given the level of prospective investments currently under review. Although there can be no assurance that we will secure these new investments, we plan to raise new debt and equity capital as appropriate to fund investment growth prospectively.

Dividends to shareholders for the three months ended March 31, 2003 and 2002, were \$63.0 million and \$53.3 million, respectively. Cash flow from operations before new investments has historically been sufficient to finance our operations and pay dividends to shareholders.

We maintain a matched-funding philosophy that focuses on matching the estimated maturities of our loan and investment portfolio to the estimated maturities of our borrowings. We use our short-term credit facilities as a means to bridge to long-term financing, which may or may not result in temporary differences in the matching of estimated maturities. We evaluate our interest rate exposure on an ongoing basis. To the extent deemed necessary, we may hedge variable and short-term interest rate exposure through interest rate swaps or other techniques.

At March 31, 2003, our debt to equity ratio was 0.54 to 1.00 and our weighted average cost of funds was 7.6%. Availability on the revolving line of credit, net of amounts committed for standby letters of credit issued under the line of credit facility, was

\$461.2 million on March 31, 2003. We believe that we have access to capital sufficient to fund our ongoing investment and operating activities.

CRITICAL ACCOUNTING POLICIES

The consolidated financial statements are based on the selection and application of critical accounting policies, which require management to make significant estimates and assumptions. Critical accounting policies are those that are both important to the presentation of our financial condition and results of operations and require management's most difficult, complex, or subjective judgments. Our critical accounting policies are those applicable to the valuation of investments and certain revenue recognition matters as discussed below.

Valuation of Portfolio Investments. As a business development company, we invest in illiquid securities including debt and equity securities of companies, non-investment grade CMBS and collateralized debt obligations. Our investments are generally subject to restrictions on resale and generally have no established trading market. We value substantially all of our investments at fair value as determined in good faith by the board of directors in accordance with our valuation policy. We determine fair value to be the amount for which an investment could be exchanged in an orderly disposition over a reasonable period of time between willing parties other than in a forced or liquidation sale. Our valuation policy considers the fact that no ready market exists for substantially all of the securities in which we invest. Our valuation policy is intended to provide a consistent basis for determining the fair value of the portfolio. We will record unrealized depreciation on investments when we believe that an investment has become impaired, including where collection of a loan or realization of an equity security is doubtful, or when the enterprise value of the company does not currently support the cost of our debt or equity investments. Enterprise value means the entire value of the company to a potential buyer, including the sum of the values of all debt and equity securities used to capitalize the enterprise at a point in time. We will record unrealized appreciation if we believe that the underlying portfolio company has appreciated in value and, therefore, our equity security has also appreciated in value. The value of investments in publicly traded securities are determined using quoted market prices discounted for restrictions on resale, if any.

Loans and Debt Securities. For loans and debt securities, fair value generally approximates cost unless the borrower's enterprise value or overall financial condition or other factors lead to a determination of fair value at a different amount.

When we receive nominal cost warrants or free equity securities (nominal cost equity), we allocate our cost basis in our investment between debt securities and nominal cost equity at the time of origination. At that time, the original issue discount basis of the nominal cost equity is recorded by increasing the cost basis in the equity and decreasing the cost basis in the related debt securities.

Interest income is recorded on an accrual basis to the extent that such amounts are expected to be collected. For loans and debt securities with contractual payment-in-kind interest, which represents contractual interest accrued and added to the loan balance that generally becomes due at maturity, we will not accrue payment-in-kind interest if the portfolio company valuation indicates that the payment-in-kind interest is not collectible. Interest on loans and debt securities is not accrued if we have doubt about interest collection. Loans in workout status classified as Grade 4 or 5 assets do not accrue interest. In addition, interest may not accrue on loans or debt securities to portfolio companies that

are more than 50% owned by us if such companies are in need of additional working capital. Loan origination fees, original issue discount, and market discount are capitalized and then amortized into interest income using the effective interest method. Prepayment premiums are recorded on loans when received.

The weighted average yield on loans and debt securities is computed as the (a) annual stated interest rate earned plus the annual amortization of loan origination fees, original issue discount, and market discount earned on accruing loans and debt securities, divided by (b) total loans and debt securities at value. The weighted average yield is computed as of the balance sheet date.

Equity Securities. Our equity interests in portfolio companies for which there is no liquid public market are valued at fair value based on the enterprise value of the portfolio company, which is determined using various factors, including cash flow from operations of the portfolio company and other pertinent factors, such as recent offers to purchase a portfolio company's securities or other liquidation events. The determined fair values are generally discounted to account for restrictions on resale and minority ownership positions.

The value of our equity interests in public companies for which market quotations are readily available is based upon the closing public market price on the balance sheet date. Securities that carry certain restrictions on sale are typically valued at a discount from the public market value of the security.

Dividend income is recorded on preferred equity securities on an accrual basis to the extent that such amounts are expected to be collected and on common equity securities on the record date for private companies or on the ex-dividend date for publicly traded companies.

Commercial Mortgage-Backed Securities (CMBS) and Collateralized Debt Obligations (CDO). CMBS bonds and CDO bonds and preferred shares are carried at fair value, which is based on a discounted cash flow model that utilizes prepayment and loss assumptions based on historical experience and projected performance, economic factors, the characteristics of the underlying cash flow, and comparable market yields for similar CMBS bonds and CDO bonds and preferred shares. Our assumption with regard to the discount rate for determining fair value is based on the yield of comparable securities. We recognize income from the amortization of original issue discount using the effective interest method, using the anticipated yield over the projected life of the investment. Yields are revised when there are changes in estimates of future credit losses, actual losses incurred, or actual and estimated prepayment speeds. Changes in estimated yield are recognized as an adjustment to the estimated yield over the remaining life of the CMBS bonds and CDO bonds and preferred shares from the date the estimated yield is changed. We recognize unrealized appreciation or depreciation on our CMBS bonds and CDO bonds and preferred shares as comparable yields in the market change and based on changes in estimated cash flows resulting from changes in prepayment or loss assumptions in the underlying collateral pool.

Net Realized Gains or Losses and Net Change in Unrealized Appreciation or Depreciation. Realized gains or losses are measured by the difference between the net proceeds from the repayment or sale and the cost basis of the investment without regard to unrealized appreciation or depreciation previously recognized, and include investments charged off during the year, net of recoveries. Net change in unrealized appreciation or depreciation reflects the change in portfolio investment values during the reporting period.

Fee Income. Fee income includes fees for guarantees and services rendered by us to portfolio companies and other third parties such as diligence, structuring, transaction services, management services, and investment advisory services. Guaranty fees are recognized as income over the related period of the guaranty. Diligence, structuring, and transaction services fees are generally recognized as income when services are rendered or when the related transactions are completed. Management and investment advisory services fees are generally recognized as income as the services are rendered.

S-27

INTERIM FINANCIAL STATEMENTS

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEET

| (in thousands, except share and per share amounts) | March 31, 2003 | December 31, 2002 |
|--|-------------------|----------------------|
| | (unaudited) | |
| ASSETS | | |
| Portfolio at value: | | |
| Private finance | | |
| Companies more than 25% owned (cost: 2003-\$671,917; 2002-\$628,535) | \$ 756,685 | \$ 710,587 |
| Companies 5% to 25% owned (cost: 2003-\$210,553; 2002-\$219,124) | 232,568 | 255,677 |
| Companies less than 5% owned (cost: 2003-\$865,117; 2002-\$863,243) | 752,831 | 776,951 |
| Total private finance | 1,742,084 | 1,743,215 |
| Commercial real estate finance (cost: 2003-\$643,772; 2002-\$718,312) | 634,853 | 744,952 |
| Total portfolio at value | 2,376,937 | 2,488,167 |
| Other assets | 106,031 | 100,221 |
| Deposits of proceeds from sales of borrowed Treasury securities | 99,425 | 194,745 |
| Cash and cash equivalents | 8,104 | 11,186 |
| Total assets | \$2,590,497 | \$2,794,319 |
| LIABILITIES AND SHAREHOLDERS EQUITY | | |
| Liabilities: | | |
| Notes payable and debentures | \$ 794,200 | \$ 794,200 |
| Revolving line of credit | 61,750 | 204,250 |
| Obligations to replenish borrowed Treasury securities | 100,339 | 197,027 |
| Accounts payable and other liabilities | 38,915 | 45,771 |
| Total liabilities | 995,204 | 1,241,248 |
| Commitments and contingencies | | |
| Preferred stock | 7,000 | 7,000 |
| Shareholders equity: | | |
| Common stock, \$0.0001 par value, 200,000,000 shares authorized; 113,056,001 and 108,698,409 shares issued and outstanding at March 31, 2003, and December 31, 2002, respectively | 11 | 11 |
| Additional paid-in capital | 1,631,745 | 1,547,183 |
| Notes receivable from sale of common stock | (23,890) | (24,704) |
| Net unrealized appreciation (depreciation) on portfolio | (31,725) | 39,411 |
| Undistributed (distributions in excess of) earnings | 12,152 | (15,830) |

Edgar Filing: ALLIED CAPITAL CORP - Form N-2/A

| | | |
|--|-------------|-------------|
| Total shareholders' equity | 1,588,293 | 1,546,071 |
| Total liabilities and shareholders' equity | \$2,590,497 | \$2,794,319 |
| Net asset value per common share | \$ 14.05 | \$ 14.22 |

The accompanying notes are an integral part of these consolidated financial statements.

S-28

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENT OF OPERATIONS

| | For the Three Months Ended March 31, | |
|---|---|-----------|
| | 2003 | 2002 |
| | (unaudited) | |
| (in thousands, except per share amounts) | | |
| Interest and Related Portfolio Income: | | |
| Interest and dividends | | |
| Companies more than 25% owned | \$ 15,203 | \$ 9,473 |
| Companies 5% to 25% owned | 6,493 | 7,440 |
| Companies less than 5% owned | 43,825 | 48,060 |
| | | |
| Total interest and dividends | 65,521 | 64,973 |
| Premiums from loan dispositions | | |
| Companies more than 25% owned | 108 | |
| Companies 5% to 25% owned | 485 | |
| Companies less than 5% owned | 528 | 1,613 |
| | | |
| Total premiums from loan dispositions | 1,121 | 1,613 |
| Fees and other income | | |
| Companies more than 25% owned | 5,709 | 6,975 |
| Companies 5% to 25% owned | 53 | |
| Companies less than 5% owned | 726 | 8,830 |
| | | |
| Total fees and other income | 6,488 | 15,805 |
| | | |
| Total interest and related portfolio income | 73,130 | 82,391 |
| Expenses: | | |
| Interest | 17,922 | 17,469 |
| Employee | 8,121 | 8,035 |
| Administrative | 4,417 | 3,018 |
| | | |
| Total operating expenses | 30,460 | 28,522 |
| | | |
| Net investment income | 42,670 | 53,869 |
| | | |
| Net Realized and Unrealized Gains (Losses): | | |
| Net realized gains | | |
| Companies 5% to 25% owned | 16,688 | 718 |
| Companies less than 5% owned | 31,651 | 8,887 |
| | | |
| Total net realized gains | 48,339 | 9,605 |
| Net change in unrealized appreciation or depreciation | (71,136) | (7,513) |
| | | |
| Total net gains (losses) | (22,797) | 2,092 |
| | | |
| Net increase in net assets resulting from operations | \$ 19,873 | \$ 55,961 |
| | | |
| Basic earnings per common share | \$ 0.18 | \$ 0.56 |

Edgar Filing: ALLIED CAPITAL CORP - Form N-2/A

| | | |
|--|---------|---------|
| Diluted earnings per common share | \$ 0.18 | \$ 0.55 |
| Weighted average common shares outstanding basic | 109,458 | 99,977 |
| Weighted average common shares outstanding diluted | 110,098 | 102,364 |

The accompanying notes are an integral part of these consolidated financial statements.

S-29

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENT OF CHANGES IN NET ASSETS

| (in thousands, except per share amounts) | For the Three Months Ended March 31, | |
|---|---|--------------|
| | 2003 | 2002 |
| | (unaudited) | |
| Operations: | | |
| Net investment income | \$ 42,670 | \$ 53,869 |
| Net realized gains | 48,339 | 9,605 |
| Net change in unrealized appreciation or depreciation | (71,136) | (7,513) |
| | 19,873 | 55,961 |
| Shareholder distributions: | | |
| Common stock dividends | (62,972) | (53,259) |
| Preferred stock dividends | (55) | (55) |
| | (63,027) | (53,314) |
| Capital share transactions: | | |
| Sale of common stock | 82,362 | 19,950 |
| Issuance of common stock upon the exercise of stock options | 510 | 6,293 |
| Issuance of common stock in lieu of cash distributions | 1,690 | 1,572 |
| Net decrease (increase) in notes receivable from sale of common stock | 814 | (1,244) |
| | 85,376 | 26,571 |
| Total increase in net assets | 42,222 | 29,218 |
| Net assets at beginning of period | 1,546,071 | 1,352,123 |
| Net assets at end of period | \$ 1,588,293 | \$ 1,381,341 |
| Net asset value per common share | \$ 14.05 | \$ 13.71 |
| Common shares outstanding at end of period | 113,056 | 100,765 |

The accompanying notes are an integral part of these consolidated financial statements.

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENT OF CASH FLOWS

| | For the Three Months Ended March 31, | |
|---|---|------------------|
| | 2003 | 2002 |
| | (unaudited) | |
| (in thousands) | | |
| Cash flows from operating activities: | | |
| Net increase in net assets resulting from operations | \$ 19,873 | \$ 55,961 |
| Adjustments | | |
| Portfolio investments | (269,007) | (80,040) |
| Repayments of investment principal | 75,979 | 31,013 |
| Proceeds from investment sales | 244,092 | 125,099 |
| Change in accrued or reinvested interest and dividends | (11,087) | (13,258) |
| Amortization of loan discounts and fees | (5,535) | (3,883) |
| Changes in other assets and liabilities | (1,851) | (10,033) |
| Depreciation and amortization | 412 | 266 |
| Gain on cashless exercise of warrants | (3,876) | |
| Realized losses | 212 | 3,320 |
| Net change in unrealized appreciation or depreciation | 71,136 | 7,513 |
| | <u>120,348</u> | <u>115,958</u> |
| Cash flows from financing activities: | | |
| Sale of common stock | 82,362 | 19,950 |
| Sale of common stock upon the exercise of stock options | 510 | 4,832 |
| Collections of notes receivable from sale of common stock | 814 | 217 |
| Common dividends and distributions paid | (64,464) | (51,687) |
| Preferred stock dividends paid | (55) | (55) |
| Net repayments on revolving line of credit | (142,500) | (87,750) |
| Other financing activities | (97) | (57) |
| | <u>(123,430)</u> | <u>(114,550)</u> |
| Net increase (decrease) in cash and cash equivalents | (3,082) | 1,408 |
| Cash and cash equivalents at beginning of period | 11,186 | 889 |
| | <u>\$ 8,104</u> | <u>\$ 2,297</u> |

The accompanying notes are an integral part of these consolidated financial statements.

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENT OF INVESTMENTS

March 31, 2003

| Private Finance Portfolio Company (in thousands, except number of shares) | Investment(2) | (unaudited) | |
|---|-------------------------------------|-------------|----------|
| | | Cost | Value |
| Companies More Than 25% Owned | | | |
| Acme Paging, L.P. (Telecommunications) | Loan | \$ 4,042 | \$ 4,042 |
| | Equity Interests | 13,274 | 7,723 |
| | Common Stock (670 shares) | 27 | 27 |
| Alaris Consulting, LLC (Business Services) | Loan | 16,660 | 16,014 |
| | Equity Interests | 5,165 | |
| | Guaranty (\$1,100) | | |
| American Healthcare Services, Inc. (Healthcare) | Loan | 22,601 | 22,601 |
| | Debt Securities | 18,061 | 15,891 |
| | Common Stock (79,567,042 shares) | 1,000 | |
| | Guaranty (\$1,766) | | |
| Avborne, Inc. (Business Services) | Loan | 2,770 | 2,770 |
| | Preferred Stock (12,500 shares) | 14,138 | 2,300 |
| | Common Stock (27,500 shares) | | |
| | Standby Letters of Credit (\$7,025) | | |
| Business Loan Express, LLC (Financial Services) | Loans | 25,000 | 25,000 |
| | Debt Securities | 37,960 | 37,960 |
| | Class A Equity Interests | 43,705 | 43,705 |
| | Class B Equity Interests | 51,111 | 70,918 |
| | Class C Equity Interests | 108,241 | 130,029 |
| | Guaranty (\$57,246 See Note 3) | | |
| The Color Factory, Inc. (Consumer Products) | Loan | 11,089 | 11,089 |
| | Preferred Stock (1,000 shares) | 1,002 | 1,002 |
| | Common Stock (980,000 shares) | 6,535 | 3,500 |
| Foresite Towers, LLC (Tower Leasing) | Equity Interests | 15,522 | 13,775 |
| Gordian Group, Inc. (Business Services) | Loan | 7,570 | 7,570 |
| | Common Stock (1,000 shares) | 2,088 | 3,200 |
| HealthASPex, Inc. (Business Services) | Preferred Stock (1,000,000 shares) | 700 | 700 |
| | Preferred Stock (1,451,380 shares) | 4,900 | 2,551 |
| | Common Stock (1,451,380 shares) | 4 | |
| The Hillman Companies, Inc.(1) (Consumer Products) | Debt Securities | 42,472 | 42,472 |
| | Common Stock (6,890,937 shares) | 50,645 | 138,863 |

Edgar Filing: ALLIED CAPITAL CORP - Form N-2/A

- (1) Public company.
- (2) Common stock, preferred stock, warrants, options, and equity interests are generally non-income producing and restricted.
- (3) Non-U.S. company.
- (4) Non-registered investment company.

The accompanying notes are an integral part of these consolidated financial statements.

S-32

Edgar Filing: ALLIED CAPITAL CORP - Form N-2/A

| | | March 31, 2003 | |
|---|------------------------------------|----------------|-----------|
| Private Finance Portfolio Company (in thousands, except number of shares) | Investment(2) | (unaudited) | |
| | | Cost | Value |
| HMT, Inc. (Business Services) | Debt Securities | \$ 9,104 | \$ 9,104 |
| | Preferred Stock (554,052 shares) | 2,303 | 2,303 |
| | Common Stock (300,000 shares) | 3,000 | 3,000 |
| | Warrants | 1,155 | 1,155 |
| Housecall Medical Resources, Inc. (Healthcare) | Loan | 14,975 | 14,975 |
| | Preferred Stock (3,890,344 shares) | 3,889 | 3,889 |
| | Common Stock (864,000 shares) | 86 | 86 |
| Litterer Beteiligungs-GmbH(3) (Business Services) | Debt Securities | 1,325 | 1,325 |
| | Equity Interest | 295 | 318 |
| MVL Group, Inc. (Business Services) | Loan | 18,698 | 18,698 |
| | Debt Securities | 16,398 | 16,398 |
| | Common Stock (648,661 shares) | 810 | 747 |
| Powell Plant Farms, Inc. (Consumer Products) | Loan | 26,832 | 26,832 |
| | Debt Securities | 19,224 | 9,709 |
| | Preferred Stock (1,483 shares) | | |
| | Warrants | | |
| Redox Brands, Inc. (Consumer Products) | Loan | 3,000 | 3,000 |
| | Debt Securities | 9,940 | 9,940 |
| | Preferred Stock (2,404,086 shares) | 6,965 | 6,965 |
| | Warrants | 584 | 584 |
| Staffing Partners Holding Company, Inc. (Business Services) | Debt Securities | 6,304 | 6,304 |
| | Preferred Stock (414,600 shares) | 4,968 | 4,335 |
| | Common Stock (50,200 shares) | 50 | |
| | Warrants | 10 | |
| STS Operating, Inc. (Industrial Products) | Preferred Stock (5,769,424 shares) | 6,525 | 6,525 |
| | Common Stock (3,000,000 shares) | 3,177 | 3,177 |
| Sure-Tel, Inc. (Consumer Services) | Preferred Stock (1,000,000 shares) | 1,000 | 1,000 |
| | Common Stock (37,000 shares) | 5,018 | 2,614 |
| Total companies more than 25% owned | | \$671,917 | \$756,685 |
| Companies 5% to 25% Owned | | | |
| Aspen Pet Products, Inc. (Consumer Products) | Loans | \$ 16,886 | \$ 16,886 |
| | Preferred Stock (2,067 shares) | 2,024 | 2,024 |
| | Common Stock (1,400 shares) | 140 | 140 |
| Autania AG(1,3) (Industrial Products) | Common Stock (250,000 shares) | 2,169 | 2,655 |

Edgar Filing: ALLIED CAPITAL CORP - Form N-2/A

| | | | |
|--|--|-----------------|------------------|
| Blue Rhino Corporation(1) (Consumer Products) | Debt Securities Common Stock (1,070,179 shares) | 14,074 5,076 | 14,074 10,926 |
|--|--|-----------------|------------------|

- (1) Public company.
- (2) Common stock, preferred stock, warrants, options, and equity interests are generally non-income producing and restricted.
- (3) Non-U.S. company.
- (4) Non-registered investment company.

The accompanying notes are an integral part of these consolidated financial statements.
S-33

Edgar Filing: ALLIED CAPITAL CORP - Form N-2/A

| | | March 31, 2003 | |
|---|------------------------------------|----------------|----------|
| Private Finance Portfolio Company (in thousands, except number of shares) | Investment(2) | (unaudited) | |
| | | Cost | Value |
| Border Foods, Inc. (Consumer Products) | Debt Securities | \$ 9,402 | \$ 9,402 |
| | Preferred Stock (50,919 shares) | 2,000 | 2,000 |
| | Common Stock (1,447 shares) | 35 | 35 |
| | Warrants | 665 | 665 |
| CBA-Mezzanine Capital Finance, LLC (Financial Services) | Loan | 6,531 | 6,531 |
| CorrFlex Graphics, LLC (Business Services) | Debt Securities | 12,135 | 12,135 |
| | Warrants | | 19,332 |
| | Options | | 1,669 |
| The Debt Exchange Inc. (Business Services) | Preferred Stock (921,875 shares) | 1,250 | 1,250 |
| EDM Consulting, LLC (Business Services) | Debt Securities | 1,802 | 269 |
| | Equity Interests | 250 | |
| International Fiber Corporation (Industrial Products) | Debt Securities | 22,661 | 22,661 |
| | Common Stock (1,029,069 shares) | 5,483 | 6,816 |
| | Warrants | 550 | 684 |
| Liberty-Pittsburgh Systems, Inc. (Business Services) | Debt Securities | 3,422 | 3,422 |
| | Common Stock (123,929 shares) | 142 | 67 |
| Logic Bay Corporation (Business Services) | Common Stock (1,437,420 shares) | 5,000 | |
| Magna Card, Inc. (Consumer Products) | Debt Securities | 153 | 153 |
| | Preferred Stock (1,875 shares) | 94 | 94 |
| | Common Stock (4,687 shares) | | |
| Master Plan, Inc. (Business Services) | Loan | 959 | 959 |
| | Common Stock (156 shares) | 42 | |
| MortgageRamp, Inc. (Business Services) | Common Stock (772,000 shares) | 3,860 | 2,084 |
| Nobel Learning Communities, Inc.(1) (Education) | Debt Securities | 9,782 | 9,782 |
| | Preferred Stock (1,063,830 shares) | 2,000 | 2,000 |
| | Warrants | 575 | 218 |
| Packaging Advantage Corporation (Business Services) | Debt Securities | 14,262 | 14,262 |
| | Common Stock (232,168 shares) | 2,386 | 2,386 |
| | Warrants | 963 | 963 |
| Professional Paint, Inc. (Consumer Products) | Debt Securities | 23,507 | 23,507 |
| | Preferred Stock (15,000 shares) | 20,803 | 20,803 |
| | Common Stock (110,000 shares) | 69 | 5,995 |

- (1) Public company.
- (2) Common stock, preferred stock, warrants, options, and equity interests are generally non-income producing and restricted.
- (3) Non-U.S. company.
- (4) Non-registered investment company.

The accompanying notes are an integral part of these consolidated financial statements.

S-34

Edgar Filing: ALLIED CAPITAL CORP - Form N-2/A

| | | March 31, 2003 | |
|---|---------------------------------|----------------|------------|
| Private Finance Portfolio Company (in thousands, except number of shares) | Investment(2) | (unaudited) | |
| | | Cost | Value |
| Progressive International Corporation (Consumer Products) | Debt Securities | \$ 3,970 | \$ 3,970 |
| | Preferred Stock (500 shares) | 500 | 500 |
| | Common Stock (197 shares) | 13 | 150 |
| | Warrants | | |
| Prosperco Finanz Holding AG(3) (Financial Services) | Convertible Debentures | 7,616 | 5,000 |
| | Common Stock (1,528 shares) | 1,059 | |
| | Warrants | | |
| Sidarus Holdings, Inc. (Business Services) | Debt Securities | 4,975 | 4,975 |
| | Preferred Stock (98,000 shares) | 980 | 980 |
| | Common Stock (492,941 shares) | 20 | 20 |
| | Warrants | | |
| Total Foam, Inc. (Industrial Products) | Debt Securities | 258 | 124 |
| | Common Stock (164 shares) | 10 | |
| Total companies 5% to 25% owned | | \$ 210,553 | \$ 232,568 |
| Companies Less Than 5% Owned | | | |
| ACE Products, Inc. (Industrial Products) | Loans | \$ 17,164 | \$ 10,562 |
| Advantage Sales and Marketing, Inc. (Business Services) | Debt Securities | 10,614 | 10,614 |
| | Warrants | 382 | 1,556 |
| Alderwoods Group, Inc.(1) (Consumer Services) | Common Stock (357,568 shares) | 5,006 | 1,255 |
| Allied Office Products, Inc. (Business Services) | Common Stock (31,333 shares) | 7,695 | 50 |
| American Barbecue & Grill, Inc. (Retail) | Warrants | 125 | |
| ASW Holding Corporation (Industrial Products) | Warrants | 25 | 25 |
| Bakery Chef, Inc. (Consumer Products) | Loans | 18,519 | 18,519 |
| Camden Partners Strategic Fund II, L.P.(4) (Private Equity Fund) | Limited Partnership Interest | 2,425 | 2,145 |
| Candlewood Hotel Company(1) (Hospitality) | Preferred Stock (3,250 shares) | 3,250 | 635 |

Edgar Filing: ALLIED CAPITAL CORP - Form N-2/A

| | | | |
|------------------------|----------|-----|-----|
| Celebrities, Inc. | Loan | 198 | 198 |
| (Broadcasting & Cable) | Warrants | 12 | 228 |

| | | | |
|---------------------|------|--------|--------|
| Clif Bar, Inc. | Loan | 24,900 | 24,900 |
| (Consumer Products) | | | |

- (1) Public company.
- (2) Common stock, preferred stock, warrants, options, and equity interests are generally non-income producing and restricted.
- (3) Non-U.S. company.
- (4) Non-registered investment company.

The accompanying notes are an integral part of these consolidated financial statements.
S-35

Edgar Filing: ALLIED CAPITAL CORP - Form N-2/A

| | | March 31, 2003 | |
|---|---------------------------------|----------------|----------|
| Private Finance Portfolio Company (in thousands, except number of shares) | Investment(2) | (unaudited) | |
| | | Cost | Value |
| Colibri Holding Corporation (Consumer Products) | Debt Securities | \$ 3,493 | \$ 3,493 |
| | Preferred Stock (237 shares) | 300 | 300 |
| | Common Stock (3,362 shares) | 1,250 | 1,088 |
| | Warrants | 290 | 252 |
| Component Hardware Group, Inc. (Industrial Products) | Debt Securities | 11,415 | 11,415 |
| | Preferred Stock (18,000 shares) | 2,268 | 2,268 |
| | Common Stock (2,000 shares) | 200 | 600 |
| Cooper Natural Resources, Inc. (Industrial Products) | Loan | 299 | 299 |
| | Debt Securities | 1,919 | 1,919 |
| | Preferred Stock (6,316 shares) | 1,427 | 1,427 |
| | Warrants | 832 | 832 |
| Coverall North America, Inc. (Business Services) | Loan | 12,407 | 12,407 |
| | Debt Securities | 6,425 | 6,425 |
| CTT Holdings (Consumer Products) | Loan | 1,250 | 1,250 |
| Drilltec Patents & Technologies Company, Inc. (Industrial Products) | Loan | 10,918 | |
| | Debt Securities | 1,500 | |
| eCentury Capital Partners, L.P.(4) (Private Equity Fund) | Limited Partnership Interest | 3,125 | 1,071 |
| Elaxis Beta GmbH(3) (Industrial Products) | Options | 426 | 289 |
| Eparfin S.A.(3) (Consumer Products) | Loan | 29 | 29 |
| E-Talk Corporation (Business Services) | Debt Securities | 8,852 | |
| | Warrants | 1,157 | |
| Executive Greetings, Inc. (Business Services) | Debt Securities | 18,830 | 14,315 |
| | Warrants | 360 | |
| Fairchild Industrial Products Company (Industrial Products) | Debt Securities | 5,954 | 5,954 |
| | Warrants | 280 | |
| Frozen Specialities, Inc. (Consumer Products) | Debt Securities | 9,958 | 9,958 |
| | Warrants | 435 | 435 |
| Galaxy American Communications, LLC (Broadcasting & Cable) | Debt Securities | 49,704 | 20,000 |
| | Options | | |
| | Standby Letter of Credit (\$37) | | |

Edgar Filing: ALLIED CAPITAL CORP - Form N-2/A

| | | | |
|--------------------------|--------------------------------|--------|--------|
| Garden Ridge Corporation | Debt Securities | 27,264 | 25,712 |
| (Retail) | Preferred Stock (1,130 shares) | 1,130 | |
| | Common Stock (847,800 shares) | 613 | |

- (1) Public company.
- (2) Common stock, preferred stock, warrants, options, and equity interests are generally non-income producing and restricted.
- (3) Non-U.S. company.
- (4) Non-registered investment company.

The accompanying notes are an integral part of these consolidated financial statements.

S-36

Edgar Filing: ALLIED CAPITAL CORP - Form N-2/A

| Private Finance Portfolio Company (in thousands, except number of shares) | Investment(2) | March 31, 2003 | |
|---|----------------------------------|----------------|----------------------|
| | | Cost | (unaudited) Value |
| Gibson Guitar Corporation (Consumer Products) | Debt Securities | \$ 18,154 | \$ 18,154 |
| | Warrants | 525 | 2,325 |
| Ginsey Industries, Inc. (Consumer Products) | Loans | 5,000 | 5,000 |
| | Convertible Debentures | 500 | 500 |
| | Warrants | | 2,250 |
| Global Communications, LLC (Business Services) | Loan | 2,347 | 2,347 |
| | Debt Securities | 16,472 | 16,472 |
| | Preferred Equity Interest | 14,067 | 14,067 |
| | Options | 1,639 | 1,639 |
| Grant Broadcasting Systems II (Broadcasting & Cable) | Warrants | 87 | 3,000 |
| Grotech Partners, VI, L.P.(4) (Private Equity Fund) | Limited Partnership Interest | 3,205 | 2,321 |
| The Hartz Mountain Corporation (Consumer Products) | Debt Securities | 27,766 | 27,766 |
| | Common Stock (200,000 shares) | 2,000 | 2,000 |
| | Warrants | 2,613 | 2,613 |
| Haven Eldercare of New England, LLC (Healthcare) | Loan | 35,853 | 35,853 |
| Headwaters Incorporated(1) (Industrial Products) | Loan | 9,956 | 9,956 |
| Healthmarket, Inc. (Health Insurance) | Debt Securities | 9,518 | 9,518 |
| | Warrants | 440 | 440 |
| Hotelevision, Inc. (Broadcasting & Cable) | Common Stock (315,100 shares) | 315 | |
| Icon International, Inc. (Business Services) | Common Stock (35,101 shares) | 1,219 | 2,103 |
| Impact Innovations Group, LLC (Business Services) | Debt Securities | 6,797 | 3,541 |
| | Warrants | 1,674 | |
| Intellirisk Management Corporation (Business Services) | Loan | 23,519 | 23,519 |
| Interline Brands, Inc. (Business Services) | Debt Securities | 34,351 | 34,351 |
| | Preferred Stock (199,313 shares) | 1,849 | 1,849 |
| | Common Stock (15,615 shares) | 139 | 139 |
| | Warrants | 1,181 | 1,181 |

Edgar Filing: ALLIED CAPITAL CORP - Form N-2/A

| | | | |
|---|-----------------------------|-------------|-------------|
| Jakel, Inc. (Industrial Products) | Loan | 23,307 | 10,130 |
| JRI Industries, Inc. (Industrial Products) | Debt Securities Warrants | 1,541 74 | 1,541 39 |

- (1) Public company.
- (2) Common stock, preferred stock, warrants, options, and equity interests are generally non-income producing and restricted.
- (3) Non-U.S. company.
- (4) Non-registered investment company.

The accompanying notes are an integral part of these consolidated financial statements.

S-37

Edgar Filing: ALLIED CAPITAL CORP - Form N-2/A

| | | March 31, 2003 | |
|---|----------------------------------|----------------|----------|
| Private Finance Portfolio Company (in thousands, except number of shares) | Investment(2) | (unaudited) | |
| | | Cost | Value |
| Julius Koch USA, Inc. (Industrial Products) | Warrants | \$ 259 | \$ 5,174 |
| Kirker Enterprises, Inc. (Industrial Products) | Equity Interest | 4 | 4 |
| | Warrants | 348 | 3,501 |
| Kirkland's, Inc.(1) (Retail) | Common Stock (122,142 shares) | 38 | 1,527 |
| Kyrus Corporation (Business Services) | Debt Securities | 6,669 | 6,669 |
| | Warrants | 348 | 450 |
| Love Funding Corporation (Financial Services) | Preferred Stock (26,000 shares) | 359 | 213 |
| Matrics, Inc. (Business Services) | Preferred Stock (511,876 shares) | 500 | 500 |
| | Warrants | | |
| MedAssets, Inc. (Business Services) | Debt Securities | 16,147 | 16,147 |
| | Preferred Stock (227,865 shares) | 2,049 | 2,049 |
| | Warrants | 136 | 180 |
| Mid-Atlantic Venture Fund IV, L.P.(4) (Private Equity Fund) | Limited Partnership Interest | 4,725 | 2,838 |
| Midview Associates, L.P. (Housing) | Warrants | | |
| Norstan Apparel Shops, Inc. (Retail) | Debt Securities | 11,828 | 11,828 |
| | Common Stock (29,622 shares) | 4,750 | 4,750 |
| | Warrants | 655 | 655 |
| North American Archery, LLC (Consumer Products) | Loans | 1,390 | 840 |
| | Convertible Debentures | 2,248 | 59 |
| | Guaranty (\$1,020) | | |
| Northeast Broadcasting Group, L.P. (Broadcasting & Cable) | Debt Securities | 254 | 254 |
| Novak Biddle Venture Partners III, L.P.(4) (Private Equity Fund) | Limited Partnership Interest | 690 | 548 |
| Nursefinders, Inc. (Business Services) | Debt Securities | 11,233 | 11,233 |
| | Warrants | 900 | 1,046 |
| Onyx Television GmbH(3) (Broadcasting & Cable) | Preferred Units | 201 | |

Edgar Filing: ALLIED CAPITAL CORP - Form N-2/A

| | | | |
|--|-----------------------------|---------------|---------------|
| Opinion Research Corporation(1) (Business Services) | Debt Securities Warrants | 14,401 996 | 14,401 599 |
|--|-----------------------------|---------------|---------------|

- (1) Public company.
- (2) Common stock, preferred stock, warrants, options, and equity interests are generally non-income producing and restricted.
- (3) Non-U.S. company.
- (4) Non-registered investment company.

The accompanying notes are an integral part of these consolidated financial statements.
S-38

Edgar Filing: ALLIED CAPITAL CORP - Form N-2/A

| | | March 31, 2003 | |
|---|---------------------------------|----------------|----------|
| Private Finance Portfolio Company (in thousands, except number of shares) | Investment(2) | (unaudited) | |
| | | Cost | Value |
| Oriental Trading Company, Inc. (Consumer Products) | Preferred Equity Interest | \$ 1,751 | \$ 1,751 |
| | Common Equity Interest | | 3,500 |
| Pico Products, Inc. (Industrial Products) | Loan | 1,406 | 1,406 |
| Polaris Pool Systems, Inc. (Consumer Products) | Debt Securities | 10,814 | 10,814 |
| | Warrants | 1,145 | 1,145 |
| Raytheon Aerospace, LLC (Business Services) | Debt Securities | 5,249 | 5,249 |
| | Equity Interest | | 350 |
| Resun Leasing, Inc. (Business Services) | Loan | 30,000 | 30,000 |
| Scitor Corporation (Business Services) | Loan | 22,283 | 22,283 |
| Simula, Inc.(1) (Industrial Products) | Loan | 21,518 | 21,518 |
| Soff-Cut Holdings, Inc. (Industrial Products) | Debt Securities | 9,394 | 9,394 |
| | Preferred Stock (300 shares) | 300 | 300 |
| | Common Stock (2,000 shares) | 200 | 200 |
| Southwest PCS, LLC (Telecommunications) | Loan | 1,000 | 1,000 |
| Spa Lending Corporation (Recreation) | Preferred Stock (28,672 shares) | 424 | 306 |
| Startec Global Communications Corporation(1) (Telecommunications) | Loan | 25,715 | 25,715 |
| | Debt Securities | 20,670 | |
| SunStates Refrigerated Services, Inc. (Warehouse Facilities) | Loans | 4,592 | 1,490 |
| | Debt Securities | 2,445 | |
| Sydran Food Services II, L.P. (Retail) | Debt Securities | 12,973 | 9,949 |
| | Equity Interests | 3,747 | |
| | Warrants | 162 | |
| Tubbs Snowshoe Company, LLC (Consumer Products) | Debt Securities | 3,931 | 3,931 |
| | Equity Interests | 500 | 379 |
| | Warrants | 54 | |
| United Pet Group, Inc. | Debt Securities | 9,091 | 9,091 |

Edgar Filing: ALLIED CAPITAL CORP - Form N-2/A

| | | | |
|--|------------------------------|-------|-------|
| (Consumer Products) | Warrants | 85 | 235 |
| Updata Venture Partners II, L.P.(4) (Private Equity Fund) | Limited Partnership Interest | 1,602 | 1,990 |

- (1) Public company.
- (2) Common stock, preferred stock, warrants, options, and equity interests are generally non-income producing and restricted.
- (3) Non-U.S. company.
- (4) Non-registered investment company.

The accompanying notes are an integral part of these consolidated financial statements.
S-39

Edgar Filing: ALLIED CAPITAL CORP - Form N-2/A

| | | March 31, 2003 | |
|---|------------------------------|----------------|--------------|
| Private Finance Portfolio Company (in thousands, except number of shares) | Investment(2) | (unaudited) | |
| | | Cost | Value |
| U.S. Security Holdings, Inc. (Business Services) | Debt Securities | \$ 24,134 | \$ 24,134 |
| | Warrants | 826 | 1,100 |
| Venturehouse Group, LLC(4) (Private Equity Fund) | Equity Interest | 1,000 | 384 |
| Walker Investment Fund II, LLLP(4) (Private Equity Fund) | Limited Partnership Interest | 1,178 | 419 |
| Warn Industries, Inc. (Consumer Products) | Debt Securities | 4,406 | 4,406 |
| | Warrants | 1,429 | 4,000 |
| Wilshire Restaurant Group, Inc. (Retail) | Debt Securities | 16,437 | 16,437 |
| | Warrants | 735 | 541 |
| Wilton Industries, Inc. (Consumer Products) | Loan | 9,600 | 9,600 |
| Woodstream Corporation (Consumer Products) | Loan | 2,621 | 2,621 |
| | Debt Securities | 7,689 | 7,689 |
| | Equity Interests | 1,700 | 5,535 |
| | Warrants | 450 | 1,465 |
| Total companies less than 5% owned | | \$ 865,117 | \$ 752,831 |
| Total private finance (121 portfolio companies) | | \$ 1,747,587 | \$ 1,742,084 |

(1) Public company.

(2) Common stock, preferred stock, warrants, options, and equity interests are generally non-income producing and restricted.

(3) Non-U.S. company.

(4) Non-registered investment company.

The accompanying notes are an integral part of these consolidated financial statements.

S-40

Edgar Filing: ALLIED CAPITAL CORP - Form N-2/A

| (in Thousands) | Stated Interest | Face | March 31, 2003 | |
|--|-----------------|------------|----------------|------------|
| | | | Cost | Value |
| Commercial Real Estate Finance | | | | |
| Commercial Mortgage-Backed Securities | | | | |
| Mortgage Capital Funding, Series 1998-MC3 | 5.5% | \$ 47,103 | \$ 25,475 | \$ 23,641 |
| Morgan Stanley Capital I, Series 1999-RM1 | 6.4% | 29,629 | 9,673 | 10,026 |
| COMM 1999-1 | 5.7% | 57,163 | 26,081 | 27,158 |
| Morgan Stanley Capital I, Series 1999-FNV1 | 6.1% | 28,595 | 14,081 | 11,835 |
| DLJ Commercial Mortgage Trust 1999-CG2 | 6.1% | 44,635 | 14,016 | 15,142 |
| Commercial Mortgage Acceptance Corp., Series 1999-C1 | 6.8% | 18,346 | 5,233 | 5,962 |
| LB Commercial Mortgage Trust, Series 1999-C2 | 6.7% | 11,603 | 1,781 | 1,768 |
| Chase Commercial Mortgage Securities Corp., Series 1999-2 | 6.5% | 20,545 | 5,561 | 6,184 |
| FUNB CMT, Series 1999-C4 | 6.5% | 22,887 | 7,869 | 7,048 |
| Heller Financial, HFCMC Series 2000 PH-1 | 6.6% | 25,767 | 8,796 | 9,096 |
| SBMS VII, Inc., Series 2000-NL1 | 7.2% | 9,214 | 4,564 | 3,844 |
| DLJ Commercial Mortgage Trust, Series 2000-CF1 | 7.0% | 24,328 | 9,434 | 9,808 |
| Deutsche Bank Alex. Brown, Series Comm 2000-C1 | 6.9% | 17,922 | 5,284 | 4,009 |
| LB-UBS Commercial Mortgage Trust, Series 2000-C4 | 6.9% | 17,484 | 4,059 | 4,101 |
| Credit Suisse First Boston Mortgage Securities Corp., Series 2001-CK1 | 5.9% | 16,805 | 4,109 | 3,954 |
| JP Morgan-CIBC-Deutsche 2001 | 5.8% | 25,370 | 6,886 | 6,936 |
| Lehman Brothers-UBS Warburg 2001-C2 | 6.4% | 22,756 | 6,623 | 6,606 |
| SBMS VII, Inc., Series 2001-C1 | 6.1% | 23,049 | 5,664 | 5,169 |
| GE Capital Commercial Mortgage Securities Corp., Series 2001-2 | 6.1% | 21,228 | 6,306 | 5,946 |
| Credit Suisse First Boston Mortgage Securities Corp., Series 2001-CKN5 | 5.2% | 21,456 | 5,210 | 5,184 |
| JP Morgan Chase Commercial Mortgage Securities Corp., Series 2001-C1 | 5.6% | 24,493 | 5,891 | 5,609 |
| SBMS VII, Inc., Series 2001-C2 | 6.2% | 21,619 | 5,922 | 5,956 |
| FUNB CMT, Series 2002-C1 | 6.0% | 28,303 | 11,526 | 12,123 |
| GE Capital Commercial Mortgage Corp., Series 2002-1 | 6.2% | 50,631 | 24,929 | 29,475 |
| GMAC Commercial Mortgage Securities, Inc., Series 2002-C2 | 5.8% | 40,573 | 20,044 | 22,332 |
| GE Capital Commercial Mortgage Corp., Series 2002-3 | 5.1% | 50,047 | 22,548 | 23,340 |
| Morgan Stanley Dean Witter Capital I Trust 2002-IQ3 | 6.0% | 27,858 | 13,150 | 13,688 |
| LB-UBS Commercial Mortgage Trust 2003-C1 | 4.6% | 50,896 | 22,040 | 21,660 |
| GS Mortgage Securities Corporation II Series 2003-C1 | 4.7% | 39,543 | 19,046 | 18,900 |
| Total commercial mortgage-backed securities | | \$ 839,848 | \$ 321,801 | \$ 326,500 |
| Collateralized Debt Obligations | | | | |
| Crest 2001-1, Ltd.(3) | | | \$ 23,655 | \$ 23,655 |
| Crest 2002-1, Ltd.(3) | | | 23,728 | 23,728 |
| Crest 2002-IG, Ltd.(3) | | | 4,798 | 4,798 |
| Crest Clarendon Street 2002-1, Ltd.(3) | | | 979 | 979 |
| Crest 2003-1, Ltd.(3) | | | 118,802 | 118,802 |
| Total collateralized debt obligations | | | \$ 171,962 | \$ 171,962 |

Edgar Filing: ALLIED CAPITAL CORP - Form N-2/A

The accompanying notes are an integral part of these consolidated financial statements.

S-41

| | | March 31, 2003 | | |
|---|--|--------------------|--------------------|--------------------|
| | | (unaudited) | | |
| Interest Rate Ranges | | Number of Loans | Cost | Value |
| Commercial Mortgage Loans | | | | |
| Up to 6.99% | | 13 | \$ 11,122 | \$ 12,419 |
| 7.00% 8.99% | | 20 | 29,733 | 26,603 |
| 9.00% 10.99% | | 6 | 7,736 | 7,666 |
| 11.00% 12.99% | | 15 | 19,587 | 12,286 |
| 13.00% 14.99% | | 6 | 6,466 | 4,740 |
| Total commercial mortgage loans | | 60 | \$ 74,644 | \$ 63,714 |
| Residual Interest | | | \$ 69,335 | \$ 69,035 |
| Real Estate Owned | | | 6,030 | 3,642 |
| Total commercial real estate finance | | | \$ 643,772 | \$ 634,853 |
| Total portfolio | | | \$2,391,359 | \$2,376,937 |

- (1) Public company.
- (2) Common stock, preferred stock, warrants, options, and equity interests are generally non-income producing and restricted.
- (3) Non-U.S. company.
- (4) Non-registered investment company.

The accompanying notes are an integral part of these consolidated financial statements.

S-42

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Information at and for the three months ended March 31, 2003 and 2002 is unaudited)

Note 1. Organization

Allied Capital Corporation, a Maryland corporation, is a closed-end management investment company that has elected to be regulated as a business development company (BDC) under the Investment Company Act of 1940 (1940 Act). Allied Capital Corporation (ACC) has a subsidiary that has also elected to be regulated as a BDC, Allied Investment Corporation (Allied Investment), which is licensed under the Small Business Investment Act of 1958 as a Small Business Investment Company (SBIC). In addition, ACC has a real estate investment trust subsidiary, Allied Capital REIT, Inc. (Allied REIT), and several subsidiaries which are single member limited liability companies established primarily to hold real estate properties. ACC also has a subsidiary, A.C. Corporation (AC Corp), that provides diligence and structuring services on private finance and commercial real estate finance transactions, as well as structuring, transaction, management, and advisory services to the Company, its portfolio companies and other third parties.

Allied Capital Corporation and its subsidiaries, collectively, are referred to as the Company.

In accordance with specific rules prescribed for investment companies, subsidiaries hold investments on behalf of the Company or provide substantial services to the Company. Portfolio investments are held for purposes of deriving investment income and future capital gains. The Company consolidates the results of its subsidiaries for financial reporting purposes. The financial results of the Company's portfolio investments are not consolidated in the Company's financial statements.

The investment objective of the Company is to achieve current income and capital gains. In order to achieve this objective, the Company invests in companies in a variety of industries and non-investment grade commercial mortgage-backed securities (CMBS).

Note 2. Summary of Significant Accounting Policies

Basis of Presentation

The consolidated financial statements include the accounts of ACC and its subsidiaries. All intercompany accounts and transactions have been eliminated in consolidation. Certain reclassifications have been made to the 2002 balances to conform with the 2003 financial statement presentation.

The accompanying unaudited consolidated financial statements of the Company have been prepared in accordance with accounting principles generally accepted in the United States of America (GAAP) for interim financial information. Accordingly, they do not include all of the information and footnotes required by GAAP for complete consolidated financial statements. In the opinion of management, the unaudited consolidated financial results of the Company included herein contain all adjustments (consisting of only normal recurring accruals) necessary to present fairly the financial position of the Company as of March 31, 2003, and the results of operations, changes in net assets, and cash flows for the three months ended March 31, 2003 and 2002. The results of operations for the three months ended March 31, 2003, are not necessarily indicative of the operating results to be expected for the full year.

During 2002, the Company revised its financial statement presentation to provide additional detail for the private finance portfolio, the interest and related portfolio income and net realized gains or losses by presenting these balances in the three categories described below. The consolidated

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 2. Summary of Significant Accounting Policies, continued

statement of operations for the three months ended March 31, 2002, has been revised to conform to this presentation.

The private finance portfolio, the interest and related portfolio income and net realized gains or losses earned on the private finance portfolio are presented in three categories: companies more than 25% owned, which represent portfolio companies where the Company directly or indirectly owns more than 25% of the outstanding voting securities of such portfolio company and, therefore, are deemed controlled by the Company under the 1940 Act; companies owned 5% to 25%, which represent portfolio companies where the Company directly or indirectly owns 5% to 25% of the outstanding voting securities of such portfolio company or where the Company holds one or more seats on the portfolio company's board of directors and, therefore, are deemed to be an affiliated person under the 1940 Act; and companies less than 5% owned which represent portfolio companies where the Company directly or indirectly owns less than 5% of the outstanding voting securities of such portfolio company and where the Company has no other affiliations with such portfolio company. The interest and related portfolio income and net realized gains or losses from the commercial real estate finance portfolio and other sources are included in the companies less than 5% owned category on the consolidated statement of operations.

Valuation Of Portfolio Investments

The Company, as a BDC, invests in illiquid securities including debt and equity securities of companies, non-investment grade CMBS, and collateralized debt obligations. The Company's investments are generally subject to restrictions on resale and generally have no established trading market. The Company values substantially all of its investments at fair value as determined in good faith by the board of directors in accordance with the Company's valuation policy. The Company determines fair value to be the amount for which an investment could be exchanged in an orderly disposition over a reasonable period of time between willing parties other than in a forced or liquidation sale. The Company's valuation policy considers the fact that no ready market exists for substantially all of the securities in which it invests. The Company's valuation policy is intended to provide a consistent basis for determining the fair value of the portfolio. The Company will record unrealized depreciation on investments when it believes that an investment has become impaired, including where collection of a loan or realization of an equity security is doubtful, or when the enterprise value of the company does not currently support the cost of the Company's debt or equity investments. Enterprise value means the entire value of the company to a potential buyer, including the sum of the values of all debt and equity securities used to capitalize the enterprise at a point in time. The Company will record unrealized appreciation if it believes that the underlying portfolio company has appreciated in value and, therefore, the Company's equity security has also appreciated in value. The value of investments in publicly traded securities are determined using quoted market prices discounted for restrictions on resale, if any.

Loans and Debt Securities

For loans and debt securities, fair value generally approximates cost unless the borrower's enterprise value or overall financial condition or other factors lead to a determination of fair value at a different amount.

When the Company receives nominal cost warrants or free equity securities (nominal cost equity), the Company allocates its cost basis in its investment between its debt securities and its

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 2. Summary of Significant Accounting Policies, continued

nominal cost equity at the time of origination. At that time, the original issue discount basis of the nominal cost equity is recorded by increasing the cost basis in the equity and decreasing the cost basis in the related debt securities.

Interest income is recorded on an accrual basis to the extent that such amounts are expected to be collected. For loans and debt securities with contractual payment-in-kind interest, which represents contractual interest accrued and added to the loan balance that generally becomes due at maturity, the Company will not accrue payment-in-kind interest if the portfolio company valuation indicates that the payment-in-kind interest is not collectible. Interest on loans and debt securities is not accrued if the Company has doubt about interest collection. Loans in workout status classified as Grade 4 or 5 assets do not accrue interest. In addition, interest may not accrue on loans or debt securities to portfolio companies that are more than 50% owned by the Company if such companies are in need of additional working capital. Loan origination fees, original issue discount, and market discount are capitalized and then amortized into interest income using the effective interest method. Prepayment premiums are recorded on loans when received.

The weighted average yield on loans and debt securities is computed as the (a) annual stated interest rate earned plus the annual amortization of loan origination fees, original issue discount, and market discount earned on accruing loans and debt securities, divided by (b) total loans and debt securities at value. The weighted average yield is computed as of the balance sheet date.

Equity Securities

The Company's equity interests in portfolio companies for which there is no liquid public market are valued at fair value based on the enterprise value of the portfolio company, which is determined using various factors, including cash flow from operations of the portfolio company and other pertinent factors such as recent offers to purchase a portfolio company's securities or other liquidation events. The determined fair values are generally discounted to account for restrictions on resale and minority ownership positions.

The value of the Company's equity interests in public companies for which market quotations are readily available is based upon the closing public market price on the balance sheet date. Securities that carry certain restrictions on sale are typically valued at a discount from the public market value of the security.

Dividend income is recorded on preferred equity securities on an accrual basis to the extent that such amounts are expected to be collected, and on common equity securities on the record date for private companies or on the ex-dividend date for publicly traded companies.

Commercial Mortgage-Backed Securities (CMBS) and Collateralized Debt Obligations (CDO)

CMBS bonds and CDO bonds and preferred shares are carried at fair value, which is based on a discounted cash flow model that utilizes prepayment and loss assumptions based on historical experience and projected performance, economic factors, the characteristics of the underlying cash flow, and comparable market yields for similar CMBS bonds and CDO bonds and preferred shares. The Company's assumption with regard to the discount rate for determining fair value is based on the yield of comparable securities. The Company recognizes income from the amortization of original issue discount using the effective interest method, using the anticipated yield over the projected life of

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 2. Summary of Significant Accounting Policies, continued

the investment. Yields are revised when there are changes in estimates of future credit losses, actual losses incurred, or actual and estimated prepayment speeds. Changes in estimated yield are recognized as an adjustment to the estimated yield over the remaining life of the CMBS bonds and CDO bonds and preferred shares from the date the estimated yield is changed. The Company recognizes unrealized appreciation or depreciation on its CMBS bonds and CDO bonds and preferred shares as comparable yields in the market change and based on changes in estimated cash flows resulting from changes in prepayment or loss assumptions in the underlying collateral pool.

Residual Interest

The Company values its residual interest from a previous securitization and recognizes income using the same accounting policies used for the CMBS bonds. The residual interest is carried at fair value generally based on discounted estimated future cash flows (see Note 3). The Company recognizes income from the residual interest using the effective interest method. At each reporting date, the effective yield is recalculated and used to recognize income until the next reporting date.

Net Realized Gains or Losses and Net Change in Unrealized Appreciation or Depreciation

Realized gains or losses are measured by the difference between the net proceeds from the repayment or sale and the cost basis of the investment without regard to unrealized appreciation or depreciation previously recognized, and include investments charged off during the year, net of recoveries. Net change in unrealized appreciation or depreciation reflects the change in portfolio investment values during the reporting period.

Fee Income

Fee income includes fees for guarantees and services rendered by the Company to portfolio companies and other third parties such as diligence, structuring, transaction services, management services, and investment advisory services. Guaranty fees are recognized as income over the related period of the guaranty. Diligence, structuring, and transaction services fees are generally recognized as income when services are rendered or when the related transactions are completed. Management and investment advisory services fees are generally recognized as income as the services are rendered.

Deferred Financing Costs

Financing costs are based on actual costs incurred in obtaining debt financing and are deferred and amortized as part of interest expense over the term of the related debt instrument.

Cash and Cash Equivalents

Cash and cash equivalents include cash in banks and all highly liquid investments with original maturities of three months or less.

Dividends to Shareholders

Dividends to shareholders are recorded on the record date.

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 2. Summary of Significant Accounting Policies, continued

Stock Compensation Plans

At March 31, 2003 and 2002, the Company had a stock-based employee compensation plan. The Company accounts for this plan under the recognition and measurement principles of APB Opinion No. 25, *Accounting for Stock Issued to Employees*, and related Interpretations. No stock-based employee compensation cost is reflected in net increase in net assets resulting from operations, as all options granted under this plan had an exercise price equal to the market value of the underlying common stock on the date of grant. The following table illustrates the effect on net increase in net assets resulting from operations and earnings per share if the Company had applied the fair value recognition provisions of FASB Statement No. 123, *Accounting for Stock-Based Compensation*, to stock-based employee compensation.

| | For the Three Months Ended March 31, | |
|--|--|-----------|
| | 2003 | 2002 |
| (in thousands, except per share amounts) | | |
| Net increase in net assets resulting from operations as reported | \$ 19,873 | \$ 55,961 |
| Less total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects | (1,348) | (1,658) |
| Pro forma net increase in net assets resulting from operations | 18,525 | 54,303 |
| Less preferred stock dividends | (55) | (55) |
| Pro forma income available to common shareholders | \$ 18,470 | \$ 54,248 |
| Basic earnings per common share: | | |
| As reported | \$ 0.18 | \$ 0.56 |
| Pro forma | \$ 0.17 | \$ 0.54 |
| Diluted earnings per common share: | | |
| As reported | \$ 0.18 | \$ 0.55 |
| Pro forma | \$ 0.17 | \$ 0.53 |

Pro forma expenses are based on the underlying value of the options granted by the Company. The fair value of each option grant is estimated on the date of grant using the Black-Scholes option pricing model, with the following weighted average assumptions for grants:

| | For the Three Months Ended March 31, | |
|--|--|---------|
| | 2003 | 2002 |
| Risk-free interest rate | 2.8% | 4.4% |
| Expected life | 5.0 | 5.0 |
| Expected volatility | 39.1% | 39.7% |
| Dividend yield | 8.9% | 8.5% |
| Weighted average fair value per option | \$ 3.23 | \$ 4.98 |

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 2. Summary of Significant Accounting Policies, continued

Federal and State Income Taxes

The Company intends to comply with the requirements of the Internal Revenue Code (Code) that are applicable to regulated investment companies (RIC) and real estate investment trusts (REIT). The Company and its subsidiaries that qualify as a RIC or a REIT intend to annually distribute or retain through a deemed distribution all of their taxable income to shareholders; therefore, the Company has made no provision for income taxes for these entities. AC Corp is a corporation subject to federal and state income taxes and records a provision for income taxes as appropriate.

Per Share Information

Basic earnings per share is calculated using the weighted average number of shares outstanding for the period presented. Diluted earnings per share reflects the potential dilution that could occur if options to issue common stock were exercised into common stock. Earnings per share is computed after subtracting dividends on preferred shares.

Use of Estimates in the Preparation of Financial Statements

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. Actual results could differ from these estimates.

The consolidated financial statements include portfolio investments at value of \$2.4 billion and \$2.5 billion as of March 31, 2003, and December 31, 2002, respectively (92% and 89%, respectively, of total assets). Substantially all of these investments represent investments whose fair values have been determined by the board of directors in good faith in the absence of readily available market values. Because of the inherent uncertainty of valuation, the board of directors determined values may differ significantly from the values that would have been used had a ready market existed for the investments, and the differences could be material.

New Accounting Pronouncements

In November 2002, the FASB issued Interpretation No. 45, *Guarantors Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others* (the Interpretation) which expands on the accounting guidance of Statements No. 5, 57 and 107 and incorporates without change the provisions of FASB Interpretation No. 34, which is being superceded. The Interpretation will significantly change current practice in the accounting for and disclosure of guarantees. Guarantees meeting the characteristics described in the Interpretation are to be recognized at fair value and significant disclosure rules have been implemented even if the likelihood of the guarantor making payments is remote. The disclosure requirements are effective for financial statements of interim or annual periods ending after December 15, 2002, while the initial measurement provisions are applicable on a prospective basis to guarantees issued or modified after December 31, 2002. Certain guarantees are excluded from the initial recognition provisions of the Interpretation, however specific disclosures are still required. The Company has applied the initial recognition and measurement provisions for guarantees issued in the first quarter of 2003 and there

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 2. Summary of Significant Accounting Policies, continued

was no material effect on the Company's financial position or its results of operations. See Note 5 for the disclosures related to the Company's guarantees.

In January 2003, the FASB issued Interpretation No. 46, *Consolidation of Variable Interest Entities* (the Interpretation) which provides new guidance on the consolidation of certain entities defined as variable interest entities. The Interpretation specifies that any enterprise subject to SEC Regulation S-X Rule 6-03(c)(1) shall not consolidate any entity that is not also subject to that same rule. As the Company is subject to this rule, it does not believe that the Interpretation will have an impact on its financial position or results of operations.

Note 3. Portfolio*Private Finance*

At March 31, 2003, and December 31, 2002, the private finance portfolio consisted of the following:

| (\$ in thousands) | 2003 | | | 2002 | | |
|---------------------------|---------------------|---------------------|----------|---------------------|---------------------|----------|
| | Cost | Value | Yield | Cost | Value | Yield |
| Loans and debt securities | \$ 1,276,957 | \$ 1,148,289 | 14.0%(1) | \$ 1,272,401 | \$ 1,151,256 | 14.4%(1) |
| Equity interests | 470,630 | 593,795 | | 438,501 | 591,959 | |
| Total | \$ 1,747,587 | \$ 1,742,084 | | \$ 1,710,902 | \$ 1,743,215 | |

(1) The weighted average yield on loans and debt securities is computed as the (a) annual stated interest rate earned plus the annual amortization of loan origination fees, original issue discount, and market discount earned on accruing loans and debt securities, divided by (b) total loans and debt securities at value. At March 31, 2003, the cost and value of loans and debt securities include the Class A equity interests in BLX and the yield includes dividends earned on these equity interests. The weighted average yield is computed as of the balance sheet date.

Private finance investment activity principally involves providing financing through privately negotiated long-term debt and equity investments. Private finance investments are generally structured as loans and debt securities that carry a relatively high fixed rate of interest, which may be combined with equity features, such as conversion privileges, or warrants or options to purchase a portion of the portfolio company's equity at a pre-determined strike price, which is generally a nominal price for warrants or options in a private company. Private finance investments are generally issued by privately owned companies and are generally illiquid and subject to restrictions on resale or transferability.

Loans and debt securities generally have a maturity of five to ten years, with interest-only payments in the early years and payments of both principal and interest in the later years, although debt maturities and principal amortization schedules vary. At March 31, 2003, and December 31, 2002, approximately 95% of the Company's loans and debt securities had fixed interest rates.

Equity interests consist primarily of securities issued by privately owned companies and may be subject to restrictions on their resale or may be otherwise illiquid. Equity securities generally do not produce a current return, but are held in anticipation of investment appreciation and ultimate realized gain on sale.

Edgar Filing: ALLIED CAPITAL CORP - Form N-2/A

The Company may acquire more than 50% of the common stock of a portfolio company in a control buyout transaction. The Company's most significant investments acquired through control

S-49

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 3. Portfolio, continued

buyout transactions both at March 31, 2003, and December 31, 2002, were Business Loan Express, LLC and The Hillman Companies, Inc.

At March 31, 2003, and December 31, 2002, the Company had an investment at value totaling \$307.6 million and \$256.8 million, respectively, in Business Loan Express, LLC (BLX), a small business lender that participates in the U.S. Small Business Administration 7(a) Guaranteed Loan Program. During the first quarter of 2003, the Company invested \$50 million in BLX in the form of a \$25 million short-term line of credit and \$25 million of preferred equity in connection with BLX 's acquisition of \$128 million in assets from Amresco Independence Funding, Inc. BLX also completed its corporate reorganization to a limited liability company during the quarter by merging BLX, Inc. into BLX, LLC. Prior to this transaction, BLX converted \$43 million of the Company 's subordinated debt to preferred stock in BLX, Inc., which was exchanged upon the merger for Class A equity interests of BLX, LLC. In addition, as part of the merger, the Company exchanged its existing preferred stock and common equity investments in BLX, Inc. for similar classes of member 's equity in BLX, LLC represented by Class B and Class C equity interests, respectively. At March 31, 2003, the Company owned 94.9% of the voting Class C equity interests. BLX has a stock appreciation rights plan for management which will dilute the value available to the Class C equity interest holders.

At the time of the corporate reorganization of BLX, Inc. from a C corporation to a limited liability company, for tax purposes BLX had a built-in gain representing the aggregate fair market value of its assets in excess of the tax basis of its assets. As a regulated investment company, the Company will be subject to the built-in gain rules on the assets of BLX. Under these rules, taxes will be payable by the Company at the time and to the extent that the built-in gains on BLX 's assets at the date of reorganization are recognized in a taxable disposition of such assets in the 10-year period following the date of the reorganization. At such time, the built-in gains realized upon the disposition of these assets will be included in the Company 's taxable income, net of the corporate level taxes paid by the Company on the built-in gains. However, if these assets are disposed of after the 10-year period, there will be no corporate level taxes on these built-in gains.

While the Company has no obligation to pay the built-in gains tax until these assets are disposed of in the future, it may be necessary to record a liability for these taxes in the future should the Company intend to sell the assets of BLX within the 10-year period. The Company estimates its future tax liability resulting from the built-in gains at the date of BLX 's reorganization may total up to \$42 million. At March 31, 2003, the Company has considered the increase in fair value of its investment in BLX due to BLX 's tax attributes as an LLC and has also considered the corresponding reduction in fair value of its investment due to these estimated built-in gain taxes in determining the fair value of its investment in BLX.

