

ALLIED CAPITAL CORP  
Form 10-Q  
May 08, 2007

**FORM 10-Q**  
**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**  
**WASHINGTON, DC 20549**

**Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**

**For The Quarterly Period**  
**Ended March 31, 2007**

**Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**

**Commission File Number:**  
**0-22832**

**ALLIED CAPITAL CORPORATION**  
*(Exact Name of Registrant as Specified in its Charter)*

**Maryland**  
*(State or Jurisdiction of*  
*Incorporation or Organization)*

**52-1081052**  
*(IRS Employer*  
*Identification No.)*

**1919 Pennsylvania Avenue, N.W.**  
**Washington, DC 20006**  
*(Address of Principal Executive Offices)*

**Registrant's telephone number, including area code: (202) 721-6100**

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter periods as the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.  
YES  NO

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of "accelerated filer" and "large accelerated filer" in Rule 12b-2 of the Exchange Act. Large Accelerated Filer  Accelerated Filer  Non-Accelerated Filer

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).  
YES  NO

On May 7, 2007, there were 152,279,012 shares outstanding of the Registrant's common stock, \$0.0001 par value.

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**PART I: FINANCIAL INFORMATION****Item 1. Financial Statements****ALLIED CAPITAL CORPORATION AND SUBSIDIARIES  
CONSOLIDATED BALANCE SHEET**

	<b>March 31, 2007</b>	<b>December 31, 2006</b>
<b>(in thousands, except per share amounts)</b>	<b>(unaudited)</b>	
<b>ASSETS</b>		
Portfolio at value:		
Private finance		
Companies more than 25% owned (cost: 2007-\$1,836,724; 2006-\$1,578,822)	\$ 1,773,164	\$ 1,490,180
Companies 5% to 25% owned (cost: 2007-\$438,374; 2006-\$438,560)	457,871	449,813
Companies less than 5% owned (cost: 2007-\$2,159,014; 2006-\$2,479,981)	2,145,284	2,437,908
Total private finance (cost: 2007-\$4,434,112; 2006-\$4,497,363)	4,376,319	4,377,901
Commercial real estate finance (cost: 2007-\$103,384; 2006-\$103,546)	122,529	118,183
Total portfolio at value (cost: 2007-\$4,537,496; 2006-\$4,600,909)	4,498,848	4,496,084
Investments in money market and other securities	271,170	202,210
Accrued interest and dividends receivable	67,690	64,566
Other assets	148,041	122,958
Cash	327	1,687
Total assets	\$ 4,986,076	\$ 4,887,505
<b>LIABILITIES AND SHAREHOLDERS EQUITY</b>		
Liabilities:		
Notes payable and debentures (maturing within one year: 2007-\$ ; 2006-\$ )	\$ 1,891,516	\$ 1,691,394
Revolving line of credit		207,750
Accounts payable and other liabilities	116,283	147,117
Total liabilities	2,007,799	2,046,261
Commitments and contingencies		
Shareholders equity:		
Common stock, \$0.0001 par value, 200,000 shares authorized; 152,124 and 148,575 shares issued and outstanding at March 31, 2007, and December 31, 2006, respectively	15	15
Additional paid-in capital	2,595,936	2,493,335
Common stock held in deferred compensation trust	(31,371)	(28,335)
Notes receivable from sale of common stock	(2,715)	(2,850)
Net unrealized appreciation (depreciation)	(57,164)	(123,084)
Undistributed earnings	473,576	502,163
Total shareholders equity	2,978,277	2,841,244

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Total liabilities and shareholders' equity	\$ 4,986,076	\$ 4,887,505
Net asset value per common share	\$ 19.58	\$ 19.12

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

**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENT OF OPERATIONS**

	<b>For the Three Months Ended March 31,</b>	
<b>(in thousands, except per share amounts)</b>	<b>2007</b>	<b>2006</b>
	<b>(unaudited)</b>	
<b>Interest and Related Portfolio Income:</b>		
Interest and dividends		
Companies more than 25% owned	\$ 27,157	\$ 30,146
Companies 5% to 25% owned	11,861	5,650
Companies less than 5% owned	62,965	53,085
Total interest and dividends	101,983	88,881
<b>Fees and other income</b>		
Companies more than 25% owned	3,989	12,087
Companies 5% to 25% owned	28	2,716
Companies less than 5% owned	1,952	7,327
Total fees and other income	5,969	22,130
Total interest and related portfolio income	107,952	111,011
<b>Expenses:</b>		
Interest	30,288	24,485
Employee	21,928	21,428
Employee stock options	3,661	3,606
Administrative	13,224	11,334
Total operating expenses	69,101	60,853
Net investment income before income taxes	38,851	50,158
Income tax expense (benefit), including excise tax	(649)	8,858
Net investment income	39,500	41,300
<b>Net Realized and Unrealized Gains (Losses):</b>		
Net realized gains (losses)		
Companies more than 25% owned	(1,350)	433,187
Companies 5% to 25% owned	166	(343)
Companies less than 5% owned	28,850	(9)
Total net realized gains	27,666	432,835
Net change in unrealized appreciation or depreciation	65,920	(374,548)

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Total net gains	93,586	58,287
Net increase in net assets resulting from operations	\$ 133,086	\$ 99,587
Basic earnings per common share	\$ 0.89	\$ 0.72
Diluted earnings per common share	\$ 0.87	\$ 0.70
Weighted average common shares outstanding basic	149,503	138,759
Weighted average common shares outstanding diluted	152,827	141,738

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

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

	<b>For the Three Months Ended March 31,</b>	
<b>(in thousands, except per share amounts)</b>	<b>2007</b>	<b>2006</b>
	<b>(unaudited)</b>	
<b>Operations:</b>		
Net investment income	\$ 39,500	\$ 41,300
Net realized gains	27,666	432,835
Net change in unrealized appreciation or depreciation	65,920	(374,548)
Net increase in net assets resulting from operations	133,086	99,587
<b>Shareholder distributions:</b>		
Common stock dividends	(95,753)	(82,518)
Net decrease in net assets resulting from shareholder distributions	(95,753)	(82,518)
<b>Capital share transactions:</b>		
Sale of common stock	93,784	82,970
Issuance of common stock in lieu of cash distributions	4,266	3,640
Issuance of common stock upon the exercise of stock options	1,366	3,935
Stock option expense	3,661	3,606
Net decrease in notes receivable from sale of common stock	135	130
Purchase of common stock held in deferred compensation trust	(3,089)	(2,121)
Distribution of common stock held in deferred compensation trust	53	38
Other	(476)	
Net increase in net assets resulting from capital share transactions	99,700	92,198
Total increase in net assets	137,033	109,267
Net assets at beginning of period	2,841,244	2,620,546
Net assets at end of period	\$ 2,978,277	\$ 2,729,813
Net asset value per common share	\$ 19.58	\$ 19.50
Common shares outstanding at end of period	152,124	139,984

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



**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENT OF CASH FLOWS**

	<b>For the Three Months Ended March 31,</b>	
	<b>2007</b>	<b>2006</b>
<b>(in thousands)</b>	<b>(unaudited)</b>	
<b>Cash flows from operating activities:</b>		
Net increase in net assets resulting from operations	\$ 133,086	\$ 99,587
<b>Adjustments:</b>		
Portfolio investments	(170,216)	(647,851)
Principal collections related to investment repayments or sales	235,509	340,410
Change in accrued or reinvested interest and dividends	(11,267)	2,061
Net collection (amortization) of discounts and fees	(1,844)	(277)
Redemption of (investments in) money market securities	(66,335)	(16,726)
Stock option expense	3,661	3,606
Changes in other assets and liabilities	(40,453)	2,797
Depreciation and amortization	507	433
Realized gains from the receipt of notes and other consideration from sale of investments, net of collections	(2,814)	(179,987)
Realized losses	5,515	3,651
Net change in unrealized (appreciation) or depreciation	(65,920)	374,548
<b>Net cash provided by (used in) operating activities</b>	<b>19,429</b>	<b>(17,748)</b>
<b>Cash flows from financing activities:</b>		
Sale of common stock	93,784	82,970
Sale of common stock upon the exercise of stock options	1,366	3,935
Collections of notes receivable from sale of common stock	135	130
Borrowings under notes payable	200,000	
Repayments on notes payable and debentures		(12,000)
Net borrowings under (repayments on) revolving line of credit	(207,750)	1,250
Purchase of common stock held in deferred compensation trust	(3,089)	(2,121)
Other financing activities	(6,325)	53
Common stock dividends and distributions paid	(98,910)	(82,976)
<b>Net cash provided by (used in) financing activities</b>	<b>(20,789)</b>	<b>(8,759)</b>
<b>Net decrease in cash</b>	<b>(1,360)</b>	<b>(26,507)</b>
Cash at beginning of period	1,687	31,363
<b>Cash at end of period</b>	<b>\$ 327</b>	<b>\$ 4,856</b>

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



**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENT OF INVESTMENTS**

March 31, 2007

Private Finance Portfolio Company (in thousands, except number of shares)	Investment <sup>(1)(2)</sup>	Principal	Cost	Value
(unaudited)				
<b>Companies More Than 25% Owned</b>				
Alaris Consulting, LLC (Business Services)	Senior Loan (16.5%, Due 12/05 12/07) <sup>(6)</sup> Equity Interests Guaranty (\$1,100)	\$ 27,055	\$ 26,987 5,877	\$
Avborne, Inc. <sup>(7)</sup> (Business Services)	Preferred Stock (12,500 shares) Common Stock (27,500 shares)		611	873
Avborne Heavy Maintenance, Inc. <sup>(7)</sup> (Business Services)	Preferred Stock (1,568 shares) Common Stock (2,750 shares) Guaranty (\$2,401)		2,401	
Border Foods, Inc. (Consumer Products)	Preferred Stock (100,000 shares) Common Stock (148,838 shares)		12,721 3,847	
Business Loan Express, LLC (Financial Services)	Class A Equity Interests(25.0% See Note 3) <sup>(6)</sup> Class B Equity Interests Class C Equity Interests Guaranty (\$182,392 See Note 3) Standby Letters of Credit (\$20,000 See Note 3)	85,822	85,822 119,436 109,301	85,822 79,139 64,976
Calder Capital Partners, LLC <sup>(5)</sup> (Financial Services)	Senior Loan (8.0%, Due 5/09) <sup>(6)</sup> Equity Interests	1,326	1,326 2,154	1,326 2,154
Callidus Capital Corporation (Financial Services)	Senior Loan (12.0%, Due 12/08) Subordinated Debt (18.0%, Due 10/08) Common Stock (100 shares)	1,150 6,021	1,150 6,021 2,067	1,150 6,021 24,493
Coverall North America, Inc. (Business Services)	Unitranche Debt (12.0%, Due 7/11) Subordinated Debt (15.0%, Due 7/11) Common Stock (884,880 shares)	35,054 6,000	34,896 5,974 16,648	34,896 5,974 21,475
CR Holding, Inc.		39,917	39,752	39,752

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(Consumer Products)	Subordinated Debt (16.6%, Due 2/13) Common Stock (37,200,551 shares)		33,321	30,880
Direct Capital Corporation (Financial Services)	Subordinated Debt (16.0%, Due 3/13) Common Stock (2,097,234 shares)	35,750	35,574 19,250	35,574 19,250
Financial Pacific Company (Financial Services)	Subordinated Debt (17.4%, Due 2/12 8/12) Preferred Stock (10,964 shares) Common Stock (14,735 shares)	71,947	71,732 10,276 14,819	71,732 16,739 67,540
ForeSite Towers, LLC (Tower Leasing)	Equity Interests			557
Global Communications, LLC (Business Services)	Senior Loan (10.7%, Due 9/02 11/07) <sup>(6)</sup> Subordinated Debt (17.0%, Due 12/03 9/05) <sup>(7)</sup> Preferred Equity Interest Options	15,957 11,339	15,957 11,336 14,067 1,639	15,957 4,930
Gordian Group, Inc. (Business Services)	Senior Loan (10.0%, Due 6/06 12/08) <sup>(6)</sup> Common Stock (1,000 shares)	11,792	11,798 6,942	

- (1) Interest rates represent the weighted average annual stated interest rate on loans and debt securities, which are presented by nature of indebtedness for a single issuer. The maturity dates represent the earliest and the latest maturity dates.
- (2) Common stock, preferred stock, warrants, options, and equity interests are generally non-income producing and restricted.
- (3) Public company.
- (4) Non-U.S. company or principal place of business outside the U.S.
- (5) Non-registered investment company.
- (6) Loan or debt security is on non-accrual status and therefore is considered non-income producing.
- (7) Avborne, Inc. and Avborne Heavy Maintenance, Inc. are affiliated companies.

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

**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENT OF INVESTMENTS (Continued)**

March 31, 2007

Private Finance Portfolio Company (in thousands, except number of shares)	Investment <sup>(1)(2)</sup>	Principal	Cost	Value
				(unaudited)
Healthy Pet Corp. (Consumer Services)	Senior Loan (9.9%, Due 8/10)	\$ 32,338	\$ 32,338	\$ 32,338
	Subordinated Debt (15.0%, Due 8/10)	43,939	43,807	43,807
	Common Stock (30,142 shares)		30,142	43,818
HMT, Inc. (Energy Services)	Preferred Stock (554,052 shares)		2,637	2,637
	Common Stock (300,000 shares)		3,000	30,173
	Warrants		1,155	11,617
Hot Stuff Foods, LLC (Consumer Products)	Senior Loan (8.8%, Due 2/11-2/12)	49,770	49,549	49,549
	Subordinated Debt (13.7%, Due 8/12 2/13)	60,606	60,361	57,254
	Subordinated Debt (16.0%, Due 2/13) <sup>(6)</sup>	20,841	20,749	
	Common Stock (1,147,453 shares)		56,187	
Huddle House, Inc. (Retail)	Subordinated Debt (15.0%, Due 12/12)	58,515	58,239	58,239
	Common Stock (415,328 shares)		41,533	43,078
Impact Innovations Group, LLC (Business Services)	Equity Interests in Affiliate			319
Insight Pharmaceuticals Corporation (Consumer Products)	Subordinated Debt (15.0%, Due 9/12)	44,257	44,116	44,116
	Subordinated Debt (19.0%, Due 9/12) <sup>(6)</sup>	16,181	16,130	14,510
	Preferred Stock (25,000 shares)		25,000	
	Common Stock (620,000 shares)		6,325	
Jakel, Inc. (Industrial Products)	Subordinated Debt (15.5%, Due 3/08) <sup>(6)</sup>	15,692	15,692	
	Preferred Stock (6,460 shares)		6,460	
	Common Stock (158,061 shares)		9,347	
Legacy Partners Group, Inc. (Financial Services)	Senior Loan (14.0%, Due 5/09) <sup>(6)</sup>	4,843	4,843	4,843
	Equity Interests		4,261	613
Litterer Beteiligungs-GmbH <sup>(4)</sup>	Subordinated Debt (8.0%, Due 3/07)	698	698	698

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(Business Services)	Equity Interest		1,809	1,980
Mercury Air Centers, Inc.	Subordinated Debt (16.0%, Due 4/09			
(Business Services)	11/12)	49,862	49,737	49,737
	Common Stock (57,970 shares)		35,053	251,709
	Standby Letters of Credit (\$75)			
MVL Group, Inc.	Senior Loan (12.0%, Due 6/09 7/09)	30,674	30,613	30,613
(Business Services)	Subordinated Debt (14.5%, Due 6/09 7/09)	39,449	39,092	39,092
	Common Stock (648,661 shares)		643	1,333
Penn Detroit Diesel Allison, LLC	Subordinated Debt (15.5%, Due 8/13)	38,459	38,287	38,287
(Business Services)	Equity Interests		21,128	23,965
Powell Plant Farms, Inc.	Senior Loan (15.0%, Due 12/07) <sup>(6)</sup>	38,990	30,142	30,142
(Consumer Products)	Subordinated Debt (20.0%, Due 6/03) <sup>(6)</sup>	19,291	19,223	3,837
	Preferred Stock (1,483 shares)			
	Warrants			
Service Champ, Inc.	Subordinated Debt (15.5%, Due 4/12)	27,910	27,802	27,802
(Business Services)	Common Stock (63,888 shares)		13,662	16,488

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- (2) Common stock, preferred stock, warrants, options, and equity interests are generally non-income producing and restricted.
- (3) Public company.
- (4) Non-U.S. company or principal place of business outside the U.S.
- (5) Non-registered investment company.
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The accompanying notes are an integral part of these consolidated financial statements.

**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENT OF INVESTMENTS (Continued)**

March 31, 2007

Private Finance Portfolio Company (in thousands, except number of shares)	Investment <sup>(1)(2)</sup>	Principal	Cost	Value
			(unaudited)	
Staffing Partners Holding Company, Inc.  (Business Services)	Subordinated Debt (13.5%, Due 1/07) <sup>(6)</sup>	\$ 541	\$ 541	\$ 540
Startec Global Communications Corporation  (Telecommunications)	Senior Loan (10.0%, Due 5/07 5/09) Common Stock (19,180,000 shares)	13,583	13,583 37,255	13,583 17,085
Sweet Traditions, Inc. (Retail)	Senior Loan (9.0%, Due 8/11) Preferred Stock (961 Shares) Common Stock (10,000 Shares) Standby Letter of Credit (\$120)	39,022	35,382 950 50	35,382 950 50
Triview Investments, Inc. <sup>(8)</sup>  (Broadcasting & Cable/Business Services/Consumer Products)	Senior Loan (9.6%, Due 6/07 12/07) Subordinated Debt (15.4%, Due 1/10 7/12) Subordinated Debt (8.4%, Due 11/07 7/08) <sup>(9)</sup> Common Stock (202 shares) Guaranty (\$800) Standby Letter of Credit (\$200)	14,758 63,455 4,850	14,754 63,142 4,850 102,755	14,754 63,142 4,850 39,024
Total companies more than 25% owned			\$ 1,836,724	\$ 1,773,164
<b>Companies 5% to 25% Owned</b>				
Advantage Sales & Marketing, Inc. (Business Services)	Subordinated Debt (12.0%, Due 3/14) Equity Interests	\$ 153,082	\$ 152,433	\$ 152,433 11,000
Air Medical Group Holdings LLC (Healthcare Services)	Senior Loan (9.0%, Due 3/11) Subordinated Debt (14.0%, Due 11/12) Equity Interests	2,557 35,183	2,495 35,133 3,470	2,495 35,133 6,900
Alpine ESP Holdings, Inc.	Preferred Stock (622 shares)		622	543

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(Business Services)	Common Stock (13,513 shares)		14	
Amerex Group, LLC	Subordinated Debt (12.0%, Due 1/13)	8,400	8,400	8,400
(Consumer Products)	Equity Interests		3,527	20,235
BB&T Capital Partners/Windsor Mezzanine Fund, LLC <sup>(5)</sup>	Equity Interests		5,873	5,554
(Private Equity Fund)				
Becker Underwood, Inc.	Subordinated Debt (14.5%, Due 8/12)	24,399	24,321	24,321
(Industrial Products)	Common Stock(5,073 shares)		5,813	3,300
BI Incorporated	Subordinated Debt (13.5%, Due 2/14)	30,385	30,256	30,256
(Business Services)	Common Stock (40,000 shares)		4,000	6,000

- (1) Interest rates represent the weighted average annual stated interest rate on loans and debt securities, which are presented by nature of indebtedness for a single issuer. The maturity dates represent the earliest and the latest maturity dates.
- (2) Common stock, preferred stock, warrants, options, and equity interests are generally non-income producing and restricted.
- (3) Public company.
- (4) Non-U.S. company or principal place of business outside the U.S.
- (5) Non-registered investment company.
- (6) Loan or debt security is on non-accrual status and therefore is considered non-income producing.
- (8) Triview Investments, Inc. holds investments in Longview Cable & Data, LLC (Broadcasting & Cable) with a cost of \$67.8 million and a value of \$7.8 million, Triax Holdings, LLC (Consumer Products) with a cost of \$98.9 million and a value of \$93.4 million, and Crescent Hotels & Resorts, LLC and affiliates (Business Services) with a cost of \$18.8 million and a value of \$20.6 million.

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



**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENT OF INVESTMENTS (Continued)**

March 31, 2007

Private Finance Portfolio Company (in thousands, except number of shares)	Investment <sup>(1)(2)</sup>	Principal	Cost	Value
			(unaudited)	
CitiPostal, Inc. and Affiliates (Business Services)	Senior Loan (11.1%, Due 8/13-11/14) Equity Interests	\$ 20,423	\$ 20,326 4,415	\$ 20,326 5,350
Creative Group, Inc. (Business Services)	Subordinated Debt (12.0%, Due 9/13) Warrant	15,000	13,686 1,387	13,686 865
Drew Foam Companies, Inc. (Business Services)	Preferred Stock (722 shares) Common Stock (7,287 shares)		722 7	688
MedBridge Healthcare, LLC (Healthcare Services)	Senior Loan (6.0%, Due 8/09) <sup>(6)</sup> Subordinated Debt (10.0%, Due 8/14) <sup>(6)</sup> Convertible Subordinated Debt (2.0%, Due 8/14) <sup>(6)</sup> Equity Interests	7,164 5,184 2,970	7,164 5,184 984 1,416	7,164 2,408
Multi-Ad Services, Inc. (Business Services)	Unitranche Debt (11.3%, Due 11/11) Equity Interests	19,900	19,785 2,000	19,785 1,777
Nexcel Synthetics, LLC (Consumer Products)	Subordinated Debt (14.5%, Due 6/09) Equity Interests	8,000	7,982 1,755	7,982 759
PresAir LLC (Industrial Products)	Senior Loan (7.5%, Due 12/10) <sup>(6)</sup> Equity Interests	5,810	5,492 1,341	2,462
Progressive International Corporation (Consumer Products)	Subordinated Debt (16.0%, Due 12/09) Preferred Stock (500 shares) Common Stock (197 shares) Warrants	7,591	7,574 500 13	7,574 1,046 2,800
Regency Healthcare Group, LLC (Healthcare Services)	Senior Loan (11.1%, Due 6/12) Unitranche Debt (11.1%, Due 6/12) Equity Interests	1,250 20,000	1,232 19,913 1,500	1,232 19,913 1,640

SGT India Private Limited <sup>(4)</sup> (Business Services)	Common Stock (109,524 shares)		4,093	3,040
Soteria Imaging Services, LLC (Healthcare Services)	Subordinated Debt (11.6%, Due 11/10) Equity Interests	19,500	18,603 2,170	18,603 2,542
Universal Environmental Services, LLC (Business Services)	Unitranche Debt (15.5%, Due 2/09) Equity Interests	10,989	10,963 1,810	9,659
Total companies 5% to 25% owned			\$ 438,374	\$ 457,871
<b>Companies Less Than 5% Owned</b>				
3SI Security Systems, Inc. (Consumer Products)	Subordinated Debt (14.5%, Due 8/13)	\$ 27,111	\$ 26,999	\$ 26,999
AgData, L.P. (Consumer Services)	Unitranche Debt (10.3%, Due 7/12)	11,330	11,272	11,272
Axiom Healthcare Pharmacy, Inc. (Healthcare Services)	Unitranche Debt (12.0%, Due 12/12) Common Stock (26,500 shares)	9,000	8,920 2,650	8,920 1,800
Baird Capital Partners IV Limited Partnership <sup>(5)</sup> (Private Equity Fund)	Limited Partnership Interest		1,183	962

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

**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENT OF INVESTMENTS (Continued)**

March 31, 2007

Private Finance Portfolio Company (in thousands, except number of shares)	Investment <sup>(1)(2)</sup>	Principal	Cost	Value
			(unaudited)	
Benchmark Medical, Inc. (Healthcare Services)	Warrants		\$ 18	\$
BenefitMall, Inc. (Business Services)	Unitranche Debt (13.3%, Due 8/12) Common Stock (45,528,000 shares) <sup>(11)</sup> Warrants <sup>(11)</sup> Standby Letters of Credit (\$9,981)	\$ 110,030	109,665 45,528	109,665 46,755
Breeze-Eastern Corporation <sup>(3)</sup> (Industrial Products)	Senior Loan (10.1%, Due 5/11)	9,975	9,975	9,975
Broadcast Electronics, Inc. (Business Services)	Senior Loan (9.1%, Due 7/12)	4,950	4,919	4,919
Callidus Debt Partners CDO Fund I, Ltd. <sup>(4)(9)</sup> (Senior Debt Fund)	Class C Notes (12.9%, Due 12/13) Class D Notes (17.0%, Due 12/13)	18,800 9,400	18,946 9,473	18,988 9,494
Callidus Debt Partners CLO Fund III, Ltd. <sup>(4)(9)</sup> (Senior Debt Fund)	Preferred Shares (23,600,000 shares, 9.9%) <sup>(10)</sup>		22,702	22,514
Callidus Debt Partners CLO Fund IV, Ltd. <sup>(4)(9)</sup> (Senior Debt Fund)	Income Notes (13.1%) <sup>(10)</sup>		12,795	12,795
Callidus Debt Partners CLO Fund V, Ltd. <sup>(4)(9)</sup> (Senior Debt Fund)	Income Notes (15.8%) <sup>(10)</sup>		14,320	14,320
Callidus MAPS CLO Fund I LLC <sup>(9)</sup> (Senior Debt Fund)	Class E Notes (10.9%, Due 12/17) Income Notes (13.3%) <sup>(10)</sup>	17,000	17,000 50,963	17,145 46,463
Camden Partners Strategic Fund II, L.P. <sup>(5)</sup> (Private Equity Fund)	Limited Partnership Interest		997	2,215

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Carlisle Wide Plank Floors, Inc. (Consumer Products)	Unitranche Debt (10.5%, Due 6/11) Preferred Stock (400,000 Shares)	14,000	13,906 400	13,906 400
Catterton Partners V, L.P. <sup>(5)</sup> (Private Equity Fund)	Limited Partnership Interest		3,760	4,016
Catterton Partners VI, L.P. <sup>(5)</sup> (Private Equity Fund)	Limited Partnership Interest		1,072	987
Centre Capital Investors IV, LP <sup>(5)</sup> (Private Equity Fund)	Limited Partnership Interest		1,801	1,501

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- (9) The fund is managed by Callidus Capital, a portfolio company of Allied Capital.
- (11) Common stock is non-voting. In addition to non-voting stock ownership, the Company has an option to acquire a majority of the voting securities of the portfolio company at fair market value.
- (10) Represents the effective yield earned on these preferred equity investments. The yield is included in interest income from companies less than 5% owned in the consolidated statement of operations.

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

**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENT OF INVESTMENTS (Continued)**

March 31, 2007

Private Finance Portfolio Company (in thousands, except number of shares)	Investment <sup>(1)(2)</sup>	Principal	Cost	Value
			(unaudited)	
Commercial Credit Group, Inc. (Financial Services)	Subordinated Debt (14.8%, Due 2/11) Preferred Stock (32,500 shares) Warrants	\$ 10,000	\$ 9,962 3,900	\$ 9,962 3,900
Community Education Centers, Inc. (Education Services)	Subordinated Debt (16.0%, Due 12/10)	34,420	34,334	34,334
Compass Group Diversified Holdings LLC <sup>(3)</sup> (Financial Services)	Senior Loan (8.4%, Due 11/11)	9,069	8,952	8,952
Component Hardware Group, Inc. (Industrial Products)	Subordinated Debt (13.5%, Due 1/13)	18,226	18,146	18,146
Cook Inlet Alternative Risk, LLC (Business Services)	Unitranche Debt (10.0%, Due 4/12) Equity Interests	60,000	59,663 2,000	59,663 2,700
Cortec Group Fund IV, L.P. <sup>(5)</sup> (Private Equity)	Limited Partnership Interest		1,712	1,226
CSAV, Inc. (Business Services)	Subordinated Debt (11.8%, Due 6/13)	37,500	37,500	37,500
DCWV Acquisition Corporation (Consumer Products)	Senior Loan (8.8%, Due 7/12) Unitranche Debt (11.0%, Due 7/12)	3,700 16,575	3,687 16,485	3,687 16,485
Deluxe Entertainment Services Group, Inc. (Business Services)	Subordinated Debt (13.6%, Due 7/11)	30,000	30,000	30,000
Distant Lands Trading Co. (Consumer Products)	Senior Loan (10.1%, Due 11/11) Unitranche Debt (11.0%, Due 11/11) Common Stock (4,000 shares)	5,450 54,375	5,408 54,144 4,000	5,408 54,144 3,194

Drilltec Patents & Technologies

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Company, Inc. (Energy Services)	Subordinated Debt (18.0%, Due 8/06)	4,119	4,119	4,119
	Subordinated Debt (16.5%, Due 8/06) <sup>(6)</sup>	10,994	10,918	10,994
Driven Brands, Inc. d/b/a Meineke and Econo Lube (Consumer Services)	Senior Loan (8.9%, Due 6/11)	37,070	36,926	36,926
	Subordinated Debt (12.1%, Due 6/12 6/13)	83,000	82,701	82,701
	Common Stock (11,675,331 shares) <sup>(11)</sup> Warrants <sup>(11)</sup>		29,455	19,935
Digital VideoStream, LLC (Business Services)	Unitranche Debt (11.0%, Due 2/12)	17,838	17,737	17,737
	Convertible Subordinated Debt (10.0%, Due 2/16)	3,824	3,808	3,808
Dynamic India Fund IV <sup>(4)(5)</sup> (Private Equity Fund)	Equity Interests		3,850	3,850
EarthColor, Inc. (Business Services)	Subordinated Debt (15.0%, Due 11/13)	107,000	106,497	106,497
	Common Stock (53,540 shares) <sup>(11)</sup> Warrants <sup>(11)</sup>		53,540	51,796
eCentury Capital Partners, L.P. <sup>(5)</sup> (Private Equity Fund)	Limited Partnership Interest		6,274	2,738

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**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENT OF INVESTMENTS (Continued)**

March 31, 2007

Private Finance Portfolio Company (in thousands, except number of shares)	Investment <sup>(1)(2)</sup>	(unaudited)		
		Principal	Cost	Value
Elexis Beta GmbH <sup>(4)</sup> (Industrial Products)	Options		\$ 426	\$ 50
Farley s & Sathers Candy Company, Inc. (Consumer Products)	Subordinated Debt (11.4%, Due 3/11)	\$ 20,000	19,935	19,935
Frozen Specialties, Inc. (Consumer Products)	Warrants		435	270
Garden Ridge Corporation (Retail)	Subordinated Debt (7.0%, Due 5/12) <sup>(6)</sup>	22,500	22,500	22,500
Geotrace Technologies, Inc. (Energy Services)	Subordinated Debt (10.0%, Due 6/09) Warrants	23,495	22,105 2,350	22,105 2,100
Ginsey Industries, Inc. (Consumer Products)	Subordinated Debt (12.5%, Due 5/07)	2,489	2,489	2,489
Grant Broadcasting Systems II (Broadcasting & Cable)	Subordinated Debt (5.0%, Due 6/11)	3,005	3,005	3,005
Grotech Partners, VI, L.P. <sup>(5)</sup> (Private Equity Fund)	Limited Partnership Interest		8,223	6,139
Havco Wood Products LLC (Industrial Products)	Senior Debt (9.9%, Due 8/11) Unitranche Debt (11.5%, Due 8/11) Equity Interests	2,000 13,600	1,982 12,707 1,055	1,982 12,707 3,000
Haven Eldercare of New England, LLC (Healthcare Services)	Subordinated Debt (12.0%, Due 8/09)	2,527	2,527	2,527
HealthASPex Services Inc. (Business Services)	Senior Loan (4.0%, Due 7/08)	500	500	500
The Hillman Companies, Inc. <sup>(3)</sup>		44,580	44,434	44,434

Subordinated Debt (10.0%, Due 9/11)				
(Consumer Products)				
The Homax Group, Inc. (Consumer Products)	Senior Loan (9.2%, Due 10/12)	12,550	12,550	12,550
	Subordinated Debt (12.0%, Due 4/14)	14,000	13,189	13,189
	Preferred Stock (89 shares)		89	80
	Common Stock (28 shares)		6	
	Warrants		1,106	993
Ideal Snacks Corporation (Consumer Products)	Senior Loan (9.0%, Due 6/10)	5,850	5,818	5,818
Integrity Interactive Corporation (Business Services)	Unitranche Debt (10.5%, Due 2/12)	29,000	28,823	28,823
International Fiber Corporation				
(Industrial Products)				
	Subordinated Debt (14.0%, Due 6/12)	22,098	22,029	22,029
	Preferred Stock (25,000 shares)		2,500	2,200

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**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENT OF INVESTMENTS (Continued)**

March 31, 2007

Private Finance Portfolio Company (in thousands, except number of shares)	Investment <sup>(1)(2)</sup>	Principal	Cost	Value
			(unaudited)	
Kodiak Fund LP <sup>(5)</sup> (Private Equity Fund)	Equity Interests		\$ 9,513	\$ 9,460
Line-X, Inc. (Consumer Products)	Senior Loan (12.0%, Due 8/11) Unitranche Debt (12.0% Due 8/11) Standby Letter of Credit (\$1,500)	\$ 2,200 47,884	2,182 47,692	2,182 46,224
MedAssets, Inc. (Business Services)	Preferred Stock (227,865 shares) Common Stock (50,000 shares)		2,049	3,670 150
MHF Logistical Solutions, Inc. (Business Services)	Subordinated Debt (11.5%, Due 6/12) <sup>(6)</sup> Subordinated Debt (18.0%, Due 6/13) <sup>(6)</sup> Common Stock (20,934 shares) <sup>(11)</sup> Warrants <sup>(11)</sup>	33,600 11,211	33,448 11,154 20,942	27,518
Mid-Atlantic Venture Fund IV, L.P. <sup>(5)</sup> (Private Equity Fund)	Limited Partnership Interest		6,975	3,037
Mogas Energy, LLC (Energy Services)	Subordinated Debt (9.5%, Due 8/08)	16,285	15,086	15,086
NetShape Technologies, Inc. (Industrial Products)	Senior Debt (8.6%, Due 2/13)	8,991	8,957	8,957
Network Hardware Resale, Inc. (Business Services)	Unitranche Debt (10.5%, Due 12/11) Convertible Subordinated Debt (9.8%, Due 12/15)	36,701 13,242	36,893 13,307	36,893 13,599
Norwesco, Inc. (Industrial Products)	Subordinated Debt (12.6%, Due 1/12 7/12) Common Stock (559,603 shares) <sup>(11)</sup> Warrants <sup>(11)</sup>	82,595	82,297 38,313	82,297 81,086
Novak Biddle Venture Partners III, L.P. <sup>(5)</sup> (Private Equity Fund)	Limited Partnership Interest		1,835	1,883

