

ALLIED CAPITAL CORP  
Form 10-Q  
May 10, 2005

**FORM 10-Q**  
**SECURITIES AND EXCHANGE COMMISSION**  
**WASHINGTON, DC 20549**  
**QUARTERLY REPORT PURSUANT TO**  
**SECTION 13 OR 15(d) OF**  
**THE SECURITIES EXCHANGE ACT OF 1934**

**For The Quarterly Period**  
**Ended March 31, 2005**

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

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

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

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

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

**Registrant's telephone number, including area code: (202) 331-1112**

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter periods as the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

YES  NO

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act) YES  NO

On May 6, 2005, there were 133,613,932 shares outstanding of the Registrant's common stock, \$0.0001 par value.

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## PART I: FINANCIAL INFORMATION

Item 1. *Financial Statements*ALLIED CAPITAL CORPORATION AND SUBSIDIARIES  
CONSOLIDATED BALANCE SHEET

(in thousands, except share and per share amounts)	March 31, 2005	December 31, 2004
<b>ASSETS</b>		
Portfolio at value:		
Private finance		
Companies more than 25% owned (cost: 2005-\$1,426,861; 2004-\$1,389,342)	\$ 1,437,474	\$ 1,359,641
Companies 5% to 25% owned (cost: 2005-\$196,842; 2004-\$194,750)	187,459	188,902
Companies less than 5% owned (cost: 2005-\$786,607; 2004-\$800,828)	753,537	753,543
Total private finance (cost: 2005-\$2,410,310; 2004-\$2,384,920)	2,378,470	2,302,086
Commercial real estate finance (cost: 2005-\$809,613; 2004-\$722,612)	816,536	711,325
Total portfolio at value (cost: 2005-\$3,219,923; 2004-\$3,107,532)	3,195,006	3,013,411
Deposits of proceeds from sales of borrowed Treasury securities	98,741	38,226
Accrued interest and dividends receivable	81,937	79,489
Other assets	77,783	72,712
Cash and cash equivalents	51,087	57,160
Total assets	\$ 3,504,554	\$ 3,260,998
<b>LIABILITIES AND SHAREHOLDERS EQUITY</b>		
Liabilities:		
Notes payable and debentures (maturing within one year: 2005-\$165,000; 2004-\$169,000)	\$ 1,033,135	\$ 1,064,568
Revolving line of credit	263,250	112,000
Obligations to replenish borrowed Treasury securities	98,741	38,226
Accounts payable and other liabilities	76,280	66,426
Total liabilities	1,471,406	1,281,220
Commitments and contingencies		
Shareholders' equity:		
Common stock, \$0.0001 par value, 200,000,000 shares authorized; 133,562,534 and 133,098,807 shares issued and outstanding at March 31, 2005, and December 31, 2004,	13	13

respectively

Additional paid-in capital	2,106,106	2,094,421
Common stock held in deferred compensation trust	(15,389)	(13,503)
Notes receivable from sale of common stock	(5,420)	(5,470)
Net unrealized appreciation (depreciation) on portfolio	(37,183)	(107,767)
Undistributed (distributions in excess of) earnings	(14,979)	12,084
 Total shareholders equity	 2,033,148	 1,979,778
 Total liabilities and shareholders equity	 \$ 3,504,554	 \$ 3,260,998
 Net asset value per common share	 \$ 15.22	 \$ 14.87

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

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

	<b>For the Three Months Ended March 31,</b>	
	<b>2005</b>	<b>2004</b>
<b>(in thousands, except per share amounts)</b>	<b>(unaudited)</b>	
<b>Interest and Related Portfolio Income:</b>		
Interest and dividends		
Companies more than 25% owned	\$ 28,251	\$ 15,952
Companies 5% to 25% owned	5,921	5,986
Companies less than 5% owned	50,773	51,601
Total interest and dividends	84,945	73,539
<b>Loan prepayment premiums</b>		
Companies more than 25% owned		
Companies 5% to 25% owned		
Companies less than 5% owned	1,677	950
Total loan prepayment premiums	1,677	950
<b>Fees and other income</b>		
Companies more than 25% owned	4,881	4,489
Companies 5% to 25% owned	70	347
Companies less than 5% owned	3,346	2,440
Total fees and other income	8,297	7,276
<b>Total interest and related portfolio income</b>	<b>94,919</b>	<b>81,765</b>
<b>Expenses:</b>		
Interest	20,225	19,113
Employee	15,456	12,355
Administrative	20,754	5,827
Total operating expenses	56,435	37,295
Net investment income before income taxes	38,484	44,470
Income tax expense (benefit)	(268)	(75)
Net investment income	38,752	44,545
<b>Net Realized and Unrealized Gains (Losses):</b>		
Net realized gains (losses)		
Companies more than 25% owned	399	146,683
Companies 5% to 25% owned	(3)	4,628

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Companies less than 5% owned	9,889	(3,461)
Total net realized gains	10,285	147,850
Net change in unrealized appreciation or depreciation	70,584	(172,087)
Total net gains (losses)	80,869	(24,237)
Net increase in net assets resulting from operations	\$ 119,621	\$ 20,308
Basic earnings per common share	\$ 0.90	\$ 0.16
Diluted earnings per common share	\$ 0.88	\$ 0.15
Weighted average common shares outstanding basic	133,283	128,314
Weighted average common shares outstanding diluted	135,579	131,968

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

	<b>For the Three Months Ended March 31,</b>	
	<b>2005</b>	<b>2004</b>
<b>(in thousands, except per share amounts)</b>	<b>(unaudited)</b>	
<b>Operations:</b>		
Net investment income	\$ 38,752	\$ 44,545
Net realized gains	10,285	147,850
Net change in unrealized appreciation or depreciation	70,584	(172,087)
<b>Net increase in net assets resulting from operations</b>	<b>119,621</b>	<b>20,308</b>
<b>Shareholder distributions:</b>		
Common stock dividends	(76,100)	(73,357)
Preferred stock dividends		(45)
<b>Net decrease in net assets resulting from shareholder distributions</b>	<b>(76,100)</b>	<b>(73,402)</b>
<b>Capital share transactions:</b>		
Issuance of common stock for portfolio investments	7,200	
Issuance of common stock upon the exercise of stock options	2,618	11,782
Issuance of common stock in lieu of cash distributions	1,418	1,484
Net decrease in notes receivable from sale of common stock	50	5,192
Purchase of common stock held in deferred compensation trust	(1,886)	
Other	449	29
<b>Net increase in net assets resulting from capital share transactions</b>	<b>9,849</b>	<b>18,487</b>
<b>Total increase (decrease) in net assets</b>	<b>53,370</b>	<b>(34,607)</b>
<b>Net assets at beginning of period</b>	<b>1,979,778</b>	<b>1,914,577</b>
<b>Net assets at end of period</b>	<b>\$ 2,033,148</b>	<b>\$ 1,879,970</b>
<b>Net asset value per common share</b>	<b>\$ 15.22</b>	<b>\$ 14.60</b>
<b>Common shares outstanding at end of period</b>	<b>133,563</b>	<b>128,761</b>

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



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

	<b>For the Three Months Ended March 31,</b>	
<b>(in thousands)</b>	<b>2005</b>	<b>2004</b>
	<b>(unaudited)</b>	
<b>Cash flows from operating activities:</b>		
Net increase in net assets resulting from operations	\$ 119,621	\$ 20,308
<b>Adjustments</b>		
Portfolio investments	(257,957)	(170,597)
Principal collections related to investment repayments or sales	158,262	237,161
Change in accrued or reinvested interest and dividends	(10,534)	(13,098)
Amortization of discounts and fees	(1,772)	(1,573)
Changes in other assets and liabilities	8,158	3,376
Depreciation and amortization	486	409
Realized gains from the receipt of notes and other securities as consideration from sale of investments, net of collections	152	(48,318)
Realized losses	4,418	8,152
Net change in unrealized (appreciation) or depreciation	(70,584)	172,087
<b>Net cash provided by (used in) operating activities</b>	<b>(49,750)</b>	<b>207,907</b>
<b>Cash flows from financing activities:</b>		
Sale of common stock upon the exercise of stock options	2,618	11,782
Collections of notes receivable from sale of common stock	50	5,192
Borrowings under notes payable and debentures		15,212
Repayments on notes payable and debentures	(31,000)	(7,000)
Net borrowings under (repayments on) revolving line of credit	151,250	
Purchase of common stock held in deferred compensation trust	(1,886)	
Other financing activities	(12)	(110)
Common stock dividends and distributions paid	(77,343)	(71,873)
<b>Net cash provided by (used in) financing activities</b>	<b>43,677</b>	<b>(46,797)</b>
Net increase (decrease) in cash and cash equivalents	(6,073)	161,110
Cash and cash equivalents at beginning of period	57,160	214,167
Cash and cash equivalents at end of period	\$ 51,087	\$ 375,277

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

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

March 31, 2005

<b>Private Finance Portfolio Company</b> (in thousands, except number of shares)	<b>Investment<sup>(1)(2)</sup></b>	<b>Principal</b>	<b>Cost</b>	<b>Value</b>
<b>(unaudited)</b>				
<b>Companies More Than 25% Owned</b>				
Acme Paging, L.P. <sup>(4)</sup> (Telecommunications)	Loan (6.8%, Due 12/07 1/08) <sup>(6)</sup> Equity Interests Common Stock (4,656 shares)	\$ 4,631	\$ 4,631 13,274 27	\$
Advantage Sales & Marketing, Inc. (Business Services)	Loan (12.0%, Due 9/09)  Debt Securities (18.5%, Due 12/09) Common Stock (18,957,011 shares)	60,000  126,621	59,743  126,621 73,932	59,743  126,621 167,044
Alaris Consulting, LLC (Business Services)	Loan (16.3%, Due 12/05 12/07) <sup>(6)</sup> Equity Interests Guaranty (\$1,100)	24,025	24,068 5,165	4,719
American Healthcare Services, Inc. and Affiliates (Healthcare Services)	Loan (1.0%, Due 12/04 12/05) <sup>(6)</sup>	5,200	4,801	4,212
Avborne, Inc. <sup>(7)</sup> (Business Services)	Preferred Stock (12,500 shares) Common Stock (27,500 shares)		7,014	881
Avborne Heavy Maintenance, Inc. <sup>(7)</sup> (Business Services)	Preferred Stock (1,568 shares)  Common Stock (2,750 shares)			
Business Loan Express, LLC (Financial Services)	Class A Equity Interests Class B Equity Interests Class C Equity Interests Guaranty (\$104,574 See Note 3)	55,494	55,494 117,436 109,301	55,494 140,523 134,696

Standby Letters of Credit  
 (\$35,550  
 See Note 3)

Callidus Capital Corporation (Financial Services)	Loan (5.2%, Due 12/05)	54,854	54,854	54,854
	Loan (12.0%, Due 12/06)	1,300	1,300	1,300
	Debt Securities (18.0%, Due 10/08)	4,234	4,234	4,234
	Common Stock (10 shares)		1,867	4,100
Fairchild Industrial Products Company (Industrial Products)	Loan (8.5%, Due 7/09)	6,668	6,668	6,668
	Debt Securities (12.1%, Due 7/09)	3,729	3,729	3,729
	Common Stock (1,000 shares)		2,841	6,233

(1) Interest rates represent the weighted average annual stated interest rate on loans and debt securities, which are presented by nature of indebtedness for a single issuer. The maturity dates represent the earliest and the latest maturity dates.

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

(3) Public company.

(4) Non-U.S. company or principal place of business outside the U.S.

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(7) Avborne, Inc. and Avborne Heavy Maintenance, Inc. are affiliated companies.

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March 31, 2005

<b>Private Finance Portfolio Company (in thousands, except number of shares)</b>	<b>Investment<sup>(1)(2)</sup></b>	<b>Principal</b>	<b>(unaudited)</b>	
			<b>Cost</b>	<b>Value</b>
Financial Pacific Company (Financial Services)	Loan (17.4%, Due 2/12 8/12) Preferred Stock (9,950 shares) Common Stock (14,735 shares)	\$ 69,132	\$ 68,828 9,950 14,819	\$ 68,828 10,945 36,250
ForeSite Towers, LLC (Tower Leasing)	Equity Interests		18,703	20,802
GAC Investments, Inc. (Broadcasting & Cable)	Common Stock (107 shares) Guaranty (\$800) Standby Letter of Credit (\$200)		57,350	7,049
Global Communications, LLC (Business Services)	Loan (14.5%, Due 12/03 12/06) Debt Securities (13.0%, Due 9/02 9/05) Preferred Equity Interest Options	6,393 18,321	6,393 18,318 14,067 1,639	6,393 18,318 14,723
Gordian Group, Inc. (Business Services)	Loan (10.0%, Due 12/05 12/08) <sup>(6)</sup> Common Stock (1,000 shares)	11,392	11,434 5,820	5,698
HealthASPex, Inc. (Business Services)	Preferred Stock (1,000,000 shares) Preferred Stock (1,451,380 shares) Common Stock (1,451,380 shares)		700 4,900 4	700 1,507
HMT, Inc. (Energy Services)	Debt Securities (13.3%, Due 12/08) Preferred Stock (554,052 shares) Common Stock (300,000 shares) Warrants	10,000	9,349 2,637 3,000 1,155	9,349 2,637 4,260 1,640
Housecall Medical Resources, Inc. (Healthcare Services)	Loan (16.8%, Due 11/07 11/09) Common Stock (864,000 shares)	15,757	15,704 86	15,704 34,032
Impact Innovations Group, LLC (Business Services)	Equity Interests in Affiliate			772

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Insight Pharmaceuticals Corporation (Consumer Products)	Senior Loan (8.3%, Due 12/07)	66,470	66,146	66,146
	Loan (15.0%, Due 12/09)	57,500	57,237	57,237
	Preferred Stock (25,000 shares)		25,000	25,500
	Common Stock (6,200 shares)		6,325	6,325
Jakel, Inc. (Industrial Products)	Loan (15.5%, Due 3/08) <sup>(6)</sup>	5,412	5,412	
	Debt Securities (15.5%, Due 3/08) <sup>(6)</sup>	8,330	8,330	
	Preferred Stock (6,460 shares)		6,460	
	Common Stock (158,061 shares)		9,347	
Legacy Partners Group, LLC (Financial Services)	Loan (14.0%, Due 5/09) <sup>(6)</sup>	7,147	7,147	6,047
	Debt Securities (18.0%, Due 5/09) <sup>(6)</sup>	2,952	2,952	
	Equity Interests		2,729	

