

ALLIED CAPITAL CORP
Form N-2
March 31, 2003

As filed with the Securities and Exchange Commission on March 31, 2003

Registration No. 333-

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM N-2

REGISTRATION STATEMENT

**UNDER
THE SECURITIES ACT OF 1933**

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

ALLIED CAPITAL CORPORATION

(Exact Name of Registrant as Specified in Charter)

1919 Pennsylvania Avenue, N.W.

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

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

William L. Walton, Chairman and Chief Executive Officer

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

Copies of information to:

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

Approximate Date of Proposed Public Offering:

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

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

CALCULATION OF REGISTRATION FEE UNDER THE SECURITIES ACT OF 1933

Title of Securities Being Registered	Amount Being Registered	Proposed Maximum Offering Price Per Share(1)	Proposed Maximum Aggregate Offering Price	Amount of Registration Fee(2)
Common Stock, \$0.0001 par value per share	18,000,000 shares	\$ 19.95	\$ 359,100,000	\$ 11,574

- (1) Estimated solely for purposes of calculating the registration fee pursuant to Rule 457(c) under the Securities Act of 1933 on the basis of the average of the high and low sales prices of the common stock on March 26, 2003 as reported on the New York Stock Exchange.
- (2) Pursuant to Rule 457(p) under the Securities Act of 1933, the Registrant is offsetting the filing fee with \$17,478 of filing fees associated with \$189,980,000 of securities which remain unsold and were registered on a registration statement on Form N-2 (File No. 333-87862) filed by the Registrant on May 8, 2002.

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

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

18,000,000 Shares

Common Stock

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

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

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

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

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

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

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

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

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

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

, 2003

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

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ABOUT THIS PROSPECTUS

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

PROSPECTUS SUMMARY

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

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

BUSINESS (Page 49)

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

private finance, and

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

Our investment portfolio generally includes:

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

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

non-investment grade commercial mortgage-backed securities,

preferred shares in collateralized debt obligations, and

commercial mortgage loans.

We identify loans and investments through our numerous relationships with:

mezzanine and private equity investors,

investment banks, and

other intermediaries, including professional services firms.

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

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

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

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

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

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

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

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

DETERMINATION OF

NET ASSET VALUE (Page 74)

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

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

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

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

PLAN OF DISTRIBUTION (Page 105)

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

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

Our shares of common stock may be offered directly to one or more purchasers, through agents designated from time to time by us, or to or through underwriters or dealers. The supplement to this prospectus relating to the offering will

identify any agents or underwriters involved in the sale of our shares of common stock, and will set forth any applicable purchase price, fee and commission or discount arrangement or the basis upon which such amount may be calculated.

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

USE OF PROCEEDS *(Page 16)*

Unless otherwise specified in the prospectus supplement accompanying this prospectus, we intend to use the net proceeds from selling shares of common stock for general corporate purposes, which include investments in the debt or equity securities of primarily private companies or non-investment grade commercial mortgage-backed securities, repayment of indebtedness, acquisitions and other general corporate purposes.

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

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

DIVIDEND REINVESTMENT PLAN *(Page 100)*

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

RISK FACTORS *(Page 9)*

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

As a business development company, our portfolio includes securities primarily issued by privately held companies. These investments may involve a high degree of business and financial risk; they are illiquid, and may not produce current returns or capital gains. If we were forced to immediately liquidate some or all of the investments in the portfolio, the proceeds of such liquidation would be significantly less than the current value of such investments.

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

We may not borrow money unless we maintain asset coverage for indebtedness of at least 200% which may affect returns to shareholders. We borrow funds to make investments. As a result, we are exposed to the risks of leverage, which may be considered a speculative investment technique. Borrowings, also known as leverage, magnify the potential for gain and loss on amounts invested and therefore increase the risks associated with investing in our securities.

A large number of entities and individuals compete for the same kind of investment opportunities as we do. Our business of making private equity investments may be affected by current and future market conditions. The absence of an active senior lending environment may

slow the amount of private equity investment activity generally. As a result, the pace of our investment activity may slow.

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

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

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

CERTAIN ANTI-TAKEOVER

PROVISIONS *(Page 102)*

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

LEGAL PROCEEDINGS *(Page 66)*

A series of class action lawsuits were filed in 2002 in the United States District Court for the Southern District of New York against us, certain of our directors and officers and our former independent auditors, with respect to alleged violations of the securities laws. The complaints seek compensatory and other damages, and costs and expenses associated with the litigation. The lawsuits have been consolidated into a single proceeding. We have filed a motion to dismiss the lawsuit and the plaintiffs have filed an opposition to this motion. We have filed a reply to the plaintiff's opposition. We believe that the lawsuit is without merit, and we intend to defend the lawsuit vigorously. While we do not expect this matter to materially affect our financial condition or results of operations, there can be no assurance as to whether any such pending litigation will have a material adverse effect on our financial condition or results of operations in any future reporting period.

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

FEES AND EXPENSES

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

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

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

Example

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

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

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

See Dividend Reinvestment Plan.

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

SELECTED CONDENSED CONSOLIDATED FINANCIAL DATA

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

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

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

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

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

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

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

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

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

WHERE YOU CAN FIND

ADDITIONAL INFORMATION

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

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

RISK FACTORS

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

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

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

future regulatory actions 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.