Oahu Waste Services, Inc. (Business Services)	Stock Appreciation Rights		239	800
Odyssey Investment Partners Fund III, LP <sup>(5)</sup> (Private Equity Fund)	Limited Partnership Interest		2,462	2,310
Passport Health Communications, Inc. (Healthcare Services)	Subordinated Debt (14.0%, Due 4/12) Preferred Stock (651,381 shares)	10,222	10,181 2,000	10,181 2,255
Pendum, Inc. (Business Services)	Subordinated Debt (17.0%, Due 1/11) <sup>(6)</sup> Preferred Stock (82,715 shares) Warrants	34,028	34,028	26,676
Performant Financial Corporation (Business Services)	Common Stock (478,816 shares)		734	

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**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENT OF INVESTMENTS (Continued)**

March 31, 2007

Private Finance Portfolio Company (in thousands, except number of shares)	Investment <sup>(1)(2)</sup>	Principal	Cost	Value
			(unaudited)	
Postle Aluminum Company, LLC (Industrial Products)	Unitranche Debt (11.0%, Due 10/12) Equity Interests	\$ 62,250	\$ 61,927 2,500	\$ 61,927 2,600
Pro Mach, Inc. (Industrial Products)	Subordinated Debt (12.5%, Due 6/12) Equity Interests	14,471	14,406 1,500	14,406 2,200
Promo Works, LLC (Business Services)	Unitranche Debt (10.3%, Due 12/11) Guaranty (\$900)	31,000	30,739	30,739
S.B. Restaurant Company (Retail)	Unitranche Debt (9.8%, Due 4/11) Preferred Stock (54,125 shares) Warrants Standby Letters of Credit (\$2,611)	41,501	41,118 135 619	41,118 135 1,600
SBBUT, LLC (Consumer Products)	Equity Interests			
Service Center Metals, LLC (Industrial Products)	Subordinated Debt (15.5%, Due 9/11) Equity Interests	5,000	4,978 313	4,978 325
Soff-Cut Holdings, Inc. (Industrial Products)	Preferred Stock (300 shares) Common Stock (2,000 shares)		300 200	300 200
SPP Mezzanine Funding, L.P. <sup>(5)</sup> (Private Equity Fund)	Limited Partnership Interest		2,825	3,159
SPP Mezzanine Funding II, L.P. <sup>(5)</sup> (Private Equity Fund)	Limited Partnership Interest		1,105	846
Stag-Parkway, Inc. (Business Services)	Unitranche Debt (10.8%, Due 7/12)	63,000	62,724	62,724
STS Operating, Inc. (Industrial Products)	Subordinated Debt (11.0%, Due 1/13)	30,386	30,256	30,256
The Step2 Company, LLC	Unitranche Debt (10.5%, Due 4/12)	64,348	64,064	64,064

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(Consumer Products)	Equity Interests		2,000	1,991
Tradesmen International, Inc. (Business Services)	Subordinated Debt (12.0%, Due 12/09)	9,136	8,629	8,629
TransAmerican Auto Parts, LLC (Consumer Products)	Subordinated Debt (14.0%, Due 11/12) Equity Interests	13,011	12,960 1,198	12,960 845
Universal Air Filter Company (Industrial Products)	Unitranche Debt (11.0%, Due 11/11)	18,867	18,781	18,781
Uputa Venture Partners II, L.P. <sup>(5)</sup> (Private Equity Fund)	Limited Partnership Interest		4,627	5,047
Venturehouse-Cibernet Investors, LLC (Business Services)	Equity Interest		42	42
Venturehouse Group, LLC <sup>(5)</sup> (Private Equity Fund)	Equity Interest		598	901
VICORP Restaurants, Inc. (Retail)	Warrants		33	

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

**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENT OF INVESTMENTS (Continued)**

March 31, 2007

Private Finance Portfolio Company (in thousands, except number of shares)	Investment <sup>(1)(2)</sup>	Principal	Cost	Value
			(unaudited)	
Walker Investment Fund II, LLLP <sup>(5)</sup> (Private Equity Fund)	Limited Partnership Interest		\$ 1,330	\$ 458
Wear Me Apparel Corporation (Consumer Products)	Subordinated Debt (15.0%, Due 12/10) Warrants	\$ 39,990	39,509 1,219	39,990 5,120
Webster Capital II, L.P. <sup>(5)</sup> (Private Equity Fund)	Limited Partnership Interest		75	75
Wilton Industries, Inc. (Consumer Products)	Subordinated Debt (16.0%, Due 6/08)	2,400	2,400	2,400
Woodstream Corporation (Consumer Products)	Subordinated Debt (13.5%, Due 11/12 5/13) Common Stock (180 shares) Warrants	53,293	53,174 673	53,174 3,885 2,815
York Insurance Services Group, Inc. (Business Services)	Subordinated Debt (14.5%, Due 1/14) Common Stock (15,000 shares)	44,471	44,274 1,500	44,274 2,000
Other companies	Other debt investments <sup>(6)</sup> Other equity investments	223	223 8	218
Total companies less than 5% owned			\$ 2,159,014	\$ 2,145,284
Total private finance (144 portfolio companies)			\$ 4,434,112	\$ 4,376,319

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(3) Public company.

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

**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENT OF INVESTMENTS (Continued)**

**Commercial Real Estate Finance**  
(in thousands, except number of loans)

<b>March 31, 2007</b>				
	Interest Rate Ranges	Number of Loans	(unaudited)	
			Cost	Value
<b>Commercial Mortgage Loans</b>				
	Up to 6.99%	3	\$ 20,443	\$ 19,693
	7.00% 8.99%	9	24,034	24,269
	9.00% 10.99%	4	24,316	24,316
	15.00% and above	2	3,970	3,970
Total commercial mortgage loans <sup>(13)</sup>		18	\$ 72,763	\$ 72,248
<b>Real Estate Owned</b>			\$ 15,657	\$ 20,969
<b>Equity Interests<sup>(2)</sup></b> Companies more than 25% owned (Guarantees \$6,871)			\$ 14,964	\$ 29,312
Total commercial real estate finance			\$ 103,384	\$ 122,529
Total portfolio			\$ 4,537,496	\$ 4,498,848

	Yield	Cost	Value
<b>Liquidity Portfolio<sup>(14)</sup></b>			
American Beacon Money Market Select FD Fund	5.3%	\$ 87,789	\$ 87,789
Certificate of Deposit (Due June 2007)	5.5%	41,143	41,143
American Beacon Money Market Fund	5.2%	40,904	40,904
SEI Daily Income Tr Prime Obligation Fund	5.2%	35,113	35,113
Blackrock Liquidity Funds	5.2%	10	10
Total liquidity portfolio		\$ 204,959	\$ 204,959
<b>Other Investments in Money Market Securities<sup>(14)</sup></b>			
Columbia Treasury Reserves Money Market Fund	5.2%	\$ 64,998	\$ 64,998
Blackrock Liquidity Funds	5.2%	\$ 1,213	\$ 1,213

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- (5) Non-registered investment company.
- (13) Commercial mortgage loans totaling \$19.2 million at value were on non-accrual status and therefore were considered non-income producing.
- (14) Included in investments in money market and other securities on the accompanying Consolidated Balance Sheet.

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



**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENT OF INVESTMENTS**

December 31, 2006

**Private Finance**

**Portfolio Company**

(in thousands, except number of shares)

	Investment <sup>(1)(2)</sup>	Principal	Cost	Value
<b>Companies More Than 25% Owned</b>				
Alaris Consulting, LLC (Business Services)	Senior Loan (16.5%, Due 12/05 12/07) <sup>(6)</sup> Equity Interests Guaranty (\$1,100)	\$ 27,055	\$ 26,987 5,305	\$
Avborne, Inc. <sup>(7)</sup> (Business Services)	Preferred Stock (12,500 shares) Common Stock (27,500 shares)		610	918
Avborne Heavy Maintenance, Inc. <sup>(7)</sup> (Business Services)	Preferred Stock (1,568 shares) Common Stock (2,750 shares) Guaranty (\$2,401)		2,401	
Border Foods, Inc. (Consumer Products)	Preferred Stock (100,000 shares) Common Stock (148,838 shares)		12,721 3,848	
Business Loan Express, LLC (Financial Services)	Class A Equity Interests(25.0%) <sup>(6)</sup> Class B Equity Interests Class C Equity Interests Guaranty (\$189,706 See Note 3) Standby Letters of Credit (\$25,000 See Note 3)	66,622	66,622 119,436 109,301	66,622 79,139 64,976
Calder Capital Partners, LLC <sup>(5)</sup> (Financial Services)	Senior Loan (8.0%, Due 5/09) <sup>(6)</sup> Equity Interests	975	975 2,076	975 2,076
Callidus Capital Corporation (Financial Services)	Subordinated Debt (18.0%, Due 10/08) Common Stock (100 shares)	5,762	5,762 2,058	5,762 22,550
Coverall North America, Inc. (Business Services)	Unitranche Debt (12.0%, Due 7/11) Subordinated Debt (15.0%, Due 7/11) Common Stock (884,880 shares)	36,500 6,000	36,333 5,972 16,649	36,333 5,972 19,619
CR Brands, Inc. (Consumer Products)	Subordinated Debt (16.6%, Due 2/13) Common Stock (37,200,551 shares)	39,573	39,401 33,321	39,401 25,738

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Financial Pacific Company (Financial Services)	Subordinated Debt (17.4%, Due 2/12 8/12) Preferred Stock (10,964 shares) Common Stock (14,735 shares)	71,589	71,362 10,276 14,819	71,362 15,942 65,186
ForeSite Towers, LLC (Tower Leasing)	Equity Interests		7,620	12,290
Global Communications, LLC (Business Services)	Senior Loan (10.7%, Due 9/02 11/07) <sup>(6)</sup> Subordinated Debt (17.0%, Due 12/03 9/05) <sup>(6)</sup> Preferred Equity Interest Options	15,957 11,339	15,957 11,336 14,067 1,639	15,957 11,237
Gordian Group, Inc. (Business Services)	Senior Loan (10.0%, Due 6/06 12/08) <sup>(6)</sup> Common Stock (1,000 shares)	11,792	11,803 6,762	

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- (5) Non-registered investment company.
- (6) Loan or debt security is on non-accrual status and therefore is considered non-income producing.
- (7) Avborne, Inc. and Avborne Heavy Maintenance, Inc. are affiliated companies.

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

**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENT OF INVESTMENTS (Continued)**

December 31, 2006

Private Finance Portfolio Company (in thousands, except number of shares)	Investment <sup>(1)(2)</sup>	Principal	Cost	Value
Healthy Pet Corp. (Consumer Services)	Senior Loan (9.9%, Due 8/10)	\$ 27,038	\$ 27,038	\$ 27,038
	Subordinated Debt (15.0%, Due 8/10)	43,720	43,579	43,579
	Common Stock (30,142 shares)		30,142	28,921
HMT, Inc. (Energy Services)	Preferred Stock (554,052 shares)		2,637	2,637
	Common Stock (300,000 shares)		3,000	8,664
	Warrants		1,155	3,336
Huddle House, Inc. (Retail)	Senior Loan (8.9%, Due 12/11)	19,950	19,950	19,950
	Subordinated Debt (15.0%, Due 12/12)	58,484	58,196	58,196
	Common Stock (415,328 shares)		41,662	41,662
Impact Innovations Group, LLC (Business Services)	Equity Interests in Affiliate			873
Insight Pharmaceuticals Corporation (Consumer Products)	Subordinated Debt (16.1%, Due 9/12)	60,049	59,850	59,850
	Preferred Stock (25,000 shares)		25,000	7,845
	Common Stock (620,000 shares)		6,325	
Jakel, Inc. (Industrial Products)	Subordinated Debt (15.5%, Due 3/08) <sup>(6)</sup>	15,192	15,192	6,655
	Preferred Stock (6,460 shares)		6,460	
	Common Stock (158,061 shares)		9,347	
Legacy Partners Group, LLC (Financial Services)	Senior Loan (14.0%, Due 5/09) <sup>(6)</sup>	7,646	7,646	4,843
	Subordinated Debt (18.0%, Due 5/09) <sup>(6)</sup>	2,952	2,952	
	Equity Interests		4,248	
Litterer Beteiligungs-GmbH <sup>(4)</sup> (Business Services)	Subordinated Debt (8.0%, Due 3/07)	692	692	692
	Equity Interest		1,809	1,199
Mercury Air Centers, Inc. (Business Services)	Subordinated Debt (16.0%, Due 4/09)			
	11/12)	49,358	49,217	49,217
	Common Stock (57,970 shares)		35,053	195,019
	Standby Letters of Credit (\$1,581)			

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MVL Group, Inc. (Business Services)	Senior Loan (12.0%, Due 6/09 7/09)	27,299	27,245	27,245
	Subordinated Debt (14.5%, Due 6/09)	35,846	35,478	35,478
	Common Stock (648,661 shares)		643	
Penn Detroit Diesel Allison, LLC (Business Services)	Subordinated Debt (15.5%, Due 8/13)	38,173	37,994	37,994
	Equity Interests		21,128	25,949
Powell Plant Farms, Inc. (Consumer Products)	Senior Loan (15.0%, Due 12/07) <sup>(6)</sup>	35,040	26,192	26,192
	Subordinated Debt (20.0%, Due 6/03) <sup>(6)</sup>	19,291	19,223	962
	Preferred Stock (1,483 shares)			
	Warrants			
Service Champ, Inc. (Business Services)	Subordinated Debt (15.5%, Due 4/12)	27,733	27,619	27,619
	Common Stock (63,888 shares)		13,662	16,786

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**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENT OF INVESTMENTS (Continued)**

December 31, 2006

Private Finance Portfolio Company (in thousands, except number of shares)	Investment <sup>(1)(2)</sup>	Principal	Cost	Value
Staffing Partners Holding Company, Inc.  (Business Services)	Subordinated Debt (13.5%, Due 1/07) <sup>(6)</sup>	\$ 540	\$ 540	\$ 486
Startec Global Communications Corporation  (Telecommunications)	Senior Loan (10.0%, Due 5/07 5/09) Common Stock (19,180,000 shares)	15,965	15,965 37,256	15,965 11,232
Sweet Traditions, LLC (Retail)	Senior Loan (9.0%, Due 8/11) Equity Interests Standby Letter of Credit (\$120)	39,022	35,172 450	35,172 450
Triview Investments, Inc. <sup>(8)</sup>  (Broadcasting & Cable/Business Services/Consumer Products)	Senior Loan (9.6%, Due 6/07 12/07) Subordinated Debt (16.0%, Due 9/11 7/12) Subordinated Debt (7.9%, Due 11/07 7/08) <sup>(9)</sup> Common Stock (202 shares) Guaranty (\$800) Standby Letter of Credit (\$200)	14,758 56,288 4,327	14,747 56,008 4,327 98,604	14,747 56,008 4,342 31,322
Total companies more than 25% owned			\$ 1,578,822	\$ 1,490,180
<b>Companies 5% to 25% Owned</b>				
Advantage Sales & Marketing, Inc. (Business Services)	Subordinated Debt (12.0%, Due 3/14) Equity Interests	\$ 152,320	\$ 151,648	\$ 151,648 11,000
Air Medical Group Holdings LLC (Healthcare Services)	Senior Loan (9.9%, Due 3/11) Subordinated Debt (14.0%, Due 11/12) Equity Interests	1,828 35,180	1,763 35,128 3,470	1,763 35,128 5,950
Alpine ESP Holdings, Inc. (Business Services)	Preferred Stock (622 shares) Common Stock (13,513 shares)		622 14	602

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Amerex Group, LLC (Consumer Products)	Subordinated Debt (12.0%, Due 1/13) Equity Interests	8,400	8,400 3,546	8,400 13,823
BB&T Capital Partners/Windsor Mezzanine Fund, LLC <sup>(5)</sup> (Private Equity Fund)	Equity Interests		5,873	5,554
Becker Underwood, Inc. (Industrial Products)	Subordinated Debt (14.5%, Due 8/12) Common Stock (5,073 shares)	24,244	24,163 5,813	24,163 3,700
BI Incorporated (Business Services)	Subordinated Debt (13.5%, Due 2/14) Common Stock (40,000 shares)	30,269	30,135 4,000	30,135 4,100

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- (2) Common stock, preferred stock, warrants, options, and equity interests are generally non-income producing and restricted.
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- (6) Loan or debt security is on non-accrual status and therefore is considered non-income producing.
- (8) Triview Investments, Inc. holds investments in Longview Cable & Data, LLC (Broadcasting & Cable) with a cost of \$67.3 million and a value of \$7.5 million, Triax Holdings, LLC (Consumer Products) with a cost of \$98.9 million and a value of \$91.5 million, and Crescent Hotels & Resorts, LLC and affiliates (Business Services) with a cost of \$7.5 million and a value of \$7.3 million.

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

**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENT OF INVESTMENTS (Continued)**

December 31, 2006

Private Finance Portfolio Company (in thousands, except number of shares)	Investment <sup>(1)(2)</sup>	Principal	Cost	Value
CitiPostal, Inc. and Affiliates (Business Services)	Senior Loan (11.1%, Due 8/13-11/14) Equity Interests	\$ 20,670	\$ 20,569 4,447	\$ 20,569 4,700
Creative Group, Inc. (Business Services)	Subordinated Debt (12.0%, Due 9/13) Warrant	15,000	13,656 1,387	13,656 1,387
Drew Foam Companies, Inc. (Business Services)	Preferred Stock (722 shares) Common Stock (7,287 shares)		722 7	722 7
MedBridge Healthcare, LLC (Healthcare Services)	Senior Loan (6.0%, Due 8/09) <sup>(6)</sup> Subordinated Debt (10.0%, Due 8/14) <sup>(6)</sup> Convertible Subordinated Debt (2.0%, Due 8/14) <sup>(6)</sup> Equity Interests	7,164 5,184 2,970	7,164 5,184 984 1,306	7,164 1,813
Multi-Ad Services, Inc. (Business Services)	Unitranche Debt (11.3%, Due 11/11) Equity Interests	20,000	19,879 2,000	19,879 2,000
Nexcel Synthetics, LLC (Consumer Products)	Subordinated Debt (14.5%, Due 6/09) Equity Interests	10,998	10,978 1,755	10,978 1,486
PresAir LLC (Industrial Products)	Senior Loan (7.5%, Due 12/10) <sup>(6)</sup> Equity Interests	5,810	5,492 1,336	2,206
Progressive International Corporation (Consumer Products)	Subordinated Debt (16.0%, Due 12/09) Preferred Stock (500 shares) Common Stock (197 shares) Warrants	7,553	7,533 500 13	7,533 1,024 2,300
Regency Healthcare Group, LLC (Healthcare Services)	Senior Loan (11.1%, Due 6/12) Unitranche Debt (11.1%, Due 6/12) Equity Interests	1,250 20,000	1,232 19,908 1,500	1,232 19,908 1,616

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SGT India Private Limited <sup>(4)</sup> (Business Services)	Common Stock (109,524 shares)		3,944	3,346
Soteria Imaging Services, LLC (Healthcare Services)	Subordinated Debt (11.6%, Due 11/10) Equity Interests	18,500	17,569 2,163	17,569 2,541
Universal Environmental Services, LLC (Business Services)	Unitranche Debt (14.5%, Due 2/09) Equity Interests	10,989	10,962 1,795	10,211
Total companies 5% to 25% owned			\$ 438,560	\$ 449,813

**Companies Less Than 5% Owned**

3SI Security Systems, Inc. (Consumer Products)	Subordinated Debt (14.5%, Due 8/13)	\$ 26,857	\$ 26,740	\$ 26,740
AgData, L.P. (Consumer Services)	Unitranche Debt (10.3%, Due 7/12)	11,330	11,269	11,269
Anthony, Inc. (Industrial Products)	Subordinated Debt (13.3%, Due 8/11 9/12)	14,818	14,768	14,768
Axiom Healthcare Pharmacy, Inc. (Healthcare Services)	Senior Loan (12.0%, Due 12/12) Unitranche Debt (12.0%, Due 12/12) Common Stock (26,500 shares)	200 9,000	161 8,956 2,650	161 8,956 2,650
Baird Capital Partners IV Limited Partnership <sup>(5)</sup> (Private Equity Fund)	Limited Partnership Interest		876	876

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**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENT OF INVESTMENTS (Continued)**

December 31, 2006

Private Finance Portfolio Company (in thousands, except number of shares)	Investment <sup>(1)(2)</sup>	Principal	Cost	Value
Bantek West, Inc. (Business Services)	Subordinated Debt (11.6%, Due 1/11) <sup>(6)</sup>	\$ 30,000	\$ 30,000	\$ 21,463
Benchmark Medical, Inc. (Healthcare Services)	Warrants		18	
BenefitMall, Inc. (Business Services)	Unitranche Debt (13.3%, Due 8/12) Common Stock (45,528,000 shares) <sup>(11)</sup> Warrants <sup>(11)</sup> Standby Letters of Credit (\$9,981)	110,030	109,648 45,528	109,648 43,578
Breeze-Eastern Corporation <sup>(3)</sup> (Industrial Products)	Senior Loan (10.1%, Due 5/11)	10,000	10,000	10,000
Broadcast Electronics, Inc. (Business Services)	Senior Loan (9.1%, Due 7/12)	4,963	4,930	4,930
C&K Market, Inc. (Retail)	Subordinated Debt (14.0%, Due 12/08)	27,819	27,738	27,738
Callidus Debt Partners CDO Fund I, Ltd. <sup>(4)(9)</sup> (Senior Debt Fund)	Class C Notes (12.9%, Due 12/13) Class D Notes (17.0%, Due 12/13)	18,800 9,400	18,951 9,476	18,951 9,476
Callidus Debt Partners CLO Fund III, Ltd. <sup>(4)(9)</sup> (Senior Debt Fund)	Preferred Shares (23,600,000 shares, 12.7%) <sup>(12)</sup>		23,285	23,010
Callidus Debt Partners CLO Fund IV, Ltd. <sup>(4)(9)</sup> (Senior Debt Fund)	Income Notes (13.8%) <sup>(12)</sup>		12,986	12,986
Callidus Debt Partners CLO Fund V, Ltd. <sup>(4)(9)</sup> (Senior Debt Fund)	Income Notes (15.8%) <sup>(12)</sup>		13,769	13,769
	Class E Notes (10.9%, Due 12/17)	17,000	17,000	17,155

Callidus MAPS CLO Fund I LLC <sup>(9)</sup> (Senior Debt Fund)	Income Notes (15.9%) <sup>(12)</sup>		50,960	47,421
Camden Partners Strategic Fund II, L.P. <sup>(5)</sup> (Private Equity Fund)	Limited Partnership Interest		2,141	2,873
Carlisle Wide Plank Floors, Inc. (Consumer Products)	Unitranche Debt (10.5%, Due 6/11) Preferred Stock (400,000 Shares)	14,000	13,900 400	13,900 400
Catterton Partners V, L.P. <sup>(5)</sup> (Private Equity Fund)	Limited Partnership Interest		3,306	3,412
Catterton Partners VI, L.P. <sup>(5)</sup> (Private Equity Fund)	Limited Partnership Interest		531	531
Centre Capital Investors IV, LP <sup>(5)</sup> (Private Equity Fund)	Limited Partnership Interest		1,991	1,889

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- (9) The fund is managed by Callidus Capital, a portfolio company of Allied Capital.
- (11) Common stock is non-voting. In addition to non-voting stock ownership, the Company has an option to acquire a majority of the voting securities of the portfolio company at fair market value.
- (12) Represents the effective yield earned on these preferred equity investments. The yield is included in interest income from companies less than 5% owned in the consolidated statement of operations.

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

**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENT OF INVESTMENTS (Continued)**

**December 31, 2006**

<b>Private Finance Portfolio Company (in thousands, except number of shares)</b>	<b>Investment<sup>(1)(2)</sup></b>	<b>Principal</b>	<b>Cost</b>	<b>Value</b>
Commercial Credit Group, Inc. (Financial Services)	Subordinated Debt (14.8%, Due 2/11) Preferred Stock (32,500 shares) Warrants	\$ 5,000	\$ 4,959 3,900	\$ 4,959 3,900
Community Education Centers, Inc. (Education Services)	Subordinated Debt (16.0%, Due 12/10)	34,158	34,067	34,067
Compass Group Diversified Holdings LLC <sup>(3)</sup> (Financial Services)	Senior Loan (8.4%, Due 11/11)	8,500	8,375	8,375
Component Hardware Group, Inc. (Industrial Products)	Subordinated Debt (13.5%, Due 1/13)	18,158	18,075	18,075
Cook Inlet Alternative Risk, LLC (Business Services)	Unitranche Debt (10.0%, Due 4/12) Equity Interests	67,500	67,146 2,000	67,146 2,300
Cortec Group Fund IV, L.P. <sup>(5)</sup> (Private Equity)	Limited Partnership Interest		1,137	1,137
CSAV, Inc. (Business Services)	Subordinated Debt (11.9%, Due 6/13)	37,500	37,500	37,500
DCWV Acquisition Corporation (Consumer Products)	Senior Loan (8.9%, Due 7/12) Unitranche Debt (11.0%, Due 7/12)	2,074 16,788	2,060 16,694	2,060 16,694
Deluxe Entertainment Services Group, Inc. (Business Services)	Subordinated Debt (13.6%, Due 7/11)	30,000	30,000	30,000
Distant Lands Trading Co. (Consumer Products)	Senior Loan (10.6%, Due 11/11) Unitranche Debt (11.0%, Due 11/11) Common Stock (4,000 shares)	2,700 54,375	2,656 54,130 4,000	2,656 54,130 2,975
Drilltec Patents & Technologies Company, Inc.	Subordinated Debt (18.0%, Due 8/06)	4,119	4,119	4,119

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(Energy Services)	Subordinated Debt (16.5%, Due 8/06) <sup>(6)</sup>	10,994	10,918	9,121
Driven Brands, Inc.	Senior Loan (8.9%, Due 6/11)	37,070	36,918	36,918
d/b/a Meineke and Econo Lube	Subordinated Debt (12.1%, Due 6/12 6/13)	83,000	82,684	82,684
(Consumer Services)	Common Stock (11,675,331 shares) <sup>(11)</sup> Warrants <sup>(11)</sup>		29,455	19,702
Digital VideoStream, LLC	Unitranche Debt (11.0%, Due 2/12)	19,127	19,021	19,021
(Business Services)	Convertible Subordinated Debt (10.0%, Due 2/16)	3,730	3,714	3,714
Dynamic India Fund IV <sup>(4)(5)</sup>	Equity Interests		3,850	3,850
(Private Equity Fund)				
EarthColor, Inc.	Senior Loan (7.4%, Due 11/11)	35,000	35,000	35,000
(Business Services)	Subordinated Debt (15.0%, Due 11/13)	107,000	106,478	106,478
	Common Stock (53,540 shares) <sup>(11)</sup> Warrants <sup>(11)</sup>		53,540	53,540
eCentury Capital Partners, L.P. <sup>(5)</sup>	Limited Partnership Interest		6,274	2,090
(Private Equity Fund)				

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- (11) Common stock is non-voting. In addition to non-voting stock ownership, the Company has an option to acquire a majority of the voting securities of the portfolio company at fair market value.

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

**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENT OF INVESTMENTS (Continued)**

December 31, 2006

Private Finance Portfolio Company (in thousands, except number of shares)	Investment <sup>(1)(2)</sup>	Principal	Cost	Value
Elexis Beta GmbH <sup>(4)</sup> (Industrial Products)	Options		\$ 426	\$ 50
Farley s & Sathers Candy Company, Inc. (Consumer Products)	Subordinated Debt (11.4%, Due 3/11)	\$ 20,000	19,931	19,931
Frozen Specialties, Inc. (Consumer Products)	Warrants		435	320
Garden Ridge Corporation (Retail)	Subordinated Debt (7.0%, Due 5/12) <sup>(6)</sup>	22,500	22,500	22,500
Geotrace Technologies, Inc. (Energy Services)	Subordinated Debt (10.0%, Due 6/09) Warrants	23,945	22,481 2,350	22,481 1,900
Ginsey Industries, Inc. (Consumer Products)	Subordinated Debt (12.5%, Due 3/07)	2,743	2,743	2,743
Grant Broadcasting Systems II (Broadcasting & Cable)	Subordinated Debt (5.0%, Due 6/11)	3,005	3,005	3,005
Grotech Partners, VI, L.P. <sup>(5)</sup> (Private Equity Fund)	Limited Partnership Interest		8,223	6,088
Havco Wood Products LLC (Industrial Products)	Unitranche Debt (11.1%, Due 8/11) Equity Interests	19,654	18,615 1,049	18,615 3,000
Haven Eldercare of New England, LLC <sup>(10)</sup> (Healthcare Services)	Subordinated Debt (12.0%, Due 8/09)	2,827	2,827	2,827
Haven Healthcare Management, LLC <sup>(10)</sup> (Healthcare Services)	Subordinated Debt (18.0%, Due 4/07)	140	140	140
HealthASPex Services Inc. (Business Services)	Senior Loan (4.0%, Due 7/08)	500	500	500
The Hillman Companies, Inc. <sup>(3)</sup>	Subordinated Debt (10.0%, Due 9/11)	44,580	44,427	44,427

(Consumer Products)				
The Homax Group, Inc. (Consumer Products)	Senior Loan (9.2%, Due 10/12)	12,485	12,485	12,485
	Subordinated Debt (12.0%, Due 4/14)	14,000	13,171	13,171
	Preferred Stock (89 shares)		89	89
	Common Stock (28 shares)		6	6
	Warrants		1,106	1,106
Hot Stuff Foods, LLC (Consumer Products)	Senior Loan (8.9%, Due 2/11-2/12)	48,580	48,351	48,351
	Subordinated Debt (13.7%, Due 8/12 2/13)	60,606	60,353	60,353
	Subordinated Debt (16.0%, Due 2/13) <sup>(6)</sup>	20,841	20,749	8,460
	Common Stock (1,122,452 shares) <sup>(11)</sup> Warrants <sup>(11)</sup>		56,186	
Ideal Snacks Corporation (Consumer Products)	Senior Loan (9.0%, Due 6/10)	5,850	5,815	5,815
Integrity Interactive Corporation (Business Services)	Unitranche Debt (10.5%, Due 2/12)	29,500	29,314	29,314
International Fiber Corporation (Industrial Products)	Subordinated Debt (14.0%, Due 6/12)	21,986	21,914	21,914
	Preferred Stock (25,000 shares)		2,500	2,200

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- (5) Non-registered investment company.
- (6) Loan or debt security is on non-accrual status and therefore is considered non-income producing.
- (10) Haven Eldercare of New England, LLC and Haven Healthcare Management, LLC are affiliated companies.
- (11) Common stock is non-voting. In addition to non-voting stock ownership, the Company has an option to acquire a majority of the voting securities of the portfolio company at fair market value.

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**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENT OF INVESTMENTS (Continued)**

December 31, 2006

Private Finance Portfolio Company (in thousands, except number of shares)	Investment <sup>(1)(2)</sup>	Principal	Cost	Value
Kodiak Fund LP <sup>(5)</sup> (Private Equity Fund)	Equity Interests		\$ 4,700	\$ 4,656
Line-X, Inc. (Consumer Products)	Senior Loan (9.1%, Due 8/11) Unitranche Debt (10.0% Due 8/11) Standby Letter of Credit (\$1,500)	\$ 2,000 48,509	1,981 48,306	1,981 48,306
MedAssets, Inc. (Business Services)	Preferred Stock (227,865 shares) Common Stock (50,000 shares)		2,049	3,623 250
MHF Logistical Solutions, Inc. (Business Services)	Subordinated Debt (11.5%, Due 6/12) Subordinated Debt (18.0%, Due 6/13) <sup>(6)</sup> Common Stock (20,934 shares) <sup>(11)</sup> Warrants <sup>(11)</sup>	33,600 11,211	33,448 11,155 20,942	33,448 8,719
Mid-Atlantic Venture Fund IV, L.P. <sup>(5)</sup> (Private Equity Fund)	Limited Partnership Interest		6,974	3,221
Mogas Energy, LLC (Energy Services)	Subordinated Debt (9.5%, Due 3/12 4/12) Warrants	16,336	15,100 1,774	16,318 6,250
Network Hardware Resale, Inc. (Business Services)	Unitranche Debt (10.5%, Due 12/11) Convertible Subordinated Debt (9.8%, Due 12/15)	37,154 12,000	37,357 12,068	37,357 12,559
Norwesco, Inc. (Industrial Products)	Subordinated Debt (12.6%, Due 1/12 7/12) Common Stock (559,603 shares) <sup>(11)</sup> Warrants <sup>(11)</sup>	82,486	82,172 38,313	82,172 83,329
Novak Biddle Venture Partners III, L.P. <sup>(5)</sup> (Private Equity Fund)	Limited Partnership Interest		1,834	1,947
Oahu Waste Services, Inc. (Business Services)	Stock Appreciation Rights		239	800

Odyssey Investment Partners Fund III, LP <sup>(5)</sup> (Private Equity Fund)	Limited Partnership Interest		1,883	1,744
Palm Coast Data, LLC (Business Services)	Senior Loan (8.9%, Due 8/10)	15,306	15,243	15,243
	Subordinated Debt (15.5%, Due 8/12 8/15)	30,396	30,277	30,277
	Common Stock (21,743 shares) <sup>(11)</sup>		21,743	41,707
	Warrants <sup>(11)</sup>			
Passport Health Communications, Inc. (Healthcare Services)	Subordinated Debt (14.0%, Due 4/12) Preferred Stock (651,381 shares)	10,145	10,101 2,000	10,101 2,189
Performant Financial Corporation (Business Services)	Common Stock (478,816 shares)		734	

- (1) Interest rates represent the weighted average annual stated interest rate on loans and debt securities, which are presented by nature of indebtedness for a single issuer. The maturity dates represent the earliest and the latest maturity dates.
- (2) Common stock, preferred stock, warrants, options, and equity interests are generally non-income producing and restricted.
- (3) Public company.
- (4) Non-U.S. company or principal place of business outside the U.S.
- (5) Non-registered investment company.
- (6) Loan or debt security is on non-accrual status and therefore is considered non-income producing.
- (11) Common stock is non-voting. In addition to non-voting stock ownership, the Company has an option to acquire a majority of the voting securities of the portfolio company at fair market value.