As the controlling equity owner of BLX, the Company has provided an unconditional guaranty to the BLX credit facility lenders in an amount up to 50% of the total obligations (consisting of principal, accrued interest, and other fees) on BLX 's three-year unsecured \$149.0 million revolving credit facility that matures in March 2004. The amount guaranteed by the Company at March 31, 2003, was \$57.2 million. This guaranty can be called by the lenders only in the event of a default by BLX. BLX was in compliance with the terms of its credit facility at March 31, 2003. The Company has also provided two standby letters of credit in connection with two term securitization transactions completed by BLX totaling \$10.6 million. In consideration for providing this guaranty and the two

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 3. Portfolio, continued

standby letters of credit, BLX paid the Company a fee of \$1.0 million and \$0.8 million for the three months ended March 31, 2003 and 2002, respectively. BLX is headquartered in New York, NY.

At March 31, 2003, and December 31, 2002, the Company had an investment in The Hillman Companies, Inc. (Hillman) totaling \$181.3 million and \$180.5 million at value, respectively. At March 31, 2003, the Company owned 96.8% of Hillman's common stock. The Company's common stock ownership is subject to dilution by management options. Hillman is a leading manufacturer of key making equipment and distributor of key blanks, fasteners, signage, and other small hardware components and operates in multiple channels of the retail marketplace such as hardware stores, national and regional home centers, and mass merchants. Hillman has certain patent-protected products, including key duplication technology, that is important to its business. Hillman's primary operations are located in Cincinnati, Ohio.

Total interest and portfolio related income earned from the Company's investments in BLX and Hillman for the three months ended March 31, 2003 and 2002, was \$15.3 million and \$12.3 million, respectively.

At March 31, 2003, and December 31, 2002, loans and debt securities in workout status (classified as Grades 4 and 5 under the Company's internal grading system) that were not accruing interest were as follows at value:

| (in thousands) | 2003 | 2002 |
|-------------------------------|----------|----------|
| Companies more than 25% owned | \$20,798 | \$ 9,709 |
| Companies 5% to 25% owned | 393 | 411 |
| Companies less than 5% owned | 60,936 | 65,931 |
| Total | \$82,127 | \$76,051 |

In addition to Grade 4 and 5 assets that are in workout, the Company may not accrue interest on loans and debt securities to companies that are more than 50% owned by the Company if such companies are in need of additional working capital and, therefore, the Company may defer current debt service. Loans and debt securities to such companies totaled \$58.5 million and \$63.6 million at value at March 31, 2003, and December 31, 2002, respectively. In addition, loans to companies that are less than 50% owned by the Company and were not in workout but were not accruing interest totaled \$21.6 million and \$7.2 million at value at March 31, 2003, and December 31, 2002, respectively.

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 3. Portfolio, continued

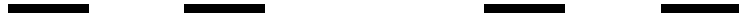
The industry and geographic compositions of the private finance portfolio at value at March 31, 2003, and December 31, 2002, were as follows:

| | <u>2003</u> | <u>2002</u> |
|--------------------------|-------------------|-------------------|
| Industry | | |
| Consumer products | 32% | 34% |
| Business services | 26 | 26 |
| Financial services | 18 | 16 |
| Industrial products | 8 | 9 |
| Healthcare | 5 | 5 |
| Retail | 4 | 4 |
| Telecommunications | 2 | 2 |
| Education | 1 | 1 |
| Broadcasting & cable | 1 | 1 |
| Other | 3 | 2 |
| | <u> </u> | <u> </u> |
| Total | 100% | 100% |
| | <u> </u> | <u> </u> |
| Geographic Region | | |
| Mid-Atlantic | 49% | 45% |
| Southeast | 15 | 16 |
| West | 15 | 15 |
| Midwest | 13 | 16 |
| Northeast | 7 | 7 |
| International | 1 | 1 |
| | <u> </u> | <u> </u> |
| Total | 100% | 100% |
| | <u> </u> | <u> </u> |

Commercial Real Estate Finance

At March 31, 2003, and December 31, 2002, the commercial real estate finance portfolio consisted of the following:

| | <u>2003</u> | | | <u>2002</u> | | |
|---|-------------------|-------------------|--------------|-------------------|-------------------|--------------|
| | <u>Cost</u> | <u>Value</u> | <u>Yield</u> | <u>Cost</u> | <u>Value</u> | <u>Yield</u> |
| (\$ in thousands) | | | | | | |
| CMBS bonds | \$321,801 | \$326,500 | 15.5% | \$523,671 | \$555,519 | 14.2% |
| Collateralized debt obligation bonds and preferred shares | 171,962 | 171,962 | 16.4% | 52,818 | 52,818 | 17.2% |
| Loans | 74,644 | 63,714 | 7.0% | 66,546 | 63,707 | 7.5% |
| Residual interest | 69,335 | 69,035 | 9.4% | 69,335 | 69,035 | 9.4% |
| Real estate owned | 6,030 | 3,642 | | 5,942 | 3,873 | |
| | <u> </u> | <u> </u> | | <u> </u> | <u> </u> | |
| Total | \$643,772 | \$634,853 | | \$718,312 | \$744,952 | |



S-52



ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 3. Portfolio, continued

CMBS Bonds. At March 31, 2003, and December 31, 2002, CMBS bonds consisted of the following:

| (\$ in thousands) | 2003 | 2002 |
|-------------------------|------------|--------------|
| Face | \$ 839,848 | \$ 1,173,194 |
| Original issue discount | (518,047) | (649,523) |
| Cost | \$ 321,801 | \$ 523,671 |
| Value | \$ 326,500 | \$ 555,519 |

The non-investment grade and unrated tranches of the CMBS bonds in which the Company invests are junior in priority for payment of interest and principal to the more senior tranches of the related CMBS bond issuance. Cash flow from the underlying mortgages generally is allocated first to the senior tranches, with the most senior tranches having a priority right to the cash flow. Then, any remaining cash flow is allocated, generally, among the other tranches in order of their relative seniority. To the extent there are defaults and unrecoverable losses on the underlying mortgages or the properties securing those mortgages resulting in reduced cash flows, the most subordinate tranche will bear this loss first. At March 31, 2003, the Company's CMBS bonds were subordinate to 91% to 99% of the tranches of bonds issued in various CMBS transactions. Given that the non-investment grade CMBS bonds in which the Company invests are junior in priority for payment of principal, the Company invests in these CMBS bonds at a significant discount from the face amount of the bonds.

The underlying rating classes of the CMBS bonds at value at March 31, 2003, and December 31, 2002, were as follows:

| (\$ in thousands) | 2003 | | 2002 | |
|-------------------|------------|---------------------|------------|---------------------|
| | Value | Percentage of Total | Value | Percentage of Total |
| BB+ | \$ 37,774 | 11.6% | \$ 49,811 | 9.0% |
| BB | 25,493 | 7.8 | 39,011 | 7.0 |
| BB- | 15,688 | 4.8 | 22,030 | 4.0 |
| B+ | 24,772 | 7.6 | 121,038 | 21.8 |
| B | 23,961 | 7.3 | 141,998 | 25.6 |
| B- | 78,684 | 24.1 | 83,493 | 15.0 |
| CCC+ | 10,868 | 3.3 | | |
| CCC | 15,030 | 4.6 | 8,634 | 1.5 |
| Unrated | 94,230 | 28.9 | 89,504 | 16.1 |
| Total | \$ 326,500 | 100.0% | \$ 555,519 | 100.0% |

At March 31, 2003, and December 31, 2002, the underlying collateral for the Company's CMBS bonds consisted of approximately 4,600 and 4,500 commercial mortgage loans and real estate properties owned with a total outstanding principal balance of \$27.8 billion and \$25.0 billion, respectively. At March 31, 2003, and December 31, 2002, 0.9% and 1.0%, respectively, of the mortgage loans in the underlying collateral pool for the Company's CMBS bonds were over 30 days delinquent or were classified as real estate owned.

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 3. Portfolio, continued

The property types and the geographic composition of the underlying mortgage loans and real estate properties owned in the underlying collateral pool calculated using the outstanding principal balance at March 31, 2003, and December 31, 2002, were as follows:

| | 2003 | 2002 |
|--------------------------|-------|-------|
| | _____ | _____ |
| Property Type | | |
| Retail | 33% | 32% |
| Housing | 26 | 27 |
| Office | 23 | 21 |
| Industrial Real Estate | 6 | 7 |
| Hospitality | 6 | 6 |
| Other | 6 | 7 |
| | _____ | _____ |
| Total | 100% | 100% |
| | _____ | _____ |
| Geographic Region | | |
| West | 30% | 31% |
| Mid-Atlantic | 27 | 25 |
| Midwest | 22 | 22 |
| Southeast | 16 | 17 |
| Northeast | 5 | 5 |
| | _____ | _____ |
| Total | 100% | 100% |
| | _____ | _____ |

The Company's yield on its CMBS bonds is based upon a number of assumptions that are subject to certain business and economic uncertainties and contingencies. Examples include the timing and magnitude of credit losses on the mortgage loans underlying the CMBS bonds that are a result of the general condition of the real estate market (including vacancies, rental rates and tenant credit quality) and changes in market rental rates. The initial yield on each CMBS bond has been computed assuming an approximate 1% loss rate on its entire underlying collateral mortgage pool, with the estimated losses being assumed to occur in three equal installments in years three, six, and nine. As each CMBS bond ages, the amount of losses and the expected timing of recognition of such losses will be updated, and the respective yield will be adjusted as necessary. As of March 31, 2003, the Company had identified and recorded specific losses of \$28.0 million, which reduced the face amount and original issue discount on the CMBS bonds, but did not result in a change in the cost and value of the CMBS bonds. As these uncertainties and contingencies are difficult to predict and are subject to future events which may alter these assumptions, no assurance can be given that the anticipated yields to maturity will be achieved.

Collateralized Debt Obligation Bonds and Preferred Shares (CDOs). At March 31, 2003, the Company owned BBB rated bonds in one CDO totaling \$29.7 million at value and preferred shares in five CDOs totaling \$142.3 million at value secured by investment grade unsecured debt issued by various real estate investment trusts (REITs) and investment and non-investment grade CMBS bonds. The investment grade REIT collateral consists of debt with a cut-off balance of \$1.2 billion and was issued by 44 REITs. The investment grade CMBS collateral consists of CMBS bonds with a face amount of \$496.0 million issued in 41 separate CMBS transactions and the non-investment grade CMBS collateral consists of BB+, BB, BB-, B+, and B rated CMBS bonds with a face amount of \$873.7 million issued in 42 separate CMBS transactions (CMBS Collateral). Included in the CMBS Collateral for the CDOs are \$793.7 million of CMBS bonds that are senior in

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 3. Portfolio, continued

priority of repayment to certain lower rated CMBS bonds held by the Company, which were issued in 27 separate CMBS transactions.

The BBB rated bonds and the preferred shares owned by the Company are junior in priority for payment of principal and interest to the more senior tranches of debt issued by the CDOs. To the extent there are defaults and unrecoverable losses on the underlying collateral resulting in reduced cash flows, the preferred shares will bear this loss first and then the BBB rated bonds would bear any loss after the preferred shares. At March 31, 2003, the Company's BBB bonds and preferred shares in the CDOs were subordinate to 61% to 98% of the more senior tranches of debt issued in various CDO transactions.

As of March 31, 2003, the Company acts as the disposition consultant with respect to four of the CDOs, which allows the Company to approve disposition plans for individual collateral securities. As of March 31, 2002, the Company acted as the disposition consultant with respect to two of the CDOs. For these services, the Company collects annual fees based on the outstanding collateral pool balance, and for the quarters ended March 31, 2003 and 2002, this fee totaled \$201 thousand and \$37 thousand, respectively.

Loans. The commercial mortgage loan portfolio contains loans that were originated by the Company or were purchased from third-party sellers. At March 31, 2003, and December 31, 2002, approximately 85% and 15% and 84% and 16% of the Company's commercial mortgage loan portfolio was composed of fixed and adjustable interest rate loans, respectively. As of March 31, 2003, and December 31, 2002, loans with a value of \$16.3 million and \$13.0 million, respectively, were not accruing interest. Loans greater than 120 days delinquent generally do not accrue interest.

The property types and the geographic composition securing the commercial mortgage loan portfolio at value at March 31, 2003, and December 31, 2002, were as follows:

| | <u>2003</u> | <u>2002</u> |
|--------------------------|-------------------|-------------------|
| Property Type | | |
| Retail | 25% | 21% |
| Office | 20 | 20 |
| Hospitality | 20 | 23 |
| Healthcare | 15 | 15 |
| Recreation | 3 | 3 |
| Other | 17 | 18 |
| | <u> </u> | <u> </u> |
| Total | 100% | 100% |
| | <u> </u> | <u> </u> |
| Geographic Region | | |
| Southeast | 39% | 40% |
| West | 22 | 20 |
| Mid-Atlantic | 17 | 17 |
| Midwest | 11 | 12 |
| Northeast | 11 | 11 |
| | <u> </u> | <u> </u> |
| Total | 100% | 100% |
| | <u> </u> | <u> </u> |

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 3. Portfolio, continued

Residual Interest. At March 31, 2003, and December 31, 2002, the residual interest consisted of the following:

| (in thousands) | 2003 | | 2002 | |
|--------------------------|-----------------|-----------------|-----------------|-----------------|
| | Cost | Value | Cost | Value |
| Residual interest | \$68,853 | \$68,853 | \$68,853 | \$68,853 |
| Residual interest spread | 482 | 182 | 482 | 182 |
| Total | \$69,335 | \$69,035 | \$69,335 | \$69,035 |

The residual interest primarily consists of a retained interest totaling \$68.9 million from a 1998 asset securitization. At March 31, 2003, one class of bonds rated AAA was outstanding, totaling \$6.0 million. The residual interest represents a right to cash flows from the underlying collateral pool of loans after these senior bond obligations are satisfied. The Company had the right to call the bonds upon a minimum of ten days notice to the bondholders. During April 2003, the call provision was exercised and, accordingly, the bondholders were repaid in full and the remaining available cash, loans, and real estate owned of the trust were subsequently returned to the Company as payment on the residual interest.

At December 31, 2002, the Company used a discounted cash flow methodology for determining the fair value of its retained residual interest and residual interest spread (Residual). In determining the cash flow of the Residual, the Company assumed a prepayment speed of 15% after the applicable prepayment lockout period and credit losses of 1% or approximately \$0.8 million of the total principal balance of the underlying collateral throughout the life of the collateral. These assumptions resulted in an expected weighted average life of the bonds of four months. The value of the resulting Residual cash flows at December 31, 2002, was then determined by applying a discount rate of 9% which, in the Company's view, was commensurate with the market risk of comparable assets.

Because the Company was in the process of exercising its call provision at March 31, 2003, the fair value of the Residual was determined based upon an analysis of the value of each of the underlying assets and liabilities of the trust as opposed to a discounted cash flow analysis.

Note 4. Debt

At March 31, 2003, and December 31, 2002, the Company had the following debt:

| (in thousands) | 2003 | | 2002 | |
|---|-----------------|----------------|-----------------|----------------|
| | Facility Amount | Amount Drawn | Facility Amount | Amount Drawn |
| Notes payable and debentures: | | | | |
| Unsecured long-term notes payable | \$ 694,000 | \$694,000 | \$ 694,000 | \$694,000 |
| SBA debentures | 101,800 | 94,500 | 101,800 | 94,500 |
| OPIC loan | 5,700 | 5,700 | 5,700 | 5,700 |
| Total notes payable and debentures | 801,500 | 794,200 | 801,500 | 794,200 |

Edgar Filing: ALLIED CAPITAL CORP - Form N-2/A

| | | | | |
|--------------------------|---------------------|-------------------|---------------------|-------------------|
| Revolving line of credit | <u>527,500(1)</u> | <u>61,750</u> | <u>527,500</u> | <u>204,250</u> |
| Total | <u>\$ 1,329,000</u> | <u>\$ 855,950</u> | <u>\$ 1,329,000</u> | <u>\$ 998,450</u> |

(1) On April 18, 2003, the Company renewed the revolving line of credit. The committed amount under the renewed facility is \$462.5 million.

S-56

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 4. Debt, continued

Notes Payable and Debentures

Unsecured Long-Term Notes Payable. The Company issued unsecured long-term notes to private institutional investors. The notes require semi-annual interest payments until maturity and have original terms of five or seven years. At March 31, 2003, the notes had remaining maturities of two months to four years. The weighted average fixed interest rate on the notes was 7.6% at March 31, 2003, and December 31, 2002. The notes may be prepaid in whole or in part, together with an interest premium, as stipulated in the note agreement.

On May 14, 2003, the Company issued \$153 million of five-year and \$147 million of seven-year unsecured long-term notes, primarily to insurance companies. The five- and seven-year notes have fixed interest rates of 5.45% and 6.05%, respectively, and have substantially the same terms as the Company's existing unsecured long-term notes. On May 30, 2003, \$140 million of the Company's existing unsecured long term notes will mature and the Company will use proceeds from the new long-term note issuance to repay this amount.

SBA Debentures. At March 31, 2003, and December 31, 2002, the Company had debentures payable to the SBA with original terms of ten years and at fixed interest rates ranging from 5.9% to 8.2%. At March 31, 2003, the debentures had remaining maturities of two to nine years. The weighted average interest rate was 7.0% at March 31, 2003, and December 31, 2002. The debentures require semi-annual interest-only payments with all principal due upon maturity. The SBA debentures are subject to prepayment penalties if paid prior to the fifth anniversary date of the notes. At March 31, 2003, the Company had a commitment from the SBA to borrow up to an additional \$7.3 million above the current amount outstanding. The commitment expires on September 30, 2005.

Scheduled future maturities of notes payable and debentures at March 31, 2003, are as follows:

| Year | Amount Maturing (in thousands) |
|------------|-----------------------------------|
| 2003 | \$ 140,000 |
| 2004 | 221,000 |
| 2005 | 179,000 |
| 2006 | 180,700 |
| 2007 | |
| Thereafter | 73,500 |
| | <hr/> |
| Total | \$ 794,200 |
| | <hr/> |

Revolving Line of Credit

On April 18, 2003, the Company renewed its unsecured revolving line of credit under substantially similar terms with a committed amount under the renewed facility of \$462.5 million. The revolving line of credit may be expanded through new or additional commitments up to \$600 million at the Company's option. The renewed line of credit expires in April 2005 and may be extended under substantially similar terms for one additional year at the Company's sole option. The facility bears interest at a rate equal to (i) the one-month LIBOR plus 1.25%, (ii) the Bank of America, N.A. prime rate, or (iii) the Federal Funds rate plus 0.50% at the Company's option. The interest rate adjusts at the beginning of each new interest period, usually every 30 days. The interest rates were 2.8% and 2.7% at March 31, 2003, and December 31, 2002, respectively, and the facility requires an annual commitment fee equal to 0.25% of the committed amount. The line of credit generally requires monthly payments of interest, and all principal is due upon maturity.

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 4. Debt, continued

The average debt outstanding on the revolving line of credit was \$97.1 million and \$68.3 million for the three months ended March 31, 2003, and the year ended December 31, 2002, respectively. The maximum amount borrowed under this facility and the weighted average interest rate for the three months ended March 31, 2003, and the year ended December 31, 2002, were \$208.8 million and \$216.5 million, and 2.7% and 3.2%, respectively. As of March 31, 2003, the amount available under the revolving line of credit was \$461.2 million, net of amounts committed for standby letters of credit of \$4.6 million issued under the credit facility.

The Company has various financial and operating covenants required by the revolving line of credit and the notes payable and debentures. These covenants require the Company to maintain certain financial ratios, including debt to equity and interest coverage, and a minimum net worth. The Company's credit facilities limit its ability to declare dividends if the Company defaults under certain provisions. As of March 31, 2003, the Company was in compliance with these covenants.

Note 5. Guarantees

In the ordinary course of business, the Company has issued guarantees and has extended standby letters of credit through financial intermediaries on behalf of certain portfolio companies. As of March 31, 2003, and December 31, 2002, the Company had issued guarantees of debt, rental obligations, and lease obligations aggregating \$61.1 million and \$54.6 million, respectively, and had extended standby letters of credit aggregating \$17.6 million and \$11.3 million, respectively. Under these arrangements, the Company would be required to make payments to third-party beneficiaries if the portfolio companies were to default on their related payment obligations. The maximum amount of future payments is \$78.7 million and \$65.9 million at March 31, 2003, and December 31, 2002, respectively. At March 31, 2003, and December 31, 2002, no amounts had been recorded as a liability for the Company's guarantees or standby letters of credit.

As of March 31, 2003, the guarantees and standby letters of credit expire as follows:

| (in thousands) | Total | 2003 | 2004 | 2005 | 2006 | 2007 | After 2007 |
|--|----------|---------|----------|-------|---------|-------|------------|
| Guarantees of debt and lease obligations | \$61,132 | \$1,547 | \$57,957 | \$270 | \$142 | \$114 | \$1,102 |
| Standby letters of credit | 17,612 | | 4,587 | | 7,025 | | 6,000 |
| Total | \$78,744 | \$1,547 | \$62,544 | \$270 | \$7,167 | \$114 | \$7,102 |

Note 6. Preferred Stock

Allied Investment has outstanding a total of 60,000 shares of \$100 par value, 3% cumulative preferred stock and 10,000 shares of \$100 par value, 4% redeemable cumulative preferred stock issued to the SBA pursuant to Section 303(c) of the Small Business Investment Act of 1958, as amended. The 3% cumulative preferred stock does not have a required redemption date. Allied Investment has the option to redeem in whole or in part the preferred stock by paying the SBA the par value of such securities and any dividends accumulated and unpaid to the date of redemption. The 4% redeemable cumulative preferred stock has a required redemption date in June 2005.

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 7. Shareholders Equity

Sales of common stock for the three months ended March 31, 2003 and 2002, were as follows:

| | For the Three Months Ended March 31, | |
|--|---|-----------|
| | 2003 | 2002 |
| (in thousands) | | |
| Number of common shares | 4,250 | 785 |
| Gross proceeds | \$ 85,880 | \$ 20,600 |
| Less costs including underwriting fees | (3,518) | (650) |
| Net proceeds | \$ 82,362 | \$ 19,950 |

The Company has a dividend reinvestment plan, whereby the Company may buy shares of its common stock in the open market or issue new shares in order to satisfy dividend reinvestment requests. If the Company issues new shares, the issue price is equal to the average of the closing sale prices reported for the Company's common stock for the five consecutive days immediately prior to the dividend payment date.

Dividend reinvestment plan activity for the three months ended March 31, 2003 and 2002 was as follows:

| | For the Three Months Ended March 31, | |
|--|---|----------|
| | 2003 | 2002 |
| (in thousands, except per share amounts) | | |
| Shares issued | 84 | 57 |
| Average price per share | \$ 20.13 | \$ 27.64 |

Note 8. Earnings Per Common Share

Earnings per common share for the three months ended March 31, 2003 and 2002, were as follows:

| | For the Three Months Ended March 31, | |
|--|---|-----------|
| | 2003 | 2002 |
| (in thousands, except per share amounts) | | |
| Net increase in net assets resulting from operations | \$ 19,873 | \$ 55,961 |
| Less preferred stock dividends | (55) | (55) |
| Income available to common shareholders | \$ 19,818 | \$ 55,906 |
| Weighted average common shares outstanding basic | 109,458 | 99,977 |
| Dilutive options outstanding to officers | 640 | 2,387 |

Edgar Filing: ALLIED CAPITAL CORP - Form N-2/A

| | | | |
|--|---------|-------------------|-------------------|
| Weighted average common shares outstanding | diluted | 110,098 | 102,364 |
| | | <u> </u> | <u> </u> |
| Basic earnings per common share | | \$ 0.18 | \$ 0.56 |
| | | <u> </u> | <u> </u> |
| Diluted earnings per common share | | \$ 0.18 | \$ 0.55 |
| | | <u> </u> | <u> </u> |

Note 9. Dividends and Distributions

The Company's board of directors declared and the Company paid a \$0.57 per common share dividend, or \$63.0 million, for the three months ended March 31, 2003. The Company paid a dividend of \$53.3 million to common shareholders for the three months ended March 31, 2002.

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 9. Dividends and Distributions, continued

The Company's board of directors also declared a dividend of \$0.57 per common share for the second quarter of 2003.

Note 10. Supplemental Disclosure of Cash Flow Information

For the three months ended March 31, 2003 and 2002, the Company paid \$6.2 million and \$5.9 million, respectively, for interest. For the three months ended March 31, 2003 and 2002, the Company's non-cash financing activities totaled \$1.7 million and \$3.0 million, respectively, and includes stock option exercises and dividend reinvestment.

Note 11. Hedging Activities

The Company invests in CMBS bonds, which are purchased at prices that are based in part on comparable Treasury rates. The Company has entered into transactions with one or more financial institutions to hedge against movement in Treasury rates on certain of the BB+ through B rated CMBS bonds. These transactions, referred to as short sales, involved the Company receiving the proceeds from the short sales of borrowed Treasury securities, with the obligation to replenish the borrowed Treasury securities at a later date based on the then current market price. Borrowed Treasury securities and the related obligations to replenish the borrowed Treasury securities, including accrued interest payable on the obligations, as of March 31, 2003, and December 31, 2002, consisted of the following:

| (in thousands) Description of Issue | 2003 | 2002 |
|--|------------|------------|
| 10-year Treasury securities, due February 2012 | \$ | \$ 52,053 |
| 10-year Treasury securities, due November 2012 | 44,450 | 107,327 |
| 10-year Treasury securities, due February 2013 | 41,259 | |
| 5-year Treasury securities, due November 2007 | 9,872 | 37,647 |
| 5-year Treasury securities, due February 2008 | 4,758 | |
| | ————— | ————— |
| Total | \$ 100,339 | \$ 197,027 |
| | ————— | ————— |

As of March 31, 2003, and December 31, 2002, the total obligations to replenish borrowed Treasury securities had increased since the related original sale dates due to changes in the yield on the borrowed Treasury securities, resulting in unrealized depreciation on the obligations of \$0.2 million and \$7.1 million, respectively. The net proceeds related to the sales of the borrowed Treasury securities were \$99.4 million and \$189.3 million at March 31, 2003, and December 31, 2002, respectively. Under the terms of the transactions, the Company has provided additional cash collateral of \$17 thousand and \$5.4 million at March 31, 2003, and December 31, 2002, respectively, for the difference between the net proceeds related to the sales of the borrowed Treasury securities and the obligations to replenish the securities. The Company has deposited the proceeds related to the sales of the borrowed Treasury securities and the additional cash collateral with the financial institutions under repurchase agreements. The repurchase agreements are collateralized by U.S. Treasury securities and are settled weekly. As of March 31, 2003, the repurchase agreements were due on April 2, 2003, and had a weighted average interest rate of 0.6%. The weighted average interest rate on the repurchase agreements as of December 31, 2002, was 0.8%.

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 12. Financial Highlights

| | At and for the Three Months Ended March 31, | | At and for the Year Ended December 31, |
|--|--|----------|--|
| | 2003 | 2002 | 2002 |
| Per Common Share Data | | | |
| Net asset value, beginning of period | \$ 14.22 | \$ 13.57 | \$ 13.57 |
| Net investment income* | 0.39 | 0.53 | 1.77 |
| Net gains (losses)* | (0.21) | 0.02 | 0.43 |
| Net increase in net assets resulting from operations | 0.18 | 0.55 | 2.20 |
| Net decrease in net assets from shareholder distributions | (0.57) | (0.53) | (2.23) |
| Net increase in net assets from capital share transactions | 0.22 | 0.12 | 0.68 |
| Net asset value, end of period | \$ 14.05 | \$ 13.71 | \$ 14.22 |
| Market value, end of period | \$ 19.98 | \$ 27.50 | \$ 21.83 |
| Total return | (6)% | 8% | (7)% |

* Based on diluted weighted average number of shares outstanding for the period.

| | At and for the Three Months Ended March 31, | | At and for the Year Ended December 31, |
|--|---|--------------|--|
| | 2003 | 2002 | 2002 |
| Ratios and Supplemental Data | | | |
| Ending net assets | \$ 1,588,293 | \$ 1,381,341 | \$ 1,546,071 |
| Common shares outstanding at end of period | 113,056 | 100,765 | 108,698 |
| Diluted weighted average common shares outstanding | 110,098 | 102,364 | 103,574 |
| Employee and administrative expenses/ average net assets | 0.80% | 0.81% | 3.82% |
| Total expenses/average net assets | 1.94% | 2.09% | 8.75% |
| Net investment income/average net assets | 2.72% | 3.94% | 12.94% |
| Net increase in net assets resulting from operations(1)/average net assets | 1.27% | 4.09% | 15.98% |
| Portfolio turnover rate | 11.06% | 3.49% | 15.12% |
| Average debt outstanding | \$ 891,325 | \$ 938,347 | \$ 938,148 |
| Average debt per share | \$ 8.10 | \$ 9.17 | \$ 9.06 |

(1) Net gains and losses can fluctuate significantly from period to period. As a result, quarterly comparisons may not be meaningful.

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 13. Litigation

Subsequent to the end of the quarter, the U.S. District Court for the Southern District of New York dismissed a consolidated securities class action lawsuit alleging violations of the federal securities laws filed against the Company and certain of its officers. In its ruling, the court found that the plaintiffs had failed to allege sufficient facts to support their claim and, therefore, dismissed the lawsuit in its entirety.

The Company is a party to certain other lawsuits including legal proceedings incidental to the normal course of its business including enforcement of its rights under contracts with its portfolio companies. While the outcome of these legal proceedings cannot at this time be predicted with certainty, the Company does not expect that these proceedings will have a material effect upon its financial condition or results of operations.

S-62

Independent Accountants Review Report

The Board of Directors and Shareholders

Allied Capital Corporation and Subsidiaries:

We have reviewed the accompanying consolidated balance sheet of Allied Capital Corporation and subsidiaries, including the consolidated statement of investments, as of March 31, 2003, and the related consolidated statements of operations, changes in net assets and cash flows and the financial highlights (included in Note 12) for the three-month periods ended March 31, 2003 and 2002. These consolidated financial statements and financial highlights are the responsibility of the Company's management.

We conducted our reviews in accordance with standards established by the American Institute of Certified Public Accountants. A review of interim financial information consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with auditing standards generally accepted in the United States of America, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our reviews, we are not aware of any material modifications that should be made to the consolidated financial statements and financial highlights referred to above for them to be in conformity with accounting principles generally accepted in the United States of America.

We have previously audited, in accordance with auditing standards generally accepted in the United States of America, the consolidated balance sheet of Allied Capital Corporation and subsidiaries as of December 31, 2002, and the related consolidated statements of operations, changes in net assets and cash flows (not presented herein), and the financial highlights (included in Note 12), for the year then ended; and in our report dated February 11, 2003, we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying condensed consolidated balance sheet as of December 31, 2002, is fairly stated, in all material respects, in relation to the consolidated balance sheet from which it has been derived.

/s/ KPMG LLP

Washington, D.C.

April 21, 2003, except as to Note 4
which is as of May 14, 2003

S-63

NOTICE REGARDING INDEPENDENT PUBLIC ACCOUNTANTS REVIEW REPORT

With respect to the unaudited interim financial information as of March 31, 2003 and for the three-month periods ended March 31, 2003 and 2002, included herein, KPMG LLP has reported that they applied limited procedures in accordance with professional standards for a review of such information. However, their separate report included herein, states that they did not audit and they do not express an opinion on that interim financial information. Accordingly, the degree of reliance on their report on such information should be restricted in light of the limited nature of the review procedures applied. The accountants are not subject to the liability provisions of Section 11 of the Securities Act of 1933 for their report on the unaudited interim financial information because that report is not a report or a part of the registration statement prepared or certified by the accountants within the meaning of Sections 7 and 11 of the Securities Act of 1933.

S-64

**PROSPECTUS (SUBJECT TO COMPLETION)
ISSUED _____, 2003**

18,000,000 Shares

Common Stock

We are an internally managed closed-end management investment company that has elected to be regulated as a business development company under the Investment Company Act of 1940.

Our investment objective is to achieve current income and capital gains. We seek to achieve our investment objective by investing primarily in private companies in a variety of industries throughout the United States. No assurances can be given that we will continue to achieve our objective.

Please read this prospectus, and the accompanying prospectus supplement, if any, before investing, and keep it for future reference. It contains important information about us. The SEC maintains an Internet website (<http://www.sec.gov>) that contains other information about us.

We may offer, from time to time, up to 18,000,000 shares of our common stock in one or more offerings.

The shares of common stock may be offered at prices and on terms to be described in one or more supplements to this prospectus. The offering price per share of our common stock less any underwriting commissions or discounts will not be less than the net asset value per share of our common stock at the time we make the offering.

Our common stock is traded on the New York Stock Exchange under the symbol ALD. As of _____, 2003, the last reported sale price on the New York Stock Exchange for the common stock was \$ _____.

You should review the information, including the risk of leverage, set forth under **Risk Factors on page 9 of this prospectus before investing in our common stock.**

Neither the Securities and Exchange Commission nor any state securities commission has approved or disapproved of these securities or passed upon the adequacy or accuracy of this prospectus. Any representations to the contrary is a criminal offense.

The information in this prospectus is not complete and may be changed. We may not sell these securities until the registration statement filed with the Securities and Exchange Commission is effective. This prospectus is not an offer to sell these securities and is not soliciting an offer to buy these securities in any state where the offer or sale is not permitted.

This prospectus may not be used to consummate sales of shares of common stock unless accompanied by a prospectus supplement.

_____, 2003

We have not authorized any dealer, salesman or other person to give any information or to make any representation other than those contained or incorporated by reference in this prospectus or any accompanying supplement to this prospectus. You must not rely upon any information or representation not contained or incorporated by reference in this prospectus or the accompanying prospectus supplement as if we had authorized it. This prospectus and any prospectus supplement do not constitute an offer to sell or a solicitation of any offer to buy any security other than the registered securities to which they relate, nor do they constitute an offer to sell or a solicitation of an offer to buy any securities in any jurisdiction to any person to whom it is unlawful to make such an offer or solicitation in such jurisdiction. The information contained in this prospectus and any prospectus supplement is accurate as of the dates on their covers.

TABLE OF CONTENTS

| | Page |
|---|-------------|
| Prospectus Summary | 1 |
| Fees and Expenses | 5 |
| Selected Condensed Consolidated Financial Data | 6 |
| Where You Can Find Additional Information | 8 |
| Risk Factors | 9 |
| Use of Proceeds | 16 |
| Price Range of Common Stock and Distributions | 17 |
| Management's Discussion and Analysis of Financial Condition and Results of Operations | 18 |
| Senior Securities | 45 |
| Business | 49 |
| Legal Proceedings | 66 |
| Portfolio Companies | 67 |
| Determination of Net Asset Value | 74 |
| Management | 78 |
| Compensation of Executive Officers and Directors | 84 |
| Control Persons and Principal Holders of Securities | 89 |
| Certain Relationships and Related Party Transactions | 91 |
| Tax Status | 92 |
| Certain Government Regulations | 96 |
| Dividend Reinvestment Plan | 100 |
| Description of Capital Stock | 101 |
| Plan of Distribution | 105 |
| Legal Matters | 106 |
| Safekeeping, Transfer and Dividend Paying Agent and Registrar | 106 |
| Brokerage Allocation and Other Practices | 106 |
| Independent Public Accountants | 106 |
| Notice Regarding Arthur Andersen LLP | 107 |
| Index to Consolidated Financial Statements | F-1 |

ABOUT THIS PROSPECTUS

This prospectus is part of a registration statement that we have filed with the Securities and Exchange Commission using the shelf registration process. Under the shelf registration process, we may offer, from time to time, up to 18,000,000 shares of our common stock on the terms to be determined at the time of the offering. Shares of our common stock may be offered at prices and on terms described in one or more supplements to this prospectus. This prospectus provides you with a general description of the shares of our common stock that we may offer. Each time we use this prospectus to offer shares of our common stock, we will provide a prospectus supplement that will contain specific information about the terms of that offering. The prospectus supplement may also add, update or change information contained in this prospectus. Please carefully read this prospectus and any prospectus supplement together with the additional information described under **Where You Can Find Additional Information** in the Prospectus Summary section and **Risk Factors** before you make an investment decision.

PROSPECTUS SUMMARY

The following summary contains basic information about this offering. It may not contain all the information that is important to an investor. For a more complete understanding of this offering, we encourage you to read this entire document and the documents to which we have referred.

In this prospectus or any accompanying prospectus supplement, unless otherwise indicated, Allied Capital, we, us or our refer to Allied Capital Corporation and its subsidiaries.

BUSINESS (Page 49)

We are a business development company that participates in the private equity market. We generally invest in illiquid securities through privately negotiated transactions. We provide long-term debt and equity investment capital to support the expansion of companies in a variety of industries. We generally invest in private middle market companies though, from time to time, we may invest in public companies that lack access to public capital or whose securities may not be marginable. We have been investing in businesses for over 40 years and have financed thousands of companies nationwide. Our investment and lending activity is generally focused in two areas:

private finance, and

commercial real estate finance, primarily the investment in non-investment grade commercial mortgage-backed securities.

Our investment portfolio generally includes:

long-term unsecured loans with or without equity features known as mezzanine financing,

equity investments in companies, which may or may not constitute a controlling equity interest,

non-investment grade commercial mortgage-backed securities,

preferred shares in collateralized debt obligations, and

commercial mortgage loans.

We identify loans and investments through our numerous relationships with:

mezzanine and private equity investors,

investment banks, and

other intermediaries, including professional services firms.

Our credit and investment approval process is centralized at our headquarters in Washington, DC.

Our tax structure generally allows us to pass-through our income to our shareholders through dividends without the imposition of a corporate level of taxation, if certain requirements are met. See Tax Status.

We are an internally managed diversified closed-end management investment company that has elected to be regulated as a business development company under the Investment Company Act of 1940, which we refer to as the 1940 Act. Our investment objective is to achieve current income and capital gains. We seek to achieve our investment objective by investing primarily in private businesses in a variety of industries throughout the United States.

As a business development company, we are required to meet certain regulatory tests, the most significant relating to our investments and borrowings. A business development company is required to invest at least 70% of its assets in eligible portfolio companies, which includes private or thinly traded public, U.S.-based entities. A business development company must also maintain a coverage ratio of assets to senior securities of at least 200%. See Certain Government Regulations.

Edgar Filing: ALLIED CAPITAL CORP - Form N-2/A

Our executive offices are located at 1919 Pennsylvania Avenue, NW,

Washington, DC, 20006 and our telephone number is (202) 331-1112. In addition, we have regional offices in New York and Chicago.

Our Internet website address is *www.alliedcapital.com*. Information contained on our website is not incorporated by reference into this prospectus and you should not consider information contained on our website to be part of this prospectus.

Our common stock is traded on the New York Stock Exchange under the symbol ALD.

DETERMINATION OF

NET ASSET VALUE (Page 74)

Our portfolio investments are generally recorded at fair value as determined in good faith by our board of directors in the absence of readily available public market values.

At December 31, 2002, approximately 89% of our total assets represented portfolio investments recorded at fair value. Pursuant to the requirements of the 1940 Act, we value substantially all of our portfolio investments at fair value as determined in good faith by the board of directors on a quarterly basis. Since there is typically no readily available market value for the investments in our portfolio, our board of directors determines in good faith the fair value of these portfolio investments pursuant to a valuation policy and a consistently applied valuation process.

There is no single standard for determining fair value in good faith. As a result, determining fair value requires that judgment be applied to the specific facts and circumstances of each portfolio investment while employing a consistently applied valuation process for the types of investments we make. Unlike banks, we are not permitted to provide a general reserve for anticipated loan losses. Instead we are required to specifically value each individual investment and record unrealized depreciation for an investment that we believe has become impaired including where collection of a loan or realization of an equity security is doubtful or when the enterprise value of the company does not currently support the cost of our debt or equity investment. Enterprise value means the entire value of the company to a potential buyer including the sum of the values of all debt and equity securities used to capitalize the enterprise at a point in time. Conversely, we will record unrealized appreciation if we believe that the underlying portfolio company has appreciated in value and, therefore, our equity security has also appreciated in value. Without a readily available market value and because of the inherent uncertainty of valuation, the fair value of our investments determined in good faith by the board of directors may differ significantly from the values that would have been used had a ready market existed for the investments, and the differences could be material.

We adjust quarterly the valuation of our portfolio to reflect the change in the value of each investment in our portfolio. Any changes in value are recorded in our statement of operations as Net unrealized gains (losses).

PLAN OF DISTRIBUTION (Page 105)

We may offer, from time to time, up to 18,000,000 shares of our common stock, on terms to be determined at the time of the offering.

Shares of our common stock may be offered at prices and on terms described in one or more supplements to this prospectus. The offering price per share of our common stock less any underwriting commission or discount will not be less than the net asset value per share of our common stock at the time we make the offering.

Our shares of common stock may be offered directly to one or more purchasers,

through agents designated from time to time by us, or to or through underwriters or dealers. The supplement to this prospectus relating to the offering will identify any agents or underwriters involved in the sale of our shares of common stock, and will set forth any applicable purchase price, fee and commission or discount arrangement or the basis upon which such amount may be calculated.

We may not sell shares of common stock without delivering a prospectus supplement describing the method and terms of the offering of such shares.

USE OF PROCEEDS *(Page 16)*

We intend to use the net proceeds from selling shares of common stock for general corporate purposes, which include investments in the debt or equity securities of primarily private companies or non-investment grade commercial mortgage-backed securities, repayment of indebtedness, acquisitions and other general corporate purposes. The supplement to this prospectus relating to an offering will more fully identify the use of the proceeds from such offering.

PRICE RANGE OF COMMON STOCK AND DISTRIBUTIONS *(Page 17)*

We intend to pay quarterly dividends to holders of our common stock. The amount of our quarterly dividends is determined by our board of directors.

DIVIDEND REINVESTMENT PLAN *(Page 100)*

We maintain an opt in dividend reinvestment plan for our common shareholders. As a result, if our board of directors declares a dividend, then our new shareholders that have not opted in to our dividend reinvestment plan will receive cash dividends. New shareholders must notify our transfer agent in writing if they wish to enroll in the dividend reinvestment plan.

RISK FACTORS *(Page 9)*

Investment in our shares of common stock involves certain risks relating to our business and our investment objective that you should consider before purchasing our shares of common stock.

As a business development company, our portfolio includes securities primarily issued by privately held companies. These investments may involve a high degree of business and financial risk; they are illiquid, and may not produce current returns or capital gains. If we were forced to immediately liquidate some or all of the investments in the portfolio, the proceeds of such liquidation would be significantly less than the current value of such investments. We may be required to liquidate some or all of our portfolio investments to meet our debt service obligations or in the event we are required to fulfill our obligations under agreements pursuant to which we guarantee the repayment of indebtedness by third parties.

An economic slowdown may affect the ability of a portfolio company to engage in a liquidity event, which is a transaction that involves the sale or recapitalization of all or part of a portfolio company. These conditions could lead to financial losses in our portfolio and a decrease in our revenues, net income and assets. Numerous other factors may affect a borrower's ability to repay its loan, including the failure to meet its business plan, a downturn in its industry or negative economic conditions.

We may not borrow money unless we maintain asset coverage for indebtedness of at least 200% which may affect returns to shareholders. We borrow funds to make investments. As a result, we are exposed to the risks of leverage, which may be

considered a speculative investment technique. Borrowings, also known as leverage, magnify the potential for gain and loss on amounts invested and therefore increase the risks associated with investing in our securities.

A large number of entities and individuals compete for the same kind of investment opportunities as we do. Our business of making private equity investments may be affected by current and future market conditions. The absence of an active senior lending environment may slow the amount of private equity investment activity generally. As a result, the pace of our investment activity may slow.

We may not be able to pay dividends and the loss of pass-through tax treatment could have a material adverse effect on our total return, if any.

Also, we are subject to certain risks associated with valuing our portfolio, investing in non-investment grade commercial mortgage-backed securities, changing interest rates, accessing additional capital, fluctuating financial results, and operating in a regulated environment.

Our common stock price may be volatile due to market factors that may be beyond our control.

CERTAIN ANTI-TAKEOVER

PROVISIONS *(Page 102)*

Our charter and bylaws, as well as certain statutory and regulatory requirements, contain certain provisions that may have the effect of discouraging a third party from making an acquisition proposal for Allied Capital. These anti-takeover provisions may inhibit a change in control in circumstances that could give the holders of our common stock the opportunity to realize a premium over the market price for our common stock.

LEGAL PROCEEDINGS *(Page 66)*

On April 21, 2003, the U.S. District Court for the Southern District of New York dismissed a consolidated class action lawsuit alleging violations of the federal securities laws filed against us and certain of our officers. In its ruling, the court found that the plaintiffs had failed to allege sufficient facts to support their claim and, therefore, dismissed the lawsuit in its entirety.

We are a party to certain other lawsuits in the normal course of our business. While the outcome of these legal proceedings cannot at this time be predicted with certainty, we do not expect that these proceedings will have a material effect upon our financial condition or results of operations.

FEES AND EXPENSES

This table describes the various costs and expenses that an investor in our shares of common stock will bear directly or indirectly.

| | |
|---|-------|
| Shareholder Transaction Expenses | |
| Sales load (as a percentage of offering price)(1) | % |
| Dividend reinvestment plan fees(2) | None |
| Annual Expenses (as a percentage of consolidated net assets attributable to common stock)(3) | |
| Operating expenses(4) | 3.5% |
| Interest payments on borrowed funds(5) | 4.6% |
| | <hr/> |
| Total annual expenses(6) | 8.1% |
| | <hr/> |

- (1) In the event that the shares of common stock to which this prospectus relates are sold to or through underwriters, a corresponding prospectus supplement will disclose the applicable sales load.
- (2) The expenses of our dividend reinvestment plan are included in Operating expenses. We do not have a stock purchase plan. The participants in the dividend reinvestment plan will bear a pro rata share of brokerage commissions incurred with respect to open market purchases or sales, if any. See Dividend Reinvestment Plan.
- (3) Consolidated net assets attributable to common stock equals net assets (*i.e.*, total consolidated assets less total consolidated liabilities and preferred stock) at December 31, 2002.
- (4) Operating expenses represent our operating expenses for the year ending December 31, 2002 excluding interest on indebtedness.
- (5) The Interest payments on borrowed funds represents our interest expenses for the year ending December 31, 2002. We had outstanding borrowings of \$998.5 million at December 31, 2002. See Risk Factors.
- (6) Total annual expenses as a percentage of consolidated net assets attributable to common stock are higher than the total annual expenses percentage would be for a company that is not leveraged. We borrow money to leverage our net assets and increase our total assets. The SEC requires that Total annual expenses percentage be calculated as a percentage of *net* assets, rather than the total assets, including assets that have been funded with borrowed monies. If the Total annual expenses percentage were calculated instead as a percentage of consolidated total assets, our Total annual expenses would be 4.5% of consolidated total assets.

Example

The following example, required by the SEC, demonstrates the projected dollar amount of total cumulative expenses that would be incurred over various periods with respect to a hypothetical investment in us. In calculating the following expense amounts, we assumed we would have no additional leverage and that our operating expenses would remain at the levels set forth in the table above. In the event that shares to which this prospectus relates are sold to or through underwriters, a corresponding prospectus supplement will restate this example to reflect the applicable sales load.

| | <u>1 Year</u> | <u>3 Years</u> | <u>5 Years</u> | <u>10 Years</u> |
|---|---------------|----------------|----------------|-----------------|
| You would pay the following expenses on a \$1,000 investment, assuming a 5.0% annual return | \$ 81 | \$245 | \$410 | \$832 |

Although the example assumes (as required by the SEC) a 5.0% annual return, our performance will vary and may result in a return of greater or less than 5.0%. In addition, while the example assumes reinvestment of all dividends and distributions at net asset value, participants in the dividend reinvestment plan may receive shares of common stock that we issue at or above net asset value or are purchased by the administrator of the dividend reinvestment plan, at the market price in effect at the time, which may be higher than, at, or below net asset value.

See Dividend Reinvestment Plan.

**The example should not be considered a representation of future expenses, and the actual expenses
may be greater or less than those shown.**

SELECTED CONDENSED CONSOLIDATED FINANCIAL DATA

You should read the condensed consolidated financial information below with the Consolidated Financial Statements and Notes thereto included in this prospectus. Financial information for the year ended December 31, 2002 has been derived from our financial statements that were audited by KPMG LLP. Financial information for the years ended December 31, 2001, 2000, 1999 and 1998 has been derived from our financial statements that were audited by Arthur Andersen LLP. For important information about Arthur Andersen LLP, see the section entitled Notice Regarding Arthur Andersen LLP. See **Management's Discussion and Analysis of Financial Condition and Results of Operations** on page 18 for more information.

| (in thousands, except per share data) | Year Ended December 31, | | | | |
|---|-------------------------|-------------------|-------------------|------------------|------------------|
| | 2002 | 2001 | 2000 | 1999 | 1998 |
| Operating Data: | | | | | |
| Interest and related portfolio income: | | | | | |
| Interest and dividends | \$ 264,042 | \$ 240,464 | \$ 182,307 | \$ 121,112 | \$ 80,281 |
| Premiums from loan dispositions | 2,776 | 2,504 | 16,138 | 14,284 | 5,949 |
| Post-merger gain on securitization of commercial mortgage loans | | | | | 14,812 |
| Fees and other income | 43,110 | 46,142 | 13,144 | 5,744 | 5,696 |
| Total interest and related portfolio income | 309,928 | 289,110 | 211,589 | 141,140 | 106,738 |
| Expenses: | | | | | |
| Interest | 70,443 | 65,104 | 57,412 | 34,860 | 20,694 |
| Employee | 33,126 | 29,656 | 26,025 | 22,889 | 18,878 |
| Administrative | 21,504 | 15,299 | 15,435 | 12,350 | 11,921 |
| Total operating expenses | 125,073 | 110,059 | 98,872 | 70,099 | 51,493 |
| Net investment income before income taxes and net realized and unrealized gains | | | | | |
| Income tax expense (benefit) | 930 | (412) | | | 787 |
| Net investment income before net realized and unrealized gains | 183,925 | 179,463 | 112,717 | 71,041 | 54,458 |
| Net realized and unrealized gains: | | | | | |
| Net realized gains | 44,937 | 661 | 15,523 | 25,391 | 22,541 |
| Net unrealized gains (losses) | (571) | 20,603 | 14,861 | 2,138 | 1,079 |
| Total net realized and unrealized gains | 44,366 | 21,264 | 30,384 | 27,529 | 23,620 |
| Net increase in net assets resulting from operations | \$ 228,291 | \$ 200,727 | \$ 143,101 | \$ 98,570 | \$ 78,078 |
| Per Share: | | | | | |
| Diluted earnings per common share | \$ 2.20 | \$ 2.16 | \$ 1.94 | \$ 1.64 | \$ 1.50 |
| Dividends per common share(1) | \$ 2.23 | \$ 2.01 | \$ 1.82 | \$ 1.60 | \$ 1.43 |
| Weighted average common shares outstanding diluted(2) | 103,574 | 93,003 | 73,472 | 60,044 | 51,974 |

Edgar Filing: ALLIED CAPITAL CORP - Form N-2/A

| (in thousands, except per share data) | At December 31, | | | | |
|--|-----------------|--------------|--------------|--------------|------------|
| | 2002 | 2001 | 2000 | 1999 | 1998 |
| Balance Sheet Data: | | | | | |
| Portfolio at value | \$ 2,488,167 | \$ 2,329,590 | \$ 1,788,001 | \$ 1,228,497 | \$ 807,119 |
| Portfolio at cost | 2,429,214 | 2,286,602 | 1,765,895 | 1,222,901 | 803,479 |
| Total assets | 2,794,319 | 2,460,713 | 1,853,817 | 1,290,038 | 856,079 |
| Total debt outstanding(3) | 998,450 | 1,020,806 | 786,648 | 592,850 | 334,350 |
| Preferred stock issued to Small Business Administration(3) | 7,000 | 7,000 | 7,000 | 7,000 | 7,000 |
| Shareholders' equity | 1,546,071 | 1,352,123 | 1,029,692 | 667,513 | 491,358 |
| Shareholders' equity per common share (net asset value) | \$ 14.22 | \$ 13.57 | \$ 12.11 | \$ 10.20 | \$ 8.79 |
| Common shares outstanding at period end(2) | 108,698 | 99,607 | 85,057 | 65,414 | 55,919 |

| | Year Ended December 31, | | | | |
|--------------------------|-------------------------|------------|------------|------------|------------|
| | 2002 | 2001 | 2000 | 1999 | 1998 |
| Other Data: | | | | | |
| Investments funded | \$ 506,376 | \$ 680,329 | \$ 901,545 | \$ 751,871 | \$ 524,530 |
| Repayments | 143,167 | 74,461 | 111,031 | 139,561 | 138,081 |
| Sales | 213,474 | 129,980 | 280,244 | 198,368 | 81,013 |
| Realized gains | 95,562 | 10,107 | 28,604 | 31,536 | 25,757 |
| Realized losses | (50,625) | (9,446) | (13,081) | (6,145) | (3,216) |
| Return on average assets | 9.0% | 9.4% | 9.1% | 9.2% | 10.1% |
| Return on average equity | 16.0% | 17.0% | 17.2% | 17.5% | 18.0% |

(1) Dividends are based on taxable income, which differs from income for financial reporting purposes.

(2) Excludes 234,977, 516,779 and 810,456 common shares held in the deferred compensation trust at and for the years ended December 31, 2000, 1999, and 1998, respectively.

(3) See "Senior Securities" on page 45 for more information regarding our level of indebtedness.

| (in thousands, except per share data) | 2002 | | | | 2001 | | | |
|--|-----------|-----------|-----------|-----------|-----------|-----------|-----------|-----------|
| | Qtr 4 | Qtr 3 | Qtr 2 | Qtr 1 | Qtr 4 | Qtr 3 | Qtr 2 | Qtr 1 |
| Quarterly Data (unaudited): | | | | | | | | |
| Total interest and related portfolio income | \$ 78,015 | \$ 76,329 | \$ 73,193 | \$ 82,391 | \$ 82,666 | \$ 72,634 | \$ 68,739 | \$ 65,071 |
| Net investment income before net realized and unrealized gains | 42,401 | 45,094 | 42,561 | 53,869 | 53,428 | 44,189 | 42,118 | 39,728 |
| Net increase in net assets resulting from operations | 53,356 | 45,520 | 73,454 | 55,961 | 42,890 | 59,703 | 46,106 | 52,028 |
| Diluted earnings per common share | 0.51 | 0.44 | 0.71 | 0.55 | 0.43 | 0.63 | 0.51 | 0.60 |
| Dividends declared per common share | 0.59 | 0.56 | 0.55 | 0.53 | 0.51 | 0.51 | 0.50 | 0.49 |
| Net asset value per common share(1) | 14.22 | 13.95 | 14.02 | 13.71 | 13.57 | 13.42 | 12.79 | 12.26 |

(1) We determine net asset value per common share as of the last day of the quarter. The net asset values shown are based on outstanding shares at the end of each period.

WHERE YOU CAN FIND

ADDITIONAL INFORMATION

We have filed with the SEC a registration statement on Form N-2 together with all amendments and related exhibits under the Securities Act of 1933. The registration statement contains additional information about us and the securities being offered by this prospectus. You may inspect the registration statement and the exhibits without charge at the SEC at 450 Fifth Street, NW, Washington, DC 20549. You may obtain copies from the SEC at prescribed rates.

We file annual, quarterly and current reports, proxy statements and other information with the SEC. You can inspect our SEC filings, without charge, at the SEC's Public Reference Room at 450 Fifth Street, NW, Washington, DC 20549. The SEC also maintains a web site at <http://www.sec.gov> that contains our SEC filings. You can also obtain copies of these materials from the SEC's Public Reference Room at 450 Fifth Street, NW, Washington, DC 20549, at prescribed rates. Please call the SEC at 1-800-SEC-0330 for further information on the Public Reference Room. Copies may also be obtained, after paying a duplicating fee, by electronic request to publicinfo@sec.gov or by written request to Public Reference Section, Washington, DC 20549-0102. You can also inspect reports and other information we file at the offices of the New York Stock Exchange, and you are able to inspect those at 20 Broad Street, New York, NY 10005.

RISK FACTORS

Investing in Allied Capital involves a number of significant risks relating to our business and investment objective. As a result, there can be no assurance that we will achieve our investment objective. In addition to the other information contained in this prospectus, you should consider carefully the following information before making an investment in shares of our common stock. In addition to the risk factors described below, other factors that could cause actual results to differ materially include:

the ongoing global economic downturn, coupled with war or the threat of war;

risk associated with possible disruption in our operations due to terrorism; and

future regulatory actions and conditions in our operating areas.

Investing in private companies involves a high degree of risk. Our portfolio consists of primarily long-term loans to, and investments in, private companies. Investments in private businesses involve a high degree of business and financial risk, which can result in substantial losses and accordingly should be considered speculative. There is generally no publicly available information about the companies in which we invest, and we rely significantly on the diligence of our employees and agents to obtain information in connection with our investment decisions. In addition, some smaller businesses have narrower product lines and market shares than their competition and may be more vulnerable to customer preferences, market conditions, or economic downturns, which may adversely affect the return on, or the recovery of, our investment in such businesses.

Our portfolio of investments is illiquid. We generally acquire our investments directly from the issuer in privately negotiated transactions. The majority of the investments in our portfolio are typically subject to restrictions on resale or otherwise have no established trading market. We typically exit our investments when the portfolio company has a liquidity event such as a sale, recapitalization, or initial public offering of the company. The illiquidity of our investments may adversely affect our ability to dispose of debt and equity securities at times when it may be otherwise advantageous for us to liquidate such investments. In addition, if we were forced to immediately liquidate some or all of the investments in the portfolio, the proceeds of such liquidation would be significantly less than the current value of such investments. We may be required to liquidate some or all of our portfolio investments to meet our debt service obligations or in the event we are required to fulfill our obligations under agreements pursuant to which we guarantee the repayment of certain indebtedness by third parties.

Substantially all of our portfolio investments are recorded at fair value as determined in good faith by our board of directors and, as a result, there is uncertainty regarding the value of our portfolio investments. At December 31, 2002, approximately 89% of our total assets represented portfolio investments recorded at fair value. Pursuant to the requirements of the 1940 Act, we value substantially all of our investments at fair value as determined in good faith by our board of directors on a quarterly basis. Since there is typically no readily available market value for the investments in our portfolio, our board of directors determines in good faith the fair value of these investments pursuant to a valuation policy and a consistently applied valuation process.

There is no single standard for determining fair value in good faith. As a result, determining fair value requires that judgment be applied to the specific facts and circumstances of each portfolio investment while employing a consistently applied valuation

process for the types of investments we make. Unlike banks, we are not permitted to provide a general reserve for anticipated loan losses; we are instead required by the 1940 Act to specifically value each individual investment on a quarterly basis and record unrealized depreciation for an investment that we believe has become impaired, including where collection of a loan or realization of an equity security is doubtful, or when the enterprise value of the company does not currently support the cost of our debt or equity investment. Enterprise value means the entire value of the company to a potential buyer including the sum of the values of all debt and equity securities to be used to capitalize the enterprise at a point in time. Conversely, we will record unrealized appreciation if we believe that the underlying portfolio company has appreciated in value and, therefore, our equity security has also appreciated in value. Without a readily available market value and because of the inherent uncertainty of valuation, the fair value of our investments determined in good faith by the board of directors may differ significantly from the values that would have been used had a ready market existed for the investments, and the differences could be material.

We adjust quarterly the valuation of our portfolio to reflect the board of directors' determination of the fair value of each investment in our portfolio. Any changes in fair value are recorded in our statement of operations as Net unrealized gains (losses).

Economic recessions or downturns could impair our portfolio companies and harm our operating results. Many of the companies in which we have made or will make investments may be susceptible to economic slowdowns or recessions. An economic slowdown may affect the ability of a company to engage in a liquidity event such as a sale, recapitalization or initial public offering. Our nonperforming assets are likely to increase and the value of our portfolio is likely to decrease during these periods. These conditions could lead to financial losses in our portfolio and a decrease in our revenues, net income, and assets.

Our business of making private equity investments and positioning them for liquidity events also may be affected by current and future market conditions. The absence of an active senior lending environment may slow the amount of private equity investment activity generally. As a result, the pace of our investment activity may slow. In addition, significant changes in the capital markets could have an effect on the valuations of private companies and on the potential for liquidity events involving such companies. This could affect the amount and timing of gains realized on our investments.

Our borrowers may default on their payments, which may have an effect on our financial performance. We make long-term unsecured, subordinated loans and invest in equity securities, which may involve a higher degree of repayment risk. We primarily invest in companies that may have limited financial resources and that may be unable to obtain financing from traditional sources. Numerous factors may affect a borrower's ability to repay its loan, including the failure to meet its business plan, a downturn in its industry, or negative economic conditions. Deterioration in a borrower's financial condition and prospects may be accompanied by deterioration in any related collateral.

Our private finance investments may not produce current returns or capital gains. Private finance investments are typically structured as debt securities with a relatively high fixed rate of interest and with equity features such as conversion rights, warrants, or options. As a result, private finance investments are generally structured to generate interest income from the time they are made and may also produce a realized gain from

an accompanying equity feature. We cannot be sure that our portfolio will generate a current return or capital gains.

Our financial results could be negatively affected if Business Loan Express fails to perform as expected. Business Loan Express, Inc. (BLX) is our largest portfolio investment. Our financial results could be negatively affected if BLX, as a portfolio company, fails to perform as expected or if government funding for, or regulations related to, the Small Business Administration 7(a) Guaranteed Loan Program change. At December 31, 2002, the investment totaled \$256.8 million at value, or 9.2% of total assets.

In addition, as controlling shareholder of BLX, we have provided an unconditional guaranty to BLX's senior credit facility lenders in an amount equal to 50% of BLX's total obligations on its \$124.0 million revolving credit facility. The amount we have guaranteed at December 31, 2002, was \$51.6 million. This guaranty can only be called in the event of a default by BLX. We have also provided two standby letters of credit in connection with two term loan securitizations completed by BLX totaling \$10.6 million.

Investments in non-investment grade commercial mortgage-backed securities and collateralized debt obligations may be illiquid, may have a higher risk of default, and may not produce current returns. The commercial mortgage-backed securities and collateralized debt obligation preferred shares in which we invest are not investment grade, which means that nationally recognized statistical rating organizations rate them below the top four investment-grade rating categories (i.e., AAA through BBB), and are sometimes referred to as junk bonds. Non-investment grade commercial mortgage-backed securities and collateralized debt obligation preferred shares tend to be less liquid, may have a higher risk of default and may be more difficult to value. Non-investment grade securities usually provide a higher yield than do investment grade securities, but with the higher return comes greater risk of default. Economic recessions or downturns may cause defaults or losses on collateral securing these securities to increase. Non-investment grade securities are considered speculative, and their capacity to pay principal and interest in accordance with the terms of their issue is not ensured.

We may not borrow money unless we maintain asset coverage for indebtedness of at least 200%, which may affect returns to shareholders. We must maintain asset coverage for total borrowings of at least 200%. Our ability to achieve our investment objective may depend in part on our continued ability to maintain a leveraged capital structure by borrowing from banks or other lenders on favorable terms. There can be no assurance that we will be able to maintain such leverage. If asset coverage declines to less than 200%, we may be required to sell a portion of our investments when it is disadvantageous to do so. As of December 31, 2002, our asset coverage for senior indebtedness was 270%.

We borrow money, which magnifies the potential for gain or loss on amounts invested and may increase the risk of investing in us. Borrowings, also known as leverage, magnify the potential for gain or loss on amounts invested and, therefore, increase the risks associated with investing in our securities. We borrow from and issue senior debt securities to banks, insurance companies, and other lenders. Lenders of these senior securities have fixed dollar claims on our consolidated assets that are superior to the claims of our common shareholders. If the value of our consolidated assets increases, then leveraging would cause the net asset value attributable to our common stock to increase more sharply than it would have had we not leveraged. Conversely, if the value of our consolidated assets decreases, leveraging would cause net asset value to decline more sharply than it otherwise would have had we not leveraged. Similarly, any increase in our

consolidated income in excess of consolidated interest payable on the borrowed funds would cause our net income to increase more than it would without the leverage, while any decrease in our consolidated income would cause net income to decline more sharply than it would have had we not borrowed. Such a decline could negatively affect our ability to make common stock dividend payments. Leverage is generally considered a speculative investment technique.

At December 31, 2002, we had \$998.5 million of outstanding indebtedness, bearing a weighted average annual interest cost of 6.9%. In order for us to cover these annual interest payments on indebtedness, we must achieve annual returns on our assets of at least 2.5%.