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

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

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

There is no single standard for determining fair value in good faith. As a result, determining fair value requires that judgment be applied to the specific facts and circumstances of each portfolio investment while employing a consistently applied valuation process for the types of investments we make. Unlike banks, we are not permitted to

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

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

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

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

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

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

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

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

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

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

We borrow money, which magnifies the potential for gain or loss on amounts invested and may increase the risk of investing in us. Borrowings, also known as leverage, magnify the potential for gain or loss on amounts invested and, therefore, increase the risks associated with investing in our securities. We borrow from and issue senior debt securities to banks, insurance companies, and other lenders. Lenders of these senior securities have fixed dollar claims on our consolidated assets that are superior to the claims of our common shareholders. If the value of our consolidated assets increases, then leveraging would cause the net asset value attributable to our common stock to increase more sharply than it would have had we not leveraged. Conversely, if the value of our consolidated assets decreases, leveraging would cause net asset value to decline more sharply than it otherwise would have had we not leveraged. Similarly, any increase in our consolidated income in excess of consolidated interest payable on the borrowed funds would cause our net income to increase more than it would without the leverage, while any decrease in our consolidated income would cause net income to decline more sharply than

it would have had we not borrowed. Such a decline could negatively affect our ability to make common stock dividend payments. Leverage is generally considered a speculative investment technique.

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

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

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

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

We will continue to need additional capital to grow because we must distribute our income. We will continue to need capital to fund incremental growth in our investments. Historically, we have borrowed from financial institutions and have issued equity securities. A reduction in the availability of new capital could limit our ability to grow. We must distribute at least 90% of our taxable ordinary income, which excludes net realized long-

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

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

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

We operate in a competitive market for investment opportunities. We compete for investments with a large number of private equity funds and mezzanine funds, investment banks and other equity and non-equity based investment funds, and other sources of financing, including traditional financial services companies such as commercial banks. Some of our competitors have greater resources than we do. Increased competition would make it more difficult for us to purchase or originate investments at attractive prices. As a

result of this competition, sometimes we may be precluded from making otherwise attractive investments.

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

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

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

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

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

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

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

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

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

general economic conditions and trends;

loss of a major funding source; or

departures of key personnel.

Recently, the trading price of our common stock has been volatile. Due to the continued potential volatility of our stock price, we may be the target of securities litigation

in the future. Securities litigation could result in substantial costs and divert management's attention and resources from our business. For information about current securities class action lawsuits filed against us, see Legal Proceedings.

Disclosure Regarding Forward-Looking Statements

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

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

USE OF PROCEEDS

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

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

PRICE RANGE OF COMMON STOCK AND DISTRIBUTIONS

Our common stock is traded on the New York Stock Exchange under the symbol ALD. The following table lists the high and low closing sales prices for our common stock, the closing sales price as a percentage of net asset value (NAV) and quarterly dividends per share. On March 31, 2003, the last reported closing sale price of the common stock was \$ 21.57 per share.

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

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

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

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

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

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

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

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

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

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

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

future regulatory actions 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 company, and the financial information presented may represent unaudited, projected or pro forma financial information, and therefore may not be indicative of actual results.

OVERVIEW

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

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

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

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

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

PORTFOLIO AND INVESTMENT ACTIVITY

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

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

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

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

Private Finance

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Commercial Real Estate Finance

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

The investment grade CMBS collateral consists of CMBS bonds with a face amount of \$479.0 million issued in 39 separate CMBS transactions. The non-investment grade CMBS collateral consists of BB+, BB, and BB- CMBS bonds with a face amount of \$463.4 million issued in 39 separate CMBS transactions. Included in the CMBS collateral for the CDOs are \$397.9 million of CMBS bonds that are senior in priority of repayment to certain lower rated CMBS bonds held by us, which were issued in 23 separate CMBS transactions. The preferred shares are junior in priority for payment of principal to the more senior tranches of debt issued by the CDOs. To the extent there are defaults and unrecoverable losses on the underlying collateral resulting in reduced cash flows, the preferred shares will bear this loss first. At December 31, 2002, our preferred shares in the CDOs were subordinate to approximately 96% of the more senior tranches of debt issued by the CDOs. Income received from our CDO investments provided an effective yield of 17.2% and 16.9% at December 31, 2002 and 2001, respectively.

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

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

Portfolio Asset Quality

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

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

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

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

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

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

For the total investment portfolio, workout loans and debt securities (which excludes equity securities that are included in the total Grade 4 and 5 assets above) not accruing interest that were classified in Grade 4 and 5 were \$89.1 million at value at December 31, 2002, or 3.6% of the total portfolio. Included in this category at December 31, 2002, were loans of \$13.0 million that were secured by commercial real estate. Workout loans and debt securities not accruing interest were \$85.0 million at value at December 31, 2001, or 3.6% of the total portfolio, of which \$8.9 million was related to portfolio companies in liquidation and \$4.1 million represented loans secured by commercial real estate. As of

December 31, 2002, \$7.6 million representing receivables related to portfolio companies in liquidation were included in other assets. In addition to Grade 4 and 5 assets that are in workout, loans and debt securities to companies that are more than 50% owned by us that were not accruing interest totaled \$63.6 million at value at December 31, 2002, and loans and debt securities to companies that are less than 50% owned by us that were not in workout but were not accruing interest totaled \$7.2 million and \$23.9 million at value at December 31, 2002 and 2001, respectively.

