ALLIED CAPITAL CORP
Form 497
December 10, 2003

PROSPECTUS SUPPLEMENT
(To Prospectus dated June 11, 2003)

Filed Pursuant to Rule 497
Registration Statement No. 333-104149

2,000,000 Shares

Common Stock

We are offering for sale 2,000,000 shares of our common stock. Our common stock is traded on the New York Stock Exchange under the symbol ALD. The last reported sales price for our common stock on December 9, 2003, was $27.64 per share.

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

	Per Share	Total
Public offering price	$27.07	$54,140,000
Underwriting discount	$1.35	$2,700,000
Proceeds to Allied Capital Corporation(1)	$25.72	$51,440,000

(1) Before deducting expenses payable by us estimated to be $195,000.

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

We have granted the underwriter a 30-day option to purchase up to 300,000 shares of common stock to cover overallotments. If the underwriter exercises the option in full, the public offering price, the underwriting discount and proceeds to us would be $62,261,000, $3,105,000 and $59,156,000, respectively.

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

The shares of common stock will be ready for delivery on or about December 15, 2003.

Merrill Lynch & Co.

The date of this prospectus supplement is December 10, 2003.

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

TABLE OF CONTENTS

Prospectus Supplement

	Page Number
Fees and Expenses	S-1
Use of Proceeds	S-2
Underwriting	S-3
Legal Matters	S-5
Recent Developments	S-5
Interim Management s Discussion and Analysis of Financial Condition and Results of Operations	S-7
Interim Consolidated Financial Statements	S-41
Notice Regarding Independent Accountants Review Report	S-79

Prospectus

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

(i)

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

Information contained in this prospectus supplement and the accompanying prospectus 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 negat thereof or other variations thereon or comparable terminology. The matters described in Risk Factors in the accompanying prospectus and certain other factors noted throughout this prospectus supplement and the accompanying prospectus 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.

FEES AND EXPENSES

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

Shareholders Transaction Expenses	
Sales load (as a percentage of offering price)[(1)]	5.0%
Dividend reinvestment plan fees[(2)]	None
Annual Expenses (as a percentage of consolidated net assets attributable to common shares)(3)	
Operating expenses[(4)]	3.3%
Interest payments on borrowed funds[(5)]	4.4%
Total annual expenses[(6)]	7.7%

---

(1) Represents the underwriting discounts and commissions with respect to the shares sold by Allied Capital in this offering.

(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, if any. See Dividend Reinvestment Plan in the accompanying prospectus.

(3) Consolidated net assets attributable to common stock equals net assets (*i.e.*, total consolidated assets less total consolidated liabilities and preferred stock) at September 30, 2003.

(4) Operating expenses represent our estimated operating expenses for the year ending December 31, 2003, excluding interest on indebtedness. This percentage for the year ended December 31, 2002, was 3.5%.

(5) The Interest payments on borrowed funds represents our estimated interest expenses for the year ending December 31, 2003. We had outstanding borrowings of $954.2 million at September 30, 2003. This percentage for the year ended December 31, 2002, was 4.6%. See Risk Factors in the accompanying prospectus.

(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 the 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.

	1 Year	3 Years	5 Years	10 Years
You would pay the following expenses on a $1,000 investment, assuming a 5.0% annual return	$125	$275	$427	$813

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 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 in the accompanying prospectus.

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

USE OF PROCEEDS

The net proceeds from the sale of the shares of our common stock, after deducting estimated expenses of this offering, are estimated to be $51.2 million. We intend to use the net proceeds from selling our common stock for investment in the debt or equity securities of private companies, non-investment grade commercial mortgage-backed securities or collateralized debt obligation bonds and preferred shares and other general corporate purposes.

UNDERWRITING

Subject to the terms and conditions stated in the underwriting agreement with Merrill Lynch, Pierce, Fenner & Smith Incorporated, the underwriter has agreed to purchase, and we have agreed to sell to the underwriter, all 2,000,000 of the shares offered by this prospectus supplement.

The underwriting agreement provides that the obligation of the underwriter to purchase the shares offered by us is subject to some conditions. The underwriter is obligated to purchase all of the shares offered by us, if any of the shares are purchased.

This offering of the shares is made for delivery when, as and if accepted by the underwriter and subject to prior sale and to withdrawal, cancellation or modification of this offering without notice. The underwriter reserves the right to reject an order for the purchase of shares in whole or in part.