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		March 31, 2005		
Private Finance Portfolio Company (in thousands, except number of shares)	Investment <sup>(1)(2)</sup>	(unaudited)		Value
		Principal	Cost	
Litterer Beteiligungs-GmbH <sup>(4)</sup> (Business Services)	Debt Securities (8.0%, Due 3/07)	\$ 677	\$ 677	\$ 677
	Equity Interest		1,756	3,431
Maui Body Works, Inc. (Healthcare Services)	Common Stock (100 shares)		2,500	
Mercury Air Centers, Inc. (Business Services)	Senior Loan (10.0%, Due 4/09)	23,500	23,500	23,500
	Loan (16.0%, Due 4/09)	38,540	38,356	38,356
	Common Stock (57,068 shares)		33,723	33,723
	Standby Letters of Credit (\$1,322)			
MVL Group, Inc. (Business Services)	Loan (12.3%, Due 10/07 7/09)	15,030	14,618	14,618
	Debt Securities (14.4%, Due 7/09)	18,153	17,661	17,661
	Common Stock (648,661 shares)		643	6,082
Norstan Apparel Shops, Inc. (Retail)	Loan (16.0%, Due 12/07) <sup>(6)</sup>	500	500	
	Debt Securities (17.8%, Due 12/07 9/08) <sup>(6)</sup>	13,588	12,960	
	Common Stock (29,663 shares)		4,790	
	Warrants		655	
Pennsylvania Avenue Investors, L.P. <sup>(5)</sup> (Private Equity Fund)	Equity Interests		1,289	880
Powell Plant Farms, Inc. (Consumer Products)	Loan (15.0%, Due 12/05)	37,790	28,942	28,942
	Debt Securities (20.0%, Due 6/03) <sup>(6)</sup>	19,291	19,224	11,571
	Preferred Stock (1,483 shares)			
	Warrants			
Redox Brands, Inc.	Preferred Stock (2,726,444 shares)		7,903	11,655

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(Consumer Products)	Warrants Guaranty (\$125)		584		481
Staffing Partners Holding Company, Inc.	Loan (13.5%, Due 10/06) <sup>(6)</sup>	974	974		974
	Debt Securities (13.5%, Due 10/06) <sup>(6)</sup>	5,906	5,906		5,906
(Business Services)	Preferred Stock (439,600 shares)		4,968		187
	Common Stock (69,773 shares)		50		
	Warrants		10		
Startec Global Communications Corporation	Loan (10.0%, Due 5/07 5/09)	16,518	16,518		16,518
	Common Stock (19,180,000 shares)		37,255		5,015
(Telecommunications)					
STS Operating, Inc. (Industrial Products)	Loan (15.3%, Due 3/12)	8,436	8,436		8,436
	Common Stock (3,000,000 shares)		3,522		12,948
	Options				
Total companies more than 25% owned			\$ 1,426,861		\$ 1,437,474

**Companies 5% to 25% Owned**

Air Evac Lifeteam	Debt Securities (12.9%, Due 7/10)	\$ 41,493	\$ 41,322	\$ 41,322
(Healthcare Services)	Equity Interests		3,000	1,654

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March 31, 2005

<b>Private Finance Portfolio Company (in thousands, except number of shares)</b>	<b>Investment<sup>(1)(2)</sup></b>	<b>Principal</b>	<b>(unaudited) Cost</b>	<b>Value</b>
Aspen Pet Products, Inc. (Consumer Products)	Loans (19.0%, Due 6/08) Preferred Stock (2,763 shares) Common Stock (1,400 shares) Warrants	\$ 19,165	\$ 19,073 2,154 140	\$ 19,073 917
Becker Underwood, Inc. (Industrial Products)	Loan (14.5%, Due 8/12) Common Stock (4,364 shares)	23,197	23,090 5,000	23,090 3,400
Border Foods, Inc. (Consumer Products)	Loan (13.0%, Due 12/10) Debt Securities (13.0%, Due 12/10) Preferred Stock (50,919 shares) Common Stock (1,810 shares) Warrants	3,000 10,000	3,000 9,525 2,000 45 665	3,000 9,525 982
The Debt Exchange Inc. (Business Services)	Preferred Stock (921,875 shares)		1,250	1,839
MasterPlan, Inc. (Business Services)	Loan (12.0%, Due on demand) Common Stock (1,350 shares)	959	959 42	1,204 3,300
MedBridge Healthcare, LLC (Healthcare Services)	Loan (5.1%, Due 8/09 8/14) Convertible Debenture (2.0%, Due 8/14) <sup>(6)</sup>	11,447 3,000	11,447 1,015	11,447
MortgageRamp, Inc. (Business Services)	Common Stock (772,000 shares)		3,860	306
Nexcel Synthetics, LLC (Consumer Products)	Loan (14.5%, Due 6/09) Equity Interests	10,340	10,305 1,690	10,305 559
Packaging Advantage Corporation (Business Services)	Debt Securities (18.5%, Due 4/08) Common Stock (232,168 shares) Warrants	15,439	14,731 2,386 963	14,731 1,384 559
Pres Air Trol LLC	Debt Securities (12.0%, Due 4/10)	6,307	5,988	5,988



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(Industrial Products)	Equity Interests		1,323	371
Progressive International Corporation (Consumer Products)	Loan (16.0%, Due 12/09)	7,290	7,260	7,260
	Preferred Stock (500 shares)		500	832
	Common Stock (197 shares)		13	182
	Warrants			
Soteria Imaging Services, LLC (Healthcare Services)	Loan (12.5%, Due 11/10)	9,500	8,380	8,380
	Equity Interests		2,114	2,114
Universal Environmental Services, LLC (Business Services)	Loan (13.5%, Due 2/09)			
		12,150	12,102	12,102
	Equity Interests		1,500	1,633
Total companies 5% to 25% owned			\$ 196,842	\$ 187,459

**Companies Less Than 5% Owned**

Anthony, Inc. (Industrial Products)	Loan (11.4%, Due 9/11 9/12)	\$ 14,561	\$ 14,494	\$ 14,494
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		<b>March 31, 2005</b>		
<b>Private Finance Portfolio Company (in thousands, except number of shares)</b>	<b>Investment<sup>(1)(2)</sup></b>	<b>Principal</b>	<b>(unaudited) Cost</b>	<b>Value</b>
Apogen Technologies, Inc. (Business Services)	Debt Securities (13.0%, Due 1/10) Preferred Stock (270,008 shares) Common Stock (1,256,452 shares) Warrants	\$ 5,000	\$ 4,983 2,700 50	\$ 4,983 3,252 2,295 462
Aviation Technologies, Inc. (Industrial Products)	Loan (17.0%, Due 5/11)	21,341	21,264	21,264
Benchmark Medical, Inc. (Healthcare Services)	Debt Securities (14.0%, Due 12/08) Warrants	13,752	13,695 18	13,695 18
BI Incorporated (Business Services)	Loan (14.0%, due 2/12)	16,000	15,921	15,921
C&K Market, Inc. (Retail)	Loan (13.0%, due 12/08)	14,444	14,372	14,372
Callidus Debt Partners CLO Fund III, LTD <sup>(4)</sup> (Senior Debt CLO Fund)	Preferred Shares (23,600,000 shares)		24,392	24,392
Camden Partners Strategic Fund II, L.P. <sup>(5)</sup> (Private Equity Fund)	Limited Partnership Interest		2,142	2,871
Catterton Partners V, L.P. <sup>(5)</sup> (Private Equity Fund)	Limited Partnership Interest		2,340	2,109
CBS Personnel Holdings, Inc. (Business Services)	Loan (15.5%, Due 12/09)	20,181	20,090	20,090
Colibri Holding Corporation (Consumer Products)	Debt Securities (12.5%, Due 9/08) Preferred Stock (459 shares) Common Stock (3,362 shares) Warrants	3,750	3,513 523 1,250 290	3,513 826 584 136

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Community Education Centers, Inc. (Education Services)	Loan (15.0%, Due 12/10)	23,813	23,718	23,718
Component Hardware Group, Inc. (Industrial Products)	Preferred Stock (18,000 shares)		2,605	2,709
	Common Stock (2,000 shares)		200	600
Cooper Natural Resources, Inc. (Industrial Products)	Debt Securities (0%, Due 11/07)	1,335	1,335	1,300
	Preferred Stock (6,316 shares)		1,424	
	Warrants		830	
Coverall North America, Inc. (Business Services)	Loan (14.6%, Due 2/11)	26,899	26,844	26,844
	Preferred Stock (6,500 shares)		6,500	6,561
	Warrants		2,950	2,950

(1) Interest rates represent the weighted average annual stated interest rate on loans and debt securities, which are presented by nature of indebtedness for a single issuer. The maturity dates represent the earliest and the latest maturity dates.

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

(3) Public company.

(4) Non-U.S. company or principal place of business outside the U.S.

(5) Non-registered investment company.

(6) Loan or debt security is on non-accrual status and therefore is considered non-income producing.

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

		<b>March 31, 2005</b>		
<b>Private Finance Portfolio Company (in thousands, except number of shares)</b>	<b>Investment<sup>(1)(2)</sup></b>	<b>Principal</b>	<b>(unaudited) Cost</b>	<b>Value</b>
CTT Holdings (Consumer Products)	Loan (0%, Due 3/10) <sup>(6)</sup>	\$ 1,125	\$ 1,125	\$ 563
DCS Business Services, Inc. (Business Services)	Common Stock (478,816 shares)		734	2,000
Drilltec Patents & Technologies Company, Inc. (Energy Services)	Loan (10.0%, Due 8/06) <sup>(6)</sup> Debt Securities (15.5%, Due 8/06) <sup>(6)</sup>	10,994 1,500	10,918 1,500	
eCentury Capital Partners, L.P. <sup>(5)</sup> (Private Equity Fund)	Limited Partnership Interest		5,024	424
EDM Consulting, LLC (Business Services)	Loan (5.8%, Due 12/06)	100	100	100
Elexis Beta GmbH <sup>(4)</sup> (Industrial Products)	Options		426	50
E-Talk Corporation (Business Services)	Preferred Stock (133 shares) Common Stock (8,656 shares)		10,009	1,468 500
Frozen Specialties, Inc. (Consumer Products)	Warrants		435	435
Garden Ridge Corporation (Retail)	Debt Securities (12.9%, Due 12/05 12/07) <sup>(9)</sup> Preferred Stock (1,130 shares) Common Stock (847,800 shares)	27,271	27,271 1,130 613	12,722
Geotrace Technologies, Inc. (Energy Services)	Debt Securities (12.0%, Due 6/09) Warrants	18,400	16,380 2,350	16,380 2,350
Ginsey Industries, Inc. (Consumer Products)	Loans (12.5%, Due 3/06) Convertible Debentures (12.5%, Due 3/06) Warrants	4,307 500	4,307 500	4,307 697 2,103
Grant Broadcasting Systems II	Loan (5.0%, Due 6/09)	2,756	2,756	2,756

(Broadcasting &amp; Cable)

Grotech Partners, VI, L.P. <sup>(5)</sup> (Private Equity Fund)	Limited Partnership Interest		6,329	4,115
Haven Eldercare of New England, LLC <sup>(8)</sup> (Healthcare Services)	Loans (9.3%, Due 10/05)	46,671	46,669	46,669
Haven Healthcare Management, LLC <sup>(8)</sup> (Healthcare Services)	Loan (18.0% Due 8/06)	6,000	6,000	6,000
The Hillman Companies, Inc. <sup>(3)</sup> (Consumer Products)	Loan (13.5%, Due 9/11)	43,265	43,057	43,057

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(8) Haven Eldercare of New England, LLC and Haven Healthcare Management, LLC are affiliated companies.