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

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

Hedging Activities

Because we invest in BB+ through B rated CMBS bonds, which were purchased at prices based in part on comparable Treasury rates, we have entered into transactions with financial institutions to hedge against movement in Treasury rates on certain of these CMBS bonds. These transactions involved receiving the proceeds from the sales of borrowed Treasury securities, with the obligations to replenish the borrowed Treasury securities at a later date based on the then current market price, whatever that price may be. Risks in these contracts arise from movements in the value of the borrowed Treasury securities and interest rates and from the possible inability of counterparties to meet the terms of their contracts; we do not anticipate nonperformance by any counterparty.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Realized losses for the year ended December 31, 2002, primarily resulted from transactions involving eleven private finance portfolio companies, including Velocita, Inc. (\$16.0 million), Schwinn Holdings Corporation (\$7.9 million), Convenience Corporation of America (\$5.8 million), Startec Global Communications Corporation (\$4.5 million), The Loewen Group, Inc. (\$2.7 million), Monitoring Solutions, Inc. (\$1.7 million), Most Confiserie (\$1.0 million), NetCare AG (\$1.0 million), iSolve Incorporated (\$0.9 million), Sure-Tel, Inc. (\$0.5 million), and Soff-Cut Holdings, Inc. (\$0.5 million), and also from nine commercial real estate investments (\$4.7 million). For the years ended December 31,

2002, 2001, and 2000, we reversed previously recorded unrealized depreciation totaling \$49.0 million, \$8.9 million, and \$12.0 million, respectively, when losses were realized.

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

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

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

Valuation Methodology - Private Finance Our process for determining the fair value of a private finance investment begins with determining the enterprise value of the portfolio company. The fair value of our investment is based on the enterprise value at which the portfolio company could be sold in an orderly disposition over a reasonable period of time between willing parties other than in a forced or liquidation sale. The

liquidity event whereby we exit a private finance investment is generally the sale, the recapitalization or, in some cases, the initial public offering of the portfolio company.

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

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

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

Valuation Methodology CMBS Bonds CMBS bonds are carried at fair value, which is based on a discounted cash flow model, which utilizes prepayment and loss assumptions based on historical experience and projected performance, economic factors, the characteristics of the underlying cash flow and comparable market yields for similar CMBS bonds. Our assumption with regard to discount rate is based on the yield of comparable securities. We recognize income from the amortization of original issue discount using the effective interest method, using the anticipated yield over the projected

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

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

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

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

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

The Hillman Companies, Inc. Hillman achieved several milestones in 2002, including the completion of two acquisitions, the reduction of excess corporate overhead, and significant improvements to its operating structure. In performing our valuation analysis of Hillman at December 31, 2002, we quantified the impact of these milestones in order to determine normalized EBITDAM of approximately \$58.5 million.

We believe the current enterprise value for Hillman is approximately \$409.5 million, or 7.0 times 2002 normalized EBITDAM of \$58.5 million. The multiple was determined by obtaining a range of multiples representing the multiple of enterprise value to EBITDA for comparable public companies and the multiple of enterprise value to EBITDA for

acquisition transactions involving companies in Hillman's peer group. From this market comparable analysis, we selected a 7.0 times multiple for our valuation. Using an enterprise value of \$409.5 million, the value of our equity investment in Hillman is approximately \$138.4 million, or \$87.8 million greater than our cost basis of \$50.6 million.

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

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

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

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

We experienced a significant level of new or additional unrealized depreciation in the portfolio during 2002, largely due to a struggling U.S. economy and continued deterioration in the technology, broadcasting and cable, and telecommunications sectors. Total unrealized losses on Grade 4 and Grade 5 investments related to the technology, broadcasting and cable, and telecommunications sectors were \$64.2 million in 2002. In addition to investments in these industries, we also recorded \$87.7 million in unrealized losses on other investments in workout status included in our Grade 4 and Grade 5 investments. We also recorded \$21.4 million in unrealized losses related to Grade 3 investments where we do not currently expect any loss of principal or interest over time,

but where we believe the enterprise value of a portfolio company has decreased such that our investment on a current sale basis has also decreased.

OTHER MATTERS

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

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

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

FINANCIAL CONDITION, LIQUIDITY AND CAPITAL RESOURCES

Cash and Cash Equivalents

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

Debt and Other Commitments

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

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

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

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

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

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

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

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

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

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

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

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

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

Equity Capital and Dividends

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

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

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

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

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

Cash flow provided by operating activities adding back new portfolio investments for the year ended December 31, 2002, was \$571.7 million and dividends paid to shareholders for 2002 were \$229.9 million. Cash flow provided by operating activities adding back new portfolio investments for the year ended December 31, 2001, was \$330.8 million and dividends paid to shareholders for 2001 were \$186.2 million. Cash flow from operations before new investments has historically been sufficient to finance our operations.

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

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

CRITICAL ACCOUNTING POLICIES

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

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

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

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

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

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

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

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

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

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

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

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

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

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

SENIOR SECURITIES

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

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

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

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

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

BUSINESS

General

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

Private finance and

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

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

Corporate History and Offices

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

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

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

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

Private Finance

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

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

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

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

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

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

* Based on our market experience.

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

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

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

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

Management teams with meaningful equity ownership

Dominant or defensible market position

High return on invested capital

Revenues of \$50 million to \$500 million

Stable operating margins

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

Solid cash flow margins

Sound balance sheets

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Commercial Real Estate Finance

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

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

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

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

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

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

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

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

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

Investment Sourcing

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

private mezzanine and equity investors;

investment banks;

business brokers;

merger and acquisition advisors;

financial services companies; and

banks, law firms and accountants.

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

Investment Approval and Underwriting Procedures

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

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

Initial investment screening;

Presentation of investment to investment professionals at weekly meeting;

Initial approval of the investment by the investment committee;

Due diligence completed and investment structured;

Independent internal peer review of the investment completed;

Final approval of the investment by the investment committee;

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

Investment is funded.

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

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

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

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

Review initial loan collateral pool data;

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

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

Review re-underwriting data for the entire pool;

Submit bond purchase to investment committee for approval;

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

Complete final pricing and structuring of investment; and

Fund investment.