We have agreed to indemnify the underwriter against certain liabilities, including liabilities under the Securities Act, and to contribute to payments the underwriter may be required to make in respect of these liabilities.

Commissions and Discounts

The underwriter proposes to offer the shares to the public initially at the public offering price set forth on the cover of this prospectus supplement.

The following table shows the per share and total underwriting discounts and commissions to be paid to the underwriter by us assuming both no exercise and full exercise of the underwriter s option to purchase additional shares.

	Without Option	With Option
Per share	$1.35	$1.35
Total	$2,700,000	$3,105,000

We estimate that the total expenses of this offering, excluding the underwriting discounts and commissions, will be approximately $195,000 which will be paid by us.

Overallotment Option

The underwriter has the option to purchase up to 300,000 additional shares of common stock from us at the same price it is paying for the 2,000,000 shares offered hereby. The underwriter may purchase additional shares only to cover overallotments made in connection with this offering and only within 30 days after the date of this prospectus supplement. The underwriter will offer any additional shares that it purchases on the terms described in the preceding paragraph.

No Sale of Similar Securities

We and certain of our executive officers have agreed not to sell or transfer any shares of common stock or to engage in certain hedging transactions with respect to the common stock for a period of 60 days after the date of this prospectus supplement without first obtaining the written consent of Merrill Lynch, Pierce, Fenner & Smith Incorporated, except in certain limited circumstances, including our additional issuance of equity securities through privately negotiated transactions that may or may not involve an

underwriter, whether or not registered with the SEC, aggregating not more than $50 million.

Price Stabilization and Short Positions

In connection with this offering, the underwriter may purchase and sell shares of our common stock in the open market. These transactions may include stabilizing transactions, short sales and purchases to cover positions created by short sales. Stabilizing transactions consist of bids or purchases made for the purpose of preventing or retarding a decline in the market price of our common stock while this offering is in progress. Short sales involve the sale by the underwriter of a greater number of shares than it is required to purchase in this offering. Short sales may be either covered short sales or naked short sales. Covered short sales are sales made in an amount not greater than the underwriter s over-allotment option to purchase additional shares in this offering. The underwriter may close out any covered short position by either exercising its over-allotment option or purchasing shares in the open market. In determining the source of shares to close out the covered short position, the underwriter will consider, among other things, the price of shares available for purchase in the open market as compared to the price at which it may purchase shares through the over-allotment option. Naked short sales are sales in excess of the over-allotment option. The underwriter must close out any naked short position by purchasing shares in the open market. A naked short position is more likely to be created if the underwriter is concerned there may be downward pressure on the price of shares in the open market after pricing that could adversely affect investors who purchase in this offering.

We have been advised by the representatives of the underwriter that these transactions may be effected on the NYSE or otherwise and, if commenced, may be discontinued at any time. Similar to other purchase activities, these activities may have the effect of raising or maintaining the market price of our shares or preventing a decline in the market price of our shares. As a result, the price of our shares may be higher than the price that might otherwise exist in the open market.

Settlement

The underwriter expects to deliver the shares through the facilities of The Depository Trust Company in New York, New York, on or about December 15, 2003. At that time, the underwriter will pay us for the shares in immediately available funds. For the fourth quarter of 2003, our Board of Directors declared a dividend of $0.57 per common share. The fourth quarter dividend is payable on December 26, 2003, with a record date of December 12, 2003. Accordingly, the shares offered by this prospectus supplement will not be entitled to the fourth quarter dividend.

Other Relationships

In the ordinary course of business, the underwriter and/or its affiliates have in the past performed, and may continue to perform, commercial banking, financial advisory and investment banking services for us for which they have received, or may receive, customary compensation. An affiliate of the underwriter is a member of the lending syndicate for our unsecured revolving line of credit.

Other Information

This offering is being conducted in compliance with Rule 2810 of the Conduct Rules of the National Association of Securities Dealers, Inc.

The address for Merrill Lynch, Pierce, Fenner & Smith Incorporated is 4 World Financial Center, New York, N.Y. 10080.

LEGAL MATTERS

Certain legal matters with respect to the validity of the shares of common stock we are offering will be passed upon for us by Sutherland Asbill & Brennan LLP, Washington, D.C. Certain legal matters related to the offering will be passed upon for the underwriter by Morgan, Lewis & Bockius LLP, New York, New York.