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

March 31, 2005

<b>Private Finance Portfolio Company (in thousands, except number of shares)</b>	<b>Investment<sup>(1)(2)</sup></b>	<b>Principal</b>	<b>(unaudited)</b>	
			<b>Cost</b>	<b>Value</b>
Homax Holdings, Inc. (Consumer Products)	Debt (12.0%, Due 8/11) Preferred Stock (89 shares) Common Stock (28 shares) Warrants	\$ 14,000	\$ 12,958 89 6 1,106	\$ 12,958 85 6 1,377
Icon International, Inc. (Business Services)	Common Stock (25,707 shares)		76	
Interline Brands, Inc. <sup>(3)</sup> (Business Services)	Common Stock (152,371 shares)		2,294	2,850
International Fiber Corporation (Industrial Products)	Debt Securities (14.0%, Due 6/12) Preferred Stock (25,000 shares)	21,222	21,127 2,500	21,127 2,500
MedAssets, Inc. (Business Services)	Preferred Stock (227,865 shares) Warrants		2,049 136	2,765 45
Mid-Atlantic Venture Fund IV, L.P. <sup>(5)</sup> (Private Equity Fund)	Limited Partnership Interest		6,600	3,012
Mogas Energy, LLC (Energy Services)	Debt Securities (9.5%, Due 3/12 4/12) Warrants	17,476	15,988 1,774	15,988 2,800
Nobel Learning Communities, Inc. <sup>(3)</sup> (Education)	Preferred Stock (1,214,356 shares) Warrants		2,764 575	2,764 861
Norwesco, Inc. (Industrial Products)	Loan (14.0%, Due 12/11)	15,000	14,928	14,928
Novak Biddle Venture Partners III, L.P. <sup>(5)</sup> (Private Equity Fund)	Limited Partnership Interest		1,189	1,299
Oahu Waste Services, Inc. (Business Services)	Stock Appreciation Rights		239	400

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Onyx Television GmbH <sup>(4)</sup> (Broadcasting & Cable)	Preferred Units		201	
Opinion Research Corporation <sup>(3)</sup> (Business Services)	Warrants		996	600
Oriental Trading Company, Inc. (Consumer Products)	Common Stock (13,820 shares)			5,900
Pro Mach, Inc. (Industrial Products)	Loan (13.8%, Due 6/12)	19,000	18,909	18,909
	Equity Interests		1,500	1,500
RadioVisa Corporation (Broadcasting & Cable)	Loan (15.5%, Due 12/08)	26,189	26,080	26,080
Resun Leasing, Inc. (Business Services)	Loan (15.5%, Due 11/07)	30,000	30,000	30,000
S.B. Restaurant Company (Retail)	Debt Securities (15.0%, Due 11/08)	17,796	17,271	17,271
	Preferred Stock (54,125 shares)		135	135
	Warrants		619	525

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		<b>March 31, 2005</b>		
<b>Private Finance Portfolio Company (in thousands, except number of shares)</b>	<b>Investment<sup>(1)(2)</sup></b>	<b>Principal</b>	<b>(unaudited) Cost</b>	<b>Value</b>
SBBUT, LLC (Consumer Products)	Equity Interests		\$ 85	\$ 85
Soff-Cut Holdings, Inc. (Industrial Products)	Preferred Stock (300 shares) Common Stock (2,000 shares)		300 200	
SPP Mezzanine Fund, L.P. <sup>(5)</sup> (Private Equity Fund)	Limited Partnership Interest		1,663	1,553
SunStates Refrigerated Services, Inc. (Warehouse Facilities)	Loan (8.3%, Due 1/05) <sup>(6)</sup>	\$ 30	30	25
Tradesmen International, Inc. (Business Services)	Debt Securities (12.0%, Due 12/09) Warrants	15,000	14,226 710	14,226 710
United Site Services, Inc. (Business Services)	Loan (12.7%, Due 6/10 12/10) Common Stock (160,588 shares)	53,918	53,649 1,000	53,649 1,000
Universal Tax Systems, Inc. (Business Services)	Loan (14.5%, Due 7/11)	18,711	18,628	18,628
Udata Venture Partners II, L.P. <sup>(5)</sup> (Private Equity Fund)	Limited Partnership Interest		4,375	4,233
Venturehouse-Cibernet Investors, LLC (Business Services)	Equity Interest		34	34
Venturehouse Group, LLC <sup>(5)</sup> (Private Equity Fund)	Equity Interest		598	403
VICORP Restaurants, Inc. <sup>(3)</sup> (Retail)	Warrants		33	742
	Limited Partnership Interest		1,330	728



Walker Investment Fund II, LLLP <sup>(5)</sup> (Private Equity Fund)				
Wear Me Apparel Corporation (Consumer Products)	Debt Securities (17.0%, Due 12/10) Warrants	45,000	44,056 1,219	44,056 700
Weston Solutions, Inc. (Business Services)	Loan (17.3%, Due 6/10)	7,350	7,323	7,323
Wilshire Restaurant Group, Inc. (Retail)	Debt Securities (20.0%, Due 6/07) <sup>(6)</sup> Warrants	19,107	18,566 735	18,884 735
Wilton Industries, Inc. (Consumer Products)	Loan (19.3%, Due 6/08)	7,200	7,200	7,200
Woodstream Corporation (Consumer Products)	Loan (12.6%, Due 8/12 2/13) Common Stock (180 shares)	30,970	30,919 673	30,919 3,500
Other companies	Other investments Guaranty (\$226)	862	870	864
Total companies less than 5% owned			\$ 786,607	\$ 753,537
Total private finance (116 portfolio companies)			\$ 2,410,310	\$ 2,378,470

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March 31, 2005

	Stated Interest	Face (un	audited)	Value
<b>Commercial Real Estate Finance</b>				
<b>(in thousands, except number of issuances)</b>				
<b>Commercial Mortgage-Backed Securities</b>				
Mortgage Capital Funding, Series 1998-MC3	5.5%	\$ 51,105	\$ 35,925	\$ 31,436
Morgan Stanley Capital I, Series 1999-RM1	6.4%	27,936	9,138	9,138
COMM 1999-1	5.7%	50,032	28,525	27,677
Morgan Stanley Capital I, Series 1999-FNV1	6.1%	20,168	10,060	7,575
DLJ Commercial Mortgage Trust 1999-CG2	6.1%	39,165	13,333	14,176
Commercial Mortgage Acceptance Corp., Series 1999-C1	6.8%	18,173	4,582	4,844
LB Commercial Mortgage Trust, Series 1999-C2	6.7%	11,151	1,520	1,733
Chase Commercial Mortgage Securities Corp., Series 1999-2	6.5%	20,576	5,027	9,254
FUNB CMT, Series 1999-C4	6.5%	18,587	7,688	6,876
Heller Financial, HFCMC Series 2000 PH-1	6.6%	23,536	8,440	8,500
SBMS VII, Inc., Series 2000-NL1	7.2%	7,924	4,323	3,464
DLJ Commercial Mortgage Trust, Series 2000-CF1	7.0%	24,793	11,370	8,953
Deutsche Bank Alex. Brown, Series Comm 2000-C1	6.9%	12,290	3,286	2,441
LB-UBS Commercial Mortgage Trust, Series 2000-C4	6.9%	13,841	2,575	1,092
Credit Suisse First Boston Mortgage Securities Corp., Series 2001-CK1	5.9%	16,861	4,123	5,074
JP Morgan-CIBC-Deutsche 2001	5.8%	20,528	6,872	3,384
Lehman Brothers-UBS Warburg 2001-C2	6.4%	22,203	6,426	8,977
SBMS VII, Inc., Series 2001-C1	6.1%	10,637	2,148	1,576
GE Capital Commercial Mortgage Securities Corp., Series 2001-2	6.1%	18,446	6,867	6,867
Credit Suisse First Boston Mortgage Securities Corp., Series 2001-CKN5	5.2%	16,881	5,098	3,486
JP Morgan Chase Commercial Mortgage Securities Corp., Series 2001-C1	5.6%	21,141	5,791	5,791
SBMS VII, Inc., Series 2001-C2	6.2%	21,735	5,703	5,703
FUNB CMT, Series 2002-C1	6.0%	17,181	7,305	6,517
GE Capital Commercial Mortgage Corp., Series 2002-1	6.2%	25,965	7,127	8,393
GMAC Commercial Mortgage Securities, Inc., Series 2002-C2	5.8%	23,053	7,614	7,614
GE Capital Commercial Mortgage Corp., Series 2002-3	5.1%	27,796	6,298	6,298

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Morgan Stanley Dean Witter Capital I Trust 2002-IQ3	6.0%	12,508	1,775	1,775
LB-UBS Commercial Mortgage Trust 2003-C1	4.6%	23,999	3,944	3,944
GS Mortgage Securities Corporation II Series 2003-C1	4.7%	20,147	5,592	5,592
Credit Suisse First Boston Mortgage Securities Corp., Series 2003-CK2	4.9%	32,170	12,502	12,862
COMM 2003-LNB1	4.4%	20,094	3,216	3,216
Wachovia Bank Commercial Mortgage Trust, Series 2003-C5	4.3%	34,527	8,098	8,098
GMAC Commercial Mortgage Securities, Inc., Series 2003-C2	5.5%	30,654	6,670	6,670
Wachovia Bank Commercial Mortgage Trust, Series 2003-C9	5.3%	28,737	8,981	8,981
GE Commercial Mortgage Corporation, Series 2004-C1	5.0%	27,083	7,168	7,168
LB-UBS Commercial Mortgage Trust 2004-C1	4.9%	21,365	5,832	5,832
MezzCapp Commercial Mortgage Trust, Series 2004-C1	10.0%	1,990	813	813
COMM 2004-LNB3	5.3%	26,708	9,670	9,670
GMAC Commercial Mortgage Securities, Inc. Series 2004-C1	5.3%	23,035	10,608	10,507
GS Mortgage Securities Corporation II, Series 2004-C1	4.6%	20,076	8,294	8,294
J.P. Morgan Chase Commercial Mortgage Securities Corp., Series 2004-LN2	5.3%	29,590	9,345	9,345
Wachovia Bank Commercial Mortgage Trust, Series 2004-C14	5.3%	21,947	5,299	5,299
COMM 2004-LNB4	4.7%	43,033	20,963	21,168
Credit Suisse First Boston Mortgage Security Corp., Series 2004-C5	4.7%	12,125	9,491	9,411
ACGS, 2004-1	5.4%	9,292	9,224	9,086
ACGS, 2004-1, LLC Interests		21,700	17,188	17,188
GE Capital Commercial Mortgage Corp., Series 2005-C1	4.7%	11,279	8,758	8,789
LB-UBS Commercial Mortgage Trust, Series 2005-C1	4.7%	50,737	28,368	28,243
Wachovia Bank Commercial Mortgage Trust, Series 2005-C17	5.1%	98,520	56,564	57,270
Total commercial mortgage-backed securities (48 issuances)		\$ 1,203,020	\$ 475,527	\$ 466,060

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

		<b>March 31, 2005</b>		
		<b>(unaudited)</b>		
		<b>Cost</b>	<b>Value</b>	
<b>Commercial Real Estate Finance</b>				
<b>(in thousands, except number of loans)</b>				
<b>Collateralized Debt Obligations</b>				
Crest 2001-1, Ltd. <sup>(4)</sup>		\$ 21,853	\$ 23,190	
Crest 2002-1, Ltd. <sup>(4)</sup>		24,807	28,076	
Crest 2002-IG, Ltd. <sup>(4)</sup>		3,997	4,949	
Crest Clarendon Street 2002-1, Ltd. <sup>(4)</sup>		914	1,053	
Crest 2003-1, Ltd. <sup>(4)</sup>		94,731	101,171	
Crest 2003-2, Ltd. <sup>(4)</sup>		26,560	27,894	
TIAA Real Estate CDO 2003-1, Ltd. <sup>(4)</sup>		937	1,050	
Crest Exeter Street Solar 2004-1, Ltd. <sup>(4)</sup>		1,636	1,770	
Fairfield Street Solar 2004-1, Ltd. <sup>(4)</sup>		5,957	5,964	
Crest 2004-1, Ltd. <sup>(4)</sup>		32,096	32,035	
	Total collateralized debt obligations (10 issuances)	\$ 213,488	\$ 227,152	
	<b>Interest Rate Ranges</b>	<b>Number of Loans</b>		
<b>Commercial Mortgage Loans</b>				
	Up to 6.99%	10	\$ 27,555	\$ 25,663
	7.00% 8.99%	16	31,035	30,590
	9.00% 10.99%	4	19,093	18,784
	11.00% 12.99%	3	8,497	8,054
	13.00% 14.99%	2	2,617	2,617
	15.00% and above	2	3,970	3,970
	Total commercial mortgage loans <sup>(9)</sup>	37	\$ 92,767	\$ 89,678
<b>Real Estate Owned</b>			\$ 15,369	\$ 18,443
<b>Equity Interests<sup>(2)</sup></b>				
Companies more than 25% owned (Guarantees \$2,681)			\$ 12,462	\$ 12,655
Companies less than 5% owned				2,548
	Total equity interests		\$ 12,462	\$ 15,203
	Total commercial real estate finance		\$ 809,613	\$ 816,536

Total portfolio	\$ 3,219,923	\$ 3,195,006
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(9) Commercial mortgage loans totaling \$22.9 million were on non-accrual status and therefore were considered non-income producing.

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

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

**(Information at and for the three months ended March 31, 2005 and 2004 is unaudited)**

**Note 1. Organization**

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

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

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

The investment objective of the Company is to achieve current income and capital gains. In order to achieve this objective, the Company has invested in companies in a variety of industries, non-investment grade commercial mortgage-backed securities ( CMBS ) and collateralized debt obligation bonds and preferred shares ( CDOs ).

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

***Basis of Presentation***

The consolidated financial statements include the accounts of ACC and its subsidiaries. All intercompany accounts and transactions have been eliminated in consolidation. Certain reclassifications have been made to the 2004 balances to conform with the 2005 financial statement presentation.

The accompanying unaudited consolidated financial statements of the Company have been prepared in accordance with U.S. generally accepted accounting principles ( GAAP ) for interim financial information. Accordingly, they do not include all of the information and footnotes required by GAAP for complete consolidated financial statements. In the opinion of management, the unaudited consolidated financial results of the Company included herein contain all adjustments (consisting of only normal recurring accruals) necessary to present fairly the financial position of the Company as of March 31, 2005, and the results of operations, changes in net assets, and cash flows for the three months ended March 31, 2005 and 2004. The results of operations for the three months ended March 31, 2005, are not necessarily indicative of the operating results to be expected for the full year.

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

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

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

In the ordinary course of business, the Company enters into transactions with portfolio companies in the more than 25% owned and the 5% to 25% owned categories that may be considered related party transactions.

***Valuation Of Portfolio Investments***

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

***Loans and Debt Securities***

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

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

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

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

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

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

***Equity Securities***

The Company's equity 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, recent transactions involving the purchase or sale of the portfolio company's equity securities, or other liquidation events. The determined equity values are generally discounted to account for restrictions on resale or minority ownership positions.

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

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



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

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

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

CMBS bonds and CDO bonds and preferred shares are carried at fair value, which is based on a discounted cash flow model that utilizes prepayment and loss assumptions based on historical experience and projected performance, economic factors, the characteristics of the underlying cash flow, and comparable yields for similar CMBS bonds and CDO bonds and preferred shares, when available. The Company recognizes unrealized appreciation or depreciation on its CMBS bonds and CDO bonds and preferred shares as comparable yields in the market change and/or based on changes in estimated cash flows resulting from changes in prepayment or loss assumptions in the underlying collateral pool. The Company has determined the fair value of its CMBS bonds and CDO bonds and preferred shares on an individual security-by-security basis. If the Company was to sell a group of these investments in a pool in one or more transactions, the total value received for that pool may be different than the sum of the fair values of the individual bonds or preferred shares.

The Company recognizes income from the amortization of original issue discount using the effective interest method, using the anticipated yield over the projected life of the investment. Yields are revised when there are changes in actual and estimated prepayment speeds or actual and estimated credit losses. Changes in estimated yield are recognized as an adjustment to the estimated yield over the remaining life of the CMBS bonds and CDO bonds and preferred shares from the date the estimated yield is changed.