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



**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENT OF INVESTMENTS (Continued)**

**December 31, 2006**

<b>Private Finance Portfolio Company (in thousands, except number of shares)</b>	<b>Investment<sup>(1)(2)</sup></b>	<b>Principal</b>	<b>Cost</b>	<b>Value</b>
Postle Aluminum Company, LLC (Industrial Products)	Unitranche Debt (11.0%, Due 10/12) Equity Interests	\$ 57,500	\$ 57,189 2,500	\$ 57,189 2,500
Pro Mach, Inc. (Industrial Products)	Subordinated Debt (12.5%, Due 6/12) Equity Interests	14,471	14,402 1,500	14,402 2,200
Promo Works, LLC (Business Services)	Unitranche Debt (10.3%, Due 12/11) Guaranty (\$1,200)	31,000	30,727	30,727
S.B. Restaurant Company (Retail)	Unitranche Debt (9.8%, Due 4/11) Preferred Stock (54,125 shares) Warrants Standby Letters of Credit (\$2,611)	41,501	41,094 135 619	41,094 135 1,200
SBBUT, LLC (Consumer Products)	Equity Interests			
Service Center Metals, LLC (Industrial Products)	Subordinated Debt (15.5%, Due 9/11) Equity Interests	5,000	4,976 312	4,976 318
Soff-Cut Holdings, Inc. (Industrial Products)	Preferred Stock (300 shares) Common Stock (2,000 shares)		300 200	300 180
SPP Mezzanine Funding, L.P. <sup>(5)</sup> (Private Equity Fund)	Limited Partnership Interest		2,551	2,825
SPP Mezzanine Funding II, L.P. <sup>(5)</sup> (Private Equity Fund)	Limited Partnership Interest		326	326
Stag-Parkway, Inc. (Business Services)	Unitranche Debt (10.8%, Due 7/12)	63,000	62,711	62,711
STS Operating, Inc. (Industrial Products)	Subordinated Debt (15.0%, Due 1/13)	30,156	30,021	30,021
The Step2 Company, LLC (Consumer Products)	Unitranche Debt (10.5%, Due 4/12) Equity Interests	67,898	67,457 2,000	67,457 1,763

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Tradesmen International, Inc. (Business Services)	Subordinated Debt (12.0%, Due 12/09) Warrants	15,000	14,468 710	14,468 3,300
TransAmerican Auto Parts, LLC (Consumer Products)	Subordinated Debt (14.0%, Due 11/12) Equity Interests	12,947	12,892 1,190	12,892 747
Universal Air Filter Company (Industrial Products)	Unitranche Debt (11.0%, Due 11/11)	19,117	19,026	19,026
Uputa Venture Partners II, L.P. <sup>(5)</sup> (Private Equity Fund)	Limited Partnership Interest		5,477	5,158
Venturehouse-Cibernet Investors, LLC (Business Services)	Equity Interest		42	42
Venturehouse Group, LLC <sup>(5)</sup> (Private Equity Fund)	Equity Interest		598	365
VICORP Restaurants, Inc. (Retail)	Warrants		33	

- (1) Interest rates represent the weighted average annual stated interest rate on loans and debt securities, which are presented by nature of indebtedness for a single issuer. The maturity dates represent the earliest and the latest maturity dates.
- (2) Common stock, preferred stock, warrants, options, and equity interests are generally non-income producing and restricted.
- (3) Public company.
- (4) Non-U.S. company or principal place of business outside the U.S.
- (5) Non-registered investment company.
- (6) Loan or debt security is on non-accrual status and therefore is considered non-income producing.

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

**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENT OF INVESTMENTS (Continued)**

December 31, 2006

Private Finance Portfolio Company (in thousands, except number of shares)	Investment <sup>(1)(2)</sup>	Principal	Cost	Value
Walker Investment Fund II, LLLP <sup>(5)</sup> (Private Equity Fund)	Limited Partnership Interest		\$ 1,329	\$ 458
Wear Me Apparel Corporation (Consumer Products)	Subordinated Debt (15.0%, Due 12/10) Warrants	\$ 40,000	39,407 1,219	39,407 5,120
Wilton Industries, Inc. (Consumer Products)	Subordinated Debt (16.0%, Due 6/08)	2,400	2,400	2,400
Woodstream Corporation (Consumer Products)	Subordinated Debt (13.5%, Due 11/12 5/13) Common Stock (180 shares) Warrants	53,114	52,989 673	52,989 3,885 2,815
York Insurance Services Group, Inc. (Business Services)	Subordinated Debt (14.5%, Due 1/14) Common Stock (15,000 shares)	44,249	44,045 1,500	44,045 1,500
Other companies	Other debt investments <sup>(6)</sup> Other equity investments	223	223 8	218
Total companies less than 5% owned			\$ 2,479,981	\$ 2,437,908
Total private finance (145 portfolio companies)			\$ 4,497,363	\$ 4,377,901

- (1) Interest rates represent the weighted average annual stated interest rate on loans and debt securities, which are presented by nature of indebtedness for a single issuer. The maturity dates represent the earliest and the latest maturity dates.
- (2) Common stock, preferred stock, warrants, options, and equity interests are generally non-income producing and restricted.
- (3) Public company.
- (4) Non-U.S. company or principal place of business outside the U.S.
- (5) Non-registered investment company.
- (6) Loan or debt security is on non-accrual status and therefore is considered non-income producing.

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

**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENT OF INVESTMENTS (Continued)**

**Commercial Real Estate Finance**  
(in thousands, except number of loans)

	Interest Rate Ranges	Number of Loans	December 31, 2006	
			Cost	Value
<b>Commercial Mortgage Loans</b>				
	Up to 6.99%	3	\$ 20,470	\$ 19,692
	7.00% 8.99%	9	24,092	24,073
	9.00% 10.99%	4	24,117	24,117
	15.00% and above	2	3,970	3,970
Total commercial mortgage loans <sup>(13)</sup>		18	\$ 72,649	\$ 71,852
<b>Real Estate Owned</b>			\$ 15,708	\$ 19,660
<b>Equity Interests<sup>(2)</sup></b> Companies more than 25% owned (Guarantees \$6,871)			\$ 15,189	\$ 26,671
Total commercial real estate finance			\$ 103,546	\$ 118,183
Total portfolio			\$ 4,600,909	\$ 4,496,084

	Yield	Cost	Value
<b>Liquidity Portfolio</b>			
American Beacon Money Market Select FD Fund <sup>(14)</sup>	5.3%	\$ 85,672	\$ 85,672
Certificate of Deposit (Due March 2007) <sup>(14)</sup>	5.6%	40,565	40,565
American Beacon Money Market Fund <sup>(14)</sup>	5.2%	40,384	40,384
SEI Daily Income Tr Prime Obligation Fund <sup>(14)</sup>	5.2%	34,671	34,671
Blackrock Liquidity Funds <sup>(14)</sup>	5.2%	476	476
Total liquidity portfolio		\$ 201,768	\$ 201,768
<b>Other Investments in Money Market Securities<sup>(14)</sup></b>			
Columbia Treasury Reserves Money Market Fund	5.2%	\$ 441	\$ 441
Columbia Money Market Reserves	5.2%	\$ 1	\$ 1

- (1) Interest rates represent the weighted average annual stated interest rate on loans and debt securities, which are presented by nature of indebtedness for a single issuer. The maturity dates represent the earliest and the latest maturity dates.
- (2) Common stock, preferred stock, warrants, options, and equity interests are generally non-income producing and restricted.
- (3) Public company.
- (4) Non-U.S. company or principal place of business outside the U.S.
- (5) Non-registered investment company.
- (13) Commercial mortgage loans totaling \$18.9 million at value were on non-accrual status and therefore were considered non-income producing.
- (14) Included in investments in money market and other securities on the accompanying Consolidated Balance Sheet.

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

**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**(Information at and for the three months ended March 31, 2007 and 2006 is unaudited)**

**Note 1. Organization**

Allied Capital Corporation, a Maryland corporation, is a closed-end, non-diversified 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 real estate investment trust subsidiary, Allied Capital REIT, Inc. ( Allied REIT ), and several subsidiaries that are single member limited liability companies established for specific purposes including holding real estate properties. ACC also has a subsidiary, A.C. Corporation ( AC Corp ), that generally provides diligence and structuring services, as well as transaction, management, consulting, and other services, including underwriting and arranging senior loans, to the Company and its portfolio companies.

ACC and its subsidiaries, collectively, are referred to as the Company. The Company consolidates the results of its subsidiaries for financial reporting purposes.

Pursuant to Article 6 of Regulation S-X, the financial results of the Company's portfolio investments are not consolidated in the Company's financial statements. Portfolio investments are held for purposes of deriving investment income and future capital gains.

The investment objective of the Company is to achieve current income and capital gains. In order to achieve this objective, the Company has primarily invested in debt and equity securities of private companies in a variety of industries.

**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 2006 balances to conform with the 2007 financial statement presentation.

The accompanying unaudited consolidated financial statements of the Company have been prepared in accordance with U.S. generally accepted accounting principles ( 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, 2007, the results of operations for the three months ended March 31, 2007 and 2006, and changes in net assets and cash flows for the three months ended March 31, 2007 and 2006. The results of operations for the three months ended March 31, 2007, are not necessarily indicative of the operating results to be expected for the full year.

The private finance portfolio and the interest and related portfolio income and net realized gains (losses) 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

**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**Note 2. Summary of Significant Accounting Policies, continued**

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 (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.

In the ordinary course of business, the Company enters into transactions with portfolio companies that may be considered related party transactions.

***Valuation of Portfolio Investments***

The Company, as a BDC, has invested in illiquid securities including debt and equity securities of companies and CDO and CLO bonds and preferred shares/income notes. The Company's investments may be subject to certain 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 portfolio 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 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/or the Company's equity security has also appreciated in value. The value of investments in publicly traded securities is 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, overall financial condition or other factors lead to a determination of fair value at a different amount. The value of loan and debt securities may be greater than the Company's cost basis if the amount that would be repaid on the loan or debt security upon the sale of the portfolio company is greater than the Company's cost basis.

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.



**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**Note 2. Summary of Significant Accounting Policies, continued**

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. In general, interest is not accrued on loans and debt securities if the Company has doubt about interest collection or where the enterprise value of the portfolio company may not support further accrual. Loans in workout status 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 depending on such company's capital requirements. Loan origination fees, original issue discount, and market discount are capitalized and then amortized into interest income using a method that approximates the effective interest method. Upon the prepayment of a loan or debt security, any unamortized loan origination fees are recorded as interest income and any unamortized original issue discount or market discount is recorded as a realized gain. Prepayment premiums are recorded on loans and debt securities when received.

The weighted average yield on loans and debt securities is computed as the (a) annual stated interest on accruing loans and debt securities plus the annual amortization of loan origination fees, original issue discount, and market discount on accruing loans and debt securities less the annual amortization of loan origination costs, 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 securities 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, multiples at which private companies are bought and sold, and other pertinent factors, such as recent offers to purchase a portfolio company, recent transactions involving the purchase or sale of the portfolio company's equity securities, liquidation events, or other events. The determined equity values are generally discounted when the company has a minority ownership position, restrictions on resale, specific concerns about the receptivity of the capital markets to a specific company at a certain time, or other factors.

The value of the Company's equity securities in public companies for which market quotations are readily available is based on 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 on preferred equity securities is recorded as dividend income on an accrual basis to the extent that such amounts are expected to be collected and to the extent that the Company has the option to receive the dividend in cash. Dividend income on common equity securities is recorded 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**

***Collateralized Debt Obligations ( CDO ) and Collateralized Loan Obligations ( CLO )***

CDO and CLO bonds and preferred shares/ income notes ( CDO/ CLO Assets ) are carried at fair value, which is based on a discounted cash flow model that utilizes prepayment, re-investment and loss assumptions based on historical experience and projected performance, economic factors, the characteristics of the underlying cash flow, and comparable yields for similar bonds and preferred shares/income notes, when available. The Company recognizes unrealized appreciation or depreciation on its CDO/ CLO Assets as comparable yields in the market change and/or based on changes in estimated cash flows resulting from changes in prepayment, re-investment or loss assumptions in the underlying collateral pool. The Company determines the fair value of its CDO/CLO Assets on an individual security-by-security basis.

The Company recognizes interest income on the preferred shares/income notes using the effective interest method, based on the anticipated yield and the estimated cash flows over the projected life of the investment. Yields are revised when there are changes in actual or estimated cash flows due to changes in prepayments and/or re-investments, credit losses or asset pricing. Changes in estimated yield are recognized as an adjustment to the estimated yield over the remaining life of the preferred share/income note from the date the estimated yield was changed. CDO and CLO bonds have stated interest rates.

***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 period, net of recoveries. Net change in unrealized appreciation or depreciation primarily reflects the change in portfolio investment values during the reporting period, including the reversal of previously recorded unrealized appreciation or depreciation when gains or losses are realized. Net change in unrealized appreciation or depreciation also reflects the change in the value of U.S. Treasury bills and deposits of proceeds from sales of borrowed Treasury securities, and depreciation on accrued interest and dividends receivable and other assets where collection is doubtful.

***Fee Income***

Fee income includes fees for loan prepayment premiums, guarantees, commitments, and services rendered by the Company to portfolio companies and other third parties such as diligence, structuring, transaction services, management and consulting services, and other services. Loan prepayment premiums are recognized at the time of prepayment. Guaranty and commitment fees are generally recognized as income over the related period of the guaranty or commitment, respectively. Diligence, structuring, and transaction services fees are generally recognized as income when services are rendered or when the related transactions are completed. Management, consulting and other services fees are generally recognized as income as the services are rendered.

**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**Note 2. Summary of Significant Accounting Policies, continued**

***Guarantees***

Guarantees meeting the characteristics described in FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others* (the Interpretation) and issued or modified after December 31, 2002, are recognized at fair value at inception. Guarantees made on behalf of portfolio companies are considered in determining the fair value of the Company's investments. See Note 5.

***Financing Costs***

Debt 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 using a method that approximates the effective interest method. Costs associated with the issuance of common stock, such as underwriting, accounting and legal fees, and printing costs are recorded as a reduction to the proceeds from the sale of common stock.

***Dividends to Shareholders***

Dividends to shareholders are recorded on the record date.

***Stock Compensation Plans***

The Company has a stock-based employee compensation plan. See Note 9. Effective January 1, 2006, the Company adopted the provisions of FASB Statement No. 123 (Revised 2004), *Share-Based Payment* (the Statement). The Statement was adopted using the modified prospective method of application, which required the Company to recognize compensation costs on a prospective basis beginning January 1, 2006. Accordingly, the Company did not restate prior year financial statements. Under this method, the unamortized cost of previously awarded options that were unvested as of January 1, 2006, is recognized over the remaining service period in the statement of operations beginning in 2006, using the fair value amounts determined for pro forma disclosure under Statement No. 123. With respect to options granted on or after January 1, 2006, compensation cost based on estimated grant date fair value is recognized over the related service period in the statement of operations. The stock option expense for the three months ended March 31, 2007 and 2006, was as follows:

	2007	2006
<b>(\$ in millions, except per share amounts)</b>		
<b>Employee Stock Option Expense:</b>		
Previously awarded, unvested options as of January 1, 2006	\$ 3.2	\$ 3.4
Options granted on or after January 1, 2006	0.5	0.2
Total employee stock option expense	\$ 3.7	\$ 3.6
Per basic share	\$ 0.02	\$ 0.03
Per diluted share	\$ 0.02	\$ 0.03

**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**Note 2. Summary of Significant Accounting Policies, continued**

The stock option expense shown in the table above was based on the underlying value of the options granted by the Company. The fair value of each option grant was estimated on the date of grant using the Black-Scholes option pricing model and expensed over the vesting period. The following weighted average assumptions were used to calculate the fair value of options granted during the three months ended March 31, 2007, and 2006:

	2007 <sup>(1)</sup>	2006
Expected term (in years)		5.0
Risk-free interest rate	%	4.3%
Expected volatility	%	29.6%
Dividend yield	%	9.0%
Weighted average fair value per option	\$	\$ 3.35

<sup>(1)</sup> The Company did not grant any options during the three months ended March 31, 2007.

The expected term of the options granted represents the period of time that such options are expected to be outstanding. To determine the expected term of the options, the Company used historical data to estimate option exercise time frames, including considering employee terminations. The risk free rate was based on the U.S. Treasury bond yield curve at the date of grant. Expected volatilities were determined based on the historical volatility of the Company's common stock over a historical time period consistent with the expected term. The dividend yield was determined based on the Company's historical dividend yield over a historical time period consistent with the expected term.

To determine the stock options expense, the calculated fair value of the options granted is applied to the options granted, net of assumed future option forfeitures. The Company estimates that the employee-related stock option expense under the Statement that will be recorded in the Company's statement of operations will be approximately \$11.8 million, \$4.0 million, and \$0.1 million for the years ended December 31, 2007, 2008, and 2009, respectively, which includes approximately \$1.9 million, \$1.0 million, and \$0.1 million, respectively, related to options granted since adoption of the Statement (January 1, 2006). This estimate may change if the Company's assumptions related to future option forfeitures change. This estimate does not include any expense related to future stock option grants as the fair value of those stock options will be determined at the time of grant. The aggregate total stock option expense remaining as of March 31, 2007, is expected to be recognized over an estimated weighted-average period of 1.0 years.

***Federal and State Income Taxes and Excise Tax***

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 ). ACC and any subsidiaries that qualify as a RIC or a REIT intend to distribute or retain through a deemed distribution all of their annual taxable income to shareholders; therefore, the Company has made no provision for income taxes exclusive of excise taxes for these entities.

**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**Note 2. Summary of Significant Accounting Policies, continued**

If the Company does not distribute at least 98% of its annual taxable income in the year earned, the Company will generally be required to pay an excise tax equal to 4% of the amount by which 98% of the Company's annual taxable income exceeds the distributions from such taxable income for the year. To the extent that the Company determines that its estimated current year annual taxable income will be in excess of estimated current year dividend distributions from such taxable income, the Company accrues excise taxes on estimated excess taxable income as taxable income is earned using an annual effective excise tax rate. The annual effective excise tax rate is determined by dividing the estimated annual excise tax by the estimated annual taxable income.

Income taxes for AC Corp are accounted for under the asset and liability method. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases as well as operating loss and tax credit carryforwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled.

***Per Share Information***

Basic earnings per common share is calculated using the weighted average number of common shares outstanding for the period presented. Diluted earnings per common 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, if any.

***Use of Estimates in the Preparation of Financial Statements***

The preparation of financial statements in conformity with U.S. generally accepted accounting principles 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 \$4.5 billion at both March 31, 2007, and December 31, 2006. At March 31, 2007, and December 31, 2006, 90% and 92%, respectively, of the Company's total assets represented portfolio 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.

***Recent Accounting Pronouncements***

In June 2006, the FASB issued Interpretation No. 48, *Accounting for Uncertainty in Income Taxes*, which clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with FASB Statement No. 109, *Accounting for Income Taxes*. This interpretation is effective for fiscal years beginning after December 15, 2006. The adoption of this interpretation did not have a significant effect on the Company's consolidated financial position or its results of operations.

**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**Note 2. Summary of Significant Accounting Policies, continued**

In September 2006, the FASB issued Statement No. 157, *Fair Value Measurements*. This statement defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. This statement is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. The Company does not expect the adoption of this statement to have a significant effect on the Company's consolidated financial position or its results of operations.

In February 2007, the FASB issued Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities Including an Amendment of FASB Statement No. 115*. This statement permits an entity to choose to measure many financial instruments and certain other items at fair value. This statement applies to all reporting entities, and contains financial statement presentation and disclosure requirements for assets and liabilities reported at fair value as a consequence of the election. This statement is effective for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. The Company does not expect the adoption of this statement to have a significant effect on the Company's consolidated financial position or its results of operations.

**Note 3. Portfolio****Private Finance**

At March 31, 2007, and December 31, 2006, the private finance portfolio consisted of the following:

	2007			2006		
	Cost	Value	Yield <sup>(1)</sup>	Cost	Value	Yield <sup>(1)</sup>
(\$ in millions)						
Loans and debt securities:						
Senior loans	\$ 406.8	\$ 365.0	8.4%	\$ 450.0	\$ 405.2	8.4%
Unitranche debt <sup>(2)</sup>	783.0	780.2	11.4%	800.0	799.2	11.2%
Subordinated debt	2,036.2	1,946.1	12.5%	2,038.3	1,980.8	12.9%
Total loans and debt securities <sup>(3)</sup>	3,226.0	3,091.3	11.7%	3,288.3	3,185.2	11.9%
Equity securities	1,208.1	1,285.0		1,209.1	1,192.7	
Total	\$ 4,434.1	\$ 4,376.3		\$ 4,497.4	\$ 4,377.9	

(1) The weighted average yield on loans and debt securities is computed as the (a) annual stated interest on accruing loans and debt securities plus the annual amortization of loan origination fees, original issue discount, and market discount on accruing loans and debt securities less the annual amortization of loan origination costs, divided by (b) total loans and debt securities at value. At March 31, 2007, and December 31, 2006, the cost and value of subordinated debt included the Class A equity interests in BLX and the guaranteed dividend yield on these equity interests was included in interest income. During the fourth quarter of 2006, the Class A equity interests were placed on non-accrual status. The weighted average yield is computed as of the balance sheet date.

(2) Unitranche debt is a single debt investment that is a blend of senior and subordinated debt terms.

(3)

The total principal balance outstanding on loans and debt securities was \$3,258.7 million and \$3,322.3 million at March 31, 2007, and December 31, 2006, respectively. The difference between principal and cost is represented by unamortized loan origination fees and costs, original issue discounts, and market discounts totaling \$32.7 million and \$34.0 million at March 31, 2007, and December 31, 2006, respectively.

**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**Note 3. Portfolio, continued**

The Company's private finance investment activity principally involves providing financing through privately negotiated long-term debt and equity investments. The Company's private finance debt and equity investments are generally issued by private companies and are generally illiquid and may be subject to certain restrictions on resale.

The Company's private finance debt 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. The annual stated interest rate is only one factor in pricing the investment relative to the Company's rights and priority in the portfolio company's capital structure, and will vary depending on many factors, including if the Company has received nominal cost equity or other components of investment return, such as loan origination fees or market discount. The stated interest rate may include some component of contractual payment-in-kind interest, which represents contractual interest accrued and added to the loan balance that generally becomes due at maturity.

At March 31, 2007, and December 31, 2006, 89% and 86%, respectively, of the private finance loans and debt securities had a fixed rate of interest and 11% and 14%, respectively, had a floating rate of interest. Senior loans generally carry a floating rate of interest, usually set as a spread over LIBOR, and generally require payments of both principal and interest throughout the life of the loan. Senior loans generally have contractual maturities of three to six years and interest is generally paid to the Company monthly or quarterly. Unitranche debt generally carries a fixed rate of interest and may require payments of both principal and interest throughout the life of the loan. Unitranche debt generally has contractual maturities of five to six years and interest is generally paid to the Company quarterly. Subordinated debt generally carries a fixed rate of interest generally with contractual maturities of five to ten years and generally has interest-only payments in the early years and payments of both principal and interest in the later years, although maturities and principal amortization schedules may vary. Interest is generally paid to the Company quarterly.

Equity securities consist primarily of securities issued by private companies and may be subject to certain restrictions on their resale and are generally illiquid. The Company may make equity investments for minority stakes in portfolio companies or may receive equity features, such as nominal cost warrants, in conjunction with its debt investments. The Company may also invest in the equity (preferred and/or voting or non-voting common) of a portfolio company where the Company's equity ownership may represent a significant portion of the equity, but may or may not represent a controlling interest. If the Company invests in non-voting equity in a buyout investment, the Company generally has the option to acquire a controlling stake in the voting securities of the portfolio company at fair market value. The Company may incur costs associated with making buyout investments that will be included in the cost basis of the Company's equity investment. These include costs such as legal, accounting and other professional fees associated with diligence, referral and investment banking fees, and other costs. Equity securities generally do not produce a current return, but are held with the potential for investment appreciation and ultimate gain on sale.

**Mercury Air Centers, Inc.** At March 31, 2007, the Company's investment in Mercury Air Centers, Inc. (Mercury) totaled \$84.8 million at cost and \$301.4 million at value, which included unrealized appreciation of \$216.6 million. At December 31, 2006, the Company's investment in



**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**Note 3. Portfolio, continued**

Mercury totaled \$84.3 million at cost and \$244.2 million at value, which included unrealized appreciation of \$159.9 million.

Mercury owns and operates fixed base operations generally under long-term leases from local airport authorities, which consist of terminal and hangar complexes that service the needs of the general aviation community. Mercury is headquartered in Richmond Heights, OH. The Company completed the purchase of a majority ownership in Mercury in April 2004.

Total interest and related portfolio income earned from the Company's investment in Mercury for the three months ended March 31, 2007, and 2006, was as follows:

	<b>For the Three Months Ended March 31,</b>	
	<b>2007</b>	<b>2006</b>
<b>(\$ in millions)</b>		
Interest income	\$ 2.0	\$ 2.9
Fees and other income	0.1	0.2
<b>Total interest and related portfolio income</b>	<b>\$ 2.1</b>	<b>\$ 3.1</b>

Interest income from Mercury included \$0.5 million for both the three months ended March 31, 2007 and 2006, which was paid in kind. The interest paid in kind was paid to the Company through the issuance of additional debt.

Net change in unrealized appreciation or depreciation included a net increase in unrealized appreciation on the Company's investment in Mercury of \$56.7 million and \$4.7 million for the three months ended March 31, 2007 and 2006, respectively.

In April 2007, the Company signed a definitive agreement to sell its majority equity interest in Mercury. Based on the definitive agreement, Mercury is expected to sell for an enterprise value of approximately \$427 million, subject to pre- and post-closing adjustments. In connection with the transaction, the Company expects to be repaid approximately \$50 million of subordinated debt outstanding to Mercury at closing. The transaction is expected to close in the third quarter of 2007 upon satisfying certain closing conditions, including regulatory approvals.

**Business Loan Express, LLC.** BLX originates, sells, and services primarily real estate secured loans, including real estate secured conventional small business loans, Small Business Administration's 7(a) loans and small investment real estate loans. BLX is headquartered in New York, NY.

The Company's investment in BLX totaled \$314.5 million at cost and \$229.9 million at value, which included unrealized depreciation of \$84.6 million, at March 31, 2007, and \$295.3 million at cost and \$210.7 million at value, which included unrealized depreciation of \$84.6 million, at December 31, 2006. In the first quarter of 2007 the Company increased its investment in BLX by \$19.2 million by acquiring additional Class A equity interests. In addition, in the first quarter of 2007, the chief executive officer of BLX invested \$3.0 million in the form of Class A equity interests in BLX. The Company agreed to purchase these interests for cash at fair value in the event that BLX amends or otherwise restructures its existing senior credit facility or he is terminated for any reason.

**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**Note 3. Portfolio, continued**

The purpose of these additional investments was to fund payments to the SBA discussed below and to provide additional equity to BLX.

Total interest and related portfolio income earned from the Company's investment in BLX for the three months ended March 31, 2007 and 2006, was as follows:

	<b>For the Three Months Ended March 31,</b>	
	<b>2007</b>	<b>2006</b>
<b>(\$ in millions)</b>		
Interest income on subordinated debt and Class A equity interests	\$	\$ 3.9
Fees and other income	1.4	2.2
<b>Total interest and related portfolio income</b>	<b>\$ 1.4</b>	<b>\$ 6.1</b>

Interest and dividend income from BLX for the three months ended March 31, 2006, included interest income of \$1.8 million which was paid in kind. The interest paid in kind was paid to the Company through the issuance of additional equity interests. In the fourth quarter of 2006, the Company placed its investment in BLX's 25% Class A equity interests on non-accrual status. As a result, there was no interest income from the Company's investment in BLX for the three months ended March 31, 2007.

In consideration for providing the revolving credit facility guaranty and the standby letters of credit, the Company earned fees of \$1.4 million and \$1.6 million for the three months ended March 31, 2007 and 2006, respectively, which were included in fees and other income. The remaining fees and other income relate to management fees from BLX. The Company did not charge a management fee to BLX in the first quarter of 2007.

Net change in unrealized appreciation or depreciation included no change in the unrealized depreciation on the Company's investment in BLX for the three months ended March 31, 2007, and a net decrease in unrealized appreciation of \$22.7 million for the three months ended March 31, 2006.

BLX is a national, non-bank lender that participates in the SBA's 7(a) Guaranteed Loan Program and is licensed by the SBA as a Small Business Lending Company (SBLC). The Office of the Inspector General of the SBA (OIG) and the United States Secret Service are conducting an ongoing investigation of allegedly fraudulently obtained SBA-guaranteed loans issued by BLX. Specifically, on or about January 9, 2007, BLX became aware of an indictment captioned as the United States v. Harrington, No. 2:06-CR-20662 pending in the United States District Court for the Eastern District of Michigan. The indictment alleges that a former BLX employee in the Detroit office engaged in the fraudulent origination of loans guaranteed, in substantial part, by the SBA. The Company understands that BLX is working cooperatively with the U.S. Attorney's Office and the investigating agencies with respect to this matter. The OIG and the U.S. Department of Justice are also conducting a civil investigation of BLX's lending practices in various jurisdictions. These investigations are ongoing. As an SBA lender, BLX is also subject to other SBA and OIG audits, investigations, and reviews. These investigations, audits and reviews, 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 adverse impact on BLX and, as a result,

**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**Note 3. Portfolio, continued**

could negatively affect the Company's financial results. The Company has considered these matters in performing the valuation of BLX at March 31, 2007. The Company is monitoring the situation and has retained a third party to work with BLX to conduct a review of BLX's current internal control systems, with a focus on preventing fraud and further strengthening BLX's operations.

On March 6, 2007, BLX entered into an agreement with the SBA. According to the agreement, BLX remains a preferred lender in the SBA 7(a) Guaranteed Loan Program and retains the ability to sell loans into the secondary market. As part of this agreement, BLX agreed to the immediate payment of approximately \$10 million to the SBA to cover amounts paid by the SBA with respect to some of the SBA-guaranteed loans that have been the subject of inquiry by the United States Attorney's Office for the Eastern District of Michigan. As part of the SBA's increased oversight, the agreement provides that any loans originated and closed by BLX during the term of the agreement will be reviewed by an independent third party selected by the SBA prior to the sale of such loans into the secondary market. The agreement also requires BLX to repurchase the guaranteed portion of certain loans that default after having been sold into the secondary market, and subjects such loans to a similar third party review prior to any reimbursement of BLX by the SBA. In connection with this agreement, BLX also entered into an escrow agreement with the SBA and an escrow agent in which BLX agreed to deposit \$10 million with the escrow agent for any additional payments BLX may be obligated to pay to the SBA in the future. BLX remains subject to SBA rules and regulations and as a result may be required to make additional payments to the SBA in the ordinary course of business. The agreement states that nothing in the agreement shall affect the rights of BLX to securitize or service its loans. Notwithstanding the foregoing, BLX and the SBA are conducting ongoing discussions with respect to BLX's ability to securitize the unguaranteed portions of SBA loans.

On or about January 16, 2007, BLX and Business Loan Center LLC (BLC) became aware of a lawsuit titled, United States, ex rel James R. Brickman and Greenlight Capital, Inc. v. Business Loan Express LLC f/k/a Business Loan Express, Inc.; Business Loan Center LLC f/k/a Business Loan Center, Inc.; Robert Tannenhauser; Matthew McGee; and George Harrigan, 05-CV-3147 (JEC), that is pending in the United States District Court for the Northern District of Georgia. The complaint includes allegations arising under the False Claims Act and relating to alleged fraud in connection with SBA guarantees on shrimp vessel loans made by BLX and BLC. On April 9, 2007, BLX, BLC and the other defendants filed motions to dismiss the complaint in its entirety. The motions are pending.

At December 31, 2006, the Company held all of BLX's Class A and Class B equity interests, and 94.9% of the Class C equity interests. At March 31, 2007, the Company held 96.6% of the Class A equity interests, all of the Class B equity interests and 94.9% of the Class C equity interests. BLX has an equity appreciation rights plan for management that will dilute the value available to the Class C equity interest holders. As a limited liability company, BLX's taxable income flows through directly to its members. BLX's annual taxable income generally differs from its book income for the fiscal year due to temporary and permanent differences in the recognition of income and expenses. BLX's taxable income is first allocated to the Class A equity interests to the extent that guaranteed dividends are paid in cash or in kind on such interests, with the remainder being allocated to the Class B and C equity interests.

At the time of the corporate reorganization of BLX, Inc. from a C corporation to a limited liability company in 2003, 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 RIC, the Company will be

**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**Note 3. Portfolio, continued**

subject to special 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. At the date of BLX's reorganization, the Company estimated that its future tax liability resulting from the built-in gains may total up to a maximum of \$40 million. 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 or its interests in BLX 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 or its interests in BLX within the 10-year period. At March 31, 2007, and December 31, 2006, the Company 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 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.