Illustration. The following table illustrates the effect of leverage on returns from an investment on our common stock assuming various annual returns, net of expenses. The calculations in the table below are hypothetical and actual returns may be higher or lower than those appearing below. The calculation assumes (i) \$2,794.3 million in total assets, (ii) an average cost of funds of 6.9%, (iii) \$998.5 million in debt outstanding and (iv) \$1,546.1 million of shareholders' equity.

| | Assumed Return on Our Portfolio | | | | | | |
|-------------------------------------|---------------------------------|--------|--------|-------|------|-------|-------|
| | (net of expenses) | | | | | | |
| | -20% | -10% | -5% | 0% | 5% | 10% | 20% |
| Corresponding return to shareholder | -40.7% | -22.6% | -13.6% | -4.6% | 4.5% | 13.5% | 31.6% |

Changes in interest rates may affect our cost of capital and net investment income. Because we borrow money to make investments, our net investment income before net realized and unrealized gains or losses, or net investment income, is dependent upon the difference between the rate at which we borrow funds and the rate at which we invest these funds. As a result, there can be no assurance that a significant change in market interest rates will not have a material adverse effect on our net investment income. In periods of rising interest rates, our cost of funds would increase, which would reduce our net investment income. We use a combination of long-term and short-term borrowings and equity capital to finance our investing activities. We utilize our revolving line of credit as a means to bridge to long-term financing. Our long-term fixed-rate investments are financed primarily with long-term fixed-rate debt and equity. We may use interest rate risk management techniques in an effort to limit our exposure to interest rate fluctuations. Such techniques may include various interest rate hedging activities to the extent permitted by the 1940 Act. We have analyzed the potential impact of changes in interest rates on interest income net of interest expense. Assuming that the balance sheet were to remain constant and no actions were taken to alter the existing interest rate sensitivity, a hypothetical immediate 1% change in interest rates would have affected the net income by less than 1% over a one year horizon. Although management believes that this measure is indicative of our sensitivity to interest rate changes, it does not adjust for potential changes in credit quality, size and composition of the assets on the balance sheet and other business developments that could affect net increase in assets resulting from operations, or net income. Accordingly, no assurances can be given that actual results would not differ materially from the potential outcome simulated by this estimate.

We will continue to need additional capital to grow because we must distribute our income. We will continue to need capital to fund incremental growth in our investments.

Historically, we have borrowed from financial institutions and have issued equity securities. A reduction in the availability of new capital could limit our ability to grow. We must distribute at least 90% of our taxable ordinary income, which excludes net realized long-term capital gains, to our shareholders to maintain our regulated investment company status. As a result, such earnings will not be available to fund investment originations. We expect to continue to borrow from financial institutions and issue additional debt and equity securities. If we fail to obtain funds from such sources or from other sources to fund our investments, it could limit our ability to grow, which could have a material adverse effect on the value of our common stock. In addition, as a business development company, we are generally required to maintain a ratio of at least 200% of total assets to total borrowings, which may restrict our ability to borrow in certain circumstances.

Loss of pass-through tax treatment would substantially reduce net assets and income available for dividends. We have operated so as to qualify as a regulated investment company under Subchapter M of the Internal Revenue Code of 1986. If we meet source of income, diversification, and distribution requirements, we will qualify for effective pass-through tax treatment. For a discussion of the income, diversification and distribution requirements, see [Certain Government Regulations](#) [Regulated Investment Company Status](#). We would cease to qualify for such pass-through tax treatment if we were unable to comply with these requirements. In addition, we may have difficulty meeting the requirement to make distributions to our shareholders because in certain cases we may recognize income before or without receiving cash representing such income. If we fail to qualify as a regulated investment company, we will have to pay corporate-level taxes on all of our income whether or not we distribute it, which would substantially reduce the amount of income available for distribution to our stockholders. Even if we qualify as a regulated investment company, we generally will be subject to a corporate-level income tax on the income we do not distribute. Moreover, if we do not distribute at least 98% of our taxable income, we generally will be subject to a 4% excise tax.

There is a risk that you may not receive dividends or distributions. We intend to make distributions on a quarterly basis to our stockholders. We may not be able to achieve operating results that will allow us to make distributions at a specific level or to increase the amount of these distributions from time to time. In addition, due to the asset coverage test applicable to us as a business development company, we may be limited in our ability to make distributions. Also, our credit facilities limit our ability to declare dividends if we default under certain provisions. If we do not distribute a certain percentage of our income annually, we will suffer adverse tax consequences, including possible loss of our status as a regulated investment company. In addition, in accordance with accounting principles generally accepted in the United States of America and tax regulations, we include in income certain amounts that we have not yet received in cash, such as contractual payment-in-kind interest which represents contractual interest added to the loan balance that becomes due at the end of the loan term. The increases in loan balances as a result of contractual payment-in-kind arrangements are included in income in advance of receiving cash payment and are separately included in the change in accrued or reinvested interest and dividends in our consolidated statement of cash flows. Since we may recognize income before or without receiving cash representing such income, we may have difficulty meeting the requirement to distribute at least 90% of our investment company taxable income to maintain our status as a regulated investment company.

We operate in a competitive market for investment opportunities. We compete for investments with a large number of private equity funds and mezzanine funds, investment

banks and other equity and non-equity based investment funds, and other sources of financing, including traditional financial services companies such as commercial banks. Some of our competitors have greater resources than we do. Increased competition would make it more difficult for us to purchase or originate investments at attractive prices. As a result of this competition, sometimes we may be precluded from making otherwise attractive investments.

We depend on key personnel. We depend on the continued services of our executive officers and other key management personnel. If we were to lose any of these officers or other management personnel, such a loss could result in inefficiencies in our operations and lost business opportunities.

Changes in the law or regulations that govern us could have a material impact on us or our operations. We are regulated by the SEC and the Small Business Administration. In addition, changes in the laws or regulations that govern business development companies, regulated investment companies, real estate investment trusts, and small business investment companies may significantly affect our business. Any change in the law or regulations that govern our business could have a material impact on us or our operations. Laws and regulations may be changed from time to time, and the interpretations of the relevant laws and regulations also are subject to change.

Results may fluctuate and may not be indicative of future performance. Our operating results will fluctuate and, therefore, you should not rely on current or historical period results to be indicative of our performance in future reporting periods. Factors that could cause operating results to fluctuate include, among others, variations in the investment origination volume and fee income earned, variation in timing of prepayments, variations in and the timing of the recognition of realized and unrealized gains or losses, the degree to which we encounter competition in our markets, and general economic conditions.

Our common stock price may be volatile. The trading price of our common stock may fluctuate substantially. The price of our common stock may be higher or lower than the price you pay for your shares, depending on many factors, some of which are beyond our control and may not be directly related to our operating performance. These factors include the following:

price and volume fluctuations in the overall stock market from time to time;

significant volatility in the market price and trading volume of securities of business development companies or other financial services companies;

volatility resulting from trading in derivative securities related to our common stock including puts, calls, long-term equity anticipation securities, or LEAPs, or short trading positions;

changes in regulatory policies or tax guidelines with respect to business development companies or regulated investment companies;

actual or anticipated changes in our earnings or fluctuations in our operating results or changes in the expectations of securities analysts;

general economic conditions and trends;

loss of a major funding source; or

departures of key personnel.

Recently, the trading price of our common stock has been volatile. Due to the continued potential volatility of our stock price, we may be the target of securities litigation in the future. Securities litigation could result in substantial costs and divert management's attention and resources from our business.

Disclosure Regarding Forward-Looking Statements

Information contained or incorporated by reference in this prospectus, and the accompanying prospectus supplement, if any, may contain forward-looking statements which can be identified by the use of forward-looking terminology such as may, will, expect, intend, anticipate, estimate or continue or the negative thereof or other variations or similar words or phrases. The matters described in Risk Factors and certain other factors noted throughout this prospectus, and the accompanying prospectus supplement, if any, and in any exhibits to the registration statement of which this prospectus, and the accompanying prospectus supplement, if any, is a part, constitute cautionary statements identifying important factors with respect to any such forward-looking statements, including certain risks and uncertainties, that could cause actual results to differ materially from those in such forward-looking statements.

Although we believe that the assumptions on which these forward-looking statements are based are reasonable, any of those assumptions could prove to be inaccurate, and as a result, the forward-looking statements based on those assumptions also could be incorrect. Important assumptions include our ability to originate new investments, maintain certain margins and levels of profitability, access the capital markets for debt and equity capital, the ability to meet regulatory requirements and the ability to maintain certain debt to asset ratios. In light of these and other uncertainties, the inclusion of a projection or forward-looking statement in this prospectus should not be regarded as a representation by us that our plans and objectives will be achieved. You should not place undue reliance on these forward-looking statements, which apply only as of the date of this prospectus or any accompanying supplement to this prospectus.

USE OF PROCEEDS

We intend to use the net proceeds from selling shares of our common stock for general corporate purposes, which include investment in the debt or equity securities of primarily private companies or non-investment grade commercial mortgage-backed securities, repayment of indebtedness, acquisitions and other general corporate purposes. We typically raise new equity when we have attractive investment opportunities. The supplement to this prospectus relating to an offering will more fully identify the use of the proceeds from such offering.

We anticipate that substantially all of the net proceeds of any offering of shares of our common stock will be used, as described above, within six months, but in no event longer than two years. Pending investment, we intend to invest the net proceeds of any offering of shares of our common stock in time deposits, income-producing securities with maturities of three months or less that are issued or guaranteed by the federal government or an agency of the federal government, and high quality debt securities maturing in one year or less from the time of investment. Our ability to achieve our investment objective may be limited to the extent that the net proceeds of any offering, pending full investment, are held in time deposits and other short-term instruments.

PRICE RANGE OF COMMON STOCK AND DISTRIBUTIONS

Our common stock is traded on the New York Stock Exchange under the symbol ALD. The following table lists the high and low closing sales prices for our common stock, the closing sales price as a percentage of net asset value (NAV) and quarterly dividends per share. On June 30, 2003, the last reported closing sale price of the common stock was \$ 19.44 per share.

| | NAV(1) | Closing Sale Price(2) | | Premium of High Sales Price to NAV | Premium of Low Sales Price to NAV | Declared Dividends |
|--|----------|-----------------------|----------|------------------------------------|-----------------------------------|--------------------|
| | | High | Low | | | |
| Year ended December 31, 2001 | | | | | | |
| First Quarter | \$ 12.26 | \$ 24.44 | \$ 20.13 | 199% | 164% | \$ 0.49 |
| Second Quarter | 12.79 | 25.40 | 19.57 | 199 | 153 | 0.50 |
| Third Quarter | 13.42 | 24.83 | 21.50 | 185 | 160 | 0.51 |
| Fourth Quarter | 13.57 | 26.00 | 21.57 | 192 | 159 | 0.51 |
| Year ending December 31, 2002 | | | | | | |
| First Quarter | \$ 13.71 | \$ 28.93 | \$ 25.84 | 211% | 188% | \$ 0.53 |
| Second Quarter | 14.02 | 27.66 | 20.88 | 197 | 149 | 0.55 |
| Third Quarter | 13.95 | 24.49 | 18.90 | 176 | 135 | 0.56 |
| Fourth Quarter | 14.22 | 22.87 | 18.90 | 161 | 133 | 0.56 |
| Extra Dividend | | | | | | 0.03 |
| Year ended December 31, 2003 | | | | | | |
| First Quarter | \$ 14.05 | \$ 23.18 | \$ 19.44 | 165% | 138% | \$ 0.57 |
| Second Quarter (through June 30, 2003) | * | | | * | * | 0.57 |

(1) Net asset value per share is determined as of the last day in the relevant quarter and therefore may not reflect the net asset value per share on the date of the high and low sales prices. The net asset values shown are based on outstanding shares at the end of each period.

(2) Prior to June 6, 2001, our common stock was traded on the Nasdaq National Market under the symbol ALLC. The closing sale prices listed are as reflected on the respective exchanges for the periods presented.

* Net asset value has not yet been calculated for this period.

Our common stock continues to trade in excess of net asset value. There can be no assurance, however, that we will maintain a premium to net asset value.

We intend to pay quarterly dividends to shareholders of our common stock. The amount of our quarterly dividends is determined by our board of directors. Our board of directors has established a dividend policy to review the dividend rate quarterly, and may adjust the quarterly dividend rate throughout the year. See Management's Discussion and Analysis of Financial Condition and Results of Operations Equity Capital and Dividends and Tax Status. We cannot assure that we will achieve investment results or maintain a tax status that will permit any particular level of dividend payment. Our credit facilities limit our ability to declare dividends if we default under certain provisions.

We maintain an opt in dividend reinvestment plan for our common shareholders. As a result, if our board of directors declares a dividend, then our new shareholders will receive cash dividends, unless they specifically opt in to the dividend reinvestment plan to reinvest their dividends and receive additional shares of common stock. See Dividend Reinvestment Plan.

MANAGEMENT'S DISCUSSION AND ANALYSIS

OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The information contained in this section should be read in conjunction with our 2002 Consolidated Financial Statements and the Notes thereto. In addition, this prospectus contains certain forward-looking statements. These statements include the plans and objectives of management for future operations and financial objectives and can be identified by the use of forward-looking terminology such as may, will, expect, intend, anticipate, estimate, or continue or the negative thereof or other variations thereon or comparable terminology. These forward-looking statements are subject to the inherent uncertainties in predicting future results and conditions. Certain factors that could cause actual results and conditions to differ materially from those projected in these forward-looking statements are set forth above in the Risk Factors section. Other factors that could cause actual results to differ materially include:

the ongoing global economic downturn, coupled with war or the threat of war;

risks associated with possible disruption in our operations due to terrorism; and

future regulatory actions and conditions in our operating areas.

Financial or other information presented for private finance portfolio companies has been obtained from the portfolio company, and the financial information presented may represent unaudited, projected or pro forma financial information, and therefore may not be indicative of actual results.

OVERVIEW

We are a business development company that provides long-term debt and equity investment capital to support the expansion of companies in a variety of industries. Our lending and investment activity is generally focused on private finance and commercial real estate finance, primarily the investment in non-investment grade commercial mortgage-backed securities, which we refer to as CMBS. Our private finance activity principally involves providing financing through privately negotiated long-term debt and equity investment capital. Our private financing is generally used to fund growth, buyouts, acquisitions, recapitalizations, note purchases, and bridge financings. We generally invest in private companies though, from time to time, we may invest in public companies that lack access to public capital or whose securities may not be marginable.

Our portfolio composition at December 31, 2002, 2001, and 2000, was as follows:

| | <u>2002</u> | <u>2001</u> | <u>2000</u> |
|--------------------------------|-------------|-------------|-------------|
| Private Finance | 70% | 68% | 72% |
| Commercial Real Estate Finance | 30% | 32% | 28% |

Our earnings depend primarily on the level of interest and dividend income, fee income, and net realized and unrealized gains or losses earned on our investment portfolio after deducting interest paid on borrowed capital and operating expenses. Interest income results from the stated interest rate earned on a loan and the amortization of loan

origination points and discounts. The level of interest income is directly related to the balance of the interest-bearing investment portfolio multiplied by the weighted average yield. Our ability to generate interest income is dependent on economic, regulatory, and competitive factors that influence new investment activity, the amount of loans and debt securities for which interest is not accruing and our ability to secure debt and equity capital for our investment activities.

PORTFOLIO AND INVESTMENT ACTIVITY

Total portfolio investment activity and yields at and for the years ended December 31, 2002, 2001, and 2000, were as follows:

| (\$ in millions) | 2002 | 2001 | 2000 |
|--|-----------|-----------|-----------|
| Portfolio at value | \$2,488.2 | \$2,329.6 | \$1,788.0 |
| Investments funded | \$ 506.4 | \$ 680.3 | \$ 901.5 |
| Change in accrued or reinvested interest and dividends | \$ 44.7 | \$ 51.6 | \$ 32.2 |
| Principal repayments | \$ 143.2 | \$ 74.5 | \$ 111.0 |
| Sales(1) | \$ 213.5 | \$ 130.0 | \$ 280.2 |
| Yield(2) | 14.0% | 14.3% | 14.1% |

(1) Sales for the year ended December 31, 2000, include \$128.5 million of small business loans sold.

(2) The weighted average yield on interest-bearing investments is computed as the (a) annual stated interest rate earned plus the annual amortization of loan origination fees, original issue discount, and market discount earned on accruing interest-bearing investments, divided by (b) total interest-bearing investments at value. The weighted average yield is computed as of the balance sheet date.

Private Finance

The private finance portfolio, investment activity, and yields at and for the years ended December 31, 2002, 2001, and 2000, were as follows:

| (\$ in millions) | 2002 | 2001 | 2000 |
|--|------------------|------------------|------------------|
| Portfolio at value: | | | |
| Loans and debt securities | \$1,151.2 | \$1,107.9 | \$ 966.3 |
| Equity interests | 592.0 | 487.2 | 316.2 |
| Total portfolio | \$1,743.2 | \$1,595.1 | \$1,282.5 |
| Investments funded | \$ 297.2 | \$ 287.7 | \$ 600.9 |
| Change in accrued or reinvested interest and dividends | \$ 42.6 | \$ 48.9 | \$ 31.8 |
| Principal repayments | \$ 129.3 | \$ 43.8 | \$ 75.7 |
| Yield* | 14.4% | 14.8% | 14.6% |

* The weighted average yield on loans and debt securities is computed as the (a) annual stated interest rate earned plus the annual amortization of loan origination fees, original issue discount, and market discount earned on accruing loans and debt securities, divided by (b) total loans and debt securities at value. The weighted average yield is computed as of the balance sheet date.

Edgar Filing: ALLIED CAPITAL CORP - Form N-2/A

Investments funded for the years ended December 31, 2002, 2001, and 2000, consisted of the following:

| (\$ in millions) | Loans and Debt Securities | Equity Interests | Total |
|---|---------------------------------|---------------------|----------|
| <i>For the Year Ended December 31, 2002(1)</i> | | | |
| Companies more than 25% owned | \$ 86.1 | \$ 18.7 | \$ 104.8 |
| Companies 5% to 25% owned | 22.3 | 0.4 | 22.7 |
| Companies less than 5% owned | 154.6 | 15.1 | 169.7 |
| Total | \$ 263.0 | \$ 34.2 | \$ 297.2 |
| <i>For the Year Ended December 31, 2001(1)</i> | | | |
| Companies more than 25% owned | \$ 47.8 | \$ 78.3 | \$ 126.1 |
| Companies 5% to 25% owned | 13.5 | 4.5 | 18.0 |
| Companies less than 5% owned | 136.9 | 6.7 | 143.6 |
| Total | \$ 198.2 | \$ 89.5 | \$ 287.7 |
| <i>For the Year Ended December 31, 2000(1)</i> | | | |
| Companies more than 25% owned | \$ 10.8 | \$ 111.5 | \$ 122.3 |
| Companies 5% to 25% owned | 121.8 | 42.7 | 164.5 |
| Companies less than 5% owned | 288.7 | 25.4 | 314.1 |
| Total | \$ 421.3 | \$ 179.6 | \$ 600.9 |

- (1) The private finance portfolio is presented in three categories – companies more than 25% owned, which represent portfolio companies where we directly or indirectly own more than 25% of the outstanding voting securities of such portfolio company and, therefore, are deemed controlled by us under the Investment Company Act of 1940, or the 1940 Act; companies owned 5% to 25%, which represent portfolio companies where we directly or indirectly own 5% to 25% of the outstanding voting securities of such portfolio company or where we hold one or more seats on the portfolio company’s board of directors and, therefore, are deemed to be an affiliated person under the 1940 Act; and companies less than 5% owned, which represent portfolio companies where we directly or indirectly own less than 5% of the outstanding voting securities of such portfolio company and where we have no other affiliations with such portfolio company.

At December 31, 2002, we had outstanding funding commitments of \$92.8 million to portfolio companies, including \$25.7 million committed to private venture capital funds. At December 31, 2002, we also had total commitments to private finance portfolio companies in the form of standby letters of credit and guarantees of \$65.9 million.

We fund new investments using cash, through the issuance of our common equity, the reinvestment of previously accrued interest and dividends in debt or equity securities, or the current reinvestment of interest and dividend income through the receipt of a debt or equity security (payment-in-kind income). From time to time we may opt to reinvest accrued interest receivable in a new debt or equity security in lieu of receiving such interest in cash and providing a subsequent investment.

We may acquire more than 50% of the common stock of a company in a control buyout transaction. Control investments are generally structured such that we earn a current return through a combination of interest income on our senior loans and subordinated debt, dividends on our preferred and common stock, and management or transaction services fees to compensate us for the managerial assistance that we provide to a controlled portfolio company. In some cases for companies that are more than 50%

owned, we may not accrue interest on loans and debt securities if such company is in need of additional capital. In such cases, we may defer current debt service. Our most significant investments acquired through control buyout transactions at December 31, 2002, were Business Loan Express, Inc. (BLX), acquired in 2000, and The Hillman Companies, Inc., acquired in 2001.

Business Loan Express, Inc. At December 31, 2002, our investment in BLX totaled \$221.4 million at cost and \$256.8 million at value, or 9.2% of our total assets, which includes unrealized appreciation of \$35.4 million.

BLX is the nation's second largest non-bank government guaranteed lender utilizing the SBA's 7(a) Guaranteed Loan Program and is licensed by the SBA as a Small Business Lending Company (SBLC). BLX is a preferred lender as designated by the SBA in 68 markets across the United States, and originates, sells, and services small business loans. In addition to the 7(a) Guaranteed Loan Program, BLX originates conventional small business loans and originates loans under the USDA Business and Industry Guaranteed Loan Program. BLX has offices across the United States and is headquartered in New York, New York.

Edgar Filing: ALLIED CAPITAL CORP - Form N-2/A

Summary financial data for BLX at and for the six months ended December 31, 2002, and their year ended June 30, 2002, was as follows:

| (\$ in millions) | At and for the Six Months Ended December 31, 2002(1) | At and for the Year Ended June 30, 2002 |
|---|--|---|
| Operating Data | | |
| Total revenue | \$ 51.1 | \$ 84.6 |
| Profits before taxes(4) | \$ 1.6 | \$ 3.6 |
| Earnings before interest, taxes and management fees (EBITM)(4) | \$ 24.5 | \$ 43.0 |
| Balance Sheet Data | | |
| Total assets(2) | \$ 290.8 | \$ 277.1 |
| Total debt | \$ 194.9 | \$ 183.0 |
| Total shareholders' equity | \$ 60.4 | \$ 59.9 |
| Cash Flow Data | | |
| Cash provided by operating activities | \$ 8.0 | \$ 18.7 |
| Cash used in investing activities | \$ (14.3) | \$ (37.1) |
| Cash provided by financing activities | \$ 7.0 | \$ 3.0 |
| Other Data | | |
| Total loan originations | \$ 308.8 | \$ 565.1 |
| Serviced loan portfolio | \$1,619.5 | \$1,372.6 |
| Number of loans | 2,373 | 2,083 |
| Loan delinquencies(3) | 8.6% | 9.4% |
| Serviced Loan Portfolio by Industry | | |
| Hotels | 26% | 27% |
| Gas stations/convenience stores | 19 | 16 |
| Restaurants | 10 | 10 |
| Manufacturing and industrial | 10 | 10 |
| Professional and retail services | 9 | 10 |
| Shrimp/fishing vessels | 6 | 7 |
| Recreation | 5 | 5 |
| Child care and health care services | 4 | 4 |
| Other | 11 | 11 |
| Total | 100% | 100% |

- (1) The results of operations, changes in cash flows, and loan originations for the six months ended December 31, 2002, are not necessarily indicative of the operating results to be expected for the full year.
- (2) Included in total assets is \$6 million of goodwill. There is no other goodwill on BLX's balance sheet. We acquired 94.9% of BLC Financial Services, Inc. on December 31, 2000. Push-down accounting was not required with respect to this transaction; accordingly, goodwill was not recorded by BLX.
- (3) Represents the percentage of loans in the total serviced loan portfolio that are greater than 30 days delinquent, which includes loans in workout status. Loans greater than 30 days delinquent for the SBA 7(a) loan portfolio only, which are included in the total serviced loan portfolio, were 8.7% at December 31, 2002.
- (4) BLX incurred certain one-time expenses of approximately \$1 million for the six months ended December 31, 2002, associated with the Amresco Independence Funding transaction and its reorganization to an LLC.

BLX sells or securitizes substantially all of the loans it originates. BLX currently sells the guaranteed piece of SBA 7(a) guaranteed loans for cash premiums of up to 10% of the guaranteed loan amount plus a retained annual servicing fee generally between 1.0%

and 2.0% of the guaranteed loan amount. Alternatively, BLX may sell the guaranteed pieces of SBA 7(a) guaranteed loans at par and retain an annual servicing spread, at current prices of generally between 4.0% and 4.8%. BLX securitizes the unguaranteed pieces of the SBA 7(a) loans and conventional loans it originates. Typically, BLX retains up to 2.7% of the term loan securitization pools and receives a spread from the excess of loan interest received on the loans sold over the interest cost on the securities issued in the securitization generally between 4.7% and 4.9%. Over 90-day delinquencies in securitized pools were approximately 1% of loans securitized at December 31, 2002.

As a result of BLX's guaranteed loan sales and securitization transactions, BLX had assets at December 31, 2002, of approximately \$124.3 million representing the residual interests in and servicing assets for loans sold or securitized, together referred to as Residual Interests. These Residual Interests represent the discounted present value of estimated future cash flow streams to be received from loans sold or securitized after making allowances for estimated prepayments, losses, and loan delinquencies.

If scheduled loan payments on all loans were to be received as stated in the loan agreements, estimated future cash flows to BLX from loans sold or securitized would total approximately \$499.7 million in the aggregate over the remaining term of these loans. Of the approximate \$499.7 million, estimated cash flows for the 12 months ended December 31, 2003, 2004, 2005, and 2006, would be approximately \$38.5 million, \$37.2 million, \$36.3 million, and \$35.3 million, respectively, although there can be no assurance that scheduled loan payments will approximate actual cash received.

The loans originated by BLX are generally secured by commercial real estate. Loans originated under the SBA 7(a) Guaranteed Loan Program also require the personal guarantee of the borrower and, in many cases, the loans are also secured by additional real estate collateral. Because the loans are secured by collateral, BLX's annual loan losses for its serviced SBA 7(a) loans, computed using the unguaranteed balance of the SBA 7(a) loan portfolio, were less than 1% on average for the last five fiscal years.

Because of the government guarantee attached to SBA 7(a) loans, BLX's loss of principal exposure to loans greater than 90 days delinquent at December 31, 2002, was \$38.4 million in the aggregate. At December 31, 2002, BLX has accrued loss reserves of \$10.6 million, which when deducted from 90-day delinquencies would reduce their unreserved financial exposure to 90-day delinquencies to \$27.8 million. BLX's reserves represent 28% of over 90-day delinquent loans. BLX's loans are underwritten to have substantial collateral coverage and also carry personal guarantees of the borrowers.

BLX's sources of cash flow from operations include net income, cash proceeds from loan sales net of cash used for loans originated, and changes in working capital. BLX's cash used in investing activities includes the origination of residual interests from loans sold, net of collections of residual interests, and cash used to purchase fixed assets.

BLX has a three-year \$124 million revolving credit facility that matures in March 2004. As the controlling shareholder of BLX, we have provided an unconditional guaranty to the revolving credit facility lenders in an amount of up to 50% of the total obligations (consisting of principal, accrued interest, and other fees) of BLX under the revolving credit facility. The amount guaranteed by us at December 31, 2002, was \$51.6 million. This guaranty can be called by the lenders only in the event of a default by BLX. BLX was in compliance with the terms of the revolving credit facility at December 31, 2002.

We have also provided two standby letters of credit in connection with two term securitization transactions completed by BLX totaling \$10.6 million.

In January 2003, BLX announced the completion of a \$128.0 million acquisition of performing loans and other assets from Amresco Independence Funding. BLX purchased \$121.5 million of performing loans at par and other assets purchased totaled \$6.5 million. The acquisition has increased BLX's serviced portfolio to over \$2 billion, and BLX now serves in excess of 2,800 small business borrowers. We provided \$50 million of the capital to fund this acquisition. Our \$50 million financing was in the form of a short-term revolving credit facility of \$25 million to fund the temporary capital needs of construction loans purchased and loans pending sale, as well as \$25 million of preferred equity to support the future growth potential of the company post acquisition.

In February 2003, BLX completed a corporate reorganization to a limited liability company. As BLX LLC moves forward, its taxable earnings will flow directly to its members and we represent approximately 95% of the economic interests in the LLC. In connection with the reorganization, BLX has changed its fiscal year end to September 30.

Changes in the laws or regulations that govern SBLCs or the SBA 7(a) Guaranteed Loan Program or changes in government funding for this program could have a material impact on BLX or its operations. As of October 1, 2002, the SBA implemented a maximum loan size of \$500,000 for loans originated through the SBA 7(a) Guaranteed Loan Program due to Federal budget constraints. In February 2003, legislation was enacted to return the SBA 7(a) Guaranteed Loan Program to a sufficient level of funding. This legislation has enabled the SBA to return the maximum loan size to previous levels.

The Hillman Companies, Inc. At December 31, 2002, our investment in Hillman totaled \$92.6 million at cost and \$180.5 million at value, or 6.5% of total assets. During the fourth quarter of 2002, Hillman distributed \$6.5 million of preferred stock in STS Operating, Inc. (STS) to us, which reduced our cost basis in Hillman's common stock and added to our investment in STS.

Hillman is a leading manufacturer of key making equipment and distributor of key blanks, fasteners, signage, and other small hardware components and operates in multiple channels of the retail marketplace such as hardware stores, national and regional home centers, and mass merchants. Hillman has certain patent-protected products, including key duplication technology, that is important to its business. Hillman's primary operations are located in Cincinnati, Ohio.

For the year ended December 31, 2002, Hillman had total revenue of \$286.8 million, earnings before interest, taxes, depreciation, amortization, and management fees, or EBITDAM, of \$50.2 million, and profits before taxes of \$10.0 million. Hillman had total assets of \$368.9 million and total debt of \$146.7 million at December 31, 2002.

Commercial Real Estate Finance

The commercial real estate finance portfolio, investment activity, and yields at and for the years ended December 31, 2002, 2001, and 2000, were as follows:

| (\$ in millions) | 2002 | 2001 | 2000 |
|--|----------------|----------------|----------------|
| Portfolio at value: | | | |
| CMBS bonds | \$555.5 | \$558.3 | \$311.3 |
| CDO preferred shares | 52.8 | 24.2 | |
| Commercial mortgage loans | 63.7 | 79.6 | 106.4 |
| Residual interest | 69.0 | 69.9 | 81.7 |
| Real estate owned | 4.0 | 2.5 | 6.1 |
| Total portfolio | \$745.0 | \$734.5 | \$505.5 |
| Investments funded | \$209.2 | \$392.6 | \$149.0 |
| Change in accrued or reinvested interest | \$ 2.1 | \$ 2.7 | \$ 1.1 |
| Principal repayments | \$ 13.9 | \$ 30.7 | \$ 24.3 |
| CMBS and commercial real estate loan sales | \$213.5 | \$130.0 | \$151.7 |
| Yield* | 13.4% | 13.5% | 13.1% |

* The weighted average yield on the interest-bearing investments is computed as the (a) annual stated interest rate earned plus the annual amortization of loan origination fees, original issue discount, and market discount earned on accruing interest-bearing investments, divided by (b) total interest-bearing investments at value. The weighted average yield is computed as of the balance sheet date. Interest-bearing investments for the commercial real estate finance portfolio include all investments except for real estate owned.

Our primary commercial real estate finance investment activity is the investment in non-investment grade commercial mortgage-backed securities, or CMBS. We believe that CMBS is an attractive asset class because of the yields that can be earned on securities that are secured by commercial mortgage loans and ultimately commercial real estate properties. Our CMBS investment activity level will be dependent upon our ability to invest in CMBS at attractive yields. We plan to continue our CMBS investment activity; however, in order to maintain a balanced portfolio, we expect that CMBS will not exceed 25% of our total assets.

Our commercial real estate investment activity for the years ended December 31, 2002, 2001, and 2000, was as follows:

| (\$ in millions) | Face Amount | Discount | Amount Funded | Yield(1)(2) |
|---|----------------|------------------|----------------|--------------|
| For the Year Ended December 31, 2002 | | | | |
| CMBS bonds | \$302.5 | \$(140.2) | \$162.3 | 13.4% |
| CDO preferred shares | 29.0 | | 29.0 | 17.5% |
| Commercial mortgage loans | 11.7 | (1.7) | 10.0 | 13.5% |
| Real estate owned | 7.9 | | 7.9 | |
| Total | \$351.1 | \$(141.9) | \$209.2 | 14.0% |
| For the Year Ended December 31, 2001 | | | | |
| CMBS bonds | \$661.4 | \$(295.6) | \$365.8 | 14.0% |
| CDO preferred shares | 24.6 | | 24.6 | 16.9% |
| Commercial mortgage loans | 2.2 | | 2.2 | 10.0% |
| Total | \$688.2 | \$(295.6) | \$392.6 | 14.2% |

Edgar Filing: ALLIED CAPITAL CORP - Form N-2/A

| (\$ in millions) | Face Amount | Discount | Amount Funded | Yield(1)(2) |
|---|----------------|------------------|------------------|--------------|
| For the Year Ended December 31, 2000 | | | | |
| CMBS bonds | \$244.6 | \$(120.3) | \$124.3 | 14.7% |
| Commercial mortgage loans | 25.5 | (0.8) | 24.7 | 10.9% |
| Total | \$270.1 | \$(121.1) | \$149.0 | 14.1% |

- (1) The yield on new CMBS bond investments will vary from period to period depending on the concentration of lower yielding BB+, BB, and BB- CMBS bonds purchased in that period to the total amount invested.
- (2) Total yield calculation excludes new investments in real estate owned.

CMBS Bonds. The non-investment grade and unrated tranches of the CMBS bonds in which we invest are junior in priority for payment of interest and principal to the more senior tranches of the related CMBS bond issuance. Cash flow from the underlying mortgages generally is allocated first to the senior tranches, with the most senior tranches having a priority right to the cash flow. Then, any remaining cash flow is allocated, generally, among the other tranches in order of their relative seniority. To the extent there are defaults and unrecoverable losses on the underlying mortgages resulting in reduced cash flows, our most subordinate tranche will bear this loss first. At December 31, 2002, our CMBS bonds were subordinate to 91% to 97% of the tranches of bonds issued in various CMBS transactions. Given that the non-investment grade CMBS bonds in which we invest are junior in priority for payment of principal and interest, we invest in these CMBS bonds at a discount from the face amount of the bonds. The discount increases with the decrease in the seniority of the CMBS bonds. For the years ended December 31, 2002, 2001, and 2000, the average discount for the CMBS bonds in which we invested was 46%, 45%, and 49%, respectively.

The underlying pools of mortgage loans that are collateral for our new CMBS bond investments for the years ended December 31, 2002, 2001, and 2000, had respective underwritten loan to value and underwritten debt service coverage ratios as follows:

| Loan to Value Ranges (\$ in millions) | 2002 | | 2001 | | 2000 | |
|--|------------------|-------------|------------------|-------------|------------------|-------------|
| | Amount | Percentage | Amount | Percentage | Amount | Percentage |
| Less than 60% | \$ 909.3 | 20% | \$1,259.7 | 15% | \$ 577.1 | 14% |
| 60-65% | 287.3 | 6 | 941.6 | 11 | 402.8 | 10 |
| 65-70% | 587.9 | 13 | 1,140.6 | 14 | 648.1 | 16 |
| 70-75% | 1,214.5 | 27 | 2,400.4 | 29 | 1,450.9 | 36 |
| 75-80% | 1,477.5 | 33 | 2,466.4 | 30 | 958.9 | 23 |
| Greater than 80% | 47.8 | 1 | 119.6 | 1 | 36.6 | 1 |
| Total | \$4,524.3 | 100% | \$8,328.3 | 100% | \$4,074.4 | 100% |
| Weighted average loan to value | 68.5% | | 69.7% | | 70.2% | |

| Debt Service Coverage Ratio(1) Ranges (\$ in millions) | 2002 | | 2001 | | 2000 | |
|--|-------------------|------------|-----------|------------|-----------|------------|
| | Amount | Percentage | Amount | Percentage | Amount | Percentage |
| | Greater than 2.00 | \$ 366.9 | 8% | \$ 484.8 | 6% | \$ 197.0 |
| 1.76-2.00 | 229.6 | 5 | 158.2 | 2 | 99.1 | 3 |
| 1.51-1.75 | 477.4 | 11 | 855.0 | 10 | 341.8 | 8 |
| 1.26-1.50 | 2,739.6 | 60 | 5,008.3 | 60 | 2,204.5 | 54 |
| Less than 1.25 | 710.8 | 16 | 1,822.0 | 22 | 1,232.0 | 30 |
| Total | \$4,524.3 | 100% | \$8,328.3 | 100% | \$4,074.4 | 100% |
| Weighted average debt service coverage ratio | 1.41 | | 1.48 | | 1.35 | |

(1) Defined as annual net cash flow before debt service divided by annual debt service payments.

As a part of our strategy to maximize our return on equity capital, we sold CMBS bonds rated BB+ through B during the year ended December 31, 2002, with a cost basis of \$205.9 million, and bonds rated BB+ through BB-during the years ended December 31, 2001 and 2000, with a cost basis of \$124.5 million and \$98.7 million, respectively. These bonds had a weighted average effective yield of 11.5%, 10.3%, and 11.5% and were sold for \$225.6 million, \$126.8 million, and \$102.5 million, respectively, resulting in realized gains on the sales. The sales of these primarily lower yielding bonds increased our overall liquidity.

The effective yield on our CMBS bond portfolio at December 31, 2002, 2001, and 2000, was 14.2%, 14.7%, and 15.4%, respectively. The yield on the CMBS bond portfolio at any point in time will vary depending on the concentration of lower yielding BB+, BB, and BB- CMBS bonds held in the portfolio. At December 31, 2002, 2001, and 2000, the unamortized discount related to the CMBS bond portfolio was \$649.5 million, \$611.9 million, and \$364.9 million, respectively. At December 31, 2002, the CMBS bond portfolio had a fair value of \$555.5 million, which included net unrealized appreciation on the CMBS bonds of \$31.8 million.

During January 2003, we sold BB+ through B CMBS bonds with a cost basis of \$115.7 million for \$128.8 million in cash proceeds. We recognized a gain on this sale of \$12.2 million, net of a realized loss of \$0.9 million from a hedge related to the CMBS bonds sold. After completion of this sale, the CMBS bond portfolio yield increased to approximately 15%. However, the yield on the CMBS bond portfolio will continue to fluctuate as we invest in more CMBS bond issuances that contain higher rated, lower yielding BB+, BB, and BB-bonds.

At December 31, 2002, the underlying pools of mortgage loans that are collateral for our CMBS bonds consisted of approximately 4,500 commercial mortgage loans with a total outstanding principal balance of \$25.0 billion. At December 31, 2002 and 2001, 1.0% and 0.5%, respectively, of the loans in the underlying collateral pool for our CMBS bonds were over 30 days delinquent or were classified as real estate owned.

Collateralized Debt Obligation Preferred Shares. During the years ended December 31, 2002 and 2001, we invested in the preferred shares of three and one, respectively, collateralized debt obligations, or CDOs, which are secured by investment grade unsecured debt issued by various real estate investment trusts, or REITs, and investment and non-investment grade CMBS bonds. The investment grade REIT collateral consists of debt with a cut-off balance of \$1,017.6 million and was issued by 42 REITs. The investment grade CMBS collateral consists of CMBS bonds with a face amount of \$479.0 million issued in 39 separate CMBS transactions. The non-investment grade CMBS

collateral consists of BB+, BB, and BB CMBS bonds with a face amount of \$463.4 million issued in 39 separate CMBS transactions. Included in the CMBS collateral for the CDOs are \$397.9 million of CMBS bonds that are senior in priority of repayment to certain lower rated CMBS bonds held by us, which were issued in 23 separate CMBS transactions. The preferred shares are junior in priority for payment of principal to the more senior tranches of debt issued by the CDOs. To the extent there are defaults and unrecoverable losses on the underlying collateral resulting in reduced cash flows, the preferred shares will bear this loss first. At December 31, 2002, our preferred shares in the CDOs were subordinate to approximately 96% of the more senior tranches of debt issued by the CDOs. Income received from our CDO investments provided an effective yield of 17.2% and 16.9% at December 31, 2002 and 2001, respectively.

Commercial Mortgage Loans and Real Estate Owned. Since 1998, we have been liquidating much of our whole commercial mortgage loan portfolio so that we can redeploy the proceeds into higher yielding assets. For the years ended December 31, 2002, 2001, and 2000, we sold \$7.5 million, \$5.5 million, and \$53.0 million, respectively, of commercial mortgage loans and real estate owned. At December 31, 2002, our whole commercial mortgage loan portfolio had been reduced to \$63.7 million from \$79.6 million at December 31, 2001.

Residual Interests. The residual interest primarily consists of a retained interest from a 1998 asset securitization whereby bonds were sold in three classes rated AAA, AA and A. The residual interest represents a right to cash flows from the underlying collateral pool of loans after these senior bond obligations are satisfied. At December 31, 2002, one class of bonds rated AAA was outstanding totaling \$17.6 million. We have the right to call the bonds upon a minimum of ten days notice to the bondholders. Once the bonds are fully repaid, either through the cash flows from the securitized loans or due to us calling the bonds, the remaining loans in the trust will be returned to us as payment on the residual interest. At December 31, 2002, the value of the cash, loans and REO in the trust totaled \$86.6 million.

Portfolio Asset Quality

Portfolio by Grade. We employ a standard grading system for the entire portfolio. Grade 1 is used for those investments from which a capital gain is expected. Grade 2 is used for investments performing in accordance with plan. Grade 3 is used for investments that require closer monitoring; however, no loss of interest or principal is expected. Grade 4 is used for investments that are in workout and for which some loss of current interest is expected, but no loss of principal is expected. Grade 5 is used for investments that are in workout and for which some loss of principal is expected.

At December 31, 2002 and 2001, our portfolio was graded as follows:

| Grade | 2002 | | 2001 | |
|------------------|--------------------|-------------------------------|--------------------|-------------------------------|
| | Portfolio at Value | Percentage of Total Portfolio | Portfolio at Value | Percentage of Total Portfolio |
| (\$ in millions) | | | | |
| 1 | \$ 801.0 | 32.1% | \$ 603.3 | 25.9% |
| 2 | 1,400.8 | 56.3 | 1,553.8 | 66.7 |
| 3 | 166.0 | 6.7 | 79.5 | 3.4 |
| 4 | 23.6 | 1.0 | 44.5 | 1.9 |
| 5 | 96.8 | 3.9 | 48.5 | 2.1 |
| | \$2,488.2 | 100.0% | \$2,329.6 | 100.0% |

Total Grades 4 and 5 assets as a percentage of the total portfolio at value at December 31, 2002 and 2001, were 4.9% and 4.0%, respectively. Included in Grades 4 and 5 assets at December 31, 2002 and 2001, were assets totaling \$24.1 million and \$6.6 million, respectively, that are secured by commercial real estate. Grade 4 and 5 assets include loans, debt securities, and equity securities. We expect that a number of portfolio companies will be in the Grades 4 or 5 categories from time to time. Part of the business of private finance is working with troubled portfolio companies to improve their businesses and protect our investment. The number of portfolio companies and related investment amount included in Grades 4 and 5 may fluctuate from period to period. We continue to follow our historical practice of working with a troubled portfolio company in order to recover the maximum amount of our investment, but record unrealized depreciation for the expected amount of the loss when such exposure is identified.

At December 31, 2002, we saw an increase in Grade 3 assets in this difficult economy. We have been working with a number of portfolio companies that are in the process of restructuring their operations or balance sheets due to changes in the economic environment or other changes in their business, and we have classified investments in these types of situations in Grade 3 because they are close monitoring situations. We may record some depreciation on a Grade 3 investment to reflect any decline in value while the company is in a close monitoring situation; however, we currently do not expect a loss of investment return or principal for these assets.

Loans and Debt Securities on Non-Accrual Status. Loans and debt securities on non-accrual status for which we have doubt about interest collection and are in workout status are classified as Grade 4 or 5 assets. In addition, we may not accrue interest on loans and debt securities to companies that are more than 50% owned by us from time to time if such companies are in need of additional capital. In these situations we may choose to defer current debt service.

For the total investment portfolio, workout loans and debt securities (which excludes equity securities that are included in the total Grade 4 and 5 assets above) not accruing interest that were classified in Grade 4 and 5 were \$89.1 million at value at December 31, 2002, or 3.6% of the total portfolio. Included in this category at December 31, 2002, were loans of \$13.0 million that were secured by commercial real estate. Workout loans and debt securities not accruing interest were \$85.0 million at value at December 31, 2001, or 3.6% of the total portfolio, of which \$8.9 million was related to portfolio companies in liquidation and \$4.1 million represented loans secured by commercial real estate. As of December 31, 2002, \$7.6 million representing receivables related to portfolio companies in liquidation were included in other assets. In addition to Grade 4 and 5 assets that are in workout, loans and debt securities to companies that are more than 50% owned by us that were not accruing interest totaled \$63.6 million at value at December 31, 2002, and loans and debt securities to companies that are less than 50% owned by us that were not in workout but were not accruing interest totaled \$7.2 million and \$23.9 million at value at December 31, 2002 and 2001, respectively.

Loans and Debt Securities Over 90 Days Delinquent. Loans and debt securities greater than 90 days delinquent were \$103.1 million at value at December 31, 2002, or 4.1% of the total portfolio. Included in this category were loans valued at \$26.0 million that were secured by commercial real estate. Loans and debt securities greater than 90 days delinquent were \$39.1 million at value at December 31, 2001, or 1.7% of the total portfolio. Included in this category were loans valued at \$14.1 million that were secured by commercial real estate.

As a provider of long-term privately negotiated investment capital, we may defer payment of principal or interest from time to time. As a result, the amount of the portfolio that is greater than 90 days delinquent or on non-accrual status may vary from quarter to quarter. The nature of our private finance portfolio company relationships frequently provide an opportunity for portfolio companies to amend the terms of payment to us or to restructure their debt and equity capital. During such restructuring, we may not receive or accrue interest or dividend payments. The investment portfolio is priced to provide current returns for shareholders assuming that a portion of the portfolio at any time may not be accruing interest currently. We also price our investments for a total return including interest or dividends plus capital gains from the sale of equity securities. Therefore, the amount of loans greater than 90 days delinquent or on non-accrual status is not necessarily an indication of future principal loss or loss of anticipated investment return. Our portfolio grading system is used as a means to assess loss of investment return or investment principal.

Hedging Activities

Because we invest in BB+ through B rated CMBS bonds, which were purchased at prices based in part on comparable Treasury rates, we have entered into transactions with financial institutions to hedge against movement in Treasury rates on certain of these CMBS bonds. These transactions, referred to as short sales, involved receiving the proceeds from the sales of borrowed Treasury securities, with the obligations to replenish the borrowed Treasury securities at a later date based on the then current market price, whatever that price may be. Risks in these contracts arise from movements in the value of the borrowed Treasury securities and interest rates and from the possible inability of counterparties to meet the terms of their contracts. If the value of the borrowed Treasury securities increases, we will incur losses on these transactions, which are limited only by the increase in value of the borrowed Treasury securities; conversely, the value of the CMBS bonds would likely increase. If the value of the borrowed Treasury securities decreases, we will incur gains on these transactions, which are limited only by the decline in value of the borrowed Treasury securities; conversely, the value of the CMBS bonds would likely decrease. We do not anticipate nonperformance by any counterparty in connection with these transactions.

The total obligations to replenish borrowed Treasury securities, including accrued interest payable on the obligations, were \$197.0 million and \$47.3 million at December 31, 2002 and 2001, respectively, which included unrealized depreciation on the obligations of \$7.1 million and unrealized appreciation on the obligations of \$1.2 million, respectively, due to changes in the yield on the borrowed Treasury securities. The net proceeds related to the sales of the borrowed Treasury securities were \$189.3 million and \$48.5 million at December 31, 2002 and 2001, respectively. Under the terms of the transactions, we have provided additional cash collateral of \$5.4 million at December 31, 2002, for the difference between the net proceeds related to the sales of the borrowed Treasury securities and the obligations to replenish the securities on the weekly settlement date, which is included in deposits of proceeds from sales of borrowed Treasury securities in the accompanying financial statements.

RESULTS OF OPERATIONS**Comparison of the Years Ended December 31, 2002, 2001, and 2000**

The following table summarizes our condensed operating results for the years ended December 31, 2002, 2001, and 2000.

| (in thousands, except per share amounts) | 2002 | 2001 | Change | Percent Change | 2001 | 2000 | Change | Percent Change |
|--|-------------------|-------------------|------------------|----------------|-------------------|-------------------|------------------|----------------|
| Interest and Related Portfolio Income | | | | | | | | |
| Interest and dividends | \$ 264,042 | \$ 240,464 | \$ 23,578 | 10% | \$ 240,464 | \$ 182,307 | \$ 58,157 | 32% |
| Premiums from loan dispositions | 2,776 | 2,504 | 272 | 11% | 2,504 | 16,138 | (13,634) | (84)% |
| Fees and other income | 43,110 | 46,142 | (3,032) | (7)% | 46,142 | 13,144 | 32,998 | 251% |
| Total interest and related portfolio income | 309,928 | 289,110 | 20,818 | 7% | 289,110 | 211,589 | 77,521 | 37% |
| Expenses | | | | | | | | |
| Interest | 70,443 | 65,104 | 5,339 | 8% | 65,104 | 57,412 | 7,692 | 13% |
| Employee(1) | 33,126 | 29,656 | 3,470 | 12% | 29,656 | 26,025 | 3,631 | 14% |
| Administrative(1) | 21,504 | 15,299 | 6,205 | 41% | 15,299 | 15,435 | (136) | (1)% |
| Total operating expenses | 125,073 | 110,059 | 15,014 | 14% | 110,059 | 98,872 | 11,187 | 11% |
| Net investment income before income taxes and net realized and unrealized gains | 184,855 | 179,051 | 5,804 | 3% | 179,051 | 112,717 | 66,334 | 59% |
| Income tax expense (benefit) | 930 | (412) | 1,342 | (326)% | (412) | — | (412) | — |
| Net investment income before net realized and unrealized gains | 183,925 | 179,463 | 4,462 | 2% | 179,463 | 112,717 | 66,746 | 59% |
| Net Realized and Unrealized Gains | | | | | | | | |
| Net realized gains | 44,937 | 661 | 44,276 | * | 661 | 15,523 | (14,862) | * |
| Net unrealized gains (losses) | (571) | 20,603 | (21,174) | * | 20,603 | 14,861 | 5,742 | * |
| Total net realized and unrealized gains | 44,366 | 21,264 | 23,102 | * | 21,264 | 30,384 | (9,120) | * |
| Net income | \$ 228,291 | \$ 200,727 | \$ 27,564 | 14% | \$ 200,727 | \$ 143,101 | \$ 57,626 | 40% |
| Diluted earnings per common share | \$ 2.20 | \$ 2.16 | \$ 0.04 | 2% | \$ 2.16 | \$ 1.94 | \$ 0.22 | 11% |
| Weighted average common shares outstanding diluted | 103,574 | 93,003 | 10,571 | 11% | 93,003 | 73,472 | 19,531 | 27% |

* Net realized and net unrealized gains and losses can fluctuate significantly from year to year. As a result, annual comparisons of net realized and net unrealized gains and losses may not be meaningful.

(1) Employee and administrative expenses for the year ended December 31, 2002, include costs associated with the closing of our German office of \$0.5 million and \$2.5 million, respectively, for a total of \$3.0 million, or \$0.03 per common share.

Net income results from total interest and related portfolio income earned, less total expenses incurred in our operations, plus or minus net realized and unrealized gains (losses).

Total Interest and Related Portfolio Income. Total interest and related portfolio income includes interest and dividend income, premiums from loan dispositions, and fees and other income.

The increase in interest and dividend income earned resulted primarily from the growth of our investment portfolio and the dividends earned on certain equity securities. The level of interest income is directly related to the balance of the interest-bearing investment portfolio multiplied by the weighted average yield. The weighted average yield varies from period to period based on the current stated interest rate earned on interest-bearing investments and the amount of loans and debt securities for which interest is not accruing. Our interest-bearing investments in the portfolio increased by 2.9% to \$1,896.2 million at December 31, 2002, from \$1,842.4 million at December 31, 2001, and increased by 25.2% during 2001 from \$1,471.8 million at December 31, 2000. The weighted average yield on the interest-bearing investments in the portfolio at December 31, 2002, 2001, and 2000, was as follows:

Included in premiums from loan dispositions are prepayment premiums of \$2.8 million, \$2.0 million, and \$2.8 million for the years ended December 31, 2002, 2001, and 2000, respectively. While the scheduled maturities of private finance and commercial real estate loans range from five to ten years, it is not unusual for our borrowers to refinance or pay off their debts to us ahead of schedule. Because we seek to finance primarily seasoned, performing companies, such companies at times can secure lower cost financing as their balance sheets strengthen or as more favorable interest rates become available, or a company may enter into a transaction that triggers the early repayment of their debt to us. Therefore, we generally structure our loans to require a prepayment premium for the first three to five years of the loan. Premiums from loan dispositions for the year ended December 31, 2000, included premiums from loan sales of \$13.3 million primarily due to the loan sale activities of our small business lending operation prior to its merger with BLX at the end of 2000.

Fees and other income primarily include fees related to financial structuring, diligence, transaction services, management services to portfolio companies, guaranty, and other advisory services. As a business development company, we are required to make significant managerial assistance available to the companies in our investment portfolio. Managerial assistance includes management and consulting services including, but not limited to, information technology, web site development, marketing, human resources, personnel recruiting, board recruiting, corporate governance, and risk management.

Fees and other income for the year ended December 31, 2002, included fees of \$15.0 million related to structuring and diligence, fees of \$4.4 million related to transaction services provided to portfolio companies, and fees of \$23.2 million related to management

services provided to portfolio companies, other advisory services, and guaranty fees. Fees and other income for the years ended December 31, 2001 and 2000, included structuring and diligence fees of \$15.5 million and \$6.0 million, respectively, and management services, other advisory services and guaranty fees of \$13.1 million and \$3.1 million, respectively. For the year ended December 31, 2001, fees and other income also included \$16.6 million related to transaction services provided to portfolio companies. Fees and other income are generally related to specific transactions or services, and, therefore, may vary substantially from period to period. Points or loan origination fees that represent yield enhancement on a loan are capitalized and amortized into interest income over the life of the loan.

BLX and Hillman are our most significant portfolio investments and together represented 15.6% of our total assets at December 31, 2002. Total interest and related portfolio income earned from these investments for the years ended December 31, 2002, 2001, and 2000, were \$49.5 million, \$39.6 million, and \$2.7 million, respectively. In July 2002, we sold WyoTech Acquisition Corporation, which was a significant portfolio investment during 2002, 2001, and 2000. Total interest and related portfolio income earned on this investment for the years ended December 31, 2002, 2001, and 2000 was \$3.6 million, \$5.5 million, and \$2.4 million, respectively.

Operating Expenses. Operating expenses include interest, employee, and administrative expenses. Our single largest expense is interest on our indebtedness. The fluctuations in interest expense during the years ended December 31, 2002, 2001, and 2000, are attributable to changes in the level of our borrowings under various notes payable and debentures and our revolving credit facility. Our borrowing activity and weighted average interest cost, including fees and closing costs, at and for the years ended December 31, 2002, 2001, and 2000, were as follows:

| (\$ in millions) | 2002 | 2001 | 2000 |
|--------------------------------|---------|------------|---------|
| Total Outstanding Debt | \$998.5 | \$ 1,020.8 | \$786.6 |
| Average Outstanding Debt | \$938.1 | \$ 847.1 | \$707.4 |
| Weighted Average Interest Cost | 6.9% | 7.0% | 8.3% |
| BDC Asset Coverage* | 270% | 245% | 245% |

* As a business development company, we are generally required to maintain a minimum ratio of 200% of total assets to total borrowings.

Employee expenses include salaries and employee benefits. The change in employee expense reflects the effect of wage increases and the change in mix of employees given their area of responsibility and relevant experience level. Total employees were 105, 97, and 97 at December 31, 2002, 2001, and 2000, respectively.

Administrative expenses include the leases for our headquarters in Washington, DC, and our regional offices, travel costs, stock record expenses, directors fees, legal and accounting fees, insurance premiums, and various other expenses. The increase in administrative expenses as compared to the year ended December 31, 2001, includes approximately \$1.6 million from legal, consulting, and other fees, including costs incurred to defend against class action lawsuits alleging violations of securities laws and to respond to market activity in our stock. Administrative expenses also increased by approximately \$0.9 million due to increased costs for corporate liability insurance, \$0.7 million due to travel costs, including corporate aircraft depreciation, and \$0.7 million due to outsourced technology assistance.

During the fourth quarter of 2002, we closed our office in Frankfurt, Germany, due to difficulty in finding attractive investment opportunities in Germany. In conjunction with this, we incurred employee and administrative costs of \$0.5 million and \$2.5 million, respectively, which reduced our net income for the year ended December 31, 2002, by a total of \$3.0 million, or \$0.03 per share.

Realized Gains and Losses. Net realized gains result from the sale of equity securities associated with certain private finance investments, the sale of CMBS bonds, and the realization of unamortized discount resulting from the sale and early repayment of private finance loans and commercial mortgage loans, offset by losses on investments. Net realized gains and losses for the years ended December 31, 2002, 2001, and 2000, were as follows:

| (\$ in millions) | 2002 | 2001 | 2000 |
|--------------------|---------|---------|---------|
| Realized Gains | \$ 95.5 | \$ 10.1 | \$ 28.6 |
| Realized Losses | (50.6) | (9.4) | (13.1) |
| Net Realized Gains | \$ 44.9 | \$ 0.7 | \$ 15.5 |

Realized gains and losses for the year ended December 31, 2002, resulted from various private finance and commercial real estate finance transactions. Realized gains for the year ended December 31, 2002, primarily resulted from transactions involving eight private finance portfolio companies, including WyoTech Acquisition Corporation (\$60.8 million), Aurora Communications, LLC (\$4.9 million), Oriental Trading Company, Inc. (\$2.5 million), Kirkland & Co., Inc. (\$2.2 million), American Home Care Supply, LLC (\$1.3 million), Autania AG (\$0.8 million), FTI Consulting, Inc. (\$0.7 million), and Cumulus Media, Inc. (\$0.5 million). In addition, gains were also realized on CMBS bonds (\$19.1 million, net of a realized loss of \$0.5 million from a hedge related to the CMBS bonds sold), and one commercial real estate investment (\$1.3 million). For the years ended December 31, 2002, 2001, and 2000, we reversed previously recorded unrealized appreciation totaling \$78.8 million, \$6.5 million, and \$7.5 million, respectively, when gains were realized. When we exit an investment and realize a gain, we make an accounting entry to reverse any unrealized appreciation we had previously recorded to reflect the appreciated value of the investment.

The most significant gain realized in 2002 was from the sale of WyoTech Acquisition Corporation. We acquired WyoTech in December of 1998 and owned 91% of the common equity of WyoTech. On July 1, 2002, WyoTech was sold for \$84.4 million. At June 30, 2002, our investment had a cost basis of \$16.4 million, which represented all of the debt (\$12.6 million), preferred stock (\$3.7 million) and 91% of the common equity capital (\$0.1 million) of WyoTech. Our total proceeds from the sale of WyoTech, including the repayment of debt and preferred stock and the sale of our common equity ownership, were \$77.2 million. We recognized a realized gain of \$60.8 million on the transaction. The sale of WyoTech is subject to post-closing working capital adjustments, if any, and customary indemnification provisions.

Realized losses for the year ended December 31, 2002, primarily resulted from transactions involving eleven private finance portfolio companies, including Velocita, Inc. (\$16.0 million), Schwinn Holdings Corporation (\$7.9 million), Convenience Corporation of America (\$5.8 million), Startec Global Communications Corporation (\$4.5 million), The Loewen Group, Inc. (\$2.7 million), Monitoring Solutions, Inc. (\$1.7 million), Most Confiserie (\$1.0 million), NetCare AG (\$1.0 million), iSolve Incorporated (\$0.9 million),

Sure-Tel, Inc. (\$0.5 million), and Soff-Cut Holdings, Inc. (\$0.5 million), and also from nine commercial real estate investments (\$4.7 million). For the years ended December 31, 2002, 2001, and 2000, we reversed previously recorded unrealized depreciation totaling \$49.0 million, \$8.9 million, and \$12.0 million, respectively, when losses were realized. When we exit an investment and realize a loss, we make an accounting entry to reverse any realized depreciation we had previously recorded to reflect the depreciated value of the investment.

Unrealized Gains and Losses. We determine the value of each investment in our portfolio on a quarterly basis, and changes in value result in unrealized gains or losses being recognized. At December 31, 2002, approximately 89% of our total assets represented portfolio investments recorded at fair value. Value, as defined in Section 2(a)(41) of the Investment Company Act of 1940, is (i) the market price for those securities for which a market quotation is readily available and (ii) for all other securities and assets, fair value is as determined in good faith by the board of directors. Since there is typically no readily available market value for the investments in our portfolio, we value substantially all of our portfolio investments at fair value as determined in good faith by the board of directors pursuant to a valuation policy and a consistently applied valuation process. Because of the inherent uncertainty of determining the fair value of investments that do not have a readily available market value, the fair value of our investments determined in good faith by the board of directors may differ significantly from the values that would have been used had a ready market existed for the investments, and the differences could be material.

There is no single standard for determining fair value in good faith. As a result, determining fair value requires that judgment be applied to the specific facts and circumstances of each portfolio investment while employing a consistently applied valuation process for the types of investments we make. Unlike banks, we are not permitted to provide a general reserve for anticipated loan losses. Instead, we are required to specifically value each individual investment on a quarterly basis. We will record unrealized depreciation on investments when we believe that an investment has become impaired, including where collection of a loan or realization of an equity security is doubtful, or when the enterprise value of the company does not currently support the cost of our debt or equity investment. Conversely, we will record unrealized appreciation if we believe that the underlying portfolio company has appreciated in value and, therefore, our equity security has also appreciated in value. Changes in fair value are recorded in the statement of operations as unrealized gains and losses.

As a business development company, we invest in illiquid securities including debt and equity securities of primarily private companies and non-investment grade CMBS. The structure of each private finance debt and equity security is specifically negotiated to enable us to protect our investment and maximize our returns. We include many terms governing interest rate, repayment terms, prepayment penalties, financial covenants, operating covenants, ownership parameters, dilution parameters, liquidation preferences, voting rights, and put or call rights. Our investments are generally subject to restrictions on resale and generally have no established trading market. Because of the type of investments that we make and the nature of our business, our valuation process requires an analysis of various factors. Our fair value methodology includes the examination of, among other things, the underlying investment performance, financial condition, and market changing events that impact valuation.

Valuation Methodology Private Finance Our process for determining the fair value of a private finance investment begins with determining the enterprise value of the portfolio company. The fair value of our investment is based on the enterprise value at which the portfolio company could be sold in an orderly disposition over a reasonable period of time between willing parties other than in a forced or liquidation sale. The liquidity event whereby we exit a private finance investment is generally the sale, the recapitalization or, in some cases, the initial public offering of the portfolio company.

There is no one methodology to determine enterprise value and, in fact, for any one portfolio company, enterprise value is best expressed as a range of fair values, from which we derive a single estimate of enterprise value. To determine the enterprise value of a portfolio company, we analyze its historical and projected financial results. We generally require portfolio companies to provide annual audited and monthly unaudited financial statements, as well as annual projections for the upcoming fiscal year. Typically in the private equity business, companies are bought and sold based on multiples of EBITDA, cash flow, net income, revenues or, in limited instances, book value. The private equity industry uses financial measures such as EBITDA or EBITDAM (Earnings Before Interest, Taxes, Depreciation, Amortization and, in some instances, Management fees) in order to assess a portfolio company's financial performance and to value a portfolio company. EBITDA and EBITDAM are not intended to represent cash flow from operations as defined by accounting principles generally accepted in the United States of America and such information should not be considered as an alternative to net income, cash flow from operations, or any other measure of performance prescribed by accounting principles generally accepted in the United States of America. When using EBITDA to determine enterprise value, we may adjust EBITDA for non-recurring items. Such adjustments are intended to normalize EBITDA to reflect the portfolio company's earnings power. Adjustments to EBITDA may include compensation to previous owners, acquisition, recapitalization, or restructuring related items or one-time non-recurring income or expense items.

In determining a multiple to use for valuation purposes, we look to private merger and acquisition statistics, discounted public trading multiples or industry practices. In estimating a reasonable multiple, we consider not only the fact that our portfolio company may be a private company relative to a peer group of public comparables, but we also consider the size and scope of our portfolio company and its specific strengths and weaknesses. In some cases, the best valuation methodology may be a discounted cash flow analysis based on future projections. If a portfolio company is distressed, a liquidation analysis may provide the best indication of enterprise value.

If there is adequate enterprise value to support the repayment of our debt, the fair value of our loan or debt security normally corresponds to cost unless the borrower's condition or other factors lead to a determination of fair value at a different amount. The fair value of equity interests in portfolio companies are determined based on various factors, including the enterprise value remaining for equity holders after the repayment of the portfolio company's debt and other pertinent factors such as recent offers to purchase a portfolio company's equity interest or other potential liquidity events. The determined equity values are generally discounted when we have a minority position, restrictions on resale, specific concerns about the receptivity of the capital markets to a specific company at a certain time, or other factors.