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

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

***Fee Income***

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

***Guarantees***

The Company accounts for guarantees under FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others* (the Interpretation). In accordance with the Interpretation, guarantees meeting the characteristics described in the Interpretation, and issued or modified after December 31, 2002, are

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

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

recognized at fair value at inception. However, certain guarantees are excluded from the initial recognition provisions of the Interpretation. See Note 5 for disclosures related to the Company's guarantees.

***Financing Costs***

Debt financing costs are based on actual costs incurred in obtaining debt financing and are deferred and amortized as part of interest expense over the term of the related debt instrument. Costs associated with the issuance of common stock, such as underwriting, accounting and legal fees, and printing costs are recorded as a reduction to the proceeds from the sale of common stock.

***Cash and Cash Equivalents***

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

***Dividends to Shareholders***

Dividends to shareholders are recorded on the record date.

***Stock Compensation Plans***

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

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

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

Statement No. 123, *Accounting for Stock-Based Compensation*, to stock-based employee compensation for the three months ended March 31, 2005 and 2004.

	<b>For the Three Months Ended March 31,</b>	
	<b>2005</b>	<b>2004</b>
<b>(in thousands, except per share amounts)</b>		
Net increase in net assets resulting from operations as reported	\$ 119,621	\$ 20,308
Less total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	(2,856)	(3,052)
Pro forma net increase in net assets resulting from operations	116,765	17,256
Less preferred stock dividends		(45)
Pro forma net income available to common shareholders	\$ 116,765	\$ 17,211
Basic earnings per common share:		
As reported	\$ 0.90	\$ 0.16
Pro forma	\$ 0.88	\$ 0.13
Diluted earnings per common share:		
As reported	\$ 0.88	\$ 0.15
Pro forma	\$ 0.86	\$ 0.13

Pro forma expenses are based on the underlying value of the options granted by the Company. The fair value of each option grant is estimated on the date of grant using the Black-Scholes option pricing model and expensed over the vesting period. The following weighted average assumptions were used to calculate the fair value of options granted during the three months ended March 31, 2005 and 2004:

	<b>For the Three Months Ended March 31,</b>	
	<b>2005<sup>(1)</sup></b>	<b>2004</b>
Risk-free interest rate	%	2.7%
Expected life		5.0
Expected volatility	%	37.0%
Dividend yield	%	8.7%
Weighted average fair value per option	\$	\$ 4.25

<sup>(1)</sup> The Company did not grant any options during the three months ended March 31, 2005.

***Federal and State Income Taxes***

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

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

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

***Per Share Information***

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

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

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

The consolidated financial statements include portfolio investments at value of \$3.2 billion and \$3.0 billion at March 31, 2005, and December 31, 2004, respectively. At March 31, 2005, and December 31, 2004, 91% and 92%, respectively, of the Company's total assets represented portfolio investments whose fair values have been determined by the Board of Directors in good faith in the absence of readily available market values. Because of the inherent uncertainty of valuation, the Board of Directors' determined values may differ significantly from the values that would have been used had a ready market existed for the investments, and the differences could be material.

***Recent Accounting Pronouncements***

In December 2004, the FASB issued Statement No. 123 (Revised 2004), *Share-Based Payment* (the Statement), which requires companies to recognize the grant-date fair value of stock options and other equity-based compensation issued to employees in the income statement. The Statement expresses no preference for a type of valuation model and was originally effective for most public companies' interim or annual periods beginning after June 15, 2005. In April 2005, the Securities and Exchange Commission issued a rule deferring the effective date to January 1, 2006, for most companies. The scope of the Statement includes a wide range of share-based compensation arrangements including share options, restricted share plans, performance-based awards, share appreciation rights, and employee share purchase plans. The Statement replaces FASB Statement No. 123, *Accounting for Stock-Based Compensation*, and supersedes APB Opinion No. 25, *Accounting for Stock Issued to Employees*. The Company is currently evaluating the effects of the Statement on its financial position and results of operations with respect to the selection of a valuation model. See the Company's current disclosure under APB Opinion No. 25 above.

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

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

At March 31, 2005, and December 31, 2004, the private finance portfolio consisted of the following:

(\$ in thousands)	2005			2004		
	Cost	Value	Yield <sup>(1)</sup>	Cost	Value	Yield <sup>(1)</sup>
Loans and debt securities <sup>(2)</sup>	\$ 1,653,393	\$ 1,556,359	13.8%	\$ 1,679,855	\$ 1,602,869	13.9%
Equity interests	756,917	822,111		705,065	699,217	
<b>Total</b>	<b>\$ 2,410,310</b>	<b>\$ 2,378,470</b>		<b>\$ 2,384,920</b>	<b>\$ 2,302,086</b>	

(1) The weighted average yield on loans and debt securities is computed as the (a) annual stated interest plus the annual amortization of loan origination fees, original issue discount, and market discount on accruing loans and debt securities less the annual amortization of loan origination costs, divided by (b) total loans and debt securities at value. At March 31, 2005, and December 31, 2004, the cost and value of loans and debt securities include the Class A equity interests in BLX and the guaranteed dividend yield on these equity interests is included in interest income. The weighted average yield is computed as of the balance sheet date.

(2) The principal balance outstanding on loans and debt securities was \$1.7 billion and \$1.7 billion at March 31, 2005, and December 31, 2004, respectively. The difference between principal and cost is represented by unamortized loan origination fees and costs, original issue discounts, and market discounts totaling \$27.2 million and \$29.8 million at March 31, 2005, and December 31, 2004, respectively.

The Company's private finance investment activity principally involves providing financing through privately negotiated long-term debt and equity investments. The Company's private finance investments are generally issued by private companies and are generally illiquid and subject to restrictions on resale. Private finance investments are generally structured as loans and debt securities that carry a relatively high fixed rate of interest, which may be combined with equity features, such as conversion privileges, or warrants or options to purchase a portion of the portfolio company's equity at a pre-determined strike price, which is generally a nominal price for warrants or options in a private company. The annual stated interest rate is only one factor in pricing the investment relative to the Company's rights and priority in the portfolio company's capital structure, and will vary depending on many factors, including if the Company has received nominal cost equity or other components of investment return, such as loan origination fees or market discount. The stated interest rate may include some component of contractual payment-in-kind interest, which represents contractual interest accrued and added to the loan balance that generally becomes due at maturity. At March 31, 2005, and December 31, 2004, approximately 92% and 94%, respectively, of the Company's loans and debt securities had fixed interest rates.

Loans and debt securities generally have a maturity of five to ten years, with interest-only payments in the early years and payments of both principal and interest in the later years, although debt maturities and principal amortization schedules vary.

Equity interests consist primarily of securities issued by private companies and may be subject to restrictions on their resale and are generally illiquid. The Company may incur closing costs associated with making control investments, which will be added to the cost basis of the Company's equity investment. Equity securities generally do

not produce a current return, but are held with the potential for investment appreciation and ultimate gain on sale.

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

**Note 3. Portfolio, continued**

The Company's largest investments at March 31, 2005, and December 31, 2004, were in Advantage Sales & Marketing, Inc. and Business Loan Express, LLC.

In June 2004, the Company completed the purchase of a majority ownership in Advantage Sales & Marketing, Inc. ( Advantage ). The Company's investment totaled \$260.3 million at cost and \$353.4 million at value at March 31, 2005, and \$258.7 million at cost and \$283.0 million at value at December 31, 2004. Advantage is a leading sales and marketing agency providing outsourced sales, merchandising, and marketing services to the consumer packaged goods industry. Advantage has offices across the United States and is headquartered in Irvine, CA.

Total interest and related portfolio income earned from the Company's investment in Advantage for the three months ended March 31, 2005, was \$9.2 million, which includes interest income of \$7.7 million and fees and other income of \$1.5 million. Net change in unrealized appreciation or depreciation for the three months ended March 31, 2005, includes \$68.9 million of unrealized appreciation related to Advantage.

The Company's investment in Business Loan Express, LLC ( BLX ) totaled \$282.2 million at cost and \$330.7 million at value at March 31, 2005, and \$280.4 million at cost and \$335.2 million at value at December 31, 2004. BLX is a small business lender that participates in the U.S. Small Business Administration's 7(a) Guaranteed Loan Program. At March 31, 2005, and December 31, 2004, the Company owned 94.9% of the voting Class C equity interests. BLX has an equity appreciation rights plan for management which will dilute the value available to the Class C equity interest holders. BLX is headquartered in New York, NY.

Total interest and related portfolio income earned from the Company's investment in BLX for the three months ended March 31, 2005 and 2004, was \$7.8 million and \$11.1 million, respectively, which included interest income on the subordinated debt and Class A equity interests of \$3.4 million and \$5.6 million, respectively, dividend income on Class B interests of \$2.0 million and \$2.0 million, respectively, and fees and other income of \$2.4 million and \$3.5 million, respectively. Interest and dividend income from BLX for the three months ended March 31, 2005 and 2004, included interest and dividend income of \$1.6 million and \$2.6 million, respectively, which was paid in kind. The interest and dividends paid in kind were paid to the Company through the issuance of additional debt or equity interests.

Net change in unrealized appreciation or depreciation for the three months ended March 31, 2005 and 2004, included a net decrease in unrealized appreciation of \$6.3 million and \$9.3 million, respectively, on the Company's investment in BLX.

At December 31, 2004, the Company's subordinated debt investment in BLX was \$44.6 million at cost and value. Effective January 1, 2005, this debt plus accrued interest of \$0.2 million was exchanged for Class B equity interests, which are included in private finance equity interests. Since the subordinated debt is no longer outstanding, the amount of taxable income available to flow through to BLX's equity holders will increase by the amount of interest that would have otherwise been paid on this debt.

The Company has provided BLX with a \$20 million revolving credit facility for working capital. At March 31, 2005, and December 31, 2004, there were no amounts outstanding under this facility.



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

**Note 3. Portfolio, continued**

As a limited liability company, BLX's taxable income flows through directly to its members. BLX's annual taxable income generally differs from its book income for the fiscal year due to temporary and permanent differences in the recognition of income and expenses. The Company holds all of BLX's Class A and Class B interests, and 94.9% of the Class C interests. BLX's taxable income is first allocated to the Class A interests to the extent that dividends are paid in cash or in kind on such interests, with the remainder being allocated to the Class B and Class C interests. BLX declares dividends on its Class B interests based on an estimate of its annual taxable income allocable to such interests.

At the time of the corporate reorganization of BLX, Inc. from a C corporation to a limited liability company in 2003, for tax purposes BLX had a built-in gain representing the aggregate fair market value of its assets in excess of the tax basis of its assets. As a RIC, the Company will be subject to special built-in gain rules on the assets of BLX. Under these rules, taxes will be payable by the Company at the time and to the extent that the built-in gains on BLX's assets at the date of reorganization are recognized in a taxable disposition of such assets in the 10-year period following the date of the reorganization. At such time, the built-in gains realized upon the disposition of these assets will be included in the Company's taxable income, net of the corporate level taxes paid by the Company on the built-in gains. However, if these assets are disposed of after the 10-year period, there will be no corporate level taxes on these built-in gains.

While the Company has no obligation to pay the built-in gains tax until these assets are disposed of in the future, it may be necessary to record a liability for these taxes in the future should the Company intend to sell the assets of BLX within the 10-year period. The Company estimates that its future tax liability resulting from the built-in gains at the date of BLX's reorganization may total up to \$40 million. At March 31, 2005, and December 31, 2004, the Company considered the increase in fair value of its investment in BLX due to BLX's tax attributes as an LLC and has also considered the reduction in fair value of its investment due to these estimated built-in gain taxes in determining the fair value of its investment in BLX.

As the controlling equity owner of BLX, the Company has provided an unconditional guaranty to the BLX credit facility lenders in an amount equal to 50% of the total obligations (consisting of principal, letters of credit issued under the facility, accrued interest, and other fees) on BLX's three-year \$275.0 million revolving credit facility, which includes a sub-facility for the issuance of letters of credit for up to a total of \$50.0 million. The facility matures in January 2007. The amount guaranteed by the Company at March 31, 2005, was \$104.6 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 March 31, 2005. At March 31, 2005, the Company had also provided four standby letters of credit totaling \$35.6 million in connection with four term securitization transactions completed by BLX. In consideration for providing the guaranty and the standby letters of credit, BLX paid the Company fees of \$1.6 million and \$1.3 million for the three months ended March 31, 2005 and 2004, respectively.

Other activities (at cost) in portfolio companies more than 25% owned excluding changes in unrealized appreciation or depreciation during the three months ended March 31, 2005, included:

a partial repayment of \$8.2 million of the Company's investment in Avborne, Inc. (Avborne) as a result of the sale of Avborne's assets during the first quarter of 2005;

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

**Note 3. Portfolio, continued**

additional fundings of \$41.8 million on Callidus Capital Corporation's revolving line of credit related to its middle market underwriting and syndication facility. Callidus repaid borrowings under this facility totaling \$27.9 million during the quarter, for net additional borrowings under the facility during the quarter of \$13.9 million; the contribution of existing debt securities of GAC Investments, Inc. with a cost basis of \$11.0 million to capital, resulting in an increase in the Company's common stock cost basis;

an additional loan of \$2.0 million to Gordian Group, Inc.;

an additional \$9.5 million debt and equity investment in Mercury Air Centers, Inc. to finance its acquisition of Corporate Wings;

additional fundings of \$5.8 million on Powell Plant Farms, Inc.'s revolving credit facility for working capital;

the repayment of the Company's debt investment of \$14.0 million in Redox Brands, Inc.; and

an additional debt investment of \$8.4 million in STS Operating, Inc. (STS) to support the recapitalization of STS. In connection, with the recapitalization, STS redeemed the Company's preferred stock investment.

In addition, the Company appointed three members to Norstan Apparel Shop Inc.'s (Norstan) board of directors and now has control of the board, therefore, Norstan is now included in the portfolio companies more than 25% owned category.