At March 31, 2007, BLX had a three-year \$500.0 million revolving credit facility provided by third party lenders that matures in March 2009. The revolving credit facility may be expanded through new or additional commitments up to \$600.0 million at BLX's option. This facility provides for a sub-facility for the issuance of letters of credit for up to an amount equal to 25% of the committed facility. The Company has provided an unconditional guaranty to these revolving credit facility lenders in an amount equal to 50% of the total obligations (consisting of principal, letters of credit issued under the facility, accrued interest, and other fees) of BLX under this facility. At March 31, 2007, the principal amount outstanding on the revolving credit facility was \$300.8 million and letters of credit issued under the facility were \$55.9 million. The total obligation guaranteed by us at March 31, 2007, was \$179.4 million. At March 31, 2007, the Company had also provided four standby letters of credit totaling \$20.0 million in connection with four term securitization transactions completed by BLX.

The guaranty on the BLX revolving line of credit facility can be called by the lenders in the event of a default, which includes certain defaults under the Company's revolving credit facility. Among other requirements, the BLX facility requires that BLX maintain compliance with certain financial covenants such as interest coverage, maximum debt to net worth, asset coverage, and maintenance of certain asset quality metrics. In addition, BLX would have an event of default if BLX failed to maintain its lending status with the SBA and such failure could reasonably be expected to result in a material adverse effect on BLX, or if BLX failed to maintain certain financing programs for the sale or long-term funding of BLX's loans. At March 31, 2007, BLX received waivers from its lenders with respect to non-compliance with certain covenants, including waiver of compliance with the interest coverage ratio and certain other covenants to permit BLX to comply with its obligations under its agreement with the SBA. In addition, BLX and the SBA are conducting ongoing discussions with respect to BLX's ability to securitize the unguaranteed portions of SBA loans. The waiver provides that BLX may retain unguaranteed portions of SBA loans on its balance sheet. Certain of these waivers expire on June 30, 2007.

BLX has a separate non-recourse warehouse facility to enable it to securitize the unguaranteed portion of its SBA loans. BLX has been receiving temporary extensions of the warehouse facility, and

**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**Note 3. Portfolio, continued**

the current extension expires on June 1, 2007. BLX is in negotiations with the warehouse facility providers to renew and amend the facility for an additional one year term, subject to satisfactory conclusion of discussions with the SBA with respect to BLX's ability to securitize the unguaranteed portions of SBA loans. If the current facility were to expire without renewal, the outstanding amounts owing to the warehouse providers do not become immediately due and payable. Instead, BLX would be required to apply substantially all collections on the unguaranteed interests that currently are in the warehouse facility to repay the outstanding amounts owing to the warehouse providers until the warehouse providers were paid in full, similar to an amortizing term loan. In such an event, BLX would not have the right to sell additional unguaranteed interests in SBA loans into this facility.

The Company is monitoring BLX's discussions with the SBA, the senior lenders and the warehouse securitization facility providers, and intends to work with BLX management to implement its business plan, including funding alternatives. The ultimate resolution of these matters could have a material adverse impact on BLX's financial condition, and, as a result, the Company's financial results could be negatively affected.

**Advantage Sales and Marketing, Inc.** In June 2004, the Company completed the purchase of a majority voting ownership in Advantage, which was subject to dilution by a management option pool. Advantage is a sales and marketing agency providing outsourced sales, merchandising, and marketing services to the consumer packaged goods industry. Advantage has offices across the United States and is headquartered in Irvine, CA.

On March 29, 2006, the Company sold its majority equity interest in Advantage. The Company was repaid its \$184 million in subordinated debt outstanding and realized a gain at closing on its equity investment sold of \$433.1 million, subject to post-closing adjustments. Subsequent to closing on this sale, the Company realized additional gains in 2006 resulting from post-closing adjustments totaling \$1.3 million. In addition, there is potential for the Company to receive additional consideration through an earn-out payment that would be based on Advantage's 2006 audited results. The Company's realized gain of \$434.4 million for the year ended December 31, 2006, subject to post-closing adjustments, excludes any earn-out amounts.

As consideration for the common stock sold in the transaction, the Company received a \$150 million subordinated note, with the balance of the consideration paid in cash. In addition, a portion of the Company's cash proceeds from the sale of the common stock were placed in escrow, subject to certain holdback provisions. At March 31, 2007, the amount of the escrow included in other assets in the accompanying consolidated balance sheet was approximately \$24 million.

Total interest and related portfolio income earned from the Company's investment in Advantage while the Company held a majority equity interest for the three months ended March 31, 2006, was \$14.1 million.

Net change in unrealized appreciation or depreciation for the three months ended March 31, 2006, included the reversal of \$389.7 million of previously recorded unrealized appreciation associated with the realization of a gain on the sale of the Company's majority equity interest in Advantage.

In connection with the sale transaction, the Company retained an equity investment in the business valued at \$15 million at closing as a minority shareholder. During the fourth quarter of 2006,

**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**Note 3. Portfolio, continued**

Advantage made a distribution on this minority equity investment, which reduced the Company's cost basis to zero and resulted in a realized gain of \$4.8 million.

The Company's investment in Advantage, which was composed of subordinated debt and a minority equity interest, totaled \$152.4 million at cost and \$163.4 million at value at March 31, 2007, and \$151.6 million at cost and \$162.6 million at value at December 31, 2006. This investment was included in companies 5% to 25% owned in the consolidated financial statements as the Company continues to hold a seat on Advantage's board of directors.

**Collateralized Loan Obligations ( CLOs ) and Collateralized Debt Obligations ( CDOs ).** At March 31, 2007, and December 31, 2006, the Company owned bonds and preferred shares/income notes in CLOs and a CDO as follows:

	2007			2006		
	Cost	Value	Yield <sup>(1)</sup>	Cost	Value	Yield <sup>(1)</sup>
<b>(\$ in millions)</b>						
<i>Bonds<sup>(2)</sup>:</i>						
Callidus Debt Partners CDO Fund I, Ltd.	\$ 28.4	\$ 28.5	14.3%	\$ 28.4	\$ 28.4	14.3%
Callidus MAPS CLO Fund I LLC	17.0	17.1	10.9%	17.0	17.2	10.9%
Total bonds	45.4	45.6	13.0%	45.4	45.6	13.0%
<i>Preferred Shares/ Income Notes<sup>(3)</sup>:</i>						
Callidus Debt Partners CLO Fund III, Ltd.	22.7	22.5	9.9%	23.3	23.0	12.7%
Callidus Debt Partners CLO Fund IV, Ltd.	12.8	12.8	13.1%	13.0	13.0	13.8%
Callidus Debt Partners CLO Fund V, Ltd.	14.3	14.3	15.8%	13.8	13.8	15.8%
Callidus MAPS CLO Fund I LLC	51.0	46.5	13.3%	51.0	47.4	15.9%
Total preferred shares/ income notes	100.8	96.1	12.8%	101.1	97.2	14.8%
<b>Total</b>	<b>\$ 146.2</b>	<b>\$ 141.7</b>		<b>\$ 146.5</b>	<b>\$ 142.8</b>	

(1) The yield on these securities is included in interest and dividend income in the accompanying statement of operations.

(2) These securities are included in private finance subordinated debt.

(3) These securities are included in private finance equity securities.

The bonds, preferred shares and income notes of the CLOs and CDO in which the Company has invested are junior in priority for payment of interest and principal to the more senior notes issued by the CLOs and CDO. Cash flow from the underlying collateral assets in the CLOs and CDO is generally allocated first to the senior bonds in order of priority, then any remaining cash flow is generally distributed to the preferred shareholders and income note holders. To the extent there are defaults and unrecoverable losses on the underlying collateral assets that result in reduced cash flows, the preferred shares/income notes will bear this loss first and then the subordinated bonds would bear any loss after the preferred shares/income notes.

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At March 31, 2007 and December 31, 2006 the face value of the CLO and CDO bonds held by the Company were subordinate to approximately 82% to 84% and 82% to 85%, respectively, of the face value of the securities issued in these CLOs and CDO. At both March 31, 2007, and December 31, 2006, the face value of the CLO preferred shares/income notes held by the Company were subordinate to approximately 86% to 92% of the face value of the securities issued in these CLOs.

**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**Note 3. Portfolio, continued**

At March 31, 2007, and December 31, 2006, the underlying collateral assets of these CLO and CDO investments, consisting primarily of senior debt, were issued by 482 issuers and 465 issuers, respectively, and had balances as follows:

(\$ in millions)	2007	2006
Bonds	\$ 272.9	\$ 245.4
Syndicated loans	1,758.7	1,769.9
Cash <sup>(1)</sup>	16.2	59.5
 Total underlying collateral assets	 \$ 2,047.8	 \$ 2,074.8

<sup>(1)</sup> Includes undrawn liability amounts.

At March 31, 2007, there were no delinquencies in the underlying collateral assets of the CLO and CDO issuances owned by the Company. At December 31, 2006, there was one defaulted obligor in the underlying collateral assets of Callidus MAPS CLO Fund I, LLC. There were no other delinquencies in the underlying collateral assets in the other CLO and CDO issuances owned by the Company. At December 31, 2006, the total face value of defaulted obligations was \$9.6 million, or approximately 0.5% of the total underlying collateral assets.

The initial yields on the CLO and CDO bonds, preferred shares and income notes are based on the estimated future cash flows from the underlying collateral assets expected to be paid to these CLO and CDO classes. As each CLO and CDO bond, preferred share or income note ages, the estimated future cash flows are updated based on the estimated performance of the underlying collateral assets, and the respective yield is adjusted as necessary. As future cash flows are subject to uncertainties and contingencies that are difficult to predict and are subject to future events that may alter current assumptions, no assurance can be given that the anticipated yields to maturity will be achieved.

**Loans and Debt Securities on Non-Accrual Status.** At March 31, 2007, and December 31, 2006, private finance loans and debt securities at value not accruing interest were as follows:

(\$ in millions)	2007	2006
Loans and debt securities in workout status		
Companies more than 25% owned	\$ 45.5	\$ 51.1
Companies 5% to 25% owned	4.9	4.0
Companies less than 5% owned	61.0	31.6
Loans and debt securities not in workout status		
Companies more than 25% owned	121.2	87.1
Companies 5% to 25% owned	7.2	7.2
Companies less than 5% owned	26.9	38.9
 Total	 \$ 266.7	 \$ 219.9



**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**Note 3. Portfolio, continued**

*Industry and Geographic Compositions.* The industry and geographic compositions of the private finance portfolio at value at March 31, 2007, and December 31, 2006, were as follows:

	2007	2006
<b>Industry</b>		
Business services	37%	39%
Consumer products	20	20
Financial services	12	9
Industrial products	9	9
Consumer services	6	6
Retail	5	6
Healthcare services	3	3
Energy services	2	2
Other <sup>(1)</sup>	6	6
<b>Total</b>	<b>100%</b>	<b>100%</b>
<b>Geographic Region<sup>(2)</sup></b>		
Mid-Atlantic	31%	31%
Midwest	32	30
Southeast	15	18
West	16	17
Northeast	6	4
<b>Total</b>	<b>100%</b>	<b>100%</b>

(1) Includes investments in senior debt CDO and CLO funds which represented 3% of the private finance portfolio at both March 31, 2007, and December 31, 2006. These funds invest in senior debt representing a variety of industries.

(2) The geographic region for the private finance portfolio depicts the location of the headquarters for the Company's portfolio companies. The portfolio companies may have a number of other locations in other geographic regions.

**Commercial Real Estate Finance**

At March 31, 2007, and December 31, 2006, the commercial real estate finance portfolio consisted of the following:

	2007			2006		
	Cost	Value	Yield <sup>(1)</sup>	Cost	Value	Yield <sup>(1)</sup>
<b>(\$ in millions)</b>						
Commercial mortgage loans	\$ 72.8	\$ 72.2	7.5%	\$ 72.6	\$ 71.9	7.5%
Real estate owned	15.6	21.0		15.7	19.6	

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Equity interests	15.0	29.3	15.2	26.7
Total	\$ 103.4	\$ 122.5	\$ 103.5	\$ 118.2

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

**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**Note 3. Portfolio, continued**

**Commercial Mortgage Loans and Equity Interests.** The commercial mortgage loan portfolio contains loans that were originated by the Company or were purchased from third-party sellers. At both March 31, 2007, and December 31, 2006, approximately 96% and 4% of the Company's commercial mortgage loan portfolio was composed of fixed and adjustable interest rate loans, respectively. At March 31, 2007, and December 31, 2006, loans with a value of \$19.2 million and \$18.9 million, respectively, were not accruing interest. Loans greater than 120 days delinquent generally do not accrue interest.

Equity interests consist primarily of equity securities issued by privately owned companies that invest in single real estate properties. These equity interests may be subject to certain restrictions on their resale and are generally illiquid. Equity interests generally do not produce a current return, but are generally held in anticipation of investment appreciation and ultimate realized gain on sale.

The property types and the geographic composition securing the commercial mortgage loans and equity interests at value at March 31, 2007, and December 31, 2006, were as follows:

	<b>2007</b>	<b>2006</b>
<b>Property Type</b>		
Hospitality	45%	45%
Office	20	20
Retail	19	19
Housing	13	13
Other	3	3
Total	100%	100%
<b>Geographic Region</b>		
Southeast	36%	36%
Mid-Atlantic	34	35
Midwest	23	21
Northeast	7	8
West		
Total	100%	100%

**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**Note 4. Debt**

At March 31, 2007, and December 31, 2006, the Company had the following debt:

	2007			2006		
	Facility Amount	Amount Drawn	Annual Interest Cost <sup>(1)</sup>	Facility Amount	Amount Drawn	Annual Interest Cost <sup>(1)</sup>
<b>(\$ in millions)</b>						
<b>Notes payable and debentures:</b>						
Privately issued unsecured notes payable	\$1,041.5	\$1,041.5	6.1%	\$1,041.4	\$1,041.4	6.1%
Publicly issued unsecured notes payable	850.0	850.0	6.7%	650.0	650.0	6.6%
Total notes payable and debentures	1,891.5	1,891.5	6.3%	1,691.4	1,691.4	6.3%
Revolving line of credit <sup>(4)</sup>	922.5		%	922.5	207.7	6.4% <sup>(2)</sup>
Total debt	\$2,814.0	\$1,891.5	6.5% <sup>(3)</sup>	\$2,613.9	\$1,899.1	6.5% <sup>(3)</sup>

(1) The weighted average annual interest cost is computed as the (a) annual stated interest on the debt plus the annual amortization of commitment fees, other facility fees and amortization of debt financing costs that are recognized into interest expense over the contractual life of the respective borrowings, divided by (b) debt outstanding on the balance sheet date.

(2) There were no amounts drawn on the revolving line of credit at March 31, 2007. The annual interest cost at December 31, 2006, reflects the interest rate payable for borrowings under the revolving line of credit. In addition to the current interest payable, there were annual costs of commitment fees, other facility fees and amortization of debt financing costs of \$3.8 million and \$3.9 million at March 31, 2007, and December 31, 2006, respectively.

(3) The annual interest cost for total debt includes the annual cost of commitment fees, other facility fees and amortization of debt financing costs on the revolving line of credit regardless of the amount outstanding on the facility as of the balance sheet date.

(4) At March 31, 2007, \$888.0 million remained unused and available on the revolving line of credit, net of amounts committed for standby letters of credit of \$34.5 million issued under the credit facility.

**Notes Payable and Debentures**

**Privately Issued Unsecured Notes Payable.** The Company has privately issued unsecured long-term notes to institutional investors. The notes have five- or seven-year maturities and have fixed rates of interest. The notes require payment of interest only semi-annually, and all principal is due upon maturity. At March 31, 2007, the notes had maturities from May 2008 to May 2013. The notes may be prepaid in whole or in part, together with an interest premium, as stipulated in the note agreements.

The Company also has privately issued five-year unsecured long-term notes denominated in Euros and Sterling for a total U.S. dollar equivalent of \$15.2 million. The notes have fixed interest rates and have substantially the same terms as the Company's other unsecured notes. The Euro notes require annual interest payments and the Sterling notes require semi-annual interest payments until maturity. Simultaneous with issuing the notes, the Company entered into a cross currency swap with a financial institution which fixed the Company's interest and principal payments in U.S. dollars for the life of the debt.

**Publicly Issued Unsecured Notes Payable.** The Company has outstanding publicly issued unsecured notes as follows:

<b>(\$ in millions)</b>	<b>Amount</b>	<b>Maturity Date</b>
6.625% Notes due 2011	\$ 400.0	July 15, 2011
6.000% Notes due 2012	250.0	April 1, 2012
6.875% Notes due 2047	200.0	April 15, 2047
Total	\$ 850.0	

**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**Note 4. Debt, continued**

The 6.625% Notes due 2011 and the 6.000% Notes due 2012 require payment of interest only semi-annually, and all principal is due upon maturity. The Company has the option to redeem these notes in whole or in part, together with a redemption premium, as stipulated in the notes.

On March 28, 2007, the Company completed the issuance of \$200.0 million of 6.875% Notes due 2047 for net proceeds of \$193.0 million (net of underwriting discounts and estimated offering expenses). In April 2007, the Company issued additional notes, through an over-allotment option, totaling \$30.0 million for net proceeds of \$29.1 million (net of underwriting discounts and estimated offering expenses).

The 6.875% Notes due 2047 require payment of interest only quarterly, and all principal is due upon maturity. The Company may redeem these notes in whole or in part at any time or from time to time on or after April 15, 2012, at par and upon the occurrence of certain tax events as stipulated in the notes.

**Scheduled Maturities.** Scheduled future maturities of notes payable at March 31, 2007, were as follows:

Year	Amount Maturing
	(\$ in millions)
2007	\$
2008	153.0
2009	269.0
2010	408.0
2011	472.5
Thereafter	589.0
<b>Total</b>	<b>\$ 1,891.5</b>

**Revolving Line of Credit**

At March 31, 2007, and December 31, 2006, the Company had an unsecured revolving line of credit with a committed amount of \$922.5 million that expires on September 30, 2008. At the Company's option, borrowings under the revolving line of credit generally bear interest at a rate equal to (i) LIBOR (for the period the Company selects) plus 1.05% or (ii) the higher of the Federal Funds rate plus 0.50% or the Bank of America, N.A. prime rate. The revolving line of credit requires the payment of an annual commitment fee equal to 0.20% of the committed amount (whether used or unused). The revolving line of credit generally requires payments of interest at the end of each LIBOR interest period, but no less frequently than quarterly, on LIBOR based loans and monthly payments of interest on other loans. All principal is due upon maturity.

The annual cost of commitment fees, other facility fees and amortization of debt financing costs was \$3.8 million and \$3.9 million at March 31, 2007, and December 31, 2006, respectively.

The revolving credit facility provides for a sub-facility for the issuance of letters of credit for up to an amount equal to 16.66% of the committed facility or \$153.7 million. The letter of credit fee is 1.05% per annum on letters of credit issued, which is payable quarterly.

**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 \$142.1 million and \$301.9 million, respectively, for the three months ended March 31, 2007 and 2006. The maximum amount borrowed under this facility and the weighted average stated interest rate for the three months ended March 31, 2007 and 2006, were \$225.5 million and 6.4%, respectively, and \$540.3 million and 5.9%, respectively. At March 31, 2007, the amount available under the revolving line of credit was \$888.0 million, net of amounts committed for standby letters of credit of \$34.5 million issued under the credit facility.

***Covenant Compliance***

The Company has various financial and operating covenants required by the privately issued unsecured notes payable and the revolving line of credit outstanding at March 31, 2007, and December 31, 2006. These covenants require the Company to maintain certain financial ratios, including debt to equity and interest coverage, and a minimum net worth. These credit facilities provide for customary events of default, including, but not limited to, payment defaults, breach of representations or covenants, cross-defaults, bankruptcy events, failure to pay judgments, attachment of the Company's assets, change of control and the issuance of an order of dissolution. Certain of these events of default are subject to notice and cure periods or materiality thresholds. The Company's credit facilities limit its ability to declare dividends if the Company defaults under certain provisions. As of March 31, 2007, and December 31, 2006, the Company was in compliance with these covenants.

The Company has certain financial and operating covenants that are required by the publicly issued unsecured notes payable, including that the Company will maintain a minimum ratio of 200% of total assets to total borrowings, as required by the Investment Company Act of 1940, as amended, while these notes are outstanding. As of March 31, 2007, and December 31, 2006, the Company was in compliance with these covenants.

**Note 5. Guarantees and Commitments**

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. All standby letters of credit have been issued through Bank of America, N.A. As of March 31, 2007, and December 31, 2006, the Company had issued guarantees of debt, rental obligations, and lease obligations aggregating \$194.5 million and \$202.1 million, respectively, and had extended standby letters of credit aggregating \$34.5 million and \$41.0 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 potential future payments was \$229.0 million and \$243.1 million at March 31, 2007, and December 31, 2006, respectively.

**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**Note 5. Guarantees and Commitments, continued**

As of March 31, 2007, the guarantees and standby letters of credit expired as follows:

(in millions)	Total	2007	2008	2009	2010	2011	After 2011
Guarantees	\$ 194.5	\$ 0.3	\$ 3.0	\$ 184.9	\$	\$ 4.4	\$ 1.9
Standby letters of credit <sup>(1)</sup>	34.5	4.0	30.5				
Total <sup>(2)</sup>	\$ 229.0	\$ 4.3	\$ 33.5	\$ 184.9	\$	\$ 4.4	\$ 1.9

(1) Standby letters of credit are issued under the Company's revolving line of credit that expires in September 2008. Therefore, unless a standby letter of credit is set to expire at an earlier date, it is assumed that the standby letters of credit will expire contemporaneously with the expiration of the Company's line of credit in September 2008.

(2) The Company's most significant commitments relate to its investment in Business Loan Express, LLC (BLX), which commitments totaled \$202.4 million at March 31, 2007. At March 31, 2007, the Company guaranteed 50% of the outstanding total obligations on BLX's revolving line of credit for a total guaranteed amount of \$179.4 million and had also provided four standby letters of credit totaling \$20.0 million in connection with four term securitizations completed by BLX. In addition, the Company has agreed to purchase the \$3.0 million of Class A equity interests purchased by the chief executive officer of BLX at fair value in the event that BLX amends or otherwise restructures its existing senior credit facility or he is terminated for any reason. See Note 3. In the ordinary course of business, the Company enters into agreements with service providers and other parties that may contain provisions for the Company to indemnify such parties under certain circumstances.

At March 31, 2007, the Company had outstanding commitments to fund investments totaling \$410.8 million, including \$401.9 million related to private finance investments and \$8.9 related to commercial real estate finance investments.

**Note 6. Shareholders' Equity**

Sales of common stock for the three months ended March 31, 2007 and 2006, were as follows:

(in millions)	2007	2006
Number of common shares	3,325	3,000
Gross proceeds	\$ 97,256	\$ 87,750
Less costs, including underwriting fees	3,472	4,780
Net proceeds	\$ 93,784	\$ 82,970

The Company issued 0.1 million and 0.2 million shares of common stock upon the exercise of stock options during the three months ended March 31, 2007 and 2006, respectively.



**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**Note 6. Shareholders' Equity, continued**

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 trading days immediately prior to the dividend payment date. For the three months ended March 31, 2007 and 2006, the Company issued new shares in order to satisfy dividend reinvestment requests. Dividend reinvestment plan activity for the three months ended March 31, 2007 and 2006, was as follows:

	<b>For the Three Months Ended March 31,</b>	
	<b>2007</b>	<b>2006</b>
<b>(in millions, except per share amounts)</b>		
Shares issued	0.1	0.1
Average price per share	\$ 29.23	\$ 30.29

**Note 7. Earnings Per Common Share**

Earnings per common share for the three months ended March 31, 2007 and 2006, were as follows:

	<b>For the Three Months Ended March 31,</b>	
	<b>2007</b>	<b>2006</b>
<b>(in millions, except per share amounts)</b>		
Net increase in net assets resulting from operations	\$ 133.1	\$ 99.6
Weighted average common shares outstanding - basic	149.5	138.7
Dilutive options outstanding	3.3	3.0
Weighted average common shares outstanding - diluted	152.8	141.7
Basic earnings per common share	\$ 0.89	\$ 0.72
Diluted earnings per common share	\$ 0.87	\$ 0.70

**Note 8. Employee Compensation Plans**

The Company has deferred compensation plans. Amounts deferred by participants under the deferred compensation plans are funded to a trust, which is managed by a third-party trustee. The accounts of the deferred compensation trust are consolidated with the Company's accounts. The assets of the trust are classified as other assets and the liability to the plan participants is included in other liabilities in the accompanying financial statements. The deferred compensation plan accounts at March 31, 2007, and December 31, 2006, totaled \$20.3 million and \$18.6 million, respectively.

The Company has an Individual Performance Award ( IPA ), which was established as a long-term incentive compensation program for certain officers. In conjunction with the program, the Board

**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**Note 8. Employee Compensation Plans, continued**

of Directors has approved non-qualified deferred compensation plans ( DCP II ), which are managed through a trust by a third-party trustee. The administrator of the DCP II is the Compensation Committee of the Company's Board of Directors ( DCP II Administrator ).

The IPA is generally determined annually at the beginning of each year but may be adjusted throughout the year. The IPA is deposited in the trust in four equal installments, generally on a quarterly basis, in the form of cash. The Compensation Committee of the Board of Directors designed the DCP II to require the trustee to use the cash to purchase shares of the Company's common stock in the open market. During both the three months ended March 31, 2007 and 2006, 0.1 million shares were purchased in the DCP II.

All amounts deposited and then credited to a participant's account in the trust, based on the amount of the IPA received by such participant, 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 DCP II are immediately vested and generally non-forfeitable once deposited by the Company into the trust. A participant's account shall generally become distributable only after his or her termination of employment, or in the event of a change of control of the Company. Upon the participant's termination of employment, one-third of the participant's account will be immediately distributed in accordance with the plan, one-half of the then current remaining balance will be distributed on the first anniversary of his or her employment termination date and the remainder of the account balance will be distributed on the second anniversary of the employment termination date. Distributions are subject to the participant's adherence to certain non-solicitation requirements. All DCP II accounts will be distributed in a single lump sum in the event of a change of control of the Company. To the extent that a participant has an employment agreement, such participant's DCP II account will be fully distributed in the event that such participant's employment is terminated for good reason as defined under that participant's employment agreement. Sixty days following a distributable event, the Company and each participant may, at the discretion of the Company, and subject to the Company's trading window during that time, redirect the participant's account to other investment options.

During any period of time in which a participant has an account in the DCP II, any dividends declared and paid on shares of the Company's common stock allocated to the participant's account shall be reinvested in shares of the Company's common stock.

The IPA amounts are contributed into the DCP II trust and invested in the Company's common stock. The accounts of the DCP II are consolidated with the Company's accounts. The common stock is classified as common stock held in deferred compensation trust in the accompanying financial statements and the deferred compensation obligation, which represents the amount owed to the employees, is included in other liabilities. Changes in the value of the Company's common stock held in the deferred compensation trust are not recognized. However, the liability is marked to market with a corresponding charge or credit to employee compensation expense. At March 31, 2007, and December 31, 2006, common stock held in DCP II was \$31.4 million and \$28.3 million, respectively, and the IPA liability was \$33.1 million and \$33.9 million, respectively. At March 31, 2007, and December 31, 2006, the DCP II held 1.1 million shares and 1.0 million shares, respectively, of the Company's common stock.

**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**Note 8. Employee Compensation Plans, continued**

The IPA expense for the three months ended March 31, 2007 and 2006, were as follows:

(\$ in millions)	2007	2006
IPA contributions	\$ 2.5	\$ 1.7
IPA mark to market expense (benefit)	(4.0)	1.0
<b>Total IPA expense (benefit)</b>	<b>\$ (1.5)</b>	<b>\$ 2.7</b>

The Company also has an individual performance bonus ( IPB ), which is distributed in cash to award recipients equally throughout the year (beginning in February of each year) as long as the recipient remains employed by the Company. If a recipient terminates employment during the year, any remaining cash payments under the IPB would be forfeited. For the three months ended March 31, 2007 and 2006, the IPB expense was \$2.0 million and \$1.4 million, respectively. The IPA and IPB expenses are included in employee expenses.

**Note 9. Stock 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. 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 to officers generally vest ratably over a three year period. Options granted to non-officer directors vest on the grant date.

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.

There are 32.2 million shares authorized under the Option Plan. At March 31, 2007, and December 31, 2006, the number of shares available to be granted under the Option Plan was 1.9 million and 1.6 million, respectively.

**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**Note 9. Stock Option Plan, continued**

Information with respect to options granted, exercised and forfeited under the Option Plan for the three months ended March 31, 2007, was as follows:

	Shares	Weighted Average Exercise Price Per Share	Weighted Average Contractual Remaining Term (Years)	Aggregate Intrinsic Value at March 31, 2007 <sup>(1)</sup>
<b>(in millions, except per share amounts)</b>				
Options outstanding at January 1, 2007	23.2	\$ 24.92		
Granted		\$		
Exercised	(0.1)	\$ 17.46		
Forfeited	(0.3)	\$ 29.08		
Options outstanding at March 31, 2007	22.8	\$ 24.89	6.01	\$ 92.0
Exercisable at March 31, 2007	16.6	\$ 23.73	5.36	\$ 85.6
Exercisable and expected to be exercisable at March 31, 2007 <sup>(2)</sup>	22.5	\$ 24.85	5.98	\$ 91.7

<sup>(1)</sup> Represents the difference between the market value of the options at March 31, 2007, and the cost for the option holders to exercise the options.

<sup>(2)</sup> The amount of options expected to be exercisable at March 31, 2007, is calculated based on an estimate of expected forfeitures.

During the three months ended March 31, 2006, 0.5 million options were granted, 0.2 million options were exercised and 0.3 million options were forfeited.

There were no shares vested during the three months ended March 31, 2007, and the fair value of the shares vested during the three months ended March 31, 2006, was \$6 thousand. The total intrinsic value of the options exercised during the three months ended March 31, 2007 and 2006, was \$0.9 million and \$1.1 million, respectively.

**Note 10. Dividends and Distributions and Taxes**

The Company's Board of Directors declared and the Company paid a dividend of \$0.63 per common share and \$0.59 per common share for the first quarters of 2007 and 2006, respectively. These dividends totaled \$95.8 million and \$82.5 million for the three months ended March 31, 2007 and 2006, respectively. The Company declared an extra cash dividend of \$0.05 per share during 2006 and this was paid to shareholders on January 19, 2007. The Company declared an extra cash dividend of \$0.03 per share during 2005, which was paid to shareholders on January 27, 2006.

The Company's Board of Directors also declared a dividend of \$0.64 per common share for the second quarter of 2007.

At December 31, 2006, the Company had estimated excess taxable income of \$397.1 million available for distribution to shareholders in 2007. Estimated excess taxable income for 2006 represents approximately

\$120.6 million of ordinary income and approximately \$276.5 million of net long-term capital gains. Dividends for 2007 will first be paid out of the excess taxable income carried over from

**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**Note 10. Dividends and Distributions and Taxes, continued**

2006. Given our regular quarterly dividend payout, which for the first quarter of 2007 was \$95.8 million, the Company expects that substantially all of the 2007 dividend payments will be made from excess 2006 taxable earnings. The Company currently expects that its estimated annual taxable income for 2007 will be significantly in excess of its estimated dividend distributions to shareholders in 2007 from such taxable income, and, therefore, the Company expects to carry over excess taxable income for distribution to shareholders in 2008. The Company will generally be required to pay a nondeductible excise tax equal to 4% of the amount by which 98% of the Company's annual taxable income exceeds the distributions from such taxable income for the year. The Company accrues an excise tax on the estimated excess taxable income earned for the respective periods. For the three months ended March 31, 2007 and 2006, the Company recorded an excise tax of \$3.6 million and \$8.4 million, respectively.

In addition to excess taxable income carried forward, the Company currently estimates that it has cumulative deferred taxable income related to installment sale gains of approximately \$220.7 million as of December 31, 2006, which is composed of cumulative deferred taxable income of \$39.6 million as of December 31, 2005, and approximately \$181.1 million for the year ended December 31, 2006. These gains have been recognized for financial reporting purposes in the respective years they were realized, but are generally deferred for tax purposes until the notes or other amounts received from the sale of the related investments are collected in cash. The realized gains deferred through installment treatment for 2006 are estimates and will not be finally determined until the Company files its 2006 tax return in September 2007.

The Company's undistributed book earnings of \$502.2 million as of December 31, 2006, resulted from undistributed ordinary income and long-term capital gains. The difference between undistributed book earnings at the end of the year and taxable income carried over from the current year into the next year relates to a variety of timing and permanent differences in the recognition of income and expenses for book and tax purposes.

The Company's consolidated subsidiary, AC Corp, is subject to federal and state income taxes. For the three months ended March 31, 2007 and 2006, AC Corp's income tax benefit was \$4.2 million and income tax expense was \$0.5 million, respectively.

**Note 11. Supplemental Disclosure of Cash Flow Information**

The Company paid interest of \$24.9 million and \$7.5 million, respectively, for the three months ended March 31, 2007 and 2006.

For the three months ended March 31, 2007 and 2006, principal collections related to investment repayments or sales did not include any collections of discounts previously amortized into interest income and added to the cost basis of a loan or debt security.

Non-cash operating activities for the three months ended March 31, 2007 and 2006, totaled \$3.1 million and \$160.5 million, respectively. Non-cash operating activities for the three months ended March 31, 2006, included a note received as consideration from the sale of the Company's equity investment in Advantage of \$150.0 million.

Non-cash financing activities included the issuance of common stock in lieu of cash distributions totaling \$4.3 million and \$3.6 million, for the three months ended March 31, 2007 and 2006, respectively.