Valuation Methodology CMBS Bonds CMBS bonds are carried at fair value, which is based on a discounted cash flow model, which utilizes prepayment and loss

assumptions based on historical experience and projected performance, economic factors, the characteristics of the underlying cash flow and comparable market yields for similar CMBS bonds. Our assumption with regard to discount rate is based on the yield of comparable securities. We recognize income from the amortization of original issue discount using the effective interest method, using the anticipated yield over the projected life of the investment. Yields are revised when there are changes in estimates of future credit losses, actual losses incurred, or actual and estimated prepayment speeds. Changes in estimated yield are recognized as an adjustment to the estimated yield over the remaining life of the CMBS bonds from the date the estimated yield is changed. We recognize unrealized appreciation or depreciation on our CMBS bonds as comparable yields in the market change and based on changes in estimated cash flows resulting from changes in prepayment or loss assumptions in the underlying collateral pool.

For the portfolio, net unrealized gains (losses) for the years ended December 31, 2002, 2001, and 2000, were as follows:

| (\$ in millions) | 2002 | 2001 | 2000 |
|---|------------------|-----------------|-----------------|
| Unrealized gains: | | | |
| Unrealized gains | \$ 215.0 | \$ 88.0 | \$ 29.2 |
| Reversal of previously recorded unrealized depreciation associated with realized losses | 49.0 | 8.9 | 12.0 |
| Total unrealized gains | \$ 264.0 | \$ 96.9 | \$ 41.2 |
| Unrealized losses: | | | |
| Unrealized losses | \$(185.8) | \$(69.8) | \$(18.8) |
| Reversal of previously recorded unrealized appreciation associated with realized gains | (78.8) | (6.5) | (7.5) |
| Total unrealized losses | \$(264.6) | \$(76.3) | \$(26.3) |
| Net unrealized gains (losses) | \$ (0.6) | \$ 20.6 | \$ 14.9 |

Unrealized gains associated with changes in the value of investments in our portfolio of \$215.0 million for the year ended December 31, 2002, resulted from the recording of new or additional unrealized appreciation of \$214.6 million and the reversal of previously recorded unrealized depreciation of \$0.4 million. Unrealized appreciation for the year resulted primarily from the increase in the value of our investments in The Hillman Companies, Inc. (\$87.8 million), Business Loan Express, Inc. (\$19.9 million), CMBS bonds (\$29.6 million, net of an unrealized loss of \$8.2 million from a hedge related to the CMBS bonds), WyoTech Acquisition Corporation (\$16.6 million), Blue Rhino Corporation (\$16.6 million), CorrFlex Graphics LLC (\$13.8 million), Kirkland's, Inc. (\$5.8 million), CyberRep (\$4.9 million), Morton Grove Pharmaceuticals, Inc. (\$4.4 million), and Oriental Trading Company, Inc. (\$4.3 million).

The most significant components of unrealized gains resulted from our investments in Hillman, BLX, and CMBS bonds. The following is a simplified summary of the methodology that we used to determine the fair value of these investments.

The Hillman Companies, Inc. Hillman achieved several milestones in 2002, including the completion of two acquisitions, the reduction of excess corporate overhead, and significant improvements to its operating structure. In performing our valuation

analysis of Hillman at December 31, 2002, we quantified the impact of these milestones in order to determine normalized EBITDAM of approximately \$58.5 million.

We believe the current enterprise value for Hillman is approximately \$409.5 million, or 7.0 times 2002 normalized EBITDAM of \$58.5 million. The multiple was determined by obtaining a range of multiples representing the multiple of enterprise value to EBITDA for comparable public companies and the multiple of enterprise value to EBITDA for acquisition transactions involving companies in Hillman's peer group. From this market comparable analysis, we selected a 7.0 times multiple for our valuation. Using an enterprise value of \$409.5 million, the value of our equity investment in Hillman is approximately \$138.4 million, or \$87.8 million greater than our cost basis of \$50.6 million.

Business Loan Express, Inc. To determine the value of our investment in BLX at December 31, 2002, we performed four separate valuation analyses to determine its enterprise value: (1) analysis of comparable public company trading multiples, (2) analysis of BLX's value assuming an initial public offering, (3) analysis of merger and acquisition transactions for financial services companies, and (4) a discounted dividend analysis. The range of enterprise values resulting from these analyses was between \$366 million and \$504 million. We used an enterprise value of \$373 million to value our equity investment in BLX. This enterprise value is based on a pro forma equity value of 7.4 times trailing pro forma BLX net income adjusted for certain capital structure changes that would likely occur should the company be sold. Given an enterprise value of \$373 million, the equity value for our common stock investment has a value of \$140.0 million. The common equity value of \$140.0 million at December 31, 2002, increased by \$19.9 million over the equity value of \$120.1 million at December 31, 2001, resulting in an unrealized gain of \$19.9 million during 2002. Our investment at fair value of \$256.8 million at December 31, 2002, represents a multiple of 1.7 times our share of BLX's junior capital at December 31, 2002.

CMBS Bonds. We recorded a net unrealized gain on our CMBS bond portfolio of \$37.8 million for 2002. We determined the fair value of our CMBS bond portfolio using a discounted cash flow model based upon (i) the current performance of the underlying collateral loans, which utilizes prepayment and loss assumptions based upon historical and projected experience, economic factors and the characteristics of the underlying cash flow, and (ii) current market yields for comparable CMBS bonds, based on comparable Treasury rates and market spreads. In addition, we recorded an unrealized loss of \$8.2 million from a hedge related to the CMBS bonds. For 2002, the net unrealized gain on the CMBS bond portfolio, net of the unrealized loss from the related hedge, was \$29.6 million.

Given that market yields fluctuate, it is possible that there may be future adjustments to the fair value of the CMBS bonds. As a result, we have not classified the appreciated CMBS bonds as Grade 1 assets at December 31, 2002, since they may not result in any future capital gain. Therefore, CMBS bonds remain in Grade 2.

Unrealized losses associated with the changes in the value of investments in our portfolio totaled \$185.8 million for the year ended December 31, 2002, and resulted from the recording of new or additional unrealized depreciation of \$178.4 million and the reversal of previously recorded unrealized appreciation of \$7.4 million.

We experienced a significant level of new or additional unrealized depreciation in the portfolio during 2002, largely due to a struggling U.S. economy and continued deterioration

in the technology, broadcasting and cable, and telecommunications sectors. Total unrealized losses on Grade 4 and Grade 5 investments related to the technology, broadcasting and cable, and telecommunications sectors were \$64.2 million in 2002. In addition to investments in these industries, we also recorded \$87.7 million in unrealized losses on other investments in workout status included in our Grade 4 and Grade 5 investments. We also recorded \$21.4 million in unrealized losses related to Grade 3 investments where we do not currently expect any loss of principal or interest over time, but where we believe the enterprise value of a portfolio company has decreased such that our investment on a current sale basis has also decreased.

OTHER MATTERS

Per Share Amounts. All per share amounts included in Management's Discussion and Analysis of Financial Condition and Results of Operations section have been computed using the weighted average shares used to compute diluted earnings per share, which were 103.6 million, 93.0 million, and 73.5 million for the years ended December 31, 2002, 2001, and 2000, respectively.

Regulated Investment Company Status. We have elected to be taxed as a regulated investment company under Subchapter M of the Internal Revenue Code of 1986. As long as we qualify as a regulated investment company, we are not taxed on our investment company taxable income or realized capital gains, to the extent that such taxable income or gains are distributed, or deemed to be distributed, to shareholders on a timely basis. Annual tax distributions generally differ from net income for the fiscal year due to temporary and permanent timing differences in the recognition of income and expenses, returns of capital and net unrealized appreciation or depreciation, which are not included in taxable income.

In order to maintain our status as a regulated investment company, we must, in general, (1) continue to qualify as a business development company; (2) derive at least 90% of our gross income from dividends, interest, gains from the sale of securities and other specified types of income; (3) meet investment diversification requirements as defined in the Internal Revenue Code; and (4) distribute annually to shareholders at least 90% of our investment company taxable income as defined in the Internal Revenue Code. We intend to take all steps necessary to continue to qualify as a regulated investment company. However, there can be no assurance that we will continue to qualify for such treatment in future years.

FINANCIAL CONDITION, LIQUIDITY AND CAPITAL RESOURCES

Cash and Cash Equivalents

At December 31, 2002, we had \$11.2 million in cash and cash equivalents. We invest otherwise uninvested cash in U.S. government- or agency-issued or guaranteed securities that are backed by the full faith and credit of the United States, or in high quality, short-term repurchase agreements fully collateralized by such securities. Our objective is to manage to a low cash balance and fund new originations with our revolving line of credit.

Debt and Other Commitments

We had outstanding debt at December 31, 2002, as follows:

| (\$ in millions) | Facility Amount | Amount Outstanding | Annual Interest Cost(1) | Annual Portfolio Return to Cover Interest Payments(3) |
|--|--------------------|-----------------------|-------------------------------|---|
| Notes payable and debentures: | | | | |
| Unsecured long-term notes | \$ 694.0 | \$694.0 | 7.7% | 1.9% |
| Small Business Administration debentures | 101.8 | 94.5 | 8.2% | 0.3% |
| Overseas Private Investment Corporation loan | 5.7 | 5.7 | 6.6% | 0.0% |
| | — | — | — | — |
| Total notes payable and debentures | \$ 801.5 | \$794.2 | 7.8% | 2.2% |
| | — | — | — | — |
| Revolving line of credit | 527.5 | 204.3 | 3.7%(2) | 0.3% |
| | — | — | — | — |
| Total debt | \$ 1,329.0 | \$998.5 | 6.9% | 2.5% |
| | — | — | — | — |

- (1) The annual interest cost on notes payable and debentures includes the cost of commitment fees and other facility fees that are recognized into interest expense over the contractual life of the respective borrowings.
- (2) The current interest rate payable on the revolving line of credit was 2.7% at December 31, 2002, which excludes the annual cost of commitment fees and other facility fees of \$2.0 million.
- (3) The annual portfolio return to cover interest payments is calculated as the December 31, 2002 annualized cost of debt per class of financing divided by total assets at December 31, 2002.

Unsecured Long-Term Notes. We have issued long-term debt to institutional lenders, primarily insurance companies. The notes have five-or seven-year maturities, with maturity dates beginning in 2003. The notes require payment of interest only semi-annually, and all principal is due upon maturity.

Small Business Administration Debentures. We, through our small business investment company subsidiary, have debentures payable to the Small Business Administration with contractual maturities of ten years. The notes require payment of interest only semi-annually, and all principal is due upon maturity. Under the small business investment company program, we may borrow up to \$113.4 million from the Small Business Administration. At December 31, 2002, the Small Business Administration has a commitment to lend up to an additional \$7.3 million above the current amount outstanding. The commitment expires on September 30, 2005.

Revolving Line of Credit. As of December 31, 2002, we have a \$527.5 million unsecured revolving line of credit that expires in August 2003, with the right to extend the maturity for one additional year at our sole option under substantially similar terms. This facility was increased by \$30.0 million during 2002 from \$497.5 million at December 31, 2001, and may be further expanded up to \$600 million. As of December 31, 2002, \$318.0 million remains unused and available, net of amounts committed for standby letters of credit of \$5.3 million issued under the credit facility. The credit facility bears interest at a rate equal to (i) the one-month LIBOR plus 1.25%, (ii) the Bank of America, N.A. prime rate, or (iii) the Federal Funds rate plus 0.50% at our option. The credit facility requires monthly payments of interest, and all principal is due upon maturity.

We have various financial and operating covenants required by the revolving line of credit and the notes payable and debentures. These covenants require us to maintain certain financial ratios, including debt to equity and interest coverage, and a minimum net worth. Our credit facilities limit our ability to declare dividends if we default under certain provisions. As of December 31, 2002, we were in compliance with these covenants.

Edgar Filing: ALLIED CAPITAL CORP - Form N-2/A

Auction Rate Reset Note. We repaid a \$75.0 million Auction Rate Reset Note Series A in December 2002. We have entered into an agreement with the placement agent of this note to serve as the placement agent on a future offering of \$75.0 million of debt, equity or other securities in one or more public or private transactions. If we do not conduct a capital raise, we will incur additional expenses of approximately \$3.2 million.

The following table shows our significant contractual obligations as of December 31, 2002.

| (\$ in millions) | Payments Due By Year | | | | | | |
|--|----------------------|-----------------|-----------------|-----------------|-----------------|---------------|----------------|
| | Total | 2003 | 2004 | 2005 | 2006 | 2007 | After 2007 |
| Notes payable and debentures: | | | | | | | |
| Unsecured long-term notes | \$ 694.0 | \$ 140.0 | \$ 214.0 | \$ 165.0 | \$ 175.0 | \$ | \$ |
| Small Business Administration debentures | 94.5 | | 7.0 | 14.0 | | | 73.5 |
| Overseas Private Investment Corporation loan | 5.7 | | | | 5.7 | | |
| Revolving line of credit(1) | 204.3 | | 204.3 | | | | |
| Operating Leases | 21.0 | 2.6 | 2.7 | 2.7 | 2.6 | 2.5 | 7.9 |
| Total contractual obligations | \$ 1,019.5 | \$ 142.6 | \$ 428.0 | \$ 181.7 | \$ 183.3 | \$ 2.5 | \$ 81.4 |

(1) The revolving line of credit expires in August 2003 and may be extended under substantially similar terms for one additional year at our sole option. We assume that we would exercise our option to extend the revolving line of credit resulting in an assumed maturity of August 2004. At December 31, 2002, \$318.0 million remains unused and available, net of amounts committed for standby letters of credit of \$5.3 million issued under the credit facility.

The following table shows our contractual commitments that may have the effect of creating, increasing, or accelerating our liabilities as of December 31, 2002.

| (\$ in millions) | Amount of Commitment Expiration Per Year | | | | | | |
|---------------------------|--|---------------|----------------|---------------|---------------|---------------|---------------|
| | Total | 2003 | 2004 | 2005 | 2006 | 2007 | After 2007 |
| Standby letters of credit | \$ 11.3 | \$ | \$ 5.3 | \$ | \$ | \$ | \$ 6.0 |
| Guarantees | 54.6 | 1.7 | 52.4 | 0.3 | 0.1 | 0.1 | |
| Total commitments | \$ 65.9 | \$ 1.7 | \$ 57.7 | \$ 0.3 | \$ 0.1 | \$ 0.1 | \$ 6.0 |

Equity Capital and Dividends

Because we are a regulated investment company, we distribute our income and require external capital for growth. Because we are a business development company, we are limited in the amount of debt capital we may use to fund our growth, since we are generally required to maintain a minimum ratio of 200% of total assets to total borrowings, or approximately a 1 to 1 debt to equity ratio.

To support our growth during the year ended December 31, 2002, we raised \$172.8 million in new equity capital, including \$86.5 million raised through a non-transferable rights offering. During 2001, we raised \$286.9 million in new equity capital through the sale of shares from our shelf registration statement. We issue equity from time to time when we have attractive investment opportunities. In addition, we raised \$6.3 million in new equity capital through the issuance of shares through our dividend reinvestment plan during both of the years ended December 31, 2002 and 2001. During

the year ended December 31, 2002, total shareholders' equity had increased \$193.9 million to \$1,546.1 million.

Our board of directors reviews the dividend rate quarterly, and may adjust the quarterly dividend throughout the year. For the first, second, third, and fourth quarters of 2002, the board of directors declared a dividend of \$0.53, \$0.55, \$0.56, and \$0.56 per common share, respectively. An extra cash dividend of \$0.03 per share was declared during 2002 and was paid to shareholders on January 9, 2003. For the first quarter of 2003, the board of directors has declared a dividend of \$0.57 per common share. Dividends are paid based on our taxable income, which includes our taxable interest and fee income as well as taxable net realized capital gains. Our board of directors evaluates whether to retain or distribute capital gains on an annual basis. Our dividend policy allows us to continue to distribute capital gains, but will also allow us to retain gains to support future growth.

Liquidity and Capital Resources. We plan to maintain a strategy of financing our business and related debt maturities with cash from operations, through borrowings under short- or long-term credit facilities or other debt securities, through asset sales, or through the sale or issuance of new equity capital. We currently anticipate an increased level of new investment activity during 2003 given the level of prospective investments currently under review. Although there can be no assurance that we will secure these new investments, we plan to raise new debt and equity capital as appropriate to fund investment growth prospectively.

Dividends paid to shareholders for the years ended December 31, 2002 and 2001 were \$229.9 million and \$186.2 million, respectively. Cash flow from operations before new investments has historically been sufficient to finance our operations.

We maintain a matched-funding philosophy that focuses on matching the estimated maturities of our loan and investment portfolio to the estimated maturities of our borrowings. We use our short-term credit facilities as a means to bridge to long-term financing, which may or may not result in temporary differences in the matching of estimated maturities. We evaluate our interest rate exposure on an ongoing basis. To the extent deemed necessary, we may hedge variable and short-term interest rate exposure through interest rate swaps or other techniques.

At December 31, 2002, our debt to equity ratio was 0.65 to 1 and our weighted average cost of funds was 6.9%. Availability on the revolving line of credit, net of amounts committed for standby letters of credit issued under the line of credit facility, was \$318.0 million on December 31, 2002. We believe that we have access to capital sufficient to fund our ongoing investment and operating activities.

CRITICAL ACCOUNTING POLICIES

The consolidated financial statements are based on the selection and application of critical accounting policies, which require management to make significant estimates and assumptions. Critical accounting policies are those that are both important to the presentation of our financial condition and results of operations and require management's most difficult, complex, or subjective judgments. Our critical accounting policies are those

applicable to the valuation of investments and certain revenue recognition matters as discussed below.

Valuation of Portfolio Investments. As a business development company, we invest in illiquid securities including debt and equity securities of primarily private companies and non-investment grade CMBS. Our investments are generally subject to restrictions on resale and generally have no established trading market. We value substantially all of our investments at fair value as determined in good faith by the board of directors in accordance with our valuation policy. We determine fair value to be the amount for which an investment could be exchanged in an orderly disposition over a reasonable period of time between willing parties other than in a forced or liquidation sale. Our valuation policy considers the fact that no ready market exists for substantially all of the securities in which we invest. Our valuation policy is intended to provide a consistent basis for determining the fair value of the portfolio. We will record unrealized depreciation on investments when we believe that an investment has become impaired, including where collection of a loan or realization of an equity security is doubtful, or when the enterprise value of the company does not currently support the cost of our debt or equity investments. Conversely, we will record unrealized appreciation if we believe that the underlying portfolio company has appreciated in value and, therefore, our equity security has also appreciated in value. The value of investments in publicly traded securities are determined using quoted market prices discounted for restrictions on resale.

Loans and Debt Securities. For loans and debt securities, fair value generally approximates cost unless the borrower's enterprise value or overall financial condition or other factors lead to a determination of fair value at a different amount.

When we receive nominal cost warrants or free equity securities (nominal cost equity), we allocate our cost basis in our investment between debt securities and nominal cost equity at the time of origination. At that time, the original issue discount basis of the nominal cost equity is recorded by increasing the cost basis in the equity and decreasing the cost basis in the related debt securities.

Interest income is recorded on an accrual basis to the extent that such amounts are expected to be collected. For loans and debt securities with contractual payment-in-kind interest, which represents contractual interest accrued and added to the loan balance that generally becomes due at maturity, we will not accrue payment-in-kind interest if the portfolio company valuation indicates that the payment-in-kind interest is not collectible. Interest on loans and debt securities is not accrued if we have doubt about interest collection. Loans in workout status classified as Grade 4 or Grade 5 assets do not accrue interest. In addition, interest may not accrue on loans or debt securities to portfolio companies that are more than 50% owned by us if such companies are in need of additional capital. Loan origination fees, original issue discount, and market discount are capitalized and then amortized into interest income using the effective interest method. Prepayment premiums are recorded on loans when received.

The weighted average yield on loans and debt securities is computed as the (a) annual stated interest rate earned plus the annual amortization of loan origination fees, original issue discount, and market discount earned on accruing loans and debt securities, divided by (b) total loans and debt securities at value. The weighted average yield is computed as of the balance sheet date.

Equity Securities. Our equity interests in portfolio companies for which there is no liquid public market are valued at fair value based on the enterprise value of the portfolio company, which is determined using various factors, including cash flow from operations of the portfolio company and other pertinent factors, such as recent offers to purchase a portfolio company's securities or other liquidation events. The determined fair values are generally discounted to account for restrictions on resale and minority ownership positions.

The value of our equity interests in public companies for which market quotations are readily available is based upon the closing public market price on the balance sheet date. Securities that carry certain restrictions on sale are typically valued at a discount from the public market value of the security.

Dividend income is recorded on preferred equity securities on an accrual basis to the extent that such amounts are expected to be collected and on common equity securities on the record date for private companies or on the ex-dividend date for publicly traded companies.

Commercial Mortgage-Backed Securities (CMBS). CMBS bonds are carried at fair value, which is based upon a discounted cash flow model that utilizes prepayment and loss assumptions based upon historical experience and projected performance, economic factors, the characteristics of the underlying cash flow and comparable market yields for similar CMBS bonds. Our assumption with regard to discount rate for determining fair value is based on the yield of comparable securities. We recognize income from the amortization of original issue discount using the effective interest method, using the anticipated yield over the projected life of the investment. Yields are revised when there are changes in estimates of future credit losses, actual losses incurred, or actual and estimated prepayment speeds. Changes in estimated yield are recognized as an adjustment to the estimated yield over the remaining life of the CMBS bonds from the date the estimated yield is changed. We recognize unrealized appreciation or depreciation on our CMBS bonds as comparable yields in the market change and based on changes in estimated cash flows resulting from changes in prepayment or loss assumptions in the underlying collateral pool.

Residual Interest. We value our residual interest from a previous securitization and recognize income using the same accounting policies used for the CMBS bonds. The residual interest is carried at fair value based on discounted estimated future cash flows. We recognize income from the residual interest using the effective interest method. At each reporting date, the effective yield is recalculated and used to recognize income until the next reporting date.

Net Realized and Unrealized Gains or Losses. Realized gains or losses are measured by the difference between the net proceeds from the sale and the cost basis of the investment without regard to unrealized gains or losses previously recognized, and include investments charged off during the year, net of recoveries. Unrealized gains or losses reflect the change in portfolio investment values during the reporting period.

Fee Income. Fee income includes fees for diligence, structuring, transaction services, management services, and investment advisory services rendered by us to portfolio companies and other third parties. Diligence, structuring, and transaction services fees are generally recognized as income when services are rendered or when the related transactions are completed. Management and investment advisory services fees are generally recognized as income as the services are rendered.

SENIOR SECURITIES

Information about our senior securities is shown in the following tables as of the fiscal year ended December 31, unless otherwise noted. The indicates information which the SEC expressly does not require to be disclosed for certain types of senior securities.

| Class and Year | Total Amount Outstanding Exclusive of Treasury Securities(1) | Asset Coverage Per Unit(2) | Involuntary Liquidating Preference Per Unit(3) | Average Market Value Per Unit(4) |
|---|--|----------------------------------|---|--|
| Unsecured Long-term Notes Payable | | | | |
| 1993 | \$ 0 | \$ 0 | \$ | N/A |
| 1994 | 0 | 0 | | N/A |
| 1995 | 0 | 0 | | N/A |
| 1996 | 0 | 0 | | N/A |
| 1997 | 0 | 0 | | N/A |
| 1998 | 180,000,000 | 2,734 | | N/A |
| 1999 | 419,000,000 | 2,283 | | N/A |
| 2000 | 544,000,000 | 2,445 | | N/A |
| 2001 | 694,000,000 | 2,453 | | N/A |
| 2002 | 694,000,000 | 2,704 | | N/A |
| Small Business Administration Debentures(5) | | | | |
| 1993 | \$ 49,800,000 | \$6,013 | \$ | N/A |
| 1994 | 54,800,000 | 3,695 | | N/A |
| 1995 | 61,300,000 | 2,868 | | N/A |
| 1996 | 61,300,000 | 2,485 | | N/A |
| 1997 | 54,300,000 | 2,215 | | N/A |
| 1998 | 47,650,000 | 2,734 | | N/A |
| 1999 | 62,650,000 | 2,283 | | N/A |
| 2000 | 78,350,000 | 2,445 | | N/A |
| 2001 | 94,500,000 | 2,453 | | N/A |
| 2002 | 94,500,000 | 2,704 | | N/A |
| Overseas Private Investment Corporation Loan | | | | |
| 1993 | \$ 0 | \$ 0 | \$ | N/A |
| 1994 | 0 | 0 | | N/A |
| 1995 | 0 | 0 | | N/A |
| 1996 | 8,700,000 | 2,485 | | N/A |
| 1997 | 8,700,000 | 2,215 | | N/A |
| 1998 | 5,700,000 | 2,734 | | N/A |
| 1999 | 5,700,000 | 2,283 | | N/A |
| 2000 | 5,700,000 | 2,445 | | N/A |
| 2001 | 5,700,000 | 2,453 | | N/A |
| 2002 | 5,700,000 | 2,704 | | N/A |

| Class and Year | Total Amount Outstanding Exclusive of Treasury Securities(1) | Asset Coverage Per Unit(2) | Involuntary Liquidating Preference Per Unit(3) | Average Market Value Per Unit(4) |
|---|--|----------------------------|--|----------------------------------|
| Revolving Lines of Credit | | | | |
| 1993 | \$ 0 | \$ 0 | \$ | N/A |
| 1994 | 32,226,000 | 3,695 | | N/A |
| 1995 | 20,414,000 | 2,868 | | N/A |
| 1996 | 45,099,000 | 2,485 | | N/A |
| 1997 | 38,842,000 | 2,215 | | N/A |
| 1998 | 95,000,000 | 2,734 | | N/A |
| 1999 | 82,000,000 | 2,283 | | N/A |
| 2000 | 82,000,000 | 2,445 | | N/A |
| 2001 | 144,750,000 | 2,453 | | N/A |
| 2002 | 204,250,000 | 2,704 | | N/A |
| Auction Rate Reset Note | | | | |
| 1993 | \$ 0 | \$ 0 | \$ | N/A |
| 1994 | 0 | 0 | | N/A |
| 1995 | 0 | 0 | | N/A |
| 1996 | 0 | 0 | | N/A |
| 1997 | 0 | 0 | | N/A |
| 1998 | 0 | 0 | | N/A |
| 1999 | 0 | 0 | | N/A |
| 2000 | 76,598,000 | 2,445 | | N/A |
| 2001 | 81,856,000 | 2,453 | | N/A |
| 2002 | 0 | 0 | | N/A |
| Master Repurchase Agreement and Master Loan and Security Agreement | | | | |
| 1993 | \$ 0 | \$ 0 | \$ | N/A |
| 1994 | 23,210,000 | 3,695 | | N/A |
| 1995 | 0 | 0 | | N/A |
| 1996 | 85,775,000 | 2,485 | | N/A |
| 1997 | 225,821,000 | 2,215 | | N/A |
| 1998 | 6,000,000 | 2,734 | | N/A |
| 1999 | 23,500,000 | 2,283 | | N/A |
| 2000 | 0 | 0 | | N/A |
| 2001 | 0 | 0 | | N/A |
| 2002 | 0 | 0 | | N/A |

| Class and Year | Total Amount Outstanding Exclusive of Treasury Securities(1) | Asset Coverage Per Unit(2) | Involuntary Liquidating Preference Per Unit(3) | Average Market Value Per Unit(4) |
|---|--|----------------------------------|---|--|
| Senior Note Payable(6) | | | | |
| 1993 | \$ 20,000,000 | \$ 6,013 | \$ | N/A |
| 1994 | 20,000,000 | 3,695 | | N/A |
| 1995 | 20,000,000 | 2,868 | | N/A |
| 1996 | 20,000,000 | 2,485 | | N/A |
| 1997 | 20,000,000 | 2,215 | | N/A |
| 1998 | 0 | 0 | | N/A |
| 1999 | 0 | 0 | | N/A |
| 2000 | 0 | 0 | | N/A |
| 2001 | 0 | 0 | | N/A |
| 2002 | 0 | 0 | | N/A |
| Bonds Payable | | | | |
| 1993 | \$ 0 | \$ 0 | \$ | N/A |
| 1994 | 0 | 0 | | N/A |
| 1995 | 98,625,000 | 2,868 | | N/A |
| 1996 | 54,123,000 | 2,485 | | N/A |
| 1997 | 0 | 0 | | N/A |
| 1998 | 0 | 0 | | N/A |
| 1999 | 0 | 0 | | N/A |
| 2000 | 0 | 0 | | N/A |
| 2001 | 0 | 0 | | N/A |
| 2002 | 0 | 0 | | N/A |
| Redeemable Cumulative Preferred Stock(5) | | | | |
| 1993 | \$ 1,000,000 | \$ 546 | \$ 100 | N/A |
| 1994 | 1,000,000 | 351 | 100 | N/A |
| 1995 | 1,000,000 | 277 | 100 | N/A |
| 1996 | 1,000,000 | 242 | 100 | N/A |
| 1997 | 1,000,000 | 217 | 100 | N/A |
| 1998 | 1,000,000 | 267 | 100 | N/A |
| 1999 | 1,000,000 | 225 | 100 | N/A |
| 2000 | 1,000,000 | 242 | 100 | N/A |
| 2001 | 1,000,000 | 244 | 100 | N/A |
| 2002 | 1,000,000 | 268 | 100 | N/A |
| Non-Redeemable Cumulative Preferred Stock(5) | | | | |
| 1993 | \$ 6,000,000 | \$ 546 | \$ 100 | N/A |
| 1994 | 6,000,000 | 351 | 100 | N/A |
| 1995 | 6,000,000 | 277 | 100 | N/A |
| 1996 | 6,000,000 | 242 | 100 | N/A |
| 1997 | 6,000,000 | 217 | 100 | N/A |
| 1998 | 6,000,000 | 267 | 100 | N/A |
| 1999 | 6,000,000 | 225 | 100 | N/A |
| 2000 | 6,000,000 | 242 | 100 | N/A |
| 2001 | 6,000,000 | 244 | 100 | N/A |
| 2002 | 6,000,000 | 268 | 100 | N/A |

- (1) Total amount of each class of senior securities outstanding at the end of the period presented.
- (2) The asset coverage ratio for a class of senior securities representing indebtedness is calculated as our consolidated total assets, less all liabilities and indebtedness not represented by senior securities, divided by senior securities representing indebtedness. This asset coverage ratio is multiplied by \$1,000 to determine the Asset Coverage Per Unit. The asset coverage ratio for a class of senior securities that is preferred stock is calculated as our consolidated total assets, less all liabilities and indebtedness not represented by senior securities, divided by senior securities representing indebtedness, plus the involuntary liquidation preference of the preferred stock (see footnote 3). The Asset Coverage Per Unit for preferred stock is expressed in terms of dollar amounts per share.
- (3) The amount to which such class of senior security would be entitled upon the involuntary liquidation of the issuer in preference to any security junior to it.
- (4) Not applicable, as senior securities are not registered for public trading.
- (5) Issued by our small business investment company subsidiary to the Small Business Administration. These categories of senior securities are not subject to the asset coverage requirements of the 1940 Act. See Certain Government Regulations Small Business Administration Regulations.
- (6) We were the obligor on \$15 million of the senior notes. Our small business investment company subsidiary was the obligor on the remaining \$5 million, which is not subject to the asset coverage requirements of the 1940 Act.

BUSINESS

General

As a business development company, we provide long-term debt and equity investment capital to support the expansion of companies in a variety of industries. We generally invest in illiquid securities through privately negotiated transactions. We generally invest in private middle market companies though, from time to time, we may invest in public companies that lack access to public capital or whose securities may not be marginable. We have been investing in businesses for over 40 years and have financed thousands of companies nationwide. Today, our investment and lending activity is generally focused in two areas:

Private finance and

Commercial real estate finance, primarily the investment in non-investment grade commercial mortgage-backed securities.

Our investment portfolio consists primarily of long-term unsecured loans with or without equity features, equity investments in companies, which may or may not constitute a controlling equity interest, non-investment grade commercial mortgage-backed securities, preferred shares in collateralized debt obligations, and commercial mortgage loans. At December 31, 2002, our investment portfolio totaled \$2.5 billion at value. Our investment objective is to achieve current income and capital gains.

Corporate History and Offices

Allied Capital Corporation was formed in 1958. On December 31, 1997, Allied Capital Corporation, Allied Capital Corporation II, Allied Capital Commercial Corporation and Allied Capital Advisers, Inc. merged with and into Allied Capital Lending Corporation in a tax-free stock-for-stock exchange. Immediately following the merger, Allied Capital Lending Corporation changed its name to Allied Capital Corporation.

We are a Maryland corporation and a closed-end management investment company that has elected to be regulated as a business development company under the Investment Company Act of 1940. We are a registered investment adviser. We have a subsidiary that has also elected to be regulated as a BDC, Allied Investment Corporation, which is licensed under the Small Business Investment Act of 1958 as a Small Business Investment Company. See Certain Government Regulations below for further information about small business investment company regulation.

In addition, we have a real estate investment trust subsidiary, Allied Capital REIT, Inc., and several subsidiaries which are single-member limited liability companies established primarily to hold real estate properties. We have also established a subsidiary, A.C. Corporation (AC Corp) that provides diligence and structuring services on private finance and commercial real estate transactions, as well as structuring, transaction, management and advisory services to Allied Capital, our portfolio companies and other third parties.

Our executive offices are located at 1919 Pennsylvania Avenue, NW, Washington, DC 20006 and our telephone number is (202) 331-1112. In addition, we have regional offices in New York and Chicago.

Private Finance

We participate in the private equity business by providing privately negotiated long-term debt and equity investment capital. Our private finance investment activity is generally focused on providing junior capital in the form of subordinated debt with or without equity features, such as warrants or options, often referred to as mezzanine financing. In certain situations, we may also take a controlling equity position in a company. Our private financing is generally used to fund growth, buyouts, acquisitions, recapitalizations, note purchases, and bridge financings. We generally invest in private companies though, from time to time, we may invest in public companies that lack access to public capital or whose securities may not be marginable.

At December 31, 2002, 66% of the private finance portfolio consisted of loans and debt securities and 34% consisted of equity securities.

Our private finance portfolio includes investments in a wide variety of industries, including non-durable consumer products, business services, financial services, light industrial products, healthcare services, retail, telecommunications, education and broadcasting. The industry and geographic compositions of the private finance portfolio at value at December 31, 2002 and 2001, were as follows:

| | <u>2002</u> | <u>2001</u> |
|--------------------------|-------------|-------------|
| Industry | | |
| Consumer products | 34% | 28% |
| Business services | 26 | 22 |
| Financial services | 16 | 15 |
| Industrial products | 9 | 10 |
| Healthcare | 5 | 3 |
| Retail | 4 | 5 |
| Telecommunications | 2 | 4 |
| Broadcasting & cable | 1 | 4 |
| Education | 1 | 5 |
| Other | 2 | 4 |
| | — | — |
| Total | 100% | 100% |
| | — | — |
| Geographic Region | | |
| Mid-Atlantic | 45% | 43% |
| Midwest | 16 | 17 |
| Southeast | 16 | 14 |
| West | 15 | 19 |
| Northeast | 7 | 5 |
| International | 1 | 2 |
| | — | — |
| Total | 100% | 100% |
| | — | — |

Market and Competition. Capital providers for the finance of private companies can be generally categorized as shown in the diagram below:

| Capital Provider | Banks | Commercial Finance Companies | Private Placement/High Yield | Private Mezzanine Funds | Allied Capital | Private Equity Funds |
|----------------------------------|-------------------------|------------------------------|---|---|---|----------------------|
| Primary Business Focus | Senior, short-term debt | Asset-based lending | Large credits (private > \$50 mm) (public > \$150 mm) | Unsecured long-term debt with warrants Preferred and common equity | Unsecured long-term debt with warrants Preferred and common equity | Equity |
| Typical Pricing Spectrum* | LIBOR+ | | | | | 25%+ |

* Based on our market experience.

Banks are primarily focused on providing senior secured and unsecured short-term debt. They typically do not provide meaningful long-term unsecured loans. Commercial finance companies are primarily focused on providing senior secured long-term debt. The private placement and high-yield debt markets are focused primarily on very large financing transactions, typically in excess of the financings we do. We typically do not compete with banks, commercial finance companies, or the private placement/high yield market. Instead, we compete directly with the private mezzanine sector of the private capital market. Private mezzanine funds are also focused on providing unsecured long-term debt to private companies for the types of transactions discussed above. We believe that we have key structural and operational advantages when compared to private mezzanine funds.

Many private mezzanine funds operate with a more expensive cost structure than ours because of carried interest fees paid to the management of the funds. In addition, our access to the public equity markets generally gives us a lower cost of capital than that of private mezzanine funds. Our lower cost of capital may give us a pricing advantage when competing for new investments. In addition, the perpetual nature of our corporate structure enables us to be a better long-term partner for our portfolio companies than a traditional mezzanine fund, which typically has a limited life.

Over our 42-year history, we have developed and maintained relationships with intermediaries including investment banks, financial services companies, and private mezzanine and equity sponsors, through which we source investment opportunities. Through these relationships, especially those with equity sponsors, we have been able to strengthen our position as a long-term investor. For the transactions in which we have provided debt capital, an equity sponsor provides a reliable source of additional equity capital if the portfolio company requires additional financing. Private equity sponsors also assist us in confirming our own due diligence findings when assessing a new investment opportunity, and they provide assistance and leadership to the portfolio company's management team throughout our investment period.

Investment Criteria. When assessing a prospective investment, we look for companies with certain target characteristics, which may or may not be present in the companies in which we invest. Our target characteristics generally include the following:

Management teams with meaningful equity ownership

Dominant or defensible market position

High return on invested capital

Revenues of \$50 million to \$500 million

Stable operating margins

EBITDA (or Earnings Before Interest, Taxes, Depreciation and Amortization) of at least \$5 million

Solid cash flow margins

Sound balance sheets

We generally target and do not target the following industries, though we will consider investments in any industry if the prospective company demonstrates unique characteristics that make it an attractive investment opportunity:

| Industries Targeted <i>Less Cyclical/Cash Flow Intensive/ High Return on Capital</i> | Industries Not Targeted <i>Cyclical/Capital Intensive/ Low Return on Capital</i> |
|--|--|
| Consumer products | Heavy equipment |
| Business services | Natural resources |
| Financial services | Commodity retail |
| Light industrial products | Low value-add distribution |
| Broadcasting | Agriculture |
| | Transportation |

Investment Structure. Once we have determined that a prospective portfolio company is suitable for investment, we work with the management and the other capital providers, including senior, junior, and equity capital providers, to structure a deal. We negotiate among these parties to agree on how our investment is expected to perform relative to the other capital in the portfolio company's capital structure. Generally, our private finance portfolio companies seek a component of senior capital above us and an equity piece below us.

Our private finance mezzanine investments are generally structured as unsecured, subordinated loans that carry a relatively high contractual fixed interest rate generally in excess of 12%, to provide interest income. At December 31, 2002, approximately 95% of the loans and debt securities in the private finance portfolio have fixed rates of interest. The loans have interest-only payments in the early years and payments of both principal and interest in the later years, with maturities of five to ten years, although debt maturities and principal amortization schedules vary. Such payments are generally made to us quarterly.

Our mezzanine debt instruments are tailored to the facts and circumstances of the deal. The specific structure is negotiated over a period of several months and is designed to

protect our rights and manage our risk in the transaction. We may structure the debt instrument to require restrictive affirmative and negative covenants, default penalties, lien protection, equity calls, take control provisions and board observation rights. Our private finance mezzanine investments may include equity features, such as warrants or options to buy a minority interest in the portfolio company. The warrants we receive with our debt securities generally require only a nominal cost to exercise, and thus, as the portfolio company appreciates in value, we achieve additional investment return from this equity interest. We may structure the warrants to provide minority rights provisions and event-driven puts. We seek to achieve additional investment return from the appreciation and sale of our warrants. We generally target a total return of 16% to 25% for our private finance mezzanine investments. The typical private finance structure focuses, first, on the protection of our investment principal and then on investment return.

We exit our private finance investments generally when a liquidity event takes place, such as the sale, recapitalization, or initial public offering of such portfolio company. Generally, our warrants expire five years after the related debt is repaid. The warrants typically include registration rights, which allow us to sell the securities if the portfolio company completes a public offering. Most of the gains we realize from our warrant portfolio arise as a result of the sale of the portfolio company to another business or through a recapitalization. Historically, we have not been dependent on the public equity markets for the sale of our warrant positions.

We may also acquire preferred or common equity in a company as a part of our private finance investing activities, particularly when we see a unique opportunity to profit from the growth of a company. Preferred equity investments may be structured with a dividend yield, which would provide us with a current return. With respect to preferred or common equity investments, we generally target an investment return of 25% to 40%.

In addition to our private finance mezzanine investment activities, we may acquire more than 50% of the common stock of a company in a control buyout transaction. In addition to our common equity investment, we may also provide additional capital to the controlled portfolio company in the form of senior loans, subordinated debt or preferred stock. The types of companies that we would acquire through a control buyout transaction are generally the same types of companies that we would invest in through our other private finance investing activities. In particular, we may see opportunities to acquire illiquid public companies and take them private. We intend to be selective about the companies in which we acquire a controlling interest to ensure that we maintain a diversified portfolio.

We generally structure our control investments such that we earn a current return through a combination of interest income on our senior loans and subordinated debt, dividends on our preferred and common stock, and management or transaction services fees to compensate us for the managerial assistance that we provide to a controlled portfolio company. For these types of investments, we generally target an overall investment return of 25% to 40%.

At December 31, 2002, our most significant investments acquired through control buyout transactions were Business Loan Express, Inc. (BLX) and The Hillman Companies, Inc.

At December 31, 2002, we had an investment at value totaling \$256.8 million in BLX, a small business lender that participates in the U.S. Small Business Administration 7(a) Guaranteed Loan Program. At December 31, 2002, we owned 94.9% of BLX's common stock. Our common stock ownership is subject to dilution by management options. As the controlling shareholder of BLX, we have provided an unconditional guaranty to the BLX credit facility lenders in an amount up to 50% of the total obligations (consisting of principal, accrued interest and other fees) on BLX's three-year unsecured \$124.0 million revolving credit facility that matures in March 2004. The amount guaranteed by us at December 31, 2002 was \$51.6 million. This guaranty can be called by the lenders only in the event of a default by BLX. BLX was in compliance with the terms of its credit facility at December 31, 2002. We have also provided two standby letters of credit in connection with two term securitization transactions completed by BLX totaling \$10.6 million.

BLX is the nation's second largest non-bank government guaranteed lender utilizing the SBA's 7(a) Guaranteed Loan Program and is licensed by the SBA as a Small Business Lending Company (SBLC). BLX is a preferred lender as designated by the SBA in 68 markets across the United States, and originates, sells, and services small business loans. In addition to the 7(a) Guaranteed Loan Program, BLX originates conventional small business loans and originates loans under the USDA Business and Industry Guaranteed Loan Program. In February 2003, BLX completed a corporate reorganization to a limited liability company. BLX has offices across the United States and is headquartered in New York, New York.

At December 31, 2002, we had an investment in The Hillman Companies, Inc. totaling \$180.5 million at value. At December 31, 2002, we owned 96.8% of Hillman's common stock. Our common stock ownership is subject to dilution by management options. Hillman is a leading manufacturer of key making equipment and distributor of key blanks, fasteners, signage, and other small hardware components and operates in multiple channels of the retail marketplace such as hardware stores, national and regional home centers, and mass merchants. Hillman has certain patent-protected products, including key duplication technology, that is important to its business. Hillman's primary operations are located in Cincinnati, Ohio.

We fund new investments using cash, through the issuance of our common equity, the reinvestment of previously accrued interest and dividends in debt or equity securities, or the current reinvestment of interest and dividend income through the receipt of a debt or equity security (payment-in-kind income). From time to time, we may also opt to reinvest accrued interest receivable in a new debt or equity security, in lieu of receiving such interest in cash and providing a subsequent investment. When we acquire a controlling interest in a company, we may have the opportunity to acquire the company's equity with our common stock. The issuance of our stock as consideration may provide us with the benefit of raising equity without having to access the public markets in an underwritten offering, including the added benefit of the elimination of any underwriter commissions.

As a business development company, we are required to make significant managerial assistance available to the companies in our investment portfolio. In addition to the interest and dividends received from our private finance investments, we will often generate additional fee income for the structuring, diligence, transaction and management services and guarantees we provide to our portfolio companies.

Commercial Real Estate Finance

Our primary commercial real estate investment activity is the investment in non-investment grade commercial mortgage-backed securities, which we refer to as CMBS. As an investor, we believe that CMBS bonds have attractive risk/return characteristics. The CMBS bonds in which we invest are non-investment grade, which means that nationally recognized statistical rating organizations rate them below the top four investment-grade rating categories (i.e., AAA through BBB), and are sometimes referred to as junk bonds. Unlike most junk bonds, which are typically unsecured debt instruments, the non-investment grade CMBS bonds in which we invest are secured by an underlying collateral pool of commercial mortgage loans, which are, in turn, secured by commercial real estate. The underlying collateral for our CMBS bonds consists of senior mortgage loans on commercial real estate properties where the loans, on average, were underwritten to achieve a loan to value ratio of approximately 70%. We generally invest in CMBS bonds on the initial issuance of the CMBS bond offering, and are able to underwrite and negotiate to acquire the securities at a significant discount from their face amount, generally resulting in an estimated yield to maturity ranging from 13% to 16%. We find the yields for CMBS bonds attractive given their collateral protection.

We believe this risk/return dynamic exists in the market because there are significant barriers to entry for a non-investment grade CMBS investor. First, non-investment grade CMBS are long-term investments and require long-term investment capital. Our capital structure, which is in excess of 50% equity capital, is well suited for this asset class. Second, when we purchase CMBS bonds in an initial issuance, we re-underwrite the mortgage loans in the underlying collateral pool, and we meet with issuers to discuss the nature and type of loans we will accept into the pool. We have significant commercial mortgage loan underwriting expertise, both in terms of the number of professionals we employ and the depth of their commercial real estate experience. Access to this type of expertise is another barrier to entry into this market.

As a non-investment grade CMBS investor, we recognize that non-investment grade bonds have a higher degree of risk than do investment-grade bonds. Non-investment grade securities are considered speculative, and their capacity to pay principal and interest in accordance with the terms of their issue is not ensured. They tend to be less liquid, may have a higher risk of default, and may be more difficult to value. We invest in non-investment grade CMBS bonds represented by the BB+ to non-rated tranches of a CMBS issuance. The non-investment grade CMBS bonds in which we invest are junior in priority for payment of principal and interest to the more senior tranches of the related CMBS bond issuance. Cash flow from the underlying mortgages is allocated first to the senior tranches, with the most senior tranches having a priority right to the cash flow. Then, any remaining cash flow is allocated, among the other tranches in order of their relative seniority. To the extent there are defaults and unrecoverable losses on the underlying mortgages resulting in reduced cash flows, our most subordinate tranche will bear this loss first. At December 31, 2002, our CMBS bonds were subordinate to 91% to 97% of the tranches of bonds issued in various CMBS transactions.

To mitigate the risks associated with a CMBS investment discussed above, we perform extensive due diligence prior to each investment in CMBS. The underwriting procedures and criteria used to underwrite each of the commercial mortgage loans in each collateral pool are described in detail below. We will only invest in CMBS when we believe, as a result of our underwriting procedures, that the underlying mortgage pool adequately secures our position. At December 31, 2002, the underlying pools of mortgage

loans that are collateral for our CMBS bonds consisted of approximately 4,500 commercial mortgage loans with a total outstanding principal balance of \$25.0 billion. These mortgage loans are secured by properties located in diverse geographic locations across the United States, and include a variety of property types such as retail, multi-family housing, office, industrial real estate, and hospitality.

The property types and the geographic composition of the underlying mortgage loans securing the CMBS bonds, calculated using the outstanding principal balance, at December 31, 2002 and 2001, were as follows:

| | <u>2002</u> | <u>2001</u> |
|--------------------------|-------------|-------------|
| Property Type | | |
| Retail | 32% | 31% |
| Housing | 27 | 27 |
| Office | 21 | 22 |
| Industrial Real Estate | 7 | 6 |
| Hospitality | 6 | 7 |
| Other | 7 | 7 |
| | <u> </u> | <u> </u> |
| Total | 100% | 100% |
| | <u> </u> | <u> </u> |
| Geographic Region | | |
| West | 31% | 32% |
| Mid-Atlantic | 25 | 24 |
| Midwest | 22 | 21 |
| Southeast | 17 | 17 |
| Northeast | 5 | 6 |
| | <u> </u> | <u> </u> |
| Total | 100% | 100% |
| | <u> </u> | <u> </u> |

In addition to our CMBS bond investments, we have invested in the preferred shares of four collateralized debt obligations, or CDOs, secured by investment grade unsecured debt issued by various real estate investment trusts, or REITs, and CMBS bonds. The preferred shares are junior in priority for payment of principal and interest to the more senior tranches of debt issued by the CDOs. To the extent there are defaults and unrecoverable losses on the underlying collateral resulting in reduced cash flows, the preferred shares will bear this loss first. At December 31, 2002, our preferred shares in the CDOs were subordinate to approximately 96% of the more senior tranches of debt issued by the CDOs. The yield on the CDOs at December 31, 2002 was 17.2%.

Our CMBS investing activity complements our private finance activity because it provides a steady stream of recurring interest income. In addition, given the depth of our commercial real estate experience and the due diligence that we perform prior to an investment in CMBS, we have from time to time received structuring and diligence fees upon the investment in CMBS bonds. These fees are separately negotiated for each transaction. In order to maintain a balanced investment portfolio, we expect that our investment in CMBS will not exceed 25% of our total assets.

Investment Sourcing

We maintain a network of relationships with investors, lenders and intermediaries including:

private mezzanine and equity investors;

investment banks;

business brokers;

merger and acquisition advisors;

financial services companies; and

banks, law firms and accountants.

We believe that our experience and reputation provide a competitive advantage in originating new investments. We have established an extensive network of investment referral relationships over our history.

Investment Approval and Underwriting Procedures

In assessing new investment opportunities, we follow an institutionalized process which includes a due diligence process and a centralized credit and investment approval process requiring committee review, all of which are described below.

Private Finance. The typical private finance transaction requires two to four months of diligence and structuring before funding occurs. The due diligence process is significantly longer for those transactions in which we take a control position or substantial equity stake in the company. The key steps in our private finance investment process are as follows:

Initial investment screening;

Presentation of investment to investment professionals at weekly meeting;

Initial approval of the investment by the investment committee;

Due diligence completed and investment structured;

Independent internal peer review of the investment completed;

Final approval of the investment by the investment committee;

Approval of the investment by the executive committee of the board of directors (for all investments greater than \$10 million); and

Investment is funded.

In a typical private financing, we thoroughly review, analyze, and substantiate, through due diligence, the business plan and operations of the potential portfolio company. We perform financial due diligence, often with the assistance of an accounting firm; perform operational due diligence, often with the assistance of an industry consultant; study the industry and competitive landscape; and conduct numerous reference checks with current and former employees, customers, suppliers, and competitors.

Private finance transactions are approved by an investment committee consisting of our most senior officers and chaired by our Chairman and Chief Executive Officer, William L. Walton. The private finance approval process benefits from the investment committee members and our other investment professionals who have significant

professional experience. For every transaction of \$10 million or greater, we also require approval from the executive committee of the board of directors in addition to the investment committee approval. Even after all such approvals are received, due diligence must be successfully completed with final investment committee approval before funds are disbursed to a portfolio company.

CMBS. We receive extensive packages of information regarding the mortgage loans comprising a CMBS pool. We work with the issuer, the investment bank, and the rating agencies in performing our diligence on a CMBS investment. The typical CMBS investment takes between two to three months to complete because of the breadth and depth of our diligence procedures. The key steps in our CMBS investment process are as follows:

Review initial loan collateral pool data;

Prepare and submit a preliminary bid letter to purchase non-investment grade bonds;

Commence underwriting process for loans in collateral pool including physical site inspection;

Review re-underwriting data for the entire pool;

Submit bond purchase to investment committee for approval;

Submit bond purchase to executive committee of the board of directors for approval;

Complete final pricing and structuring of investment; and

Fund investment.

We re-underwrite the underlying commercial mortgage loans securing the CMBS. We analyze the estimate of underwriteable cash flow and analyze necessary carve-outs, such as replacement reserves. We study the trends of the industry and geographic location of each property, and independently assess our own estimate of the anticipated cash flow over the period of the loan. Our loan officers and consultants physically inspect the collateral properties, and assess appraised values based on our own opinion of comparable market values.

Based on the findings of our diligence procedures, we may reject certain mortgage loans from inclusion in the pool. We then formulate our negotiated price and discount to achieve an effective loss-adjusted yield on our investment over a ten-year period to approximate 13% to 16%.

CMBS transactions are approved by an investment committee consisting of our most senior officers and chaired by our Chairman and Chief Executive Officer, William L. Walton. CMBS transactions over \$10 million are reviewed and approved by the executive committee of the board of directors.

Portfolio

Portfolio Diversity. We monitor the portfolio to maintain industry diversity. We currently do not have a policy with respect to concentrating (i.e., investing 25% or more of our total assets) in any industry or group of industries and currently our portfolio is not concentrated. We may or may not concentrate in any industry or group of industries in the future.

Loan Servicing. Our loan servicing staff is responsible for routine loan servicing, which includes:

delinquency monitoring;

payment processing;

borrower inquiries;

escrow analysis and processing;

third-party reporting; and

insurance and tax administration.

In addition, our staff is responsible for special servicing activities including delinquency monitoring and collection, workout administration, and management of foreclosed assets.

Portfolio by Grade. We employ a standard grading system for the entire portfolio. Grade 1 is used for those investments from which a capital gain is expected. Grade 2 is used for investments performing in accordance with plan. Grade 3 is used for investments that require closer monitoring; however, no loss of investment return or principal is expected. Grade 4 is used for investments that are in workout and for which some loss of current investment return is expected, but no loss of principal is expected. Grade 5 is used for investments that are in workout and for which some loss of principal is expected.

At December 31, 2002 and 2001, our portfolio was graded as follows:

| Grade | 2002 | | 2001 | |
|------------------|--------------------|-------------------------------|--------------------|-------------------------------|
| | Portfolio at Value | Percentage of Total Portfolio | Portfolio at Value | Percentage of Total Portfolio |
| (\$ in millions) | | | | |
| 1 | \$ 801.0 | 32.1% | \$ 603.3 | 25.9% |
| 2 | 1,400.8 | 56.3 | 1,553.8 | 66.7 |
| 3 | 166.0 | 6.7 | 79.5 | 3.4 |
| 4 | 23.6 | 1.0 | 44.5 | 1.9 |
| 5 | 96.8 | 3.9 | 48.5 | 2.1 |
| | <u>\$2,488.2</u> | <u>100.0%</u> | <u>\$2,329.6</u> | <u>100.0%</u> |

Total Grades 4 and 5 assets as a percentage of the total portfolio at value at December 31, 2002 and 2001, were 4.9% and 4.0%, respectively. Included in Grades 4 and 5 assets at December 31, 2002 and 2001, were assets totaling \$24.1 million and \$6.6 million, respectively, that are secured by commercial real estate. Grade 4 and 5 assets include loans, debt securities, and equity securities. We expect that a number of portfolio companies will be in the Grades 4 or 5 categories from time to time. Part of the business of private finance is working with troubled portfolio companies to improve their businesses and protect our investment. The number of portfolio companies and related investment amount included in Grades 4 and 5 may fluctuate from period to period. We continue to follow our historical practice of working with a troubled portfolio company in order to recover the maximum amount of our investment, but record unrealized depreciation for the expected amount of the loss when such exposure is identified.

At December 31, 2002, we saw an increase in Grade 3 assets in this difficult economy. We have been working with a number of portfolio companies that are in the

process of restructuring their operations or balance sheets due to changes in the economic environment or other changes in their business, and we have classified investments in these types of situations in Grade 3 because they are close monitoring situations. We may record some depreciation on a Grade 3 investment to reflect any decline in value while the company is in a close monitoring situation; however, we currently do not expect a loss of investment return or principal for these assets.

Loans and Debt Securities on Non-Accrual Status. Loans and debt securities on non-accrual status for which we have doubt about interest collection and are in workout status are classified as Grade 4 or 5 assets. In addition, we may not accrue interest on loans and debt securities to companies that are more than 50% owned by us from time to time if such companies are in need of additional capital. In these situations we may choose to defer current debt service.

For the total investment portfolio, workout loans and debt securities (which excludes equity securities that are included in the total Grade 4 and 5 assets above) not accruing interest that were classified in Grade 4 and 5, were \$89.1 million at value at December 31, 2002, or 3.6% of the total portfolio. Included in this category at December 31, 2002, were loans of \$13.0 million that were secured by commercial real estate. Workout loans and debt securities not accruing interest were \$85.0 million at value at December 31, 2001, or 3.6% of the total portfolio, of which \$8.9 million was related to portfolio companies in liquidation, and \$4.1 million represented loans secured by commercial real estate. As of December 31, 2002, \$7.6 million representing receivables related to portfolio companies in liquidation were included in other assets. In addition to Grade 4 and 5 assets that are in workout, loans and debt securities to companies that are more than 50% owned by us that were not accruing interest totaled \$63.6 million at value at December 31, 2002, and loans and debt securities to companies that are less than 50% owned by us that were not in workout but were not accruing interest totaled \$7.2 million and \$23.9 million at value at December 31, 2002, and 2001, respectively.

Loans and Debt Securities Over 90 Days Delinquent. Loans and debt securities greater than 90 days delinquent were \$103.1 million at value at December 31, 2002, or 4.1% of the total portfolio. Included in this category were loans valued at \$26.0 million that were secured by commercial real estate. Loans and debt securities greater than 90 days delinquent were \$39.1 million at value at December 31, 2001, or 1.7% of the total portfolio. Included in this category were loans valued at \$14.1 million that were secured by commercial real estate.

As a provider of long-term privately negotiated investment capital, we may defer payment of principal or interest from time to time. As a result, the amount of the portfolio that is greater than 90 days delinquent or on non-accrual status may vary from quarter to quarter. The nature of our private finance portfolio company relationships frequently provide an opportunity for portfolio companies to amend the terms of payment to us or to restructure their debt and equity capital. During such restructuring, we may not receive or accrue interest or dividend payments. The investment portfolio is priced to provide current returns for shareholders assuming that a portion of the portfolio at any time may not be accruing interest currently. We also price our investments for a total return including interest or dividends plus capital gains from the sale of equity securities. Therefore, the amount of loans and debt securities greater than 90 days delinquent or on non-accrual status is not necessarily an indication of future principal loss or loss of anticipated investment return. Our portfolio grading system is used as a means to assess loss of investment return or investment principal.

At December 31, 2002 and 2001, 1.0% and 0.5%, respectively, of the loans in the underlying collateral pool for our CMBS bond portfolio were over 30 days delinquent or were classified as real estate owned. We closely monitor the performance of all of the loans in the underlying collateral pools securing our CMBS investments.

Portfolio Monitoring. We monitor loan delinquencies in order to assess the appropriate course of action and overall portfolio quality. With respect to our private finance portfolio, investment professionals closely monitor the status and performance of each individual investment throughout each quarter. This portfolio company monitoring process includes discussions with the senior management team of the company's financial performance, the review of current financial statements, and generally includes attendance at portfolio company board meetings. Through the process, investments that may require closer monitoring are generally detected early, and for each such investment, an appropriate course of action is determined. For the private finance portfolio, loan delinquencies or payment default is not necessarily an indication of credit quality or the need to pursue active workout of a portfolio investment. Because we are a provider of long-term privately negotiated investment capital, it is not atypical for us to defer payment of principal or interest from time to time. As a result, the amount of our private finance portfolio that is delinquent at any one time may vary. The nature of our private finance portfolio relationships frequently provide an opportunity for us to restructure the debt and equity capital of the portfolio company. During such restructuring, we may not receive or accrue interest or dividend payments. Our senior investment professionals actively work with the portfolio company in these instances to negotiate an appropriate course of action.

The investment portfolio is priced to provide current returns for shareholders assuming that a portion of the portfolio at any time may not be accruing interest currently. We also price our investments for a total return including current interest or dividends plus capital gains from sale of equity securities. Therefore, the amount of loans that are delinquent is not necessarily an indication of future principal loss or loss of anticipated investment return. Our portfolio grading system is used as a means to assess loss of investment return or loss of investment principal. We expect that a certain number of portfolio companies will be in the Grade 4 or 5 categories from time to time. Part of the business of private finance is working with troubled portfolio companies to improve their businesses and protect our investment. The number of portfolio companies and related investment amount included in Grades 4 and 5 may fluctuate from quarter to quarter. We continue to follow our historical practice of working with a troubled portfolio company in order to recover the maximum amount of our investment, but record unrealized depreciation for the amount of the loss when such exposure is identified.

With respect to our CMBS portfolio, we monitor the performance of the individual loans in the underlying collateral pool through market data and discussions with the pool master servicers and special servicers. The master servicers are responsible for the day-to-day loan servicing functions, including billing, payment processing, collections on loans less than 60 days past due, tax and insurance escrow processing, and property inspections. The special servicers are responsible for collections on loans greater than 60 days past due, including workout administration and management of foreclosed properties. We discuss the status of past due or underperforming loans with the master servicers on a monthly basis. When a loan moves to a special servicer, a workout plan is formulated by the special servicer and generally reviewed by us as the directing certificate holder. Once reviewed by us, the special servicer carries out the workout plan, updating us on the status. We generally have the ability to replace the named special servicer at any time.

We act as the disposition consultant with respect to three of our collateralization debt obligations, or CDO investments, which allows us to approve disposition plans for individual collateral securities. For these services, we collect annual fees based on the outstanding collateral pool balance.

Business Loan Express. Our single largest portfolio investment is in Business Loan Express (BLX). BLX is the nation's second largest non-bank government guaranteed lender utilizing the SBA's 7(a) Guaranteed Loan Program and is licensed by the SBA as a Small Business Lending Company (SBLC). In addition to the 7(a) Guaranteed Loan Program, BLX originates conventional small business loans and originates loans under the USDA Business and Industry Guaranteed Loan Program.

BLX originates small business loans and then sells or securitizes substantially all of the loans it originates and retains servicing on the loans sold. BLX currently sells the guaranteed piece of SBA 7(a) guaranteed loans and securitizes the unguaranteed pieces of the SBA 7(a) loans and conventional loans it originates. Typically, BLX retains up to 2.7% of the term loan securitization pools.

BLX focuses its loan origination activity on small businesses that are owner-operated and generally secures its loans with single-purpose real estate associated with the business such as limited service hotels, gas stations and convenience stores, full-service restaurants, and manufacturing and retail properties. In addition, BLX has made loans to shrimp and fishing businesses that secure their loans with the shrimp or fishing vessel.

Summary serviced loan portfolio data for BLX at December 31, 2002, was as follows:

| (\$ in millions) | December 31, 2002 |
|--|-------------------|
| Total serviced loan portfolio | \$1,619.5 |
| Number of loans serviced | 2,373 |
| <i>Serviced Loan Portfolio By Industry</i> | |
| Hotels | 26% |
| Gas stations/convenience stores | 19 |
| Restaurants | 10 |
| Manufacturing and industrial | 10 |
| Professional and retail services | 9 |
| Shrimp/fishing vessels | 6 |
| Recreation | 5 |
| Child care and health care services | 4 |
| Other | 11 |
| Total | 100% |

BLX closely monitors its portfolio as well as the industries in which its borrowers operate. BLX's loan servicing and special servicing departments actively work with each borrower to assess BLX's financial exposure to troubled situations. At December 31, 2002, BLX's loan delinquencies in its serviced portfolio were 8.6%.

The ability of small businesses to repay their loans may be adversely affected by numerous factors, including a downturn in their industry or negative economic conditions. Small businesses are also more vulnerable to customer preferences, competition, rising fuel prices and market conditions and, as a result, delinquencies in BLX's portfolio may increase. For instance, the shrimp and fishing industry has been affected by rising fuel costs and competition from imported shrimp. For these reasons, BLX focuses on collateral protection for each loan in addition to the cash flow of the small business and receives personal guarantees from the principal owners of the small business.

Changes in the laws or regulations that govern SBLCs or the SBA 7(a) Guaranteed Loan Program or changes in government funding for this program could have a material impact on BLX or its operations. As of October 1, 2002, the SBA implemented a maximum loan size of \$500,000 for loans originated through the SBA 7(a) Guaranteed Loan Program due to Federal budget constraints. In February 2003, legislation was enacted to return the SBA 7(a) Guaranteed Loan Program to a sufficient level of funding. This legislation has enabled the SBA to return the maximum loan size to previous levels.