On March 31, 2004, the Company sold its control investment in Hillman, which was one of the Company's largest investments, for a total transaction value of \$510 million, including the repayment of outstanding debt and adding the value of Hillman's outstanding trust preferred shares. The Company was repaid its existing \$44.6 million in outstanding debt. Total consideration to the Company from the sale at closing, including the repayment of debt, was \$244.3 million, which included net cash proceeds of \$196.8 million and the receipt of a new subordinated debt instrument of \$47.5 million. During the second quarter of 2004, the Company sold a \$5.0 million participation in its subordinated debt in Hillman to a third party, which reduced the Company's investment, and no gain or loss resulted from the transaction. For the three months ended March 31, 2004, the Company realized a gain of \$149.0 million on the transaction. For the year ended December 31, 2004, the Company realized a gain of \$150.3 million on the transaction.

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

**Note 3. Portfolio, continued**

At March 31, 2005, and December 31, 2004, loans and debt securities at value not accruing interest were as follows:

(\$ in thousands)	2005	2004
Loans and debt securities in workout status (classified as Grade 4 or 5)		
Companies more than 25% owned	\$ 26,200	\$ 34,374
Companies less than 5% owned	13,309	16,550
Loans and debt securities not in workout status		
Companies more than 25% owned	12,927	29,368
Companies 5% to 25% owned		678
Companies less than 5% owned	18,885	15,864
 Total	 \$ 71,321	 \$ 96,834

The industry and geographic compositions of the private finance portfolio at value at March 31, 2005, and December 31, 2004, were as follows:

	2005	2004
<b>Industry</b>		
Business services	34%	32%
Financial services	22	21
Consumer products	18	20
Healthcare services	8	8
Industrial products	7	8
Retail	3	2
Energy services	2	2
Broadcasting and cable	1	2
Other	5	5
 Total	 100%	 100%
<b>Geographic Region<sup>(1)</sup></b>		
Mid-Atlantic	38%	40%
West	32	30
Midwest	15	16
Southeast	10	10
Northeast	5	4
 Total	 100%	 100%

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

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

**Note 3. Portfolio, continued***Commercial Real Estate Finance*

At March 31, 2005, and December 31, 2004, the commercial real estate finance portfolio consisted of the following:

	2005			2004		
	Cost	Value	Yield <sup>(1)</sup>	Cost	Value	Yield <sup>(1)</sup>
<b>(\$ in thousands)</b>						
CMBS bonds	\$ 475,527	\$ 466,060	13.0%	\$ 383,310	\$ 373,805	14.6%
CDO bonds and preferred shares	213,488	227,152	15.8%	212,590	212,573	16.8%
Commercial mortgage loans	92,767	89,678	6.4%	99,373	95,056	6.8%
Real estate owned	15,369	18,443		16,170	16,871	
Equity interests	12,462	15,203		11,169	13,020	
<b>Total</b>	<b>\$ 809,613</b>	<b>\$ 816,536</b>		<b>\$ 722,612</b>	<b>\$ 711,325</b>	

<sup>(1)</sup> The weighted average yield on the interest-bearing investments is computed as the (a) annual stated interest plus the annual amortization of loan origination fees, original issue discount, and market discount on accruing interest-bearing investments less the annual amortization of origination costs, divided by (b) total interest-bearing investments at value. The weighted average yield is computed as of the balance sheet date. Interest-bearing investments for the commercial real estate finance portfolio include all investments except for real estate owned and equity interests.

**CMBS Bonds and Collateralized Debt Obligation Bonds and Preferred Shares ( CDOs ).** Subsequent to March 31, 2005, the Company completed the sale of its portfolio of CMBS bonds and CDO bonds and preferred shares on May 3, 2005, as outlined in Note 15.

**Commercial Mortgage Loans and Equity Interests.** The commercial mortgage loan portfolio contains loans that were originated by the Company or were purchased from third-party sellers. At March 31, 2005, approximately 94% and 6% of the Company's commercial mortgage loan portfolio was composed of fixed and adjustable interest rate loans, respectively. At December 31, 2004, approximately 94% and 6% of the Company's commercial mortgage loan portfolio was composed of fixed and adjustable interest rate loans, respectively. As of March 31, 2005, and December 31, 2004, loans with a value of \$22.9 million and \$18.0 million, respectively, were not accruing interest. Loans greater than 120 days delinquent generally do not accrue interest.

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

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

**Note 3. Portfolio, continued**

The property types and the geographic composition securing the commercial mortgage loans and equity interests at value at March 31, 2005, and December 31, 2004, were as follows:

	2005	2004
<b>Property Type</b>		
Hospitality	50%	49%
Retail	20	21
Office	17	17
Housing	6	5
Other	7	8
<b>Total</b>	<b>100%</b>	<b>100%</b>
<b>Geographic Region</b>		
Mid-Atlantic	29%	20%
Midwest	27	30
Southeast	22	26
West	15	16
Northeast	7	8
<b>Total</b>	<b>100%</b>	<b>100%</b>

**Note 4. Debt**

At March 31, 2005, and December 31, 2004, the Company had the following debt:

	2005			2004		
	Facility Amount	Amount Drawn	Annual Interest Cost <sup>(1)</sup>	Facility Amount	Amount Drawn	Annual Interest Cost <sup>(1)</sup>
<b>(\$ in thousands)</b>						
Notes payable and debentures:						
Unsecured notes payable	\$ 980,935	\$ 980,935	6.5%	\$ 981,368	\$ 981,368	6.5%
SBA debentures	53,800	46,500	7.8%	84,800	77,500	8.2%
OPIC loan	5,700	5,700	6.6%	5,700	5,700	6.6%
<b>Total notes payable and debentures</b>	<b>1,040,435</b>	<b>1,033,135</b>	<b>6.6%</b>	<b>1,071,868</b>	<b>1,064,568</b>	<b>6.6%</b>
Revolving line of credit	587,500	263,250	5.7% <sup>(2)</sup>	552,500	112,000	6.3% <sup>(2)</sup>
<b>Total debt</b>	<b>\$ 1,627,935</b>	<b>\$ 1,296,385</b>	<b>6.4%<sup>(2)</sup></b>	<b>\$ 1,624,368</b>	<b>\$ 1,176,568</b>	<b>6.6%<sup>(2)</sup></b>

- (1) The weighted average annual interest cost is computed as the (a) annual stated interest on the debt plus the annual amortization of commitment fees and other facility fees that are recognized into interest expense over the contractual life of the respective borrowings, divided by (b) debt outstanding on the balance sheet date.
- (2) The stated interest rate payable on the revolving line of credit was 4.4% and 4.7% at March 31, 2005, and December 31, 2004, respectively, which excluded the annual cost of commitment fees and other facility fees of \$3.3 million and \$1.8 million, respectively. The annual cost of commitment fees and other facility fees of \$3.3 million at March 31, 2005, includes the extension fee of \$1.8 million that the Company paid on April 18, 2005, as discussed below. The annual interest cost for total debt includes the annual cost of commitment fees and other facility fees on the revolving line of credit regardless of the amount drawn on the facility as of the balance sheet date.

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

**Note 4. Debt, continued***Notes Payable and Debentures*

**Unsecured Notes Payable.** The Company has issued unsecured long-term notes to private institutional investors. The notes require semi-annual interest payments until maturity and have original terms of five or seven years. At March 31, 2005, the notes had remaining maturities of two months to seven years. The notes may be prepaid in whole or in part, together with an interest premium, as stipulated in the note agreement.

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

**SBA Debentures.** At March 31, 2005, the Company had debentures payable to the SBA with original terms of ten years and at fixed interest rates ranging from 5.9% to 7.5%. During the first quarter of 2005, the Company repaid \$31.0 million of the SBA debentures. At March 31, 2005, the debentures had remaining maturities of six to seven years. The debentures require semi-annual interest-only payments with all principal due upon maturity. The SBA debentures are subject to prepayment penalties if paid prior to the fifth anniversary date of the notes.

At March 31, 2005, the Company had a commitment from the SBA to borrow up to an additional \$7.3 million above the current amount outstanding. The commitment expires on September 30, 2005.

**Scheduled Maturities.** Scheduled future maturities of notes payable and debentures at March 31, 2005, were as follows:

Year	Amount Maturing
	(\$ in thousands)
2005	\$ 165,000
2006	180,700
2007	
2008	153,000
2009	268,435
Thereafter	266,000
<b>Total</b>	<b>\$ 1,033,135</b>

**Revolving Line of Credit**

During the first quarter of 2005, the Company expanded the committed amount under the unsecured revolving credit facility to \$587.5 million. The committed amount may be further expanded through new or additional commitments up to \$600 million at the Company's option. During the second quarter of 2005, the Company extended the maturity of the line of credit to April 2006 under substantially similar terms. The extension of the facility required payment of an extension fee of 0.3%



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

**Note 4. Debt, continued**

on existing commitments and the interest rate on outstanding borrowings will increase by 0.5% during the extension period. After the extension notice, the facility generally bears interest at a rate, at the Company's option, equal to (i) the one-month LIBOR plus 2.00%, (ii) the Bank of America, N.A. cost of funds plus 2.00% or (iii) the higher of the Bank of America, N.A. prime rate or the Federal Funds rate plus 1.00%. The interest rate adjusts at the beginning of each new interest period, usually every 30 days. The facility requires an annual commitment fee equal to 0.25% of the committed amount. The annual cost of commitment fees and other facility fees was \$3.3 million and \$1.8 million at March 31, 2005, and December 31, 2004, respectively. The facility fees at March 31, 2005, include the extension fee of \$1.8 million that the Company paid on April 18, 2005. The line of credit generally requires monthly payments of interest, and all principal is due upon maturity.

The average debt outstanding on the revolving line of credit was \$72.3 million for the three months ended March 31, 2005. The maximum amount borrowed under this facility and the weighted average stated interest rate for the three months ended March 31, 2005, were \$263.3 million and 4.1%, respectively. There were no amounts outstanding on the revolving line of credit for the three months ended March 31, 2004. As of March 31, 2005, the amount available under the revolving line of credit was \$287.2 million, net of amounts committed for standby letters of credit of \$37.1 million issued under the credit facility.

Subsequent to March 31, 2005, in connection with the sale of the Company's CMBS and CDO assets on May 3, 2005, as outlined in Note 15, the Company used a portion of the cash proceeds from the sale to repay outstanding borrowings under the revolving line of credit.

***Covenant Compliance***

The Company has various financial and operating covenants required by the notes payable and debentures and the revolving line of credit. These covenants require the Company to maintain certain financial ratios, including debt to equity and interest coverage, and a minimum net worth. The Company's credit facilities limit its ability to declare dividends if the Company defaults under certain provisions. As of March 31, 2005, and December 31, 2004, the Company was in compliance with these covenants.

**Note 5. Guarantees**

In the ordinary course of business, the Company has issued guarantees and has extended standby letters of credit through financial intermediaries on behalf of certain portfolio companies. All standby letters of credit have been issued through Bank of America, N.A. As of March 31, 2005, and December 31, 2004, the Company had issued guarantees of debt, rental obligations, lease obligations and severance obligations aggregating \$109.5 million and \$100.2 million, respectively, and had extended standby letters of credit aggregating \$37.1 million and \$44.1 million, respectively. Under these arrangements, the Company would be required to make payments to third-party beneficiaries if the portfolio companies were to default on their related payment obligations. The maximum amount of potential future payments was \$146.6 million and \$144.3 million at March 31, 2005, and December 31, 2004, respectively. At March 31, 2005, and December 31, 2004, \$0.3 million and \$0.8 million, respectively, had been recorded as a liability for the Company's guarantees and no amounts had been recorded as a liability for the Company's standby letters of credit.

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

**Note 5. Guarantees, continued**

As of March 31, 2005, the guarantees and standby letters of credit expire as follows:

(in millions)	Total	2005	2006	2007	2008	2009	After 2009
Guarantees	\$ 109.5	\$ 0.3	\$ 0.9	\$ 104.6	\$ 0.1	\$ 2.5	\$ 1.1
Standby letters of credit <sup>(1)</sup>	37.1		37.1				
<b>Total</b>	<b>\$ 146.6</b>	<b>\$ 0.3</b>	<b>\$ 38.0</b>	<b>\$ 104.6</b>	<b>\$ 0.1</b>	<b>\$ 2.5</b>	<b>\$ 1.1</b>

<sup>(1)</sup> Standby letters of credit are issued under the Company's revolving line of credit that was set to expire in April 2005 and has been extended under substantially similar terms for one additional year at the Company's option, for an assumed maturity of April 2006. Therefore, unless a standby letter of credit is set to expire at an earlier date, it is assumed that the standby letters of credit will expire contemporaneously with the expiration of the Company's line of credit in April 2006.

In the ordinary course of business, the Company enters into agreements with service providers and other parties that may contain provisions for the Company to indemnify such parties under certain circumstances.

At March 31, 2005, the Company had outstanding commitments to fund investments totaling \$360.7 million. In addition, during the fourth quarter of 2004 and the first quarter of 2005, the Company sold certain commercial mortgage loans that the Company may be required to repurchase under certain circumstances. These recourse provisions expire by January 2006. The aggregate outstanding principal balance of these sold loans was \$16.8 million at March 31, 2005.

**Note 6. Shareholders' Equity**

The Company did not sell any common stock during the three months ended March 31, 2005 or 2004. The Company issued 0.3 million shares of common stock with a value of \$7.2 million as consideration for an additional investment in Mercury Air Center, Inc. during the three months ended March 31, 2005.

The Company has a dividend reinvestment plan, whereby the Company may buy shares of its common stock in the open market or issue new shares in order to satisfy dividend reinvestment requests. If the Company issues new shares, the issue price is equal to the average of the closing sale prices reported for the Company's common stock for the five consecutive trading days immediately prior to the dividend payment date. For the three months ended March 31, 2005 and 2004, the Company issued new shares in order to satisfy dividend reinvestment requests.