**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,
	2007 <sup>(1)</sup>	2006	2006
<b>Per Common Share Data</b>			
Net asset value, beginning of period	\$ 19.12	\$ 19.17	\$ 19.17
Net investment income <sup>(2)</sup>	0.26	0.29	1.30
Net realized gains <sup>(2)(3)</sup>	0.18	3.05	3.66
Net investment income plus net realized gains <sup>(2)</sup>	0.44	3.34	4.96
Net change in unrealized appreciation or depreciation <sup>(2)(3)</sup>	0.43	(2.64)	(3.28)
Net increase in net assets resulting from operations <sup>(2)</sup>	0.87	0.70	1.68
Net decrease in net assets from shareholder distributions	(0.63)	(0.59)	(2.47)
Net increase in net assets from capital share transactions <sup>(2)</sup>	0.22	0.22	0.74
Net asset value, end of period	\$ 19.58	\$ 19.50	\$ 19.12
Market value, end of period	\$ 28.81	\$ 30.60	\$ 32.68
Total return <sup>(4)</sup>	(9.9)%	6.2%	20.6%
<b>Ratios and Supplemental Data</b>			
(\$ and shares in thousands, except per share amounts)			
Ending net assets	\$ 2,978.3	\$ 2,729.8	\$ 2,841.2
Common shares outstanding at end of period	152.1	140.0	148.6
Diluted weighted average common shares outstanding	152.8	141.7	145.6
Employee, employee stock option and administrative expenses/average net assets <sup>(5)</sup>	1.33%	1.36%	5.38%
Total operating expenses/average net assets <sup>(5)</sup>	2.37%	2.27%	9.05%
Net investment income/average net assets <sup>(5)</sup>	1.36%	1.54%	6.90%
Net increase in net assets resulting from operations/average net assets <sup>(5)</sup>	4.57%	3.72%	8.94%
Portfolio turnover rate <sup>(5)</sup>	3.78%	9.33%	27.05%
Average debt outstanding	\$ 1,841.2	\$ 1,491.5	\$ 1,491.0
Average debt per share <sup>(2)</sup>	\$ 12.05	\$ 10.52	\$ 10.24

(1) The results for the three months ended March 31, 2007, are not necessarily indicative of the operating results to be expected for the full year.



- (2) Based on diluted weighted average number of common shares outstanding for the period.
- (3) Net realized gains and net change in unrealized appreciation or depreciation can fluctuate significantly from period to period. As a result, quarterly comparisons may not be meaningful.
- (4) Total return assumes the reinvestment of all dividends paid for the periods presented.
- (5) The ratios for the three months ended March 31, 2007 and 2006, do not represent annualized results.

**Note 13. Litigation**

On June 23, 2004, the Company was notified by the SEC that the SEC is conducting an informal investigation of the Company. On December 22, 2004, the Company received letters from the U.S. Attorney for the District of Columbia requesting the preservation and production of information regarding the Company and Business Loan Express, LLC in connection with a criminal

**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**Note 13. Litigation, continued**

investigation. Based on the information available to the Company at this time, the inquiries appear to primarily pertain to matters related to portfolio valuation and the Company's portfolio company, Business Loan Express, LLC. To date, the Company has produced materials in response to requests from both the SEC and the U.S. Attorney's office, and a director and certain current and former employees have provided testimony and have been interviewed by the staff of the SEC and, in some cases, the U.S. Attorney's Office. The Company is voluntarily cooperating with these investigations.

In late December 2006, the Company received a subpoena from the U.S. Attorney for the District of Columbia requesting, among other things, the production of records regarding the use of private investigators by the Company or its agents. The Board established a committee, which was advised by its own counsel, to review this matter. In the course of gathering documents responsive to the subpoena, the Company became aware that an agent of the Company obtained what were represented to be telephone records of David Einhorn and which purport to be records of calls from Greenlight Capital during a period of time in 2005. Also, while the Company was gathering documents responsive to the subpoena, allegations were made that the Company's management had authorized the acquisition of these records and that management was subsequently advised that these records had been obtained. The Company's management has stated that these allegations are not true. The Company is cooperating fully with the inquiry by the United States Attorney's office.

On February 13, 2007, Rena Nadoff filed a shareholder derivative action in the Superior Court of the District of Columbia, captioned *Rena Nadoff v. Walton, et al.*, CA 001060-07, seeking unspecified compensatory and other damages, as well as equitable relief on behalf of Allied Capital Corporation. Ms. Nadoff's complaint names as defendants the members of Allied Capital's Board of Directors; Allied Capital is a nominal defendant for purposes of the derivative action. The complaint alleges breach of fiduciary duty by the Board of Directors arising from internal control failures and mismanagement of Business Loan Express, LLC, an Allied Capital portfolio company. The Company believes the lawsuit is without merit, and intends to defend the lawsuit vigorously. The Company and the individual directors filed a motion to dismiss the complaint in its entirety. The motion is pending.

On February 26, 2007, Dana Ross filed a class action complaint in the U.S. District Court for the District of Columbia in which she alleges that Allied Capital Corporation and certain members of management violated Sections 10(b) and 20(a) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder. The complaint is captioned *Dana Ross v. Walton, et al.*, CV 00402. Dana Ross claims that, between March 1, 2006, and January 10, 2007, Allied Capital either failed to disclose or misrepresented information concerning the loan origination practices of Business Loan Express, LLC, an Allied Capital portfolio company. Dana Ross seeks unspecified compensatory and other damages, as well as other relief. The Company believes the lawsuit is without merit, and intends to defend the lawsuit vigorously. There may be other similar class action lawsuits filed.

In addition, the Company is party to certain lawsuits in the normal course of business.

While the outcome of any of the legal proceedings described above cannot at this time be predicted with certainty, the Company does not expect these matters will materially affect its financial condition or results of operations.

**Report of Independent Registered Public Accounting Firm**

The Board of Directors and Shareholders

Allied Capital Corporation:

We have reviewed the accompanying consolidated balance sheet of Allied Capital Corporation and subsidiaries, including the consolidated statement of investments, as of March 31, 2007, 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, 2007 and 2006. These consolidated financial statements and financial highlights are the responsibility of the Company's management.

We conducted our reviews in accordance with standards of the Public Company Accounting Oversight Board (United States). 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 standards of the Public Company Accounting Oversight Board (United States), 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 U.S. generally accepted accounting principles.

We have previously audited, in accordance with standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheet of Allied Capital Corporation and subsidiaries, including the consolidated statement of investments, as of December 31, 2006, and the related consolidated statements of operations, changes in net assets and cash flows (not presented herein), and the financial highlights, for the year then ended; and in our report dated February 28, 2007, we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying condensed consolidated balance sheet including the consolidated statement of investments as of December 31, 2006, is fairly stated, in all material respects, in relation to the consolidated balance sheet from which it has been derived.

Washington, D.C.

May 7, 2007

**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**  
**SCHEDULE OF INVESTMENTS IN AND ADVANCES TO AFFILIATES**

PRIVATE FINANCE Portfolio Company (in thousands)	Investment <sup>(1)</sup>	Amount of Interest or Dividends		December	Gross Additions <sup>(3)</sup>	Gross Reductions <sup>(4)</sup>	March 31, 2007 Value
		Credited to Income <sup>(6)</sup>	Other <sup>(2)</sup>	31, 2006 Value			
<b>Companies More Than 25% Owned</b>							
Alaris Consulting, LLC (Business Services)	Senior Loan <sup>(5)</sup>			\$	\$ 572	\$ (572)	\$
	Equity Interests						
Avborne, Inc. (Business Services)	Preferred Stock			918		(45)	873
	Common Stock						
Avborne Heavy Maintenance, Inc. (Business Services)	Preferred Stock						
	Common Stock						
Border Foods, Inc. (Consumer Products)	Preferred Stock						
	Common Stock						
Business Loan Express, LLC (Financial Services)	Class A Equity Interests <sup>(5)</sup>			66,622	19,200		85,822
	Class B Equity Interests			79,139			79,139
	Class C Equity Interests			64,976			64,976
Calder Capital Partners, LLC	Senior Loan <sup>(5)</sup>		\$ 49	975	400	(49)	1,326

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(Financial Services)	Equity Interests		2,076	78		2,154
Callidus Capital Corporation (Financial Services)	Senior Loan Subordinated Debt	\$ 17		2,100	(950)	1,150
	Common Stock	271	5,762	259		6,021
			22,550	1,943		24,493
Coverall North America, Inc. (Business Services)	Unitranche Debt Subordinated Debt	1,084	36,333	9	(1,446)	34,896
	Common Stock	227	5,972	2		5,974
			19,619	1,856		21,475
CR Holding, Inc. (Consumer Products)	Subordinated Debt	1,664	39,401	351		39,752
	Common Stock		25,738	5,142		30,880
Direct Capital Corporation (Financial Services)	Subordinated Debt	479		35,574		35,574
	Common Stock			19,250		19,250
Financial Pacific Company (Financial Services)	Subordinated Debt	3,142	71,362	370		71,732
	Preferred Stock		15,942	797		16,739
	Common Stock		65,186	2,354		67,540
ForeSite Towers, LLC (Tower Leasing)	Equity Interests	1,269	12,290		(11,733)	557
Global Communications, LLC (Business Services)	Senior Loan <sup>(5)</sup>		15,957			15,957
	Subordinated Debt <sup>(5)</sup>		11,237		(6,307)	4,930
	Preferred Equity Interest Options					
Gordian Group, Inc. (Business Services)	Senior Loan <sup>(5)</sup>	(4)		176	(176)	
	Common Stock					

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Healthy Pet Corp. (Consumer Services)	Senior Loan	764	27,038	5,350	(50)	32,338
	Subordinated Debt	1,657	43,579	228		43,807
	Common Stock		28,921	14,897		43,818
HMT, Inc. (Energy Services)	Preferred Stock		2,637			2,637
	Common Stock		8,664	21,509		30,173
	Warrants		3,336	8,281		11,617
Hot Stuff Foods, LLC <sup>(7)</sup> (Consumer Products)	Senior Loan	848		49,659	(110)	49,549
	Subordinated Debt	804		60,361	(3,107)	57,254
	Subordinated Debt <sup>(5)</sup>			8,460	(8,460)	
	Common Stock					
Huddle House, Inc. (Retail)	Senior Loan	426	19,950		(19,950)	
	Subordinated Debt	2,205	58,196	221	(178)	58,239
	Common Stock		41,662	1,545	(129)	43,078
Impact Innovations Group, LLC (Business Services)	Equity Interests in					
	Affiliate		873		(554)	319

See related footnotes at the end of this schedule.

PRIVATE FINANCE Portfolio Company		Amount of Interest or Dividends		December 31,			March 31, 2007 Value
		Credited	Other <sup>(2)</sup>	2006 Value	Gross Additions <sup>(3)</sup>	Gross Reductions <sup>(4)</sup>	
(in thousands)	Investment <sup>(1)</sup>	to Income <sup>(6)</sup>					
Insight Pharmaceuticals Corporation (Consumer Products)	Subordinated Debt	\$ 1,445		\$ 43,884	\$ 232	\$	\$ 44,116
	Subordinated Debt <sup>(5)</sup>			15,966	164	(1,620)	14,510
	Preferred Stock Common Stock			7,845		(7,845)	
Jakel, Inc. (Industrial Products)	Subordinated Debt <sup>(5)</sup> Preferred Stock Common Stock			6,655	500	(7,155)	
Legacy Partners Group, Inc. (Financial Services)	Senior Loan <sup>(5)</sup> Subordinated Debt Equity Interests			4,843			4,843
					613		613
Litterer Beteiligungs-GmbH (Business Services)	Subordinated Debt Equity Interest	10		692	6		698
				1,199	781		1,980
Mercury Air Centers, Inc. (Business Services)	Subordinated Debt Common Stock	2,010		49,217	520		49,737
				195,019	56,690		251,709
MVL Group, Inc. (Business Services)	Senior Loan Subordinated Debt Common Stock	1,410		27,245	3,368		30,613
		877		35,478	3,614		39,092
					1,333		1,333

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Penn Detroit Diesel Allison, LLC (Business Services)	Subordinated Debt	1,497	37,994	293	38,287
	Equity Interests		25,949	(1,984)	23,965
Powell Plant Farms, Inc. (Consumer Products)	Senior Loan <sup>(5)</sup>		26,192	3,950	30,142
	Subordinated Debt <sup>(5)</sup>		962	2,875	3,837
	Preferred Stock Warrants				
Service Champ, Inc. (Business Services)	Subordinated Debt	1,087	27,619	183	27,802
	Common Stock		16,786	(298)	16,488
Staffing Partners Holding Company, Inc. (Business Services)	Subordinated Debt <sup>(5)</sup>		486	54	540
Startec Global Communications Corporation (Telecommunications)	Senior Loan	367	15,965	(2,382)	13,583
	Common Stock		11,232	5,853	17,085
Sweet Traditions, Inc. (Retail)	Senior Loan	1,088	35,172	210	35,382
	Preferred Stock		400	550	950
	Common Stock		50		50
Triview Investments, Inc. (Broadcasting & Cable/ Business Services/ Consumer Products)	Senior Loan	455	14,747	7	14,754
	Subordinated Debt	1,414	56,008	7,134	63,142
	Subordinated Debt <sup>(5)</sup>	637	4,342	508	4,850
	Common Stock	7	31,322	7,983	39,024
<b>Total companies more than 25% owned</b>		<b>\$27,157</b>	<b>\$1,490,180</b>		<b>\$1,773,164</b>
<b>Companies 5% to 25% Owned</b>					



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Advantage Sales & Marketing, Inc. (Business Services)	Subordinated Debt	\$ 4,593	\$ 151,648	\$ 785	\$	\$ 152,433
	Equity Interests		11,000			11,000
Air Medical Group Holdings LLC (Healthcare Services)	Senior Loan	61	1,763	1,782	(1,050)	2,495
	Subordinated Debt	1,234	35,128	5		35,133
	Equity Interests		5,950	950		6,900
Alpine ESP Holdings, Inc. (Business Services)	Preferred Stock		602		(59)	543
	Common Stock					
Amerex Group, LLC (Consumer Products)	Subordinated Debt	252	8,400			8,400
	Equity Interests		13,823	6,431	(19)	20,235
BB&T Capital Partners/Windsor Mezzanine Fund, LLC (Private Equity Fund)	Equity Interests		5,554			5,554
Becker Underwood, Inc. (Industrial Products)	Subordinated Debt	889	24,163	158		24,321
	Common Stock		3,700		(400)	3,300
BI Incorporated (Business Services)	Subordinated Debt	1,030	30,135	121		30,256
	Common Stock		4,100	1,900		6,000
CitiPostal, Inc. and Affiliates (Business Services)	Senior Loan	571	20,569	4	(247)	20,326
	Common Stock		4,700	682	(32)	5,350
Creative Group, Inc. (Business Services)	Subordinated Debt	480	13,656	30		13,686
	Warrants		1,387		(522)	865

See related footnotes at the end of this schedule.



PRIVATE FINANCE Portfolio Company  (in thousands)	Investment <sup>(1)</sup>	Amount of Interest or Dividends		December 31,			March 31,
		Credited to Income <sup>(6)</sup>	Other <sup>(2)</sup>	2006 Value	Gross Additions <sup>(3)</sup>	Gross Reductions <sup>(4)</sup>	2007 Value
Drew Foam Companies, Inc. (Business Services)	Preferred Stock Common Stock			\$ 722 7	\$ 	\$ (34) (7)	\$ 688
MedBridge Healthcare, LLC (Healthcare Services)	Senior Loan <sup>(5)</sup> Subordinated Debt <sup>(5)</sup> Convertible Subordinated Debt <sup>(5)</sup> Equity Interests			7,164 1,813	595	110 (110)	7,164 2,408
Multi-Ad Services, Inc. (Business Services)	Unitranche Debt Equity Interests	\$ 567		19,879 2,000	6	(100) (223)	19,785 1,777
Nexcel Synthetics, LLC (Consumer Products)	Subordinated Debt Equity Interests	332		10,978 1,486	101	(3,097) (727)	7,982 759
PresAir LLC (Industrial Products)	Senior Loan <sup>(5)</sup> Equity Interests			2,206	256 5	(5)	2,462
Progressive International Corporation (Consumer Products)	Subordinated Debt Preferred Stock	305		7,533 1,024 2,300	41 22 500		7,574 1,046 2,800

	Common Stock Warrants					
Regency Healthcare Group, LLC (Healthcare Services)	Senior Loan Unitranche Debt Equity Interests	36 560	1,232 19,908 1,616	5 24		1,232 19,913 1,640
SGT India Private Limited (Business Services)	Common Stock		3,346	149	(455)	3,040
Soteria Imaging Services, LLC (Healthcare Services)	Subordinated Debt Equity Interests	580	17,569 2,541	1,034 7		18,603 2,542
Universal Environmental Services, LLC (Business Services)	Unitranche Debt Equity Interests	371	10,211		(552) (15)	9,659
<b>Total companies 5% to 25% owned</b>		<b>\$11,861</b>	<b>\$449,813</b>			<b>\$457,871</b>

This schedule should be read in conjunction with the Company's consolidated financial statements, including the consolidated statement of investments and Note 3 to the consolidated financial statements. Note 3 includes additional information regarding activities in the private finance portfolio.

- (1) Common stock, preferred stock, warrants, options, and equity interests are generally non-income producing and restricted. The principal amount for loans and debt securities and the number of shares of common stock and preferred stock is shown in the consolidated statement of investments as of March 31, 2007.
- (2) Other includes interest, dividend, or other income which was applied to the principal of the investment and therefore reduced the total investment. These reductions are also included in the Gross Reductions for the investment, as applicable.
- (3) Gross additions include increases in the cost basis of investments resulting from new portfolio investments, paid-in-kind interest or dividends, the amortization of discounts and closing fees, the exchange of one or more existing securities for one or more new securities and the movement of an existing portfolio company into this category from a different category. Gross additions also include net increases in unrealized appreciation or net decreases in unrealized depreciation.

- (4) Gross reductions include decreases in the cost basis of investments resulting from principal collections related to investment repayments or sales, the exchange of one or more existing securities for one or more new securities and the movement of an existing portfolio company out of this category into a different category. Gross reductions also include net increases in unrealized depreciation or net decreases in unrealized appreciation.
- (5) Loan or debt security is on non-accrual status at March 31, 2007, and is therefore considered non-income producing. Loans or debt securities on non-accrual status at the end of the period may or may not have been on non-accrual status for the full period.
- (6) Represents the total amount of interest or dividends credited to income for the portion of the year an investment was included in the companies more than 25% owned or companies 5% to 25% owned categories, respectively.
- (7) In the first quarter of 2007, the Company exercised its option to acquire a majority of the voting securities of Hot Stuff Foods, LLC at fair market value. Therefore, Hot Stuff Foods, LLC was reclassified to companies more than 25% owned.

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

The following analysis of the financial condition and results of operations of the Company should be read in conjunction with the Company's Consolidated Financial Statements and the Notes thereto included herein and in the Company's annual report on Form 10-K for the year ended December 31, 2006. In addition, this quarterly report on Form 10-Q 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 section. Other factors that could cause actual results to differ materially include:

*changes in the economy and general economic conditions;*

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

*future changes in laws or regulations and conditions in our operating areas; and*

*other risks and uncertainties as may be detailed from time to time in our public announcements and SEC filings.*

Financial or other information presented for private finance portfolio companies has been obtained from the portfolio companies, 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 U.S. generally accepted accounting principles 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 U.S. generally accepted accounting principles.

**OVERVIEW**

As a business development company, we are in the private equity business. Specifically, we provide long-term debt and equity investment capital to companies in a variety of industries. Our private finance activity principally involves providing financing to middle market U.S. companies through privately negotiated long-term debt and equity investment capital. Our financing is generally used to fund buyouts, acquisitions, growth, recapitalizations, note purchases, and other types of financings. We generally invest in private companies though, from time to time, we may invest in companies that are public but lack access to additional public capital. Our investment objective is to achieve current income and capital gains.

Our portfolio composition at March 31, 2007 and 2006, and December 31, 2006, was as follows:

	March 31,		December 31,
	2007	2006	2006
Private finance	97%	96%	97%
Commercial real estate finance	3%	4%	3%

Our earnings depend primarily on the level of interest and dividend income, fee and other income, and net realized and unrealized gains or losses on our investment portfolio after deducting interest expense on borrowed capital, operating expenses and income taxes, including excise tax. Interest income results from the stated interest rate earned

on a loan or debt security and the amortization of loan origination fees and discounts. The

level of interest income is directly related to the balance of the interest-bearing investment portfolio outstanding during the period 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, interest rates on the types of loans we make, the level of repayments in the portfolio, 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. The level of fee income is primarily related to the level of new investment activity and the level of fees earned from portfolio companies. The level of investment activity can vary substantially from period to period depending on many factors, including the amount of debt and equity capital available to middle market companies, the level of merger and acquisition activity for such companies, the general economic environment, and the competitive environment for the types of investments we make.

Because we are a regulated investment company for tax purposes, we intend to distribute substantially all of our annual taxable income available for distribution to shareholders as dividends to our shareholders. See Other Matters below.

#### PORTFOLIO AND INVESTMENT ACTIVITY

The total portfolio at value, investment activity, and the yield on interest-bearing investments at and for the three months ended March 31, 2007 and 2006, and at and for the year ended December 31, 2006, were as follows:

(\$ in millions)	At and for the Three Months Ended March 31,		At and for the Year Ended December 31,
	2007	2006	2006
Portfolio at value	\$ 4,498.8	\$ 3,691.0	\$ 4,496.1
Investments funded	\$ 170.2	\$ 797.9	\$ 2,437.8
Change in accrued or reinvested interest and dividends <sup>(1)</sup>	\$ 11.3	\$ (2.1)	\$ 11.3
Principal collections related to investment repayments or sales	\$ 235.5	\$ 340.4	\$ 1,055.3
Yield on interest-bearing portfolio investments <sup>(2)</sup>	11.6%	12.3%	11.8%

(1) Includes changes in accrued or reinvested interest related to our investments in money market securities of \$2.6 million, \$1.1 million, and \$3.1 million, respectively, for the three months ended March 31, 2007 and 2006, and for the year ended December 31, 2006.

(2) The weighted average yield on interest-bearing investments is computed as the (a) annual stated interest on accruing loans and debt securities plus the annual amortization of loan origination fees, original issue discount, and market discount on accruing loans and debt securities less the annual amortization of loan origination costs, 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 at value, investment activity, and the yield on loans and debt securities at and for the three months ended March 31, 2007 and 2006, and at and for the year ended December 31, 2006, were as follows:

(\$ in millions)	At and for Three Months Ended March 31,				At and for the Year Ended December 31,	
	2007		2006		2006	
	Value	Yield <sup>(2)</sup>	Value	Yield <sup>(2)</sup>	Value	Yield <sup>(2)</sup>
Portfolio at value:						
Loans and debt securities:						
Senior loans	\$ 365.0	8.4%	\$ 420.1	9.3%	\$ 405.2	8.4%
Unitranche debt	780.2	11.4%	362.7	11.1%	799.2	11.2%
Subordinated debt	1,946.1	12.5%	1,747.2	13.6%	1,980.8	12.9%
Total loans and debt securities	3,091.3	11.7%	2,530.0	12.5%	3,185.2	11.9%
Equity securities	1,285.0		1,031.6		1,192.7	
Total portfolio	\$ 4,376.3		\$ 3,561.6		\$ 4,377.9	
Investments funded <sup>(1)</sup>	\$ 170.2		\$ 795.9		\$ 2,423.4	
Change in accrued or reinvested interest and dividends	\$ 9.1		\$ (4.2)		\$ 7.2	
Principal collections related to investment repayments or sales <sup>(3)</sup>	\$ 235.1		\$ 336.6		\$ 1,015.4	

(1) Investments funded for the three months ended March 31, 2006, and for the year ended December 31, 2006, included debt investments in certain portfolio companies received in conjunction with the sale of such companies. See Private Finance, Investments Funded below.

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

(3) Includes collections from the sale or repayment of senior loans totaling \$94.7 million, \$13.2 million, and \$322.7 million for the three months ended March 31, 2007 and 2006, and for the year ended December 31, 2006, respectively.

Our investment activity is focused on making long-term investments in the debt and equity of primarily private middle market companies. Debt investments may include senior loans, unitranche debt (a single debt investment that is a blend of senior and subordinated debt terms), or subordinated debt (with or without equity features). The junior debt that we invest in that is lower in repayment priority than senior debt is also known as mezzanine debt. Equity investments may include a minority equity stake in connection with a debt investment or a substantial equity stake in

connection with a buyout transaction. In a buyout transaction, we generally invest in senior and/or subordinated debt and equity (preferred and/or voting or non-voting common) where our equity ownership represents a significant portion of the equity, but may or may not represent a controlling interest.

We intend to take a balanced approach to private equity investing that emphasizes a complementary mix of debt investments and buyout investments. The combination of these two types of investments provides current interest and related portfolio income and the potential for future capital gains. The private equity investment marketplace is very active. Purchase price multiples remain high and debt pricing is competitive. In this competitive market, we are focusing on investments that provide the opportunity for attractive total returns such as buyout investments or debt investments where we can make co-investments in the portfolio company's equity securities. In many instances we believe that debt-only investments, which provide only interest income with no potential for future capital gain, may be unattractive for our portfolio in today's competitive pricing environment.

The level of investment activity for investments funded and principal repayments for private finance investments can vary substantially from period to period depending on the number and size of investments that we make or that we exit and many other factors, including the amount of debt and equity capital available to middle market companies, the level of merger and acquisition activity for such companies, the general economic environment, and the competitive environment for the types of investments we make.

In the current market, we believe that it is important to be disciplined in our investing activities, carefully considering investment risk and return. For 2006, we reviewed over \$65 billion in prospective investments and we closed on approximately 3% of the potential new investments that we reviewed. For the first quarter of 2007, we reviewed over \$20 billion in prospective investments and we closed on approximately 1% of the potential new investments we reviewed. We continue to have an active pipeline of new investments under consideration and we believe that merger and acquisition activity for middle market companies will remain strong in 2007.

**Investments Funded.** Investments funded and the weighted average yield on loans and debt securities funded for the three months ended March 31, 2007 and 2006, and for the year ended December 31, 2006, consisted of the following:

**For the Three Months Ended March 31, 2007**

	Debt Investments		Buyout Investments		Total	
	Amount	Yield <sup>(1)</sup>	Amount	Yield <sup>(1)</sup>	Amount	Yield <sup>(1)</sup>
<b>(\$ in millions)</b>						
Loans and debt securities:						
Senior loans	\$ 41.2	8.8%	\$ 12.7	10.4%	\$ 53.9	9.2%
Unitranche debt <sup>(2)</sup>	5.3	11.0%			5.3	11.0%
Subordinated debt	14.4	9.3%	62.1	10.5%	76.5	10.3%
Total loans and debt securities	60.9	9.1%	74.8	10.5%	135.7	9.9%
Equity	9.7		24.8		34.5	
Total	\$ 70.6		\$ 99.6		\$ 170.2	

**For the Three Months Ended March 31, 2006**

	Debt Investments		Buyout Investments		Total	
	Amount	Yield <sup>(1)</sup>	Amount	Yield <sup>(1)</sup>	Amount	Yield <sup>(1)</sup>
<b>(\$ in millions)</b>						
Loans and debt securities:						
Senior loans	\$ 85.0	9.1%	\$ 117.8	8.9%	\$ 202.8	9.0%
Unitranche debt <sup>(2)</sup>	75.0	10.6%			75.0	10.6%
Subordinated debt <sup>(3)</sup>	279.3	12.5%	145.4	13.9%	424.7	13.0%
Total loans and debt securities	439.3	11.5%	263.2	11.6%	702.5	11.6%
Equity	24.6		68.8		93.4	
Total	\$ 463.9		\$ 332.0		\$ 795.9	

**For the Year Ended December 31, 2006**

	Debt Investments		Buyout Investments		Total	
	Amount	Yield <sup>(1)</sup>	Amount	Yield <sup>(1)</sup>	Amount	Yield <sup>(1)</sup>
<b>(\$ in millions)</b>						
Loans and debt securities:						
Senior loans	\$ 245.4	9.4%	\$ 239.8	8.9%	\$ 485.2	9.2%

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Unitranche debt <sup>(2)</sup>	471.7	10.7%	146.5	12.9%	618.2	11.3%
Subordinated debt <sup>(3)</sup>	510.7	13.0%	423.8	14.4%	934.5	13.6%
Total loans and debt securities	1,227.8	11.4%	810.1	12.5%	2,037.9	11.9%
Equity	91.4 <sup>(4)</sup>		294.1		385.5	
Total	\$ 1,319.2		\$ 1,104.2		\$ 2,423.4	

- (1) The weighted average yield on interest-bearing investments is computed as the (a) annual stated interest on accruing interest-bearing investments, divided by (b) total interest-bearing investments funded.
- (2) Unitranche debt is a single debt investment that is a blend of senior and subordinated debt terms. The yield on a unitranche investment reflects the blended yield of senior and subordinated debt combined.
- (3) Debt investments funded for the three months ended March 31, 2006, and for the year ended December 31, 2006, included a \$150 million subordinated debt investment in Advantage Sales & Marketing, Inc. received in conjunction with the sale of Advantage. Debt investments funded for the year ended December 31, 2006, included a \$30 million subordinated debt investment in STS Operating, Inc. received in conjunction with the sale of STS.
- (4) Equity investments for the year ended December 31, 2006, included \$26.1 million in investments in the preferred shares/income notes of collateralized loan obligations (CLOs) that are managed by Callidus Capital Corporation, a portfolio company controlled by us. These CLOs primarily invest in senior debt.

Private finance investments funded April 1, 2007, through May 4, 2007, totaled approximately \$290 million.

We generally fund new investments using cash. In addition, we may acquire securities in exchange for our common equity. Also, we may acquire new securities through 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.

We may originate, underwrite and arrange senior loans related to our portfolio investments or for other companies that are not in our portfolio. Senior loans originated by us may or may not be funded by us at closing. When these senior loans are closed, we may fund all or a portion of the underwritten commitment pending sale of the loan to other investors, which may include loan sales to Callidus Capital Corporation (Callidus) or funds managed by Callidus, a portfolio company controlled by us. In addition, we are in the process of developing a fund to invest in senior debt opportunities, which, if closed, we may sell a portion of our senior or unitranche loans to the fund. After completion of loan sales, we may or may not retain a position in these senior loans. We generally earn a fee on the senior loans originated and underwritten whether or not we fund the underwritten commitment. In addition, we may fund most or all of the debt and equity capital upon the closing of certain buyout transactions, which may include investments in lower-yielding senior debt. Subsequent to the closing, the portfolio company may refinance all or a portion of the lower-yielding senior debt, which would reduce our investment. Repayments include repayments of senior debt funded by us that was subsequently sold by us or refinanced or repaid by the portfolio companies.

**Yield.** The weighted average yield on the private finance loans and debt securities was 11.7% at March 31, 2007, as compared to 11.9% and 12.5% at December 31, 2006, and March 31, 2006, respectively. The weighted average yield on the private finance loans and debt securities may fluctuate from period to period depending on the yield on new loans and debt securities funded, the yield on loans and debt securities repaid, the amount of loans and debt securities for which interest is not accruing (see *Portfolio Asset Quality - Loans and Debt Securities on Non-Accrual Status* below) and the amount of lower-yielding senior or unitranche debt in the portfolio at the end of the period. Yields on senior and subordinated debt investments are generally lower in the current market as a result of the supply of capital available to middle market companies. We believe that debt yields will remain on the lower end of a historical range as long as merger and acquisition activity remains robust and the supply of capital remains strong.

The yield on the private finance portfolio has declined partly due to our strategy to pursue investments where our position in the portfolio company capital structure is more senior, such as senior debt and unitranche investments that typically have lower yields than subordinated debt investments. In addition, during the fourth quarter of 2006, the guaranteed dividend yield on our investment in BLX's 25% Class A equity interests was placed on non-accrual status. The Class A equity interests are included in our loans and debt securities. See *Business Loan Express, LLC* below.

**Outstanding Investment Commitments.** At March 31, 2007, we had outstanding private finance investment commitments as follows:

	<b>Companies More Than 25% Owned<sup>(1)</sup></b>	<b>Companies 5% to 25% Owned</b>	<b>Companies Less Than 5% Owned</b>	<b>Total</b>
<b>(\$ in millions)</b>				
Senior loans	\$ 18.7	\$ 15.7	\$ 90.3	\$ 124.7 <sup>(2)</sup>
Unitranche			60.2	60.2
Subordinated debt	44.2	0.1		44.3
Total loans and debt securities	62.9	15.8	150.5	229.2
Equity securities	83.0	16.0	73.7	172.7 <sup>(3)</sup>
Total	\$ 145.9	\$ 31.8	\$ 224.2	\$ 401.9

- <sup>(1)</sup> Includes various commitments to Callidus Capital Corporation (Callidus), a portfolio company controlled by us, which owns 80% (subject to dilution) of Callidus Capital Management, LLC, an asset management company that structures and manages collateralized debt obligations (CDOs), collateralized loan obligations (CLOs), and other related investments, as follows:

	<b>Committed Amount</b>	<b>Amount Drawn</b>	<b>Amount Available to be Drawn</b>
<b>(\$ in millions)</b>			
Revolving line of credit for working capital	\$ 4.0	\$ (1.1)	\$ 2.9
Subordinated debt to support warehouse facilities & warehousing activities <sup>(*)</sup>	44.0		44.0
Purchase of preferred equity in future CLO transactions	73.2		73.2
Total	\$ 121.2	\$ (1.1)	\$ 120.1

- <sup>(\*)</sup> Callidus has a secured warehouse credit facility with a third party for up to \$360 million. The facility is used primarily to finance the acquisition of loans pending securitization through a CDO or CLO. In addition, Callidus has a synthetic credit facility with a third party for up to \$50 million. In conjunction with these facilities, we have agreed to designate our subordinated debt commitment for Callidus to draw upon to provide first loss capital as needed to support the facilities.