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

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

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

Portfolio

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

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

delinquency monitoring;

payment processing;

borrower inquiries;

escrow analysis and processing;

third-party reporting; and

insurance and tax administration.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Portfolio Valuation

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Investment Gains and Losses

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

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

Employees

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

LEGAL PROCEEDINGS

A series of class action lawsuits were filed in 2002 in the United States District Court for the Southern District of New York against us, certain of our directors and officers and our former independent auditors, Arthur Andersen LLP, with respect to alleged violations of the securities laws. Specifically, these lawsuits allege that the defendants violated Section 10(b), Rule 10b-5, and Section 20(a) of the Securities Exchange Act of 1934 by purportedly misstating the value of certain portfolio investments in our financial statements, which allegedly resulted in the purchase of our common stock by purported class members at artificially inflated prices. Several of the complaints also allege state law claims for common law fraud. The complaints seek compensatory and other damages, and costs and expenses associated with the litigation. The lawsuits have been consolidated into a single proceeding captioned In re Allied Capital Corp. Securities Litigation, 02 CV 3812. The consolidated complaint does not include Arthur Andersen LLP as a named defendant or assert any state law claims against the remaining named defendants. We have filed a motion to dismiss the lawsuit and the plaintiffs have filed an opposition to this motion. We have filed a reply to the plaintiff's opposition. We believe that the lawsuit is without merit, and we intend to defend the lawsuit vigorously. While we do not expect this matter to materially affect our financial condition or results of operations, there can be no assurance as to whether any such pending litigation will have a material adverse effect on our financial condition or results of operations in any future reporting period.

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

PORTFOLIO COMPANIES

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

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

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

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

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

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

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

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

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

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

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JRI Industries, Inc. 2958 East Division Springfield, MO 65803	Machinery Manufacturer	Warrants to Purchase Common Stock	6.5%
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Name and Address of Portfolio Company	Nature of its Principal Business	Title of Securities Held by the Company	Percentage of Class Held(1)
Julius Koch USA, Inc. 387 Church Street New Bedford, MA 02745 C	Mini-Blind Cord Manufacturer	Warrants to Purchase Common Stock	39.6%
Kirker Enterprises, Inc. 55 East 6th Street Paterson, NJ 07524	Nail Enamel Manufacturer	Equity Interest in Affiliate Company Warrants to Purchase Series B Common Stock	22.5% 22.5%
Kirkland s, Inc. P.O. Box 7222 Jackson, TN 38308-7222	Home Furnishing Retailer	Common Stock	1.3%
Kyrus Corporation 5 Artillery Road Taylors, SC 29687	Value-Added Reseller, Computer Systems	Warrants to Purchase Common Stock	18.4%
Love Funding Corporation 1220 19th Street, NW, Suite 801 Washington, DC 20036	Mortgage Services	Series D Preferred Stock	26.0%
Matrics, Inc. 8850 Stanford Boulevard Suite 3000 Columbia, MD 21045	Radio Frequency Identification Technology	Series B Convertible Preferred Stock Warrants to Purchase Series B Convertible Preferred Stock	3.4% 0.2%
MedAssets Inc. 100 Northpoint Center East #150 Alpharetta, GA 30022	Healthcare Outsourcing	Series B Convertible Preferred Stock Warrants to Purchase Common Stock	6.4% 0.2%
Mid-Atlantic Venture Fund IV, L.P. 128 Goodman Drive Bethlehem, PA 18015	Private Equity Fund	Limited Partnership Interest	6.7%
Midview Associates, L.P. 2 Eaton Street, Suite 1101 Hampton, VA 23669	Residential Land Development	Warrants to Purchase Partnership Interests	35.0%
Norstan Apparel Shops, Inc. 33-00 47th Avenue Long Island City, NY 11101	Women s Apparel Retailer	Common Stock Warrants to Purchase Common Stock	26.3% 8.0%
North American Archery Group, LLC 4600 SW 41st Boulevard Gainesville, FL 32608	Sporting Equipment Manufacturer	Debentures Convertible into LLC Equity Interest	26.9%
Novak Biddle Venture Partners III, L.P. 7501 Wisconsin Avenue East Tower, Suite 1380 Bethesda, MD 20814	Private Equity Fund	Limited Partnership Interest	2.9%
Nursefinders, Inc. 1200 Copeland Road, Suite 200 Arlington, TX 76011	Healthcare Services	Warrants to Purchase Common Stock	4.1%
Onyx Television GmbH Immedia Park 6b 50670 Koln Germany	Cable Television	Preferred Units	12.0%
Opinion Research Corporation P.O. Box 183 Princeton, NJ 08542	Corporate Marketing Research Firm	Warrants to Purchase Common Stock	6.8%
Oriental Trading Company, Inc. 108th Street, 4206 South Omaha, NE 68137	Direct Marketer of Toys	Series A Redeemable Preferred Stock Class A Common Stock	1.7% 1.7%
Outsource Partners, Inc.	Outsourced Facility	Warrants to Purchase	

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200 Mansell Court East	Services Provider	Preferred Stock	4.0%
Suite 500		Warrants to Purchase	
Roswell, GA 30076		Class A Common Stock	5.4%