Dividend reinvestment plan activity for the three months ended March 31, 2005 and 2004, was as follows:

(in thousands, except per share amounts)	For the Three Months Ended March 31,	
	2005	2004
Shares issued	55	50
Average price per share	\$ 25.65	\$ 29.65



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

**Note 7. Earnings Per Common Share**

Earnings per common share for the three months ended March 31, 2005 and 2004, were as follows:

(in thousands, except per share amounts)	For the Three Months Ended March 31,	
	2005	2004
Net increase in net assets resulting from operations	\$ 119,621	\$ 20,308
Less preferred stock dividends		(45)
Income available to common shareholders	\$ 119,621	\$ 20,263
Weighted average common shares outstanding basic	133,283	128,314
Dilutive options outstanding to officers	2,296	3,654
Weighted average common shares outstanding diluted	135,579	131,968
Basic earnings per common share	\$ 0.90	\$ 0.16
Diluted earnings per common share	\$ 0.88	\$ 0.15

**Note 8. Employee Compensation Plans**

The Company has a deferred compensation plan. Amounts deferred by participants under the deferred compensation plan are funded to a trust, which is administered by trustees. The accounts of the deferred compensation trust are consolidated with the Company's accounts. The assets of the trust are classified as other assets and the liability to the plan participants is included in other liabilities in the accompanying financial statements. The deferred compensation plan accounts at March 31, 2005, and December 31, 2004, totaled \$16.7 million and \$16.1 million, respectively.

In the first quarter of 2004, the Company established the Individual Performance Award ( IPA ) as a long-term incentive compensation program for certain officers. In conjunction with the program, the Board of Directors has approved a non-qualified deferred compensation plan ( DCP II ), which is administered through a trust by an independent third-party trustee. The administrator of the DCP II is the Compensation Committee of the Company's Board of Directors ( DCP II Administrator ).

The IPA, which will generally be determined annually at the beginning of each year, is deposited in the trust in four equal installments, generally on a quarterly basis, in the form of cash. The Compensation Committee of the Board of Directors designed the DCP II to require the trustee to use the cash to purchase shares of the Company's common stock in the open market. During the three months ended March 31, 2005, 0.1 million shares were purchased in the DCP II.

All amounts deposited and then credited to a participant's account in the trust, based on the amount of the IPA received by such participant, are credited solely for purposes of accounting and computation and remain assets of the Company and subject to the claims of the Company's general creditors. Amounts credited to participants under the DCP II are immediately vested and non-forfeitable once deposited by the Company into the trust. A participant's account shall generally



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

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

become distributable only after his or her termination of employment, or in the event of a change of control of the Company. Upon the participant's termination of employment, one-third of the participant's account will be immediately distributed, one-half of the then current remaining balance will be distributed on the first anniversary of his or her employment termination date and the remainder of the account balance will be distributed on the second anniversary of the employment termination date. Distributions are subject to the participant's adherence to certain non-solicitation requirements. All DCP II accounts will be distributed in a single lump sum in the event of a change of control of the Company. To the extent that a participant has an employment agreement, such participant's DCP II account will be fully distributed in the event that such participant's employment is terminated for good reason as defined under that participant's employment agreement. The DCP II Administrator may also determine other distributable events and the timing of such distributions. Sixty days following a distributable event, the Company and each participant may, at the discretion of the Company, and subject to the Company's trading window during that time, redirect the participant's account to other investment options.

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

For the three months ended March 31, 2005 and 2004, IPA expense was \$1.9 million and \$3.5 million, respectively. The IPA amounts were contributed into the DCP II trust and invested in the Company's common stock. The accounts of the DCP II are consolidated with the Company's accounts. The common stock is classified as common stock held in deferred compensation trust in the accompanying financial statements and the deferred compensation obligation, which represents the amount owed to the employees, is included in other liabilities. Changes in the value of the Company's common stock held in the deferred compensation trust are not recognized. However, the liability is marked to market with a corresponding charge or credit to employee compensation expense. The effect of this adjustment for the three months ended March 31, 2005, was to increase the individual performance award expense by \$0.1 million. There is no adjustment for the three months ended March 31, 2004, as the contribution to the trust was pending shareholder approval and was not made until the second quarter of 2004. This resulted in a total individual performance award expense of \$2.0 million and \$3.5 million for the three months ended March 31, 2005 and 2004, respectively.

As a result of recent changes in regulation by the Jobs Creation Act of 2004 associated with deferred compensation arrangements, as well as an increase in the competitive market for recruiting top performers in private equity firms, the Compensation Committee of the Company's Board of Directors has determined for 2005 that a portion of the IPA will be replaced with an individual performance bonus ( IPB ). The IPB for 2005 will be distributed in cash to award recipients in equal bi-weekly installments as long as the recipient remains employed by the Company. If a recipient terminates employment during the year, any remaining cash payments under the IPB would be forfeited. For the three months ended March 31, 2005, the IPB expense was \$1.5 million. The IPA and IPB expenses are included in employee expenses.

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

**Note 9. Stock Option Plan**

The purpose of the stock option plan ( Option Plan ) is to provide officers and non-officer directors of the Company with additional incentives. Options are exercisable at a price equal to the fair market value of the shares on the day the option is granted. Each option states the period or periods of time within which the option may be exercised by the optionee, which may not exceed ten years from the date the option is granted. The options granted vest ratably over a three-or five-year period.

All rights to exercise options terminate 60 days after an optionee ceases to be (i) a non-officer director, (ii) both an officer and a director, if such optionee serves in both capacities, or (iii) an officer (if such officer is not also a director) of the Company for any cause other than death or total and permanent disability. In the event of a change of control of the Company, all outstanding options will become fully vested and exercisable as of the change of control.

There are 32.2 million shares authorized under the Option Plan. At March 31, 2005, and December 31, 2004, the number of shares available to be granted under the Option Plan was 8.1 million and 7.9 million, respectively. During the three months ended March 31, 2005, no options were granted. During the three months ended March 31, 2004, options for 6.8 million shares were granted to employees under the Option Plan at an exercise price of \$28.98 per share.

Options were outstanding for 20.0 million and 20.4 million shares with a weighted average exercise price of \$23.56 and \$23.55 per share at March 31, 2005, and December 31, 2004, respectively.

**Note 10. Dividends and Distributions**

The Company's Board of Directors declared and the Company paid a dividend of \$0.57 per common share for the first quarters of 2005 and 2004. These dividends totaled \$76.1 million and \$73.4 million for the three months ended March 31, 2005 and 2004, respectively. The Company declared an extra cash dividend of \$0.02 per share during 2004 and this was paid to shareholders on January 28, 2005.

The Company's Board of Directors also declared a dividend of \$0.57 per common share for the second quarter of 2005.

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

For the three months ended March 31, 2005 and 2004, the Company paid \$7.0 million and \$6.1 million, respectively, for interest.

Principal collections related to investment repayments or sales included the collection of discounts previously amortized into interest income and added to the cost basis of a loan or debt security totaling \$1.1 million and \$1.1 million for the three months ended March 31, 2005 and 2004, respectively.

Non-cash operating activities for the three months ended March 31, 2005, included the exchange of existing subordinated debt securities and accrued interest of BLX with a cost basis of \$44.8 million for additional Class B equity interests (see Note 3), the exchange of debt securities and accrued interest of Coverall North America, Inc. with a cost basis of \$24.2 million for new debt securities and

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

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

warrants with a total cost basis of \$26.8 million, and the contribution of existing debt securities of GAC Investments, Inc. with a cost basis of \$11.0 million to capital, resulting in an increase in the Company's common stock cost basis.

Non-cash operating activities for the three months ended March 31, 2004, included notes or other securities received as consideration from the sale of investments of \$48.3 million. The notes received for the three months ended March 31, 2004, included a note received for \$47.5 million in conjunction with the sale of Hillman. During the second quarter of 2004, the Company sold a \$5.0 million participation in its subordinated debt in Hillman to a third party, which reduced its investment, and no gain or loss resulted from the transaction.

For the three months ended March 31, 2005 and 2004, the Company's non-cash financing activities included \$1.4 million and \$1.5 million, respectively, related to the issuance of common stock in lieu of cash distributions. In addition, the non-cash financing activities for the three months ended March 31, 2005, also included the issuance of \$7.2 million of the Company's common stock as consideration for an additional investment in Mercury Air Centers, Inc.

**Note 12. Hedging Activities**

The Company invests in CMBS and CDO bonds, which are purchased at prices that are based in part on comparable Treasury rates. The Company has entered into transactions with one or more financial institutions to hedge against movement in Treasury rates on certain of the higher rated CMBS and CDO bonds. These transactions, referred to as short sales, involve the Company receiving the proceeds from the short sales of borrowed Treasury securities, with the obligation to replenish the borrowed Treasury securities at a later date based on the then current market price. Borrowed Treasury securities and the related obligations to replenish the borrowed Treasury securities at value, including accrued interest payable on the obligations, as of March 31, 2005, and December 31, 2004, consisted of the following:

(\$ in thousands)	2005	2004
Description of Issue		
5-year Treasury securities, due December 2009	\$	\$ 533
10-year Treasury securities, due February 2013	3,776	3,908
10-year Treasury securities, due February 2014	4,550	4,709
10-year Treasury securities, due August 2014	14,235	14,743
10-year Treasury securities, due November 2014	42,120	14,333
10-year Treasury securities, due February 2015	34,060	
<b>Total</b>	<b>\$ 98,741</b>	<b>\$ 38,226</b>

As of March 31, 2005, and December 31, 2004, the total obligations to replenish borrowed Treasury securities had decreased since the related original sale dates due to changes in the yield on the borrowed Treasury securities, resulting in unrealized appreciation on the obligations of \$2.3 million and \$0.3 million, respectively.

The net proceeds related to the sales of the borrowed Treasury securities were \$100.9 million and \$38.5 million at March 31, 2005, and December 31, 2004, respectively. Under the terms of the



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

**Note 12. Hedging Activities, continued**

transactions, the Company had received cash payments of \$2.2 million and \$0.3 million at March 31, 2005, and December 31, 2004, respectively, for the difference between the net proceeds related to the sales of the borrowed Treasury securities and the obligations to replenish the securities.

The Company has deposited the proceeds related to the sales of the borrowed Treasury securities and the additional cash collateral with Wachovia Capital Markets, LLC under repurchase agreements. The repurchase agreements are collateralized by U.S. Treasury securities and are settled weekly. As of March 31, 2005, the repurchase agreements were due on April 6, 2005, and had a weighted average interest rate of 1.7%. The weighted average interest rate on the repurchase agreements as of December 31, 2004, was 1.3%.

Subsequent to March 31, 2005, in connection with the sale of the Company's CMBS and CDO assets on May 3, 2005, as outlined in Note 15, substantially all of these hedge positions were settled.

**Note 13. Financial Highlights**

	At and for the Three Months Ended March 31,		At and for the Year Ended December 31,
	2005 <sup>(1)</sup>	2004	2004
<b>Per Common Share Data<sup>(2)</sup></b>			
Net asset value, beginning of period	\$ 14.87	\$ 14.94	\$ 14.94
Net investment income	0.29	0.34	1.52
Net realized gains <sup>(3)</sup>	0.07	1.12	0.88
Net investment income plus net realized gains	0.36	1.46	2.40
Net change in unrealized appreciation or depreciation <sup>(3)</sup>	0.52	(1.31)	(0.52)
Net increase in net assets resulting from operations	0.88	0.15	1.88
Net decrease in net assets from shareholder distributions	(0.57)	(0.57)	(2.30)
Net increase in net assets from capital share transactions	0.04	0.08	0.35
Net asset value, end of period	\$ 15.22	\$ 14.60	\$ 14.87
Market value, end of period	\$ 26.10	\$ 30.29	\$ 25.84
Total return <sup>(4)</sup>	3%	11%	1%

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

**Note 13. Financial Highlights, continued**

	At and for the Three Months Ended March 31,		At and for the Year Ended December 31,
	2005 <sup>(1)</sup>	2004	2004
<b>Ratios and Supplemental Data</b>			
(\$ and shares in thousands, except per share amounts)			
Ending net assets	\$ 2,033,148	\$ 1,879,970	\$ 1,979,778
Common shares outstanding at end of period	133,563	128,761	133,099
Diluted weighted average common shares outstanding	135,579	131,968	132,458
Employee and administrative expenses/average net assets	1.80%	0.96%	4.65%
Total expenses/average net assets	2.81%	1.97%	8.58%
Net investment income/average net assets	1.93%	2.35%	10.45%
Net increase in net assets resulting from operations/ average net assets	5.96%	1.07%	12.97%
Portfolio turnover rate	5.10%	6.83%	32.97%
Average debt outstanding	\$ 1,125,007	\$ 952,986	\$ 985,616
Average debt per share <sup>(2)</sup>	\$ 8.30	\$ 7.22	\$ 7.44

(1) The results for the three months ended March 31, 2005, are not necessarily indicative of the operating results to be expected for the full year.

(2) Based on diluted weighted average number of common shares outstanding for the period.

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

(4) Total return assumes the reinvestment of all dividends paid for the periods presented.

**Note 14. Litigation**

The Company is party to certain lawsuits in the normal course of business. While the outcome of these legal proceedings cannot at this time be predicted with certainty, the Company does not expect that the outcome of these proceedings will have a material effect upon the Company's financial condition or results of operations.

**Note 15. Subsequent Event**

On May 3, 2005, the Company completed the sale of its portfolio of CMBS bonds and CDO bonds and preferred shares to affiliates of Caisse de dépôt et placement du Québec (the Caisse) for cash proceeds of approximately \$976 million and expects to realize a net gain of approximately \$216 million, after estimated transaction and other costs of approximately \$20 million. The estimated net gain will be recognized in the second quarter of 2005.

Simultaneous with the sale of the Company's CMBS and CDO portfolio, the Company entered into certain agreements with affiliates of the Caisse, including a platform assets purchase agreement, pursuant to which the

Company agreed to sell certain additional commercial real estate-related assets to the Caisse, subject to certain adjustments and closing conditions, and a transition services agreement, pursuant to which the Company will provide certain transition services for a limited transition period. Also in connection with the platform assets purchase agreement, the Company

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

**Note 15. Subsequent Event**

agreed not to invest in CMBS and real estate-related CDOs and refrain from certain other real estate-related investing or servicing activities for a period of three years, subject to certain limitations.