RECENT DEVELOPMENTS

During the fourth quarter of 2003, we made the following significant new private finance investments:

We agreed to provide approximately $180 million in the form of equity and subordinated debt to recapitalize and acquire a majority interest in Advantage Sales & Marketing, Inc. Upon completion of the transaction, Advantage Sales & Marketing, Inc. will be the parent company of Advantage Sales & Marketing, LLC, a leading sales and marketing agency providing outsourced sales, merchandising, and marketing services to the consumer packaged goods industry. This transaction is subject to customary closing conditions, including regulatory and shareholder approvals and certain other adjustments, and is expected to close in the first quarter of 2004.

We provided $16.5 million in subordinated debt to support the buyout of Griffith Energy, Inc. from its parent company, Energy East Corporation. Griffith Energy, Inc. is a distributor of propane, heating oils, and power fuels to residential customers, wholesale customers and independent gasoline dealers in New York.

We purchased $24 million in subordinated debt with warrants of Mercury Air Group, Inc., a company that offers a broad range of services to the aviation industry through its four wholly owned subsidiaries, from a private lender.

Concurrently with our investment in Mercury Air Group, Inc., we also signed a definitive purchase agreement to acquire Mercury Air Centers, Inc., a wholly owned subsidiary of Mercury Air Group, Inc. that provides fixed base operations at 19 airports throughout the United States. The total purchase price is expected to be approximately $70 million in addition to the assumption of construction commitments, subject to certain adjustments. We intend to provide debt and equity financing for the transaction. The closing of this transaction is subject to certain conditions, including the satisfactory completion of due diligence by us and the approval of the transaction by the shareholders of Mercury Air Group, Inc. Upon completion of the purchase transaction, Mercury Air Group, Inc. will repay its $24 million subordinated debt obligation to us.

In addition, we acquired a majority interest in Callidus Capital Management, LLC for $4.8 million and management has retained a significant minority position in the company. Callidus Capital is an asset management company that structures and manages investments in collateralized debt obligations (CDOs), senior loan collateralized loan obligations (CLOs), and other related investments. In conjunction with this transaction, we committed $100 million of financing to fund working capital, support warehouse facilities, and invest in the equity of future CLOs issued by Callidus Capital.

During the fourth quarter, we have also sold certain BB+, BB and BB- rated CMBS bonds with a cost basis of $157.4 million for $160.2 million in cash proceeds.

We also recently began to implement certain internal organizational measures that we believe will allow us to grow our business more efficiently, including separating our private finance function into two focused investment areas: mezzanine investing and buyout investing. In addition, our board of directors appointed Scott Binder, one of our managing directors, to the newly created position of Chief Valuation Officer. Other initiatives include increasing our focus on growing our portfolio from within through the dedication of additional time and resources to such matters and building a dedicated resource for assisting portfolio companies in financial transactions, including securing senior debt capital and structured credit transaction.

On September 22, 2003, one of our directors, George C. Williams, retired as a member of our board of directors.

During the second quarter of 2003, our board of directors extended the term of all existing employment agreements with certain of our officers from June 30, 2003 to December 31, 2003.

INTERIM MANAGEMENT S DISCUSSION AND ANALYSIS

OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following analysis of our financial condition and results of operations should be read in conjunction with our Consolidated Financial Statements and the Notes thereto included herein and in the accompanying prospectus. The information herein contains certain forward-looking statements. These statements include the plans and objectives of management for future operations and financial objectives and can be identified by the use of forward-looking terminology such as may, will, expect, intend, anticipate, estimate, or continue or the negative thereof or 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 in the Risk Factors section in the accompanying prospectus. Other factors that could cause actual results to differ materially include:

changes in the economy;

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

future regulatory actions and conditions in our operating areas.

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

OVERVIEW

We are a business development company that provides long-term debt and equity investment capital to 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, and collateralized debt obligation bonds and preferred shares, which we refer to as CDOs. 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 September 30, 2003, and December 31, 2002, was as follows:

	2003	2002
Private Finance	70%	70%
Commercial Real Estate Finance	30%	30%

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

PORTFOLIO AND INVESTMENT ACTIVITY

Total portfolio investment activity and yields at and for the three and nine months ended September 30, 2003 and 2002, and at and for the year ended December 31, 2002, were as follows:

($ in millions)	At and for the Three Months Ended September 30,		At and for the Nine Months Ended September 30,		At and for the Year Ended December 31,
	2003	2002	2003	2002	2002
	(unaudited)		(unaudited)		
Portfolio at value	$2,601.1	$2,343.6	$2,601.1	$2,343.6	$2,488.2
Investments funded	$ 138.4	$ 157.6	$ 664.8	$ 353.0	$ 506.4
Change in accrued or reinvested interest and dividends	$ 19.6	$ 13.5	$ 40.0	$ 33.0	$ 44.7
Principal repayments	$ 69.4	$ 44.7	$ 219.7	$ 111.7	$ 143.2
Sales	$ 5.1	$ 87.2	$ 281.8	$ 213.5	$ 213.5
Yield[(1)]	14.5%	14.1%	14.5%	14.1%	14.0%

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

Private Finance

The private finance portfolio, investment activity, and yields at and for the three and nine months ended September 30, 2003 and 2002, and at and for the year ended December 31, 2002, were as follows:

($ in millions)	At and for the Three Months Ended September 30,		At and for the Nine Months Ended September 30,		At and for the Year Ended December 31,
	2003	2002	2003	2002	2002
	(unaudited)		(unaudited)		
Portfolio at value:					
Loans and debt securities	$1,158.7	$1,122.6	$1,158.7	$1,122.6	$1,151.2
Equity interests	650.0	540.0	650.0	540.0	592.0
Total portfolio	$1,808.7	$1,662.6	$1,808.7	$1,662.6	$1,743.2
Investments funded	$ 31.7	$ 148.7	$ 305.7	$ 218.4	$ 297.2
Change in accrued or reinvested interest and dividends	$ 18.4	$ 13.5	$ 37.8	$ 32.6	$ 42.6
Principal repayments	$ 53.7	$ 44.2	$ 199.7	$ 100.2	$ 129.3
Yield[(1)]	15.3%	14.4%	15.3%	14.4%	14.4%

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

Investments funded for the nine months ended September 30, 2003 and 2002, and for the year ended December 31, 2002, consisted of the following:

($ in millions)	Loans and Debt Securities	Equity Interests	Total
For the Nine Months Ended September 30, 2003[1]			
Companies more than 25% owned	$ 48.0	$28.2	$ 76.2
Companies 5% to 25% owned	18.2	1.8	20.0
Companies less than 5% owned	203.8	5.7	209.5
Total	$270.0	$35.7	$305.7
For the Nine Months Ended September 30, 2002[1]			
Companies more than 25% owned	$ 31.7	$ 4.1	$ 35.8
Companies 5% to 25% owned	24.8	7.4	32.2
Companies less than 5% owned	141.0	9.4	150.4
Total	$197.5	$20.9	$218.4
For the Year Ended December 31, 2002[1]			
Companies more than 25% owned	$ 86.1	$18.7	$104.8
Companies 5% to 25% owned	22.3	0.4	22.7
Companies less than 5% owned	154.6	15.1	169.7
Total	$263.0	$34.2	$297.2

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

At September 30, 2003, we had outstanding funding commitments of $93.4 million to private finance portfolio companies, including $27.2 million committed to private equity funds. At September 30, 2003, we also had total commitments to private finance portfolio companies in the form of standby letters of credit and guarantees of $103.5 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 or equity interests of a company in a control buyout transaction. Buyout 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/or common stock, and management or transaction services fees to compensate us for the managerial assistance that we provide to a controlled portfolio company. We plan to continue to seek buyout investments. Buyout

investments provide the opportunity to invest meaningful amounts of capital with the potential for attractive current income returns as well as the potential for future capital gains. Buyout transactions are typically larger than our mezzanine investments. In some cases for companies that are more than 50% owned, we may not accrue interest on loans and debt securities depending on the working capital needs of such company. In such cases, we may defer current debt service.

Our most significant investments acquired through control buyout transactions at September 30, 2003, were Business Loan Express, LLC (BLX), acquired in 2000, and The Hillman Companies, Inc. (Hillman), acquired in 2001.

Business Loan Express, LLC. At September 30, 2003, our investment in BLX totaled $257.8 million at cost and $344.9 million at value, or 11.5% of our total assets, which includes unrealized appreciation of $87.1 million.