- <sup>(2)</sup> Includes \$105.6 million in the form of revolving senior debt facilities to 29 companies.

- <sup>(3)</sup>

Includes \$89.8 million to 19 private equity and venture capital funds, including \$4.3 million in co-investment commitments to one private equity fund.

In addition to these outstanding investment commitments at March 31, 2007, we may be required to fund additional amounts under earn-out arrangements primarily related to buyout transactions in the future if those companies meet agreed-upon performance targets. We also had commitments to private finance portfolio companies in the form of standby letters of credit and guarantees totaling \$222.1 million. See Financial Condition, Liquidity and Capital Resources.

**Mercury Air Centers, Inc.** At March 31, 2007, our investment in Mercury Air Centers, Inc. (Mercury) totaled \$84.8 million at cost and \$301.4 million at value, or 6.0% of our total assets, which included unrealized appreciation of \$216.6 million.

Mercury owns and operates fixed base operations generally under long-term leases from local airport authorities, which consist of terminal and hangar complexes that service the needs of the general aviation community. Mercury is headquartered in Richmond Heights, OH. We completed the purchase of a majority ownership in Mercury in April 2004.



Total interest and related portfolio income earned from our investment in Mercury for the three months ended March 31, 2007 and 2006, was as follows:

	2007	2006
<b>(\$ in millions)</b>		
Interest income	\$ 2.0	\$ 2.9
Fees and other income	0.1	0.2
<b>Total interest and related portfolio income</b>	<b>\$ 2.1</b>	<b>\$ 3.1</b>

Interest income from Mercury included \$0.5 million for both the three months ended March 31, 2007 and 2006, which was paid in kind. The interest paid in kind was paid to us through the issuance of additional debt.

Net change in unrealized appreciation or depreciation included a net increase in unrealized appreciation on our investment in Mercury of \$56.7 million and \$4.7 million for the three months ended March 31, 2007 and 2006, respectively.

In April 2007, we signed a definitive agreement to sell our majority equity interest in Mercury. Based on the definitive agreement, Mercury is expected to sell for an enterprise value of approximately \$427 million, subject to pre- and post-closing adjustments. In connection with the transaction, we expect to be repaid approximately \$50 million of subordinated debt outstanding to Mercury at closing. We also expect to realize a gain on our equity being sold of approximately \$240 million, subject to pre- and post-closing adjustments. Approximately \$10 million of our proceeds from the sale of our equity will be subject to certain holdback provisions. The transaction is expected to close in the third quarter of 2007 upon satisfying certain closing conditions, including regulatory approvals.

**Business Loan Express, LLC.** BLX originates, sells, and services primarily real estate secured loans, including real estate secured conventional small business loans, SBA 7(a) loans, and small investment real estate loans. BLX has offices across the United States and is headquartered in New York, NY. We acquired BLX in 2000.

At March 31, 2007, our investment in BLX totaled \$314.5 million at cost and \$229.9 million at value, or 4.6% of our total assets, which included unrealized depreciation of \$84.6 million. In the first quarter of 2007 we increased our investment in BLX by \$19.2 million by acquiring additional Class A equity interests. In addition, in the first quarter of 2007, the chief executive officer of BLX invested \$3.0 million in the form of Class A equity interests in BLX. We agreed to purchase these interests for cash at fair value in the event that BLX amends or otherwise restructures its existing senior credit facility or he is terminated for any reason. The purpose of these additional investments was to fund payments to the SBA discussed below and to provide additional equity to BLX.

Total interest and related portfolio income earned from our investment in BLX for the three months ended March 31, 2007 and 2006, was as follows:

	2007	2006
<b>(\$ in millions)</b>		
Interest income on subordinated debt and Class A equity interests	\$	\$ 3.9
Fees and other income	1.4	2.2
<b>Total interest and related portfolio income</b>	<b>\$ 1.4</b>	<b>\$ 6.1</b>

Interest and dividend income from BLX for the three months ended March 31, 2006, included interest income of \$1.8 million which was paid in kind. The interest paid in kind was paid to us through the issuance of additional equity interests. In the fourth quarter of 2006, we placed our investment in BLX's 25% Class A equity interests on non-accrual status. As a result, there was no interest income from our investment in BLX for the three months ended March 31, 2007.



In consideration for providing a guaranty on BLX's revolving credit facility and standby letters of credit (discussed below), we earned fees of \$1.4 million and \$1.6 million for the three months ended March 31, 2007 and 2006, respectively, which were included in fees and other income. The remaining fees and other income relate to management fees from BLX. We did not charge a management fee to BLX in the first quarter of 2007.

Net change in unrealized appreciation or depreciation included no change in unrealized depreciation on our investment in BLX for the three months ended March 31, 2007, and a net decrease in unrealized appreciation of \$22.7 million for the three months ended March 31, 2006. See Results of Operations, Valuation of Business Loan Express, LLC below.

BLX is a national, non-bank lender that participates in the SBA's 7(a) Guaranteed Loan Program and is licensed by the SBA as a Small Business Lending Company (SBLC). The Office of the Inspector General of the SBA (OIG) and the United States Secret Service are conducting an ongoing investigation of allegedly fraudulently obtained SBA-guaranteed loans issued by BLX. Specifically, on or about January 9, 2007, BLX became aware of an indictment captioned as the United States v. Harrington, No. 2:06-CR-20662 pending in the United States District Court for the Eastern District of Michigan. The indictment alleges that a former BLX employee in the Detroit office engaged in the fraudulent origination of loans guaranteed, in substantial part, by the SBA. We understand that BLX is working cooperatively with the U.S. Attorney's Office and the investigating agencies with respect to this matter. The OIG and the U.S. Department of Justice are also conducting a civil investigation of BLX's lending practices in various jurisdictions. These investigations are ongoing. As an SBA lender, BLX is also subject to other SBA and OIG audits, investigations, and reviews. These investigations, audits and reviews, 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 adverse impact on BLX and, as a result, could negatively affect our financial results. We have considered these matters in performing the valuation of BLX at March 31, 2007. See Results of Operations, Valuation of Business Loan Express, LLC below. We are monitoring the situation and have retained a third party to work with BLX to conduct a review of BLX's current internal control systems, with a focus on preventing fraud and further strengthening BLX's operations.

On March 6, 2007, BLX entered into an agreement with the SBA. According to the agreement, BLX remains a preferred lender in the SBA 7(a) Guaranteed Loan Program and retains the ability to sell loans into the secondary market. As part of this agreement, BLX agreed to the immediate payment of approximately \$10 million to the SBA to cover amounts paid by the SBA with respect to some of the SBA-guaranteed loans that have been the subject of inquiry by the United States Attorney's Office for the Eastern District of Michigan. As part of the SBA's increased oversight, the agreement provides that any loans originated and closed by BLX during the term of the agreement will be reviewed by an independent third party selected by the SBA prior to the sale of such loans into the secondary market. The agreement also requires BLX to repurchase the guaranteed portion of certain loans that default after having been sold into the secondary market, and subjects such loans to a similar third party review prior to any reimbursement of BLX by the SBA. In connection with this agreement, BLX also entered into an escrow agreement with the SBA and an escrow agent in which BLX agreed to deposit \$10 million with the escrow agent for any additional payments BLX may be obligated to pay to the SBA in the future. BLX remains subject to SBA rules and regulations and as a result may be required to make additional payments to the SBA in the ordinary course of business. The agreement states that nothing in the agreement shall affect the rights of BLX to securitize or service its loans. Notwithstanding the foregoing, BLX and the SBA are conducting ongoing discussions with respect to BLX's ability to securitize the unguaranteed portions of SBA loans.

On or about January 16, 2007, BLX and Business Loan Center LLC (BLC) became aware of a lawsuit titled, United States, ex rel James R. Brickman and Greenlight Capital, Inc. v. Business Loan Express LLC f/k/a Business Loan Express, Inc.; Business Loan Center LLC f/k/a Business Loan Center, Inc.; Robert Tannenhauser; Matthew McGee; and George Harrigan, 05-CV-3147 (JEC), that is pending in the United

States District Court for the Northern District of Georgia. The complaint includes allegations arising under the False Claims Act and relating to alleged fraud in connection with SBA guarantees on shrimp vessel loans made by BLX and BLC. On April 9, 2007, BLX, BLC and the other defendants filed motions to dismiss the complaint in its entirety. The motions are pending.

At March 31, 2007, BLX had a three-year \$500.0 million revolving credit facility provided by third party lenders that matures in March 2009. The revolving credit facility may be expanded through new or additional commitments up to \$600.0 million at BLX's option. This facility provides for a sub-facility for the issuance of letters of credit for up to an amount equal to 25% of the committed facility. We have provided an unconditional guaranty to these revolving credit facility lenders in an amount equal to 50% of the total obligations (consisting of principal, letters of credit issued under the facility, accrued interest, and other fees) of BLX under this facility. At March 31, 2007, the principal amount outstanding on the revolving credit facility was \$300.8 million and letters of credit issued under the facility were \$55.9 million. The total obligation guaranteed by us at March 31, 2007, was \$179.4 million. At March 31, 2007, we had also provided four standby letters of credit totaling \$20.0 million in connection with four term securitization transactions completed by BLX.

The guaranty on the BLX revolving line of credit facility can be called by the lenders in the event of a default, which includes certain defaults under our revolving credit facility. Among other requirements, the BLX facility requires that BLX maintain compliance with certain financial covenants such as interest coverage, maximum debt to net worth, asset coverage, and maintenance of certain asset quality metrics. In addition, BLX would have an event of default if BLX failed to maintain its lending status with the SBA and such failure could reasonably be expected to result in a material adverse effect on BLX, or if BLX failed to maintain certain financing programs for the sale or long-term funding of BLX's loans. At March 31, 2007, BLX received waivers from its lenders with respect to non-compliance with certain covenants, including waiver of compliance with the interest coverage ratio and certain other covenants to permit BLX to comply with its obligations under its agreement with the SBA. In addition, BLX and the SBA are conducting ongoing discussions with respect to BLX's ability to securitize the unguaranteed portions of SBA loans. The waiver provides that BLX may retain unguaranteed portions of SBA loans on its balance sheet. Certain of these waivers expire on June 30, 2007.

BLX has a separate non-recourse warehouse facility to enable it to securitize the unguaranteed portion of its SBA loans. BLX has been receiving temporary extensions of the warehouse facility, and the current extension expires on June 1, 2007. BLX is in negotiations with the warehouse facility providers to renew and amend the facility for an additional one year term, subject to satisfactory conclusion of discussions with the SBA with respect to BLX's ability to securitize the unguaranteed portions of SBA loans. If the current facility were to expire without renewal, the outstanding amounts owing to the warehouse providers do not become immediately due and payable. Instead, BLX would be required to apply substantially all collections on the unguaranteed interests that currently are in the warehouse facility to repay the outstanding amounts owing to the warehouse providers until the warehouse providers were paid in full, similar to an amortizing term loan. In such an event, BLX would not have the right to sell additional unguaranteed interests in SBA loans into this facility.

We are monitoring BLX's discussions with the SBA, the senior lenders and the warehouse securitization facility providers, and we intend to work with BLX management to implement its business plan, including funding alternatives. The ultimate resolution of these matters could have a material adverse impact on BLX's financial condition, and, as a result, our financial results could be negatively affected.

**Advantage Sales & Marketing, Inc.** At December 31, 2005, our investment in Advantage totaled \$257.7 million at cost and \$660.4 million at value, or 16.4% of our total assets, which included unrealized appreciation of \$402.7 million. We completed the purchase of a majority ownership in Advantage in June 2004.

On March 29, 2006, we sold our majority equity interest in Advantage. We were repaid our \$184 million in subordinated debt outstanding and realized a gain at closing on our equity investment sold of \$433.1 million, subject to post-closing adjustments. Subsequent to closing on this sale, we realized additional gains in 2006

resulting from post-closing adjustments totaling \$1.3 million. In addition, there is potential for us to receive additional consideration through an earn-out payment that would be based on Advantage's 2006 audited results. Our realized gain of \$434.4 million for the year ended December 31, 2006, subject to post-closing adjustments, excludes any earn-out amounts.

As consideration for the common stock sold in the transaction, we received a \$150 million subordinated note, with the balance of the consideration paid in cash. In addition, a portion of our cash proceeds from the sale of the common stock were placed in escrow, subject to certain holdback provisions. At March 31, 2007, the amount of the escrow included in other assets on our consolidated balance sheet was approximately \$24 million. For tax purposes, the receipt of the \$150 million subordinated note as part of our consideration for the common stock sold and the hold back of certain proceeds in escrow has allowed us, through installment treatment, to defer the recognition of taxable income for a portion of our realized gain until the note or other amounts are collected.

In connection with the sale transaction, we retained an equity investment in the business valued at \$15 million at closing as a minority shareholder. During the fourth quarter of 2006, Advantage made a distribution on this minority equity investment, which reduced our cost basis to zero and resulted in a realized gain of \$4.8 million.

Total interest and related portfolio income earned from our investment in Advantage while we held a majority equity interest was \$14.1 million (which included a prepayment premium of \$5.0 million), for the three months ended March 31, 2006. In addition, we earned structuring fees of \$2.3 million on our new \$150 million subordinated debt investment in Advantage upon the closing of the sale transaction in 2006.

Our investment in Advantage at March 31, 2007, which was composed of subordinated debt and a minority equity interest, totaled \$152.4 million at cost and \$163.4 million at value, which included unrealized appreciation of \$11.0 million.

Advantage is a sales and marketing agency providing outsourced sales, merchandising, and marketing services to the consumer packaged goods industry. Advantage has offices across the United States and is headquartered in Irvine, CA.

**Commercial Real Estate Finance**

The commercial real estate finance portfolio at value, investment activity, and the yield on interest-bearing investments at and for the three months ended March 31, 2007 and 2006, and at and for the year ended December 31, 2006, were as follows:

(\$ in millions)	At and for the Three Months Ended March 31,				At and for the Year Ended December 31, 2006	
	2007		2006		Value	Yield <sup>(1)</sup>
	Value	Yield <sup>(1)</sup>	Value	Yield <sup>(1)</sup>		
Portfolio at value:						
Commercial mortgage loans	\$ 72.2	7.5%	\$ 102.7	7.6%	\$ 71.9	7.5%
Real estate owned	21.0		15.0		19.6	
Equity interests	29.3		11.7		26.7	
<b>Total portfolio</b>	<b>\$ 122.5</b>		<b>\$ 129.4</b>		<b>\$ 118.2</b>	
Investments funded	\$		\$ 2.0		\$ 14.4	
Change in accrued or reinvested interest	\$ (0.4)		\$ 1.0		\$ 1.0	
Principal collections related to investment repayments or sales	\$ 0.4		\$ 3.8		\$ 39.9	

<sup>(1)</sup> The weighted average yield on the interest-bearing investments is computed as the (a) annual stated interest on accruing loans plus the annual amortization of loan origination fees, original issue discount, and market discount on accruing interest-bearing investments less the annual amortization of origination costs, 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 and equity interests.

At March 31, 2007, we had outstanding funding commitments related to commercial mortgage loans and equity interests of \$8.9 million, and commitments in the form of standby letters of credit and guarantees related to equity interests of \$6.9 million.

**Sale of CMBS Bonds and Collateralized Debt Obligation Bonds and Preferred Shares.** On May 3, 2005, we completed the sale of our portfolio of commercial mortgage-backed securities (CMBS) and real estate related collateralized debt obligation (CDO) bonds and preferred shares. Under the sale agreement, we agreed not to primarily invest in CMBS and real estate-related CDOs and refrain from certain other real estate-related investing or servicing activities for a period of three years, or through May 2008, subject to certain limitations and excluding our existing portfolio and related activities.

**PORTFOLIO ASSET QUALITY**

**Portfolio by Grade.** We employ a grading system for our 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, 2007, and December 31, 2006, our portfolio was graded as follows:

Grade	2007		2006	
	Portfolio at Value	Percentage of Total Portfolio	Portfolio at Value	Percentage of Total Portfolio
(\$ in millions)				
1	\$ 1,468.8	32.6%	\$ 1,307.3	29.1%
2	2,457.6	54.6	2,672.3	59.4
3	339.7	7.6	308.1	6.9
4	99.3	2.2	84.2	1.9
5	133.4	3.0	124.2	2.7
	\$ 4,498.8	100.0%	\$ 4,496.1	100.0%

The amount of the portfolio in each grading category may vary substantially from period to period resulting primarily from changes in the composition of the portfolio as a result of new investment, repayment, and exit activity, changes in the grade of investments to reflect our expectation of performance, and changes in investment values.

Total Grade 4 and 5 portfolio assets were \$232.7 million and \$208.4 million, respectively, or were 5.2% and 4.6%, respectively, of the total portfolio value at March 31, 2007, and December 31, 2006. Grade 4 and 5 assets include loans, debt securities, and equity securities. We expect that a number of investments will be in the Grades 4 or 5 categories from time to time. Part of the private equity business is working with troubled portfolio companies to improve their businesses and protect our investment. The number and amount of investments included in Grade 4 and 5 may fluctuate from period to period. We continue to follow our historical practice of working with portfolio companies in order to recover the maximum amount of our investment.

At March 31, 2007, and December 31, 2006, \$155.1 million and \$135.9 million, respectively, of our investment in BLX at value was classified as Grade 3, which included our Class A equity interests and certain of our Class B equity interests that were not depreciated. At both March 31, 2007, and December 31, 2006, \$74.8 million of our investment in BLX at value was classified as Grade 5, which included certain of our Class B equity interests and our Class C equity interests that were depreciated. See Private Finance, Business Loan Express, LLC above.

**Loans and Debt Securities on Non-Accrual Status.** At March 31, 2007, and December 31, 2006, loans and debt securities at value not accruing interest for the total investment portfolio were as follows:

	2007	2006
<b>(\$ in millions)</b>		
Loans and debt securities in workout status (classified as Grade 4 or 5) <sup>(1)</sup>		
Private finance		
Companies more than 25% owned	\$ 45.5	\$ 51.1
Companies 5% to 25% owned	4.9	4.0
Companies less than 5% owned	61.0	31.6
Commercial real estate finance	4.9	12.2
Loans and debt securities not in workout status		
Private finance		
Companies more than 25% owned	121.2	87.1
Companies 5% to 25% owned	7.2	7.2
Companies less than 5% owned	26.9	38.9
Commercial real estate finance	14.3	6.7
<b>Total</b>	<b>\$ 285.9</b>	<b>\$ 238.8</b>
Percentage of total portfolio	6.4%	5.3%

<sup>(1)</sup> Workout loans and debt securities exclude equity securities that are included in the total Grade 4 and 5 assets above.

In general, interest is not accrued on loans and debt securities if we have doubt about interest collection or where the enterprise value of the portfolio company may not support further accrual. In addition, interest may not accrue on loans to portfolio companies that are more than 50% owned by us depending on such company's capital requirements. To the extent interest payments are received on a loan that is not accruing interest, we may use such payments to reduce our cost basis in the investment in lieu of recognizing interest income. At March 31, 2007, and December 31, 2006, our Class A equity interests in BLX of \$85.8 million and \$66.6 million, which represented 1.9% and 1.5% of the total portfolio at value, respectively, were included in non-accruals. See Private Finance, Business Loan Express, LLC above.

**Loans and Debt Securities Over 90 Days Delinquent.** Loans and debt securities greater than 90 days delinquent at value at March 31, 2007, and December 31, 2006, were as follows:

	2007	2006
<b>(\$ in millions)</b>		
Private finance	\$ 161.4	\$ 46.5
Commercial mortgage loans	17.9	1.9
<b>Total</b>	<b>\$ 179.3</b>	<b>\$ 48.4</b>
Percentage of total portfolio	4.0%	1.1%

The amount of loans and debt securities over 90 days delinquent increased to \$179.3 million at March 31, 2007, from \$48.4 million at December 31, 2006. The increase in loans and debt securities over 90 days delinquent primarily



relates to not receiving payment on our Class A equity interests of BLX of \$85.8 million, which represented 1.9% of the total portfolio at value. The Class A equity interests were placed on non-accrual during the fourth quarter of 2006. See Private Finance, Business Loan Express, LLC above.

The amount of the portfolio that is on non-accrual status or greater than 90 days delinquent may vary from period to period. Loans and debt securities on non-accrual status and over 90 days delinquent should not be added together as they are two separate measures of portfolio asset quality. Loans and debt securities that are in both categories (i.e., on non-accrual status and over 90 days delinquent) totaled \$159.2 million and \$44.3 million at March 31, 2007 and December 31, 2006, respectively.

## **PORTFOLIO RETURNS**

Since our merger on December 31, 1997, through March 31, 2007, our combined aggregate cash flow internal rate of return, or IRR, has been approximately 22% for private finance and CMBS/ CDO investments exited during this period. The IRR is calculated using the aggregate portfolio cash flow for all investments exited over this period. For investments exited during this period, we invested capital totaling \$4.0 billion. The weighted average holding period of these investments was 35 months. Investments are considered to be exited when the original investment objective has been achieved through the receipt of cash and/or non-cash consideration upon the repayment of our debt investment or sale of an equity investment, or through the determination that no further consideration was collectible and, thus, a loss may have been realized. The aggregate cash flow IRR for private finance investments exited was approximately 21% and for CMBS/ CDO investments exited was approximately 24% for the same period. The weighted average holding period of the private finance and CMBS/ CDO investments was 46 months and 22 months, respectively, for the same period. These IRR results represent historical results. Historical results are not necessarily indicative of future results.

## **OTHER ASSETS AND OTHER LIABILITIES**

Other assets is composed primarily of fixed assets, assets held in deferred compensation trusts, prepaid expenses, deferred financing and offering costs, and accounts receivable, which includes amounts received in connection with the sale of portfolio companies, including amounts held in escrow, and other receivables from portfolio companies. At March 31, 2007, and December 31, 2006, other assets totaled \$148.0 million and \$123.0 million, respectively.

Accounts payable and other liabilities is primarily composed of the liabilities related to the deferred compensation trust and accrued interest, bonus and taxes, including excise tax. At March 31, 2007, and December 31, 2006, accounts payable and other liabilities totaled \$116.3 million and \$147.1 million, respectively. The decrease since year end was primarily the result of the payment of liabilities at December 31, 2006, in the first quarter of 2007 related to accrued 2006 bonuses of \$38.0 million, excise tax of \$15.4 million and an extra dividend of \$7.5 million, offset by an increase in liabilities for the first quarter of 2007 related to accrued 2007 bonuses and excise taxes totaling \$13.4 million and an increase in accrued interest payable of \$12.5 million. Accrued interest fluctuates from period to period depending on the amount of debt outstanding and the contractual payment dates of the interest on such debt.

**RESULTS OF OPERATIONS****Comparison of the Three Months Ended March 31, 2007 and 2006**

The following table summarizes our operating results for the three months ended March 31, 2007 and 2006.

	For the Three Months Ended March 31,		Change	Percent Change
	2007	2006		
<b>(in thousands, except per share amounts)</b>				
<b>(unaudited)</b>				
<b>Interest and Related Portfolio Income</b>				
Interest and dividends	\$ 101,983	\$ 88,881	\$ 13,102	15%
Fees and other income	5,969	22,130	(16,161)	(73)%
Total interest and related portfolio income	107,952	111,011	(3,059)	(3)%
<b>Expenses</b>				
Interest	30,288	24,485	5,803	24%
Employee	21,928	21,428	500	2%
Employee stock options	3,661	3,606	55	2%
Administrative	13,224	11,334	1,890	17%
Total operating expenses	69,101	60,853	8,248	14%
Net investment income before income taxes	38,851	50,158	(11,307)	(23)%
Income tax expense (benefit), including excise tax	(649)	8,858	(9,507)	(107)%
Net investment income	39,500	41,300	(1,800)	(4)%
<b>Net Realized and Unrealized Gains (Losses)</b>				
Net realized gains	27,666	432,835	(405,169)	*
Net change in unrealized appreciation or depreciation	65,920	(374,548)	440,468	*
Total net gains (losses)	93,586	58,287	35,299	*
Net income	\$ 133,086	\$ 99,587	\$ 33,499	34%
Diluted earnings per common share	\$ 0.87	\$ 0.70	\$ 0.17	24%
Weighted average common shares outstanding diluted	152,827	141,738	11,089	8%

\* Net change in unrealized appreciation or depreciation and net gains (losses) can fluctuate significantly from period to period. As a result, comparisons may not be meaningful.

**Total Interest and Related Portfolio Income.** Total interest and related portfolio income includes interest and dividend income and fees and other income.

**Interest and Dividends.** Interest and dividend income for the three months ended March 31, 2007 and 2006, was composed of the following:

	2007	2006
<b>(\$ in millions)</b>		
<b>Interest</b>		
Private finance loans and debt securities	\$ 96.6	\$ 82.6
Commercial mortgage loans	1.3	2.8
Cash, U.S. Treasury bills, money market and other securities	2.8	2.9
<b>Total interest</b>	<b>100.7</b>	<b>88.3</b>
<b>Dividends</b>	<b>1.3</b>	<b>0.6</b>
<b>Total interest and dividends</b>	<b>\$ 102.0</b>	<b>\$ 88.9</b>

The level of interest income, which includes interest paid in cash and in kind, is directly related to the balance of the interest-bearing investment portfolio outstanding during the period multiplied by the weighted average yield. The interest-bearing investments in the portfolio at value and the yield on the interest-bearing investments in the portfolio at March 31, 2007 and 2006, were as follows:

<b>(\$ in millions)</b>	2007		2006	
	Value	Yield <sup>(1)</sup>	Value	Yield <sup>(1)</sup>
Private finance loans and debt securities	\$ 3,091.3	11.7%	\$ 2,530.0	12.5%
Commercial mortgage loans	72.2	7.5%	102.7	7.6%
<b>Total</b>	<b>\$ 3,163.5</b>	<b>11.6%</b>	<b>\$ 2,632.7</b>	<b>12.3%</b>

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

Our interest income from our private finance loans and debt securities has increased year over year primarily as a result of the growth in this portfolio, net of the reduction in yield. The private finance portfolio yield at March 31, 2007, of 11.7% as compared to the private finance portfolio yield of 12.5% at March 31, 2006, reflects the mix of debt investments in the private finance portfolio. The weighted average yield varies from period to period based on the current stated interest on loans and debt securities and the amount of loans and debt securities for which interest is not accruing. See the discussion of the private finance portfolio yield above under the caption **Portfolio and Investment Activity Private Finance**.

Interest income from cash, U.S. Treasury bills, money market and other securities results primarily from interest earned on our liquidity portfolio. See **Financial Condition, Liquidity and Capital Resources** below. The value and weighted average yield of the liquidity portfolio was \$205.0 million and 5.3%, respectively, at March 31, 2007, and

\$201.8 million and 5.3%, respectively, at December 31, 2006.

Dividend income results from the dividend yield on preferred equity interests, if any, or the declaration of dividends by a portfolio company on preferred or common equity interests. Dividend income will vary from period to period depending upon the timing and amount of dividends that are declared or paid by a portfolio company on preferred or common equity interests.

*Fees and Other Income.* Fees and other income primarily include fees related to financial structuring, diligence, transaction services, management and consulting services to portfolio companies, commitments, guarantees, and other services and loan prepayment premiums. As a business development company, we are

required to make significant managerial assistance available to the companies in our investment portfolio. Managerial assistance includes, but is not limited to, management and consulting services related to corporate finance, marketing, human resources, personnel and board member recruiting, business operations, corporate governance, risk management and other general business matters.

Fees and other income for the three months ended March 31, 2007 and 2006, included fees relating to the following:

	2007	2006
<b>(\$ in millions)</b>		
Structuring and diligence	\$ 1.8	\$ 11.0
Management, consulting and other services provided to portfolio companies <sup>(1)</sup>	1.8	4.1
Commitment, guaranty and other fees from portfolio companies <sup>(2)</sup>	2.0	1.7
Loan prepayment premiums	0.3	5.3
Other income	0.1	
 Total fees and other income	 \$ 6.0	 \$ 22.1

(1) 2006 includes \$1.8 million in management fees from Advantage prior to its sale on March 29, 2006. See Portfolio and Investment Activity above for further discussion.

(2) Includes guaranty and other fees from BLX of \$1.4 million and \$1.6 million for 2007 and 2006, respectively. See Private Finance, Business Loan Express, LLC above.

Fees and other income are generally related to specific transactions or services and therefore may vary substantially from period to period depending on the level of investment activity and types of services provided. Loan origination fees that represent yield enhancement on a loan are capitalized and amortized into interest income over the life of the loan.

Structuring and diligence fees primarily relate to the level of new investment originations. Private finance investments funded were \$170.2 million for the three months ended March 31, 2007, as compared to \$795.9 million for the three months ended March 31, 2006.

Loan prepayment premiums for the three months ended March 31, 2006, included \$5.0 million related to the repayment of our subordinated debt in connection with the sale of our majority equity interest in Advantage on March 29, 2006. See Portfolio and Investment Activity above for further discussion. While the scheduled maturities of private finance and commercial real estate loans generally 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. Therefore, we generally structure our loans to require a prepayment premium for the first three to five years of the loan. Accordingly, the amount of prepayment premiums will vary depending on the level of repayments and the age of the loans at the time of repayment.

*Mercury and BLX.* Mercury and BLX were our largest investments at value at March 31, 2007 and 2006, and together represented 10.6% and 12.3% of our total assets, respectively.

Total interest and related portfolio income from these investments for the three months ended March 31, 2007 and 2006, was as follows:

	2007	2006
<b>(\$ in millions)</b>		
Mercury	\$ 2.1	\$ 3.1
BLX	\$ 1.4	\$ 6.1

See Portfolio and Investment Activity above for further detail on Mercury and BLX.

**Operating Expenses.** Operating expenses include interest, employee, employee stock options, and administrative expenses.

*Interest Expense.* The fluctuations in interest expense during the three months ended March 31, 2007 and 2006, were primarily attributable to changes in the level of our borrowings under various notes payable and our revolving line of credit. Our borrowing activity and weighted average cost of debt, including fees and debt financing costs, at and for the three months ended March 31, 2007 and 2006, were as follows:

	2007	2006
<b>(\$ in millions)</b>		
Total outstanding debt	\$ 1,891.5	\$ 1,274.2
Average outstanding debt	\$ 1,841.2	\$ 1,491.5
Weighted average cost <sup>(1)</sup>	6.5%	6.5%

<sup>(1)</sup> The weighted average annual interest cost is computed as the (a) annual stated interest rate on the debt plus the annual amortization of commitment fees, other facility fees and debt financing costs that are recognized into interest expense over the contractual life of the respective borrowings, divided by (b) debt outstanding on the balance sheet date.

In addition, interest expense included interest paid to the Internal Revenue Service related to installment sale gains totaling \$0.3 million and \$0.2 million for the three months ended March 31, 2007 and 2006, respectively. Installment interest expense for the year ended December 31, 2007, is estimated to be a total of \$6.4 million. See Dividends and Distributions below.

*Employee Expense.* Employee expenses for the three months ended March 31, 2007 and 2006, were as follows:

	2007	2006
<b>(\$ in millions)</b>		
Salaries and employee benefits	\$ 21.4	\$ 17.3
Individual performance award (IPA)	2.5	1.7
IPA mark to market expense (benefit)	(4.0)	1.0
Individual performance bonus (IPB)	2.0	1.4
<b>Total employee expense</b>	<b>\$ 21.9</b>	<b>\$ 21.4</b>
Number of employees at end of period	170	155

The change in salaries and employee benefits reflects the effect of an increase in number of employees, compensation increases, and the change in mix of employees given their area of responsibility and relevant experience level. Salaries and employee benefits include an accrual for employee bonuses, which are generally paid annually after the completion of the fiscal year. The quarterly accrual is based upon an estimate of annual bonuses and is subject to change. The amount of the current year bonuses will be finalized by the Compensation Committee and the Board of Directors at the end of the year. Salaries and employee benefits included accrued bonuses of \$10.4 million and \$7.9 million for the three months ended March 31, 2007 and 2006, respectively.

The IPA is a long-term incentive compensation program for certain officers. The IPA, which is generally determined annually at the beginning of each year, is deposited into a deferred compensation trust generally in four equal installments, on a quarterly basis, in the form of cash. The trustee is required to use the cash to purchase shares of our common stock in the open market. The accounts of the trust are consolidated with our accounts. We are required to mark to market the liability of the trust and this adjustment is recorded to the IPA compensation expense. Because the IPA is deferred compensation, the cost of this award is not a current expense for purposes of computing our taxable income. The expense is deferred for tax purposes until distributions are made from the trust.



We also have an IPB, which is distributed in cash to award recipients equally throughout the year (beginning in February of each year) as long as the recipient remains employed by us.

The Compensation Committee and the Board of Directors have determined the IPA and the IPB for 2007 and they are currently estimated to be approximately \$10 million each; however, the Compensation Committee may adjust the IPA or IPB as needed, or make new awards as new officers are hired. If a recipient terminates employment during the year, any further cash contribution for the IPA or remaining cash payments under the IPB would be forfeited.

In connection with our 2006 Annual Meeting of Stockholders, the stockholders approved the issuance of up to 2.5 million shares of our common stock in exchange for the cancellation of vested in-the-money stock options granted to certain officers and directors under our Amended Stock Option Plan. Under the initiative, which has been reviewed and approved by our Board of Directors, all optionees who hold vested stock options with exercise prices below the market value of the stock (or in-the-money options), would be offered the opportunity to receive an Option Cancellation Payment (OCP) equal to the in-the-money value of the stock options cancelled, which would be paid one-half in cash and one-half in shares of our common stock, in exchange for their voluntary cancellation of their vested stock options. As part of this initiative, the Board of Directors has adopted a target ownership program that establishes minimum ownership levels for our senior officers and continues to further align the interests of our officers with those of our stockholders. We have not yet implemented the OCP as of May 8, 2007, but intend to do so in the future.