In addition, the Company entered into a letter of intent with an affiliate of the Caisse pursuant to which the parties agreed to negotiate in good faith the terms of a definitive agreement relating to the sale of certain of the Company's commercial mortgage loans and commercial real estate owned. The letter of intent does not obligate either party to enter into such a definitive agreement and terminates on June 30, 2005. At March 31, 2005, the Company's commercial mortgage loans, real estate owned and equity interests totaled \$123.3 million at value.

Upon the closing of the sale, the Company repaid outstanding borrowings on its revolving line of credit of approximately \$200 million and settled all hedge positions relating to these assets, which resulted in a net realized loss of approximately \$0.7 million, which has been included in the estimated net realized gain on the sale.

**Report of Independent Registered Public Accounting Firm**

The Board of Directors and Shareholders

Allied Capital Corporation:

We have reviewed the accompanying consolidated balance sheet of Allied Capital Corporation and subsidiaries, including the consolidated statement of investments, as of March 31, 2005, and the related consolidated statements of operations, changes in net assets and cash flows and the financial highlights (included in Note 13) for the three-month periods ended March 31, 2005 and 2004. These consolidated financial statements and financial highlights are the responsibility of the Company's management.

We conducted our reviews in accordance with standards of the Public Company Accounting Oversight Board (United States). A review of interim financial information consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with standards of the Public Company Accounting Oversight Board (United States), the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

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

We have previously audited, in accordance with standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheet of Allied Capital Corporation and subsidiaries as of December 31, 2004, and the related consolidated statements of operations, changes in net assets and cash flows (not presented herein), and the financial highlights (included in Note 13), for the year then ended; and in our report dated March 14, 2005, we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying condensed consolidated balance sheet as of December 31, 2004, is fairly stated, in all material respects, in relation to the consolidated balance sheet from which it has been derived.

/s/ KPMG LLP

Washington, D.C.

May 4, 2005

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

*The following analysis of the financial condition and results of operations of the Company should be read in conjunction with the Company's Consolidated Financial Statements and the Notes thereto included herein and in the Company's annual report on Form 10-K for the year ended December 31, 2004. In addition, this quarterly report on Form 10-Q contains certain forward-looking statements. These statements include the plans and objectives of management for future operations and financial objectives and can be identified by the use of forward-looking terminology such as may, will, expect, intend, anticipate, estimate, or continue or the negative thereof or variations thereon or comparable terminology. These forward-looking statements are subject to the inherent uncertainties in predicting future results and conditions. Certain factors that could cause actual results and conditions to differ materially from those projected in these forward-looking statements are set forth below in the Risk Factors section. Other factors that could cause actual results to differ materially include:*

*changes in the economy;*

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

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

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

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

**OVERVIEW**

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 has generally been 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, acquisitions, buyouts, recapitalizations, note purchases, bridge financings, and other types of financings. We generally invest in private companies though, from time to time, we may invest in companies that are public but lack access to additional public capital or whose securities may not be marginable.

Our portfolio composition at March 31, 2005, and December 31, 2004, was as follows:

	2005	2004
Private finance	74%	76%
Commercial real estate finance	26%	24%

On May 3, 2005, we completed the sale of our portfolio of CMBS and CDO investments. Upon the completion of this transaction, our lending and investment activity will be focused primarily on private finance investments. See Recent Developments below.

Our earnings depend primarily on the level of interest and dividend income, fee and other income, and net gains or losses earned on our investment portfolio after deducting interest expense on borrowed capital and operating expenses. Interest income results from the stated interest rate earned on a loan or debt security and the amortization of loan origination fees and discounts. The level of interest income is directly related to the balance of the interest-bearing investment portfolio outstanding during the period multiplied by the weighted average yield. Our ability to generate interest income is dependent on economic, regulatory, and competitive factors that influence new investment activity, 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.

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

#### PORTFOLIO AND INVESTMENT ACTIVITY

The total portfolio at value, investment activity, and the yield on interest-bearing investments at and for the three months ended March 31, 2005 and 2004, and at and for the year ended December 31, 2004, were as follows:

(\$ in millions)	At and for the Three Months Ended March 31,		At and for the Year Ended December 31,
	2005	2004	2004
	(unaudited)		
Portfolio at value	\$ 3,195.0	\$ 2,399.6	\$ 3,013.4
Investments funded	\$ 265.6	\$ 217.8	\$ 1,524.5
Change in accrued or reinvested interest and dividends	\$ 10.5	\$ 13.1	\$ 52.2
Principal collections related to investment repayments or sales	\$ 158.3	\$ 237.1	\$ 909.2
Yield on interest-bearing investments <sup>(1)</sup>	13.6%	14.3%	14.0%

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

**Private Finance**

The private finance portfolio at value, investment activity, and the yield on loans and debt securities at and for the three months ended March 31, 2005 and 2004, and at and for the year ended December 31, 2004, were as follows:

(\$ in millions)	At and for the Three Months Ended March 31,		At and for the Year Ended December 31,
	2005	2004	2004
	(unaudited)		
Portfolio at value:			
Loans and debt securities	\$ 1,556.4	\$ 1,182.6	\$ 1,602.9
Equity interests	822.1	503.0	699.2
Total portfolio	\$ 2,378.5	\$ 1,685.6	\$ 2,302.1
Investments funded <sup>(1)</sup>	\$ 168.2	\$ 157.7	\$ 1,140.8
Change in accrued or reinvested interest and dividends	\$ 7.9	\$ 11.1	\$ 45.6
Principal collections related to investment repayments or sales	\$ 151.2	\$ 204.8	\$ 551.9
Yield on interest-bearing investments <sup>(2)</sup>	13.8%	14.4%	13.9%

(1) Investments funded for the three months ended March 31, 2004, include a \$47.5 million subordinated debt investment in The Hillman Companies, Inc. received in conjunction with the sale of Hillman as discussed below.

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

The level of investment activity for investments funded and principal repayments for private finance investments can vary substantially from period to period depending on many factors, including the amount of debt and equity capital available to middle market companies, the level of merger and acquisition activity for such companies, the general economic environment, and the competitive environment for the types of investments we make. We believe that merger and acquisition activity in the middle market was strong in 2004 and the first quarter of 2005, which when combined with a lower interest rate environment resulted in an increase in private finance investments funded, as well as increased repayments. The first quarter of the year tends to be a seasonally slower period for deal closings as the industry recovers from what is typically an active fourth quarter closing schedule.

Investments funded for the three months ended March 31, 2005 and 2004, and for the year ended December 31, 2004, consisted of the following:

(\$ in millions)	Loans and Debt Securities	Equity Interests	Total
<i>For the Three Months Ended March 31, 2005</i>			



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Companies more than 25% owned	\$ 65.8	\$ 6.3	\$ 72.1
Companies 5% to 25% owned			
Companies less than 5% owned	87.9	8.2	96.1
Total	\$ 153.7	\$ 14.5	\$ 168.2

***For the Three Months Ended March 31, 2004***

Companies more than 25% owned	\$ 16.1	\$ 1.4	\$ 17.5
Companies 5% to 25% owned	10.8	15.4	26.2
Companies less than 5% owned	108.9	5.1	114.0
Total	\$ 135.8	\$ 21.9	\$ 157.7

(\$ in millions)	Loans and Debt Securities	Equity Interests	Total
<b>For the Year Ended December 31, 2004</b>			
Companies more than 25% owned	\$ 445.4	\$ 171.2	\$ 616.6
Companies 5% to 25% owned	112.0	14.4	126.4
Companies less than 5% owned	351.5	46.3	397.8
<b>Total</b>	<b>\$ 908.9</b>	<b>\$ 231.9</b>	<b>\$ 1,140.8</b>

We intend to continue a balanced approach to private finance investing that emphasizes a complementary mix of non-control investments and buyout investments, subject to regulatory diversity requirements. The combination of these two types of investments provides current interest and related portfolio income and the potential for future capital gains. Our current strategy is to focus on buyout and recapitalization transactions where we can control a portfolio company to manage risk and where we can potentially realize more attractive total returns from both current interest and fee income and future capital gains. In addition to our mezzanine investing, we are also focusing on smaller middle market companies for non-control transactions where we can provide both senior and subordinated debt.

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

At March 31, 2005, we had outstanding investment commitments to private finance portfolio companies totaling \$285.4 million including the following:

We have various commitments to Callidus Capital Corporation (Callidus), an asset management company that structures and manages collateralized debt obligations (CDOs), collateralized loan obligations (CLOs), and other related investments. We own 80% of the equity of the management company. Our commitment to Callidus consists of the following:

(\$ in millions)	Committed Amount	Amount Drawn	Amount Available to be Drawn
Subordinated debt to support warehouse facilities & warehousing activities <sup>(1)</sup>	\$ 50.0 <sup>(2)</sup>	\$	\$ 50.0
Revolving line of credit for working capital	2.0	1.3	0.7
Revolving line of credit facility to support underwriting and syndication activities	150.0	54.9	95.1
<b>Total</b>	<b>\$ 202.0</b>	<b>\$ 56.2</b>	<b>\$ 145.8</b>

- (1) Callidus has a secured warehouse credit facility with a third party for up to \$300 million, primarily to finance the acquisition of loans pending securitization through a CDO or CLO. In conjunction with this warehouse credit facility, we have agreed to designate up to \$45 million of our \$50 million subordinated debt commitment for Callidus to draw upon to provide first loss capital as needed to support the warehouse facility.
- (2) Subsequent to March 31, 2005, Callidus obtained an additional secured warehouse credit facility with a third party for up to \$400 million to finance the acquisition of loans pending securitization through a CDO or CLO. In conjunction with this warehouse credit facility, we increased our \$50 million subordinated debt commitment to \$85 million to provide Callidus with first loss capital to support outstanding warehouse facilities. We have agreed to designate this \$85 million subordinated debt commitment for Callidus to draw upon to provide first loss capital as needed to support its warehouse facilities.

In addition, we had a commitment to Callidus to purchase preferred equity in future CDO or CLO transactions of \$44.4 million at March 31, 2005. Subsequent to March 31, 2005, we increased our commitment to purchase preferred equity securities in Callidus future CDO or CLO transactions to \$76.8 million.

\$20.0 million in the form of a revolving credit facility to Business Loan Express, LLC (BLX) to provide working capital to the company. At March 31, 2005, BLX had no outstanding borrowings on the facility.

\$15.0 million in the form of debt of financing commitments to S.B. Restaurant Company.

\$17.1 million in the form of equity to eight private venture capital funds.

\$8.8 million in the form of equity to Pennsylvania Avenue Investors, L.P., a limited partnership controlled by us that invests in private buyout equity funds.

We may be required to fund additional amounts under earn-out arrangements primarily related to the purchase of controlled portfolio companies in the future if those companies meet agreed-upon performance targets. In addition, we had commitments to private finance portfolio companies in the form of standby letters of credit and guarantees totaling \$143.9 million.

On March 31, 2004, we sold our control investment in The Hillman Companies, Inc. (Hillman) for a total transaction value of \$510 million, including the repayment of outstanding debt and adding the value of Hillman's outstanding trust preferred shares. We were repaid our existing \$44.6 million in outstanding debt. Total consideration to us from this sale, including the repayment of debt, was \$245.6 million, which included net cash proceeds of \$198.1 million and the receipt of a new subordinated debt instrument of \$47.5 million. During the second quarter of 2004, we sold a \$5.0 million participation in our subordinated debt in Hillman to a third party, which reduced our investment, and no gain or loss resulted from the transaction. For the year ended December 31, 2004, we realized a gain of \$150.3 million on the transaction.

The yield on the private finance loans and debt securities was 13.8% at March 31, 2005, as compared to 13.9% at December 31, 2004. The weighted average yield on the private finance loans and debt securities may fluctuate from period to period depending on the yield on new loans and debt securities, the yield on loans and debt securities repaid, and the amount of lower-yielding senior debt that has been funded to controlled portfolio companies. We may fund most or all of the debt and equity capital upon the closing of certain buyout transactions, which may include investments in lower-yielding senior debt. In addition, we may provide lower-yielding senior debt to existing controlled portfolio companies. We currently expect that a portion of the senior debt outstanding to controlled portfolio companies at March 31, 2005, may be refinanced by the portfolio companies during the remainder of 2005.

Our largest investments at March 31, 2005, were in Advantage Sales & Marketing, Inc. and Business Loan Express, LLC (BLX).

***Advantage Sales and Marketing, Inc.*** At March 31, 2005, our investment in Advantage Sales & Marketing, Inc. (Advantage) totaled \$260.3 million at cost and \$353.4 million at value, or 10.1% of our total assets, which includes unrealized appreciation of \$93.1 million.

Total interest and related portfolio income earned from our investment in Advantage for the three months ended March 31, 2005, was \$9.2 million, which includes interest income of \$7.7 million and fees and other income of \$1.5 million. Net change in unrealized appreciation or depreciation for the three months ended March 31, 2005, includes \$68.9 million of unrealized appreciation related to Advantage.

Advantage is a leading sales and marketing agency providing outsourced sales, merchandising, and marketing services to the consumer packaged goods industry. We completed the purchase of a majority ownership in Advantage in June 2004. Advantage has offices across the United States and is headquartered in Irvine, CA.

**Business Loan Express, LLC.** At March 31, 2005, our investment in BLX totaled \$282.2 million at cost and \$330.7 million at value, or 9.4% of our total assets, which includes unrealized appreciation of \$48.5 million. BLX was acquired in 2000.

Total interest and related portfolio income earned from the Company's investment in BLX for the three months ended March 31, 2005 and 2004, was \$7.8 million and \$11.1 million, respectively, which includes interest income on the subordinated debt and Class A equity interests of \$3.4 million and \$5.6 million, respectively, dividend income on Class B interests of \$2.0 million and \$2.0 million, respectively, and fees and other income of \$2.4 million and \$3.5 million, respectively. Interest and dividend income from BLX for the three months ended March 31, 2005 and 2004, included interest and dividend income of \$1.6 million and \$2.6 million, respectively, which was paid in kind. The interest and dividends paid in kind were paid to the Company through the issuance of additional debt or equity interests. Accrued interest and dividends receivable at March 31, 2005, included accrued interest and dividends due from BLX totaling \$4.2 million, of which \$3.8 million was paid in cash in early April 2005.