BLX is a national, 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 in all 79 SBA districts as designated by the SBA, and originates, sells, and services small business loans. In addition to the SBA 7(a) Guaranteed Loan Program, BLX originates conventional small business loans and originates loans under the USDA Business and Industry Guaranteed Loan Program. BLX has offices across the United States and is headquartered in New York, New York. Changes in the laws or regulations that govern SBLCs or the SBA 7(a) Guaranteed Loan Program or changes in government funding for this program could have a material adverse impact on BLX and, as a result, negatively affect our financial results.

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

In January 2003, BLX completed the acquisition of $128.0 million of performing loans and other assets from AIF. BLX purchased $121.5 million of performing SBA 7(a) unguaranteed loans at par and $6.5 million of other assets. The acquisition increased BLX s serviced portfolio and enhanced its nationwide loan origination platform. 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 growth needs of BLX post acquisition.

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

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

Summary financial data for BLX at and for the year ended September 30, 2003 and 2002, is presented below. The September 30, 2003, financial data is preliminary and unaudited.

($ in millions)	At and for the Year Ended September 30, 2003[1]	At and for the Year Ended September 30, 2002
Operating Data		
Total revenue	$ 108.3	$ 94.0
Net income[2]	$ 4.7	$ 3.4
Earnings before interest, taxes and management fees (EBITM)	$ 37.5	$ 47.0
Balance Sheet Data		
Total assets[3]	$ 353.0	$ 281.1
Total debt	$ 178.5	$ 186.1
Total owners equity	$ 136.1	$ 62.1
Other Data		
Total loan originations	$ 685.8	$ 624.5
Serviced loan portfolio	$2,227.4	$1,501.6
Number of loans	3,136	2,251
Loan delinquencies[4]	8.3%	8.5%
Serviced Loan Portfolio by Industry		
Hotels	24%	27%
Gas stations/convenience stores	19	17
Professional and retail services	12	10
Restaurants	9	10
Manufacturing and industrial	9	10
Car wash/auto repair services	7	3
Child care and health care services	6	4
Shrimp/fishing vessels	5	7
Recreation	5	6
Other	4	6
Total	100%	100%

(1) Post reorganization BLX s fiscal year end changed to September 30.

(2) For the year ended September 30, 2003, net income was reduced by $2.3 million due to costs associated with the AIF acquisition and the LLC reorganization and $2.3 million due to the increased value of issued and outstanding equity appreciation rights. In addition, net income was increased by $3.4 million due to the reversal of certain net deferred tax liabilities upon the conversion of BLX from a corporation to a limited liability company. As an LLC, BLX is generally not subject to federal income tax; however, BLX is subject to certain state income and franchise taxes, and income taxes associated with a taxable subsidiary corporation.

(3) Included in total assets is $6 million of goodwill at September 30, 2003 and 2002. There is no other goodwill on BLX s balance sheet. We acquired 94.9% of BLC Financial Services, Inc. on December 31, 2000. Push-down accounting was not required with respect to this transaction; accordingly, goodwill was not recorded by BLX.

(4) 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 8.5% at September 30, 2003. SBA 7(a) loans greater than one year old at September 30, 2003, had a delinquency rate of 10.6%. BLX will from time to time grant a 90-day deferment to borrowers experiencing short-term cash flow shortfalls. Loans that have been granted a deferment that perform as required are not considered delinquent consistent with SBA practice. The ability of small businesses to repay their loans may be adversely affected by numerous factors, including a downturn in their industry or negative

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

For the year ended September 30, 2003, BLX earned revenue of $108.3 million and EBITM of $37.5 million. EBITM was reduced by $2.3 million due to costs associated with the AIF acquisition and the LLC reorganization, as well as by $2.3 million due to the increased value of issued and outstanding equity appreciation rights to employees.

For the year ended September 30, 2003, EBITM before one-time costs and equity appreciation rights expense was $42.1 million, which compares to EBITM of $47.0 million for the year ended September 30, 2002. Because of the AIF acquisition, BLX increased its infrastructure and has been implementing a company-wide integration and process improvement plan. At the same time, BLX began to focus on diversifying its portfolio to better balance its securitization pools with respect to industry diversity. The combination of these changes in processes had a negative impact on BLX s loan originations in the latter part of its 2003 fiscal year, and loan originations in the fourth quarter of fiscal year 2003 were reduced to $121.4 million from a level of $148.7 million in the third quarter of 2003. The downturn in BLX s loan originations combined with a higher cost structure had the impact of decreasing BLX s EBITM for 2003 as compared to 2002. Management of BLX believes that its loan originations will begin to return to levels more consistent with the past in the upcoming quarters. Management of BLX also believes that the increased cost of infrastructure improvements will provide greater strength and stability for BLX in the future. As is discussed in the Results of Operations section below, we considered the decline in EBITM in our valuation analysis for our investment in BLX at September 30, 2003.