Portfolio Valuation

Valuation Methodology. We determine the value of each investment in our portfolio on a quarterly basis, and changes in value result in unrealized gains or losses being recognized. At December 31, 2002, approximately 89% of our total assets represented portfolio investments recorded at fair value. Value, as defined in Section 2(a)(41) of the Investment Company Act of 1940, is (i) the market price for those securities for which a market quotation is readily available and (ii) for all other securities and assets, fair value is as determined in good faith by the board of directors. Since there is typically no readily available market value for the investments in our portfolio, we value substantially all of our portfolio investments at fair value as determined in good faith by the board of directors pursuant to a valuation policy and a consistently applied valuation process. Because of the inherent uncertainty of determining the fair value of investments that do not have a readily available market value, the fair value of our investments determined in good faith by the board of directors may differ significantly from the values that would have been used had a ready market existed for the investments, and the differences could be material.

There is no single standard for determining fair value in good faith. As a result, determining fair value requires that judgment be applied to the specific facts and circumstances of each portfolio investment while employing a consistently applied valuation process for the types of investments we make. Unlike banks, we are not permitted to provide a general reserve for anticipated loan losses. Instead, we are required to specifically value each individual investment on a quarterly basis. We will record unrealized depreciation on investments when we believe that an investment has become impaired, including where collection of a loan or realization of an equity security is doubtful, or when the enterprise value of the company does not currently support the cost of our debt or equity investment. Conversely, we will record unrealized appreciation if we believe that the underlying portfolio company has appreciated in value and, therefore, our equity security has also appreciated in value. Changes in fair value are recorded in the statement of operations as unrealized gains and losses.

As a business development company, we invest in illiquid securities including debt and equity securities of primarily private companies and non-investment grade CMBS. The structure of each private finance debt and equity security is specifically negotiated to enable us to protect our investment and maximize our returns. We include many terms governing interest rate, repayment terms, prepayment penalties, financial covenants, operating covenants, ownership parameters, dilution parameters, liquidation preferences, voting rights, and put or call rights. Our investments are generally subject to restrictions on resale and generally have no established trading market. Because of the type of investments that we make and the nature of our business, our valuation process requires an analysis of various factors. Our fair value methodology includes the examination of, among

other things, the underlying investment performance, financial condition, and market changing events that impact valuation.

Valuation Methodology - Private Finance. Our process for determining the fair value of a private finance investment begins with determining the enterprise value of the portfolio company. The fair value of our investment is based on the enterprise value at which the portfolio company could be sold in an orderly disposition over a reasonable period of time between willing parties other than in a forced or liquidation sale. The liquidity event whereby we exit a private finance investment is generally the sale, the recapitalization or, in some cases, the initial public offering of the portfolio company.

There is no one methodology to determine enterprise value and, in fact, for any one portfolio company, enterprise value is best expressed as a range of fair values, from which we derive a single estimate of enterprise value. To determine the enterprise value of a portfolio company, we analyze its historical and projected financial results. We generally require portfolio companies to provide annual audited and monthly unaudited financial statements, as well as annual projections for the upcoming fiscal year. Typically in the private equity business, companies are bought and sold based upon multiples of EBITDA, cash flow, net income, revenues or, in limited instances, book value. The private equity industry uses financial measures such as EBITDA or EBITDAM (Earnings Before Interest, Taxes, Depreciation, Amortization and, in some instances, Management fees) in order to assess a portfolio company's financial performance and to value a portfolio company. EBITDA and EBITDAM are not intended to represent cash flow from operations as defined by accounting principles generally accepted in the United States of America and such information should not be considered as an alternative to net income, cash flow from operations, or any other measure of performance prescribed by accounting principles generally accepted in the United States of America. When using EBITDA to determine enterprise value, we may adjust EBITDA for non-recurring items. Such adjustments are intended to normalize EBITDA to reflect the portfolio company's earnings power. Adjustments to EBITDA may include compensation to previous owners, acquisition, recapitalization, or restructuring related items or one-time non-recurring income or expense items.

In determining a multiple to use for valuation purposes, we look to private merger and acquisition statistics, discounted public trading multiples or industry practices. In estimating a reasonable multiple, we consider not only the fact that our portfolio company may be a private company relative to a peer group of public comparables, but we also consider the size and scope of our portfolio company and its specific strengths and weaknesses. In some cases, the best valuation methodology may be a discounted cash flow analysis based on future projections. If a portfolio company is distressed, a liquidation analysis may provide the best indication of enterprise value.

If there is adequate enterprise value to support the repayment of our debt, the fair value of our loan or debt security normally corresponds to cost unless the borrower's condition or other factors lead to a determination of fair value at a different amount. The fair value of equity interests in portfolio companies are determined based on various factors, including the enterprise value remaining for equity holders after the repayment of the portfolio company's debt and other pertinent factors such as recent offers to purchase a portfolio company's equity interest or other potential liquidity events. The determined

equity values are generally discounted when we have a minority position, restrictions on resale, specific concerns about the receptivity of the capital markets to a specific company at a certain time, or other factors.

Valuation Methodology – CMBS Bonds. CMBS bonds are carried at fair value, which is based on a discounted cash flow model, which utilizes prepayment and loss assumptions based on historical experience and projected performance, economic factors, the characteristics of the underlying cash flow and comparable market yields for similar CMBS bonds. Our assumption with regard to discount rate is based on the yield of comparable securities. We recognize income from the amortization of original issue discount using the effective interest method, using the anticipated yield over the projected life of the investment. Yields are revised when there are changes in estimates of future credit losses, actual losses incurred, or actual and estimated prepayment speeds. Changes in estimated yield are recognized as an adjustment to the estimated yield over the remaining life of the CMBS bonds from the date the estimated yield is changed. We recognize unrealized appreciation or depreciation on our CMBS bonds as comparable yields in the market change and based on changes in estimated cash flows resulting from changes in prepayment or loss assumptions in the underlying collateral pool.

Valuation Process. The following is a description of the steps we take each quarter to determine the value of our portfolio.

Our quarterly valuation process begins with each portfolio company or investment being initially valued by the investment professionals responsible for the portfolio investment, led by the Managing Director who is responsible for the relationship.

Preliminary valuation conclusions are then discussed and documented in a valuation write-up and/ or worksheet and then discussed with our portfolio management team under the supervision of the Chief Financial Officer.

The investment committee, consisting of our most senior officers and chaired by our Chairman and Chief Executive Officer, William L. Walton, meets to discuss valuations as preliminarily determined and documented by each deal team, questions the valuation data and conclusions, and arrives at an investment committee view of valuation.

The investment committee provides comments on the preliminary valuation and the deal team and portfolio management team respond and supplement the documentation based upon those comments.

The valuation documentation is updated and distributed to our board of directors and the audit committee of the board of directors.

The audit committee meets in advance of the board of directors to discuss the valuations and supporting documentation.

The board of directors meets to discuss valuations and review the input of the audit committee and management.

To the extent changes or additional information is deemed necessary, a follow-up board meeting, executive committee meeting or audit committee meeting may take place.

The board of directors determines the fair value of the portfolio in good faith.

Investment Gains and Losses

Since the majority of our portfolio consists of loans and debt securities, our investment decisions are primarily based on credit dynamics. Our underwriting focuses on the preservation of principal, and we will pursue our available means to recover our capital investment. As a result of this investment discipline and credit culture, we have a demonstrated track record of successfully resolving troubled credit situations. Our realized gains from the sale of our equity interests have historically exceeded losses, as is reflected in the chart below.

| | Year Ended December 31, | | | | |
|--------------------|-------------------------|------------|-------------|------------|------------|
| | 2002 | 2001 | 2000 | 1999 | 1998 |
| (\$ in thousands) | | | | | |
| Realized gains | \$ 95,562 | \$ 10,107 | \$ 28,604 | \$ 31,536 | \$ 25,757 |
| Realized losses | \$ (50,625) | \$ (9,446) | \$ (13,081) | \$ (6,145) | \$ (3,216) |
| Net realized gains | \$ 44,937 | \$ 661 | \$ 15,523 | \$ 25,391 | \$ 22,541 |

Employees

At December 31, 2002, we employed 105 individuals including investment and portfolio management professionals, operations professionals and administrative staff. The majority of these individuals are located in the Washington, DC office. We believe that our relations with our employees are excellent.

LEGAL PROCEEDINGS

On April 21, 2003, the U.S. District Court for the Southern District of New York dismissed a consolidated securities class action lawsuit alleging violations of the federal securities laws filed against us and certain of our officers. In its ruling, the court found that the plaintiffs had failed to allege sufficient facts to support their claim and, therefore, dismissed the lawsuit in its entirety.

We are party to certain other lawsuits including legal proceedings incidental to the normal course of our business including enforcement of our rights under contracts with our portfolio companies. While the outcome of these legal proceedings cannot at this time be predicted with certainty, we do not expect that these proceedings will have a material effect upon our financial condition or results of operations.

PORTFOLIO COMPANIES

The following is a listing of our portfolio companies in which we had an equity investment at December 31, 2002. The portfolio companies are presented in three categories – companies more than 25% owned which represent portfolio companies where we directly or indirectly own more than 25% of the outstanding voting securities of such portfolio company and, therefore, are deemed controlled by us under the 1940 Act; companies owned 5% to 25% which represent portfolio companies where we directly or indirectly own 5% to 25% of the outstanding voting securities of such portfolio company or where we hold one or more seats on the portfolio company's board of directors and, therefore, are deemed to be an affiliated person under the 1940 Act; and companies less than 5% owned which represent portfolio companies where we directly or indirectly own less than 5% of the outstanding voting securities of such portfolio company and where we have no other affiliations with such portfolio company.

We make available significant managerial assistance to our portfolio companies. We generally receive rights to observe the meetings of our portfolio companies' board of directors, and may have one or more voting seats on their boards. For information relating to the amount and nature of our investments in portfolio companies, see our consolidated statement of investments at December 31, 2002 at pages F-6 to F-16.

| Name and Address of Portfolio Company | Nature of its Principal Business | Title of Securities Held by the Company | Percentage of Class Held(1) |
|--|--------------------------------------|---|-----------------------------------|
| Companies More Than 25% Owned | | | |
| Acme Paging, L.P.(2)(3) 6080 SW 40th Street, Suite 3 Miami, FL 33155 | Paging Services | Equity Interests Equity Interests in Affiliate | 1.8% 76.9% |
| American Healthcare Services, Inc.(2)(3) 3600 Mansell Road Suite 150 Alpharetta, GA 30022 | Consumer Health Services Provider | Common Stock | 80.3% |
| Avborne, Inc.(3) c/o Trivest, Inc. 7500 NW 26th Street Miami, FL 33122 | Aviation Services | Series B Preferred Stock Common Stock | 23.8% 27.5% |
| Business Loan Express, Inc.(2)(3) 645 Madison Ave. 19th Floor New York, NY 10022 | Small Business Lender | Preferred Stock Common Stock | 100.0% 94.9% |
| The Color Factory Inc.(2)(3) 11312 Penrose Street Sun Valley, CA 91352 | Cosmetic Manufacturer | Redeemable Preferred Stock Common Stock | 100.0% 100.0% |
| Elmhurst Consulting, LLC(2)(3) 360 W. Butterfield Road, Suite 400 Elmhurst, IL 60126 | Consulting Firm | Equity Interest Common Stock in Controlled Company | 100% 95.0% |
| Foresite Towers, LLC(2)(3) 22 Iverness Center Parkway Suite 50 Birmingham, AL 35242 | Tower Leasing | Common Equity Interest Series A Preferred Equity Interest Series B Preferred | 70.0% 100.0% |
| Gordian Group, Inc.(2)(3) 499 Park Avenue 5th Floor New York, NY 10022 | Financial Advisory Services | Equity Interest Common Stock | 100.0% 100.0% |

Edgar Filing: ALLIED CAPITAL CORP - Form N-2/A

| Name and Address of Portfolio Company | Nature of its Principal Business | Title of Securities Held by the Company | Percentage of Class Held(1) |
|---|---|---|-----------------------------------|
| HealthASPex, Inc.(2)(3) Foxpointe Centre Building 1; Suite 301 201 South Johnson Road Houston, PA 15342 | Third Party Administrator | Class A Convertible Preferred Stock | 69.9% |
| | | Class B Convertible Preferred Stock | 64.8% |
| | | Common Stock | 45.8% |
| The Hillman Companies, Inc.(2)(3) 10590 Hamilton Avenue P.O. Box 31012 Cincinnati, OH 45231 | Merchandiser of Retail Hardware Supplies | Common Stock | 96.8% |
| HMT, Inc. 4422 FM 1960 West Suite 350 Houston, TX 77068 | Storage Tank Maintenance & Repair | Class B Preferred Stock | 33.2% |
| | | Common Stock | 26.1% |
| | | Warrants to Purchase Common Stock | 10.0% |
| Housecall Medical Resources, Inc.(2)(3) 6501 Deane Hill Drive Knoxville, TN 37919 | Home Healthcare Services | Preferred Stock Common Stock | 86.4% 86.4% |
| Litterer Beteiligungs-GmbH Uhlandstrasse 1 69493 Hirschberg Germany | Scaffolding Company | Equity Interest | 15.0% |
| MVL Group, Inc.(2)(3) 1061 E. Indiantown Road Suite 300 Jupiter, FL 33477 | Market Research Services | Common Stock | 64.9% |
| Powell Plant Farms, Inc.(2)(3) Route 3, Box 1058 Troup, TX 75789 | Plant Retailer | Preferred Stock | 100% |
| | | Warrants to Purchase Common Stock | 83.5% |
| | | | |
| Redox Brands, Inc.(3) 9100 Centre Point Drive Suite 200 West Chester, OH 45069 | Household Cleaning Products | Series A Convertible Preferred Stock | 100.0% |
| | | Warrants to Purchase Class A Common Stock | 8.2% |
| | | | |
| Staffing Partners Holding Company, Inc. 104 Church Lane #100 Baltimore, MD 21208 | Temporary Employee Services | Redeemable Preferred Stock | 48.3% |
| | | Class A-1 Common Stock | 50.0% |
| | | Class A-2 Common Stock | 24.4% |
| | | Class B Common Stock | 24.0% |
| | | Warrants to purchase Class B Preferred Stock | 71.4% |
| | | Warrants to purchase Class B Common Stock | 54.1% |
| | | | |
| | | | |
| STS Operating, Inc. (d/b/a SunSource Technology Services, Inc.)(3) 2301 Windsor Court Addison, IL 60101 | Engineering Design and Services | Preferred Stock | 96.2% |
| | | Common Stock | 41.0% |
| Sure-Tel, Inc.(3) 5 North McCormick Oklahoma City, OK 73127 | Prepaid Telephone Services Company | Preferred Stock | 50.0% |
| | | Common Stock | 37.0% |
| Companies 5% to 25% Owned Aspen Pet Products, Inc. | Pet Product | Series B Preferred Stock | 9.5% |

Edgar Filing: ALLIED CAPITAL CORP - Form N-2/A

| | | | |
|---|----------------------------------|-----------------------|------|
| 4735 North Florence Street Denver, CO 80238 | Provider | Series A Common Stock | 7.0% |
| Autania AG Industriestrasse 7 65779 Kelkheim Germany | Machine and Tool Manufacturer | Common Stock | 6.2% |

Edgar Filing: ALLIED CAPITAL CORP - Form N-2/A

| Name and Address of Portfolio Company | Nature of its Principal Business | Title of Securities Held by the Company | Percentage of Class Held(1) |
|---|---|--|-----------------------------------|
| Border Foods, Inc. J Street Deming Industrial Park Deming, NM 88030 | Mexican Ingredient & Food Product Manufacturer | Series A Convertible Preferred Stock | 9.4% |
| | | Warrants to Purchase Common Stock | 88.6% |
| CorrFlex Graphics, LLC(3) 701 Rickert Street Statesville, NC 28677 | Packaging Manufacturer | Warrants to Purchase Common Stock | 4.8% |
| | | Options to Purchase Common Stock | 7.0% |
| | | Warrants to Purchase Common Stock | 40.5% |
| CyberRep(3) 8300 Greensboro Drive, 6th Floor McLean, VA 22102 | Operator of Call Service Centers | | |
| The Debt Exchange, Inc. 101 Arch Street, Suite 410 Boston, MA 02110 | Online Sales of Distressed Assets | Series B Convertible Preferred Stock | 40.0% |
| EDM Consulting, LLC 81 Two Bridges Road Fairfield, NJ 07004 | Environmental Consulting | Equity Interest | 25.0% |
| International Fiber Corporation 50 Bridge Street North Tonawanda, NY 14120 | Cellulose and Fiber Producer | Common Stock | 11.7% |
| | | Warrants to Purchase Common Stock | 3.0% |
| Liberty-Pittsburgh Systems, Inc. 3498 Grand Avenue Pittsburgh, PA 15225 | Business Forms Printing | Common Stock | 17.0% |
| Logic Bay Corporation 7900 International Drive Suite 750 Minneapolis, MN 55425 | Computer-Based Training Developer | Series C Redeemable Preferred Stock | 29.4% |
| Magna Card, Inc. 10315 South Dolifield Rd. Owings Mills, MD 21117 | Magnet Packager and Distributor | Preferred Stock | 6.3% |
| | | Common Stock | 5.4% |
| Master Plan, Inc. 21540 Plummer Street Chatsworth, CA 91311 | Healthcare Outsourcing | Common Stock | 7.5% |
| MortgageRamp.com, Inc.(3) 116 Welsh Road Horsham, PA 19044 | Internet Based Loan Origination Service Platform | Class A Common Stock | 7.7% |
| Morton Grove Pharmaceuticals, Inc. 6451 West Main Street Morton Grove, IL 60053 | Generic Drug Manufacturer | Convertible Preferred Stock | 23.9% |
| Nobel Learning Communities, Inc. 1400 N. Providence Road, Suite 3055 Media, PA 19063 | Educational Services | Series D Convertible Preferred Stock | 100.0% |
| | | Warrants to Purchase Common Stock | 11.7% |
| | | Common Stock | 11.3% |
| Packaging Advantage Corporation 4633 Downey Road Los Angeles, CA 90058 | Personal Care, Household and Disinfectant Product Packager | Warrants to Purchase Common Stock | 5.4% |
| | | Common Stock | |
| Professional Paint, Inc. 8600 Park Meadow Drive, #300 Lone Tree, CO 80124 | Paint Manufacturer | Series A-1 Senior Exchangeable Preferred Stock | 50.0% |
| | | Common Stock | 13.8% |
| Progressive International Corporation 6111 S. 228th Street P.O. Box 97045 | Retail Kitchenware | Series A Redeemable Preferred Stock | 12.5% |
| | | Common Stock | 1.1% |

Edgar Filing: ALLIED CAPITAL CORP - Form N-2/A

| | | | |
|-----------------------------|--------------------|---------------------------------------|-------|
| Kent, WA 98064 | | Warrants to Purchase Common Stock | 45.3% |
| Prosperco Finanz Holding AG | Financial Services | Debt Convertible into Common Stock | 8.5% |
| Schützengasse 25 | | Common Stock | 2.6% |
| CH-8001 Zürich | | Warrants to Purchase Common Stock | 5.0% |
| Switzerland | | | |

Edgar Filing: ALLIED CAPITAL CORP - Form N-2/A

| Name and Address of Portfolio Company | Nature of its Principal Business | Title of Securities Held by the Company | Percentage of Class Held(1) |
|--|---|--|-----------------------------------|
| Total Foam, Inc. P.O. Box 688 Ridgefield, CT 06877 | Packaging Systems | Common Stock | 8.8% |
| Companies Less Than 5% Owned | | | |
| Advantage Sales and Marketing, Inc. 3444 Memorial Highway Tampa, FL 33607 | Regional Food Broker | Warrants to Purchase Common Stock | 4.5% |
| Alderwoods Group, Inc. 311 Elm Street, Suite 1000 Cincinnati, OH 45202 | Death Care Services | Common Stock | 0.9% |
| Allied Office Products, Inc. 100 Dellawanna Avenue Clifton, NJ 07014 | Office Products | Common Stock | 3.1% |
| American Barbecue & Grill, Inc. 7300 W. 110th Street, Suite 570 Overland Park, KS 66210 | Restaurant Chain | Warrants to Purchase Common Stock | 18.7% |
| ASW Holding Corporation 2825 W. 31st Street Chicago, IL 60623 | Steel Wool Manufacturer | Warrants to Purchase Common Stock | 5.9% |
| Blue Rhino Corporation 104 Cambridge Plaza Drive Winston-Salem, NC 27104 | Propane Cylinder Exchange | Warrants to Purchase Common Stock | 7.7% |
| Camden Partners Strategic Fund II, L.P. One South Street Suite 2150 Baltimore, MD 21202 | Private Equity Fund | Limited Partnership Interest | 4.2% |
| Candlewood Hotel Company 9342 East Central Wichita, KS 67206 | Extended Stay Facilities | Series A Convertible Preferred Stock Series B Convertible Preferred Stock | 2.4% 4.1% |
| Celebrities, Inc. 408-412 W. Oakland Park Boulevard Ft. Lauderdale, FL 33311-1712 | Radio Stations | Warrants to Purchase Common Stock | 25.0% |
| Colibri Holding Corporation 2201 S. Walbash Street Denver, CO 80231 | Outdoor Living Products | Preferred Stock Common Stock Warrants to Purchase Common Stock | 5.9% 4.2% 2.4% |
| Component Hardware Group, Inc. 1890 Swarthmore Ave. P.O. Box 2020 Lakewood, NJ 08701 | Designer & Developer of Hardware Components | Class A Preferred Stock Common Stock | 9.6% 13.3% |
| Cooper Natural Resources, Inc. P.O. Box 1477 Seagraves, TX 79360 | Sodium Sulfate Producer | Series A Convertible Preferred Stock Warrants to Purchase Series A Convertible Preferred Stock Warrants to Purchase Common Stock | 100.0% 36.8% 6.5% |
| eCentury Capital Partners, L.P. 8270 Greensboro Drive Suite 1025 McLean, VA 22102 | Private Equity Fund | Limited Partnership Interest | 25.0% |
| Elexis Beta GmbH Ulmenstraße 22 | Distance Measurement Device | Options to Purchase Shares | 9.8% |

Edgar Filing: ALLIED CAPITAL CORP - Form N-2/A

| | | | |
|---|---|--------------------------------------|------|
| 60325 Frankfurt am Main Germany | Manufacturer | | |
| E-Talk Corporation 4040 West Royal Lane Suite 100 Irving, TX 75063 | Telecommunications Software Provider | Warrants to Purchase Common Stock | 5.5% |

Edgar Filing: ALLIED CAPITAL CORP - Form N-2/A

| Name and Address of Portfolio Company | Nature of its Principal Business | Title of Securities Held by the Company | Percentage of Class Held(1) |
|--|---|--|-----------------------------------|
| Executive Greetings, Inc. 120 Industrial Park Access Road New Hartford, CT 06057 | Personalized Business Products | Warrants to Purchase Common Stock | 1.3% |
| Fairchild Industrial Products Company 3920 Westpoint Boulevard Winston-Salem, NC 27013 | Industrial Controls Manufacturer | Warrants to Purchase Common Stock | 22.4% |
| Frozen Specialties, Inc. 720 Barre Road Archbold, OH 43502 | Private Label Frozen Food Manufacturer | Warrants to Purchase Class A Common Stock | 2.7% |
| Galaxy American Communications, LLC 1100 N. Main Street Sikeston, MO 63801 | Cable Television Operator | Options to Purchase Common LLC Interest | 51.2% |
| Garden Ridge Corporation 19411 Atrium Place Suite 170 Houston, TX 77084 | Home Decor Retailer | Series A Preferred Stock Class A Common Stock Class B Common Stock | 2.6% 4.7% 4.7% |
| Gibson Guitar Corporation(3) 1818 Elm Hill Pike Nashville, TN 37210 | Guitar Manufacturer | Warrants to Purchase Class A Common Stock Warrants to Purchase Class B Common Stock | 3.0% 3.0% |
| Ginsey Industries, Inc. 281 Benigno Boulevard Bellmawr, NJ 08031 | Bathroom Accessories Manufacturer | Convertible Debentures Warrants to Purchase Common Stock | 8.3% 17.1% |
| Global Communications, LLC 201 East 69th Street New York, NY 10021 | Muzak Franchisee | Preferred Equity Interest Options for Common Membership Interest | 59.3% 59.3% |
| Grant Broadcasting Systems II 919 Middle River Drive, Suite 409 Ft. Lauderdale, FL 33304 | Television Stations | Warrants to Purchase Common Stock Warrants to Purchase Common Stock in | 25.0% 25.0% |
| Grotech Partners VI, L.P. c/o Grotech Capital Group 9690 Deereco Road Suite 800 Timonium, MD 21093 | Private Equity Fund | Affiliate Company Limited Partnership Interest | 2.6% |
| The Hartz Mountain Corporation 400 Plaza Drive Secaucus, NJ 07094 | Pet Supply Manufacturer | Common Stock Warrants to Purchase Common Stock | 2.0% 4.3% |
| Hotelevision, Inc. 599 Lexington Avenue Suite 2300 New York, NY 10022 | Hotel Cable-TV Network | Series 3 Preferred Stock | 16.2% |
| Icon International, Inc. 281 Tressor Boulevard 8th Floor Stamford, CT 06901 | Corporate Barter Services | Class A Common Stock Class C Common Stock | 0.8% 0.2% |
| Impact Innovations Group, LLC 2500 Northwinds Parkway Suite 200 Alpharetta, GA 30004 | Information Technology Services Provider | Warrants to Purchase Common Stock | 3.5% |
| Interline Brands, Inc. 303 Harper Drive Moorestown, NJ 08057 | Repair and Maintenance Product Distributor | Senior Preferred Stock Common Stock Warrants to Purchase Common Stock | 0.8% 0.9% 1.4% |

Edgar Filing: ALLIED CAPITAL CORP - Form N-2/A

JRI Industries, Inc.
2958 East Division
Springfield, MO 65803

Machinery Manufacturer

Warrants to Purchase
Common Stock

6.5%

Edgar Filing: ALLIED CAPITAL CORP - Form N-2/A

| Name and Address of Portfolio Company | Nature of its Principal Business | Title of Securities Held by the Company | Percentage of Class Held(1) |
|--|--|--|-----------------------------------|
| Julius Koch USA, Inc. 387 Church Street New Bedford, MA 02745 C | Mini-Blind Cord Manufacturer | Warrants to Purchase Common Stock | 39.6% |
| Kirker Enterprises, Inc. 55 East 6th Street Paterson, NJ 07524 | Nail Enamel Manufacturer | Equity Interest in Affiliate Company Warrants to Purchase Series B Common Stock | 22.5% 22.5% |
| Kirkland s, Inc. P.O. Box 7222 Jackson, TN 38308-7222 | Home Furnishing Retailer | Common Stock | 1.3% |
| Kyrus Corporation 5 Artillery Road Taylors, SC 29687 | Value-Added Reseller, Computer Systems | Warrants to Purchase Common Stock | 18.4% |
| Love Funding Corporation 1220 19th Street, NW, Suite 801 Washington, DC 20036 | Mortgage Services | Series D Preferred Stock | 26.0% |
| Matrics, Inc. 8850 Stanford Boulevard Suite 3000 Columbia, MD 21045 | Radio Frequency Identification Technology | Series B Convertible Preferred Stock Warrants to Purchase Series B Convertible Preferred Stock | 3.4% 0.2% |
| MedAssets Inc. 100 Northpoint Center East #150 Alpharetta, GA 30022 | Healthcare Outsourcing | Series B Convertible Preferred Stock Warrants to Purchase Common Stock | 6.4% 0.2% |
| Mid-Atlantic Venture Fund IV, L.P. 128 Goodman Drive Bethlehem, PA 18015 | Private Equity Fund | Limited Partnership Interest | 6.7% |
| Midview Associates, L.P. 2 Eaton Street, Suite 1101 Hampton, VA 23669 | Residential Land Development | Warrants to Purchase Partnership Interests | 35.0% |
| Norstan Apparel Shops, Inc. 33-00 47th Avenue Long Island City, NY 11101 | Women s Apparel Retailer | Common Stock Warrants to Purchase Common Stock | 26.3% 8.0% |
| North American Archery Group, LLC 4600 SW 41st Boulevard Gainesville, FL 32608 | Sporting Equipment Manufacturer | Debentures Convertible into LLC Equity Interest | 26.9% |
| Novak Biddle Venture Partners III, L.P. 7501 Wisconsin Avenue East Tower, Suite 1380 Bethesda, MD 20814 | Private Equity Fund | Limited Partnership Interest | 2.9% |
| Nursefinders, Inc. 1200 Copeland Road, Suite 200 Arlington, TX 76011 | Healthcare Services | Warrants to Purchase Common Stock | 4.1% |
| Onyx Television GmbH Immedia Park 6b 50670 Koln Germany | Cable Television | Preferred Units | 12.0% |
| Opinion Research Corporation P.O. Box 183 Princeton, NJ 08542 | Corporate Marketing Research Firm | Warrants to Purchase Common Stock | 6.8% |
| Oriental Trading Company, Inc. 108th Street, 4206 South Omaha, NE 68137 | Direct Marketer of Toys | Series A Redeemable Preferred Stock Class A Common Stock | 1.7% 1.7% |
| Outsource Partners, Inc. | Outsourced Facility | Warrants to Purchase | |

Edgar Filing: ALLIED CAPITAL CORP - Form N-2/A

| | | | |
|--|-------------------|---|------------------|
| 200 Mansell Court East Suite 500 Roswell, GA 30076 | Services Provider | Preferred Stock Warrants to Purchase Class A Common Stock | 4.0% 5.4% |
|--|-------------------|---|------------------|

Edgar Filing: ALLIED CAPITAL CORP - Form N-2/A

| Name and Address of Portfolio Company | Nature of its Principal Business | Title of Securities Held by the Company | Percentage of Class Held(1) |
|---|---|--|-----------------------------------|
| Polaris Pool Systems, Inc. P.O. Box 1149 San Marcos, CA 92079-1149 | Pool Cleaner Manufacturer | Warrants to Purchase Class B Common Stock | 4.6% |
| Raytheon Aerospace, LLC 555 Industrial Drive South Madison, MS 39110 | Aviation Maintenance and Logistics | Class B LLC Interest | 6.7% |
| Soff-Cut Holdings, Inc. 1112 Olympic Drive Corona, CA 91719 | Concrete Sawing Equipment Manufacturer | Series A Preferred Stock Common Stock | 14.3% 2.7% |
| Spa Lending Corporation 1919 Pennsylvania Avenue, N.W. Washington, DC 20006 | Health Spas | Series A Preferred Stock | 100.0% |
| Sydran Food Services II, L.P. Bishop Ranch 8 3000 Executive Parkway Ste. 515 San Ramon, CA 94583-4254 | Fast Food Franchise | Class A Preferred Units Class B Common Units Warrants to Purchase Class B Common Units | 3.4% 1.7% 12.0% |
| Tubbs Snowshoe Company, LLC 52 River Road Stowe, VT 05672 | Snowshoe Manufacturer | Equity Interests in Affiliate Company Warrants to Purchase Common Units in Affiliate Company | 7.0% 8.5% |
| United Pet Group, Inc. 463 Ohio Pike Suite 303 Cincinnati, OH 45255 | Manufacturer of Pet Products | Warrants to Purchase Common Stock | 5.8% |
| Updata Venture Partners II, L.P. 11600 Sunrise Valley Drive Reston, VA 20191 | Private Equity Fund | Limited Partnership Interest | 16.1% |
| Venturehouse Group, LLC 1780 Tysons Blvd., Suite 400 McLean, VA 22102 | Private Equity Fund | Common Equity Interest | 2.2% |
| Walker Investment Fund II, LLLP 3060 Washington Road Suite 200 Glenwood, MD 21738 | Private Equity Fund | Limited Partnership Interest | 5.1% |
| Warn Industries, Inc. 12900 S.E. Capps Rd. Clackamas, OR 97015 | Sport Utility Accessories Manufacturer | Warrants to Purchase Common Stock | 48.6% |
| Wilshire Restaurant Group, Inc. 1100 Town & Country Road Suite 1300 Orange, CA 92868-4654 | Restaurant Chain | Warrants to Purchase Common Stock Warrants to Purchase Preferred Stock | 2.7% 2.7% |
| Woodstream Corporation 69 North Locust Street Lititz, PA 17543 | Pest Control Manufacturer | Equity Interest in Affiliate Company Warrants to Purchase Common Stock | 13.7% 7.2% |

- (1) Percentages shown for securities held by us represent percentage of the class owned and do not necessarily represent voting ownership. Percentages shown for equity securities other than warrants or options represent the actual percentage of the class of security held before dilution. Percentages shown for warrants and options held represent the percentage of class of security we may own, on a fully diluted basis, assuming we exercise our warrants or options.
- (2)

Edgar Filing: ALLIED CAPITAL CORP - Form N-2/A

We directly or indirectly own more than 50% of the voting securities of the company, or control the board of directors, or are the controlling member.

- (3) The portfolio company is deemed to be an affiliated person under the 1940 Act because we hold one or more seats on the portfolio company's board of directors, are the general partner, or are the managing member.

73

DETERMINATION OF NET ASSET VALUE

We determine the net asset value per share of our common stock quarterly. The net asset value per share is equal to the value of our total assets minus liabilities and preferred stock divided by the total number of common shares outstanding.

At December 31, 2002, approximately 89% of our total assets represented portfolio investments recorded at fair value. Value, as defined in Section 2(a)(41) of the Investment Company Act of 1940, is (i) the market price for those securities for which a market quotation is readily available and (ii) for all other securities and assets, fair value is as determined in good faith by the board of directors. Since there is typically no readily available market value for the investments in our portfolio, we value substantially all of our portfolio investments at fair value as determined in good faith by the board of directors pursuant to a valuation policy and a consistently applied valuation process. Because of the inherent uncertainty of determining the fair value of investments that do not have a readily available market value, the fair value of our investments determined in good faith by the board of directors may differ significantly from the values that would have been used had a ready market existed for the investments, and the differences could be material.

There is no single standard for determining fair value in good faith. As a result, determining fair value requires that judgment be applied to the specific facts and circumstances of each portfolio investment while employing a consistently applied valuation process for the types of investments we make. Unlike banks, we are not permitted to provide a general reserve for anticipated loan losses. Instead, we are required to specifically value each individual investment on a quarterly basis. We will record unrealized depreciation on investments when we believe that an investment has become impaired, including where collection of a loan or realization of an equity security is doubtful, or when the enterprise value of the company does not currently support the cost of our debt or equity investment. Conversely, we will record unrealized appreciation if we believe that the underlying portfolio company has appreciated in value and, therefore, our equity security has also appreciated in value. Changes in fair value are recorded in the statement of operations as unrealized gains and losses.

As a business development company, we invest in illiquid securities including debt and equity securities of primarily private companies and non-investment grade CMBS. The structure of each private finance debt and equity security is specifically negotiated to enable us to protect our investment and maximize our returns. We include many terms governing interest rate, repayment terms, prepayment penalties, financial covenants, operating covenants, ownership parameters, dilution parameters, liquidation preferences, voting rights, and put or call rights. Our investments are generally subject to restrictions on resale and generally have no established trading market. Because of the type of investments that we make and the nature of our business, our valuation process requires an analysis of various factors. Our fair value methodology includes the examination of, among other things, the underlying investment performance, financial condition, and market changing events that impact valuation.

Private Finance. Our process for determining the fair value of a private finance investment begins with determining the enterprise value of the portfolio company. The fair value of our investment is based on the enterprise value at which the portfolio company could be sold in an orderly disposition over a reasonable period of time between willing parties other than in a forced or liquidation sale. The liquidity event whereby we exit a

private finance investment is generally the sale, the recapitalization or, in some cases, the initial public offering of the portfolio company.

There is no one methodology to determine enterprise value and, in fact, for any one portfolio company, enterprise value is best expressed as a range of fair values, from which we derive a single estimate of enterprise value. To determine the enterprise value of a portfolio company, we analyze its historical and projected financial results. We generally require portfolio companies to provide annual audited and monthly unaudited financial statements, as well as annual projections for the upcoming fiscal year. Typically in the private equity business, companies are bought and sold based on multiples of EBITDA, cash flow, net income, revenues or, in limited instances, book value. The private equity industry uses financial measures such as EBITDA or EBITDAM (Earnings Before Interest, Taxes, Depreciation, Amortization and, in some instances, Management fees) in order to assess a portfolio company's financial performance and to value a portfolio company. EBITDA and EBITDAM are not intended to represent cash flow from operations as defined by accounting principles generally accepted in the United States of America and such information should not be considered as an alternative to net income, cash flow from operations, or any other measure of performance prescribed by accounting principles generally accepted in the United States of America. When using EBITDA to determine enterprise value, we may adjust EBITDA for non-recurring items. Such adjustments are intended to normalize EBITDA to reflect the portfolio company's earnings power. Adjustments to EBITDA may include compensation to previous owners, acquisition, recapitalization, or restructuring related items or one-time non-recurring income or expense items.

In determining a multiple to use for valuation purposes, we look to private merger and acquisition statistics, discounted public trading multiples or industry practices. In estimating a reasonable multiple, we consider not only the fact that our portfolio company may be a private company relative to a peer group of public comparables, but we also consider the size and scope of our portfolio company and its specific strengths and weaknesses. In some cases, the best valuation methodology may be a discounted cash flow analysis based on future projections. If a portfolio company is distressed, a liquidation analysis may provide the best indication of enterprise value.

If there is adequate enterprise value to support the repayment of our debt, the fair value of our loan or debt security normally corresponds to cost unless the borrower's condition or other factors lead to a determination of fair value at a different amount. The fair value of equity interests in portfolio companies are determined based on various factors, including the enterprise value remaining for equity holders after the repayment of the portfolio company's debt and other pertinent factors such as recent offers to purchase a portfolio company's equity interest or other potential liquidity events. The determined equity values are generally discounted when we have a minority position, restrictions on resale, specific concerns about the receptivity of the capital markets to a specific company at a certain time, or other factors.

Loans and Debt Securities. For loans and debt securities, fair value generally approximates cost unless the borrower's enterprise value or overall financial condition or other factors lead to a determination of fair value at a different amount.

When we receive nominal cost warrants or free equity securities (nominal cost equity), we allocate our cost basis in our investment between debt securities and nominal cost equity at the time of origination. At that time, the original issue discount basis of the

nominal cost equity is recorded by increasing the cost basis in the equity and decreasing the cost basis in the related debt securities.

Interest income is recorded on an accrual basis to the extent that such amounts are expected to be collected. For loans and debt securities with contractual payment-in-kind interest, which represents contractual interest accrued and added to the loan balance that generally becomes due at maturity, we will not accrue payment-in-kind interest if the portfolio company valuation indicates that the payment-in-kind interest is not collectible. Interest on loans and debt securities is not accrued if we have doubt about interest collection. Loans in workout status classified as Grade 4 or Grade 5 assets do not accrue interest. In addition, interest may not accrue on loans or debt securities to portfolio companies that are more than 50% owned by us if such companies are in need of additional capital. Loan origination fees, original issue discount, and market discount are capitalized and then amortized into interest income using the effective interest method. Prepayment premiums are recorded on loans when received.

The weighted average yield on loans and debt securities is computed as the (a) annual stated interest rate earned plus the annual amortization of loan origination fees, original issue discount, and market discount earned on accruing loans and debt securities, divided by (b) total loans and debt securities at value. The weighted average yield is computed as of the balance sheet date.

Equity Securities. Our equity interests in portfolio companies for which there is no liquid public market are valued at fair value based on the enterprise value of the portfolio company, which is determined using various factors, including cash flow from operations of the portfolio company and other pertinent factors, such as recent offers to purchase a portfolio company's securities or other liquidation events. The determined fair values are generally discounted to account for restrictions on resale and minority ownership positions.

The value of our equity interests in public companies for which market quotations are readily available is based upon the closing public market price on the balance sheet date. Securities that carry certain restrictions on sale are typically valued at a discount from the public market value of the security.

Dividend income is recorded on preferred equity securities on an accrual basis to the extent that such amounts are expected to be collected and on common equity securities on the record date for private companies or on the ex-dividend date for publicly traded companies.

Commercial Mortgage-Backed Securities (CMBS). CMBS bonds are carried at fair value, which is based upon a discounted cash flow model that utilizes prepayment and loss assumptions based upon historical experience and projected performance, economic factors, the characteristics of the underlying cash flow and comparable market yields for similar CMBS bonds. Our assumption with regard to discount rate for determining fair value is based on the yield of comparable securities. We recognize income from the amortization of original issue discount using the effective interest method, using the anticipated yield over the projected life of the investment. Yields are revised when there are changes in estimates of future credit losses, actual losses incurred, or actual and estimated prepayment speeds. Changes in estimated yield are recognized as an adjustment to the estimated yield over the remaining life of the CMBS bonds from the date the estimated yield is changed. We recognize unrealized appreciation or depreciation on our CMBS bonds as comparable yields in the market change and based on changes in

estimated cash flows resulting from changes in prepayment or loss assumptions in the underlying collateral pool.

Residual Interest. We value our residual interest from a previous securitization and recognize income using the same accounting policies used for the CMBS bonds. The residual interest is carried at fair value based on discounted estimated future cash flows. We recognize income from the residual interest using the effective interest method. At each reporting date, the effective yield is recalculated and used to recognize income until the next reporting date.

MANAGEMENT

Our Board of Directors supervises our management. The responsibilities of each director include, among other things, the oversight of the investment approval process, the quarterly valuation of our assets, and oversight of our financing arrangements. The Board of Directors maintains an Executive Committee, Audit Committee, Compensation Committee, and Nominating Committee, and may establish additional committees in the future. Some or all of our directors also serve as directors of our subsidiaries.

Our investment decisions in each business area are made by investment committees composed of our most senior investment professionals. No one person is primarily responsible for making recommendations to a committee.

We are internally managed and our investment professionals manage our portfolio and the portfolios of companies for which we serve as investment adviser. These investment professionals have extensive experience in managing investments in private businesses in a variety of industries, and are familiar with our approach of lending and investing. Because we are internally managed, we pay no investment advisory fees, but instead we pay the operating costs associated with employing investment management professionals.

Structure of Board of Directors

The Board of Directors is classified into three approximately equal classes with three-year terms, with only one of the three classes expiring each year. Directors serve until their successors are elected and qualified.

Directors

Information regarding the board of directors is as follows:

| Name | Age | Position | Director Since(1) | Expiration of Term |
|--------------------------------|-----|---|-------------------|--------------------|
| Interested Directors(2) | | | | |
| William L. Walton | 53 | Chairman, Chief Executive Officer and President | 1986 | 2004 |
| George C. Williams, Jr. | 76 | Chairman Emeritus | 1964 | 2004 |
| Robert E. Long | 71 | Director | 1972 | 2004 |
| Independent Directors | | | | |
| Brooks H. Browne | 53 | Director | 1990 | 2004 |
| John D. Firestone | 59 | Director | 1993 | 2005 |
| Anthony T. Garcia | 46 | Director | 1991 | 2005 |
| Ann Torre Grant | 45 | Director | 2003 | 2006 |
| Lawrence I. Hebert | 56 | Director | 1989 | 2005 |
| John I. Leahy | 72 | Director | 1994 | 2006 |
| Alex J. Pollock | 60 | Director | 2003 | 2006 |
| Guy T. Steuart II | 71 | Director | 1984 | 2006 |
| Laura W. van Roijen | 51 | Director | 1992 | 2005 |

(1) Includes service as a director of any of the predecessor companies.

(2) Interested persons of Allied Capital, as defined in the Investment Company Act of 1940.

Each director has the same address as Allied Capital, 1919 Pennsylvania Avenue, N.W., Washington, D.C. 20006.

Executive Officers

Information regarding our executive officers is as follows:

| Name | Age | Position |
|-------------------------|-----|---|
| William L. Walton | 53 | Chairman, Chief Executive Officer and President |
| Joan M. Sweeney | 43 | Chief Operating Officer |
| Penni F. Roll | 37 | Chief Financial Officer |
| Scott S. Binder | 48 | Managing Director |
| Michael J. Grisius | 39 | Managing Director |
| Robert D. Long | 46 | Managing Director |
| Edward H. Ross | 37 | Managing Director |
| John M. Scheurer | 50 | Managing Director |
| John D. Shulman | 40 | Managing Director |
| Paul R. Tanen | 36 | Managing Director |
| Thomas H. Westbrook | 39 | Managing Director |
| G. Cabell Williams, III | 48 | Managing Director |
| Scott A. Somer | 34 | Director of Financial Operations |
| Suzanne V. Sparrow | 37 | Executive Vice President and Secretary |

Each executive officer has the same address as Allied Capital, 1919 Pennsylvania Avenue, N.W., Washington, D.C. 20006.

Biographical Information**Directors**

Our directors have been divided into two groups interested directors and independent directors. Interested directors are interested persons as defined in the Investment Company Act of 1940.

Interested Directors

William L. Walton has been the Chairman, Chief Executive Officer, and President of Allied Capital since 1997. He has served on Allied Capital's Board of Directors since 1986, and was named Chairman and CEO in February 1997. Mr. Walton previously served as Managing Director of New York-based Butler Capital Corporation, a mezzanine buyout firm, and was the personal venture capital advisor for William S. Paley, founder and Chairman of CBS. In addition, he was a Senior Vice President in Lehman Brothers Kuhn Loeb's Investment Banking Group. Mr. Walton also founded and managed two start-up businesses, Success Lab, Inc. and Language Odyssey, in the emerging education industry (1992-1996). Mr. Walton is a director of Riggs National Corporation, The Hillman Companies, Inc., and the National Venture Capital Association.

George C. Williams, Jr. is Chairman Emeritus of Allied Capital. Mr. Williams was an officer of the predecessor companies from the later of 1959 or the inception of the relevant entity and President or Chairman and Chief Executive Officer of the predecessor companies from the later of 1964 or each entity's inception until 1991. Mr. Williams is the father of G. Cabell Williams III, an executive officer of Allied Capital.

Robert E. Long has been the Chief Executive Officer and a director of Goodwyn, Long & Black Investment Management, Inc. since 1997, and has been the Chairman of Emerald City Radio Partners, LLC since 1997. Mr. Long was the President of Business News Network, Inc. from 1995 to 1998, the Chairman and Chief Executive Officer of Southern Starr Broadcasting Group, Inc. from 1991 to 1995, and a director and the President of Potomac Asset Management, Inc. from 1983 to 1991. Mr. Long is a director of AmBase Corporation, CSC Scientific, Inc., Advanced Solutions International, Inc. and Graphic Computer Solutions, Inc. Mr. Long is the father of Robert D. Long, an executive officer of Allied Capital.

Independent Directors

Brooks H. Browne is a private investor. Mr. Browne was the President of Environmental Enterprises Assistance Fund from 1993 to 2002. He is a director of SEAF and Solar Development Capital, Ltd.

John D. Firestone has been a Partner of Secor Group (venture capital) since 1978. Mr. Firestone is a director of Security Storage Company of Washington, DC, and served as a director of Bryn Mawr Bank Corporation from 1998 to 2001. Mr. Firestone is currently a member of the board of several non-profit organizations.

Anthony T. Garcia has been Vice President of Finance of Formity Systems, Inc., a developer of software products for business management of data networks, since January 2002. Mr. Garcia was a private investor from 2000 to 2001, the General Manager of Breen Capital Group (investor in tax liens) from 1997 to 2000, and a Senior Vice President of Lehman Brothers Inc. from 1985 to 1996.

Ann Torre Grant is a strategic and financial consultant. From 1995 to 1997, Ms. Grant served as Executive Vice President, CFO and Treasurer of NHP, Inc., a national real estate services firm. From 1991 to 1995, Ms. Grant was Vice President and Treasurer of US Airways. She serves on the boards of Franklin Mutual Series and SLM Corporation (Sallie Mae).

Lawrence I. Hebert has been a director and President and Chief Executive Officer of Riggs Bank N.A. (a subsidiary of Riggs National Corporation) since February 2001, and has served as a director of Riggs National Corporation since 1988. Mr. Hebert also serves as a director of Riggs Investment Management Corporation and Riggs Bank Europe Limited (both indirect subsidiaries of Riggs National Corporation). Mr. Hebert is the President and a director of Perpetual Corporation (owner of Allbritton Communications Company and ALLNEWSCO, Inc.). Mr. Hebert is a director of ALLNEWSCO, Inc. (news programming service), the President of Westfield News Advertiser, Inc. (owner of a television station and newspapers), a Trustee of The Allbritton Foundation, and Vice Chairman of Allbritton Communications Company. Mr. Hebert previously served as Vice Chairman (1983 to 1998), President (1984 to 1998), and Chairman and Chief Executive Officer (1998 to 2001) of Allbritton Communications Company. Riggs Bank N.A. has a \$60 million commitment under our revolving line of credit.

John I. Leahy has been the President of Management and Marketing Associates, a management consulting firm, since 1986. Mr. Leahy was the President and Group Executive Officer, Western Hemisphere of Black & Decker Corporation from 1982 to 1985. Mr. Leahy is a director of B&L Sales, Inc. and is the Chairman of Gallagher Fluid Seals, Inc. Mr. Leahy is Trustee Emeritus of the Sellinger School of Business, Loyola College, Maryland.

Alex J. Pollock has been President and Chief Executive Officer of the Federal Home Loan Bank of Chicago since 1991. He also serves as a director of the Great Lakes Higher Education Corporation and the Great Books Foundation. Mr. Pollock is Past President of the International Union for Housing Finance and the Bankers Club of Chicago.

Guy T. Steuart II has been a director and President of Steuart Investment Company, which manages, operates, and leases real and personal property and holds stock in operating subsidiaries engaged in various businesses, since 1960. Mr. Steuart is Trustee Emeritus of Washington and Lee University.

Laura W. van Roijen has been a private investor since 1992.

Executive Officers who are not Directors

Joan M. Sweeney, Chief Operating Officer, has been employed by Allied Capital since 1993. Ms. Sweeney oversees Allied Capital's daily operations. Prior to joining Allied Capital, Ms. Sweeney was employed by Ernst & Young, Coopers & Lybrand, and the SEC Division of Enforcement.

Penni F. Roll, Chief Financial Officer, has been employed by Allied Capital since 1995. Ms. Roll is responsible for Allied Capital's financial operations. Prior to joining Allied Capital, Ms. Roll was employed by KPMG LLP.

Scott S. Binder, Managing Director, has been employed by Allied Capital in the private finance investment group since 1997 and was a consultant to Allied Capital from 1991 until 1997. Prior to joining Allied Capital, Mr. Binder formed and was President of Overland Communications Group. He has also worked in the specialty finance and leasing industry.

Michael J. Grisius, Managing Director, has been employed by Allied Capital since 1992. Prior to joining Allied Capital, Mr. Grisius worked in corporate finance at Chemical Bank and was employed by KPMG LLP.

Robert D. Long, Managing Director, joined Allied Capital in its private finance investment group in 2002. Prior to joining Allied Capital, Mr. Long was Managing Director and Head of Investment Banking at C.E. Unterberg from 2001 to 2002, and Managing Director at E*OFFERING/Wit SoundView from 2000 to 2001. He also held management positions at Bank of America (Montgomery Securities) from 1996 to 2000, and Nomura Securities International, from 1992 to 1996, and prior to that he served as a Managing Director at CS First Boston.

Edward H. Ross, Managing Director, joined Allied Capital in its private finance investment group in 2002. Prior to joining Allied Capital, Mr. Ross co-founded and served as a Managing Director of Leveraged Capital at Wachovia Securities (previously First Union Securities) from 1998 to 2002, a merchant banking arm for the firm. He also held management positions in First Union's Leveraged Finance Group from 1994 to 1998.

John M. Scheurer, Managing Director, has been employed by Allied Capital in the commercial real estate investment group since 1991. Prior to joining Allied Capital, Mr. Scheurer worked with Capital Recovery Advisors, Inc. and First American Bank. He also started his own company, The Scheurer Company, and co-founded Hunter Associates, a leasing and consulting real estate firm in the Washington, DC area.

John D. Shulman, Managing Director, has been employed by Allied Capital in the private finance investment group since 2001. Prior to joining Allied Capital, Mr. Shulman served as the President and CEO of Onyx International, LLC from 1995 to 2001. He currently serves as a director of ChemLink Laboratories LLC and as a member of the investment committees of Taiwan Mezzanine Fund and Greater China Private Equity Fund.

Paul R. Tanen, Managing Director, has been employed by Allied Capital in the private finance investment group since 2000. Prior to joining Allied Capital, Mr. Tanen served as a Managing Director at Ridgfield Partners from 1998 to 2000, and was a Founding Member of the private equity group at Charter Oak Partners from 1992 to 1998.

Thomas H. Westbrook, Managing Director, has been employed by Allied Capital in the private finance investment group since 1991. Prior to joining Allied Capital, Mr. Westbrook worked with the North Carolina Enterprise Fund and was a Lending Officer in NationsBank's corporate lending unit.

G. Cabell Williams, III, Managing Director, has been employed by Allied Capital in the private finance investment group since 1981. Mr. Williams has served in many capacities during his tenure with Allied Capital.

Scott A. Somer, Director of Financial Operations, has been employed by Allied Capital since 1998. Mr. Somer is responsible for managing the accounting and loan servicing activities. Prior to joining Allied Capital, Mr. Somer was employed by KPMG LLP.

Suzanne V. Sparrow, Executive Vice President and Corporate Secretary, has been employed by Allied Capital since 1987. Ms. Sparrow manages our investor relations activities.

Committees of the Board of Directors

Our Board of Directors has established an Executive Committee, an Audit Committee, a Compensation Committee and a Nominating/Corporate Governance Committee.

The Executive Committee has and may exercise those rights, powers and authority that the Board of Directors from time to time grants to it, except where action by the full Board is required by statute, an order of the SEC or our charter or bylaws. The Executive Committee also reviews and approves all investments of \$10 million or more. The Executive Committee met 32 times during 2002. The 2003 Executive Committee currently consists of Messrs. Walton, Firestone, Hebert, Leahy, Long, Steuart, and Williams.

The Audit Committee operates pursuant to a charter approved by the Board of Directors, a copy of which is included as Exhibit A to our proxy statement for the 2003 Annual Meeting of Stockholders. The charter sets forth the responsibilities of the Audit Committee. The Audit Committee's responsibilities include recommending the selection of independent public accountants for Allied Capital, reviewing with such independent public accountants the planning, scope and results of their audit of our financial statements and the fees for services performed, reviewing with the independent public accountants the adequacy of internal control systems, reviewing our annual financial statements and receiving our audit reports and financial statements. The Audit Committee met 13 times during 2002. The 2003 Audit Committee currently consists of Messrs. Browne and Garcia

and Mmes. Grant and van Roijen, all of whom are considered independent under the rules promulgated by the New York Stock Exchange.

The Compensation Committee determines the compensation for our executive officers and the amount of salary and bonus to be included in the compensation package for each of our officers and employees. In addition, the Compensation Committee approves stock option grants for our officers under our stock option plan. The Compensation Committee met six times during 2002. The 2003 Compensation Committee currently consists of Messrs. Leahy, Browne, and Garcia.

The Nominating/Corporate Governance Committee recommends candidates for election as directors to the Board of Directors and makes recommendations to the Board as to our corporate governance policies. The Nominating/Corporate Governance Committee met once during 2002. The 2003 Nominating/Corporate Governance Committee currently consists of Messrs. Hebert, Browne, and Pollock and Ms. van Roijen.

COMPENSATION OF EXECUTIVE OFFICERS AND DIRECTORS

Under SEC rules applicable to business development companies, we are required to set forth certain information regarding the compensation of certain executive officers and directors. The following table sets forth compensation paid during the year ended December 31, 2002 to all of our directors and our three highest paid executive officers (collectively, the Compensated Persons) in each capacity in which each Compensated Person served. Certain of the Compensated Persons served as both officers and directors.

Our directors have been divided into two groups interested directors and independent directors. Interested directors are interested persons as defined in the Investment Company Act of 1940.

Compensation Table

| Name | Aggregate Compensation from the Company(1,2) | Securities Underlying Options/SARs(4) | Pension or Retirement Benefits Accrued as Part of Company Expenses(2) | Directors Fees by the Company(5) |
|--|--|---------------------------------------|---|----------------------------------|
| Interested Directors: | | | | |
| William L. Walton, <i>Chairman and CEO</i> | \$2,617,819 | 612,200 | | \$ |
| George C. Williams, Jr., <i>Director and Chairman Emeritus</i> (3) | 170,000 | 5,000 | | 26,000 |
| Robert E. Long, <i>Director</i> | 31,000 | 5,000 | | 31,000 |
| Independent Directors: | | | | |
| Brooks H. Browne, <i>Director</i> | 44,000 | 5,000 | | 44,000 |
| John D. Firestone, <i>Director</i> | 19,000 | 5,000 | | 19,000 |
| Anthony T. Garcia, <i>Director</i> | 23,000 | 5,000 | | 23,000 |
| Lawrence I. Hebert, <i>Director</i> | 25,000 | 5,000 | | 25,000 |
| John I. Leahy, <i>Director</i> | 37,000 | 5,000 | | 37,000 |
| Guy T. Steuart II, <i>Director</i> | 25,000 | 5,000 | | 25,000 |
| Laura W. van Roijen, <i>Director</i> | 22,000 | 5,000 | | 22,000 |
| Executive Officers: | | | | |
| Joan M. Sweeney, <i>Chief Operating Officer</i> | 1,827,615 | 462,281 | | |
| Thomas H. Westbrook, <i>Managing Director</i> | 1,588,942 | 425,625 | | |

- (1) We paid no perquisites in excess of the lesser of \$50,000 or 10% of the Compensated Person's total salary and bonus for the year.
(2) The following table provides detail as to aggregate compensation paid during 2002 as to our three highest paid executive officers:

| | Salary | Bonus and Awards | Other Benefits |
|---------------|------------|------------------|----------------|
| Mr. Walton | \$ 519,231 | \$ 2,025,000 | \$ 73,588 |
| Ms. Sweeney | 360,000 | 1,425,000 | 42,615 |
| Mr. Westbrook | 256,308 | 1,305,000 | 27,634 |

Included for each executive officer in Bonus and Awards is an annual bonus and retention award. Included for each executive officer in Other Benefits is an employer contribution to the 401(k) Plan, life insurance premiums, disability insurance, and a contribution to the Deferred Compensation Plan. See also Employment Agreements .

- (3) In addition to director's fees, Mr. Williams received \$144,000 in consulting fees.
(4) See Stock Option Awards for terms of options granted in 2002. We do not maintain a restricted stock plan or a long-term incentive plan.
(5) Consists only of directors' fees we paid during 2002. Such fees are also included in the column titled Aggregate Compensation from the Company.

Compensation of Directors

During 2002, each director received a \$10,000 annual retainer in lieu of per meeting fees; directors who serve on the Executive Committee received a \$25,000 annual retainer in lieu of per meeting fees. Members of each committee other than the Executive Committee received \$1,000 for each committee meeting attended during the year. In addition, the chairpersons of the Audit and Compensation Committees each received a \$3,000 annual retainer for their additional services in these capacities. Our Chairman and CEO, William L. Walton, did not receive directors fees.

For 2003, each non-officer director will receive an annual retainer of \$40,000. In addition, committee chairs will receive an annual retainer of \$5,000. For each meeting attended during 2003, Executive Committee members will receive \$1,000 per meeting; Audit Committee members will receive \$2,500 per meeting; and members of the Compensation and Nominating/ Corporate Governance Committees will receive \$1,500 per meeting.

Non-officer directors are eligible for stock option awards under our stock option plan pursuant to an exemptive order from the SEC. The terms of the order, which was granted in September 1999, provided for a one-time grant of 10,000 options to each non-officer director on the date that the order was issued, or on the date that any new director is elected by stockholders to the Board of Directors. Thereafter, each non-officer director will receive 5,000 options each year on the date of the annual meeting of shareholders at the fair market value on the date of grant. See Stock Option Plan.

Stock Option Awards

The following table sets forth the details relating to option grants in 2002 to Compensated Persons under our Stock Option Plan, and the potential realizable value of each grant, as prescribed to be calculated by the SEC. See Stock Option Plan.

Options Grants During 2002

| Name | Number of Securities Underlying Options Granted(1) | Percent of Total Options Granted In 2002(2) | Exercise Price Per Share | Expiration Date | Potential Realizable Value at Assumed Annual Rates Of Stock Appreciation Over 10-Year Term(3) | |
|-------------------------------|--|---|--------------------------|-----------------|---|--------------|
| | | | | | 5% | 10% |
| Interested Directors: | | | | | | |
| William L. Walton | 612,200 | 9.94% | \$21.52 | 12/13/12 | \$8,285,400 | \$20,996,830 |
| George C. Williams, Jr. | 5,000 | 0.08% | 21.52 | 12/13/12 | 67,669 | 171,487 |
| Robert E. Long | 5,000 | 0.08% | 25.97 | 5/7/12 | 81,662 | 206,947 |
| Independent Directors: | | | | | | |
| Brooks H. Browne | 5,000 | 0.08% | 25.97 | 5/7/12 | 81,662 | 206,947 |
| John D. Firestone | 5,000 | 0.08% | 25.97 | 5/7/12 | 81,662 | 206,947 |
| Anthony T. Garcia | 5,000 | 0.08% | 25.97 | 5/7/12 | 81,662 | 206,947 |
| Lawrence I. Hebert | 5,000 | 0.08% | 25.97 | 5/7/12 | 81,662 | 206,947 |
| John I. Leahy | 5,000 | 0.08% | 25.97 | 5/7/12 | 81,662 | 206,947 |
| Guy T. Steuart II | 5,000 | 0.08% | 25.97 | 5/7/12 | 81,662 | 206,947 |
| Laura W. van Roijen | 5,000 | 0.08% | 25.97 | 5/7/12 | 81,662 | 206,947 |
| Executive Officers: | | | | | | |
| Joan M. Sweeney | 462,281 | 7.50% | 21.52 | 12/13/12 | 6,256,424 | 15,855,008 |
| Thomas H. Westbrook | 425,625 | 6.91% | 21.52 | 12/13/12 | 5,760,329 | 14,597,804 |

- (1) Options granted to officers in 2002 generally vest in three equal installments beginning on June 30, 2003, with full vesting occurring on June 30, 2005, or upon a change of control of Allied Capital. Options granted to non-officer directors vest immediately.
- (2) In 2002, we granted options to purchase a total of 6,161,763 shares.
- (3) Potential realizable value is calculated on 2002 options granted, and is net of the option exercise price but before any tax liabilities that may be incurred. These amounts represent certain assumed rates of appreciation, as mandated by the Commission. Actual gains, if any, or stock option exercises are dependent on the future performance of the shares, overall market conditions, and the continued employment by

us of the option holder. The potential realizable value will not necessarily be realized.

Edgar Filing: ALLIED CAPITAL CORP - Form N-2/A

The following table sets forth the details of option exercises by Compensated Persons during 2002 and the values of those unexercised options at December 31, 2002.

Option Exercises and Year-End Option Values

| Name | Shares Acquired on Exercise | Value Realized(1) | Number of Securities Underlying Unexercised Options as of 12/31/02 | | Value of Unexercised In-the-Money Options as of 12/31/02(2) | |
|-------------------------------|-----------------------------------|----------------------|--|---------------|---|---------------|
| | | | Exercisable | Unexercisable | Exercisable | Unexercisable |
| Interested Directors: | | | | | | |
| William L. Walton | 16,782 | \$ 154,478 | 1,251,189 | 1,188,912 | \$ 3,256,557 | \$ 1,725,198 |
| George C. Williams, Jr. | | | 156,396 | 19,999 | 98,896 | 11,339 |
| Robert E. Long | | | 25,000 | | 21,650 | |
| Independent Directors: | | | | | | |
| Brooks H. Browne | | | 25,000 | | 21,650 | |
| John D. Firestone | | | 25,000 | | 21,650 | |
| Anthony T. Garcia | | | 25,000 | | 21,650 | |
| Lawrence I. Hebert | | | 25,000 | | 21,650 | |
| John I. Leahy | | | 25,000 | | 21,650 | |
| Guy T. Steuart II | | | 25,000 | | 21,650 | |
| Laura W. van Roijen | | | 25,000 | | 21,650 | |
| Executive Officers: | | | | | | |
| Joan M. Sweeney | 20,569 | 157,047 | 583,193 | 745,027 | 1,428,798 | 802,588 |
| Thomas H. Westbrook | | | 295,677 | 599,234 | 1,067,700 | 670,945 |

(1) Value realized is calculated as the closing market price on the date of exercise, net of option exercise price, but before any tax liabilities or transaction costs. This is the deemed market value, which may actually be realized only if the shares are sold at that price.

(2) Value of unexercised options is calculated as the closing market price on December 31, 2002 (\$21.83), net of the option exercise price, but before any tax liabilities or transaction costs. In-the-Money Options are options with an exercise price that is less than the market price as of December 31, 2002.

Employment Agreements

We have entered into employment agreements with six of our senior executives, including William L. Walton, our Chairman and CEO, Joan M. Sweeney, Chief Operating Officer, and Thomas H. Westbrook, Managing Director. Each of the agreements provides for a three-year term expiring on June 15, 2003, with annual renewals thereafter, and specifies each executive's compensation during the term of the agreement, in accordance with the achievement of certain performance standards.

The Board of Directors has the right to increase the base salary during the term of the employment agreement. In addition, each employment agreement states that the Board of Directors may provide, at their sole discretion, an annual cash bonus. This bonus is to be determined with reference to each executive's performance in accordance with performance criteria to be determined by the board in its sole discretion. Under each agreement, each executive also is entitled to participate in our Stock Option Plan, and to receive all other awards and benefits previously granted to each executive including life insurance premiums.