Based on the 13 million vested options outstanding and the market price of \$30.50 of our stock on March 10, 2006, the date used for disclosure in our 2006 proxy, the OCP would be approximately \$106 million if all option holders choose to cancel all vested in-the-money options in exchange for the OCP. As of March 31, 2007, there were 17 million vested options outstanding, of which 13 million were in-the-money. Using the market price of \$28.81 of our stock on March 31, 2007, the OCP would be approximately \$86 million if all option holders choose to cancel all vested in-the-money options in exchange for the OCP. As the consideration paid by us for the OCP will not exceed the fair value of the options to be canceled, no expense will be recorded for the transaction in accordance with the guidance in FASB Statement No. 123 (Revised 2004). However, the cash portion of the OCP, or approximately one-half of the payment, will reduce our paid in capital and will therefore reduce our net asset value. For income tax purposes, our tax expense resulting from the OCP would be similar to the tax expense that would result from an exercise of stock options in the market. Any tax deduction for us resulting from the OCP or an exercise of stock options in the market would be limited by Section 162(m) of the Code for persons subject to Section 162(m).

*Stock Options Expense.* In December 2004, the FASB issued Statement No. 123 (Revised 2004), Share-Based Payment (the Statement), which requires companies to recognize the grant-date fair value of stock options and other equity-based compensation issued to employees in the income statement. The Statement was effective January 1, 2006, and it applies to our stock option plan. Our employee stock options are typically granted with ratable vesting provisions, and we amortize the compensation cost over the related service period. The Statement was adopted using the modified prospective method of application, which required us to recognize compensation costs on a prospective basis beginning January 1, 2006. Under this method, the unamortized cost of previously awarded options that were unvested as of January 1, 2006, is recognized over the remaining service period in the statement of operations beginning in 2006, using the fair value amounts determined for proforma disclosure under Statement No. 123. With respect to options granted on or after January 1, 2006, compensation cost based on estimated grant date fair value is recognized in the statement of operations over the service period. The stock option expense for the three months ended March 31, 2007 and 2006, was as follows:

	2007	2006
<b>(\$ in millions)</b>		
<b>Employee Stock Option Expense:</b>		
Previously awarded, unvested options as of January 1, 2006	\$ 3.2	\$ 3.4
Options granted on or after January 1, 2006	0.5	0.2
Total employee stock option expense	\$ 3.7	\$ 3.6



We estimate that the employee-related stock option expense under the Statement that will be recorded in our statement of operations will be approximately \$11.8 million, \$4.0 million, and \$0.1 million for the years ended December 31, 2007, 2008, and 2009, respectively, which includes approximately \$1.9 million, \$1.0 million, and \$0.1 million, respectively, related to options granted since adoption of the Statement (January 1, 2006). This estimate may change if our assumptions related to future option forfeitures change. This estimate does not include any expense related to future stock option grants as the fair value of those stock options will be determined at the time of grant.

*Administrative Expense.* Administrative expenses include legal and accounting fees, valuation assistance fees, insurance premiums, the cost of leases for our headquarters in Washington, DC, and our regional offices, portfolio origination and development expenses, travel costs, stock record expenses, directors' fees and stock option expense, and various other expenses. Administrative expenses for the three months ended March 31, 2007 and 2006, were as follows:

	2007	2006
<b>(\$ in millions)</b>		
Administrative expenses	\$ 9.9	\$ 8.4
Investigation related costs	3.3	2.9
<b>Total administrative expenses</b>	<b>\$ 13.2</b>	<b>\$ 11.3</b>

Administrative expenses for the three months ended March 31, 2007, included costs of \$1.4 million incurred to engage a third party to work with BLX, a portfolio company controlled by us, to conduct a review of BLX's current internal control systems, with a focus on preventing fraud and further strengthening BLX's operations. See *Private Finance, Business Loan Express, LLC* above. Excluding these costs, administrative expenses for the three months ended March 31, 2007, were \$8.5 million as compared to \$8.4 million for the three months ended March 31, 2006.

Investigation related costs include costs associated with requests for information in connection with government investigations and other legal matters. We expect that we will continue to incur legal and other costs associated with these matters. These expenses remain difficult to predict. See *Legal Proceedings* under Item 1 of Part II.

*Income Tax Expense (Benefit), Including Excise Tax.* Income tax expense (benefit) for the three months ended March 31, 2007 and 2006, was as follows:

	2007	2006
<b>(\$ in millions)</b>		
Income tax expense (benefit)	\$ (4.2)	\$ 0.5
Excise tax expense	3.6	8.4
<b>Income tax expense (benefit), including excise tax</b>	<b>\$ (0.6)</b>	<b>\$ 8.9</b>

Our wholly owned subsidiary, A.C. Corporation, is a corporation subject to federal and state income taxes and records a benefit or expense for income taxes as appropriate based on its operating results in a given period.

Our estimated annual taxable income for 2007 currently exceeds our estimated dividend distributions to shareholders from such taxable income in 2007, and such estimated excess taxable income will be distributed in 2008. Therefore, we will generally be required to pay a 4% excise tax on the excess of 98% of our taxable income over the amount of actual distributions from such taxable income. We have recorded an estimated excise tax of \$3.6 million for the three months ended March 31, 2007. See *Dividends and Distributions*. While excise tax expense is presented in the Consolidated Statement of Operations as a reduction to net investment income, excise tax relates to both net investment income and net realized gains.



In June 2006, the FASB issued Interpretation No. 48, *Accounting for Uncertainty in Income Taxes*, which clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with FASB Statement No. 109, *Accounting for Income Taxes*. This interpretation is effective for fiscal years beginning after December 15, 2006. The adoption of this interpretation did not have a significant effect on our consolidated financial position or our results of operations.

**Realized Gains and Losses.** Net realized gains primarily result from the sale of equity securities associated with certain private finance investments 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 for the three months ended March 31, 2007 and 2006, were as follows:

(\$ in millions)	2007	2006
Realized gains	\$ 33.2	\$ 436.5
Realized losses	(5.5)	(3.7)
Net realized gains	\$ 27.7	\$ 432.8

When we exit an investment and realize a gain or loss, we make an accounting entry to reverse any unrealized appreciation or depreciation, respectively, we had previously recorded to reflect the appreciated or depreciated value of the investment. For the three months ended March 31, 2007 and 2006, we reversed previously recorded unrealized appreciation or depreciation when gains or losses were realized as follows:

(\$ in millions)	2007	2006
Reversal of previously recorded net unrealized appreciation associated with realized gains	\$ (32.1)	\$ (393.6)
Reversal of previously recorded net unrealized depreciation associated with realized losses	5.8	2.7
Total reversal	\$ (26.3)	\$ (390.9)

Realized gains for the three months ended March 31, 2007 and 2006, were as follows:  
(\$ in millions)

	2007	
	Portfolio Company	Amount
<b>Private Finance:</b>		
Palm Coast Data, LLC		\$ 20.0
Mogas Energy, LLC		4.5
Tradesmen International, Inc.		3.8
ForeSite Towers, LLC		3.8
Other		1.1
Total realized gains		\$ 33.2

2006

Portfolio Company	Amount
<b>Private Finance:</b>	
Advantage Sales & Marketing, Inc.	\$ 433.1
Nobel Learning Communications, Inc.	1.5
The Debt Exchange, Inc.	1.1
Other	0.2
 Total private finance	 435.9
<b>Commercial Real Estate:</b>	
Other	0.6
 Total commercial real estate	 0.6
 Total realized gains	 \$ 436.5

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Realized losses for the three months ended March 31, 2007 and 2006, were as follows:  
(\$ in millions)

## 2007

Portfolio Company	Amount
<b>Private Finance:</b>	
Legacy Partners Group, LLC	\$ 5.8
Other	(0.3)
Total realized losses	\$ 5.5

## 2006

Portfolio Company	Amount
<b>Private Finance:</b>	
Aspen Pet Products, Inc.	\$ 1.5
Nobel Learning Communities, Inc.	1.4
Other	0.5
Total private finance	3.4
<b>Commercial Real Estate:</b>	
Other	0.3
Total commercial real estate	0.3
Total realized losses	\$ 3.7

**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 in our statement of operations. 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 our valuation policy and a consistently applied valuation process. At March 31, 2007, portfolio investments recorded at fair value were approximately 90% of our total assets. 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 portfolio 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 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/or our equity security has 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 have invested in illiquid securities including debt and equity securities of companies and CDO and CLO bonds and preferred shares/income notes. The structure of each 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 may be subject to certain 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. However, we must derive a single estimate of enterprise value. To determine the enterprise value of a portfolio company, we analyze its historical and projected financial results. This financial and other information is generally obtained from the portfolio companies, and may represent unaudited, projected or pro forma financial information. We generally require portfolio companies to provide annual audited and quarterly 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 U.S. generally accepted accounting principles 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 U.S. generally accepted accounting principles. 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 generally look to private merger and acquisition statistics, the entry multiple for the transaction, 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 is determined based on various factors, including the enterprise value remaining for equity holders after the repayment of the portfolio company's debt and other preference capital, and other pertinent factors such as recent offers to purchase a portfolio company, recent transactions involving the purchase or sale of the portfolio company's equity securities, liquidation events, or other 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.

CDO/CLO Assets are carried at fair value, which is based on a discounted cash flow model that utilizes prepayment, re-investment and loss assumptions based on historical experience and projected performance, economic factors, the characteristics of the underlying cash flow and comparable yields for similar bonds and preferred shares/income notes, when available. We recognize unrealized appreciation or depreciation on our CDO/CLO Assets as comparable yields in the market change and/ or based on changes in estimated cash flows resulting from changes in prepayment, re-investment or loss assumptions in the underlying collateral pool. We determine the fair value of our CDO/CLO Assets on an individual security-by-security basis. If we were to sell

a group of these CDO/CLO Assets in a pool in one or more transactions, the total value received for that pool may be different than the sum of the fair values of the individual assets.

As a participant in the private equity business, we invest primarily in private middle market companies for which there is generally no publicly available information. Because of the private nature of these businesses, there is a need to maintain the confidentiality of the financial and other information that we have for the private companies in our portfolio. We believe that maintaining this confidence is important, as disclosure of such information could disadvantage our portfolio companies and could put us at a disadvantage in attracting new investments. Therefore, we do not intend to disclose financial or other information about our portfolio companies, unless required, because we believe doing so may put them at an economic or competitive disadvantage, regardless of our level of ownership or control.

We currently intend to continue to work with third-party consultants to obtain assistance in determining fair value for a portion of the private finance portfolio each quarter. We work with these consultants to obtain assistance as additional support in the preparation of our internal valuation analysis. In addition, we may receive third-party assessments of a particular private finance portfolio company's value in the ordinary course of business, most often in the context of a prospective sale transaction or in the context of a bankruptcy process. The valuation analysis prepared by management using these third-party valuation resources, when applicable, is submitted to our Board of Directors for its determination of fair value of the portfolio in good faith.

We receive third-party valuation assistance from Duff & Phelps, LLC (Duff & Phelps) and Houlihan Lokey Howard and Zukin for our private finance portfolio. For the three months ended March 31, 2007 and 2006, we received third-party valuation assistance as follows:

	<b>2007</b>	<b>2006</b>
	<b>Q1</b>	<b>Q1</b>
Number of private finance portfolio companies reviewed	88	78
Percentage of private finance portfolio reviewed at value	91.8%	87.0%

Professional fees for third-party valuation assistance were \$1.5 million for the year ended December 31, 2006, and are estimated to be approximately \$1.6 million for 2007.

*Net Change in Unrealized Appreciation or Depreciation.* Net change in unrealized appreciation or depreciation for the three months ended March 31, 2007 and 2006, consisted of the following:

	<b>2007<sup>(1)</sup></b>	<b>2006<sup>(1)</sup></b>
<b>(\$ in millions)</b>		
Net unrealized appreciation (depreciation)	\$ 92.2	\$ 16.4
Reversal of previously recorded unrealized appreciation associated with realized gains	(32.1)	(393.6)
Reversal of previously recorded unrealized depreciation associated with realized losses	5.8	2.7
Net change in unrealized appreciation or depreciation	\$ 65.9	\$ (374.5)

<sup>(1)</sup> The net change in unrealized appreciation or depreciation can fluctuate significantly from period to period. As a result, quarterly comparisons may not be meaningful.

**Valuation of Mercury Air Centers, Inc.** In April 2007, we signed a definitive agreement to sell our majority equity interest in Mercury for an enterprise value of approximately \$427 million, subject to pre-and post-closing adjustments. See Portfolio and Investment Activity above. At March 31, 2007, we estimated the enterprise value of Mercury to be \$384 million given that the closing of the transaction is subject to certain closing conditions, including regulatory approvals, and the sales price is subject to pre-and post-closing adjustments and certain holdback provisions. Using the enterprise value at March 31, 2007, of \$384 million we

determined the value of our investments in Mercury to be \$301.4 million, which resulted in unrealized appreciation of \$216.6 million at March 31, 2007. This is an increase in unrealized appreciation in the first quarter of 2007 of \$56.7 million. We received valuation assistance from Duff & Phelps for our investment in Mercury at March 31, 2007, and December 31, 2006. The transaction is expected to close in the third quarter of 2007, upon satisfying certain closing conditions, including regulatory approvals.

**Valuation of Business Loan Express, LLC.** Our investment in BLX totaled \$314.5 million at cost and \$229.9 million at value at March 31, 2007, and \$295.3 million at cost and \$210.7 million at value at December 31, 2006. To determine the value of our investment in BLX at March 31, 2007, we performed numerous valuation analyses to determine a range of values including: (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; (4) a discounted dividend analysis; and (5) adding BLX's net asset value (adjusted for certain discounts) to the estimated value of BLX's business operations, which was determined by using a discounted cash flow model. In performing the valuation analyses at March 31, 2007, we continued to consider the impact of various changes in BLX's business model due to the competitive environment for small business loans and BLX's newer non-SBA real estate lending products. We also continued to consider BLX's current regulatory issues and ongoing investigations. (See Private Finance, Business Loan Express, LLC above.) We received valuation assistance from Duff & Phelps for our investment in BLX at March 31, 2007, and December 31, 2006.

With respect to the analysis of comparable public company trading multiples and the analysis of BLX's value assuming an initial public offering, we compute a median trailing and forward price earnings multiple to apply to BLX's pro-forma net income adjusted for certain capital structure changes that we believe would likely occur should the company be sold. Each quarter we evaluate which public commercial finance companies should be included in the comparable group. The comparable group at March 31, 2007, was made up of CIT Group, Inc., Financial Federal Corporation, GATX Corporation, and Marlin Business Services Corporation, which is consistent with the comparable group at December 31, 2006.

Our investment in BLX at March 31, 2007, was valued at \$229.9 million. This fair value was within the range of values determined by our valuation analyses discussed above. Unrealized depreciation on our investment was \$84.6 million at March 31, 2007. Net change in unrealized appreciation or depreciation included no change for the three months ended March 31, 2007, and a net decrease of \$22.7 million for the three months ended March 31, 2006.

**Per Share Amounts.** All per share amounts included in the Management's Discussion and Analysis of Financial Condition and Results of Operations section have been computed using the weighted average common shares used to compute diluted earnings per share, which were 152.8 million and 141.7 million for the three months ended March 31, 2007 and 2006, respectively.

#### **OTHER MATTERS**

**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 (the Code). As long as we qualify as a regulated investment company, we are not taxed on our investment company taxable income or realized net capital gains, to the extent that such taxable income or gains are distributed, or deemed to be distributed, to shareholders on a timely basis.

Dividends are paid to shareholders from taxable income. Taxable income generally differs from net income for financial reporting purposes due to temporary and permanent differences in the recognition of income and expenses, and generally excludes net unrealized appreciation or depreciation, as gains or losses are not included in taxable income until they are realized. In addition, gains realized for financial reporting purposes may differ from gains included in taxable income as a result of our election to recognize gains using installment sale

treatment, which results in the deferment of gains for tax purposes until notes or other amounts, including amounts held in escrow, received as consideration from the sale of investments are collected in cash. See Dividends and Distributions below.

Dividends declared and paid by us in a year generally differ from taxable income for that year as such dividends may include the distribution of current year taxable income, the distribution of prior year taxable income carried over into and distributed in the current year, or returns of capital. We are generally required to distribute 98% of our taxable income during the year the income is earned to avoid paying an excise tax. If this requirement is not met, the Code imposes a nondeductible excise tax equal to 4% of the amount by which 98% of the current year's taxable income exceeds the distribution for the year. The taxable income on which an excise tax is paid is generally carried over and distributed to shareholders in the next tax year. Depending on the level of taxable income earned in a tax year, we may choose to carry over taxable income in excess of current year distributions from such taxable income into the next tax year and pay a 4% excise tax on such income, as required. See Dividends and Distributions below.

In order to maintain our status as a regulated investment company and obtain regulated investment company tax benefits, 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 asset diversification requirements as defined in the Code; and (4) timely distribute to shareholders at least 90% of our annual investment company taxable income as defined in the 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.

#### **DIVIDENDS AND DISTRIBUTIONS**

Dividends to common shareholders for the three months ended March 31, 2007 and 2006, were \$95.8 million and \$82.5 million, respectively, or \$0.63 per common share for the first quarter of 2007 and \$0.59 per common share for the first quarter of 2006. An extra cash dividend of \$0.05 per common share was declared during 2006 and was paid to shareholders on January 19, 2007. An extra cash dividend of \$0.03 per common share was declared during 2005 and was paid to shareholders on January 27, 2006.

The Board of Directors has declared a dividend of \$0.64 per common share for the second quarter of 2007.

Our Board of Directors reviews the dividend rate quarterly, and may adjust the quarterly dividend throughout the year. Dividends are declared considering our estimate of annual taxable income available for distribution to shareholders and the amount of taxable income carried over from the prior year for distribution in the current year. Our goal is to declare what we believe to be sustainable increases in our regular quarterly dividends. To the extent that we earn annual taxable income in excess of dividends paid from such taxable income for the year, we may carry over the excess taxable income into the next year and such excess income will be available for distribution in the next year as permitted under the Code (see discussion below). Such income will be treated under the Code as having been distributed during the prior year for purposes of our qualification for RIC tax treatment for such year. The maximum amount of excess taxable income that we may carry over for distribution in the next year under the Code is the total amount of dividends paid in the following year, subject to certain declaration and payment guidelines. Excess taxable income carried over and paid out in the next year is generally subject to a 4% excise tax. We believe that carrying over excess taxable income into future periods may provide increased visibility with respect to taxable earnings available to pay the regular quarterly dividend.

Taxable income includes our taxable interest, dividend and fee income, as well as taxable net capital gains. Taxable income generally differs from net income for financial reporting purposes due to temporary and permanent differences in the recognition of income and expenses, and generally excludes net unrealized appreciation or depreciation, as gains or losses are not included in taxable income until they are realized. In

addition, gains realized for financial reporting purposes may differ from gains included in taxable income as a result of our election to recognize gains using installment sale treatment, which generally results in the deferment of gains for tax purposes until notes or other amounts, including amounts held in escrow, received as consideration from the sale of investments are collected in cash. Taxable income includes non-cash income, such as changes in accrued and reinvested interest and dividends, which includes contractual payment-in-kind interest, and the amortization of discounts and fees. Cash collections of income resulting from contractual payment-in-kind interest or the amortization of discounts and fees generally occur upon the repayment of the loans or debt securities that include such items. Non-cash taxable income is reduced by non-cash expenses, such as realized losses and depreciation and amortization expense.

Our estimated annual taxable income for 2006 exceeded our dividend distributions to shareholders for 2006 from such taxable income, and, therefore, we have carried over excess taxable income, which is currently estimated to be \$397.1 million, for distribution to shareholders in 2007. Estimated excess taxable income for 2006 represents approximately \$120.6 million of ordinary income and approximately \$276.5 million of net long-term capital gains. Our taxable income for 2006 is an estimate and will not be finally determined until we file our 2006 tax return in September 2007. Therefore, the excess taxable income earned in 2006 and carried forward for distribution in 2007 may be different than this estimate.

Dividends for 2007 will first be paid out of the excess taxable income carried over from 2006. Given our regular quarterly dividend payout, which for the first quarter of 2007 was \$95.8 million, we expect that substantially all of the 2007 dividend payments will be made from excess 2006 taxable earnings. Given the significant amount of estimated excess taxable income carried forward from 2006 for distribution in 2007, we currently expect that our estimated annual taxable income for 2007 will be significantly in excess of our estimated dividend distributions to shareholders in 2007 from such taxable income, and, therefore, we expect to carry over excess taxable income for distribution to shareholders in 2008. We expect that we will generally be required to pay a 4% excise tax on the excess of 98% of our taxable income for 2007 over the amount of actual distributions from such taxable income in 2007. For the three months ended March 31, 2007, we have recorded an excise tax of \$3.6 million. Excise taxes are accrued based upon estimated excess taxable income as estimated taxable income is earned, therefore, the excise tax accrued to date in 2007 may be adjusted as appropriate in the remainder of 2007 to reflect changes in our estimate of the carry over amount and additional excise tax may be accrued during the remainder of 2007 as additional excess taxable income is earned, if any. Our ability to earn the estimated annual taxable income for 2007 depends on many factors, including our ability to make new investments at attractive yields, the level of repayments in the portfolio, the realization of gains or losses from portfolio exits, and the level of operating expenses incurred. See Management's Discussion and Analysis of Financial Condition and Results of Operations and Risk Factors.

In addition to excess taxable income available to be carried over from one tax year for distribution in the following tax year, we currently estimate that we have cumulative deferred taxable income related to installment sale gains of \$220.7 million as of December 31, 2006. These gains have been recognized for financial reporting purposes in the respective years they were realized, but will be deferred for tax purposes until the notes or other amounts received from the sale of the related investments are collected in cash. The installment sale gains for 2006 are estimates and will not be finally determined until we file our 2006 tax return in September 2007. See Other Matters Regulated Investment Company Status above.

To the extent that installment sale gains are deferred for recognition in taxable income, we pay interest to the Internal Revenue Service. Installment-related interest expense for the three months ended March 31, 2007 and 2006 was \$0.3 million and \$0.2 million, respectively. See Results of Operations above.

**FINANCIAL CONDITION, LIQUIDITY AND CAPITAL RESOURCES**

At March 31, 2007, and December 31, 2006, our liquidity portfolio, cash and investments in money market and other securities, total assets, total debt outstanding, total shareholders' equity, debt to equity ratio and asset coverage for senior indebtedness were as follows:

(\$ in millions)	2007	2006
Liquidity portfolio (includes money market and other securities)	\$ 205.0	\$ 201.8
Cash and investments in money market securities (including money market and other securities: 2007-\$66.2; 2006-\$0.4)	\$ 66.5	\$ 2.1
Total assets	\$ 4,986.1	\$ 4,887.5
Total debt outstanding	\$ 1,891.5	\$ 1,899.1
Total shareholders' equity	\$ 2,978.3	\$ 2,841.2
Debt to equity ratio <sup>(1)</sup>	0.64	0.67
Asset coverage ratio <sup>(2)</sup>	257%	250%

<sup>(1)</sup> The debt to equity ratio adjusted for the liquidity portfolio was 0.57 and 0.60 at March 31, 2007, and December 31, 2006, respectively, which is calculated as (a) total debt less the value of the liquidity portfolio divided by (b) total shareholders' equity.

<sup>(2)</sup> As a business development company, we are generally required to maintain a minimum ratio of 200% of total assets to total borrowings.

Cash generated from the portfolio includes cash flow from net investment income and net realized gains and principal collections related to investment repayments or sales. Cash flow provided by our operating activities before new investment activity for the three months ended March 31, 2007 and 2006, was as follows:

(\$ in millions)	2007	2006
Net cash provided by (used in) operating activities	\$ 19.4	\$ (17.7)
Add: portfolio investments funded	170.2	647.9
Total cash provided by operating activities before new investments	\$ 189.6	\$ 630.2

In addition to the net cash flow provided by our operating activities before funding investments, we have sources of liquidity through our liquidity portfolio and revolving line of credit as discussed below.

At March 31, 2007, and December 31, 2006, the value and yield of the securities in the liquidity portfolio were as follows:

(\$ in millions)	2007		2006	
	Value	Yield	Value	Yield
Money market securities	\$ 163.8	5.3%	\$ 161.2	5.3%
Certificate of Deposit <sup>(1)</sup>	41.2	5.5%	40.6	5.6%
Total	\$ 205.0	5.3%	\$ 201.8	5.3%



<sup>(1)</sup> The certificate of deposit matures in June 2007.

The liquidity portfolio was established to provide a pool of liquid assets within our balance sheet. Our investment portfolio is primarily composed of private, illiquid assets for which there is no readily available market. We assess the amount held in and the composition of the liquidity portfolio throughout the year.

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 securities. We place our 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.

We employ an asset-liability management approach that focuses on matching the estimated maturities of our investment portfolio to the estimated maturities of our borrowings. We use our revolving line of credit facility as a means to bridge to long-term financing in the form of debt or equity capital, which may or may not result in temporary differences in the matching of estimated maturities. Availability on the revolving line of credit, net of amounts committed for standby letters of credit issued under the line of credit facility, was \$888.0 million on March 31, 2007. We evaluate our interest rate exposure on an ongoing basis. Generally, we seek to fund our primarily fixed-rate debt portfolio and our equity portfolio with fixed-rate debt or equity capital. To the extent deemed necessary, we may hedge variable and short-term interest rate exposure through interest rate swaps or other techniques.

During the three months ended March 31, 2007 and 2006, and the year ended December 31, 2006, we sold new equity of \$93.8 million, \$83.0 million, and \$295.8 million, respectively, in public offerings. In addition, shareholders equity increased by \$5.8 million, \$7.7 million, and \$27.7 million through the exercise of stock options, the collection of notes receivable from the sale of common stock, and the issuance of shares through our dividend reinvestment plan for the three months ended March 31, 2007 and 2006, and the year ended December 31, 2006, respectively.

We currently target a debt to equity ratio ranging between 0.50:1.00 to 0.70:1.00 because we believe that it is prudent to operate with a larger equity capital base and less leverage.

At March 31, 2007, and December 31, 2006, we had outstanding debt as follows:

	2007			2006		
	Facility Amount	Amount Outstanding	Annual Interest Cost <sup>(1)</sup>	Facility Amount	Amount Outstanding	Annual Interest Cost <sup>(1)</sup>
(\$ in millions)						
Notes payable and debentures:						
Privately issued unsecured notes payable	\$ 1,041.5	\$ 1,041.5	6.1%	\$ 1,041.4	\$ 1,041.4	6.1%
Publicly issued unsecured notes payable	850.0	850.0	6.7%	650.0	650.0	6.6%
Total notes payable and debentures	1,891.5	1,891.5	6.3%	1,691.4	1,691.4	6.3%
Revolving line of credit <sup>(4)</sup>	922.5		0%	922.5	207.7	6.4% <sup>(2)</sup>
Total debt	\$ 2,814.0	\$ 1,891.5	6.5% <sup>(3)</sup>	\$ 2,613.9	\$ 1,899.1	6.5% <sup>(3)</sup>

(1) The weighted average annual interest cost is computed as the (a) annual stated interest on the debt plus the annual amortization of commitment fees, other facility fees and the amortization of debt financing costs that are recognized into interest expense over the contractual life of the respective borrowings, divided by (b) debt outstanding on the balance sheet date.

(2) There were no amounts drawn on the revolving line of credit at March 31, 2007. The annual interest cost at December 31, 2006, reflects the interest rate payable for borrowings under the revolving line of credit. In addition to the current interest rate payable, there were annual costs of commitment fees, other facility fees and amortization of debt financing costs of \$3.8 million and \$3.9 million at March 31, 2007, and December 31, 2006, respectively.

(3)

The annual interest cost for total debt includes the annual cost of commitment fees and the amortization of debt financing costs on the revolving line of credit and other facility fees regardless of the amount outstanding on the facility as of the balance sheet date.

- (4) At March 31, 2007, \$888.0 million remained unused and available on the revolving line of credit, net of amounts committed for standby letters of credit of \$34.5 million issued under the credit facility.

***Privately Issued Unsecured Notes Payable.*** We have privately issued unsecured long-term notes to institutional investors, primarily insurance companies. The notes have five- or seven-year maturities, with maturity dates beginning in 2008 and have fixed rates of interest. The notes require payment of interest only semi-annually, and all principal is due upon maturity. The notes may be prepaid in whole or in part, together with an interest premium, as stipulated in the note agreements.

We have issued five-year unsecured long-term notes denominated in Euros and Sterling for a total U.S. dollar equivalent of \$15.2 million. The notes have fixed interest rates and have substantially the same terms as our other unsecured notes. The Euro notes require annual interest payments and the Sterling notes require semi-annual interest payments until maturity. Simultaneous with issuing the notes, we entered into a cross

currency swap with a financial institution which fixed our interest and principal payments in U.S. dollars for the life of the debt.

**Publicly Issued Unsecured Notes Payable.** We have outstanding publicly issued unsecured notes as follows:

(\$ in millions)	Amount	Maturity Date
6.625% Notes due 2011	\$ 400.0	July 15, 2011
6.000% Notes due 2012	250.0	April 1, 2012
6.875% Notes due 2047	200.0	April 15, 2047
Total	\$ 850.0	

The 6.625% Notes due 2011 and the 6.000% Notes due 2012 require payment of interest only semi-annually, and all principal is due upon maturity. We have the option to redeem these notes in whole or in part, together with a redemption premium, as stipulated in the notes.

On March 28, 2007, we completed the issuance of \$200.0 million of 6.875% Notes due 2047 for net proceeds of \$193.0 million (net of underwriting discounts and estimated offering expenses). In April 2007, we issued additional notes, through an over-allotment option, totaling \$30.0 million for net proceeds of \$29.1 million (net of underwriting discounts and estimated offering expenses). The notes are listed on the New York Stock Exchange under the trading symbol AFC.

The 6.875% Notes due 2047 require payment of interest only quarterly, and all principal is due upon maturity. We may redeem these notes in whole or in part at any time or from time to time on or after April 15, 2012, at par and upon the occurrence of certain tax events as stipulated in the notes.

**Revolving Line of Credit.** At March 31, 2007, and December 31, 2006, we had an unsecured revolving line of credit with a committed amount of \$922.5 million that expires on September 30, 2008. The revolving line of credit generally bears interest at a rate equal to (i) LIBOR (for the period we select) plus 1.05% or (ii) the higher of the Federal Funds rate plus 0.50% or the Bank of America N.A. prime rate. The revolving line of credit requires the payment of an annual commitment fee equal to 0.20% of the committed amount (whether used or unused). The revolving line of credit generally requires payments of interest at the end of each LIBOR interest period, but no less frequently than quarterly, on LIBOR based loans and monthly payments of interest on other loans. All principal is due upon maturity.

At March 31, 2007, there was no outstanding balance on our unsecured revolving line of credit. The amount available under the line at March 31, 2007, was \$888.0 million, net of amounts committed for standby letters of credit of \$34.5 million. Net repayments under the revolving lines of credit for the three months ended March 31, 2007, were \$207.7 million.

We have various financial and operating covenants required by the revolving line of credit and the privately issued unsecured notes payable outstanding at March 31, 2007. These covenants require us to maintain certain financial ratios, including debt to equity and interest coverage, and a minimum net worth. These credit facilities provide for customary events of default, including, but not limited to, payment defaults, breach of representations or covenants, cross-defaults, bankruptcy events, failure to pay judgments, attachment of our assets, change of control and the issuance of an order of dissolution. Certain of these events of default are subject to notice and cure periods or materiality thresholds. Our credit facilities limit our ability to declare dividends if we default under certain provisions. As of March 31, 2007, we were in compliance with these covenants.

We have certain financial and operating covenants that are required by the publicly issued unsecured notes payable, including that we will maintain a minimum ratio of 200% of total assets to total borrowings, as required by the Investment Company Act of 1940, as amended, while these notes are outstanding. At March 31, 2007, we were in compliance with these covenants.



The following table shows our significant contractual obligations for the repayment of debt and payment of other contractual obligations as of March 31, 2007.

(\$ in millions)	Payments Due By Year						
	Total	2007	2008	2009	2010	2011	After 2011
Unsecured notes payable	\$ 1,891.5	\$	\$ 153.0	\$ 269.0	\$ 408.0	\$ 472.5	\$ 589.0
Revolving line of credit <sup>(1)</sup>							
Operating leases	23.5	3.3	4.5	4.6	4.5	1.8	4.8
Total contractual obligations	\$ 1,915.0	\$ 3.3	\$ 157.5	\$ 273.6	\$ 412.5	\$ 474.3	\$ 593.8

<sup>(1)</sup> At March 31, 2007, \$888.0 million remained unused and available on the revolving line of credit, net of amounts committed for standby letters of credit of \$34.5 million issued under the credit facility.

#### Off-Balance Sheet Arrangements

In the ordinary course of business, we have issued guarantees and have extended standby letters of credit through financial intermediaries on behalf of certain portfolio companies. We have generally issued guarantees of debt, rental and lease obligations. Under these arrangements, we would be required to make payments to third-party beneficiaries if the portfolio companies were to default on their related payment obligations. The following table shows our guarantees and standby letters of credit that may have the effect of creating, increasing, or accelerating our liabilities as of March 31, 2007.

(\$ in millions)	Amount of Commitment Expiration Per Year						
	Total	2007	2008	2009	2010	2011	After 2011
Guarantees	\$ 194.5	\$ 0.3	\$ 3.0	\$ 184.9	\$	\$ 4.4	\$ 1.9
Standby letters of credit <sup>(1)</sup>	34.5	4.0	30.5				
Total commitments <sup>(2)</sup>	\$ 229.0	\$ 4.3	\$ 33.5	\$ 184.9	\$	\$ 4.4	\$ 1.9

<sup>(1)</sup> Standby letters of credit are issued under our revolving line of credit that expires in September 2008. Therefore, unless a standby letter of credit is set to expire at an earlier date, we have assumed that the standby letters of credit will expire contemporaneously with the expiration of our line of credit in September 2008.