BLX s revenues consist of cash premiums from guaranteed loan sales, gain on sale income arising from loans sold at par or securitized where BLX will receive future cash flows representing the spread between loan interest and the interest paid on bonds issued including service fee income, interest income on loans remaining in BLX s portfolio, and other income. Gain on sale income is a non-cash source of income when recognized, and as future cash flows are received, the resulting cash reduces the receivable or residual interest that is recognized when the loan is sold. The total of cash loan sale premiums, cash interest income and cash received from residual interests and other cash income is equal to approximately 83% of BLX s revenue of $108.3 million during the year ended September 30, 2003.

BLX s business is to originate small business loans and then sell substantially all of the loans originated for cash proceeds. Loans originated during the year ended September 30, 2003, totaled $685.8 million, including loans purchased from AIF. Proceeds from loan sales during the year ended September 30, 2003, totaled approximately $664.2 million. BLX funds the construction of commercial real estate projects, and as a result is unable to sell a construction loan until the loan is fully funded and the construction is complete. In addition, BLX typically does not immediately receive the proceeds from the sale of its SBA 7(a) guaranteed and unguaranteed loan strips sold, but receives the cash upon settlement. Therefore until BLX sells construction loans or fully funded loans held for sale, it will finance the origination of the loans through funding on its revolving line of credit, or through financing provided by us.

BLX has a three-year $169.0 million revolving credit facility that matures in March 2004. As the controlling equity owner in BLX, we have provided an unconditional guaranty to the revolving credit facility lenders in an amount of up to 50% of the total obligations (consisting of principal, accrued interest, and other fees) of BLX under the revolving credit facility. The principal amount outstanding on the revolving credit facility at September 30, 2003, was $129.5 million and the amount guaranteed by us was $64.9 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

September 30, 2003. At September 30, 2003, we had provided three standby letters of credit in connection with three term securitization transactions completed by BLX totaling $25.6 million.

BLX sells the guaranteed piece of guaranteed loans for cash premiums of up to 10% of the guaranteed loan amount plus a retained annual servicing fee generally between 1.0% and 2.3% of the guaranteed loan amount. Cash premiums received from guaranteed loan sales during the year ended September 30, 2003, were approximately $31.3 million in total.

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

When BLX sells a guaranteed piece of an SBA 7(a) loan at par, or when BLX securitizes a loan, it will record a residual interest and servicing asset together referred to as Residual Interest in order to account for the retained interest in the loans sold and the net present value of the future cash flows it will receive from the loans sold or securitized. In computing the Residual Interest, BLX discounts estimated future cash flows after making assumptions as to future loan losses and loan prepayments which may reduce future cash flows. For the year ended September 30, 2003, BLX received cash payments from Residual Interest of approximately $49.3 million.

At September 30, 2003, BLX s Residual Interest totaled $175.6 million, representing BLX s estimate of the net present value of future cash flows of scheduled loan payments, after estimated future loan losses and loan prepayments. If scheduled loan payments were to be received as stated in the loan agreements with no future losses or prepayments, BLX would receive future cash flows of $733.9 million over time, with approximately $56.6 million, $52.9 million, $51.6 million, and $50.2 million (or $211.2 million in the aggregate) scheduled to be received in the next four years ending on September 30, 2004, 2005, 2006, and 2007, respectively.

The Hillman Companies, Inc. At September 30, 2003, our investment in Hillman totaled $94.1 million at cost and $186.0 million at value, or 6.2% of total assets, which includes unrealized appreciation of $91.9 million.

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

For the year ended December 31, 2002, Hillman had total revenue of $286.8 million, earnings before interest, taxes, depreciation, amortization, and management fees, or EBITDAM, of $50.2 million, and profits before taxes of $10.0 million. For the nine months ended September 30, 2003, Hillman had total revenue of $240.3 million and EBITDAM of $41.9 million. This EBITDAM is before the write-down of $6.3 million of a note receivable related to an investment made by Hillman. For the nine months ended September 30, 2003, Hillman had income before taxes of $1.9 million, which includes the write-down of the note receivable. The total revenue, EBITDAM, and loss before taxes for the nine months ended September 30, 2003, are not necessarily indicative of the operating

results to be expected for the full year. Hillman had total assets of $378.4 million, total debt of $158.0 million and trust preferred obligations at par of $105.4 million at September 30, 2003.