In addition, each employment agreement provides for a long-term cash retention award for the performance period from 2001 through 2003. The long-term cash retention award vests and is payable in six installments on June 30th and December 31st of each year from 2001 through 2003. For 2003, Mr. Walton will be eligible for a long-term cash retention award of \$1,125,000; Ms. Sweeney will be eligible for \$850,000; and Mr. Westbrook will be eligible for \$1,105,000.

Employment will terminate if the term of the agreement expires without written agreement of both parties. The executive has the right to voluntarily terminate employment at any time with 30 days' notice, and in such case, the employee will not receive any severance pay. Among other things, the employment agreements prohibit the solicitation of our employees in the event of an executive's departure for a period of two years.

If employment is terminated with cause, the employee will not receive any severance pay. If employment is terminated without cause during the term of the agreement, the executive shall be entitled to severance pay for a period not to exceed 36 months for Mr. Walton; 30 months for Ms. Sweeney; and 24 months for Mr. Westbrook. Severance pay shall include the continuation of the employee's base salary, and the greater of (a) the average of the annual bonuses paid during the preceding three years, or (b) the amount of the last annual bonus paid to the employee. In addition, the executive shall be entitled to receive any payments under the long-term cash retention award that would have vested and been payable during the severance period. However, stock options would cease to vest during the severance period.

If, within 12 months after a change of control (as defined in the employment agreements), termination of employment occurs either by the executive officer or us, the executive officer shall not be entitled to severance pay, but will instead be entitled to lump sum compensation as well as certain other benefits. For Mr. Walton, this lump sum is equal to three years of base salary and bonus (as calculated for severance pay), plus an amount equal to \$5,565,000. For Ms. Sweeney, this lump sum is equal to two and a half years of base salary and bonus, plus an amount equal to \$2,600,000. For Mr. Westbrook, this lump sum is equal to two years of base salary and bonus, plus an amount equal to \$2,350,000. Under the terms of these agreements, we would also provide compensation to offset any applicable excise tax penalties imposed on the executive under section 4999 of the Internal Revenue Code.

Certain other executive officers have employment agreements that carry terms substantially similar to those of Mr. Westbrook's agreement, as described herein.

Compensation Plans

Stock Option Plan

Our Stock Option Plan is intended to encourage stock ownership in the Company by officers and directors, thus giving them a proprietary interest in our performance. The Stock Option Plan was most recently approved by stockholders on May 7, 2002.

The Compensation Committee's principal objective in awarding stock options to our eligible officers is to align each optionee's interests with our success and the financial interests of our stockholders by linking a portion of such optionee's compensation with the performance of our stock and the value delivered to stockholders.

Stock options are granted under the Stock Option Plan at a price not less than the prevailing market value and will have value only if our stock price increases. The Compensation Committee determines the amount and features of the stock options, if any, to be awarded to optionees. The Compensation Committee evaluates a number of criteria, including the past service of each such optionee to Allied Capital, the present and potential contributions of such optionee to the success of Allied Capital and such other factors as the Compensation Committee shall deem relevant in connection with accomplishing the purposes of the Stock Option Plan, including the recipient's current stock holdings, years of service, position with Allied Capital and other factors. The

Compensation Committee does not apply a formula assigning specific weights to any of these factors when making its determination. The Compensation Committee awards stock options on a subjective basis and such awards depend in each case on the performance of the officer under consideration, and in the case of new hires, their potential performance.

On September 8, 1999, we received approval from the Commission to grant options under the Stock Option Plan to non-officer directors. On that date, each incumbent non-officer director received options to purchase 10,000 shares, and pursuant to the Commission order, each will receive options to purchase 5,000 shares each year thereafter on the date of the annual meeting of stockholders. New directors will receive options to purchase 10,000 shares upon election by stockholders to the Board of Directors, and options to purchase 5,000 shares each year thereafter on the date of the annual meeting.

The Stock Option Plan is designed to satisfy the conditions of Section 422 of the Code so that options granted under the Stock Option Plan may qualify as incentive stock options. To qualify as incentive stock options, options may not become exercisable for the first time in any year if the number of incentive options first exercisable in that year multiplied by the exercise price exceeds \$100,000.

401(k) Plan

We maintain a 401(k) plan (the 401(k) Plan). All full-time employees who are at least 21 years of age have the opportunity to contribute pre-tax salary deferrals into the 401(k) Plan up to \$12,000 annually for the 2003 plan year, and to direct the investment of these contributions. Plan participants who reach the age of 50 during the 2003 plan year will be eligible to defer an additional \$2,000 during 2003. The 401(k) Plan allows eligible participants to invest in shares of our common stock among other investment options. In addition, we expect to contribute to each participant, up to 5% of each participant's eligible compensation for the year, up to a maximum compensation of \$200,000, to each participant's plan account on the participant's behalf, which fully vests at the time of the contribution. The contribution with respect to compensation in excess of \$200,000 is made to the Deferred Compensation Plan. On February 28, 2003, the 401(k) Plan held less than 1% of our outstanding shares.

Deferred Compensation Plan

We maintain a deferred compensation plan (the Deferred Compensation Plan). The Deferred Compensation Plan is an unfunded plan, as defined by the Internal Revenue Code of 1986, as amended (the Code), that provides for the deferral of compensation by our employees and consultants. Our employees or consultants are eligible to participate in the plan at such time and for such period as designated by the Board of Directors. The Deferred Compensation Plan is administered through a trust, and we fund this plan through cash contributions.

CONTROL PERSONS AND PRINCIPAL HOLDERS OF SECURITIES

As of June 4, 2003, there were no persons that owned 25% or more of our outstanding voting securities, and no person would be deemed to control us, as such term is defined in the 1940 Act.

The following table sets forth, as of June 4, 2003, information with respect to the beneficial ownership of our common stock by the shareholders who owned more than 5% of our outstanding shares of common stock, each current director, the chief executive officer, our executive officers and our executive officers and directors as a group. Unless otherwise indicated, we believe that each beneficial owner set forth in the table has sole voting and investment power.

Our directors have been divided into two groups interested directors and independent directors. Interested directors are interested persons as defined in the Investment Company Act of 1940.

| Name of Beneficial Owner | Number of Shares Owned Beneficially(8) | Percentage of Class(1) | Dollar Range of Equity Securities Beneficially Owned by Directors(9) |
|--|--|---------------------------|---|
| Capital Research and Management Company 333 South Hope Street, 55th Floor Los Angeles, CA 90071-1447 | 7,384,000(11) | 6.53% | |
| Interested Directors: | | | |
| William L. Walton | 2,513,094(2,4,7) | 2.19% | over \$ 100,000 |
| George C. Williams, Jr. | 445,115(2,7) | * | over \$ 100,000 |
| Robert E. Long | 42,111(3)(2) | * | over \$ 100,000 |
| Independent Directors: | | | |
| Brooks H. Browne | 73,713(3) | * | over \$ 100,000 |
| John D. Firestone | 61,756(3,7) | * | over \$ 100,000 |
| Anthony T. Garcia | 88,512(3) | * | over \$ 100,000 |
| Ann Torre Grant | 10,000(3) | | none |
| Lawrence I. Hebert | 51,800 | * | over \$ 100,000 |
| John I. Leahy | 47,318 | * | over \$ 100,000 |
| Alex J. Pollock | 13,200(7)(3) | * | \$ 10,001 \$50,000 |
| Guy T. Steuart II | 354,244 | * | over \$ 100,000 |
| Laura W. van Roijen | 60,376(3,7) | * | over \$ 100,000 |
| Executive Officers: | | | |
| Scott S. Binder | 585,484(2,7) | * | |
| Michael J. Grisius | 382,778(2,7) | * | |
| Robert D. Long | 235,786(2,7,10) | * | |
| Penni F. Roll | 346,019(2) | * | |
| Edward H. Ross | 101,946 | * | |
| John M. Scheurer | 989,368(2) | * | |
| John D. Shulman | 305,119(2) | * | |
| Scott A. Somer | 40,979(2,7) | * | |
| Suzanne V. Sparrow | 182,317(2) | * | |
| Joan M. Sweeney | 1,196,452(2) | 1.05% | |
| Paul R. Tanen | 271,225(2) | * | |

Edgar Filing: ALLIED CAPITAL CORP - Form N-2/A

| Name of Beneficial Owner | Number of Shares Owned Beneficially(8) | Percentage of Class(1) |
|--|--|---------------------------|
| Thomas H. Westbrook | 720,916(2,7) | * |
| G. Cabell Williams III | 1,132,430(2,4) | 1.00% |
| All directors and executive officers as a group (25 in number) | 9,907,080(6) | 8.26% |

* Less than 1%

- (1) Based on a total of 113,162,545 shares of our common stock issued and outstanding on June 4, 2003, and 6,845,878 shares of our common stock issuable upon the exercise of immediately exercisable stock options held by individual executive officers and non-officer directors.
- (2) Share ownership for the following directors and executive officers includes:

| | Owned Directly | Options Exercisable Within 60 Days of June 4, 2003 | Allocated to 401(k) Plan |
|------------------------------|-------------------|---|-----------------------------|
| Interested Directors: | | | |
| William L. Walton | 444,797 | 1,814,435 | 3,724 |
| George C. Williams, Jr. | 287,052 | 158,063 | |
| Robert E. Long | 12,111 | 30,000 | |
| Executive Officers: | | | |
| Scott S. Binder | 77,709 | 506,191 | 1,584 |
| Michael J. Grisius | 55,346 | 312,448 | 14,984 |
| Robert D. Long | 19,000 | 215,786 | 1,000 |
| Penni F. Roll | 83,096 | 255,108 | 7,815 |
| John M. Scheurer | 279,936 | 678,423 | 31,009 |
| John D. Shulman | 4,799 | 300,320 | |
| Scott A. Somer | 742 | 39,650 | 587 |
| Suzanne V. Sparrow | 78,881 | 82,236 | 21,200 |
| Joan M. Sweeney | 298,966 | 884,549 | 12,937 |
| Paul R. Tanen | 5,161 | 266,064 | |
| Thomas H. Westbrook | 190,541 | 530,375 | |
| G. Cabell Williams III | 438,284 | 440,284 | 92,309 |

- (3) Beneficial ownership for these non-officer directors includes exercisable options to purchase 10,000 shares for Mr. Pollack and Ms. Grant and 30,000 shares for all others.
- (4) Includes 253,862 shares held by the 401(k) Plan, of which Messrs. Walton and Williams III are co-trustees. Messrs. Walton and Williams III disclaim beneficial ownership of such shares.
- (5) Includes 276,691 shares held by a corporation for which Mr. Steuart II serves as an executive officer.
- (6) Includes a total of 6,845,878 shares underlying stock options exercisable within 60 days of June 4, 2003, which are assumed to be outstanding for the purpose of calculating the group's percentage ownership, and 253,862 shares held by the 401(k) Plan.
- (7) Includes certain shares held in IRA or Keogh accounts: Walton 12,015 shares; Williams Jr. 20,798 shares; Firestone 2,745 shares; R.D. Long 15,000 shares; Pollock 1,000 shares; van Roijen 4,920 shares; Binder 273 shares; Grisius 885 shares; Somer 257 shares; Westbrook 16,365 shares.
- (8) Beneficial ownership has been determined in accordance with Rule 13d-3 of the Securities Exchange Act of 1934.
- (9) Beneficial ownership has been determined in accordance with Rule 16-1(a)(2) of the Securities Exchange Act of 1934.
- (10) Includes 4,000 shares held by a trust for the benefit of Mr. Long's children.
- (11) Information regarding share ownership was obtained from the Schedule 13G that Capital Research and Management Company filed with the SEC on May 15, 2003.

CERTAIN RELATIONSHIPS AND RELATED PARTY TRANSACTIONS

The following table sets forth certain information, as of February 28, 2003, regarding indebtedness to us in excess of \$60,000 of any person serving as a director or executive officer of the Company at any time since January 1, 2002. All of such indebtedness results from loans we made to enable the exercise of stock options. The loans are required to be fully collateralized as full recourse against the borrower and have varying terms not exceeding ten years. The interest rates charged generally reflect the applicable federal rate on the date of the loan. As of December 31, 2002, the total loans outstanding to such directors and executive officers of the Company was \$18,251,087 or 0.7% of the Company's total assets at December 31, 2002.

As a business development company under the Investment Company Act of 1940, we are entitled to provide loans to employees in connection with the exercise of options. However, as a result of provisions of the Sarbanes-Oxley Act of 2002, we are prohibited from making new loans to, or materially modifying existing loans with, our executive officers in the future.

| Name and Position with Company | Highest Amount Outstanding During 2002 | Range of Interest Rates | | Amount Outstanding at February 28, 2003 |
|---|--|----------------------------|-------|---|
| Interested Directors⁽¹⁾: | | | | |
| William L. Walton, <i>Chairman and CEO</i> | \$ 2,997,228 | 4.45% | 6.24% | \$ 2,997,228 |
| George C. Williams, Jr., <i>Director, Chairman Emeritus</i> | 1,850,386 | 5.89% | 6.24% | 1,850,386 |
| Executive Officers: | | | | |
| Joan M. Sweeney, <i>Chief Operating Officer</i> | 2,231,157 | 4.45% | 6.63% | 2,231,157 |
| Penni F. Roll, <i>Chief Financial Officer</i> | 1,273,924 | 4.45% | 6.24% | 1,273,924 |
| Scott S. Binder, <i>Managing Director</i> | 979,492 | 4.66% | 5.89% | 703,869 |
| Michael J. Grisius, <i>Managing Director</i> | 277,837 | 3.91% | 4.68% | 266,988 |
| John M. Scheurer, <i>Managing Director</i> | 2,537,259 | 4.73% | 6.63% | 2,345,719 |
| John D. Shulman, <i>Managing Director</i> | 99,991 | 2.85% | 2.85% | 99,991 |
| Paul R. Tanen, <i>Managing Director</i> | 99,994 | 3.91% | 3.91% | 99,994 |
| Thomas H. Westbrook, <i>Managing Director</i> | 2,405,138 | 4.98% | 6.24% | 1,516,681 |
| G. Cabell Williams III, <i>Managing Director</i> | 3,887,054 | 4.77% | 6.24% | 3,543,410 |
| Suzanne V. Sparrow, <i>Executive Vice President and Secretary</i> | 923,112 | 4.45% | 6.18% | 753,506 |

(1) Interested directors are interested persons as defined by the Investment Company Act of 1940.

TAX STATUS

The following discussion is a general summary of the material United States federal income tax considerations applicable to us and to an investment in our common stock. This summary does not purport to be a complete description of the income tax considerations applicable to such an investment. The discussion is based upon the Internal Revenue Code, Treasury Regulations, and administrative and judicial interpretations, each as of the date of this prospectus and all of which are subject to change. You should consult your own tax advisor with respect to tax considerations that pertain to your purchase of our common stock.

This summary is intended to apply to investments in our common stock and assumes that investors hold our common stock as capital assets. This summary does not discuss all aspects of federal income taxation relevant to holders of our common stock in light of particular circumstances, or to certain types of holders subject to special treatment under federal income tax laws, including dealers in securities, pension plans and trusts and financial institutions. This summary does not discuss any aspects of U.S. estate and gift tax or foreign, state or local tax. It does not discuss the special treatment under federal income tax laws that could result if we invested in tax-exempt securities or certain other investment assets.

Except as specifically indicated herein, this summary is intended to apply to U.S. Stockholders (as defined below) and does not purport to discuss all U.S. federal income tax consequences to persons who are not U.S. Stockholders (Non-U.S. Stockholders) from an investment in the common stock. (A U.S. Stockholder is a stockholder who is (i) a citizen or resident of the United States, (ii) a corporation or partnership created in or organized under the laws of the United States or any political subdivision thereof, (iii) an estate, the income of which is subject to United States federal income taxation regardless of its source, or (iv) a trust subject to the supervision of a court within the United States and the control of a United States person.) Non-U.S. Stockholders should consult their own tax advisors to discuss the consequences of an investment in our common stock.

Taxation as a Regulated Investment Company

We intend to be treated for tax purposes as a regulated investment company under Subchapter M of the Internal Revenue Code. If we (i) qualify as a regulated investment company and (ii) distribute to stockholders in a timely manner at least 90% of our investment company taxable income, as defined in the Internal Revenue Code (i.e., net ordinary investment income, including accrued original issue discount, and net short-term capital gain in excess of net long-term capital loss) (the 90% Distribution Requirement) each year, we generally will not be subject to federal income tax on the portion of our investment company taxable income and net capital gain (i.e., net long-term capital gain in excess of net short-term capital loss) we distribute (or treat as deemed distributed) to stockholders. (We will, however, be subject to such tax to the extent that, prior to February 2, 2013, BLX sells property held by BLX, Inc. on the date of its corporate reorganization, but only, to the extent (i) such property had a built-in gain (that is, value in excess of tax basis) on such date and (ii) such built-in gain is recognized on such sale.) In addition, if we distribute in a timely manner an amount at least equal to the sum of (i) 98% of our ordinary income for each calendar year, (ii) 98% of our capital gain net income for the one-year period ending December 31 of that calendar year, and (iii) any income not distributed in prior years, we will not be subject to the 4% nondeductible

federal excise tax on certain undistributed income of regulated investment companies (the Excise Tax Avoidance Requirements). We generally will endeavor to distribute (or treat as deemed distributed) to stockholders all of our investment company taxable income and our net capital gains, if any, for each taxable year so that we will not incur federal income or excise taxes on our earnings. We will be subject to federal income tax at the regular corporate rate for any amounts of investment company taxable income or net capital gain not distributed (or deemed distributed) to our stockholders.

In order to qualify as a regulated investment company for federal income tax purposes, we must, among other things: (a) continue to qualify as a business development company under the 1940 Act; (b) derive in each taxable year at least 90% of our gross income from dividends, interest, payments with respect to securities loans, gains from the sale of stock or other securities, or other income derived with respect to our business of investing in such stock or securities (the 90% Income Test); and (c) diversify our holdings so that at the end of each quarter of the taxable year (i) at least 50% of the value of our assets consists of cash, cash items, U.S. government securities, securities of other regulated investment companies, and other securities if such other securities of any one issuer do not represent more than 5% of our assets or more than 10% of the outstanding voting securities of the issuer, and (ii) no more than 25% of the value of our assets is invested in the securities (other than U.S. government securities or securities of other regulated investment companies) of any one issuer or of two or more issuers that are controlled (as determined under applicable Internal Revenue Code rules) by us and are engaged in the same or similar or related trades or businesses (the Diversification Tests). The failure of one or more of our subsidiaries to continue to qualify as regulated investment companies could adversely affect our ability to satisfy the Diversification Tests.

If we acquire or are deemed to have acquired debt obligations that were issued originally at a discount or that otherwise are treated under applicable tax rules as having original issue discount, we must include in income each year a portion of the original issue discount that accrues over the life of the obligation regardless of whether cash representing such income is received by us in the same taxable year. Any amount accrued as original issue discount will be included in our investment company taxable income for the year of accrual and may have to be distributed to the stockholders in order to satisfy the 90% Distribution Requirement or the Excise Tax Avoidance Requirements even though we have not received any cash representing such income.

Although we do not currently intend to do so, if we were to invest in certain options, futures, or forward contracts, we may be required to report income from such investments on a mark-to-market basis, which could result in us recognizing unrealized gains and losses for federal income tax purposes even though we may not realize such gains and losses when we ultimately dispose of such investments. We could also be required to treat such gains and losses as 60% long-term capital gain or loss and 40% short-term capital gain or loss regardless of our holding period for the investments. In addition, if we were to engage in certain hedging transactions, including hedging transactions in options, future contracts, and straddles, or other similar transactions, we could be subject to special tax rules (including constructive sale, mark-to-market, straddle, wash sale, and short sale rules), the effect of which may be to accelerate our income, defer our losses, cause adjustments in the holding periods of our securities, convert long-term capital gains into short-term capital gains or convert short-term capital losses into long-term capital losses. These rules could affect our investment company taxable income or net capital gain for a taxable year and thus affect the amounts that we would be required to distribute to our stockholders

pursuant to the 90% Distribution Requirement and the Excise Tax Avoidance Requirements for such year.

Although we do not presently expect to do so, we are authorized to borrow funds and to sell assets in order to satisfy distribution requirements. However, under the 1940 Act, we are not permitted to make distributions to stockholders while our debt obligations and other senior securities are outstanding unless certain asset coverage tests are met. Moreover, our ability to dispose of assets to meet our distribution requirements may be limited by other requirements relating to our status as a regulated investment company, including the Diversification Tests. If we dispose of assets in order to meet the 90% Distribution Requirement or the Excise Tax Avoidance Requirements, we may make such dispositions at times that, from an investment standpoint, are not advantageous.

If we fail to satisfy the 90% Distribution Requirement or otherwise fail to qualify as a regulated investment company in any taxable year, we will be subject to tax in that year on all of our taxable income, regardless of whether we make any distributions to our stockholders. In that case, all of our distributions to our stockholders will be characterized as ordinary income (to the extent of our current and accumulated earnings and profits). In contrast, as is explained below, if we qualify as a regulated investment company, a portion of our distributions or deemed distributions may be characterized as long-term capital gain in the hands of stockholders.

The remainder of this summary assumes that we qualify as a regulated investment company and satisfy the 90% Distribution Requirement.

Taxation of Stockholders

Our distributions generally are taxable to stockholders as ordinary income or capital gains. Our distributions of investment company taxable income will be taxable as ordinary income to stockholders to the extent of our current or accumulated earnings and profits, whether paid in cash or reinvested in additional common stock (including any dividends reinvested through our dividend reinvestment plan). Under new tax legislation, a portion of such distributions of investment company taxable income may constitute qualified dividends paid by us. Individual shareholders will incur a lower rate of tax on such qualified dividends than the rate of tax imposed on the remainder of our distributions of investment company taxable income. Our distributions of net capital gains properly designated by us as capital gain dividends will be taxable to each stockholder as long-term capital gains regardless of the stockholder's holding period for his or her common stock and regardless of whether paid in cash or reinvested in additional common stock (including any dividends reinvested through our dividend reinvestment plan). Distributions in excess of the Company's earnings and profits first will reduce a stockholder's adjusted tax basis in such stockholder's common stock and, after the adjusted basis is reduced to zero, will constitute capital gains to such stockholder.

At our option, we may elect to retain some or all of our net capital gains for a tax year, but designate the retained amount as a deemed distribution. In that case, among other consequences, we will pay tax on the retained amount for the benefit of our stockholders, the stockholders will be required to report their share of the deemed distribution on their tax returns as if it had been distributed to them, and the stockholders will report a credit for the tax paid thereon by us. The amount of the deemed distribution net of such tax will be added to the stockholder's cost basis for his or her common stock. Since we expect to pay tax on any retained net capital gains at our regular corporate capital gain tax rate, and since that rate is in excess of the maximum rate currently

payable by individuals on long-term capital gains, the amount of tax that individual stockholders will be treated as having paid and for which they will receive a credit will exceed the amount of tax that such stockholders would be required to pay on the retained net capital gains. Such excess generally will be available to offset other tax liabilities of the stockholders. A stockholder that does not have a sufficient amount of other tax liabilities or that is not subject to U.S. federal income tax should be able to file a return on the appropriate form or a claim for refund that allows such stockholder to recover the taxes paid on his or her behalf. In the event we select this option, we must provide written notice to the stockholders prior to the expiration of 60 days after the close of the relevant tax year.

Any dividend declared by us in October, November, or December of any calendar year, payable to stockholders of record on a specified date in such a month and actually paid during January of the following year, will be treated as if it had been received by the stockholders on December 31 of the year in which the dividend was declared.

You should consider the tax implications of buying common stock just prior to a distribution. Even if the price of the common stock includes the amount of the forthcoming distribution, you may be taxed upon receipt of the distribution and will not be entitled to offset the distribution against the tax basis in your common stock.

You may recognize taxable gain or loss if you sell or exchange your common stock. The amount of the gain or loss will be measured by the difference between your adjusted tax basis in your common stock and the amount of the proceeds you receive in exchange for such stock. Any gain or loss arising from (or, in the case of distributions in excess of earnings and profits, treated as arising from) the sale or exchange of common stock generally will be a capital gain or loss. This capital gain or loss normally will be treated as a long-term capital gain or loss if you have held your common stock for more than one year; otherwise, it will be classified as short-term capital gain or loss. However, any capital loss arising from the sale or exchange of common stock held for six months or less generally will be treated as a long-term capital loss to the extent of the amount of capital gain dividends received (or treated as deemed distributed) with respect to such stock and, for this purpose, the special rules of Section 852(b)(4)(C) of the Internal Revenue Code generally apply in determining the holding period of such stock. In addition, all or a portion of any loss realized upon a taxable disposition of common stock will be disallowed if other shares of our common stock are purchased (under our dividend reinvestment plan or otherwise) within 30 days before or after the disposition.

In general, non-corporate stockholders currently are subject to a maximum federal income tax rate on their net long-term capital gain (the excess of net long-term capital gain over net short-term capital loss) for a taxable year (including a long-term capital gain derived from an investment in our common stock) that is lower than the maximum rate for other income (excluding other income that constitutes a qualified dividend). Corporate taxpayers currently are subject to federal income tax on net capital gains at a maximum rate equal to the maximum rate applied to ordinary income. Non-corporate stockholders with net capital losses for a year (i.e., capital losses in excess of capital gains) generally may deduct up to \$3,000 of such losses against their ordinary income each year; any net capital losses of a non-corporate stockholder in excess of \$3,000 generally may be carried forward and used in subsequent years as provided in Section 1212(b) of the Internal Revenue Code. Corporate stockholders generally may not deduct any net capital losses for a year, but may carryback such losses for three years or carry forward such losses for five years.

We will send to each of our stockholders, as promptly as possible after the end of each calendar year, a notice detailing, on a per share and per distribution basis, the amounts includible in such stockholder's taxable income for such year as ordinary income (including the amount of any qualified dividends) and as long-term capital gain. In addition, the federal tax status of each year's distributions generally will be reported to the IRS. Distributions may also be subject to additional state, local, and foreign taxes depending on a stockholder's particular situation. Our ordinary income dividends to corporate stockholders may, if certain conditions are met, qualify for the dividends received deduction to the extent that we have received qualifying dividend income during the taxable year; capital gain dividends distributed by us are not eligible for the dividends received deduction.

A Non-U.S. Stockholder may be subject to withholding of U.S. federal tax at a 30% rate (or lower applicable treaty rate) on distributions (including certain redemptions of common stock) from us. Accordingly, investment in us is likely to be appropriate for a Non-U.S. Stockholder only if such person can utilize a foreign tax credit or corresponding tax benefit in respect of such withholding tax. Non-U.S. Stockholders should consult their own tax advisors with respect to the U.S. federal income and withholding tax, and state, local, and foreign tax, consequences of an investment in our common stock.

We may be required to withhold U.S. federal income tax (backup withholding) from all taxable distributions payable to (i) any stockholder who fails to furnish us with its correct taxpayer identification number or a certificate that the stockholder is exempt from backup withholding, and (ii) any stockholder with respect to whom the IRS notifies us that the stockholder has failed to properly report certain interest and dividend income to the IRS and to respond to notices to that effect. We may be required to report annually to the IRS and to each Non-U.S. Stockholder the amount of dividends paid to such stockholder and the amount, if any, of tax withheld pursuant to the backup withholding rules with respect to such dividends. This information may also be made available to the tax authorities in the Non-U.S. Stockholder's country of residence. Backup withholding is not an additional tax. Any amounts withheld under the backup withholding rules from payments made to a stockholder may be refunded or credited against such stockholder's United States federal income tax liability, if any, provided that the required information is furnished to the IRS.

You should consult your own tax advisor with respect to the particular tax consequences to you of an investment in us, including the possible effect of any pending legislation or proposed regulation.

CERTAIN GOVERNMENT REGULATIONS

We operate in a highly regulated environment. The following discussion generally summarizes certain government regulations.

Business Development Company. A business development company is defined and regulated by the 1940 Act. A business development company must be organized in the United States for the purpose of investing in or lending to primarily private companies and making managerial assistance available to them. A business development company may use capital provided by public shareholders and from other sources to invest in long-term, private investments in businesses. A business development company provides shareholders the ability to retain the liquidity of a publicly traded stock, while sharing in the possible benefits, if any, of investing in primarily privately owned companies.

Edgar Filing: ALLIED CAPITAL CORP - Form N-2/A

As a business development company, we may not acquire any asset other than qualifying assets unless, at the time we make the acquisition, the value of our qualifying assets represent at least 70% of the value of our total assets. The principal categories of qualifying assets relevant to our business are:

Securities purchased in transactions not involving any public offering, the issuer of which is an eligible portfolio company;

Securities received in exchange for or distributed with respect to securities described in the bullet above or pursuant to the exercise of options, warrants or rights relating to such securities; and

Cash, cash items, government securities or high quality debt securities (within the meaning of the 1940 Act), maturing in one year or less from the time of investment.

An eligible portfolio company is generally a domestic company that is not an investment company (other than a small business investment company wholly owned by a business development company, such as our investment in Allied Investment Corporation) and that:

does not have a class of securities registered on an exchange or a class of securities with respect to which a broker may extend margin credit;

is actively controlled by the business development company and has an affiliate of a business development company on its board of directors; or

meets such other criteria as may be established by the SEC.

Control under the 1940 Act is presumed to exist where a business development company beneficially owns more than 25% of the outstanding voting securities of the portfolio company.

To include certain securities described above as qualifying assets for the purpose of the 70% test, a business development company must make available to the issuer of those securities significant managerial assistance such as providing significant guidance and counsel concerning the management, operations, or business objectives and policies of a portfolio company or making loans to a portfolio company. We offer to provide significant managerial assistance to each of our portfolio companies.

As a business development company, we are entitled to issue senior securities in the form of stock or senior securities representing indebtedness, including debt securities and preferred stock, as long as each class of senior security has an asset coverage of at least 200% immediately after each such issuance. This limitation is not applicable to borrowings by our small business investment company subsidiary, and therefore any borrowings by this subsidiary are not included in this asset coverage test. See Risk Factors.

We may also be prohibited under the 1940 Act from knowingly participating in certain transactions with our affiliates without the prior approval of our board of directors who are not interested persons and, in some cases, prior approval by the SEC. We have been granted an exemptive order by the SEC permitting us to engage in certain transactions that would be permitted if we and our subsidiaries were one company and permitting certain transactions among our subsidiaries, subject to certain conditions and limitations.

We are periodically examined by the SEC for compliance with the 1940 Act.

As with other companies regulated by the 1940 Act, a business development company must adhere to certain substantive regulatory requirements. A majority of our directors must be persons who are not interested persons, as that term is defined in the 1940 Act. Additionally, we are required to provide and maintain a bond issued by a reputable fidelity insurance company to protect us against larceny and embezzlement. Furthermore, as a business development company, we are prohibited from protecting any director or officer against any liability to the Company or our shareholders arising from willful malfeasance, bad faith, gross negligence or reckless disregard of the duties involved in the conduct of such person's office.

We maintain a code of ethics that establishes procedures for personal investment and restricts certain transactions by our personnel. Our code of ethics generally does not permit investment by our employees in securities that may be purchased or held by us. The code of ethics is filed as an exhibit to our registration statement of which this prospectus is a part. You may read and copy the code of ethics at the SEC's Public Reference Room in Washington, D.C. You may obtain information on operations of the Public Reference Room by calling the SEC at (202) 942-8090. In addition, the code of ethics is available on the EDGAR Database on the SEC Internet site at <http://www.sec.gov>. You may obtain copies of the code of ethics, after paying a duplicating fee, by electronic request at the following email address: publicinfo@sec.gov, or by writing to the SEC's Public Reference Section, 450 5th Street, NW, Washington, D.C. 20549.

As a business development company under the 1940 Act, we are entitled to provide loans to our employees in connection with the exercise of options. However, as a result of provisions of the Sarbanes-Oxley Act of 2002, we are prohibited from making new loans to, or materially modifying existing loans with, our executive officers in the future.

We may not change the nature of our business so as to cease to be, or withdraw our election as, a business development company unless authorized by vote of a majority of the outstanding voting securities, as defined in the 1940 Act, of our shares. A majority of the outstanding voting securities of a company is defined under the 1940 Act as the lesser of: (i) 67% or more of such company's shares present at a meeting if more than 50% of the outstanding shares of such company are present and represented by proxy or (ii) more than 50% of the outstanding shares of such company. Since we made our business development company election, we have not made any substantial change in the nature of our business.

Small Business Administration Regulations. Allied Investment Corporation, a wholly owned subsidiary of Allied Capital, is licensed by the Small Business Administration as a small business investment company under Section 301(c) of the Small Business Investment Act of 1958, and has elected to be regulated as a business development company.

Small business investment companies are authorized to stimulate the flow of private equity capital to eligible small businesses. Under present Small Business Administration regulations, eligible small businesses include businesses that have a net worth not exceeding \$18 million and have average annual fully taxed net income not exceeding \$6 million for the two most recent fiscal years. In addition, a small business investment company must devote 20% of its investment activity to smaller concerns as defined by the Small Business Administration. A smaller concern is one that has a net worth not exceeding \$6 million and has average annual fully taxed net income not exceeding \$2 million for the two most recent fiscal years. Small Business Administration regulations also provide alternative size standard criteria to determine eligibility, which depend on the

industry in which the business is engaged and are based on such factors as the number of employees and gross sales. According to Small Business Administration regulations, small business investment companies may make long-term loans to small businesses, invest in the equity securities of such businesses, and provide them with consulting and advisory services. Allied Investment provides long-term loans to qualifying small businesses; equity investments and consulting and advisory services are typically provided only in connection with such loans.

Allied Investment is periodically examined and audited by the Small Business Administration's staff to determine its compliance with small business investment company regulations.

We, through Allied Investment, have debentures payable to the Small Business Administration with contractual maturities of ten years. The notes require payment of interest only semi-annually, and all principal is due upon maturity. Under the small business investment company program, we may borrow up to \$113.4 million from the Small Business Administration. At December 31, 2002, the Small Business Administration has a commitment to lend up to an additional \$7.3 million above the amount outstanding. The commitment expires on September 30, 2005.

Regulated Investment Company Status. We have elected to be taxed as a regulated investment company under Subchapter M of the Internal Revenue Code of 1986. As long as we qualify as a regulated investment company, we are not taxed on our investment company taxable income or realized capital gains, to the extent that such taxable income or gains are distributed, or deemed to be distributed, to shareholders on a timely basis. Annual tax distributions generally differ from net income for the fiscal year due to temporary and permanent timing differences in the recognition of income and expenses, returns of capital and net unrealized appreciation or depreciation, which are not included in taxable income.

In order to maintain our status as a regulated investment company, we must, in general, (1) continue to qualify as a business development company; (2) derive at least 90% of our gross income from dividends, interest, gains from the sale of securities, and other specified types of income; (3) meet investment diversification requirements as defined in the Internal Revenue Code; and (4) distribute annually to shareholders at least 90% of our investment company taxable income as defined in the Internal Revenue Code. We intend to take all steps necessary to continue to qualify as a regulated investment company. However, there can be no assurance that we will continue to qualify for such treatment in future years.

Compliance with the Sarbanes-Oxley Act of 2002 and NYSE Corporate Governance Regulations. On July 30, 2002, President Bush signed into law the Sarbanes-Oxley Act of 2002 (the Sarbanes-Oxley Act). The Sarbanes-Oxley Act imposes a wide variety of new regulatory requirements on publicly-held companies and their insiders. Many of these requirements will affect us. For example:

Our chief executive officer and chief financial officer must now certify the accuracy of the financial statements contained in our periodic reports;

Our periodic reports must disclose our conclusions about the effectiveness of our disclosure controls and procedures;

Our periodic reports must disclose whether there were significant changes in our internal controls or in other factors that could significantly affect these controls

subsequent to the date of their evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses; and

We may not make any loan to any director or executive officer and we may not materially modify any existing loans.

The Sarbanes-Oxley Act has required us to review our current policies and procedures to determine whether we comply with the Sarbanes-Oxley Act and the new regulations promulgated thereunder. We will continue to monitor our compliance with all future regulations that are adopted under the Sarbanes-Oxley Act and will take actions necessary to ensure that we are in compliance therewith.

In addition, the New York Stock Exchange has proposed corporate governance changes to its listing standards. These new rules become effective after review and approval by the SEC. Some proposed corporate governance changes will become effective immediately upon approval by the SEC, while others require compliance after specified periods, ranging from six months to two years after approval by the SEC.

We have begun to review our current policies and procedures to determine whether we comply with the New York Stock Exchange's proposed corporate governance rules. We will continue to monitor our compliance with all future listing standards that are approved by the SEC and will take actions necessary to ensure that we are in compliance therewith.

DIVIDEND REINVESTMENT PLAN

We currently maintain a dividend reinvestment plan that provides for reinvestment of our distributions on behalf of our shareholders by our transfer agent. Effective May 1, 2002, the dividend reinvestment plan was converted from an opt out to an opt in plan. As a result, if our board of directors declares a cash dividend, then our new shareholders that have not opted in to our dividend reinvestment plan will receive cash dividends, rather than reinvesting dividends in additional shares of common stock. Existing dividend reinvestment plan accounts will not be affected by this amendment and no existing instructions, either to receive cash dividends or to reinvest dividends, will be changed.

To enroll in the dividend reinvestment plan, each shareholder must complete an enrollment status form and return it to the plan agent. The plan agent shall then automatically reinvest any dividend in additional shares of common stock. You may change your status in the dividend reinvestment plan at any time by contacting our transfer agent and plan administrator in writing.

A shareholder's ability to participate in a dividend reinvestment plan may be limited according to how the shares of common stock are held. A nominee may preclude beneficial owners holding shares in street name from participating in the dividend reinvestment plan. Shareholders who wish to participate in a dividend reinvestment plan may need to hold their shares of common stock in their own name. Shareholders will be informed of their right to opt into the dividend reinvestment plan in our annual and quarterly reports to shareholders. Shareholders who hold shares in the name of a nominee should contact the nominee for details.

All distributions to investors who do not participate (or whose nominee elects not to participate) in the dividend reinvestment plan will be paid directly, or through the nominee, to the record holder by or under the discretion of the plan agent. The plan agent is American Stock Transfer and Trust Company, 59 Maiden Lane, New York, New York 10038. Their telephone number is (800) 937-5449.

Under the dividend reinvestment plan, we may issue new shares unless the market price of the outstanding shares of common stock is less than 110% of the last reported net asset value. Alternatively, the plan agent may buy shares of common stock in the market. We value newly issued shares of common stock for the dividend reinvestment plan at the average of the reported last sale prices of the outstanding shares of common stock on the last five trading days prior to the payment date of the distribution, but not less than 95% of the opening bid price on such date. The price in the case of shares bought in the market will be the average actual cost of such shares of common stock, including any brokerage commissions. There are no other fees charged to shareholders in connection with the dividend reinvestment plan. Any distributions reinvested under the plan will nevertheless remain taxable to the shareholders.

DESCRIPTION OF CAPITAL STOCK

The following summary of our capital stock does not purport to be complete and is subject to, and qualified in its entirety by, our Restated Articles of Incorporation, which we sometimes refer to as our charter. Reference is made to the charter for a detailed description of the provisions summarized below.

Our authorized capital stock is 200,000,000 shares, \$0.0001 par value. Our board of directors may classify and reclassify any unissued shares of our capital stock by setting or changing in one or more respects the preferences, conversion or other rights, voting powers, restrictions, limitations as to dividends, qualifications, terms or conditions or redemption or other rights of such shares of capital stock.

Common Stock

At June 4, 2003, there were 113,162,545 shares of common stock outstanding and 9,414,604 shares of common stock reserved for issuance under our amended stock option plan. The following are the outstanding classes of securities of Allied Capital as of June 4, 2003:

| | (1) Title of Class | (2) Amount Authorized | (3) Amount Held by Us or for Our Account | (4) Amount Outstanding Exclusive of Amounts Shown Under(3) |
|----------------------------|-----------------------|-----------------------------|---|---|
| Allied Capital Corporation | Common Stock | 200,000,000 | | 113,162,545 |

All shares of common stock have equal rights as to earnings, assets, dividends and voting privileges and all outstanding shares of common stock are fully paid and non-assessable. Distributions may be paid to the holders of common stock if and when declared by our board of directors out of funds legally available therefor. Our common stock has no preemptive, conversion, or redemption rights and is freely transferable. In the event of liquidation, each share of common stock is entitled to share ratably in all of our assets that are legally available for distributions after payment of all debts and liabilities and subject to any prior rights of holders of preferred stock, if any, then outstanding. Each share of common stock is entitled to one vote and does not have cumulative voting rights, which means that holders of a majority of the shares, if they so choose, could elect all of the directors, and holders of less than a majority of the shares would, in that case, be unable

to elect any director. All shares of common stock offered hereby will be, when issued and paid for, fully paid and non-assessable.

Limitation on Liability of Directors

We have adopted provisions in our charter limiting the liability of our directors and officers for monetary damages. The effect of these provisions in the charter is to eliminate the rights of Allied Capital and its shareholders (through shareholders' derivative suits on our behalf) to recover monetary damages against a director or officer for breach of the fiduciary duty of care as a director or officer (including breaches resulting from negligent or grossly negligent behavior) except for liability resulting from (i) actual receipt of an improper benefit or profit in money, property or services or (ii) acts committed in bad faith or active and deliberate dishonesty established by a final judgment as being material to the cause of action. These provisions do not limit or eliminate the rights of Allied Capital or any shareholder to seek non-monetary relief such as an injunction or rescission in the event of a breach of a director's or officer's duty of care. These provisions will not alter the liability of directors or officers under federal securities laws.

Certain Anti-Takeover Provisions

Our charter and bylaws and certain statutory and regulatory requirements contain certain provisions that could make more difficult the acquisition of Allied Capital by means of a tender offer, a proxy contest or otherwise. These provisions are expected to discourage certain types of coercive takeover practices and inadequate takeover bids and to encourage persons seeking to acquire control of us to negotiate first with the board of directors. We believe that the benefits of these provisions outweigh the potential disadvantages of discouraging such proposals because, among other things, negotiation of such proposals might result in an improvement of their terms. The description set forth below is intended only to be a summary of certain of our anti-takeover provisions and is qualified in its entirety by reference to our charter and the bylaws.

Classified Board of Directors

Our charter provides for our Board of Directors to be divided into three classes of directors serving staggered three-year terms, with each class to consist as nearly as possible of one-third of the directors then elected to the board. A classified board may render more difficult a change in control of Allied Capital or removal of incumbent management. We believe, however, that the longer time required to elect a majority of a classified Board of Directors helps to ensure continuity and stability of our management and policies.

Issuance of Preferred Stock

Our board of directors, without shareholder approval, has the authority to reclassify authorized but unissued common stock as preferred stock and to issue preferred stock. Such stock could be issued with voting, conversion or other rights designed to have an anti-takeover effect.

Maryland Corporate Law

We are subject to the Maryland Business Combination Statute and the Control Share Acquisition Statute, as defined below. The partial summary of the foregoing statutes

contained in this prospectus is not intended to be complete and reference is made to the full text of such statutes for their entire terms.

Business Combination Statute. Certain provisions of the Maryland General Corporation Law establish special requirements with respect to business combinations between Maryland corporations and interested shareholders unless exemptions are applicable (the Business Combination Statute). Among other things, the Business Combination Statute prohibits for a period of five years a merger or other specified transactions between a company and an interested shareholder and requires a supermajority vote for such transactions after the end of such five-year period.

Interested shareholders are all persons owning beneficially, directly or indirectly, 10% or more of the outstanding voting stock of a Maryland corporation. Business combinations include certain mergers or similar transactions subject to a statutory vote and additional transactions involving transfer of assets or securities in specified amounts to interested shareholders or their affiliates.

Unless an exemption is available, a business combination may not be consummated between a Maryland corporation and an interested shareholder or its affiliates for a period of five years after the date on which the shareholder first became an interested shareholder and thereafter may not be consummated unless recommended by the board of directors of the Maryland corporation and approved by the affirmative vote of at least 80% of the votes entitled to be cast by all holders of outstanding shares of voting stock and 66 2/3% of the votes entitled to be cast by all holders of outstanding shares of voting stock other than the interested shareholder or its affiliates or associates, unless, among other things, the corporation's shareholders receive a minimum price (as defined in the Business Combination Statute) for their shares and the consideration is received in cash or in the same form as previously paid by the interested shareholder for its shares.

A business combination with an interested shareholder which is approved by the board of directors of a Maryland corporation at any time before an interested shareholder first becomes an interested shareholder is not subject to the five-year moratorium or special voting requirements. An amendment to a Maryland corporation's charter electing not to be subject to the foregoing requirements must be approved by the affirmative vote of at least 80% of the votes entitled to be cast by all holders of outstanding shares of voting stock and 66 2/3% of the votes entitled to be cast by holders of outstanding shares of voting stock who are not interested shareholders. Any such amendment is not effective until 18 months after the vote of shareholders and does not apply to any business combination of a corporation with a shareholder who became an interested shareholder on or prior to the date of such vote.

Control Share Acquisition Statute. The Maryland General Corporation Law imposes limitations on the voting rights of shares acquired in a control share acquisition. The control share statute defines a control share acquisition to mean the acquisition, directly or indirectly, of control shares subject to certain exceptions. Control shares of a Maryland corporation are defined to be voting shares of stock which, if aggregated with all other shares of stock previously acquired by the acquiror, would entitle the acquiror to exercise voting power in electing directors with one of the following ranges of voting power:

- (1) one-tenth or more but less than one-third;

(2) one-third or more but less than a majority; or

(3) a majority of all voting power.

Control shares do not include shares which the acquiring person is entitled to vote as a result of having previously obtained shareholder approval. Control shares of a Maryland corporation acquired in a control share acquisition have no voting rights except to the extent approved by a vote of two-thirds of the votes entitled to be cast by shareholders in the election of directors, excluding shares of stock as to which the acquiring person, officers of the corporation and directors of the corporation who are employees of the corporation are entitled to exercise or direct the exercise of the voting power of the shares in the election of the directors.

The control share statute also requires Maryland corporations to hold a special meeting at the request of an actual or proposed control share acquiror generally within 50 days after a request is made with the submission of an acquiring person statement, but only if the acquiring person:

(1) gives a written undertaking and, if required by the directors of the issuing corporation, posts a bond for the cost of the meeting; and

(2) submits definitive financing agreements for the acquisition of the control shares to the extent that financing is not provided by the acquiring person.

In addition, unless the issuing corporation's charter or bylaws provide otherwise, the control share statute provides that the issuing corporation, within certain time limitations, shall have the right to redeem control shares (except those for which voting rights have previously been approved) for fair value as determined pursuant to the control share statute in the event:

(1) there is a shareholder vote and the grant of voting rights is not approved; or

(2) an acquiring person statement is not delivered to the target within 10 days following a control share acquisition.

Moreover, unless the issuing corporation's charter or bylaws provide otherwise, the control share statute provides that if, before a control share acquisition occurs, voting rights are accorded to control shares which result in the acquiring person having majority voting power, then all shareholders other than the acquiring person have appraisal rights as provided under the Maryland General Corporation Law. An acquisition of shares may be exempted from the control share statute provided that a charter or bylaw provision is adopted for such purpose prior to the control share acquisition by any person with respect to Allied Capital. The control share acquisition statute does not apply to shares acquired in a merger, consolidation or share exchange to which the corporation is a party.

Regulatory Restrictions

Allied Investment, our wholly owned subsidiary, is a small business investment company. The Small Business Administration prohibits, without prior Small Business Administration approval, a change of control or transfers which would result in any person (or group of persons acting in concert) owning 10% or more of any class of capital stock of a small business investment company. A change of control is any event which would result in a transfer of the power, direct or indirect, to direct the management and

policies of a small business investment company, whether through ownership, contractual arrangements or otherwise.

PLAN OF DISTRIBUTION

We may offer, from time to time, up to 18,000,000 shares of our common stock. We may sell the shares of our common stock through underwriters or dealers, directly to one or more purchasers, through agents or through a combination of any such methods of sale. Any underwriter or agent involved in the offer and sale of the shares of our common stock will be named in the applicable prospectus supplement.

The distribution of the shares of our common stock may be effected from time to time in one or more transactions at a fixed price or prices, which may be changed, at prevailing market prices at the time of sale, at prices related to such prevailing market prices, or at negotiated prices, provided, however, that the offering price per share of our common stock, less any underwriting commissions or discounts, must equal or exceed the net asset value per share of our common stock at the time of the offering.

In connection with the sale of the shares of our common stock, underwriters or agents may receive compensation from us or from purchasers of the shares of our common stock, for whom they may act as agents, in the form of discounts, concessions or commissions. Underwriters may sell shares of our common stock to or through dealers and such dealers may receive compensation in the form of discounts, concessions or commissions from the underwriters and/or commissions from the purchasers for whom they may act as agents. Underwriters, dealers and agents that participate in the distribution of shares of our common stock may be deemed to be underwriters under the Securities Act, and any discounts and commissions they receive from us and any profit realized by them on the resale of shares of our common stock may be deemed to be underwriting discounts and commissions under the Securities Act. Any such underwriter or agent will be identified and any such compensation received from us will be described in the applicable prospectus supplement.

Any common stock sold pursuant to a prospectus supplement will be quoted on the New York Stock Exchange, or another exchange on which the common stock is traded.

Under agreements into which we may enter, underwriters, dealers and agents who participate in the distribution of shares of our common stock may be entitled to indemnification by us against certain liabilities, including liabilities under the Securities Act. Underwriters, dealers and agents may engage in transactions with, or perform services for, us in the ordinary course of business.

If so indicated in the applicable prospectus supplement, we will authorize underwriters or other persons acting as our agents to solicit offers by certain institutions to purchase shares of our common stock from us pursuant to contracts providing for payment and delivery on a future date. Institutions with which such contracts may be made include commercial and savings banks, insurance companies, pension funds, investment companies, educational and charitable institutions and others, but in all cases such institutions must be approved by us. The obligations of any purchaser under any such contract will be subject to the condition that the purchase of shares of our common stock shall not at the time of delivery be prohibited under the laws of the jurisdiction to which such purchaser is subject. The underwriters and such other agents will not have any responsibility in respect of the validity or performance of such contracts. Such contracts will be subject only to those

conditions set forth in the prospectus supplement, and the prospectus supplement will set forth the commission payable for solicitation of such contracts.

The maximum commission or discount to be received by any member of the National Association of Securities Dealers, Inc. or independent broker-dealer will not be greater than 10% for the sale of any securities being registered and .5% for due diligence.

In order to comply with the securities laws of certain states, if applicable, shares of our common stock offered hereby will be sold in such jurisdictions only through registered or licensed brokers or dealers.

LEGAL MATTERS

The legality of shares of our common stock offered hereby will be passed upon for us by Sutherland Asbill & Brennan LLP, Washington, D.C. Certain legal matters will be passed upon for underwriters, if any, by the counsel named in the prospectus supplement.

SAFEKEEPING, TRANSFER AND DIVIDEND PAYING AGENT

AND REGISTRAR

Our investments are held in safekeeping by Riggs Bank, N.A. at 808 17th Street, N.W., Washington, D.C. 20006, as well as by LaSalle National Bank, located at 25 Northwest Point Boulevard, Suite 800, Elk Grove Village, Illinois 60007. American Stock Transfer and Trust Company, 59 Maiden Lane, New York, New York 10038 acts as our transfer, dividend paying and reinvestment plan agent and registrar.

BROKERAGE ALLOCATION AND OTHER PRACTICES

Since we generally acquire and dispose of our investments in privately negotiated transactions, we infrequently use brokers in the normal course of business.

INDEPENDENT PUBLIC ACCOUNTANTS

The audited consolidated financial statements and schedules as of December 31, 2002, and for the year then ended, have been included herein in reliance upon the reports of KPMG LLP, independent accountants, appearing elsewhere herein, and upon the authority of said firm as experts in accounting and auditing.

The audited financial statements and schedules included in this prospectus and elsewhere in the registration statement to the extent and for the periods indicated in their report have been audited by Arthur Andersen LLP, independent public accountants. For important information about Arthur Andersen LLP, see Notice Regarding Arthur Andersen LLP below.

On March 29, 2002, we selected KPMG LLP to serve as our independent public accountants for the fiscal year ending December 31, 2002. We dismissed Arthur Andersen LLP as our independent accountants effective upon completion of the December 31, 2001 audit. The decision to change accountants was approved by our Audit Committee and Board of Directors and was ratified by our stockholders on May 7, 2002.

In connection with the audits for the 2001 and 2000 fiscal years and through April 3, 2002, (1) there were no disagreements with Arthur Andersen LLP on any matter of

accounting principle or practice, financial statement disclosure, auditing scope or procedure, whereby such disagreements, if not resolved to the satisfaction of Arthur Andersen LLP, would have caused them to make reference thereto in their report on the financial statements for such years; and (2) there has been no reportable events (as defined in Item 304(a)(1)(v) of Regulation S-K).

The reports of Arthur Andersen LLP on our financial statements for fiscal years ended December 31, 2001 and 2000 contained no adverse opinion or disclaimer of opinion and were not qualified or modified as to uncertainty, audit scope or accounting principle, except for the emphasis of matter related to the inherent uncertainty of determining the value of investments whose values have been determined by the Board of Directors in good faith in the absence of readily ascertainable market values.

We had not consulted with KPMG LLP during 2001 or 2000 or the period from January 1, 2002 through March 29, 2002, on either the application of accounting principles to a specified transaction, either completed or proposed, or the type of audit opinion KPMG LLP might issue on our financial statements.

NOTICE REGARDING ARTHUR ANDERSEN LLP

Section 11(a) of the Securities Act provides that if any part of a registration statement at the time it becomes effective contains an untrue statement of a material fact or an omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading, any person acquiring a security pursuant to such registration statement, unless it is proved that at the time of such acquisition such person knew of such untruth or omission, may sue, among others, every accountant who has consented to be named as having prepared or certified any part of the registration statement or as having prepared or certified any report or valuation which is used in connection with the registration statement with respect to the statement in such registration statement, report or valuation which purports to have been prepared or certified by the accountant.

Our consolidated financial statements as of December 31, 2001 and 2000 and for each of the two years in the two-year period ended December 31, 2001 included in this prospectus were audited by our former independent auditor, Arthur Andersen LLP. However, we have not been able to obtain, after reasonable efforts, the written consent of Arthur Andersen LLP with respect to the inclusion of such consolidated financial statements in this prospectus. Under these circumstances, Rule 437a under the Securities Act permits us to file this registration statement without a consent of Arthur Andersen LLP. As a result, you will not be able to sue Arthur Andersen LLP pursuant to Section 11(a) of the Securities Act and therefore your right of recovery under that section may be limited as a result of the lack of the written consent.

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

CONSOLIDATED FINANCIAL STATEMENTS

INDEX TO CONSOLIDATED FINANCIAL STATEMENTS

| | <u>Page</u> |
|--|-------------|
| Consolidated Balance Sheet December 31, 2002 and 2001 | F-2 |
| Consolidated Statement of Operations For the Years Ended December 31, 2002, 2001, and 2000 | F-3 |
| Consolidated Statement of Changes in Net Assets For the Years Ended December 31, 2002, 2001, and 2000 | F-4 |
| Consolidated Statement of Cash Flows For the Years Ended December 31, 2002, 2001, and 2000 | F-5 |
| Consolidated Statement of Investments December 31, 2002 | F-6 |
| Notes to Consolidated Financial Statements | F-17 |
| Reports of Independent Public Accountants | F-47 |

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEET

| | December 31, | |
|---|--------------------|--------------------|
| | 2002 | 2001 |
| (in thousands, except share and per share amounts) | | |
| ASSETS | | |
| Portfolio at value: | | |
| Private finance | | |
| Companies more than 25% owned (cost: 2002-\$628,535; 2001-\$448,797) | \$ 710,587 | \$ 504,657 |
| Companies 5% to 25% owned (cost: 2002-\$219,124; 2001-\$226,020) | 255,677 | 245,561 |
| Companies less than 5% owned (cost: 2002-\$863,243; 2001-\$879,149) | 776,951 | 844,854 |
| Total private finance | 1,743,215 | 1,595,072 |
| Commercial real estate finance (cost: 2002-\$718,312; 2001-\$732,636) | 744,952 | 734,518 |
| Total portfolio at value | 2,488,167 | 2,329,590 |
| Deposits of proceeds from sales of borrowed Treasury securities | 194,745 | 48,504 |
| Other assets | 100,221 | 81,730 |
| Cash and cash equivalents | 11,186 | 889 |
| Total assets | \$2,794,319 | \$2,460,713 |
| LIABILITIES AND SHAREHOLDERS EQUITY | | |
| Liabilities: | | |
| Notes payable and debentures | \$ 794,200 | \$ 876,056 |
| Revolving line of credit | 204,250 | 144,750 |
| Obligations to replenish borrowed Treasury securities | 197,027 | 47,263 |
| Accounts payable and other liabilities | 45,771 | 33,521 |
| Total liabilities | 1,241,248 | 1,101,590 |
| Commitments and contingencies | | |
| Preferred stock | 7,000 | 7,000 |
| Shareholders equity: | | |
| Common stock, \$0.0001 par value, 200,000,000 shares authorized; 108,698,409 and 99,607,396 shares issued and outstanding at December 31, 2002 and 2001, respectively | 11 | 10 |
| Additional paid-in capital | 1,547,183 | 1,352,688 |
| Notes receivable from sale of common stock | (24,704) | (26,028) |
| Net unrealized appreciation on portfolio | 39,411 | 39,981 |
| Distributions in excess of earnings | (15,830) | (14,528) |

Edgar Filing: ALLIED CAPITAL CORP - Form N-2/A

| | | |
|---|-------------|-------------|
| Total shareholders equity | 1,546,071 | 1,352,123 |
| Total liabilities and shareholders equity | \$2,794,319 | \$2,460,713 |
| Net asset value per common share | \$ 14.22 | \$ 13.57 |

The accompanying notes are an integral part of these consolidated financial statements.

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENT OF OPERATIONS

| | For the Years Ended December 31, | | |
|---|----------------------------------|-----------|----------|
| | 2002 | 2001 | 2000 |
| (in thousands, except per share amounts) | | | |
| Interest and related portfolio income | | | |
| Interest and dividends | | | |
| Companies more than 25% owned | \$ 40,185 | \$ 25,264 | \$ 3,077 |
| Companies 5% to 25% owned | 28,629 | 27,656 | 17,194 |
| Companies less than 5% owned | 195,228 | 187,544 | 162,036 |
| Total interest and dividends | 264,042 | 240,464 | 182,307 |
| Premiums from loan dispositions | | | |
| Companies more than 25% owned | | 1,011 | |
| Companies 5% to 25% owned | 200 | 400 | 380 |
| Companies less than 5% owned | 2,576 | 1,093 | 15,758 |
| Total premiums from loan dispositions | 2,776 | 2,504 | 16,138 |
| Fees and other income | | | |
| Companies more than 25% owned | 25,344 | 24,817 | 2,000 |
| Companies 5% to 25% owned | 1,123 | 230 | 205 |
| Companies less than 5% owned | 16,643 | 21,095 | 10,939 |
| Total fees and other income | 43,110 | 46,142 | 13,144 |
| Total interest and related portfolio income | 309,928 | 289,110 | 211,589 |
| Expenses | | | |
| Interest | 70,443 | 65,104 | 57,412 |
| Employee | 33,126 | 29,656 | 26,025 |
| Administrative | 21,504 | 15,299 | 15,435 |
| Total operating expenses | 125,073 | 110,059 | 98,872 |
| Net investment income before income taxes and net realized and unrealized gains | 184,855 | 179,051 | 112,717 |
| Income tax expense (benefit) | 930 | (412) | |
| Net investment income before net realized and unrealized gains | 183,925 | 179,463 | 112,717 |
| Net Realized and Unrealized Gains | | | |
| Net realized gains (losses) | | | |
| Companies more than 25% owned | 58,444 | 1,893 | |
| Companies 5% to 25% owned | 866 | 1,639 | (54) |
| Companies less than 5% owned | (14,373) | (2,871) | 15,577 |
| Total net realized gains | 44,937 | 661 | 15,523 |
| Net unrealized gains (losses) | (571) | 20,603 | 14,861 |
| Total net realized and unrealized gains | 44,366 | 21,264 | 30,384 |

Edgar Filing: ALLIED CAPITAL CORP - Form N-2/A

| | | | |
|--|-------------------|-------------------|-------------------|
| Net increase in net assets resulting from operations | \$ 228,291 | \$ 200,727 | \$ 143,101 |
| | <u> </u> | <u> </u> | <u> </u> |
| Basic earnings per common share | \$ 2.23 | \$ 2.19 | \$ 1.95 |
| | <u> </u> | <u> </u> | <u> </u> |
| Diluted earnings per common share | \$ 2.20 | \$ 2.16 | \$ 1.94 |
| | <u> </u> | <u> </u> | <u> </u> |
| Weighted average common shares outstanding basic | 102,107 | 91,564 | 73,165 |
| | <u> </u> | <u> </u> | <u> </u> |
| Weighted average common shares outstanding diluted | 103,574 | 93,003 | 73,472 |
| | <u> </u> | <u> </u> | <u> </u> |

The accompanying notes are an integral part of these consolidated financial statements.

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENT OF CHANGES IN NET ASSETS

| (in thousands, except per share amounts) | For the Years Ended December 31, | | |
|---|----------------------------------|-------------------|-------------------|
| | 2002 | 2001 | 2000 |
| Operations | | | |
| Net investment income before net realized and unrealized gains | \$ 183,925 | \$ 179,463 | \$ 112,717 |
| Net realized gains | 44,937 | 661 | 15,523 |
| Net unrealized gains (losses) | (571) | 20,603 | 14,861 |
| Net increase in net assets resulting from operations | 228,291 | 200,727 | 143,101 |
| Shareholder distributions | | | |
| Common stock dividends | (229,935) | (186,157) | (135,795) |
| Preferred stock dividends | (230) | (230) | (230) |
| Net decrease in net assets resulting from shareholder distributions | (230,165) | (186,387) | (136,025) |
| Capital share transactions | | | |
| Sale of common stock | 172,847 | 286,888 | 250,912 |
| Issuance of common stock for portfolio investments | | 5,157 | 86,076 |
| Issuance of common stock upon the exercise of stock options | 14,517 | 10,660 | 3,309 |
| Issuance of common stock in lieu of cash distributions | 6,263 | 6,331 | 4,773 |
| Net decrease (increase) in notes receivable from sale of common stock | 1,324 | (945) | 4,378 |
| Net decrease in common stock held in deferred compensation trust | | | 6,218 |
| Other | 871 | | (563) |
| Net increase in net assets resulting from capital share transactions | 195,822 | 308,091 | 355,103 |
| Total increase in net assets | \$ 193,948 | \$ 322,431 | \$ 362,179 |
| Net assets at beginning of year | 1,352,123 | 1,029,692 | 667,513 |
| Net assets at end of year | \$ 1,546,071 | \$ 1,352,123 | \$ 1,029,692 |
| Net asset value per common share | \$ 14.22 | \$ 13.57 | \$ 12.11 |
| Common shares outstanding at end of year | 108,698 | 99,607 | 85,057 |

The accompanying notes are an integral part of these consolidated financial statements.

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENT OF CASH FLOWS

| (in thousands) | For the Years Ended December 31, | | |
|---|----------------------------------|------------|-------------|
| | 2002 | 2001 | 2000 |
| Cash flows from operating activities | | | |
| Net increase in net assets resulting from operations | \$ 228,291 | \$ 200,727 | \$ 143,101 |
| Adjustments | | | |
| Portfolio investments | (506,376) | (675,172) | (827,025) |
| Repayments of investment principal | 143,167 | 74,461 | 111,031 |
| Proceeds from investment sales | 213,474 | 129,980 | 280,244 |
| Change in accrued or reinvested interest and dividends | (44,665) | (51,554) | (32,245) |
| Amortization of discounts and fees | (20,592) | (13,929) | (10,101) |
| Changes in other assets and liabilities | (735) | 1,290 | 3,472 |
| Depreciation and amortization | 1,572 | 994 | 925 |
| Realized losses | 50,625 | 9,446 | 13,081 |
| Net unrealized losses (gains) | 571 | (20,603) | (14,861) |
| Net cash provided by (used in) operating activities | 65,332 | (344,360) | (332,378) |
| Cash flows from financing activities | | | |
| Sale of common stock | 172,847 | 286,888 | 250,912 |
| Sale of common stock upon the exercise of stock options | 12,136 | 5,428 | 319 |
| Collections of notes receivable from sale of common stock | 3,706 | 5,090 | 6,363 |
| Common dividends and distributions paid | (220,411) | (179,826) | (131,022) |
| Preferred stock dividends paid | (230) | (230) | (230) |
| Borrowings under notes payable and debentures | | 175,500 | 234,598 |
| Repayments on notes payable and debentures | (81,856) | (9,350) | (17,300) |
| Net borrowings under (repayments on) revolving line of credit | 59,500 | 62,750 | (23,500) |
| Other | (727) | (3,450) | (3,468) |
| Net cash provided by (used in) financing activities | (55,035) | 342,800 | 316,672 |
| Net increase (decrease) in cash and cash equivalents | \$ 10,297 | \$ (1,560) | \$ (15,706) |
| Cash and cash equivalents at beginning of year | 889 | 2,449 | 18,155 |
| Cash and cash equivalents at end of year | \$ 11,186 | \$ 889 | \$ 2,449 |

The accompanying notes are an integral part of these consolidated financial statements.