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Name and Address of Portfolio Company	Nature of its Principal Business	Title of Securities Held by the Company	Percentage of Class Held(1)
Polaris Pool Systems, Inc. P.O. Box 1149 San Marcos, CA 92079-1149	Pool Cleaner Manufacturer	Warrants to Purchase Class B Common Stock	4.6%
Raytheon Aerospace, LLC 555 Industrial Drive South Madison, MS 39110	Aviation Maintenance and Logistics	Class B LLC Interest	6.7%
Soff-Cut Holdings, Inc. 1112 Olympic Drive Corona, CA 91719	Concrete Sawing Equipment Manufacturer	Series A Preferred Stock Common Stock	14.3% 2.7%
Spa Lending Corporation 1919 Pennsylvania Avenue, N.W. Washington, DC 20006	Health Spas	Series A Preferred Stock	100.0%
Sydran Food Services II, L.P. Bishop Ranch 8 3000 Executive Parkway Ste. 515 San Ramon, CA 94583-4254	Fast Food Franchise	Class A Preferred Units Class B Common Units Warrants to Purchase Class B Common Units	3.4% 1.7% 12.0%
Tubbs Snowshoe Company, LLC 52 River Road Stowe, VT 05672	Snowshoe Manufacturer	Equity Interests in Affiliate Company Warrants to Purchase Common Units in Affiliate Company	7.0% 8.5%
United Pet Group, Inc. 463 Ohio Pike Suite 303 Cincinnati, OH 45255	Manufacturer of Pet Products	Warrants to Purchase Common Stock	5.8%
Updata Venture Partners II, L.P. 11600 Sunrise Valley Drive Reston, VA 20191	Private Equity Fund	Limited Partnership Interest	16.1%
Venturehouse Group, LLC 1780 Tysons Blvd., Suite 400 McLean, VA 22102	Private Equity Fund	Common Equity Interest	2.2%
Walker Investment Fund II, LLLP 3060 Washington Road Suite 200 Glenwood, MD 21738	Private Equity Fund	Limited Partnership Interest	5.1%
Warn Industries, Inc. 12900 S.E. Capps Rd. Clackamas, OR 97015	Sport Utility Accessories Manufacturer	Warrants to Purchase Common Stock	48.6%
Wilshire Restaurant Group, Inc. 1100 Town & Country Road Suite 1300 Orange, CA 92868-4654	Restaurant Chain	Warrants to Purchase Common Stock Warrants to Purchase Preferred Stock	2.7% 2.7%
Woodstream Corporation 69 North Locust Street Lititz, PA 17543	Pest Control Manufacturer	Equity Interest in Affiliate Company Warrants to Purchase Common Stock	13.7% 7.2%

- (1) Percentages shown for securities held by us represent percentage of the class owned and do not necessarily represent voting ownership. Percentages shown for equity securities other than warrants or options represent the actual percentage of the class of security held before dilution. Percentages shown for warrants and options held represent the percentage of class of security we may own, on a fully diluted basis, assuming we exercise our warrants or options.
- (2)

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We directly or indirectly own more than 50% of the voting securities of the company, or control the board of directors, or are the controlling member.

- (3) The portfolio company is deemed to be an affiliated person under the 1940 Act because we hold one or more seats on the portfolio company's board of directors, are the general partner, or are the managing member.

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DETERMINATION OF NET ASSET VALUE

We determine the net asset value per share of our common stock quarterly. The net asset value per share is equal to the value of our total assets minus liabilities and preferred stock divided by the total number of common shares outstanding.

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

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

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

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

private finance investment is generally the sale, the recapitalization or, in some cases, the initial public offering of the portfolio company.

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

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

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

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

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

nominal cost equity is recorded by increasing the cost basis in the equity and decreasing the cost basis in the related debt securities.

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

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

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

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

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

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

estimated cash flows resulting from changes in prepayment or loss assumptions in the underlying collateral pool.

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

MANAGEMENT

Our Board of Directors supervises our management. The responsibilities of each director include, among other things, the oversight of the investment approval process, the quarterly valuation of our assets, and oversight of our financing arrangements. The Board of Directors maintains an Executive Committee, Audit Committee, Compensation Committee, and Nominating Committee, and may establish additional committees in the future. Some or all of our directors also serve as directors of our subsidiaries.

Our investment decisions in each business area are made by investment committees composed of our most senior investment professionals. No one person is primarily responsible for making recommendations to a committee.

We are internally managed and our investment professionals manage our portfolio and the portfolios of companies for which we serve as investment adviser. These investment professionals have extensive experience in managing investments in private businesses in a variety of industries, and are familiar with our approach of lending and investing. Because we are internally managed, we pay no investment advisory fees, but instead we pay the operating costs associated with employing investment management professionals.

Structure of Board of Directors

The Board of Directors is classified into three approximately equal classes with three-year terms, with only one of the three classes expiring each year. Directors serve until their successors are elected and qualified.

Directors

Information regarding the board of directors is as follows:

Name	Age	Position	Director Since(1)	Expiration of Term
Interested Directors(2)				
William L. Walton	53	Chairman, Chief Executive Officer and President	1986	2004
George C. Williams, Jr.	76	Chairman Emeritus	1964	2004
Robert E. Long	71	Director	1972	2004
Independent Directors				
Brooks H. Browne	53	Director	1990	2004
John D. Firestone	59	Director	1993	2005
Anthony T. Garcia	46	Director	1991	2005
Ann Torre Grant(3)	45	Director	2003	2003
Lawrence I. Hebert	56	Director	1989	2005
John I. Leahy	72	Director	1994	2003
Alex J. Pollock(3)	60	Director	2003	2003
Guy T. Steuart II	71	Director	1984	2003
Laura W. van Roijen	51	Director	1992	2005

(1) Includes service as a director of any of the predecessor companies.

(2) Interested persons of Allied Capital, as defined in the Investment Company Act of 1940.

(3) On March 13, 2003, our Board of Directors appointed Alex J. Pollock and Ann Torre Grant to fill two board vacancies.

Each director has the same address as Allied Capital, 1919 Pennsylvania Avenue, N.W., Washington, D.C. 20006.