<sup>(2)</sup> Our most significant commitments relate to our investment in Business Loan Express, LLC (BLX), which commitments totaled \$202.4 million at March 31, 2007. At March 31, 2007, we guaranteed 50% of the outstanding total obligations on BLX's revolving line of credit for a total guaranteed amount of \$179.4 million and we had also provided four standby letters of credit totaling \$20.0 million in connection with four term securitizations completed by BLX. In addition, we have agreed to purchase the \$3.0 million of Class A equity interests purchased by the chief executive officer of BLX at fair value in the event that BLX amends or otherwise restructures its existing

senior credit facility or he is terminated for any reason. See Private Finance, Business Loan Express, LLC above for further discussion.

In addition, we had outstanding commitments to fund investments totaling \$410.8 million at March 31, 2007. See Portfolio and Investment Activity Outstanding Commitments above. We intend to fund these commitments and prospective investment opportunities with existing cash, through cash flow from operations before new investments, through borrowings under our line of credit or other long-term debt agreements, or through the sale or issuance of new equity capital.

#### **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, certain revenue recognition matters and certain tax 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 and CDO and CLO bonds and preferred shares/income notes. Our investments may be subject to certain 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 portfolio 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 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/ or our equity security has also appreciated in value. The value of investments in publicly traded securities is determined using quoted market prices discounted for restrictions on resale, if any.

See Results of Operations Change in Unrealized Appreciation or Depreciation above for more discussion on portfolio valuation.

**Loans and Debt Securities.** For loans and debt securities, fair value generally approximates cost unless the borrower's enterprise value, overall financial condition or other factors lead to a determination of fair value at a different amount. The value of loan and debt securities may be greater than our cost basis if the amount that would be repaid on the loan or debt security upon the sale of the portfolio company is greater than our cost basis.

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. In general, interest is not accrued on loans and debt securities if we have doubt about interest collection or where the enterprise value of the portfolio company may not support further accrual. Loans in workout status 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 depending on such company's capital requirements. Loan origination fees, original issue discount, and market discount are capitalized and then amortized into interest income using a method that approximates the effective interest method. Upon the prepayment of a loan or debt security, any unamortized loan origination fees are recorded as interest income and any unamortized original issue discount or market discount is recorded as a realized gain. Prepayment premiums are recorded on loans and debt securities when received.

**Equity Securities.** Our equity securities 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, multiples at which private companies are bought and sold, and other pertinent factors, such as recent offers to purchase a portfolio



company, recent transactions involving the purchase or sale of the portfolio company's equity securities, liquidation events, or other events. The determined equity values are generally discounted when we have a minority ownership position, restrictions on resale, specific concerns about the receptivity of the capital markets to a specific company at a certain time, or other factors.

The value of our equity securities in public companies for which market quotations are readily available is based on 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 on preferred equity securities is recorded as dividend income on an accrual basis to the extent that such amounts are expected to be collected and to the extent that we have the option to receive the dividend in cash. Dividend income on common equity securities is recorded on the record date for private companies or on the ex-dividend date for publicly traded companies.

***Collateralized Debt Obligations (CDO) and Collateralized Loan Obligations (CLO).*** CDO and CLO bonds and preferred shares/ income notes (CDO/ CLO Assets) are carried at fair value, which is based on a discounted cash flow model that utilizes prepayment, re-investment and loss assumptions based on historical experience and projected performance, economic factors, the characteristics of the underlying cash flow, and comparable yields for similar bonds and preferred shares/ income notes, when available. We recognize unrealized appreciation or depreciation on our CDO/ CLO Assets as comparable yields in the market change and/ or based on changes in estimated cash flows resulting from changes in prepayment, re-investment or loss assumptions in the underlying collateral pool. We determine the fair value of our CDO/ CLO Assets on an individual security-by-security basis.

We recognize interest income on the preferred shares/income notes using the effective interest method, based on the anticipated yield and the estimated cash flows over the projected life of the investment. Yields are revised when there are changes in actual or estimated cash flows due to changes in prepayments and/or re-investments, credit losses or asset pricing. Changes in estimated yield are recognized as an adjustment to the estimated yield over the remaining life of the preferred shares/income notes from the date the estimated yield was changed. CDO and CLO bonds have stated interest rates.

***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 period, net of recoveries. Net change in unrealized appreciation or depreciation primarily reflects the change in portfolio investment values during the reporting period, including the reversal of previously recorded unrealized appreciation or depreciation when gains or losses are realized. Net change in unrealized appreciation or depreciation also reflects the change in the value of U.S. Treasury bills and deposits of proceeds from sales of borrowed Treasury securities, and depreciation on accrued interest and dividends receivable and other assets where collection is doubtful.

***Fee Income.*** Fee income includes fees for loan prepayment premiums, guarantees, commitments, and services rendered by us to portfolio companies and other third parties such as diligence, structuring, transaction services, management and consulting services, and other services. Loan prepayment premiums are recognized at the time of prepayment. Guaranty and commitment fees are generally recognized as income over the related period of the guaranty or commitment, respectively. Diligence, structuring, and transaction services fees are generally recognized as income when services are rendered or when the related transactions are completed. Management, consulting and other services fees are generally recognized as income as the services are rendered.

***Federal and State Income Taxes and Excise Tax.*** We intend 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). We and any of our subsidiaries that qualify as a RIC or a REIT intend to distribute

or retain through a deemed distribution all of our annual taxable income to shareholders; therefore, we have made no provision for income taxes exclusive of excise taxes for these entities.

If we do not distribute at least 98% of our annual taxable income in the year earned, we will generally be required to pay an excise tax equal to 4% of the amount by which 98% of our annual taxable income exceeds the distributions from such taxable income for the year. To the extent that we determine that our estimated current year annual taxable income will be in excess of estimated current year dividend distributions from such taxable income, we accrue excise taxes on estimated excess taxable income as taxable income is earned using an annual effective excise tax rate. The annual effective excise tax rate is determined by dividing the estimated annual excise tax by the estimated annual taxable income.

Income taxes for AC Corp are accounted for under the asset and liability method. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases as well as operating loss and tax credit carryforwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled.

**Item 3. *Quantitative and Qualitative Disclosures About Market Risk***

There has been no material change in quantitative or qualitative disclosures about market risk since December 31, 2006.

**Item 4. *Controls and Procedures***

(a) As of the end of the period covered by this quarterly report on Form 10-Q, the Company's chief executive officer and chief financial officer conducted an evaluation of the Company's disclosure controls and procedures (as defined in Rules 13a-15 and 15d-15 of the Securities Exchange Act of 1934). Based upon this evaluation, the Company's chief executive officer and chief financial officer concluded that the Company's disclosure controls and procedures are effective to allow timely decisions regarding required disclosure of any material information relating to the Company that is required to be disclosed by the Company in the reports it files or submits under the Securities Exchange Act of 1934.

(b) There have been no changes in the Company's internal control over financial reporting that occurred during the quarter ended March 31, 2007, that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

## PART II. OTHER INFORMATION

### Item 1. *Legal Proceedings*

On June 23, 2004, we were notified by the SEC that they are conducting an informal investigation of us. On December 22, 2004, we received letters from the U.S. Attorney for the District of Columbia requesting the preservation and production of information regarding us and Business Loan Express, LLC in connection with a criminal investigation. Based on the information available to us at this time, the inquiries appear to primarily pertain to matters related to portfolio valuation and our portfolio company, Business Loan Express, LLC. To date, we have produced materials in response to requests from both the SEC and the U.S. Attorney's office, and a director and certain current and former employees have provided testimony and have been interviewed by the staff of the SEC and, in some cases, the U.S. Attorney's Office. We are voluntarily cooperating with these investigations.

In late December 2006, we received a subpoena from the U.S. Attorney for the District of Columbia requesting, among other things, the production of records regarding the use of private investigators by us or our agents. The Board established a committee, which was advised by its own counsel, to review this matter. In the course of gathering documents responsive to the subpoena, we became aware that an agent of Allied Capital obtained what were represented to be telephone records of David Einhorn and which purport to be records of calls from Greenlight Capital during a period of time in 2005. Also, while we were gathering documents responsive to the subpoena, allegations were made that our management had authorized the acquisition of these records and that management was subsequently advised that these records had been obtained. Our management has stated that these allegations are not true. We are cooperating fully with the inquiry by the United States Attorney's office.

On February 13, 2007, Rena Nadoff filed a shareholder derivative action in the Superior Court of the District of Columbia, captioned *Rena Nadoff v. Walton, et al.*, CA 001060-07, seeking unspecified compensatory and other damages, as well as equitable relief on behalf of Allied Capital Corporation. Ms. Nadoff's complaint names as defendants the members of Allied Capital's Board of Directors; Allied Capital is a nominal defendant for purposes of the derivative action. The complaint alleges breach of fiduciary duty by the Board of Directors arising from internal control failures and mismanagement of Business Loan Express, LLC, an Allied Capital portfolio company. We believe the lawsuit is without merit, and we intend to defend the lawsuit vigorously. Allied Capital and the individual directors filed a motion to dismiss the complaint in its entirety. The motion is pending.

On February 26, 2007, Dana Ross filed a class action complaint in the U.S. District Court for the District of Columbia in which she alleges that Allied Capital Corporation and certain members of management violated Sections 10(b) and 20(a) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder. The complaint is captioned *Dana Ross v. Walton, et al.*, CV 00402. Dana Ross claims that, between March 1, 2006, and January 10, 2007, Allied Capital either failed to disclose or misrepresented information concerning the loan origination practices of Business Loan Express, LLC, an Allied Capital portfolio company. Dana Ross seeks unspecified compensatory and other damages, as well as other relief. We believe the lawsuit is without merit, and we intend to defend the lawsuit vigorously. There may be other similar class action lawsuits filed.

In addition to the above matters, we are party to certain lawsuits in the normal course of business.

While the outcome of any of the legal proceedings described above cannot at this time be predicted with certainty, we do not expect these matters will materially affect our financial condition or results of operations; however, there can be no assurances whether any pending legal proceedings will have a material adverse effect on our financial condition or results of operations in any future reporting period.

**Item 1A. 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.*

**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 subject to certain 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 we may need to or 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 could be significantly less than the current value of such investments.

**Investing in private companies involves a high degree of risk.** Our portfolio primarily consists of long-term loans to and investments in middle market private companies. Investments in private businesses involve a high degree of business and financial risk, which can result in substantial losses for us in those investments 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. If we are unable to identify all material information about these companies, among other factors, we may fail to receive the expected return on our investment or lose some or all of the money invested in these companies. In addition, these businesses may have shorter operating histories, narrower product lines, smaller market shares and less experienced management than their competition and may be more vulnerable to customer preferences, market conditions, loss of key personnel, or economic downturns, which may adversely affect the return on, or the recovery of, our investment in such businesses. As an investor, we are subject to the risk that a portfolio company may make a business decision that does not serve our interest, which could decrease the value of our investment. Deterioration in a portfolio company's financial condition and prospects may be accompanied by deterioration in any collateral for the loan.

**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 March 31, 2007, portfolio investments recorded at fair value were 90% of our total assets. 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. In determining fair value in good faith, we generally obtain financial and other information from portfolio companies, which may represent unaudited, projected or proforma financial information. 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 portfolio 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 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/or our equity security has 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. Our net asset value could be affected if our determination of the fair value of our investments is materially different than the value that we ultimately realize.

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 change in unrealized appreciation or depreciation.

**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 repay our loans or 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. Adverse economic conditions also may decrease the value of any collateral securing some of our loans. 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 or a slowdown in middle market merger and acquisition activity 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 timing of exit events in our portfolio and could negatively affect the amount of gains or losses upon exit.

**Our borrowers may default on their payments, which may have a negative 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, may be highly leveraged and 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. A portfolio company's failure to satisfy financial or operating covenants imposed by us or other lenders could lead to defaults and, potentially, termination of its loans or foreclosure on its secured assets, which could trigger cross defaults under other agreements and jeopardize our portfolio company's ability to meet its obligations under the loans or debt securities that we hold. In addition, our portfolio companies may have, or may be permitted to incur, other debt that ranks senior to or equally with our securities. This means that payments on such senior-ranking securities may have to be made before we receive any payments on our subordinated loans or debt securities. Deterioration in a borrower's financial condition and prospects may be accompanied by deterioration in any related collateral and may have a negative effect on our financial results.

**Our private finance investments may not produce current returns or capital gains.** Our private finance investments are typically structured as unsecured debt securities with a relatively high fixed rate of interest and with equity features such as conversion rights, warrants, or options, or as buyouts of companies where we invest in debt and equity securities. As a result, our 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 a significant portfolio investment fails to perform as expected.** Our total investment in companies may be significant individually or in the aggregate. As a result, if a significant investment in one or more companies fails to perform as expected, our financial results could be more negatively affected and the magnitude of the loss could be more significant than if we had made smaller investments in more companies. At March 31, 2007, our largest investments at value were in Mercury Air Centers, Inc. and Business Loan Express, LLC (BLX), which represented 6.0% and 4.6% of our total assets,

respectively, and 2.0% and 1.3% of our total interest and related portfolio income, respectively, for the three months ended March 31, 2007.

BLX is a national, non-bank lender that participates in the SBA's 7(a) Guaranteed Loan Program and is licensed by the SBA as a Small Business Lending Company (SBLC). The Office of the Inspector General of the SBA (OIG) and the United States Secret Service are conducting an ongoing investigation of allegedly fraudulently obtained SBA-guaranteed loans issued by BLX. The OIG and the U.S. Department of Justice are also conducting a civil investigation of BLX's lending practices in various jurisdictions. These investigations are ongoing. As an SBA lender, BLX is also subject to other SBA and OIG audits, investigations, and reviews. These investigations, audits and reviews, 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 adverse impact on BLX and, as a result, could negatively affect our financial results. See Management's Discussion and Analysis of Financial Condition and Results of Operations - Private Finance, Business Loan Express, LLC below.

**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 or investors. Holders 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. We and, indirectly, our stockholders will bear the cost associated with our leverage activity. Our revolving line of credit and notes payable contain financial and operating covenants that could restrict our business activities, including our ability to declare dividends if we default under certain provisions. Breach of any of those covenants could cause a default under those instruments. Such a default, if not cured or waived, could have a material adverse effect on us.

At March 31, 2007, we had \$1.9 billion of outstanding indebtedness bearing a weighted average annual interest cost of 6.5% and a debt to equity ratio of 0.64 to 1.00. We may incur additional debt in the future. If our portfolio of investments fails to produce adequate returns, we may be unable to make interest or principal payments on our indebtedness when they are due. In order for us to cover annual interest payments on indebtedness, we must achieve annual returns on our assets of at least 2.5% as of March 31, 2007, which returns were achieved.

**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, insurance companies or other lenders or investors 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 March 31, 2007, our asset coverage for senior indebtedness was 257%.

**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 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 as of March 31, 2007, 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 net income by approximately 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 net 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 growth in our investments. Historically, we have borrowed from financial institutions or other investors and have issued equity securities to grow our portfolio. A reduction in the availability of new debt or equity capital could limit our ability to grow. We must distribute at least 90% of our taxable ordinary income, which excludes realized net long-term capital gains, to our shareholders to maintain our eligibility for the tax benefits available to regulated investment companies. As a result, such earnings will not be available to fund investment originations. 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. We intend to continue to borrow from financial institutions or other investors 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 debt securities or common stock.

**Loss of regulated investment company tax treatment would substantially reduce net assets and income available for debt service and dividends.** We have operated so as to qualify as a regulated investment company under Subchapter M of the Code. If we meet source of income, asset diversification, and distribution requirements, we will not be subject to corporate-level income taxation on income we timely distribute to our stockholders as dividends. We would cease to qualify for such 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 stockholders 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 debt service and distributions 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. If we do not distribute at least 98% of our annual taxable income in the year earned, we generally will be required to pay an excise tax on amounts carried over and distributed to shareholders in the next year equal to 4% of the amount by which 98% of our annual taxable income exceeds the distributions from such income for the current year.

**There is a risk that our common stockholders 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, certain of 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 the tax benefits available to us as a regulated investment company. In addition, in accordance with U.S. generally accepted accounting principles 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, or the accrual of original issue discount. 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 obtain tax benefits 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, other business development companies, investment banks, other equity and non-equity based investment funds, and other sources of financing, including specialty finance companies and traditional financial services companies such as commercial banks. Some of our competitors may 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.

**Our business depends on our 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, which could have a negative effect on our business.

**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. In addition, changes in the laws or regulations that govern business development companies, regulated investment companies, and real estate investment trusts 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, which may have a material effect on our operations.

**Failure to invest a sufficient portion of our assets in qualifying assets could preclude us from investing in accordance with our current business strategy.** As a business development company, we may not acquire any assets other than qualifying assets unless, at the time of and after giving effect to such acquisition, at least 70% of our total assets are qualifying assets. See Certain Government Regulations. Therefore, we may be precluded from investing in what we believe are attractive investments if such investments are not qualifying assets for purposes of the 1940 Act. If we do not invest a sufficient portion of our assets in qualifying assets, we could lose our status as a business development company, which would have a material adverse effect on our business, financial condition and results of operations. Similarly, these rules could prevent us from making additional investments in existing portfolio companies, which could result in the dilution of our position, or could require us to dispose of investments at inopportune times in order to comply with the 1940 Act. If we were forced to sell nonqualifying investments in the portfolio for compliance purposes, the proceeds from such sale could be significantly less than the current value of such investments.

**Results may fluctuate and may not be indicative of future performance.** Our operating results may 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, but are not limited to, variations in the investment origination volume and fee income earned, changes in the accrual status of our loans and debt securities, variations in timing of prepayments, variations in and the timing of the recognition of net realized gains or losses and changes in unrealized appreciation or depreciation, the level of our expenses, 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 the common stock may be higher or lower than the price paid by stockholders, depending on many factors, some of which are beyond our control and may not be directly related to our operating performance. These factors include, but are not limited to, 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 laws or 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.

**The trading market or market value of our publicly issued debt securities may be volatile.** Our publicly issued debt securities may or may not have an established trading market. We cannot assure that a trading market for our publicly issued debt securities will ever develop or be maintained if developed. In addition to our creditworthiness, many factors may materially adversely affect the trading market for, and market value of, our publicly issued debt securities. These factors include, but are not limited to, the following:

the time remaining to the maturity of these debt securities;

the outstanding principal amount of debt securities with terms identical to these debt securities;

the supply of debt securities trading in the secondary market, if any;

the redemption or repayment features, if any, of these debt securities;

the level, direction and volatility of market interest rates generally; and

market rates of interest higher or lower than rates borne by the debt securities.

There also may be a limited number of buyers for our debt securities. This too may materially adversely affect the market value of the debt securities or the trading market for the debt securities.

**Our credit ratings may not reflect all risks of an investment in the debt securities.** Our credit ratings are an assessment of our ability to pay our obligations. Consequently, real or anticipated changes in our credit ratings will generally affect the market value of the publicly issued debt securities. Our credit ratings, however, may not reflect the potential impact of risks related to market conditions generally or other factors discussed above on the market value of or trading market for the publicly issued debt securities.

**Terms relating to redemption may materially adversely affect your return on the debt securities.** If our debt securities are redeemable at our option, we may choose to redeem the debt securities at times when prevailing interest

rates are lower than the interest rate paid on the debt securities. In addition, if the debt securities are subject to mandatory redemption, we may be required to redeem the debt securities also at times when prevailing interest rates are lower than the interest rate paid on the debt securities. In this circumstance, a

holder of the debt securities may not be able to reinvest the redemption proceeds in a comparable security at an effective interest rate as high as the debt securities being redeemed.

**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds**

During the three months ended March 31, 2007, we issued a total of 145,974 shares of common stock under our dividend reinvestment plan pursuant to an exemption from the registration requirements of the Securities Act of 1933. The aggregate offering price for the shares of common stock sold under the dividend reinvestment plan was approximately \$4.3 million.

**Issuer Purchases of Equity Securities**

The following table provides information for the quarter ended March 31, 2007, regarding shares of our common stock that were purchased under The 2005 Allied Capital Corporation Non-Qualified Deferred Compensation Plan I (2005 DCP I) and The 2005 Allied Capital Corporation Non-Qualified Deferred Compensation Plan II (2005 DCP II), which are administered by third-party trustees. The administrator of the 2005 DCP I and the 2005 DCP II is the Compensation Committee of our Board of Directors.

	<b>Total Number of Shares Purchased</b>	<b>Average Price Paid Per Share</b>
<b>2005 DCP I<sup>(1)</sup></b>		
1/1/2007 to 1/31/2007	87	\$ 32.31
2/1/2007 to 2/28/2007	705	\$ 28.32
3/1/2007 to 3/31/2007		\$
<b>2005 DCP II<sup>(2)</sup></b>		
1/1/2007 to 1/31/2007	19,526	\$ 32.26
2/1/2007 to 2/28/2007		\$
3/1/2007 to 3/31/2007	84,325	\$ 28.90
<b>Total</b>	<b>104,643</b>	<b>\$ 29.52</b>

(1) The 2005 DCP I is an unfunded plan, as defined by the Internal Revenue Code of 1986, that provides for the deferral of compensation by our directors, employees, and consultants. In addition, we may make contributions to 2005 DCP I on compensation deemed ineligible for a 401(k) contribution. Our directors, 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 2005 DCP I is managed through a trust by a third-party trustee, and we fund this plan through cash contributions. Directors may choose to defer director's fees through the 2005 DCP I, and may choose to invest such deferred income in shares of our common stock. To the extent a director elects to invest in our common stock, the trustee of the 2005 DCP I will be required to use such deferred director's fees to purchase shares of our common stock in the market.

(2) We have established a long-term incentive compensation program whereby we will generally determine an individual performance award for certain officers annually at the beginning of each year. The Compensation Committee may adjust the individual performance awards as needed, or make new awards as new officers are hired. In conjunction with the program, we instituted the 2005 DCP II, which is an unfunded plan as defined by the Internal Revenue Code of 1986 that is managed through a trust by a third-party trustee. The individual performance awards are deposited in the trust in four equal installments, generally on a quarterly basis in the form of cash and the 2005 DCP II requires the trustee to use the cash exclusively to purchase shares of our common stock in the

market. In addition, dividends received on the Allied Capital shares held in the trust are reinvested in our common stock.

**Item 3. *Defaults Upon Senior Securities***

Not applicable.

**Item 4. Submission of Matters to a Vote of Security Holders**

None.

**Item 5. Other Information**

None.

**Item 6. Exhibits**

(a) List of Exhibits

Exhibit Number	Description
3.1	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>
3.2	Amended and Restated Bylaws. <i>(Incorporated by reference to Exhibit 3.1. filed with Allied Capital's Form 8-K on January 24, 2006).</i>
4.1	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>
4.3	Form of Note under the Indenture relating to the issuance of debt securities. <i>(Contained in Exhibit 4.4). (Incorporated by reference to Exhibit d.1 filed with Allied Capital's registration statement on Form N-2/A (File No. 333-133755) filed on June 21, 2006).</i>
4.4	Indenture by and between Allied Capital Corporation and The Bank of New York, dated June 16, 2006. <i>(Incorporated by reference to Exhibit d.2 filed with Allied Capital's registration statement on Form N-2/A (File No. 333-133755) filed on June 21, 2006).</i>
4.5	Statement of Eligibility of Trustee on Form T-1. <i>(Incorporated by reference to Exhibit d.3 filed with Allied Capital's registration statement on Form N-2 (File No. 333-133755) filed on May 3, 2006).</i>
4.6	Form of First Supplemental Indenture by and between Allied Capital Corporation and the Bank of New York, dated as of July 25, 2006. <i>(Incorporated by reference to Exhibit d.4 filed with Allied Capital's Post-Effective Amendment No. 1 to the registration statement on Form N-2/A (File No. 333-133755) filed on July 25, 2006).</i>
4.7	Form of 6.625% Note due 2011. <i>(Incorporated by reference to Exhibit d.5 filed with Allied Capital's Post-Effective Amendment No. 1 to the registration statement on Form N-2/A (File No. 333-133755) filed on July 25, 2006).</i>
4.8	Form of Second Supplemental Indenture by and between Allied Capital Corporation and The Bank of New York, dated as of December 8, 2006. <i>(Incorporated by reference to Exhibit d.6 filed with Allied Capital's Post-Effective Amendment No. 2 to the registration statement on Form N-2/A (File No. 333-133755) filed on December 8, 2006).</i>
4.9	Form of 6.000% Notes due 2012. <i>(Incorporated by reference to Exhibit d.7 filed with Allied Capital's Post-Effective Amendment No. 2 to the registration statement on Form N-2/A (File No. 333-133755) filed on December 8, 2006).</i>
4.10	Form of Third Supplemental Indenture by and between Allied Capital Corporation and The Bank of New York, dated as of March 28, 2007. <i>(Incorporated by reference to Exhibit d.8 filed with Allied Capital's Post-Effective Amendment No. 3 to the registration statement on Form N-2/A (File No. 333-133755) filed on March 28, 2007).</i>
4.11	Form of 6.875% Notes due 2047. <i>(Incorporated by reference to Exhibit d.9 filed with Allied Capital's Post-Effective Amendment No. 3 to the registration statement on Form N-2/A (File No. 333-133755) filed on March 28, 2007).</i>



Exhibit Number	Description
4.11(a)	Form of 6.875% Notes due 2047. <i>(Incorporated by reference to Exhibit d.9(a) filed with Allied Capital's Post-Effective Amendment No. 4 to the registration statement on Form N-2/A (File No. 333-133755) filed on April 2, 2007).</i>
10.1	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>
10.2	Credit Agreement, dated September 30, 2005. <i>(Incorporated by reference to Exhibit 10.1 filed with Allied Capital's Form 8-K on October 3, 2005).</i>
10.2(a)	First Amendment to Credit Agreement, dated November 4, 2005. <i>(Incorporated by reference to Exhibit 10.2(a) filed with Allied Capital's Form 10-Q for the period ended September 30, 2005).</i>
10.2(b)	Second Amendment to Credit Agreement, dated May 11, 2006. <i>(Incorporated by reference to Exhibit 10.1 filed with Allied Capital's Form 8-K filed on May 12, 2006).</i>
10.2(c)	Third Amendment to Credit Agreement, dated May 19, 2006. <i>(Incorporated by reference to Exhibit 10.1 filed with Allied Capital's Form 8-K filed on May 23, 2006).</i>
10.3	Note Agreement, dated October 13, 2005. <i>(Incorporated by reference to Exhibit 10.1 filed with Allied Capital's Form 8-K on October 14, 2005).</i>
10.4	Note Agreement, dated May 1, 2006. <i>(Incorporated by reference to Exhibit 10.1 filed with Allied Capital's Form 8-K on May 1, 2006).</i>
10.15	Control Investor Guaranty Agreement, dated as of March 17, 2006, between Allied Capital and CitiBank, N.A. and Business Loan Express, LLC <i>(Incorporated by reference to Exhibit 10.1 filed with Allied Capital's Form 8-K filed on March 23, 2006).</i>
10.17	The 2005 Allied Capital Corporation Non-Qualified Deferred Compensation Plan II. <i>(Incorporated by reference to Exhibit 10.2 filed with Allied Capital's Form 8-K filed on December 21, 2005).</i>
10.17(a)	Amendment to The 2005 Allied Capital Corporation Non-Qualified Deferred Compensation Plan II, dated January 20, 2006. <i>(Incorporated by reference to Exhibit 10.17(a) filed with Allied Capital's Form 10-K for the year ended December 31, 2005).</i>
10.18	The 2005 Allied Capital Corporation Non-Qualified Deferred Compensation Plan. <i>(Incorporated by reference to Exhibit 10.1 filed with Allied Capital's Form 8-K filed on December 21, 2005).</i>
10.18(a)	Amendment to The 2005 Allied Capital Corporation Non-Qualified Deferred Compensation Plan, dated January 20, 2006. <i>(Incorporated by reference to Exhibit 10.18(a) filed with Allied Capital's Form 10-K for the year ended December 31, 2005).</i>
10.19	Amended Stock Option Plan. <i>(Incorporated by reference to Exhibit B of Allied Capital's definitive proxy statement for Allied Capital's 2004 Annual Meeting of Stockholders filed on March 30, 2004).</i>
10.20(a)	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>
10.20(b)	Amendment to Allied Capital Corporation 401(k) Plan, dated April 15, 2004. <i>(Incorporated by reference to Exhibit 10.20(b) filed with Allied Capital's Form 10-Q for the period ended June 30, 2004).</i>



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- 10.20(c) Amendment to Allied Capital Corporation 401(k) plan, dated November 1, 2005.  
*(Incorporated by reference to Exhibit 10.20(c) filed with Allied Capital's Form 10-Q for the quarter ended September 30, 2005).*
- 10.20(d) Amendment to Allied Capital Corporation 401(k) plan, dated April 21, 2006.  
*(Incorporated by reference to Exhibit i.4(c) filed with Allied Capital's Form N-2 (File No. 333-133755) filed on May 3, 2006).*

Exhibit Number	Description
10.20(e)	Amendment to Allied Capital Corporation 401(k) plan, adopted December 18, 2006. <i>(Incorporated by reference to Exhibit 10.20(e) filed with Allied Capital's Form 10-K for the year ended December 31, 2006).</i>
10.21	Employment Agreement, dated January 1, 2004, between Allied Capital and William L. Walton. <i>(Incorporated by reference to Exhibit 10.21 filed with Allied Capital's Form 10-K for the year ended December 31, 2003).</i>
10.21(a)	Amendment to Employment Agreement, dated March 29, 2007, between Allied Capital and William L. Walton. <i>(Incorporated by reference to Exhibit 10.1 filed with Allied Capital's Form 8-K filed on April 3, 2007).</i>
10.22	Employment Agreement, dated January 1, 2004, between Allied Capital and Joan M. Sweeney. <i>(Incorporated by reference to Exhibit 10.22 filed with Allied Capital's Form 10-K for the year ended December 31, 2003).</i>
10.22(a)	Amendment to Employment Agreement, dated March 29, 2007, between Allied Capital and Joan M. Sweeney. <i>(Incorporated by reference to Exhibit 10.2 filed with Allied Capital's Form 8-K filed on April 3, 2007).</i>
10.23	Employment Agreement, dated January 1, 2004, between Allied Capital and Penelope F. Roll. <i>(Incorporated by reference to Exhibit 10.23 filed with Allied Capital's Form 10-K for the year ended December 31, 2006).</i>
10.23(a)	Amendment to Employment Agreement, dated March 29, 2007, between Allied Capital and Penelope F. Roll. <i>(Incorporated by reference to Exhibit 10.3 filed with Allied Capital's Form 8-K filed on April 3, 2007).</i>
10.25	Form of Custody Agreement with Riggs Bank N.A., which was assumed by PNC Bank through merger. <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>
10.26	Custodian Agreement with Chevy Chase Trust. <i>(Incorporated by reference to Exhibit 10.26 filed with Allied Capital's Form 10-K for the year ended December 31, 2005).</i>
10.27	Custodian Agreement with Bank of America. <i>(Incorporated by reference to Exhibit 10.27 filed with Allied Capital's Form 10-K for the year ended December 31, 2005).</i>
10.28	Code of Ethics. <i>(Incorporated by reference to Exhibit 10.28 filed with Allied Capital's Form 10-K for the year ended December 31, 2006).</i>
10.29	Custodian Agreement with Union Bank of California. <i>(Incorporated by reference to Exhibit 10.29 filed with Allied Capital's Form 10-Q for the quarter ended June 30, 2006).</i>
10.30	Custodian Agreement with M&T Bank. <i>(Incorporated by reference to Exhibit 10.30 filed with Allied Capital's Form 10-Q for the quarter ended June 30, 2006).</i>
10.31	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>
10.37	Form of Indemnification Agreement between Allied Capital and its directors and certain officers. <i>(Incorporated by reference to Exhibit 10.37 filed with Allied Capital's Form 10-K for the year ended December 31, 2003).</i>
10.38	Note Agreement, dated as of March 25, 2004. <i>(Incorporated by reference to Exhibit 10.38 filed with Allied Capital's Form 10-Q for the period ended March 31, 2004.)</i>
10.39	Note Agreement, dated as of November 15, 2004. <i>(Incorporated by reference to Exhibit 99.1 filed with Allied Capital's current report on Form 8-K filed on November 18, 2004.)</i>

- 10.40 Real Estate Securities Purchase Agreement. *(Incorporated by reference to Exhibit 2.1 filed with Allied Capital's Form 8-K filed on May 4, 2005.)*
- 10.41 Platform Assets Purchase Agreement. *(Incorporated by reference to Exhibit 2.2 filed with Allied Capital's Form 8-K filed on May 4, 2005.)*

<b>Exhibit Number</b>	<b>Description</b>
10.42	Transition Services Agreement. <i>(Incorporated by reference to Exhibit 10.1 filed with Allied Capital's Form 8-K filed on May 4, 2005.)</i>
11	Statement regarding computation of per share earnings is included in Note 7 to Allied Capital's Notes to the Consolidated Financial Statements.
15*	Letter regarding Unaudited Interim Financial Information.
31.1*	Certification of the Chief Executive Officer pursuant to Rule 13a-14 of the Securities Exchange Act of 1934.
31.2*	Certification of the Chief Financial Officer pursuant to Rule 13a-14 of the Securities Exchange Act of 1934.
32.1*	Certification of the Chief Executive Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, 18 U.S.C. Section 1350.
32.2*	Certification of the Chief Financial Officer pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, 18 U.S.C. Section 1350.

\* Filed herewith.

**SIGNATURES**

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

ALLIED CAPITAL CORPORATION  
(Registrant)

Dated: May 8, 2007

/s/ William L. Walton

William L. Walton  
Chairman and Chief Executive Officer

/s/ Penni F. Roll

Penni F. Roll  
Chief Financial Officer

**EXHIBIT INDEX**

<b>Exhibit Number</b>	<b>Description</b>
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