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENT OF INVESTMENTS

| Private Finance Portfolio Company (in thousands, except number of shares) | Investment(2) | December 31, 2002 | |
|---|---|-------------------|----------|
| | | Cost | Value |
| Companies More Than 25% Owned | | | |
| Acme Paging, L.P. (Telecommunications) | Loan | \$ 3,750 | \$ 3,750 |
| | Equity Interests | 13,274 | 9,223 |
| | Common Stock (177 shares) | 27 | 27 |
| American Healthcare Services, Inc. (Healthcare) | Loan | 22,601 | 22,601 |
| | Debt Securities | 18,061 | 15,891 |
| | Common Stock (79,567,042 shares) | 1,000 | |
| | Guaranty (\$1,967) | | |
| Avborne, Inc. (Business Services) | Loan | 9,625 | 9,625 |
| | Preferred Stock (12,500 shares) | 14,138 | 2,300 |
| | Common Stock (27,500 shares) | | |
| Business Loan Express, Inc. (Financial Services) | Debt Securities | 91,690 | 91,690 |
| | Preferred Stock (25,111 shares) | 25,111 | 25,111 |
| | Common Stock (25,503,043 shares) | 104,641 | 140,000 |
| | Guaranty (\$51,641 See Note 3) | | |
| | Standby Letters of Credit (\$10,550 See Note 3) | | |
| The Color Factory, Inc. (Consumer Products) | Loan | 9,589 | 9,589 |
| | Preferred Stock (1,000 shares) | 1,002 | 1,002 |
| | Common Stock (980 shares) | 6,535 | 6,535 |
| Elmhurst Consulting, LLC (Business Services) | Loan | 15,747 | 15,100 |
| | Equity Interests | 5,165 | |
| Foresite Towers, LLC (Tower Leasing) | Equity Interests | 15,522 | 13,775 |
| Gordian Group, Inc. (Business Services) | Loan | 7,390 | 7,390 |
| | Common Stock (1,000 shares) | 2,088 | 2,600 |
| HealthASPex, Inc. (Business Services) | Preferred Stock (1,000,000 shares) | 700 | 700 |
| | Preferred Stock (1,451,380 shares) | 4,900 | 2,617 |
| | Common Stock (1,451,380 shares) | 4 | |
| The Hillman Companies, Inc.(1) (Consumer Products) | Debt Securities | 41,980 | 41,980 |
| | Common Stock (6,890,937 shares) | 50,645 | 138,488 |
| HMT, Inc. (Business Services) | Debt Securities | 9,081 | 9,081 |
| | Preferred Stock (554,052 shares) | 2,216 | 2,216 |
| | Common Stock (300,000 shares) | 3,000 | 3,000 |
| | Warrants | 1,155 | 1,155 |

Edgar Filing: ALLIED CAPITAL CORP - Form N-2/A

- (1) Public company.
- (2) Common stock, preferred stock, warrants, options and equity interests are generally non-income producing and restricted.
- (3) Non-U.S. company.
- (4) Non-registered investment company.

The accompanying notes are an integral part of these consolidated financial statements.

F-6

Edgar Filing: ALLIED CAPITAL CORP - Form N-2/A

| Private Finance Portfolio Company (in thousands, except number of shares) | Investment(2) | December 31, 2002 | |
|---|------------------------------------|-------------------|------------|
| | | Cost | Value |
| Housecall Medical Resources, Inc. (Healthcare) | Loan | \$ 14,928 | \$ 14,928 |
| | Preferred Stock (3,890,344 shares) | 3,889 | 3,889 |
| | Common Stock (864,000 shares) | 86 | 86 |
| Litterer Beteiligungs-GmbH(3) (Business Services) | Debt Securities | 1,286 | 1,286 |
| | Equity Interest | 358 | 358 |
| MVL Group, Inc. (Business Services) | Loan | 19,450 | 18,967 |
| | Debt Securities | 16,270 | 16,270 |
| | Common Stock (648,661 shares) | | |
| Powell Plant Farms, Inc. (Consumer Products) | Loan | 24,964 | 24,964 |
| | Debt Securities | 19,224 | 9,709 |
| | Preferred Stock (1,483 shares) | | |
| | Warrants | | |
| Redox Brands, Inc. (Consumer Products) | Loan | 3,000 | 3,000 |
| | Debt Securities | 9,842 | 9,842 |
| | Preferred Stock (2,404,086 shares) | 6,965 | 6,965 |
| | Warrants | 584 | 1,450 |
| Staffing Partners Holding Company, Inc. (Business Services) | Debt Securities | 6,304 | 6,304 |
| | Preferred Stock (439,600 shares) | 4,968 | 3,807 |
| | Common Stock (50,200 shares) | 50 | |
| | Warrants | 10 | |
| STS Operating, Inc. (Industrial Products) | Preferred Stock (5,769,424 shares) | 6,525 | 6,525 |
| | Common Stock (3,000,000 shares) | 3,177 | 3,177 |
| Sure-Tel, Inc. (Consumer Services) | Preferred Stock (1,000,000 shares) | 1,000 | 1,000 |
| | Common Stock (37,000 shares) | 5,018 | 2,614 |
| Total companies more than 25% owned | | \$ 628,535 | \$ 710,587 |

Companies 5% to 25% Owned

| | | | |
|--|---------------------------------|-----------|-----------|
| Aspen Pet Products, Inc. (Consumer Products) | Loans | \$ 16,625 | \$ 16,625 |
| | Preferred Stock (2,024 shares) | 2,024 | 2,024 |
| | Common Stock (1,400 shares) | 140 | 140 |
| Autania AG(1,3) (Industrial Products) | Common Stock (250,000 shares) | 2,169 | 2,477 |
| Border Foods, Inc. (Consumer Products) | Debt Securities | 9,383 | 9,383 |
| | Preferred Stock (50,919 shares) | 2,000 | 2,000 |
| | Warrants | 665 | 665 |
| CBA-Mezzanine Capital Finance, LLC (Financial Services) | Loan | 3,949 | 3,949 |

Edgar Filing: ALLIED CAPITAL CORP - Form N-2/A

| | | | |
|------------------------|-----------------|--------|--------|
| CorrFlex Graphics, LLC | Debt Securities | 11,951 | 11,951 |
| (Business Services) | Warrants | | 19,332 |
| | Options | | 1,669 |

- (1) Public company.
- (2) Common stock, preferred stock, warrants, options and equity interests are generally non-income producing and restricted.
- (3) Non-U.S. company.
- (4) Non-registered investment company.

The accompanying notes are an integral part of these consolidated financial statements.

F-7

Edgar Filing: ALLIED CAPITAL CORP - Form N-2/A

| Private Finance Portfolio Company (in thousands, except number of shares) | Investment(2) | December 31, 2002 | |
|---|------------------------------------|-------------------|----------|
| | | Cost | Value |
| CyberRep (Business Services) | Loan | \$ 1,264 | \$ 1,264 |
| | Debt Securities | 14,868 | 14,868 |
| | Warrants | 660 | 8,236 |
| The Debt Exchange Inc. (Business Services) | Preferred Stock (921,875 shares) | 1,250 | 1,250 |
| EDM Consulting, LLC (Business Services) | Debt Securities | 1,802 | 286 |
| | Equity Interests | 250 | |
| International Fiber Corporation (Industrial Products) | Debt Securities | 22,606 | 22,606 |
| | Common Stock (1,029,069 shares) | 5,483 | 6,816 |
| | Warrants | 550 | 684 |
| Liberty-Pittsburgh Systems, Inc. (Business Services) | Debt Securities | 3,500 | 3,500 |
| | Common Stock (123,929 shares) | 142 | 67 |
| Logic Bay Corporation (Business Services) | Preferred Stock (1,131,222 shares) | 5,000 | |
| Magna Card, Inc. (Consumer Products) | Debt Securities | 153 | 153 |
| | Preferred Stock (1,875 shares) | 94 | 94 |
| | Common Stock (4,687 shares) | | |
| Master Plan, Inc. (Business Services) | Loan | 959 | 959 |
| | Common Stock (156 shares) | 42 | 650 |
| MortgageRamp, Inc. (Business Services) | Common Stock (772,000 shares) | 3,860 | 3,860 |
| Morton Grove Pharmaceuticals, Inc. (Consumer Products) | Loan | 16,356 | 16,356 |
| | Preferred Stock (106,947 shares) | 6,098 | 14,526 |
| Nobel Learning Communities, Inc.(1) (Education) | Debt Securities | 9,755 | 9,755 |
| | Preferred Stock (1,063,830 shares) | 2,000 | 2,000 |
| | Warrants | 575 | 245 |
| Packaging Advantage Corporation (Business Services) | Debt Securities | 14,234 | 14,234 |
| | Common Stock (232,168 shares) | 2,386 | 2,386 |
| | Warrants | 963 | 963 |
| Professional Paint, Inc. (Consumer Products) | Debt Securities | 22,791 | 22,791 |
| | Preferred Stock (15,000 shares) | 19,534 | 19,534 |
| | Common Stock (110,000 shares) | 69 | 5,000 |
| Progressive International Corporation (Consumer Products) | Debt Securities | 3,968 | 3,968 |
| | Preferred Stock (500 shares) | 500 | 500 |
| | Common Stock (197 shares) | 13 | 13 |
| | Warrants | | |

Edgar Filing: ALLIED CAPITAL CORP - Form N-2/A

| | | | |
|--------------------------------|-----------------------------|-------|-------|
| Prosperco Finanz Holding AG(3) | Convertible Debentures | 7,166 | 7,166 |
| (Financial Services) | Common Stock (1,528 shares) | 1,059 | 608 |
| | Warrants | | |

- (1) Public company.
- (2) Common stock, preferred stock, warrants, options and equity interests are generally non-income producing and restricted.
- (3) Non-U.S. company.
- (4) Non-registered investment company.

The accompanying notes are an integral part of these consolidated financial statements.

F-8

Edgar Filing: ALLIED CAPITAL CORP - Form N-2/A

| Private Finance Portfolio Company (in thousands, except number of shares) | Investment(2) | December 31, 2002 | |
|---|--|------------------------------|------------------------------|
| | | Cost | Value |
| Total Foam, Inc. (Industrial Products) | Debt Securities Common Stock (164 shares) | \$ 258 10 | \$ 124 |
| Total companies 5% to 25% owned | | \$219,124 | \$255,677 |
| Companies Less Than 5% Owned | | | |
| ACE Products, Inc. (Industrial Products) | Loans | \$ 17,164 | \$ 12,969 |
| Advantage Sales and Marketing, Inc. (Business Services) | Debt Securities Warrants | 10,603 382 | 10,603 1,455 |
| Alderwoods Group, Inc.(1) (Consumer Services) | Common Stock (357,568 shares) | 5,006 | 1,695 |
| Allied Office Products, Inc. (Business Services) | Common Stock (31,333 shares) | 7,695 | 50 |
| American Barbecue & Grill, Inc. (Retail) | Warrants | 125 | |
| ASW Holding Corporation (Industrial Products) | Warrants | 25 | 25 |
| Bakery Chef, Inc. (Consumer Products) | Loans | 18,213 | 18,213 |
| Blue Rhino Corporation(1) (Consumer Products) | Debt Securities Warrants | 14,018 1,200 | 14,018 18,550 |
| Camden Partners Strategic Fund II, L.P.(4) (Private Equity Fund) | Limited Partnership Interest | 2,474 | 2,308 |
| Candlewood Hotel Company(1) (Hospitality) | Preferred Stock (3,250 shares) | 3,250 | 748 |
| Celebrities, Inc. (Broadcasting & Cable) | Loan Warrants | 208 12 | 208 492 |
| Clif Bar, Inc. (Consumer Products) | Loan | 24,894 | 24,894 |
| Colibri Holding Corporation (Consumer Products) | Loans Preferred Stock (237 shares) Common Stock (3,362 shares) Warrants | 3,490 248 1,250 290 | 3,490 248 1,088 252 |
| Component Hardware Group, Inc. (Industrial Products) | Debt Securities Preferred Stock (18,000 shares) | 11,286 2,223 | 11,286 2,223 |

Edgar Filing: ALLIED CAPITAL CORP - Form N-2/A

Common Stock (2,000 shares)

200

500

- (1) Public company.
- (2) Common stock, preferred stock, warrants, options and equity interests are generally non-income producing and restricted.
- (3) Non-U.S. company.
- (4) Non-registered investment company.

The accompanying notes are an integral part of these consolidated financial statements.

F-9

Edgar Filing: ALLIED CAPITAL CORP - Form N-2/A

| Private Finance Portfolio Company (in thousands, except number of shares) | Investment(2) | December 31, 2002 | |
|---|----------------------------------|-------------------|--------|
| | | Cost | Value |
| Cooper Natural Resources, Inc. (Industrial Products) | Loan | \$ 299 | \$ 299 |
| | Debt Securities | 1,884 | 1,884 |
| | Preferred Stock (6,316 shares) | 1,427 | 1,427 |
| | Warrants | 832 | 832 |
| Coverall North America, Inc. (Business Services) | Loan | 12,405 | 12,405 |
| | Debt Securities | 6,424 | 6,424 |
| CPM Acquisition Corporation (Industrial Products) | Loan | 10,212 | 10,212 |
| CTT Holdings (Consumer Products) | Loan | 1,500 | 1,500 |
| Drilltec Patents & Technologies Company, Inc. (Industrial Products) | Loan | 10,918 | |
| | Debt Securities | 1,500 | |
| eCentury Capital Partners, L.P.(4) (Private Equity Fund) | Limited Partnership Interest | 2,500 | 839 |
| Elaxis Beta GmbH(3) (Industrial Products) | Options | 426 | 310 |
| Eparfin S.A.(3) (Consumer Products) | Loan | 29 | 29 |
| E-Talk Corporation (Business Services) | Debt Securities | 8,852 | 300 |
| | Warrants | 1,157 | |
| Executive Greetings, Inc. (Business Services) | Debt Securities | 18,830 | 16,500 |
| | Warrants | 360 | |
| Fairchild Industrial Products Company (Industrial Products) | Debt Securities | 5,942 | 5,942 |
| | Warrants | 280 | |
| Frozen Specialities, Inc. (Consumer Products) | Debt Securities | 9,915 | 9,915 |
| | Warrants | 434 | 434 |
| Galaxy American Communications, LLC (Broadcasting & Cable) | Debt Securities | 48,989 | 20,000 |
| | Options | | |
| | Standby Letter of Credit (\$750) | | |
| Garden Ridge Corporation (Retail) | Debt Securities | 27,198 | 25,667 |
| | Preferred Stock (1,130 shares) | 1,130 | |
| | Common Stock (847,800 shares) | 613 | |
| GC-Sun Holdings II, LP (Kar Products, LP) (Business Services) | Loans | 7,780 | 7,780 |

Edgar Filing: ALLIED CAPITAL CORP - Form N-2/A

| | | | |
|---------------------------|-----------------|--------|--------|
| Gibson Guitar Corporation | Debt Securities | 17,952 | 17,952 |
| (Consumer Products) | Warrants | 525 | 2,325 |

- (1) Public company.
- (2) Common stock, preferred stock, warrants, options and equity interests are generally non-income producing and restricted.
- (3) Non-U.S. company.
- (4) Non-registered investment company.

The accompanying notes are an integral part of these consolidated financial statements.

F-10

Edgar Filing: ALLIED CAPITAL CORP - Form N-2/A

| Private Finance Portfolio Company (in thousands, except number of shares) | Investment(2) | December 31, 2002 | |
|---|----------------------------------|-------------------|----------|
| | | Cost | Value |
| Ginsey Industries, Inc. (Consumer Products) | Loans | \$ 5,000 | \$ 5,000 |
| | Convertible Debentures | 500 | 500 |
| | Warrants | | 1,586 |
| Global Communications, LLC (Business Services) | Loan | 2,000 | 2,000 |
| | Debt Securities | 16,247 | 16,247 |
| | Preferred Equity Interest | 14,067 | 14,067 |
| | Options | 1,639 | 1,639 |
| Grant Broadcasting Systems II (Broadcasting & Cable) | Warrants | 87 | 3,000 |
| Grotech Partners, VI, L.P.(4) (Private Equity Fund) | Limited Partnership Interest | 3,100 | 1,961 |
| The Hartz Mountain Corporation (Consumer Products) | Debt Securities | 27,690 | 27,690 |
| | Common Stock (200,000 shares) | 2,000 | 2,000 |
| | Warrants | 2,613 | 2,613 |
| Haven Eldercare of New England, LLC (Healthcare) | Loan | 35,692 | 35,692 |
| Headwaters Incorporated(1) (Industrial Products) | Loan | 9,953 | 9,953 |
| Hotelevision, Inc. (Broadcasting & Cable) | Preferred Stock (315,100 shares) | 315 | |
| Icon International, Inc. (Business Services) | Common Stock (35,228 shares) | 1,219 | 2,103 |
| Impact Innovations Group, LLC (Business Services) | Debt Securities | 6,797 | 3,523 |
| | Warrants | 1,674 | |
| Intellirisk Management Corporation (Business Services) | Loans | 23,276 | 23,276 |
| Interline Brands, Inc. (Business Services) | Debt Securities | 34,040 | 34,040 |
| | Preferred Stock (199,313 shares) | 1,849 | 1,849 |
| | Common Stock (15,615 shares) | 139 | 139 |
| | Warrants | 1,181 | 1,181 |
| Jakel, Inc. (Industrial Products) | Loan | 23,307 | 10,130 |
| JRI Industries, Inc. (Industrial Products) | Debt Securities | 2,045 | 2,045 |
| | Warrants | 74 | 44 |
| Julius Koch USA, Inc. (Industrial Products) | Warrants | 259 | 7,000 |

Edgar Filing: ALLIED CAPITAL CORP - Form N-2/A

| | | | |
|---|-----------------------------|----------|------------|
| Kirker Enterprises, Inc. (Industrial Products) | Equity Interest Warrants | 4 348 | 4 3,501 |
|---|-----------------------------|----------|------------|

- (1) Public company.
- (2) Common stock, preferred stock, warrants, options and equity interests are generally non-income producing and restricted.
- (3) Non-U.S. company.
- (4) Non-registered investment company.

The accompanying notes are an integral part of these consolidated financial statements.

F-11

Edgar Filing: ALLIED CAPITAL CORP - Form N-2/A

| Private Finance Portfolio Company (in thousands, except number of shares) | Investment(2) | December 31, 2002 | |
|---|---|------------------------|------------------------|
| | | Cost | Value |
| Kirkland's, Inc.(1) (Retail) | Common Stock (240,442 shares) | \$ 66 | \$ 2,445 |
| Kyrus Corporation (Business Services) | Debt Securities Warrants | 6,910 348 | 6,910 450 |
| Love Funding Corporation (Financial Services) | Preferred Stock (26,000 shares) | 359 | 213 |
| Matrics, Inc. (Business Services) | Preferred Stock (511,876 shares) Warrants | 500 | 500 |
| MedAssets, Inc. (Business Services) | Debt Securities Preferred Stock (260,417 shares) Warrants | 15,880 2,049 136 | 15,880 2,049 180 |
| Mid-Atlantic Venture Fund IV, L.P.(4) (Private Equity Fund) | Limited Partnership Interest | 3,975 | 2,140 |
| Midview Associates, L.P. (Housing) | Warrants | | |
| Norstan Apparel Shops, Inc. (Retail) | Debt Securities Common Stock (29,622 shares) Warrants | 11,807 4,750 655 | 11,807 4,750 655 |
| North American Archery, LLC (Consumer Products) | Loans Convertible Debentures Guaranty (\$1,020) | 1,390 2,248 | 840 59 |
| Northeast Broadcasting Group, L.P. (Broadcasting & Cable) | Debt Securities | 264 | 264 |
| Novak Biddle Venture Partners III, L.P.(4) (Private Equity Fund) | Limited Partnership Interest | 690 | 540 |
| Nursefinders, Inc. (Business Services) | Debt Securities Warrants | 11,205 900 | 11,205 1,700 |
| Onyx Television GmbH(3) (Broadcasting & Cable) | Preferred Units (120,000 shares) | 201 | |
| Opinion Research Corporation(1) (Business Services) | Debt Securities Warrants | 14,359 996 | 14,359 641 |
| Oriental Trading Company, Inc. (Consumer Products) | Preferred Equity Interest Common Equity Interest | 1,751 | 1,751 2,600 |
| Outsource Partners, Inc. (Business Services) | Debt Securities Warrants | 24,104 826 | 24,104 1,000 |

| | | | |
|--|------|-------|-------|
| Pico Products, Inc. (Industrial Products) | Loan | 1,406 | 1,406 |
|--|------|-------|-------|

- (1) Public company.
- (2) Common stock, preferred stock, warrants, options and equity interests are generally non-income producing and restricted.
- (3) Non-U.S. company.
- (4) Non-registered investment company.

The accompanying notes are an integral part of these consolidated financial statements.

F-12

Edgar Filing: ALLIED CAPITAL CORP - Form N-2/A

| Private Finance Portfolio Company (in thousands, except number of shares) | Investment(2) | December 31, 2002 | |
|---|---------------------------------|-------------------|-----------|
| | | Cost | Value |
| Polaris Pool Systems, Inc. (Consumer Products) | Debt Securities | \$ 10,752 | \$ 10,752 |
| | Warrants | 1,145 | 1,145 |
| Proeducation GmbH(3) (Education) | Loan | 308 | 121 |
| Raytheon Aerospace, LLC (Business Services) | Debt Securities | 5,209 | 5,209 |
| | Equity Interest | | 350 |
| Scitor Corporation (Business Services) | Loan | 22,058 | 22,058 |
| Simula, Inc.(1) (Industrial Products) | Loan | 21,192 | 21,192 |
| Soff-Cut Holdings, Inc. (Industrial Products) | Debt Securities | 9,194 | 9,194 |
| | Preferred Stock (300 shares) | 300 | 300 |
| | Common Stock (2,000 shares) | 200 | 200 |
| Southwest PCS, LLC (Telecommunications) | Loan | 1,250 | 1,250 |
| Spa Lending Corporation (Recreation) | Preferred Stock (28,672 shares) | 429 | 306 |
| Startec Global Communications Corporation(1) (Telecommunications) | Loan | | |
| | Debt Securities | 25,715 | 25,715 |
| SunStates Refrigerated Services, Inc. (Warehouse Facilities) | Loans | 4,642 | 1,490 |
| | Debt Securities | 2,445 | |
| Sydran Food Services II, L.P. (Retail) | Debt Securities | 12,973 | 9,949 |
| | Equity Interests | 3,747 | |
| | Warrants | 162 | |
| Tubbs Snowshoe Company, LLC (Consumer Products) | Debt Securities | 3,928 | 3,928 |
| | Equity Interests | 500 | 500 |
| | Warrants | 54 | 54 |
| United Pet Group, Inc. (Consumer Products) | Debt Securities | 9,056 | 9,056 |
| | Warrants | 85 | 235 |
| Update Venture Partners II, L.P.(4) (Private Equity Fund) | Limited Partnership Interest | 1,602 | 4,148 |
| Venturehouse Group, LLC(4) (Private Equity Fund) | Equity Interest | 667 | 69 |

Edgar Filing: ALLIED CAPITAL CORP - Form N-2/A

| | | | |
|---|------------------------------|-----------------|-----------------|
| Walker Investment Fund II, LLLP(4) (Private Equity Fund) | Limited Partnership Interest | 1,178 | 529 |
| Warn Industries, Inc. (Consumer Products) | Debt Securities Warrants | 11,531 1,429 | 11,531 3,379 |

- (1) Public company.
- (2) Common stock, preferred stock, warrants, options and equity interests are generally non-income producing and restricted.
- (3) Non-U.S. company.
- (4) Non-registered investment company.

The accompanying notes are an integral part of these consolidated financial statements.

F-13

Edgar Filing: ALLIED CAPITAL CORP - Form N-2/A

| Private Finance Portfolio Company (in thousands, except number of shares) | Investment(2) | December 31, 2002 | |
|---|------------------|-------------------|--------------|
| | | Cost | Value |
| Wilshire Restaurant Group, Inc. (Retail) | Debt Securities | \$ 16,180 | \$ 16,180 |
| | Warrants | 735 | 541 |
| Wilton Industries, Inc. (Consumer Products) | Loan | 12,000 | 12,000 |
| Woodstream Corporation (Consumer Products) | Loan | 2,621 | 2,621 |
| | Debt Securities | 7,677 | 7,677 |
| | Equity Interests | 1,700 | 4,547 |
| | Warrants | 450 | 1,203 |
| Total companies less than 5% owned | | \$ 863,243 | \$ 776,951 |
| Total private finance (123 portfolio companies) | | \$ 1,710,902 | \$ 1,743,215 |

- (1) Public company.
- (2) Common stock, preferred stock, warrants, options and equity interests are generally non-income producing and restricted.
- (3) Non-U.S. company.
- (4) Non-registered investment company.

The accompanying notes are an integral part of these consolidated financial statements.

Edgar Filing: ALLIED CAPITAL CORP - Form N-2/A

| (in Thousands) | Stated Interest | Face | December 31, 2002 | |
|--|--------------------|--------------|-------------------|------------|
| | | | Cost | Value |
| Commercial Real Estate Finance | | | | |
| Commercial Mortgage-Backed Securities | | | | |
| Mortgage Capital Funding, Series 1998-MC3 | 5.5% | \$ 50,404 | \$ 25,162 | \$ 22,924 |
| Morgan Stanley Capital I, Series 1999-RM1 | 6.4% | 47,566 | 19,491 | 19,627 |
| COMM 1999-1 | 5.7% | 70,159 | 33,771 | 34,720 |
| Morgan Stanley Capital I, Series 1999-FNV1 | 6.1% | 33,485 | 14,040 | 13,132 |
| DLJ Commercial Mortgage Trust 1999-CG2 | 6.1% | 74,140 | 31,209 | 31,931 |
| Commercial Mortgage Acceptance Corp., Series 1999-C1 | 6.8% | 31,884 | 14,316 | 14,954 |
| LB Commercial Mortgage Trust, Series 1999-C2 | 6.7% | 25,872 | 9,863 | 11,110 |
| Chase Commercial Mortgage Securities Corp., Series 1999-2 | 6.5% | 33,380 | 13,908 | 15,077 |
| FUNB CMT, Series 1999-C4 | 6.5% | 39,283 | 15,706 | 16,253 |
| Heller Financial, HFCMC Series 2000 PH-1 | 6.6% | 42,442 | 16,767 | 17,891 |
| SBMS VII, Inc., Series 2000-NL1 | 7.2% | 18,549 | 9,218 | 9,889 |
| DLJ Commercial Mortgage Trust, Series 2000-CF1 | 7.0% | 35,773 | 16,658 | 17,717 |
| Deutsche Bank Alex. Brown, Series Comm 2000-C1 | 6.9% | 34,935 | 14,803 | 15,901 |
| LB-UBS Commercial Mortgage Trust, Series 2000-C4 | 6.9% | 31,820 | 11,095 | 12,678 |
| Credit Suisse First Boston Mortgage Securities Corp., Series 2001-CK1 | 5.9% | 35,847 | 13,760 | 15,322 |
| JP Morgan-CIBC-Deutsche 2001 | 5.8% | 39,933 | 15,795 | 16,810 |
| Lehman Brothers-UBS Warburg 2001-C2 | 6.4% | 42,014 | 17,482 | 19,313 |
| SBMS VII, Inc., Series 2001-C1 | 6.1% | 35,536 | 12,579 | 13,377 |
| GE Capital Commercial Mortgage Securities Corp., Series 2001-2 | 6.1% | 39,012 | 16,195 | 17,350 |
| Credit Suisse First Boston Mortgage Securities Corp., Series 2001-CKN5 | 5.2% | 40,150 | 15,583 | 16,628 |
| JP Morgan Chase Commercial Mortgage Securities Corp., Series 2001-C1 | 5.6% | 37,178 | 12,912 | 13,837 |
| SBMS VII, Inc., Series 2001-C2 | 6.2% | 31,369 | 11,631 | 12,520 |
| FUNB CMT, Series 2002-C1 | 6.0% | 38,238 | 16,846 | 18,416 |
| GE Capital Commercial Mortgage Corp., Series 2002-1 | 6.2% | 80,490 | 44,722 | 52,589 |
| GMAC Commercial Mortgage Securities, Inc., Series 2002-C2 | 5.8% | 62,703 | 34,988 | 39,154 |
| GE Capital Commercial Mortgage Corp., Series 2002-3 | 5.1% | 76,687 | 40,309 | 40,817 |
| Morgan Stanley Dean Witter Capital I Trust 2002-IQ3 | 6.0% | 44,345 | 24,862 | 25,582 |
| Total commercial mortgage-backed securities | | \$ 1,173,194 | \$ 523,671 | \$ 555,519 |
| Collateralized Debt Obligation Preferred Shares | | | | |
| Crest 2001-1, Ltd.(3) | | | \$ 23,372 | \$ 23,372 |
| Crest 2002-1, Ltd.(3) | | | 23,557 | 23,557 |
| Crest 2002-IG, Ltd.(3) | | | 4,883 | 4,883 |
| Crest Clarendon Street 2002-1, Ltd.(3) | | | 1,006 | 1,006 |
| Total collateralized debt obligation preferred shares | | | \$ 52,818 | \$ 52,818 |

(1) Public company.

(2) Common stock, preferred stock, warrants, options and equity interests are generally non-income producing and restricted.

(3) Non-U.S. company.

(4) Non-registered investment company.

The accompanying notes are an integral part of these consolidated financial statements.
F-15

| | Interest Rate Ranges | Number of Loans | Cost | Value |
|----------------------------------|--------------------------------------|--------------------|-------------|-------------|
| Commercial Mortgage Loans | | | | |
| | Up to 6.99% | 12 | \$ 10,190 | \$ 11,557 |
| | 7.00% 8.99% | 17 | 26,419 | 24,298 |
| | 9.00% 10.99% | 7 | 7,764 | 7,764 |
| | 11.00% 12.99% | 10 | 14,281 | 13,494 |
| | 13.00% 14.99% | 7 | 7,847 | 6,549 |
| | 15.00% and above | 1 | 45 | 45 |
| <hr/> | | | | |
| | Total commercial mortgage loans | 54 | \$ 66,546 | \$ 63,707 |
| <hr/> | | | | |
| | Residual Interest | | \$ 69,335 | \$ 69,035 |
| | Real Estate Owned | | 5,942 | 3,873 |
| <hr/> | | | | |
| | Total commercial real estate finance | | \$ 718,312 | \$ 744,952 |
| <hr/> | | | | |
| | Total portfolio | | \$2,429,214 | \$2,488,167 |
| <hr/> | | | | |

- (1) Public company.
- (2) Common stock, preferred stock, warrants, options and equity interests are generally non-income producing and restricted.
- (3) Non-U.S. company.
- (4) Non-registered investment company.

The accompanying notes are an integral part of these consolidated financial statements.

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 1. Organization

Allied Capital Corporation, a Maryland corporation, is a closed-end management investment company that has elected to be regulated as a business development company (BDC) under the Investment Company Act of 1940 (1940 Act). Allied Capital Corporation (ACC) has a subsidiary that has also elected to be regulated as a BDC, Allied Investment Corporation (Allied Investment), which is licensed under the Small Business Investment Act of 1958 as a Small Business Investment Company (SBIC). In addition, ACC has a real estate investment trust subsidiary, Allied Capital REIT, Inc. (Allied REIT), and several subsidiaries which are single member limited liability companies established primarily to hold real estate properties. In April 2001, ACC established a subsidiary, A.C. Corporation (AC Corp), which provides diligence and structuring services on private finance and commercial real estate transactions, as well as structuring, transaction, management and advisory services to the Company, its portfolio companies and other third parties.

ACC also owned Allied Capital SBLC Corporation (Allied SBLC), a BDC licensed by the Small Business Administration (SBA) as a Small Business Lending Company and a participant in the SBA Section 7(a) Guaranteed Loan Program. On December 31, 2000, ACC acquired BLC Financial Services, Inc. as a private portfolio company, which then changed its name to Business Loan Express, Inc. (BLX). As a part of the transaction, Allied SBLC was recapitalized as an independently managed, private portfolio company on December 28, 2000, and ceased to be a consolidated subsidiary of the Company at that time. Allied SBLC was then subsequently merged into BLX. The results of the operations of Allied SBLC are included in the consolidated financial results of ACC and its subsidiaries for 2000 through December 27, 2000.

Allied Capital Corporation and its subsidiaries, collectively, are hereinafter referred to as the Company.

In accordance with specific rules prescribed for investment companies, subsidiaries hold investments on behalf of the Company or provide substantial services to the Company. Portfolio investments are held for purposes of deriving investment income and future capital gains. The Company consolidates the results of its subsidiaries for financial reporting purposes. The financial results of the Company s portfolio investments are not consolidated in the Company s financial statements.

The investment objective of the Company is to achieve current income and capital gains. In order to achieve this objective, the Company invests primarily in private companies in a variety of industries and non-investment grade commercial mortgage-backed securities (CMBS).

Note 2. Summary of Significant Accounting Policies

Basis of Presentation

The consolidated financial statements include the accounts of the Company and its subsidiaries. All intercompany accounts and transactions have been eliminated in consolidation. Certain reclassifications have been made to the 2001 and 2000 balances to conform with the 2002 financial statement presentation.

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 2. Summary of Significant Accounting Policies, continued

During 2002, the Company revised its financial statement presentation to provide additional detail for the private finance portfolio and the interest and related portfolio income and net realized gains or losses by presenting these balances in the three categories described below. The 2001 and 2000 financial statements have been revised to conform to the 2002 presentation.

The private finance portfolio and the interest and related portfolio income and net realized gains or losses earned on the private finance portfolio are presented in three categories: companies more than 25% owned, which represent portfolio companies where the Company directly or indirectly owns more than 25% of the outstanding voting securities of such portfolio company and, therefore, are deemed controlled by the Company under the 1940 Act; companies owned 5% to 25%, which represent portfolio companies where the Company directly or indirectly owns 5% to 25% of the outstanding voting securities of such portfolio company or where the Company holds one or more seats on the portfolio company's board of directors and, therefore, are deemed to be an affiliated person under the 1940 Act; and companies less than 5% owned which represent portfolio companies where the Company directly or indirectly owns less than 5% of the outstanding voting securities of such portfolio company and where the Company has no other affiliations with such portfolio company. The interest and related portfolio income and net realized gains or losses from the commercial real estate finance portfolio and other sources are included in the companies less than 5% owned category on the consolidated statement of operations.

Valuation Of Portfolio Investments

The Company, as a BDC, invests in illiquid securities including debt and equity securities of primarily private companies and non-investment grade CMBS. The Company's investments are generally subject to restrictions on resale and generally have no established trading market. The Company values substantially all of its investments at fair value as determined in good faith by the board of directors in accordance with the Company's valuation policy. The Company determines fair value to be the amount for which an investment could be exchanged in an orderly disposition over a reasonable period of time between willing parties other than in a forced or liquidation sale. The Company's valuation policy considers the fact that no ready market exists for substantially all of the securities in which it invests. The Company's valuation policy is intended to provide a consistent basis for determining the fair value of the portfolio. The Company will record unrealized depreciation on investments when it believes that an investment has become impaired, including where collection of a loan or realization of an equity security is doubtful, or when the enterprise value of the company does not currently support the cost of the Company's debt or equity investments. Conversely, the Company will record unrealized appreciation if it believes that the underlying portfolio company has appreciated in value and, therefore, the Company's equity security has also appreciated in value. The value of investments in publicly traded securities are determined using quoted market prices discounted for restrictions on resale.

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 2. Summary of Significant Accounting Policies, continued

Loans and Debt Securities

For loans and debt securities, fair value generally approximates cost unless the borrower's enterprise value or overall financial condition or other factors lead to a determination of fair value at a different amount.

When the Company receives nominal cost warrants or free equity securities (nominal cost equity), the Company allocates its cost basis in its investment between its debt securities and its nominal cost equity at the time of origination. At that time, the original issue discount basis of the nominal cost equity is recorded by increasing the cost basis in the equity and decreasing the cost basis in the related debt securities.

Interest income is recorded on an accrual basis to the extent that such amounts are expected to be collected. For loans and debt securities with contractual payment-in-kind interest, which represents contractual interest accrued and added to the loan balance that generally becomes due at maturity, the Company will not accrue payment-in-kind interest if the portfolio company valuation indicates that the payment-in-kind interest is not collectible. Interest on loans and debt securities is not accrued if the Company has doubt about interest collection. Loans in workout status classified as Grade 4 or Grade 5 assets do not accrue interest. In addition, interest may not accrue on loans or debt securities to portfolio companies that are more than 50% owned by the Company if such companies are in need of additional capital. Loan origination fees, original issue discount and market discount are capitalized and then amortized into interest income using the effective interest method. Prepayment premiums are recorded on loans when received.

The weighted average yield on loans and debt securities is computed as the (a) annual stated interest rate earned plus the annual amortization of loan origination fees, original issue discount and market discount earned on accruing loans and debt securities, divided by (b) total loans and debt securities at value. The weighted average yield is computed as of the balance sheet date.

Equity Securities

The Company's equity interests in portfolio companies for which there is no liquid public market are valued at fair value based on the enterprise value of the portfolio company, which is determined using various factors, including cash flow from operations of the portfolio company and other pertinent factors such as recent offers to purchase a portfolio company's securities or other liquidation events. The determined fair values are generally discounted to account for restrictions on resale and minority ownership positions.

The value of the Company's equity interests in public companies for which market quotations are readily available is based upon the closing public market price on the balance sheet date. Securities that carry certain restrictions on sale are typically valued at a discount from the public market value of the security.

Dividend income is recorded on preferred equity securities on an accrual basis to the extent that such amounts are expected to be collected, and on common equity securities on the record date for private companies or on the ex-dividend date for publicly traded companies.

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 2. Summary of Significant Accounting Policies, continued

Commercial Mortgage-Backed Securities (CMBS)

CMBS bonds are carried at fair value, which is based on a discounted cash flow model that utilizes prepayment and loss assumptions based upon historical experience and projected performance, economic factors, the characteristics of the underlying cash flow and comparable market yields for similar CMBS bonds. The Company's assumption with regard to discount rate for determining fair value is based on the yield of comparable securities. The Company recognizes income from the amortization of original issue discount using the effective interest method, using the anticipated yield over the projected life of the investment. Yields are revised when there are changes in estimates of future credit losses, actual losses incurred, or actual and estimated prepayment speeds. Changes in estimated yield are recognized as an adjustment to the estimated yield over the remaining life of the CMBS bonds from the date the estimated yield is changed. The Company recognizes unrealized appreciation or depreciation on its CMBS bonds as comparable yields in the market change and based on changes in estimated cash flows resulting from changes in prepayment or loss assumptions in the underlying collateral pool.

Residual Interest

The Company values its residual interest from a previous securitization and recognizes income using the same accounting policies used for the CMBS bonds. The residual interest is carried at fair value based on discounted estimated future cash flows. The Company recognizes income from the residual interest using the effective interest method. At each reporting date, the effective yield is recalculated and used to recognize income until the next reporting date.

Net Realized and Unrealized Gains or Losses

Realized gains or losses are measured by the difference between the net proceeds from the sale and the cost basis of the investment without regard to unrealized gains or losses previously recognized, and include investments charged off during the year, net of recoveries. Unrealized gains or losses reflect the change in portfolio investment values during the reporting period.

Fee Income

Fee income includes fees for diligence, structuring, transaction services, management services, and investment advisory services rendered by the Company to portfolio companies and other third parties. Diligence, structuring, and transaction services fees are generally recognized as income when services are rendered or when the related transactions are completed. Management and investment advisory services fees are generally recognized as income as the services are rendered.

Deferred Financing Costs

Financing costs are based on actual costs incurred in obtaining debt financing and are deferred and amortized as part of interest expense over the term of the related debt instrument.

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 2. Summary of Significant Accounting Policies, continued

Cash and Cash Equivalents

Cash and cash equivalents include cash in banks and all highly liquid investments with original maturities of three months or less.

Dividends to Shareholders

Dividends to shareholders are recorded on the record date.

Stock Compensation Plans

At December 31, 2002, the Company has a stock-based employee compensation plan, which is described more fully in Note 10. The Company accounts for this plan under the recognition and measurement principles of APB Opinion No. 25, *Accounting for Stock Issued to Employees*, and related Interpretations. No stock-based employee compensation cost is reflected in net income, as all options granted under this plan had an exercise price equal to the market value of the underlying common stock on the date of grant. The following table illustrates the effect on net income and earnings per share if the Company had applied the fair value recognition provisions of FASB Statement No. 123, *Accounting for Stock-Based Compensation*, to stock-based employee compensation.

| (in thousands, except per share amounts) | 2002 | 2001 | 2000 |
|--|------------|------------|------------|
| Net increase in net assets resulting from operations as reported | \$ 228,291 | \$ 200,727 | \$ 143,101 |
| Less total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects | (6,863) | (7,207) | (5,385) |
| Pro forma net increase in net assets resulting from operations | 221,428 | 193,520 | 137,716 |
| Less preferred stock dividends | (230) | (230) | (230) |
| Pro forma income available to common shareholders | \$ 221,198 | \$ 193,290 | \$ 137,486 |
| Basic earnings per common share: | | | |
| As reported | \$ 2.23 | \$ 2.19 | \$ 1.95 |
| Pro forma | \$ 2.17 | \$ 2.11 | \$ 1.88 |
| Diluted earnings per common share: | | | |
| As reported | \$ 2.20 | \$ 2.16 | \$ 1.94 |
| Pro forma | \$ 2.14 | \$ 2.08 | \$ 1.87 |

Pro forma expenses are based on the underlying value of the options granted by the Company. The fair value of each option grant is estimated on the date of grant using the

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 2. Summary of Significant Accounting Policies, continued

Black-Scholes option pricing model, with the following weighted average assumptions for grants:

| | <u>2002</u> | <u>2001</u> | <u>2000</u> |
|--|-------------|-------------|-------------|
| Risk-free interest rate | 3.2% | 4.0% | 6.5% |
| Expected life | 5.0 | 5.0 | 5.0 |
| Expected volatility | 39.7% | 33.0% | 34.0% |
| Dividend yield | 8.5% | 8.0% | 8.7% |
| Weighted average fair value per option | \$3.78 | \$3.24 | \$3.02 |

Federal and State Income Taxes

The Company intends to comply with the requirements of the Internal Revenue Code (Code) that are applicable to regulated investment companies (RIC) and real estate investment trusts (REIT). The Company and its subsidiaries that qualify as a RIC or a REIT intend to annually distribute or retain through a deemed distribution all of their taxable income to shareholders; therefore, the Company has made no provision for income taxes for these entities. AC Corp is a corporation subject to federal and state income taxes and records a provision for income taxes as appropriate.

Per Share Information

Basic earnings per share is calculated using the weighted average number of shares outstanding for the period presented. Diluted earnings per share reflects the potential dilution that could occur if options to issue common stock were exercised into common stock. Earnings per share is computed after subtracting dividends on preferred shares.

Use of Estimates in the Preparation of Financial Statements

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenue and expenses during the reporting period. Actual results could differ from these estimates.

The consolidated financial statements include portfolio investments at value of \$2,488,167,000 and \$2,329,590,000 as of December 31, 2002 and 2001, respectively (89% and 95%, respectively, of total assets). Substantially all of these investments represent investments whose fair values have been determined by the board of directors in good faith in the absence of readily available market values. Because of the inherent uncertainty of valuation, the board of directors determined values may differ significantly from the values that would have been used had a ready market existed for the investments, and the differences could be material.

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 2. Summary of Significant Accounting Policies, continued

New Accounting Pronouncements

In November 2002, the FASB issued Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others* (the Interpretation) which expands on the accounting guidance of Statements No. 5, 57 and 107 and incorporates without change the provisions of FASB Interpretation No. 34, which is being superceded. The Interpretation will significantly change current practice in the accounting for and disclosure of guarantees. Guarantees meeting the characteristics described in the Interpretation are to be recognized at fair value and significant disclosure rules have been implemented even if the likelihood of the guarantor making payments is remote. The disclosure requirements are effective for financial statements of interim or annual periods ending after December 15, 2002, while the initial measurement provisions are applicable on a prospective basis to guarantees issued or modified after December 31, 2002. Certain guarantees are excluded from the initial recognition provisions of the Interpretation, however specific disclosures are still required. The Company does not expect that the initial recognition provisions will have a significant effect on the Company's financial position or its results of operations. See Note 5 for the disclosures related to the Company's guarantees.

In December 2002, the FASB issued Statement No. 148, *Accounting for Stock-Based Compensation: Transition and Disclosure: an Amendment of FASB Statement No. 123*. This Statement amends FASB Statement No. 123, *Accounting for Stock-Based Compensation*, to provide alternative methods of transition for a voluntary change to the fair value based method of accounting for stock-based employee compensation. The Company has not yet determined if it will adopt the provisions to expense the costs related to stock-based employee compensation. In addition, this statement amends the disclosure requirements of Statement No. 123 to require prominent disclosures in both annual and interim financial statements of the method of accounting for stock-based employee compensation and the effect of the method used on reported results. The disclosure requirements are effective for these financial statements and have been included above.

Note 3. Portfolio

Private Finance

At December 31, 2002 and 2001, the private finance portfolio consisted of the following:

| (\$ in thousands) | 2002 | | | 2001 | | |
|---------------------------|-------------|-------------|-------|-------------|-------------|-------|
| | Cost | Value | Yield | Cost | Value | Yield |
| Loans and debt securities | \$1,272,401 | \$1,151,256 | 14.4% | \$1,169,673 | \$1,107,890 | 14.8% |
| Equity interests | 438,501 | 591,959 | | 384,293 | 487,182 | |
| Total | \$1,710,902 | \$1,743,215 | | \$1,553,966 | \$1,595,072 | |

Private finance investment activity principally involves providing financing through privately negotiated long-term debt and equity investments. Private finance investments are

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 3. Portfolio, continued

generally structured as loans and debt securities that carry a relatively high fixed rate of interest, which may be combined with equity features, such as conversion privileges, or warrants or options to purchase a portion of the portfolio company's equity at a pre-determined strike price, which is generally a nominal price for warrants or options in a private company. Private finance investments are generally issued by privately-owned companies and are generally illiquid and subject to restrictions on resale or transferability.

Loans and debt securities generally have a maturity of five to ten years, with interest-only payments in the early years and payments of both principal and interest in the later years, although debt maturities and principal amortization schedules vary. At December 31, 2002 and 2001, approximately 95% and 98%, respectively, of the Company's loans and debt securities had fixed interest rates.

Equity interests consist primarily of securities issued by privately owned companies and may be subject to restrictions on their resale or may be otherwise illiquid. Equity securities generally do not produce a current return, but are held in anticipation of investment appreciation and ultimate gain on sale.

The Company may acquire more than 50% of the common stock of a portfolio company in a control buyout transaction. The Company's most significant investments acquired through control buyout transactions at December 31, 2002 and 2001, were Business Loan Express, Inc., The Hillman Companies, Inc., and WyoTech Acquisition Corporation.

At December 31, 2002 and 2001, the Company had an investment at value totaling \$256,801,000 and \$227,449,000, respectively, in Business Loan Express, Inc. (BLX), a small business lender that participates in the U.S. Small Business Administration 7(a) Guaranteed Loan Program. At December 31, 2002, the Company owned 94.9% of BLX's common stock. The Company's common stock ownership is subject to dilution by management options. As the controlling shareholder of BLX, the Company has provided an unconditional guaranty to the BLX credit facility lenders in an amount up to 50% of the total obligations (consisting of principal, accrued interest and other fees) on BLX's three-year unsecured \$124,000,000 revolving credit facility that matures in March 2004. The amount guaranteed by the Company at December 31, 2002, was \$51,641,000. This guaranty can be called by the lenders only in the event of a default by BLX. BLX was in compliance with the terms of its credit facility at December 31, 2002. In consideration for providing this guaranty, BLX paid the Company a guaranty fee of \$3,100,000 and \$2,285,000 in 2002 and 2001, respectively. The Company has also provided two standby letters of credit in connection with two term securitization transactions completed by BLX totaling \$10,550,000. BLX is headquartered in New York, NY.

At December 31, 2002 and 2001, the Company had an investment in The Hillman Companies, Inc. totaling \$180,468,000 and \$97,227,000 at value, respectively. At December 31, 2002, the Company owned 96.8% of Hillman's common stock. The Company's common stock ownership is subject to dilution by management options. Hillman is a leading manufacturer of key making equipment and distributor of key blanks, fasteners, signage, and other small hardware components and operates in multiple channels of the retail marketplace such as hardware stores, national and regional home centers, and

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 3. Portfolio, continued

mass merchants. Hillman has certain patent-protected products, including key duplication technology, that is important to its business. Hillman's primary operations are located in Cincinnati, Ohio.

At December 31, 2001, the Company had an investment in WyoTech Acquisition Corporation at value totaling \$60,388,000. WyoTech is a proprietary trade school and its primary operations are in Laramie, Wyoming. On July 1, 2002, the Company completed the sale of WyoTech Acquisition Corporation to a third party. The Company's total proceeds from the sale of WyoTech, including the repayment of debt and preferred stock and the sale of the Company's 91% common equity ownership, were \$77,230,000, resulting in a realized gain of \$60,755,000 in the third quarter of 2002. The sale of WyoTech is subject to post-closing working capital adjustments, if any, and customary indemnification provisions.

Total interest and portfolio related income earned from the Company's investments in BLX, Hillman, and WyoTech for the year ended December 31, 2002, was \$53,137,000.

At December 31, 2002 and 2001, loans and debt securities in workout status (classified as Grades 4 and 5 under the Company's internal grading system) that were not accruing interest were as follows at value:

| (in thousands) | 2002 | 2001 |
|-------------------------------|-------------------|-------------------|
| Companies more than 25% owned | \$ 9,709 | \$ 153 |
| Companies 5% to 25% owned | 411 | 3,418 |
| Companies less than 5% owned | 65,931 | 77,354 |
| | <u> </u> | <u> </u> |
| Total | \$76,051 | \$80,925 |
| | <u> </u> | <u> </u> |

Included in Grade 4 and 5 loans and debt securities not accruing interest were assets valued at \$8,905,000 at December 31, 2001, that were related to portfolio companies in liquidation. As of December 31, 2002, \$7,646,000 at value representing receivables related to portfolio companies in liquidation were included in other assets.

In addition to Grade 4 and 5 assets that are in workout, the Company may not accrue interest on loans and debt securities to companies that are more than 50% owned by the Company if such companies are in need of additional capital and, therefore, the Company may defer current debt service. Loans and debt securities to such companies totaled \$63,577,000 at value at December 31, 2002. Loans to companies which are less than 50% owned by the Company that were not in workout, but were not accruing interest totaled \$7,166,000 and \$12,819,000 at value at December 31, 2002 and 2001, respectively.

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 3. Portfolio, continued

The industry and geographic compositions of the private finance portfolio at value at December 31, 2002 and 2001, were as follows:

| | <u>2002</u> | <u>2001</u> |
|--------------------------|-------------|-------------|
| Industry | | |
| Consumer products | 34% | 28% |
| Business services | 26 | 22 |
| Financial services | 16 | 15 |
| Industrial products | 9 | 10 |
| Healthcare services | 5 | 3 |
| Retail | 4 | 5 |
| Telecommunications | 2 | 4 |
| Broadcasting & cable | 1 | 4 |
| Education | 1 | 5 |
| Other | 2 | 4 |
| | <u> </u> | <u> </u> |
| Total | 100% | 100% |
| | <u> </u> | <u> </u> |
| Geographic Region | | |
| Mid-Atlantic | 45% | 43% |
| Midwest | 16 | 17 |
| Southeast | 16 | 14 |
| West | 15 | 19 |
| Northeast | 7 | 5 |
| International | 1 | 2 |
| | <u> </u> | <u> </u> |
| Total | 100% | 100% |
| | <u> </u> | <u> </u> |

Commercial Real Estate Finance

At December 31, 2002 and 2001, the commercial real estate finance portfolio consisted of the following:

| (\$ in thousands) | <u>2002</u> | | | <u>2001</u> | | |
|---|-------------|--------------|--------------|-------------|--------------|--------------|
| | <u>Cost</u> | <u>Value</u> | <u>Yield</u> | <u>Cost</u> | <u>Value</u> | <u>Yield</u> |
| CMBS bonds | \$523,671 | \$555,519 | 14.2% | \$558,346 | \$558,346 | 14.7% |
| Collateralized debt obligation preferred shares | 52,818 | 52,818 | 17.2% | 24,207 | 24,207 | 16.9% |
| Loans | 66,546 | 63,707 | 7.5% | 76,120 | 79,597 | 7.7% |
| Residual interest | 69,335 | 69,035 | 9.4% | 70,179 | 69,879 | 9.4% |
| Real estate owned | 5,942 | 3,873 | | 3,784 | 2,489 | |
| | <u> </u> | <u> </u> | | <u> </u> | <u> </u> | |
| Total | \$718,312 | \$744,952 | | \$732,636 | \$734,518 | |



ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 3. Portfolio, continued

CMBS Bonds. At December 31, 2002 and 2001, CMBS bonds consisted of the following:

| | 2002 | 2001 |
|-------------------------|-------------------|--------------|
| | (\$ in thousands) | |
| Face | \$ 1,173,194 | \$ 1,170,272 |
| Original issue discount | (649,523) | (611,926) |
| Cost | \$ 523,671 | \$ 558,346 |
| Value | \$ 555,519 | \$ 558,346 |

The non-investment grade and unrated tranches of the CMBS bonds in which the Company invests are junior in priority for payment of interest and principal to the more senior tranches of the related CMBS bond issuance. Cash flow from the underlying mortgages generally is allocated first to the senior tranches, with the most senior tranches having a priority right to the cash flow. Then, any remaining cash flow is allocated, generally, among the other tranches in order of their relative seniority. To the extent there are defaults and unrecoverable losses on the underlying mortgages or the properties securing those mortgages resulting in reduced cash flows, the most subordinate tranche will bear this loss first. At December 31, 2002, the Company's CMBS bonds were subordinate to 91% to 97% of the tranches of bonds issued in various CMBS transactions. Given that the non-investment grade CMBS bonds in which the Company invests are junior in priority for payment of principal, the Company invests in these CMBS bonds at a significant discount from the face amount of the bonds.

The underlying rating classes of the CMBS bonds at value at December 31, 2002, and 2001 were as follows:

| | 2002 | | 2001 | |
|---------|-------------------|------------------------|------------|------------------------|
| | Value | Percentage of Total | Value | Percentage of Total |
| | (\$ in thousands) | | | |
| BB+ | \$ 49,811 | 9.0% | \$ 24,785 | 4.4% |
| BB | 39,011 | 7.0 | 69,404 | 12.4 |
| BB- | 22,030 | 4.0 | 67,460 | 12.1 |
| B+ | 121,038 | 21.8 | 103,560 | 18.6 |
| B | 141,998 | 25.6 | 131,362 | 23.5 |
| B- | 83,493 | 15.0 | 73,572 | 13.2 |
| CCC | 8,634 | 1.5 | 8,893 | 1.6 |
| Unrated | 89,504 | 16.1 | 79,310 | 14.2 |
| Total | \$ 555,519 | 100.0% | \$ 558,346 | 100.0% |

At December 31, 2002 and 2001, the underlying pools of mortgage loans that are collateral for the Company's CMBS bonds consisted of approximately 4,500 and 3,800 commercial mortgage loans with a total outstanding principal balance of \$24,974,035,000 and \$20,548,643,000, respectively. At December 31, 2002 and 2001, 1.0% and 0.5%, respectively, of the mortgage loans in the underlying collateral pool for the Company's CMBS bonds were over 30 days delinquent or were classified as real estate owned. The property types and the geographic composition of the underlying mortgage loans in the

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 3. Portfolio, continued

underlying collateral pool calculated using the outstanding principal balance at December 31, 2002 and 2001, were as follows:

| | <u>2002</u> | <u>2001</u> |
|--------------------------|-------------|-------------|
| Property Type | | |
| Retail | 32% | 31% |
| Housing | 27 | 27 |
| Office | 21 | 22 |
| Industrial Real Estate | 7 | 6 |
| Hospitality | 6 | 7 |
| Other | 7 | 7 |
| | <u> </u> | <u> </u> |
| Total | 100% | 100% |
| | <u> </u> | <u> </u> |
| Geographic Region | | |
| West | 31% | 32% |
| Mid-Atlantic | 25 | 24 |
| Midwest | 22 | 21 |
| Southeast | 17 | 17 |
| Northeast | 5 | 6 |
| | <u> </u> | <u> </u> |
| Total | 100% | 100% |
| | <u> </u> | <u> </u> |

The Company's yield on its CMBS bonds is based upon a number of assumptions that are subject to certain business and economic uncertainties and contingencies. Examples include the timing and magnitude of credit losses on the mortgage loans underlying the CMBS bonds that are a result of the general condition of the real estate market (including competition for tenants and their related credit quality) and changes in market rental rates. The initial yield on each CMBS bond has been computed assuming an approximate 1% loss rate on its entire underlying collateral mortgage pool, with the estimated losses being assumed to occur in three equal installments in years three, six, and nine. As each CMBS bond ages, the amount of losses and the expected timing of recognition of such losses will be updated, and the respective yield will be adjusted as necessary. As of December 31, 2002, the Company has identified specific losses of \$27,980,000, which will reduce the face amount and original issue discount on the CMBS bonds, but will not result in a change in the cost and value of the CMBS bonds. As these uncertainties and contingencies are difficult to predict and are subject to future events which may alter these assumptions, no assurance can be given that the anticipated yields to maturity will be achieved.

The Company acts as the directing certificate holder for the CMBS bonds, which allows the Company to approve disposition plans for individual loans in the underlying collateral pool.

Collateralized Debt Obligation Preferred Shares. At December 31, 2002, the Company owned preferred shares in four collateralized debt obligations (CDOs) totaling \$52,818,000 at value secured by investment grade unsecured debt issued by various real estate investment trusts (REITs) and investment and non-investment grade CMBS bonds. The investment grade REIT collateral consists of debt with a cut-off balance of \$1,017,553,000 and was issued by 42 REITs. The investment grade CMBS collateral

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 3. Portfolio, continued

consists of CMBS bonds with a face amount of \$479,021,000 issued in 39 separate CMBS transactions. The non-investment grade CMBS collateral consists of BB+, BB, and BB- CMBS bonds with a face amount of \$463,426,000 issued in 39 separate CMBS transactions (CMBS Collateral). Included in the CMBS Collateral for the CDOs are \$397,872,000 of CMBS bonds that are senior in priority of repayment to certain lower rated CMBS bonds held by the Company, which were issued in 23 separate CMBS transactions. The preferred shares are junior in priority for payment of principal and interest to the more senior tranches of debt issued by the CDOs. To the extent there are defaults and unrecoverable losses on the underlying collateral resulting in reduced cash flows, the preferred shares will bear this loss first. At December 31, 2002, the Company's preferred shares in the CDOs were subordinate to approximately 96% of the more senior tranches of debt issued by the CDOs.

The Company acts as the disposition consultant with respect to three of the CDOs, which allows the Company to approve disposition plans for individual collateral securities. For these services with respect to the CDOs, the Company collects annual fees based on the outstanding collateral pool balance, and for the years ended December 31, 2002 and 2001, this fee totaled \$526,000 and \$108,000, respectively.

Loans. The commercial mortgage loan portfolio contains loans that were originated by the Company or were purchased from third-party sellers. At December 31, 2002 and 2001, approximately 84% and 16% and 76% and 24% of the Company's commercial mortgage loan portfolio was composed of fixed and adjustable interest rate loans, respectively. As of December 31, 2002 and 2001, loans with a value of \$13,016,000 and \$15,241,000, respectively, were not accruing interest.

The property types and the geographic composition securing the commercial mortgage loan portfolio at value at December 31, 2002 and 2001, were as follows:

| | <u>2002</u> | <u>2001</u> |
|----------------------|-------------------|-------------------|
| Property Type | | |
| Hospitality | 23% | 25% |
| Retail | 21 | 21 |
| Office | 20 | 34 |
| Healthcare | 15 | |
| Recreation | 3 | 4 |
| Other | 18 | 16 |
| | <u> </u> | <u> </u> |
| Total | 100% | 100% |
| | <u> </u> | <u> </u> |

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 3. Portfolio, continued

| | 2002 | 2001 |
|--------------------------|------|------|
| Geographic Region | | |
| Southeast | 40% | 36% |
| West | 20 | 20 |
| Mid-Atlantic | 17 | 23 |
| Midwest | 12 | 16 |
| Northeast | 11 | 5 |
| | — | — |
| Total | 100% | 100% |

Residual Interest. At December 31, 2002 and 2001, the residual interest consisted of the following:

| | 2002 | | 2001 | |
|--------------------------|----------|----------|----------|----------|
| | Cost | Value | Cost | Value |
| (in thousands) | | | | |
| Residual interest | \$68,853 | \$68,853 | \$68,853 | \$68,853 |
| Residual interest spread | 482 | 182 | 1,326 | 1,026 |
| | — | — | — | — |
| Total | \$69,335 | \$69,035 | \$70,179 | \$69,879 |

The residual interest primarily consists of a retained interest totaling \$68,853,000 from a 1998 asset securitization whereby bonds were sold in three classes rated AAA, AA and A. The residual interest represents a right to cash flows from the underlying collateral pool of loans after these senior bond obligations are satisfied. At December 31, 2002, one class of bonds rated AAA was outstanding, totaling \$17,640,000. The Company has the right to call the bonds upon a minimum of ten days notice to the bondholders. Once the bonds are fully repaid, either through the cash flows from the securitized loans or due to the Company calling the bonds, the remaining loans in the trust will be returned to the Company as payment on the residual interest.

The Company sold \$295 million of loans, and received cash proceeds, net of costs, of approximately \$223 million in January 1998. The Company retained a trust certificate for its residual interest in a loan pool sold, and will receive interest income from this residual interest as well as the residual interest spread (Residual) from the interest earned on the loans sold less the interest paid on the bonds over the life of the bonds. As of December 31, 2002 and 2001, the mortgage loan pool had an approximate weighted average stated interest rate of 8.8% and 9.3% respectively. The outstanding bond classes sold had an aggregate weighted average interest rate of 6.7% and 6.6% as of December 31, 2002 and 2001, respectively.

The Company uses a discounted cash flow methodology for determining the fair value of its retained Residual. In determining the cash flow of the Residual, the Company assumes a prepayment speed of 15% after the applicable prepayment lockout period and credit losses of 1% or approximately \$813,000 of the total principal balance of the underlying collateral throughout the life of the collateral. These assumptions result in an expected weighted average life of the bonds of four months. The value of the resulting Residual cash flows is then determined by applying a discount rate of 9% which, in the Company's view, is commensurate with the market risk of comparable assets.

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 3. Portfolio, continued

Tax Basis. At December 31, 2002, the aggregate gross unrealized appreciation of the Company's investments over cost for federal income tax purposes was \$302,965,000. At December 31, 2002, the aggregate gross unrealized depreciation of the Company's investments under cost for federal income tax purposes was \$196,181,000. At December 31, 2002, the aggregate cost of securities, for federal income tax purposes was \$2,381,383,000.

Note 4. Debt

At December 31, 2002 and 2001, the Company had the following debt:

| | 2002 | | 2001 | |
|------------------------------------|--------------------|-----------------|--------------------|-----------------|
| | Facility Amount | Amount Drawn | Facility Amount | Amount Drawn |
| (in thousands) | | | | |
| Notes payable and debentures: | | | | |
| Unsecured long-term notes payable | \$ 694,000 | \$694,000 | \$ 694,000 | \$ 694,000 |
| SBA debentures | 101,800 | 94,500 | 101,800 | 94,500 |
| Auction rate reset note | | | 81,856 | 81,856 |
| OPIC loan | 5,700 | 5,700 | 5,700 | 5,700 |
| Total notes payable and debentures | 801,500 | 794,200 | 883,356 | 876,056 |
| Revolving line of credit | 527,500 | 204,250 | 497,500 | 144,750 |
| Total | \$ 1,329,000 | \$ 998,450 | \$ 1,380,856 | \$ 1,020,806 |

Notes Payable and Debentures

Unsecured Long-Term Notes Payable. The Company issued unsecured long-term notes to private institutional investors. The notes require semi-annual interest payments until maturity and have original terms of five or seven years. At December 31, 2002, the notes had remaining maturities of five months to four years. The weighted average fixed interest rate on the notes was 7.6% at December 31, 2002 and 2001. The notes may be prepaid in whole or in part, together with an interest premium, as stipulated in the note agreement.