Executive Officers

Information regarding our executive officers is as follows:

Name	Age	Position
William L. Walton	53	Chairman, Chief Executive Officer and President
Joan M. Sweeney	43	Chief Operating Officer
Penni F. Roll	37	Chief Financial Officer
Scott S. Binder	48	Managing Director
Michael J. Grisius	39	Managing Director
Robert D. Long	46	Managing Director
Edward H. Ross	37	Managing Director
John M. Scheurer	50	Managing Director
John D. Shulman	40	Managing Director
Paul R. Tanen	36	Managing Director
Thomas H. Westbrook	39	Managing Director
G. Cabell Williams, III	48	Managing Director
Scott A. Somer	34	Director of Financial Operations
Suzanne V. Sparrow	37	Executive Vice President and Secretary

Each executive officer has the same address as Allied Capital, 1919 Pennsylvania Avenue, N.W., Washington, D.C. 20006.

Biographical Information**Directors**

Our directors have been divided into two groups interested directors and independent directors. Interested directors are interested persons as defined in the Investment Company Act of 1940.

Interested Directors

William L. Walton has been the Chairman, Chief Executive Officer, and President of Allied Capital since 1997. He has served on Allied Capital's Board of Directors since 1986, and was named Chairman and CEO in February 1997. Mr. Walton previously served as Managing Director of New York-based Butler Capital Corporation, a mezzanine buyout firm, and was the personal venture capital advisor for William S. Paley, founder and Chairman of CBS. In addition, he was a Senior Vice President in Lehman Brothers Kuhn Loeb's Investment Banking Group. Mr. Walton also founded and managed two start-up businesses, Success Lab, Inc. and Language Odyssey, in the emerging education industry (1992-1996). Mr. Walton is a director of Riggs National Corporation, The Hillman Companies, Inc., and the National Venture Capital Association.

George C. Williams, Jr. is Chairman Emeritus of Allied Capital. Mr. Williams was an officer of the predecessor companies from the later of 1959 or the inception of the relevant entity and President or Chairman and Chief Executive Officer of the predecessor companies from the later of 1964 or each entity's inception until 1991. Mr. Williams is the father of G. Cabell Williams III, an executive officer of Allied Capital.

Robert E. Long has been the Chief Executive Officer and a director of Goodwyn, Long & Black Investment Management, Inc. since 1997, and has been the Chairman of Emerald City Radio Partners, LLC since 1997. Mr. Long was the President of Business News Network, Inc. from 1995 to 1998, the Chairman and Chief Executive Officer of Southern Starr Broadcasting Group, Inc. from 1991 to 1995, and a director and the President of Potomac Asset Management, Inc. from 1983 to 1991. Mr. Long is a director of AmBase Corporation, CSC Scientific, Inc., Advanced Solutions International, Inc. and Graphic Computer Solutions, Inc. Mr. Long is the father of Robert D. Long, an executive officer of Allied Capital.

Independent Directors

Brooks H. Browne is a private investor. Mr. Browne was the President of Environmental Enterprises Assistance Fund from 1993 to 2002. He is a director of SEAF and Solar Development Capital, Ltd.

John D. Firestone has been a Partner of Secor Group (venture capital) since 1978. Mr. Firestone is a director of Security Storage Company of Washington, DC, and served as a director of Bryn Mawr Bank Corporation from 1998 to 2001. Mr. Firestone is currently a member of the board of several non-profit organizations.

Anthony T. Garcia has been Vice President of Finance of Formity Systems, Inc., a developer of software products for business management of data networks, since January 2002. Mr. Garcia was a private investor from 2000 to 2001, the General Manager of Breen Capital Group (investor in tax liens) from 1997 to 2000, and a Senior Vice President of Lehman Brothers Inc. from 1985 to 1996.

Ann Torre Grant is a strategic and financial consultant. From 1995 to 1997, Ms. Grant served as Executive Vice President, CFO and Treasurer of NHP, Inc., a national real estate services firm. From 1991 to 1995, Ms. Grant was Vice President and Treasurer of US Airways. She serves on the boards of Franklin Mutual Series and SLM Corporation (Sallie Mae).

Lawrence I. Hebert has been a director and President and Chief Executive Officer of Riggs Bank N.A. (a subsidiary of Riggs National Corporation) since February 2001, and has served as a director of Riggs National Corporation since 1988. Mr. Hebert also serves as a director of Riggs Investment Management Corporation and Riggs Bank Europe Limited (both indirect subsidiaries of Riggs National Corporation). Mr. Hebert is the President and a director of Perpetual Corporation (owner of Allbritton Communications Company and ALLNEWSCO, Inc.). Mr. Hebert is a director of ALLNEWSCO, Inc. (news programming service), the President of Westfield News Advertiser, Inc. (owner of a television station and newspapers), a Trustee of The Allbritton Foundation, and Vice Chairman of Allbritton Communications Company. Mr. Hebert previously served as Vice Chairman (1983 to 1998), President (1984 to 1998), and Chairman and Chief Executive Officer (1998 to 2001) of Allbritton Communications Company. Riggs Bank N.A. has a \$60 million commitment under our revolving line of credit.

John I. Leahy has been the President of Management and Marketing Associates, a management consulting firm, since 1986. Mr. Leahy was the President and Group Executive Officer, Western Hemisphere of Black & Decker Corporation from 1982 to 1985. Mr. Leahy is a director of B&L Sales, Inc. and is the Chairman of Gallagher Fluid Seals, Inc. Mr. Leahy is Trustee Emeritus of the Sellinger School of Business, Loyola College, Maryland.

Alex J. Pollock has been President and Chief Executive Officer of the Federal Home Loan Bank of Chicago since 1991. He also serves as a director of the Great Lakes Higher Education Corporation and the Great Books Foundation. Mr. Pollock is Past President of the International Union for Housing Finance and the Bankers Club of Chicago.