Commercial Real Estate Finance

The commercial real estate finance portfolio, investment activity, and yields at and for the three and nine months ended September 30, 2003 and 2002, and at and for the year ended December 31, 2002, were as follows:

	At and for the Three Months Ended September 30,				At and for the Nine Months Ended September 30,				At and for the Year Ended December 31, 2002	
	2003		2002		2003		2002			
	(unaudited)				(unaudited)					
($ in millions)	Value	Yield(1)	Value	Yield(1)	Value	Yield(1)	Value	Yield(1)	Value	Yield(1)
CMBS bonds	$523.6	12.9%	$496.4	14.5%	$523.6	12.9%	$496.4	14.5%	$555.5	14.2%
CDO bonds and preferred shares	164.8	16.9%	53.0	17.2%	164.8	16.9%	53.0	17.2%	52.8	17.2%
Commercial mortgage loans	85.5	8.7%	59.7	8.0%	85.5	8.7%	59.7	8.0%	63.7	7.5%
Residual interest			69.0	9.4%			69.0	9.4%	69.0	9.4%
Real estate owned	13.5		2.9		13.5		2.9		4.0	
Equity interests	5.0				5.0					
Total portfolio	$792.4		$681.0		$792.4		$681.0		$745.0	
Investments funded	$106.7		$ 8.9		$359.1		$134.6		$209.2	
Change in accrued or reinvested interest	$ 1.2		$		$ 2.2		$ 0.4		$ 2.1	
Principal repayments	$ 15.7		$ 0.5		$ 20.0		$ 11.5		$ 13.9	
CMBS, CDO, and commercial real estate loan sales	$ 5.1		$ 87.2		$281.8		$213.5		$213.5	

(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 and equity interests.

Our commercial real estate investment activity for the nine months ended September 30, 2003 and 2002, and for the year ended December 31, 2002, was as follows:

($ in millions)	Face Amount	Discount	Amount Funded
For the Nine Months Ended September 30, 2003			
CMBS bonds	$432.1	$(195.1)	$237.0
CDO bonds and preferred shares	118.4	(0.3)	118.1
Commercial mortgage loans	1.8		1.8
Equity interests	2.2		2.2
Total	$554.5	$(195.4)	$359.1
For the Nine Months Ended September 30, 2002			

CMBS bonds	$181.4	$ (83.8)	$ 97.6
CDO preferred shares	29.0		29.0
Commercial mortgage loans	0.1		0.1
Real estate owned	7.9		7.9
Total	$218.4	$ (83.8)	$134.6

($ in millions)	Face Amount	Discount	Amount Funded
For the Year Ended December 31, 2002			
CMBS bonds	$302.5	$(140.2)	$162.3
CDO preferred shares	29.0		29.0
Commercial mortgage loans	11.7	(1.7)	10.0
Real estate owned	7.9		7.9
Total	$351.1	$(141.9)	$209.2

At September 30, 2003, we had outstanding funding commitments of $2.7 million and commitments in the form of standby letters of credit and guarantees of $2.7 million to commercial real estate portfolio companies.

CMBS Bonds. During the nine months ended September 30, 2003, we invested $237.0 million in 14 CMBS bond issuances, including $62.4 million of investments in BB+, BB and BB- rated bonds in six CMBS issuances where the below BB- rated bonds were purchased by other parties, and $97.6 million in three CMBS bond issuances during the nine months ended September 30, 2002. During the year ended December 31, 2002, we invested $162.3 million in five CMBS bond issuances.