SBA Debentures. At December 31, 2002 and 2001, the Company had debentures payable to the SBA with original terms of ten years and at fixed interest rates ranging from 5.9% to 8.2% and 2.4% to 8.2%, respectively. At December 31, 2002, the debentures had remaining maturities of two to nine years. The weighted average interest rate was 7.0% and 6.7% at December 31, 2002 and 2001, respectively. The debentures require semi-annual interest-only payments with all principal due upon maturity. The SBA debentures are subject to prepayment penalties if paid prior to the fifth anniversary date of the notes. At December 31, 2002, the Company has a commitment from the SBA to borrow up to an additional \$7,300,000 above the amount outstanding. The commitment expires on September 30, 2005.

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 4. Debt, continued

Auction Rate Reset Note. At December 31, 2001, the Company had an Auction Rate Reset Senior Note Series A that bore interest at the three-month London Interbank Offered Rate (LIBOR) plus 1.75%, which adjusted quarterly. Interest was due quarterly and the note matured on December 27, 2002. The Company repaid the note in full at maturity.

The Company has entered into an agreement with the placement agent of this note to serve as the placement agent on a future issuance of \$75,000,000 of debt, equity, or other securities in one or more public or private transactions. If the Company does not conduct a capital raise, the Company will incur additional expenses of approximately \$3,188,000.

Scheduled future maturities of notes payable and debentures at December 31, 2002, are as follows:

| Year | Amount Maturing (in thousands) |
|------------|-----------------------------------|
| 2003 | \$ 140,000 |
| 2004 | 221,000 |
| 2005 | 179,000 |
| 2006 | 180,700 |
| 2007 | |
| Thereafter | 73,500 |
| | <hr/> |
| Total | \$ 794,200 |
| | <hr/> |

Revolving Line of Credit

The Company has an unsecured revolving line of credit for \$527,500,000 at December 31, 2002. The facility may be expanded up to \$600,000,000 at the Company's option. The facility bears interest at a rate equal to (i) the one-month LIBOR plus 1.25%, (ii) the Bank of America, N.A. prime rate, or (iii) the Federal Funds rate plus 0.50% at the Company's option. The interest rate adjusts at the beginning of each new interest period, usually every 30 days. The interest rates were 2.7% and 3.2% at December 31, 2002 and 2001, respectively, and the facility requires an annual commitment fee equal to 0.25% of the committed amount. The line expires in August 2003 and may be extended under substantially similar terms for one additional year at the Company's sole option. The line of credit requires monthly interest payments and all principal is due upon its expiration.

The average debt outstanding on the revolving line of credit was \$68,266,000 and \$106,338,000 for the years ended December 31, 2002 and 2001, respectively. The maximum amount borrowed under this facility and the weighted average interest rate for the years ended December 31, 2002 and 2001, were \$216,500,000 and \$213,500,000, and 3.2% and 5.4%, respectively. As of December 31, 2002, the amount available under the revolving line of credit was \$317,950,000, net of amounts committed for standby letters of credit of \$5,300,000 issued under the credit facility.

The Company records debt at cost. The fair value of the Company's total debt was \$1,050,452,000 at December 31, 2002.

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 4. Debt, continued

The Company has various financial and operating covenants required by the revolving line of credit and the notes payable and debentures. These covenants require the Company to maintain certain financial ratios, including debt to equity and interest coverage, and a minimum net worth. The Company's credit facilities limit its ability to declare dividends if the Company defaults under certain provisions. As of December 31, 2002, the Company was in compliance with these covenants.

Note 5. Guarantees

In the ordinary course of business, the Company has issued guarantees and has extended standby letters of credit through financial intermediaries on behalf of certain portfolio companies. As of December 31, 2002, the Company has issued guarantees of debt, rental obligations, and lease obligations aggregating \$54,628,000 and has extended standby letters of credit aggregating \$11,300,000. Under these arrangements, the Company would be required to make payments to third-party beneficiaries if the portfolio companies were to default on their related payment obligations. The maximum amount of future payments is \$65,928,000. At December 31, 2002, no amounts have been recorded as a liability for the Company's guarantees or standby letters of credit.

As of December 31, 2002, the commitments expire as follows:

| (in thousands) | Total | 2003 | 2004 | 2005 | 2006 | 2007 | After 2007 |
|--|-----------------|----------------|-----------------|--------------|--------------|--------------|----------------|
| Guarantees of debt and lease obligations | \$54,628 | \$1,718 | \$52,349 | \$311 | \$139 | \$111 | \$ |
| Standby letters of credit | 11,300 | — | 5,300 | — | — | — | 6,000 |
| Total | \$65,928 | \$1,718 | \$57,649 | \$311 | \$139 | \$111 | \$6,000 |

Note 6. Preferred Stock

Allied Investment has outstanding a total of 60,000 shares of \$100 par value, 3% cumulative preferred stock and 10,000 shares of \$100 par value, 4% redeemable cumulative preferred stock issued to the SBA pursuant to Section 303(c) of the Small Business Investment Act of 1958, as amended. The 3% cumulative preferred stock does not have a required redemption date. Allied Investment has the option to redeem in whole or in part the preferred stock by paying the SBA the par value of such securities and any dividends accumulated and unpaid to the date of redemption. The 4% redeemable cumulative preferred stock has a required redemption date in June 2005.

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 7. Shareholders Equity

Sales of common stock for the years ended December 31, 2002 and 2001, were as follows:

| (in thousands) | 2002 | 2001 | 2000 |
|--|------------|------------|------------|
| Number of common shares | 8,047 | 13,286 | 14,812 |
| Gross proceeds | \$ 177,345 | \$ 301,539 | \$ 263,460 |
| Less costs including underwriting fees | (4,498) | (14,651) | (12,548) |
| Net proceeds | \$ 172,847 | \$ 286,888 | \$ 250,912 |

In addition, the Company issued 204,855 shares of common stock with a value of \$5,157,000 to acquire one portfolio investment in a stock-for-stock exchange during 2001. The Company also issued 4,123,407 shares of common stock with a value of \$86,076,000 to acquire BLC Financial Services, Inc. in a stock-for-stock exchange on December 31, 2000.

The Company has a dividend reinvestment plan, whereby the Company may buy shares of its common stock in the open market or issue new shares in order to satisfy dividend reinvestment requests. If the Company issues new shares, the issue price is equal to the average of the closing sale prices reported for the Company's common stock for the five consecutive days immediately prior to the dividend payment date.

Dividend reinvestment plan activity for the years ended December 31, 2002, 2001, and 2000, was as follows:

| (in thousands, except per share amounts) | 2002 | 2001 | 2000 |
|--|----------|----------|----------|
| Shares issued | 275 | 271 | 254 |
| Average price per share | \$ 22.78 | \$ 23.32 | \$ 18.79 |

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 8. Earnings Per Common Share

Earnings per common share for the years ended December 31, 2002, 2001, and 2000, were as follows:

| (in thousands, except per share amounts) | 2002 | 2001 | 2000 |
|--|------------|------------|------------|
| Net increase in net assets resulting from operations | \$ 228,291 | \$ 200,727 | \$ 143,101 |
| Less preferred stock dividends | (230) | (230) | (230) |
| Income available to common shareholders | \$ 228,061 | \$ 200,497 | \$ 142,871 |
| Basic shares outstanding | 102,107 | 91,564 | 73,165 |
| Dilutive options outstanding to officers | 1,467 | 1,439 | 307 |
| Diluted shares outstanding | 103,574 | 93,003 | 73,472 |
| Basic earnings per common share | \$ 2.23 | \$ 2.19 | \$ 1.95 |
| Diluted earnings per common share | \$ 2.20 | \$ 2.16 | \$ 1.94 |

Note 9. 401(k) Plan and Deferred Compensation Plan

The Company's 401(k) retirement investment plan is open to all of its full-time employees who are at least 21 years of age. The employees may elect voluntary pre-tax wage deferrals ranging from 0% to 100% of eligible compensation for the year up to \$11,000 annually for the 2002 plan year. Plan participants who reached the age of 50 during the 2002 plan year were eligible to defer an additional \$1,000 during the year. The Company makes contributions to the 401(k) plan of up to 5% of each participant's eligible compensation for the year up to a maximum compensation permitted by the IRS, which fully vests at the time of contribution. For the year ended December 31, 2002, the maximum compensation was \$200,000. Employer contributions that exceed the IRS limitation are directed to the participant's deferred compensation plan account. Total 401(k) contribution expense for the years ended December 31, 2002, 2001, and 2000 was \$599,000, \$560,000, and \$590,000, respectively.

The Company also has a deferred compensation plan. Eligible participants in the deferred compensation plan may elect to defer some of their compensation and have such compensation credited to a participant account. In addition, the Company makes contributions to the deferred compensation plan to the extent 401(k) contributions for eligible participants exceed the amount permitted by the Internal Revenue Service. Contribution expense for the deferred compensation plan for the years ended December 31, 2002, 2001, and 2000, was \$296,000, \$272,000, and \$197,000, respectively. All amounts credited to a participant's account are credited solely for purposes of accounting and computation and remain assets of the Company and subject to the claims of the Company's general creditors. Amounts credited to participants under the deferred compensation plan are at all times 100% vested and non-forfeitable. A participant's account shall become distributable upon his or her separation from service, retirement, disability, death, or at a future determined date. All deferred compensation plan accounts will be distributed in the event of a change of control of the Company or in the event of

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 9. 401(k) Plan and Deferred Compensation Plan, continued

the Company's insolvency. Amounts deferred by participants under the deferred compensation plan are funded to a trust, which is administered by Company-appointed trustees.

Note 10. Stock Option Plan

The Option Plan

The purpose of the stock option plan (Option Plan) is to provide officers and non-officer directors of the Company with additional incentives. On May 7, 2002, the Company's shareholders amended the Option Plan to increase the authorized shares under the plan to 25,950,000. At December 31, 2002, the number of shares available to be granted under the Option Plan was 9,415,000.

Options are exercisable at a price equal to the fair market value of the shares on the day the option is granted. Each option states the period or periods of time within which the option may be exercised by the optionee, which may not exceed ten years from the date the option is granted. The options granted vest ratably over a three- or five-year period.

All rights to exercise options terminate 60 days after an optionee ceases to be (i) a non-officer director, (ii) both an officer and a director, if such optionee serves in both capacities, or (iii) an officer (if such officer is not also a director) of the Company for any cause other than death or total and permanent disability. In the event of a change of control of the Company, all outstanding options will become fully vested and exercisable as of the change of control.

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 10. Stock Option Plan, continued

Information with respect to options granted, exercised and forfeited under the Option Plan for the years ended December 31, 2002, 2001, and 2000, is as follows:

| (in thousands, except per share amounts) | Shares | Weighted Average Exercise Price Per Share |
|--|---------|--|
| Options outstanding at January 1, 2000 | 5,889 | \$ 20.12 |
| Granted | 4,162 | 17.02 |
| Exercised | (195) | 17.68 |
| Forfeited | (950) | 19.81 |
| Options outstanding at December 31, 2000 | 8,906 | \$ 18.76 |
| Granted | 2,800 | 21.82 |
| Exercised | (553) | 19.09 |
| Forfeited | (673) | 17.66 |
| Options outstanding at December 31, 2001 | 10,480 | \$ 19.63 |
| Granted | 6,162 | 22.07 |
| Exercised | (769) | 18.85 |
| Forfeited | (1,184) | 21.09 |
| Options outstanding at December 31, 2002 | 14,689 | \$ 20.57 |

The following table summarizes information about stock options outstanding at December 31, 2002:

| Range of Exercise Prices | Outstanding | | | Exercisable | |
|---|--------------------------------|---|--|--------------------------------|--|
| | Total Number Outstanding | Weighted Average Remaining Contractual Life (years) | Weighted Average Exercise Price | Total Number Exercisable | Weighted Average Exercise Price |
| (in thousands, except per share amounts and years) | | | | | |
| \$16.81 \$17.75 | 3,212 | 7.35 | \$ 16.94 | 2,128 | \$ 16.94 |
| \$17.88 \$21.38 | 3,008 | 5.45 | \$ 20.71 | 2,374 | \$ 20.82 |
| \$21.52 | 5,462 | 9.95 | \$ 21.52 | | \$ 21.52 |
| \$21.59 \$26.29 | 2,907 | 8.66 | \$ 22.44 | 1,029 | \$ 22.10 |
| \$27.38 | 100 | 9.09 | \$ 27.38 | | \$ 27.38 |
| \$16.81 \$27.38 | 14,689 | 8.20 | \$ 20.57 | 5,531 | \$ 19.56 |

—

—

F-37

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 10. Stock Option Plan, continued

The Company accounts for its stock options as required by APB Opinion No. 25, *Accounting for Stock Issued to Employees*, and accordingly no compensation cost has been recognized as the exercise price equals the market price on the date of grant.

Notes Receivable from the Sale of Common Stock

The Company provided loans to officers for the exercise of options. The loans are full recourse, have varying terms not exceeding ten years, bear interest at the applicable federal interest rate in effect at the date of issue and have been recorded as a reduction to shareholders' equity. At December 31, 2002 and 2001, the Company had outstanding loans to officers of \$24,704,000 and \$26,028,000, respectively. Officers with outstanding loans repaid principal of \$3,706,000, \$5,090,000, and \$6,363,000, for the years ended December 31, 2002, 2001, and 2000, respectively. The Company recognized interest income from these loans of \$1,507,000, \$1,524,000, and \$1,712,000, respectively, during these same periods. This interest income is included in interest and dividends for companies less than 5% owned.

As a business development company under the Investment Company Act of 1940, the Company is entitled to provide loans to the Company's employees in connection with the exercise of options. However, as a result of provisions of the Sarbanes-Oxley Act of 2002, the Company is prohibited from making new loans to its executive officers in the future.

Note 11. Dividends and Distributions

For the years ended December 31, 2002, 2001, and 2000, the Company declared the following distributions:

| | 2002 | | 2001 | | 2000 | |
|---|--------------|-----------------|--------------|-----------------|--------------|-----------------|
| | Total Amount | Total Per Share | Total Amount | Total Per Share | Total Amount | Total Per Share |
| (in thousands, except per share amounts) | | | | | | |
| First quarter | \$ 53,259 | \$0.53 | \$ 42,080 | \$0.49 | \$ 30,715 | \$0.45 |
| Second quarter | 56,224 | 0.55 | 45,755 | 0.50 | 33,150 | 0.45 |
| Third quarter | 57,340 | 0.56 | 47,866 | 0.51 | 34,751 | 0.46 |
| Fourth quarter | 59,851 | 0.56 | 50,456 | 0.51 | 37,179 | 0.46 |
| Extra dividend | 3,261 | 0.03 | | | | |
| Total distributions to common shareholders | \$229,935 | \$2.23 | \$186,157 | \$2.01 | \$135,795 | \$1.82 |

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 11. Dividends and Distributions, continued

For income tax purposes, distributions for 2002, 2001, and 2000, were composed of the following:

| | 2002 | | 2001 | | 2000 | |
|---|--------------|-----------------|--------------|-----------------|--------------|-----------------|
| | Total Amount | Total Per Share | Total Amount | Total Per Share | Total Amount | Total Per Share |
| (in thousands, except per share amounts) | | | | | | |
| Ordinary income(1) | \$ 178,246 | \$ 1.73 | \$ 183,957 | \$ 1.99 | \$ 116,321 | \$ 1.56 |
| Long-term capital gains | 51,689 | 0.50 | 2,200 | 0.02 | 19,474 | 0.26 |
| Total distributions to common shareholders | \$ 229,935 | \$ 2.23 | \$ 186,157 | \$ 2.01 | \$ 135,795 | \$ 1.82 |

(1) For certain eligible corporate shareholders, the dividend received deduction for 2002 was \$0.08 per share.

The following table summarizes the differences between financial statement net increase in net assets resulting from operations and taxable income for the years ended December 31, 2002, 2001, and 2000:

| (in thousands) | 2002 | 2001 | 2000 |
|--|------------|------------|------------|
| Financial statement net increase in net assets resulting from operations | \$ 228,291 | \$ 200,727 | \$ 143,101 |
| Adjustments: | | | |
| Net unrealized losses (gains) | 571 | (20,603) | (14,861) |
| Interest income from securitized commercial mortgage loans | 1,258 | 3,327 | 3,149 |
| Amortization of discounts and fees | (8,541) | 8,043 | 2,771 |
| Gains from disposition of portfolio assets | | | 5,202 |
| Formula award | | (4,383) | 1,374 |
| Other expenses not deductible for tax | 1,815 | 3,230 | 1,197 |
| Other | 5,708 | (2,368) | (3,550) |
| Income tax expense (benefit) | 930 | (412) | |
| Taxable income | \$ 230,032 | \$ 187,561 | \$ 138,383 |

The Company must distribute at least 90% of its investment company taxable income to qualify for pass-through tax treatment and maintain its RIC status. For the years ended December 31, 2002 and 2001, the Company recorded tax expense of \$930,000 and a tax benefit of \$412,000, respectively.

Note 12. Cash and Cash Equivalents

Edgar Filing: ALLIED CAPITAL CORP - Form N-2/A

The Company places its cash with financial institutions and, at times, cash held in checking accounts in financial institutions may be in excess of the Federal Deposit Insurance Corporation insured limit.

F-39

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 12. Cash and Cash Equivalents, continued

At December 31, 2002 and 2001, cash and cash equivalents consisted of the following:

| (in thousands) | 2002 | 2001 |
|--|------------------|---------------|
| Cash and cash equivalents | \$ 15,497 | \$ 5,337 |
| Less escrows held | (4,311) | (4,448) |
| Total cash and cash equivalents | \$ 11,186 | \$ 889 |

Note 13. Supplemental Disclosure of Cash Flow Information

For the years ended December 31, 2002, 2001, and 2000, the Company paid \$69,143,000, \$63,237,000, and \$54,112,000, respectively, for interest. For years ended December 31, 2002, 2001, and 2000, the Company's non-cash financing activities totaled \$8,644,000, \$17,523,000, and \$92,835,000, respectively, and includes stock option exercises and dividend reinvestment. The non-cash financing activities for the years ended December 31, 2001 and 2000, also include the issuance of \$5,157,000 and \$86,076,000 of the Company's common stock to acquire portfolio investments.

Note 14. Hedging Activities

The Company invests in CMBS bonds, which are purchased at prices that are based in part on comparable Treasury rates. The Company has entered into transactions with one or more financial institutions to hedge against movement in Treasury rates on certain of the BB+ through B rated CMBS bonds. These transactions involved the Company receiving the proceeds from the sale of borrowed Treasury securities, with the obligation to replenish the borrowed Treasury securities at a later date based on the then current market price. Borrowed Treasury securities and the related obligations to replenish the borrowed Treasury securities, including accrued interest payable on the obligations, as of December 31, 2002 and 2001, consisted of the following:

| (in thousands) Description of Issue | 2002 Value | 2001 Value |
|--|-------------------|------------------|
| 10-year Treasury, due August 2011 | \$ | \$ 17,989 |
| 10-year Treasury, due August 2011 | | 5,656 |
| 10-year Treasury, due August 2011 | | 23,618 |
| 10-year Treasury, due February 2012 | 2,880 | |
| 10-year Treasury, due February 2012 | 28,573 | |
| 10-year Treasury, due February 2012 | 20,600 | |
| 10-year Treasury, due November 2012 | 23,415 | |
| 10-year Treasury, due November 2012 | 19,494 | |
| 5-year Treasury, due November 2007 | 37,647 | |
| 10-year Treasury, due November 2012 | 64,418 | |
| Total | \$ 197,027 | \$ 47,263 |

As of December 31, 2002, the total obligations on the hedge had increased since the original sale date due to changes in the yield on the borrowed Treasury securities, resulting

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 14. Hedging Activities, continued

in unrealized depreciation on the obligations of \$7,062,000. The net proceeds related to the sales of the borrowed Treasury securities were \$189,340,000 and \$48,504,000 at December 31, 2002 and 2001, respectively. Under the terms of the transactions, the Company has provided additional cash collateral of \$5,405,000 at December 31, 2002, for the difference between the net proceeds related to the sales of the borrowed Treasury securities and the obligations to replenish the securities. The Company has deposited the proceeds related to the sales of the borrowed Treasury securities and the additional cash collateral with the financial institutions under repurchase agreements. The repurchase agreements are collateralized by U.S. Treasury securities and are settled weekly. As of December 31, 2002, the repurchase agreements were due on January 3, 2003, and had a weighted average interest rate of 0.8%. This Note has been revised to further disclose the detail of the borrowed Treasury securities as of December 31, 2001.

Note 15. Financial Highlights

| | At and for the Years Ended December 31, | |
|---|--|----------|
| | 2002 | 2001 |
| Per Common Share Data | | |
| Net asset value, beginning of year | \$ 13.57 | \$ 12.11 |
| Net investment income before net realized and unrealized gains(1) | 1.77 | 1.93 |
| Net realized and unrealized gains(1) | 0.43 | 0.23 |
| Net increase in net assets resulting from operations | 2.20 | 2.16 |
| Net decrease in net assets from shareholder distributions | (2.23) | (2.01) |
| Net increase in net assets from capital share transactions | 0.68 | 1.31 |
| Net asset value, end of year | \$ 14.22 | \$ 13.57 |
| Market value, end of year | \$ 21.83 | \$ 26.00 |
| Total return | (7)% | 36% |

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 15. Financial Highlights, continued

| | At and for the Years Ended December 31, | |
|--|--|--------------|
| | 2002 | 2001 |
| Ratios and Supplemental Data (\$ and shares in thousands, except per share amounts) | | |
| Ending net assets | \$ 1,546,071 | \$ 1,352,123 |
| Common shares outstanding at end of year | 108,698 | 99,607 |
| Diluted weighted average common shares outstanding | 103,574 | 93,003 |
| Employee and administrative expenses/average net assets | 3.82% | 3.80% |
| Total expenses/average net assets | 8.75% | 9.31% |
| Net investment income before net realized and unrealized gains/average net assets | 12.94% | 15.15% |
| Net increase in net assets resulting from operations/average net assets | 15.98% | 16.99% |
| Portfolio turnover rate | 15.12% | 10.04% |
| Average debt outstanding | \$ 938,148 | \$ 847,121 |
| Average debt per share | \$ 9.06 | \$ 9.11 |

(1) Based on diluted weighted average number of shares outstanding for the period.

Note 16. Selected Quarterly Data (Unaudited)

| (in thousands, except per share amounts) | 2002 | | | |
|--|----------|----------|----------|----------|
| | Qtr. 1 | Qtr. 2 | Qtr. 3 | Qtr. 4 |
| Total interest and related portfolio income | \$82,391 | \$73,193 | \$76,329 | \$78,015 |
| Net investment income before net realized and unrealized gains | \$53,869 | \$42,561 | \$45,094 | \$42,401 |
| Net increase in net assets resulting from operations | \$55,961 | \$73,454 | \$45,520 | \$53,356 |
| Basic earnings per common share | \$ 0.56 | \$ 0.72 | \$ 0.44 | \$ 0.51 |
| Diluted earnings per common share | \$ 0.55 | \$ 0.71 | \$ 0.44 | \$ 0.51 |
| | | | | |
| | 2001 | | | |
| | Qtr. 1 | Qtr. 2 | Qtr. 3 | Qtr. 4 |
| Total interest and related portfolio income | \$65,071 | \$68,739 | \$72,634 | \$82,666 |
| Net investment income before net realized and unrealized gains | \$39,728 | \$42,118 | \$44,189 | \$53,428 |
| Net increase in net assets resulting from operations | \$52,028 | \$46,106 | \$59,703 | \$42,890 |
| Basic earnings per common share | \$ 0.61 | \$ 0.52 | \$ 0.64 | \$ 0.44 |
| Diluted earnings per common share | \$ 0.60 | \$ 0.51 | \$ 0.63 | \$ 0.43 |

Note 17. Litigation

A series of class action lawsuits were filed in 2002 in the United States District Court for the Southern District of New York against the Company, certain of its directors and officers and its former independent auditors, Arthur Andersen LLP, with respect to alleged

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 17. Litigation, continued

violations of the securities laws. Specifically, these lawsuits allege that the defendants violated Section 10(b), Rule 10b-5, and Section 20(a) of the Securities Exchange Act of 1934 by purportedly misstating the value of certain portfolio investments in the Company's financial statements, which allegedly resulted in the purchase of the Company's common stock by purported class members at artificially inflated prices. Several of the complaints also alleged state law claims for common law fraud. The complaints seek compensatory and other damages, and costs and expenses associated with the litigation. The lawsuits have been consolidated into a single proceeding. The consolidated complaint does not include Arthur Andersen LLP as a named defendant or assert any state law claims against the remaining named defendants. The Company has filed a motion to dismiss the lawsuit and the plaintiffs have filed an opposition to this motion. The Company has filed a reply to the plaintiff's opposition. The Company believes that the lawsuit is without merit, and it intends to defend the lawsuit vigorously. While the Company does not expect these matters to materially affect its financial condition or results of operations, there can be no assurance as to whether any such pending litigation will have a material adverse effect on its financial condition or results of operations in any future reporting period.

The Company also is party to certain other lawsuits in the normal course of business. While the outcome of these legal proceedings cannot at this time be predicted with certainty, the Company does not expect that these proceedings will have a material effect upon the Company's financial condition or results of operations.

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

CONSOLIDATING BALANCE SHEET

December 31, 2002

| | Allied Capital | Allied Investment | Others | Eliminations | Consolidated Total |
|--|-------------------|----------------------|------------|--------------|-----------------------|
| (in thousands) | | | | | |
| ASSETS | | | | | |
| Portfolio at value: | | | | | |
| Private finance | \$ 1,586,886 | \$ 140,807 | \$ 15,522 | \$ | \$ 1,743,215 |
| Commercial real estate finance | 660,653 | 3,485 | 80,814 | | 744,952 |
| Investments in subsidiaries | 130,353 | | | (130,353) | |
| Total portfolio at value | 2,377,892 | 144,292 | 96,336 | (130,353) | 2,488,167 |
| Deposits of proceeds from sales of borrowed Treasury securities | 194,745 | | | | 194,745 |
| Other assets | 62,255 | 9,368 | 28,598 | | 100,221 |
| Intercompany notes and receivables | 69,435 | 132 | 16,935 | (86,502) | |
| Cash and cash equivalents | 1,722 | 8,926 | 538 | | 11,186 |
| Total assets | \$ 2,706,049 | \$ 162,718 | \$ 142,407 | \$ (216,855) | \$ 2,794,319 |
| LIABILITIES AND SHAREHOLDERS EQUITY | | | | | |
| Liabilities: | | | | | |
| Notes payable and debentures | \$ 699,700 | \$ 94,500 | \$ | \$ | \$ 794,200 |
| Revolving line of credit | 204,250 | | | | 204,250 |
| Obligations to replenish borrowed Treasury securities | 197,027 | | | | 197,027 |
| Accounts payable and other liabilities | 29,590 | 2,259 | 13,922 | | 45,771 |
| Intercompany notes and payables | 29,411 | 29 | 57,062 | (86,502) | |
| Total liabilities | 1,159,978 | 96,788 | 70,984 | (86,502) | 1,241,248 |
| Commitments and contingencies | | | | | |
| Preferred stock | | 7,000 | | | 7,000 |
| Shareholders' equity: | | | | | |
| Common stock | 11 | | 1 | (1) | 11 |
| Additional paid-in capital | 1,547,183 | 53,923 | 79,116 | (133,039) | 1,547,183 |
| Notes receivable from sale of common stock | (24,704) | | | | (24,704) |
| Net unrealized appreciation (depreciation) on portfolio | 39,411 | (11,849) | (4,202) | 16,051 | 39,411 |
| Undistributed (distributions in excess of) earnings | (15,830) | 16,856 | (3,492) | (13,364) | (15,830) |
| Total shareholders' equity | 1,546,071 | 58,930 | 71,423 | (130,353) | 1,546,071 |
| Total liabilities and shareholders equity | \$ 2,706,049 | \$ 162,718 | \$ 142,407 | \$ (216,855) | \$ 2,794,319 |

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

CONSOLIDATING STATEMENT OF OPERATIONS

For the Year Ended December 31, 2002

| | Allied Capital | Allied Investment | Others | Eliminations | Consolidated Total |
|---|-------------------|----------------------|----------------|-----------------|-----------------------|
| (in thousands) | | | | | |
| Interest and Related Portfolio Income | | | | | |
| Interest and dividends | \$ 240,771 | \$ 16,158 | \$ 7,113 | \$ | \$ 264,042 |
| Intercompany interest | 4,612 | | | (4,612) | |
| Premiums from loan dispositions | 2,654 | 122 | | | 2,776 |
| Income from investments in wholly owned subsidiaries | 5,525 | | | (5,525) | |
| Fees and other income | 15,158 | 227 | 38,583 | (10,858) | 43,110 |
| Total interest and related portfolio income | 268,720 | 16,507 | 45,696 | (20,995) | 309,928 |
| Expenses | | | | | |
| Interest | 62,991 | 7,452 | | | 70,443 |
| Intercompany interest | | 4 | 4,608 | (4,612) | |
| Employee | 12,373 | | 20,753 | | 33,126 |
| Administrative | 17,632 | 113 | 14,617 | (10,858) | 21,504 |
| Total operating expenses | 92,996 | 7,569 | 39,978 | (15,470) | 125,073 |
| Net investment income before income taxes and net realized and unrealized gains | 175,724 | 8,938 | 5,718 | (5,525) | 184,855 |
| Income tax expense | | | 930 | | 930 |
| Net investment income before net realized and unrealized gains | 175,724 | 8,938 | 4,788 | (5,525) | 183,925 |
| Net Realized and Unrealized Gains (Losses) | | | | | |
| Net realized gains (losses) | 53,138 | (4,429) | (3,772) | | 44,937 |
| Net unrealized losses | (571) | (21,875) | (2,401) | 24,276 | (571) |
| Total net realized and unrealized gains (losses) | 52,567 | (26,304) | (6,173) | 24,276 | 44,366 |
| Net increase (decrease) in net assets resulting from operations | \$ 228,291 | \$ (17,366) | \$ (1,385) | \$ 18,751 | \$ 228,291 |

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

CONSOLIDATING STATEMENT OF CASH FLOWS

For the Year Ended December 31, 2002

| | Allied Capital | Allied Investment | Others | Eliminations | Consolidated Total |
|---|-------------------|----------------------|---------------|--------------|-----------------------|
| (in thousands) | | | | | |
| Cash Flows from Operating Activities | | | | | |
| Net increase (decrease) in net assets resulting from operations | \$ 228,291 | \$(17,366) | \$(1,385) | \$ 18,751 | \$ 228,291 |
| Adjustments | | | | | |
| Portfolio investments | (495,716) | (10,660) | | | (506,376) |
| Repayments of investment principal | 134,049 | 9,118 | | | 143,167 |
| Proceeds from investment sales | 207,291 | | 6,183 | | 213,474 |
| Change in accrued or reinvested interest and dividends | (41,589) | (3,076) | | | (44,665) |
| Net change in intercompany investments | (5,776) | 2,785 | (2,534) | 5,525 | |
| Amortization of discounts and fees | (19,448) | (1,144) | | | (20,592) |
| Changes in other assets and liabilities | 7,747 | 1,005 | (9,487) | | (735) |
| Depreciation and amortization | | | 1,572 | | 1,572 |
| Realized losses | 40,417 | 6,436 | 3,772 | | 50,625 |
| Net unrealized losses | 571 | 21,875 | 2,401 | (24,276) | 571 |
| | <u>55,837</u> | <u>8,973</u> | <u>522</u> | <u></u> | <u>65,332</u> |
| Cash Flows from Financing Activities | | | | | |
| Sale of common stock | 172,847 | | | | 172,847 |
| Sale of common stock upon the exercise of stock options | 12,136 | | | | 12,136 |
| Collections of notes receivable from sale of common stock | 3,706 | | | | 3,706 |
| Common dividends and distributions paid | (220,411) | | | | (220,411) |
| Preferred stock dividends paid | | (220) | (10) | | (230) |
| Repayments on notes payable and debentures | (81,856) | | | | (81,856) |
| Net borrowings under revolving line of credit | 59,500 | | | | 59,500 |
| Other | (727) | | | | (727) |
| | <u>(54,805)</u> | <u>(220)</u> | <u>(10)</u> | <u></u> | <u>(55,035)</u> |
| Net increase in cash and cash equivalents | <u>\$ 1,032</u> | <u>\$ 8,753</u> | <u>\$ 512</u> | <u>\$</u> | <u>\$ 10,297</u> |
| Cash and cash equivalents at beginning of year | <u>690</u> | <u>173</u> | <u>26</u> | <u></u> | <u>889</u> |
| Cash and cash equivalents at end of year | <u>\$ 1,722</u> | <u>\$ 8,926</u> | <u>\$ 538</u> | <u>\$</u> | <u>\$ 11,186</u> |



F-46



Independent Auditors Report

The Board of Directors and Shareholders
Allied Capital Corporation:

We have audited the accompanying consolidated balance sheet of Allied Capital Corporation and subsidiaries, including the consolidated statement of investments, as of December 31, 2002, and the related consolidated statements of operations, changes in net assets and cash flows, and the financial highlights (included in Note 15), for the year then ended. These consolidated financial statements and financial highlights are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements and financial highlights based on our audit. The consolidated financial statements of Allied Capital Corporation and subsidiaries as of December 31, 2001, and for the years ended December 31, 2001 and 2000 were audited by other auditors who have ceased operations. Those auditors' report, dated February 20, 2002, on those consolidated financial statements, was unqualified, before the revisions described in Notes 2 and 14 to the consolidated financial statements, and included an emphasis paragraph that described the Company's method of valuing investments and the inherent uncertainty of valuation as discussed in Note 2 to the consolidated financial statements.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements and financial highlights are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. Our procedures included physical counts of securities owned as of December 31, 2002. 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 audit provides a reasonable basis for our opinion.

In our opinion, the 2002 consolidated financial statements and financial highlights referred to above present fairly, in all material respects, the financial position of Allied Capital Corporation and subsidiaries as of December 31, 2002, the results of their operations, their cash flows, changes in their net assets, and financial highlights for the year then ended, in conformity with accounting principles generally accepted in the United States of America.

As discussed above, the consolidated financial statements of the Company as of December 31, 2001 and for the years ended December 31, 2001 and 2000 were audited by other auditors who have ceased operations. As described in Notes 2 and 14, those consolidated financial statements have been revised. We audited the revisions described in Notes 2 and 14 that were applied to the 2001 and 2000 consolidated financial statements. In our opinion, such revisions are appropriate and have been properly applied. However, we were not engaged to audit, review, or apply any procedures to the 2001 and 2000 consolidated financial statements of the Company other than with respect to such revisions, and, accordingly, we do not express an opinion or any other form of assurance on the 2001 and 2000 consolidated financial statements taken as a whole.

Our audit was made for the purpose of forming an opinion on the 2002 consolidated financial statements taken as a whole. The consolidating balance sheet and related consolidating statements of operations and cash flows are presented for purposes of additional analysis of the consolidated financial statements rather than to present the

Edgar Filing: ALLIED CAPITAL CORP - Form N-2/A

financial position, results of operations, and cash flows of the individual companies. The consolidating information has been subjected to the auditing procedures applied in the audit of the consolidated financial statements and, in our opinion, is fairly stated in all material respects in relation to the consolidated financial statements taken as a whole.

Washington, D.C.

February 11, 2003

F-48

Independent Auditors Report

NOTE: THIS IS A COPY OF A REPORT PREVIOUSLY ISSUED BY ARTHUR ANDERSEN LLP, ALLIED CAPITAL CORPORATION'S FORMER INDEPENDENT ACCOUNTANTS. THIS REPORT HAS NOT BEEN REISSUED BY ARTHUR ANDERSEN LLP IN CONNECTION WITH FILING OF THE REGISTRATION STATEMENT OF WHICH THIS PROSPECTUS IS A PART.

To the Shareholders and Board of Directors of Allied Capital Corporation and Subsidiaries:

We have audited the accompanying consolidated balance sheets of Allied Capital Corporation and subsidiaries as of December 31, 2001 and 2000, including the consolidated statement of investments as of December 31, 2001, and the related consolidated statements of operations, changes in net assets and cash flows for each of the three years in the period then ended, and the financial highlights (included in Note 15) for the year ended December 31, 2001. These consolidated financial statements, financial highlights and the supplementary consolidating financial information referred to below are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements, financial highlights and the supplementary consolidating financial information referred to below based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements and financial highlights are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. Our procedures included physical counts of investments. 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.

As discussed in Note 2, the consolidated financial statements include investments valued at \$2,329,590,000 as of December 31, 2001 and \$1,788,001,000 as of December 31, 2000 (172 percent and 174 percent, respectively, of net assets) whose values have been estimated by the board of directors in the absence of readily ascertainable market values. However, because of the inherent uncertainty of valuation, the board of directors' estimated values may differ significantly from the values that would have been used had a ready market existed for the investments, and the differences could be material.

In our opinion, the consolidated financial statements and financial highlights referred to above present fairly, in all material respects, the financial position of Allied Capital Corporation and subsidiaries as of December 31, 2001 and 2000, and the consolidated results of their operations, changes in net assets and cash flows for each of the three years in the period then ended, and the financial highlights for the year ended December 31, 2001 in conformity with accounting principles generally accepted in the United States.

Our audit was made for the purpose of forming an opinion on the consolidated financial statements taken as a whole. The supplementary consolidating balance sheet and related consolidating statements of operations and cash flows are presented for purposes of additional analysis of the consolidated financial statements rather than to present balance sheet, statement of operations and cash flows of the individual companies and are not a required part of the consolidated financial statements. This information has been subjected

to the auditing procedures applied in our audit of the consolidated financial statements and in our opinion, is fairly stated in all material respects in relation to the consolidated financial statements taken as a whole.

Vienna, Virginia

February 20, 2002

F-50

PART C

OTHER INFORMATION

Item 24. Financial Statements and Exhibits

1. Financial Statements.

The following financial statements of Allied Capital Corporation (the Company or the Registrant) are included in this registration statement in Part A: Information Required in a Prospectus :

| | <u>Page</u> |
|---|-------------|
| Consolidated Balance Sheet December 31, 2002 and 2001 | F-2 |
| Consolidated Statement of Operations For the Years Ended December 31, 2002, 2001 and 2000 | F-3 |
| Consolidated Statement of Changes in Net Assets For the Years Ended December 31, 2002, 2001 and 2000 | F-4 |
| Consolidated Statement of Cash Flows For the Years Ended December 31, 2002, 2001 and 2000 | F-5 |
| Consolidated Statement of Investments December 31, 2002 | F-6 |
| Notes to Consolidated Financial Statements | F-17 |
| Reports of Independent Public Accountants | F-47 |
| Consolidated Balance Sheet as of March 31, 2003 (unaudited) and December 31, 2002 | S-28 |
| Consolidated Statement of Operations (unaudited) For the Three Months Ended March 31, 2003 and 2002 | S-29 |
| Consolidated Statement of Changes in Net Assets (unaudited) For the Three Months Ended March 31, 2003 and 2002 | S-30 |
| Consolidated Statement of Cash Flows (unaudited) For the Three Months Ended March 31, 2003 and 2002 | S-31 |
| Consolidated Statement of Investments as of March 31, 2003 (unaudited) | S-32 |
| Notes to Consolidated Financial Statements | S-43 |
| Independent Accountants Review Report | S-63 |

2. Exhibits

| <u>Exhibit Number</u> | <u>Description</u> |
|---------------------------|---|
| a.1 | Restated Articles of Incorporation. <i>(Incorporated by reference to Exhibit a.1 filed with Allied Capital's Post-Effective Amendment No. 2 to registration statement on Form N-2 (File No. 333-67336) filed on March 22, 2002).</i> |
| b. | Amended and Restated Bylaws. <i>(Incorporated by reference to Exhibit b. filed with Allied Capital's Post-Effective Amendment No. 2 to registration statement on Form N-2 (File No. 333-67336) filed on March 22, 2002).</i> |
| c. | Not applicable. |
| d. | Specimen Certificate of Allied Capital's Common Stock, par value \$0.0001 per share. <i>(Incorporated by reference to Exhibit d. filed with Allied Capital's registration statement on Form N-2 (File No. 333-51899) filed on May 6, 1998).</i> |

Edgar Filing: ALLIED CAPITAL CORP - Form N-2/A

| Exhibit Number | Description |
|-------------------|---|
| e. | Dividend Reinvestment Plan, as amended. <i>(Incorporated by reference to Exhibit e. filed with Allied Capital's registration statement on Form N-2 (File No. 333-87862) filed on May 8, 2002).</i> |
| f.1 | Form of debenture between certain subsidiaries of Allied Capital and the U.S. Small Business Administration. <i>(Incorporated by reference to Exhibit 4.2 filed by a predecessor entity to Allied Capital on Form 10-K for the year ended December 31, 1996).</i> |
| f.2 | Third Amended and Restated Credit Agreement, dated April 18, 2003. <i>(Incorporated by reference to Exhibit 10.2 filed with Allied Capital's Form 10-Q for the period ended March 31, 2003).</i> |
| f.3 | Note Agreement, dated as of April 30, 1998. <i>(Incorporated by reference to Exhibit 10.2 filed with Allied Capital's Form 10-Q for the period ended June 30, 1998).</i> |
| f.4 | Loan Agreement between a predecessor entity to Allied Capital and Overseas Private Investment Corporation, dated April 10, 1995. <i>(Incorporated by reference to Exhibit f.7 filed by a predecessor entity to Allied Capital to Pre-Effective Amendment No. 2 to the registration statement on Form N-2 (File No. 33-64629) filed on January 24, 1996).</i> Letter, dated December 11, 1997, evidencing assignment of Loan Agreement from the predecessor entity of Allied Capital to Allied Capital. <i>(Incorporated by reference to Exhibit 10.3 of Allied Capital's Form 10-K for the year ended December 31, 1997).</i> |
| f.5 | Note Agreement, dated as of May 1, 1999. <i>(Incorporated by reference to Exhibit 10.5 filed with Allied Capital's Form 10-Q for the period ended June 30, 1999).</i> |
| f.6 | Amendment and Consent Agreement, dated December 11, 2000, to the Amended and Restated Credit Agreement, dated May 17, 2000. <i>(Incorporated by reference to Exhibit f.6 filed with Allied Capital's Post-Effective Amendment No. 2 to registration statement on Form N-2 (File No. 333-43534) filed on March 21, 2001).</i> |
| f.7. | Sale and Servicing Agreement, dated as of January 1, 1998, among Allied Capital CMT, Inc., Allied Capital Commercial Mortgage Trust 1998-1, Allied Capital Corporation, LaSalle National Bank and ABN AMRO Bank N.V. <i>(Incorporated by reference to Exhibit f.7.a filed with Allied Capital's registration statement on Form N-2 (File No. 333-51899) filed on May 6, 1998).</i> |
| f.8 | Indenture, dated as of January 1, 1998, between Allied Capital Commercial Mortgage Trust 1998-1 and LaSalle National Bank. <i>(Incorporated by reference to Exhibit f.7.b filed with Allied Capital's registration statement on Form N-2 (File No. 333-51899) filed on May 6, 1998).</i> |
| f.9 | Amended and Restated Trust Agreement, dated January 1, 1998, between Allied Capital CMT, Inc., LaSalle National Bank Inc. and Wilmington Trust Company. <i>(Incorporated by reference to Exhibit f.7.c filed with Allied Capital's registration statement on Form N-2 (File No. 333-51899) filed on May 6, 1998).</i> |
| f.10 | Guaranty, dated as of January 1, 1998, by Allied Capital. <i>(Incorporated by reference to Exhibit f.7.d filed with Allied Capital's registration statement on Form N-2 (File No. 333-51899) filed on May 6, 1998).</i> |

Edgar Filing: ALLIED CAPITAL CORP - Form N-2/A

| Exhibit Number | Description |
|-------------------|--|
| f.11 | Note Agreement, dated as of November 15, 1999. <i>(Incorporated by reference to Exhibit 10.4a of Allied Capital's Form 10-K for the year ended December 31, 1999).</i> |
| f.12 | Note Agreement, dated as of October 15, 2000. <i>(Incorporated by reference to Exhibit 10.4b filed with Allied Capital's Form 10-Q for the period ended September 30, 2000).</i> |
| f.13 | Note Agreement, dated as of October 15, 2001. <i>(Incorporated by reference to Exhibit f.10 filed with Allied Capital's Post-Effective Amendment No. 1 to registration statement on Form N-2 (File No. 333-67336) filed on November 14, 2001).</i> |
| f.14 | Auction Rate Reset Note Agreement, dated as of August 31, 2000, between Allied Capital and Intrepid Funding Master Trust; Forward Issuance Agreement, dated as of August 31, 2000, between Allied Capital and Banc of America Securities LLC; Remarketing and Contingency Purchase Agreement, dated as of August 31, 2000, between Allied Capital and Banc of America Securities LLC. <i>(Incorporated by reference to Exhibit f.12 filed with Allied Capital's Pre-Effective Amendment No. 1 to registration statement on Form N-2 (File No. 333-43534) filed on September 12, 2000).</i> |
| f.15 | Control Investor Guaranty Agreement, dated as of March 28, 2001, between Allied Capital and Fleet National Bank and Business Loan Express, Inc. <i>(Incorporated by reference to Exhibit f.14 filed with Allied Capital's Post-Effective Amendment No. 3 to registration statement on Form N-2 (File No. 333-43534) filed on May 15, 2001).</i> |
| f.16 | Letter Agreement amending the Auction Rate Reset Note Agreement dated as of September 30, 2002, between Allied Capital and Intrepid Funding Master Trust; Letter Agreement amending the Forward Issuance Agreement, dated as of September 30, 2002, between Allied Capital and Banc of America Securities LLC; Amendment to the Remarketing and Contingent Purchase Agreement, dated as of September 30, 2002, between Allied Capital and Banc of America Securities LLC. <i>(Incorporated by reference to Exhibit 10.29 filed with Allied Capital's Form 10-Q for the period ended September 30, 2002).</i> |
| f.17 | Amendment to the Letter Agreement and Forward Issuance Agreement, dated as of December 19, 2002, between Allied Capital and Banc of America Securities LLC. <i>(Incorporated by reference to Exhibit 10.14(c) filed with Allied Capital's Form 10-K for the year ended December 31, 2002).</i> |
| f.18 | Amendment to the Letter Agreement and Forward Issuance Agreement dated as of March 28, 2003 between Allied Capital and Banc of America Securities LLC <i>(Incorporated by reference to Exhibit 10.14(d) filed with Allied Capital's Form 10-K for the year ended December 31, 2002).</i> |
| f.19 | Note Agreement, dated as of May 14, 2003. <i>(Incorporated by reference to Exhibit 10.31 filed with Allied Capital's Form 10-Q for the quarter ended March 31, 2003).</i> |
| f.20 | Amendment, dated as of April 30, 2003, to Note Agreement, dated as of April 30, 1998. <i>(Incorporated by reference to Exhibit 10.32 filed with Allied Capital's Form 10-Q for the period ended March 31, 2003).</i> |

Edgar Filing: ALLIED CAPITAL CORP - Form N-2/A

| Exhibit Number | Description |
|-------------------|--|
| f.21 | Amendment, dated as of April 30, 2003, to Note Agreement, dated as of May 1, 1999. <i>(Incorporated by reference to Exhibit 10.33 filed with Allied Capital's Form 10-Q for the period ended March 31, 2003).</i> |
| f.22 | Amendment, dated as of April 30, 2003, to Note Agreement, dated as of November 15, 1999. <i>(Incorporated by reference to Exhibit 10.34 filed with Allied Capital's Form 10-Q for the period ended March 31, 2003).</i> |
| f.23 | Amendment, dated as of April 30, 2003, to Note Agreement, dated as of October 15, 2000. <i>(Incorporated by reference to Exhibit 10.35 filed with Allied Capital's Form 10-Q for the period ended March 31, 2003).</i> |
| f.24 | Amendment, dated as of April 30, 2003, to Note Agreement, dated as of October 15, 2001. <i>(Incorporated by reference to Exhibit 10.36 filed with Allied Capital's Form 10-Q for the period ended March 31, 2003).</i> |
| g. | Not applicable. |
| h. | Form of Underwriting Agreement, if applicable. <i>(Incorporated by reference to Exhibit h. filed with Allied Capital's registration statement on Form N-2 (File No. 333-104109) on March 31, 2003).</i> |
| i.1 | Amended and Restated Deferred Compensation Plan, dated December 30, 1998. <i>(Incorporated by reference to Exhibit 10.11 of Allied Capital's Form 10-K for the year ended December 31, 1998).</i> |
| i.2 | Amendment to Deferred Compensation Plan, dated October 18, 2000. <i>(Incorporated by reference to Exhibit i.2.a filed with Allied Capital's Post-Effective Amendment No. 1 to registration statement on Form N-2 (File No. 333-43534) filed on January 19, 2001).</i> |
| i.3 | Amended and Restated Deferred Compensation Plan, dated May 15, 2001. <i>(Incorporated by reference to Exhibit i.2.b filed with Allied Capital's Post-Effective Amendment No. 1 to registration statement on Form N-2 (File No. 333-67336) filed on November 14, 2001).</i> |
| i.4 | Amended Stock Option Plan. <i>(Incorporated by reference to Exhibit A of Allied Capital's definitive proxy statement for Allied Capital's 2002 Annual Meeting of Stockholders filed on April 3, 2002).</i> |
| i.5 | Allied Capital Corporation 401(k) Plan, dated September 1, 1999. <i>(Incorporated by reference to Exhibit 4.4 filed with Allied Capital's registration statement on Form S-8 (File No. 333-88681) filed on October 8, 1999).</i> |
| i.6 | Amendment to Allied Capital Corporation 401(k) Plan, dated December 31, 2000. <i>(Incorporated by reference to Exhibit i.5.a filed with Allied Capital's Post-Effective Amendment No. 1 to registration statement on Form N-2 (File No. 333-43534) filed on January 19, 2001).</i> |
| i.7 | Employment Agreement, dated June 15, 2000, between Allied Capital and William L. Walton. <i>(Incorporated by reference to Exhibit f.9 filed with Allied Capital's registration statement on Form N-2 (File No. 333-43534) filed on August 11, 2000).</i> |
| i.8 | Employment Agreement, dated June 15, 2000, between Allied Capital and Joan M. Sweeney. <i>(Incorporated by reference to Exhibit f.10 filed with Allied Capital's registration statement on Form N-2 (File No. 333-43534) filed on August 11, 2000).</i> |

Edgar Filing: ALLIED CAPITAL CORP - Form N-2/A

| Exhibit Number | Description |
|-------------------|---|
| i.9 | Employment Agreement, dated June 15, 2000, between Allied Capital and John M. Scheurer. <i>(Incorporated by reference to Exhibit f.10 filed with Allied Capital's Post-Effective Amendment No. 2 to registration statement on Form N-2 (File No. 333-43534) filed on March 21, 2001).</i> |
| i.10 | Employment Agreement, dated June 15, 2002, between Allied Capital and Thomas H. Westbrook and amended on March 10, 2003. <i>(Incorporated by reference to Exhibit 10.24 filed with Allied Capital's Form 10-K for the year ended December 31, 2002).</i> |
| j.1 | Form of Custody Agreement with Riggs Bank N.A. <i>(Incorporated by reference to Exhibit j.1 filed with Allied Capital's registration statement on Form N-2 (File No. 333-51899) filed on May 6, 1998).</i> |
| j.2 | Form of Custody Agreement with LaSalle National Bank. <i>(Incorporated by reference to Exhibit j.2 filed with Allied Capital's registration statement on Form N-2 (File No. 333-51899) filed on May 6, 1998).</i> |
| j.3 | Custodian Agreement with LaSalle National Bank Association dated July 9, 2001. <i>(Incorporated by reference to Exhibit j.3 filed with Allied Capital's registration statement on Form N-2 (File No. 333-67336) filed on August 10, 2001).</i> |
| l. | Opinion of counsel and consent to its use. <i>(Incorporated by reference to Exhibit l. filed with Allied Capital's registration statement on Form N-2 (File No. 333-104149) on March 31, 2003).</i> |
| m. | Not applicable. |
| n.1 | Consent of Sutherland Asbill & Brennan LLP. <i>(Contained in exhibit l.)</i> |
| n.2.a | Consent of Arthur Andersen LLP <i>(Omitted in reliance on Rule 437a of the Securities Act of 1933).</i> |
| n.2.b* | Consent of KPMG LLP, independent public accountants. |
| n.3.a | Opinion of KPMG LLP, independent public accountants, regarding Senior Securities table contained herein. <i>(Incorporated by reference to Exhibit n.3.a filed with Allied Capital's registration statement on Form N-2 (File No. 333-104149) on March 31, 2003).</i> |
| n.3.b* | Consent of KPMG LLP, independent public accountants, regarding opinion on Senior Securities table contained herein. |
| n.4* | Letter Regarding Unaudited Interim Financial Information. |
| o. | Not applicable. |
| p. | Not applicable. |
| q. | Not applicable. |
| r. | Code of Ethics. <i>(Incorporated by reference to Exhibit r. filed with Allied Capital's Pre-Effective Amendment No. 1 to the registration statement on Form N-2 (File No. 333-43534) on September 12, 2000).</i> |

* Filed herewith.

Item 25. Marketing Arrangements

The information contained under the heading Plan of Distribution of the prospectus is incorporated herein by reference, and any information concerning any underwriters will be contained in the accompanying prospectus supplement, if any.

Item 26. Other Expenses of Issuance and Distribution*

| | |
|--|-----------|
| Commission registration fee | \$ 11,574 |
| NASD filing fee | 30,500 |
| New York Stock Exchange Additional Listing Fee | 63,000 |
| Accounting fees and expenses | 100,000 |
| Legal fees and expenses | 350,000 |
| Printing and engraving | 350,000 |
| Miscellaneous fees and expenses | 4,926 |
| | <hr/> |
| Total | \$910,000 |
| | <hr/> |

* Estimated for filing purposes and excludes fees previously paid.

All of the expenses set forth above shall be borne by us.

Item 27. Persons Controlled by or Under Common Control

Direct Subsidiaries

The following list sets forth each of our subsidiaries, the state or country under whose laws the subsidiary is organized, and the percentage of voting securities or membership interests owned by us in such subsidiary:

| | |
|--|------|
| Allied Investment Corporation (Maryland) | 100% |
| Allied Capital REIT, Inc. (Allied REIT) (Maryland) | 100% |
| A.C. Corporation (Delaware) | 100% |
| Allied Capital Holdings, LLC (Delaware) | 100% |
| Allied Capital Beteiligungsberatung GmbH (Germany) | 100% |

Each of our subsidiaries are consolidated for financial reporting purposes, except as noted below.

Indirect Subsidiaries

We indirectly control the entities set forth below through Allied REIT. Allied REIT owns either all of the membership interests (in the case of a limited liability company, LLC) or all of the outstanding voting stock (in the case of a corporation) of each entity. The following list sets forth each of Allied REIT's subsidiaries, the state under whose laws the subsidiary is organized, and the percentage of voting securities or membership interests owned by Allied REIT of such subsidiary:

| | |
|---|------|
| Allied Capital Property LLC (Delaware) | 100% |
| Allied Capital Equity LLC (Delaware) | 100% |
| 9586 I-25 East Frontage Road, Longmont, CO 80504 LLC (Delaware) | 100% |
| Allied Capital CMT, Inc. (Delaware) | 100% |

Allied REIT also indirectly owns Allied Capital Commercial Mortgage Trust 1998-1, a Delaware business trust that is wholly owned by Allied Capital CMT, Inc. (CMT). Each subsidiary of Allied REIT and CMT is not required to maintain financial and other reports required under the Securities Act because each does not have a class of securities registered under the Securities Act.

We indirectly control Allied Investment Holdings LLC (Delaware) through Allied Investment Corporation, which owns 100% of the membership interests.

Other Entities Deemed to be Controlled by the Company

We provide investment advisory services or loan servicing services to the certain entities and therefore may be deemed to control such entities and their respective subsidiaries. The following list sets forth each such entity and its respective subsidiaries and the state under whose laws the entity or subsidiary is organized:

Allied Capital Germany Fund LLC (Delaware)^(1, 2)

We have also established certain limited purpose entities in order to facilitate certain portfolio transactions. In addition, we may be deemed to control certain portfolio companies. See *Portfolio Companies* in the prospectus.

(1) By so including these entities herein, the Registrant does not concede that it controls such entities.

(2) Subsidiary does not consolidate for financial reporting purposes.

Item 28. Number of Holders of Securities

The following table sets forth the approximate number of record holders of our common stock at June 4, 2003.

| Title of Class | Number of Record Holders |
|----------------------------------|--------------------------|
| Common stock, \$0.0001 par value | 5,500 |

We have privately issued long-term debt securities to 25 institutional lenders, primarily insurance companies.

Item 29. Indemnification

Section 2-418 of the Maryland General Corporation Law provides that a Maryland corporation may indemnify any director of the corporation and any person who, while a director of the corporation, is or was serving at the request of the corporation as a director, officer, partner, trustee, employee, or agent of another foreign or domestic corporation, partnership, joint venture, trust, other enterprise or employee benefit plan, made a party to any proceeding by reason of service in that capacity unless it is established that the act or omission of the director was material to the matter giving rise to the proceeding and was committed in bad faith or was the result of active and deliberate dishonesty; or the director actually received an improper personal benefit in money, property or services; or, in the case of any criminal proceeding, the director had reasonable cause to believe that the act or omission was unlawful. Indemnification may be made against judgments, penalties, fines, settlements, and reasonable expenses actually incurred by the director in connection with the proceeding, but if the proceeding was one by or in the right of the corporation, indemnification may not be made in respect of any proceeding in which the director shall have been adjudged to be liable to the corporation. Such indemnification may not be made unless authorized for a specific proceeding after a determination has been made, in the manner prescribed by the law, that indemnification is permissible in the circumstances because the director has met the applicable standard of conduct. On the other hand, the director must be indemnified for expenses if he or she has been successful in the defense of the proceeding or as otherwise ordered by a court. The law also prescribes the circumstances under which the corporation may advance expenses to, or obtain insurance or similar cover for, directors.

The law also provides for comparable indemnification for corporate officers and agents.

The Restated Articles of Incorporation of Allied Capital provide that its directors and officers shall, and its agents in the discretion of the board of directors may be indemnified to the fullest extent permitted from time to time by the laws of Maryland (with such power to indemnify officers and directors limited to the scope provided for in Section 2-418 as currently in force), provided, however, that such indemnification is limited by the Investment Company Act of 1940 or by any valid rule, regulation or order of the Securities and Exchange Commission thereunder. Allied Capital's Bylaws, however, provide that Allied Capital may not indemnify any director or officer against liability to Allied Capital or its security holders to which he or she might otherwise be subject by reason of such person's willful misfeasance, bad faith, gross negligence or reckless disregard of the duties involved in the conduct of his or her office unless a determination is made by final decision of a court, by vote of a majority of a quorum of directors who are disinterested, non-party directors or by independent legal counsel that the liability for which indemnification is sought did not arise out of such disabling conduct.

Insofar as indemnification for liabilities arising under the Securities Act of 1933 may be permitted to directors, officers and controlling persons of Allied Capital pursuant to the provisions described above, or otherwise, Allied Capital has been advised that in the opinion of the Securities and Exchange Commission such indemnification is against public policy as expressed in the Act and is, therefore, unenforceable. In the event that a claim for indemnification against such liabilities (other than the payment by Allied Capital of expenses incurred or paid by a director, officer or controlling person in the successful defense of an action, suit or proceeding) is asserted by a director, officer or controlling person in connection with the securities being registered, Allied Capital will, unless in the opinion of its counsel the matter has been settled by controlling precedent, submit to a court of appropriate jurisdiction the question whether such indemnification by it is against public policy as expressed in the Act and will be governed by the final adjudication of the court of the issue.

Allied Capital carries liability insurance for the benefit of its directors and officers on a claims-made basis of up to \$50,000,000, subject to a \$500,000 retention and the other terms thereof.

The Agreement and Plan of Merger (the "Merger Agreement") by and among Allied Capital Advisers, Allied Capital Corporation, Allied Capital Corporation II, Allied Capital Lending Corporation and Allied Capital Commercial Corporation provides that, from and after consummation of the merger Allied Capital shall indemnify any person who at the date of the Merger Agreement, or had been at any time prior to such date or who becomes prior to the effective time of the merger, an officer or director of the companies noted above other than Allied Capital Lending Corporation, or any of their respective subsidiaries, from any and all liabilities resulting from their acts and omissions prior to the effective time of the merger to the full extent permitted by Section 2-418 of the Maryland General Corporation Law and the 1940 Act, including but not limited to acts and omissions arising out of or pertaining to the merger, and shall maintain in effect for at least 72 months directors' and officers' liability insurance policies with respect to matters occurring prior to the effective time of the merger.

Item 30. Business and Other Connections of Investment Adviser

Not applicable.

Item 31. Location of Accounts and Records

We maintain at our principal office physical possession of each account, book or other document required to be maintained by Section 31(a) of the 1940 Act and the rules thereunder.

Item 32. Management Services

Not applicable.

Item 33. Undertakings

We hereby undertake:

(1) to suspend the offering of shares until the prospectus is amended if subsequent to the effective date of this registration statement, our net asset value declines more than ten percent from our net asset value as of the effective date of this registration statement or (2) our net asset value increases to an amount greater than our net proceeds as stated in the prospectus;

(2) to file, during any period in which offers or sales are being made, a post-effective amendment to this registration statement:

- (i) to include any prospectus required by Section 10(a)(3) of the Securities Act of 1933;
- (ii) to reflect in the prospectus any facts or events arising after the effective date of the registration statement (or the most recent post-effective amendment thereof) which, individually or in the aggregate, represent a fundamental change in the information set forth in the registration statement. Notwithstanding the foregoing, any increase or decrease in volume of securities offered (if the total dollar value of securities offered would not exceed that which was registered) and any deviation from the low or high end of the estimated maximum offering range may be reflected in the form of prospectus filed with the Commission pursuant to Rule 424(b) under the Securities Act of 1933 if, in the aggregate, the changes in volume and price represent no more than a 20% change in the maximum aggregate offering price set forth in the Calculation of Registration Fee table in the effective registration statement; and
- (iii) to include any material information with respect to the plan of distribution not previously disclosed in the registration statement or any material change to such information in the registration statement.

(3) that, for the purpose of determining any liability under the Securities Act of 1933, the information omitted from the form of prospectus filed as part of this registration statement in reliance upon Rule 430A and contained in a form of prospectus filed by us under Rule 497(h) under the Securities Act of 1933 shall be deemed to be part of this registration statement as of the time it was declared effective;

(4) to remove from registration by means of a post-effective amendment any of the securities being registered which remain unsold at the termination of the offering; and

(5) that, for the purpose of determining any liability under the Securities Act of 1933, each post effective amendment that contains a form of prospectus shall be deemed to be a new registration statement relating to the securities offered therein, and the offering of the securities at that time shall be deemed to be the initial bona fide offering thereof.

SIGNATURES

Pursuant to the requirements of the Securities Act of 1933, the Registrant has duly caused this registration statement to be signed on its behalf by the undersigned, thereunto duly authorized, in the City of Washington, in the District of Columbia, on the 5th day of June, 2003.

ALLIED CAPITAL CORPORATION

By: /s/ WILLIAM L. WALTON

William L. Walton,
Chairman of the Board, Chief
Executive Officer and President

Pursuant to the requirements of the Securities Act of 1933, this Registration Statement has been signed by the following persons in the capacities indicated on June 5, 2003.

| Signature | Title |
|------------------------------------|---|
| <hr/> /s/ WILLIAM L. WALTON <hr/> | Chairman of the Board, Chief Executive Officer, and President |
| William L. Walton | |
| <hr/> /s/ BROOKS H. BROWNE <hr/> | Director |
| Brooks H. Browne | |
| <hr/> /s/ JOHN D. FIRESTONE <hr/> | Director |
| John D. Firestone | |
| <hr/> /s/ ANTHONY T. GARCIA <hr/> | Director |
| Anthony T. Garcia | |
| <hr/> /s/ ANN TORRE GRANT <hr/> | Director |
| Ann Torre Grant | |
| <hr/> /s/ LAWRENCE I. HEBERT <hr/> | Director |
| Lawrence I. Hebert | |
| <hr/> /s/ JOHN I. LEAHY <hr/> | Director |
| John I. Leahy | |
| <hr/> /s/ ROBERT E. LONG <hr/> | Director |
| Robert E. Long | |
| <hr/> /s/ ALEX J. POLLOCK <hr/> | Director |
| Alex J. Pollock | |
| <hr/> /s/ GUY T. STEUART II <hr/> | Director |

Guy T. Stuart II

Edgar Filing: ALLIED CAPITAL CORP - Form N-2/A

| Signature | Title |
|--|---|
| _____ /s/ LAURA W. VAN ROIJEN _____ Laura W. van Roijen | Director |
| _____ /s/ GEORGE C. WILLIAMS, JR. _____ George C. Williams, Jr. | Director |
| _____ /s/ PENNI F. ROLL _____ Penni F. Roll | Chief Financial Officer (Principal Financial and Accounting Officer) |

INDEX TO EXHIBITS

| Exhibit Number | Description |
|---------------------------|---|
| Ex - 99.n.2.b | Consent of KPMG LLP, independent public accountants. |
| Ex - 99.n.3.b | Consent of KPMG LLP, independent public accountants, regarding opinion on Senior Securities table contained herein. |
| Ex - 99.n.4 | Letter Regarding Interim Financial Information. |