Guy T. Steuart II has been a director and President of Steuart Investment Company, which manages, operates, and leases real and personal property and holds stock in operating subsidiaries engaged in various businesses, since 1960. Mr. Steuart is Trustee Emeritus of Washington and Lee University.

Laura W. van Roijen has been a private investor since 1992.

Executive Officers who are not Directors

Joan M. Sweeney, Chief Operating Officer, has been employed by Allied Capital since 1993. Ms. Sweeney oversees Allied Capital's daily operations. Prior to joining Allied Capital, Ms. Sweeney was employed by Ernst & Young, Coopers & Lybrand, and the SEC Division of Enforcement.

Penni F. Roll, Chief Financial Officer, has been employed by Allied Capital since 1995. Ms. Roll is responsible for Allied Capital's financial operations. Prior to joining Allied Capital, Ms. Roll was employed by KPMG LLP.

Scott S. Binder, Managing Director, has been employed by Allied Capital in the private finance investment group since 1997 and was a consultant to Allied Capital from 1991 until 1997. Prior to joining Allied Capital, Mr. Binder formed and was President of Overland Communications Group. He has also worked in the specialty finance and leasing industry.

Michael J. Grisius, Managing Director, has been employed by Allied Capital since 1992. Prior to joining Allied Capital, Mr. Grisius worked in corporate finance at Chemical Bank and was employed by KPMG LLP.

Robert D. Long, Managing Director, joined Allied Capital in its private finance investment group in 2002. Prior to joining Allied Capital, Mr. Long was Managing Director and Head of Investment Banking at C.E. Unterberg from 2001 to 2002, and Managing Director at E*OFFERING/Wit SoundView from 2000 to 2001. He also held management positions at Bank of America (Montgomery Securities) from 1996 to 2000, and Nomura Securities International, from 1992 to 1996, and prior to that he served as a Managing Director at CS First Boston.

Edward H. Ross, Managing Director, joined Allied Capital in its private finance investment group in 2002. Prior to joining Allied Capital, Mr. Ross co-founded and served as a Managing Director of Leveraged Capital at Wachovia Securities (previously First Union Securities) from 1998 to 2002, a merchant banking arm for the firm. He also held management positions in First Union's Leveraged Finance Group from 1994 to 1998.

John M. Scheurer, Managing Director, has been employed by Allied Capital in the commercial real estate investment group since 1991. Prior to joining Allied Capital, Mr. Scheurer worked with Capital Recovery Advisors, Inc. and First American Bank. He also started his own company, The Scheurer Company, and co-founded Hunter Associates, a leasing and consulting real estate firm in the Washington, DC area.

John D. Shulman, Managing Director, has been employed by Allied Capital in the private finance investment group since 2001. Prior to joining Allied Capital, Mr. Shulman served as the President and CEO of Onyx International, LLC from 1995 to 2001. He currently serves as a director of ChemLink Laboratories LLC and as a member of the investment committees of Taiwan Mezzanine Fund and Greater China Private Equity Fund.

Paul R. Tanen, Managing Director, has been employed by Allied Capital in the private finance investment group since 2000. Prior to joining Allied Capital, Mr. Tanen served as a Managing Director at Ridgfield Partners from 1998 to 2000, and was a Founding Member of the private equity group at Charter Oak Partners from 1992 to 1998.

Thomas H. Westbrook, Managing Director, has been employed by Allied Capital in the private finance investment group since 1991. Prior to joining Allied Capital, Mr. Westbrook worked with the North Carolina Enterprise Fund and was a Lending Officer in NationsBank's corporate lending unit.

G. Cabell Williams, III, Managing Director, has been employed by Allied Capital in the private finance investment group since 1981. Mr. Williams has served in many capacities during his tenure with Allied Capital.

Scott A. Somer, Director of Financial Operations, has been employed by Allied Capital since 1998. Mr. Somer is responsible for managing the accounting and loan servicing activities. Prior to joining Allied Capital, Mr. Somer was employed by KPMG LLP.

Suzanne V. Sparrow, Executive Vice President and Corporate Secretary, has been employed by Allied Capital since 1987. Ms. Sparrow manages our investor relations activities.

Committees of the Board of Directors

Our Board of Directors has established an Executive Committee, an Audit Committee, a Compensation Committee and a Nominating/Corporate Governance Committee.

The Executive Committee has and may exercise those rights, powers and authority that the Board of Directors from time to time grants to it, except where action by the full Board is required by statute, an order of the SEC or our charter or bylaws. The Executive Committee also reviews and approves all investments of \$10 million or more. The Executive Committee met 32 times during 2002. The 2003 Executive Committee currently consists of Messrs. Walton, Firestone, Hebert, Leahy, Long, Steuart, and Williams.

The Audit Committee operates pursuant to a charter approved by the Board of Directors, a copy of which is included as Exhibit A to our proxy statement for the 2003 Annual Meeting of Stockholders. The charter sets forth the responsibilities of the Audit Committee. The Audit Committee's responsibilities include recommending the selection of independent public accountants for Allied Capital, reviewing with such independent public accountants the planning, scope and results of their audit of our financial statements and the fees for services performed, reviewing with the independent public accountants the adequacy of internal control systems, reviewing our annual financial statements and receiving our audit reports and financial statements. The Audit Committee met 13 times during 2002. The 2003 Audit Committee currently consists of Messrs. Browne and Garcia

and Mmes. Grant and van Roijen, all of whom are considered independent under the rules promulgated by the New York Stock Exchange.

The Compensation Committee determines the compensation for our executive officers and the amount of salary and bonus to be included in the compensation package for each of our officers and employees. In addition, the Compensation Committee approves stock option grants for our officers under our stock option plan. The Compensation Committee met six times during 2002. The 2003 Compensation Committee currently consists of Messrs. Leahy, Browne, and Garcia.