The underlying pools of mortgage loans that are collateral for our investments in new CMBS bond issuances for the nine months ended September 30, 2003 and 2002, and for the year ended December 31, 2002, had respective underwritten loan to value and underwritten debt service coverage ratios as follows:

	For the Nine Months Ended September 30,				For the Year Ended December 31, 2002	
	2003		2002			
Loan to Value Ranges ($ in millions)	Amount	Percentage	Amount	Percentage	Amount	Percentage
Less than 60%	$ 3,265.2	23%	$ 401.9	16%	$ 909.3	20%
60-65%	1,091.1	8	178.7	7	287.3	6
65-70%	1,484.1	10	264.1	11	587.9	13
70-75%	3,065.8	21	799.5	32	1,214.5	27
75-80%	5,324.2	37	812.7	33	1,477.5	33
Greater than 80%	75.5	1	12.0	1	47.8	1
Total	$14,305.9	100%	$2,468.9	100%	$4,524.3	100%
Weighted average loan to value	68.5%		70.4%		68.5%	

Debt Service Coverage Ratio[1] Ranges ($ in millions)	For the Nine Months Ended September 30, 2003		2002		For the Year Ended December 31, 2002	
	Amount	Percentage	Amount	Percentage	Amount	Percentage
Greater than 2.00	$ 3,563.6	25%	$ 103.3	4%	$ 366.9	8%
1.76-2.00	1,439.9	10	84.2	3	229.6	5
1.51-1.75	2,589.5	18	240.3	10	477.4	11
1.26-1.50	5,654.4	40	1,631.8	66	2,739.6	60
Less than 1.25	1,058.5	7	409.3	17	710.8	16
Total	$14,305.9	100%	$2,468.9	100%	$4,524.3	100%
Weighted average debt service coverage ratio	1.75		1.41		1.41	

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

From time to time, we may sell lower yielding CMBS bonds rated BB+ through BB-, and to a lesser extent CMBS bonds rated B+ and B, in order to maximize the return on our CMBS bond portfolio. The cost basis of and proceeds from CMBS bonds sold, the related net realized gains from these sales, and the weighted average yield on the CMBS bonds sold for the nine months ended September 30, 2003 and 2002, and for the year ended December 31, 2002, were as follows:

($ in millions)	For the Nine Months Ended September 30, 2003	2002	For the Year Ended December 31, 2002
Cost basis	$253.5	$205.9	$205.9
Sales proceeds	$284.8	$225.6	$225.6
Net realized gains (net of related hedge gains or losses)	$ 24.6	$ 19.1	$ 19.1
Weighted average yield	11.8%	11.5%	11.5%

The non-investment grade and unrated tranches of the CMBS bonds in which we invest are junior in priority for payment of interest and principal to the more senior tranches of the related CMBS bond issuance. Cash flow from the underlying mortgages generally is allocated first to the senior tranches, with the most senior tranches having a priority right to the cash flow. Then, any remaining cash flow is allocated, generally, among the other tranches in order of their relative seniority. To the extent there are defaults and unrecoverable losses on the underlying mortgages resulting in reduced cash flows, our most subordinate tranche will bear this loss first. At September 30, 2003, the CMBS bonds were subordinate to 87% to 99% of the tranches of bonds issued in these various CMBS transactions. Given that the non-investment grade CMBS bonds in which we invest are junior in priority for payment of interest and principal, 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 nine months ended September 30, 2003 and 2002, and for the year ended December 31, 2002, the average discount for the CMBS bonds in which we invested was 45%, 46% and 46%, respectively.

At September 30, 2003, and December 31, 2002, the unamortized discount related to the CMBS bond portfolio was $658.2 million and $649.5 million, respectively. At September 30, 2003, we have set aside $282.9 million of this unamortized discount to

absorb potential future losses, and therefore, the yield on the CMBS bonds of 12.9% assumes that this amount will not be amortized. At September 30, 2003, the CMBS bond portfolio had a fair value of $523.6 million, which included net unrealized appreciation on the CMBS bonds of $12.1 million.

The yield on our CMBS bond portfolio at September 30, 2003, and December 31, 2002, was 12.9% and 14.2%, respectively. The yield on the CMBS bond portfolio at any point in time will vary depending on the concentration of lower yielding BB+, BB, and BB- rated CMBS bonds held in the portfolio. The BB+, BB, and BB- rated CMBS bonds totaled $230.0 million and $110.9 million at value and had a yield of 8.0% and 8.8% at September 30, 2003, and December 31, 2002, respectively.

At September 30, 2003, and December 31, 2002, we held CMBS bonds in 39 and 27 separate CMBS issuances, respectively. The underlying collateral pool, consisting of commercial mortgage loans and real estate owned (REO) properties, for these CMBS bonds consisted of the following at September 30, 2003, and December 31, 2002:

($ in million)	2003	2002
Approximate number of loans and REO properties[1]	5,900	4,500
Total outstanding principal balance	$39,475	$24,974
Loans over 30 days delinquent or classified		