The Nominating/Corporate Governance Committee recommends candidates for election as directors to the Board of Directors and makes recommendations to the Board as to our corporate governance policies. The Nominating/Corporate Governance Committee met once during 2002. The 2003 Nominating/Corporate Governance Committee currently consists of Messrs. Hebert, Browne, and Pollock and Ms. van Roijen.

COMPENSATION OF EXECUTIVE OFFICERS AND DIRECTORS

Under SEC rules applicable to business development companies, we are required to set forth certain information regarding the compensation of certain executive officers and directors. The following table sets forth compensation paid during the year ended December 31, 2002 to all of our directors and our three highest paid executive officers (collectively, the Compensated Persons) in each capacity in which each Compensated Person served. Certain of the Compensated Persons served as both officers and directors.

Our directors have been divided into two groups interested directors and independent directors. Interested directors are interested persons as defined in the Investment Company Act of 1940.

Compensation Table

Name	Aggregate Compensation from the Company(1,2)	Securities Underlying Options/SARs(4)	Pension or Retirement Benefits Accrued as Part of Company Expenses(2)	Directors Fees by the Company(5)
Interested Directors:				
William L. Walton, <i>Chairman and CEO</i>	\$2,617,819	612,200		\$
George C. Williams, Jr., <i>Director and Chairman Emeritus</i> (3)	170,000	5,000		26,000
Robert E. Long, <i>Director</i>	31,000	5,000		31,000
Independent Directors:				
Brooks H. Browne, <i>Director</i>	44,000	5,000		44,000
John D. Firestone, <i>Director</i>	19,000	5,000		19,000
Anthony T. Garcia, <i>Director</i>	23,000	5,000		23,000
Lawrence I. Hebert, <i>Director</i>	25,000	5,000		25,000
John I. Leahy, <i>Director</i>	37,000	5,000		37,000
Guy T. Steuart II, <i>Director</i>	25,000	5,000		25,000
Laura W. van Roijen, <i>Director</i>	22,000	5,000		22,000
Executive Officers:				
Joan M. Sweeney, <i>Chief Operating Officer</i>	1,827,615	462,281		
Thomas H. Westbrook, <i>Managing Director</i>	1,588,942	425,625		

- (1) We paid no perquisites in excess of the lesser of \$50,000 or 10% of the Compensated Person's total salary and bonus for the year.
(2) The following table provides detail as to aggregate compensation paid during 2002 as to our three highest paid executive officers:

	Salary	Bonus and Awards	Other Benefits
Mr. Walton	\$ 519,231	\$ 2,025,000	\$ 73,588
Ms. Sweeney	360,000	1,425,000	42,615
Mr. Westbrook	256,308	1,305,000	27,634

Included for each executive officer in Bonus and Awards is an annual bonus and retention award. Included for each executive officer in Other Benefits is an employer contribution to the 401(k) Plan, life insurance premiums, disability insurance, and a contribution to the Deferred Compensation Plan. See also Employment Agreements .

- (3) In addition to director's fees, Mr. Williams received \$144,000 in consulting fees.
(4) See Stock Option Awards for terms of options granted in 2002. We do not maintain a restricted stock plan or a long-term incentive plan.
(5) Consists only of directors' fees we paid during 2002. Such fees are also included in the column titled Aggregate Compensation from the Company.

Compensation of Directors

During 2002, each director received a \$10,000 annual retainer in lieu of per meeting fees; directors who serve on the Executive Committee received a \$25,000 annual retainer in lieu of per meeting fees. Members of each committee other than the Executive Committee received \$1,000 for each committee meeting attended during the year. In addition, the chairpersons of the Audit and Compensation Committees each received a \$3,000 annual retainer for their additional services in these capacities. Our Chairman and CEO, William L. Walton, did not receive directors fees.

For 2003, each non-officer director will receive an annual retainer of \$40,000. In addition, committee chairs will receive an annual retainer of \$5,000. For each meeting attended during 2003, Executive Committee members will receive \$1,000 per meeting; Audit Committee members will receive \$2,500 per meeting; and members of the Compensation and Nominating/ Corporate Governance Committees will receive \$1,500 per meeting.

Non-officer directors are eligible for stock option awards under our stock option plan pursuant to an exemptive order from the SEC. The terms of the order, which was granted in September 1999, provided for a one-time grant of 10,000 options to each non-officer director on the date that the order was issued, or on the date that any new director is elected by stockholders to the Board of Directors. Thereafter, each non-officer director will receive 5,000 options each year on the date of the annual meeting of shareholders at the fair market value on the date of grant. See Stock Option Plan.

Stock Option Awards

The following table sets forth the details relating to option grants in 2002 to Compensated Persons under our Stock Option Plan, and the potential realizable value of each grant, as prescribed to be calculated by the SEC. See Stock Option Plan.

Options Grants During 2002

Name	Number of Securities Underlying Options Granted(1)	Percent of Total Options Granted In 2002(2)	Exercise Price Per Share	Expiration Date	Potential Realizable Value at Assumed Annual Rates Of Stock Appreciation Over 10-Year Term(3)	
					5%	10%
Interested Directors:						
William L. Walton	612,200	9.94%	\$21.52	12/13/12	\$8,285,400	\$20,996,830
George C. Williams, Jr.	5,000	0.08%	21.52	12/13/12	67,669	171,487
Robert E. Long	5,000	0.08%	25.97	5/7/12	81,662	206,947
Independent Directors:						
Brooks H. Browne	5,000	0.08%	25.97	5/7/12	81,662	