BLX is a national, non-bank 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 nationwide preferred lender, as designated by the SBA, and originates, sells, and services small business loans. In addition to the SBA 7(a) Guaranteed Loan Program, BLX originates conventional small business loans, originates loans under the USDA Business and Industry Guaranteed Loan Program (B&I) and during the quarter ended March 31, 2004, began originating small investment real estate loans. 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, could negatively affect our financial results.

As a limited liability company, BLX's taxable income flows through directly to its members. BLX's annual taxable income generally differs from its book income for the fiscal year due to temporary and permanent differences in the recognition of income and expenses. We hold all of BLX's Class A and Class B interests, and 94.9% of the Class C interests. BLX's taxable income is first allocated to the Class A interests to the extent that dividends are paid in cash or in kind on such interests, with the remainder being allocated to the Class B and C interests. BLX declares dividends on its Class B interests based on an estimate of its annual taxable income allocable to such interests.

At December 31, 2004, our subordinated debt investment in BLX was \$44.6 million at cost and value. Effective January 1, 2005, this debt plus accrued interest of \$0.2 million was exchanged for Class B equity interests of \$44.8 million, which is included in private finance equity interests. We believe this exchange strengthened BLX's equity capital base and simplified its capital structure. Since the subordinated debt is no longer outstanding, the amount of taxable income available to flow through to BLX's equity holders will increase by the amount of interest that would have otherwise been paid on this debt.

We have a commitment to BLX of \$20.0 million in the form of a revolving credit facility to provide working capital to the company. This facility matures on June 30, 2005. At March 31, 2005, BLX had no outstanding borrowings under this facility.

At March 31, 2005, BLX had a three-year \$275.0 million revolving credit facility that matures in January 2007. The facility provides for a sub-facility for the issuance of letters of credit for up to a total of \$50.0 million. As the controlling equity owner in BLX, we have provided an unconditional guaranty to the revolving credit facility lenders in an amount equal to 50% of the total obligations (consisting of principal, letters of credit issued under the facility, accrued interest, and other fees) of BLX under the revolving credit facility. At March 31, 2005, the principal amount outstanding on the revolving credit facility was \$186.5 million and letters of credit issued under the facility were \$22.0 million. The total obligation guaranteed by us at March 31, 2005, was \$104.6 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 March 31, 2005. At March 31, 2005, we had also provided four standby letters of credit totaling \$35.6 million in connection with four term securitization transactions completed by BLX.

**Commercial Real Estate Finance**

The commercial real estate finance portfolio at value, investment activity, and the yield on interest-bearing investments at and for the three months ended March 31, 2005 and 2004, and at and for the year ended December 31, 2004, were as follows:

(\$ in millions)	At and for the Three Months Ended March 31,				At and for the Year Ended December 31, 2004	
	2005		2004		Value	Yield <sup>(1)</sup>
	Value	Yield <sup>(1)</sup>	Value	Yield <sup>(1)</sup>		
(unaudited)						
Portfolio at value:						
CMBS bonds	\$ 466.1	13.0%	\$ 448.9	13.7%	\$ 373.8	14.6%
CDO bonds and preferred shares	227.1	15.8%	171.4	17.6%	212.6	16.8%
Commercial mortgage loans	89.7	6.4%	74.8	7.8%	95.0	6.8%
Real estate owned	18.4		14.3		16.9	
Equity interests	15.2		4.6		13.0	
<b>Total portfolio</b>	<b>\$ 816.5</b>		<b>\$ 714.0</b>		<b>\$ 711.3</b>	
Investments funded	\$ 97.4		\$ 60.1		\$ 383.7	
Change in accrued or reinvested interest	\$ 2.6		\$ 2.0		\$ 6.6	
Principal collections related to investment repayments or sales	\$ 7.1		\$ 32.3		\$ 357.3	

<sup>(1)</sup> The weighted average yield on the interest-bearing investments is computed as the (a) annual stated interest rate plus the annual amortization of loan origination fees, original issue discount, and market discount on accruing interest-bearing investments less the annual amortization of origination costs, divided by (b) total interest-bearing investments at value. The weighted average yield is computed as of the balance sheet date. Interest-bearing investments for the commercial real estate finance portfolio include all investments except for real estate owned and equity interests.

Our commercial real estate investments funded for the three months ended March 31, 2005 and 2004, and for the year ended December 31, 2004, was as follows:

(\$ in millions)	Face Amount	Discount	Amount Funded
<b>For the Three Months Ended March 31, 2005</b>			
CMBS bonds (3 new issuances)	\$ 160.6	\$ (67.4)	\$ 93.2
Commercial mortgage loans	4.1	(0.7)	3.4
Equity interests	0.8		0.8

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Total	\$ 165.5	\$ (68.1)	\$ 97.4
<b><i>For the Three Months Ended March 31, 2004</i></b>			
CMBS bonds (4 new issuances <sup>(1)</sup> )	\$ 114.3	\$ (54.9)	\$ 59.4
Commercial mortgage loans	0.6		0.6
Equity interests	0.1		0.1
Total	\$ 115.0	\$ (54.9)	\$ 60.1



(\$ in millions)	Face Amount	Discount	Amount Funded
<b><i>For the Year Ended December 31, 2004</i></b>			
CMBS bonds (13 new issuances <sup>(1)</sup> )	\$ 419.1	\$ (183.7)	\$ 235.4
CDO bonds and preferred shares (3 issuances)	40.5	(0.1)	40.4
Commercial mortgage loans	112.1	(8.2)	103.9
Equity interests	4.0		4.0
 Total	 \$ 575.7	 \$ (192.0)	 \$ 383.7

<sup>(1)</sup> CMBS investments also include investments in issuances in which we have previously purchased CMBS bonds.

At March 31, 2005, we had outstanding funding commitments related to commercial mortgage loans and equity interests of \$75.3 million and commitments in the form of standby letters of credit and guarantees related to equity interests of \$2.7 million.

***CMBS Bonds and Collateralized Debt Obligation Bonds and Preferred Shares.*** As outlined below under the caption Recent Developments, we completed the sale of our portfolio of CMBS bonds and CDO bonds and preferred shares to a third party on May 3, 2005.

#### **Hedging Activities**

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

The total obligations to replenish borrowed Treasury securities, including accrued interest payable on the obligations, were \$98.7 million and \$38.2 million at March 31, 2005, and December 31, 2004, respectively. The net proceeds related to the sales of the borrowed Treasury securities plus or minus the additional cash collateral provided or received under the terms of the transactions were \$98.7 million and \$38.2 million at March 31, 2005, and December 31, 2004, respectively. The amount of the hedge will vary from period to period depending upon the amount of higher rated CMBS and CDO bonds that we own and have hedged as of the balance sheet date.

In connection with the sale of CMBS and CDO assets, as outlined below, substantially all of these hedge positions were settled subsequent to March 31, 2005.

#### **Portfolio Asset Quality**

***Portfolio by Grade.*** We employ a standard grading system for our entire portfolio. Grade 1 is used for those investments from which a capital gain is expected. Grade 2 is used for investments performing in accordance with plan. Grade 3 is used for investments that require closer monitoring;



however, no loss of investment return or principal is expected. Grade 4 is used for investments that are in workout and for which some loss of current investment return is expected, but no loss of principal is expected. Grade 5 is used for investments that are in workout and for which some loss of principal is expected.

At March 31, 2005, and December 31, 2004, our portfolio was graded as follows:

Grade	At March 31, 2005		At December 31, 2004	
	Portfolio at Value	Percentage of Total Portfolio	Portfolio at Value	Percentage of Total Portfolio
(\$ in millions)				
1	\$ 1,073.8	33.6%	\$ 952.5	31.6%
2	1,939.5	60.7	1,850.5	61.4
3	94.0	3.0	121.2	4.0
4	7.7	0.2	11.7	0.4
5	80.0	2.5	77.5	2.6
	\$ 3,195.0	100.0%	\$ 3,013.4	100.0%

We continued to include our CMBS and CDO investments in Grade 2 assets at March 31, 2005, due to the uncertainty as to whether the unrealized appreciation or depreciation on our CMBS and CDO investments would have resulted in a realized gain or loss if the CMBS and CDO investments would have been sold on a security-by-security basis. See the *Recent Developments* caption below.

Total Grade 3, 4 and 5 portfolio assets as a percentage of the total portfolio at value at March 31, 2005, and December 31, 2004, were 5.7% and 7.0%, respectively. Included in Grade 3, 4 and 5 assets at March 31, 2005, and December 31, 2004, were portfolio assets totaling \$32.9 million and \$38.3 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 Grade 4 and 5 may fluctuate from period to period. We continue to follow our historical practice of working with such companies in order to recover the maximum amount of our investment.

**Loans and Debt Securities on Non-Accrual Status.** At March 31, 2005, and December 31, 2004, loans and debt securities at value not accruing interest for the total investment portfolio were as follows:

	2005	2004
(\$ in millions)		
Loans and debt securities in workout status (classified as Grade 4 or 5) <sup>(1)</sup>		
Private finance		
Companies more than 25% owned	\$ 26.2	\$ 34.4
Companies less than 5% owned	13.3	16.5
Commercial real estate finance	15.3	5.6
Loans and debt securities not in workout status		
Private finance		
Companies more than 25% owned	12.9	29.4

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Companies 5% to 25% owned		0.7
Companies less than 5% owned	18.9	15.8
Commercial real estate finance	7.7	12.5
Total	\$ 94.3	\$ 114.9
Percentage of total portfolio	3.0%	3.8%

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

**Loans and Debt Securities Over 90 Days Delinquent.** Loans and debt securities greater than 90 days delinquent at value at March 31, 2005, and December 31, 2004, were as follows:

	2005	2004
(\$ in millions)		
Private finance	\$ 85.8	\$ 73.5
Commercial real estate finance		
CMBS bonds	55.3	49.0
Commercial mortgage loans	13.7	10.1
<b>Total</b>	<b>\$ 154.8</b>	<b>\$ 132.6</b>
Percentage of total portfolio	4.8%	4.4%

Loans and debt securities on non-accrual status and over 90 days delinquent should not be added together as they are two separate measures of portfolio asset quality. Loans and debt securities that are in both categories (i.e., on non-accrual status and over 90 days delinquent) totaled \$56.2 million and \$43.9 million at March 31, 2005, and December 31, 2004, respectively, which included loans and debt securities that are secured by commercial real estate of \$7.8 million and \$10.2 million, respectively.

As a provider of long-term privately negotiated investment capital, we may defer payment of principal or interest from time to time. The nature of our private finance portfolio company relationships frequently provide an opportunity for portfolio companies to negotiate with us 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. As a result, the amount of the private finance portfolio that is greater than 90 days delinquent or on non-accrual status may vary from period to period. 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 private finance investments for a total return including interest or dividends plus gains from the sale of equity securities.

For CMBS bonds, interest payments are made to bondholders from the cash flow on the underlying collateral. To the extent there are defaults and unrecoverable losses on the underlying collateral resulting in reduced cash flows, the lower rated tranches of the CMBS bonds in which we invest may not receive current interest payments and, therefore, may become delinquent. However, if the reduced cash flows resulting from defaults or losses in the underlying collateral pool have been factored into our yield on the bonds, we may continue to accrue interest on the bonds to the extent that we expect to collect such interest over time.

Given these factors, the amount of loans, debt securities, or CMBS bonds on non-accrual status or greater than 90 days 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 investment principal.

#### **Accrued Interest and Dividends Receivable**

Accrued interest and dividends receivable as of March 31, 2005 and December 31, 2004, was as follows:

	2005	2004
(\$ in millions)		
Private finance	\$ 59.6	\$ 59.8
Commercial real estate finance		
CMBS and CDO bonds	21.3	18.9
Commercial mortgage loans and other	1.0	0.8
<b>Total</b>	<b>\$ 81.9</b>	<b>\$ 79.5</b>



## Recent Developments

On May 3, 2005, we completed the sale of our portfolio of commercial mortgage-backed securities (CMBS) and collateralized debt obligation (CDO) bonds and preferred shares to affiliates of Caisse de dépôt et placement du Québec (the Caisse) for cash proceeds of approximately \$976 million and a net realized gain of approximately \$216 million, after estimated transaction and other costs of approximately \$20 million. The estimated net gain will be recognized in the second quarter of 2005.

Simultaneous with the sale of our CMBS and CDO portfolio, we entered into a platform assets purchase agreement with CWCapital Investments LLC, an affiliate of the Caisse (CWCapital), pursuant to which we agreed to sell certain commercial real estate related assets, including servicer advances, intellectual property, software and other platform assets, subject to certain adjustments. We expect that any gain or loss on this transaction will be insignificant. This transaction is expected to close by the end of the second quarter of 2005, subject to certain closing conditions. Under this agreement, we have agreed not to invest in CMBS and real estate-related CDOs and refrain from certain other real estate-related investing or servicing activities for a period of three years, subject to certain limitations. The real estate securities purchase agreement, under which we sold the CMBS and CDO portfolio, and the platform asset purchase agreement contain customary representations and warranties, and require us to indemnify the affiliates of the Caisse that are parties to the agreements for certain liabilities arising under the agreements, subject to certain limitations and conditions.

We have also entered into a transition services agreement with CWCapital pursuant to which we will provide certain transition services to CWCapital for a limited transition period to facilitate the transfer of various servicing and other rights related to the CMBS and CDO portfolio. During the transition period, we have agreed, among other things, to continue to act as servicer or special servicer with respect to the CMBS and CDO portfolio, and to use commercially reasonable efforts to continue to employ employees who were responsible for overseeing this portfolio. We will be reimbursed for the direct costs and out-of-pocket expenses associated with servicing these assets under the transition services agreement.

In addition, we entered into a letter of intent with an affiliate of the Caisse pursuant to which the parties agreed to negotiate in good faith the terms of a definitive agreement relating to the sale of certain of our commercial mortgage loans and commercial real estate owned. The letter of intent does not obligate either party to enter into such a definitive agreement and terminates on June 30, 2005.

Upon the closing of the sale of the CMBS and CDO portfolio, we repaid outstanding borrowings on our revolving line of credit of approximately \$200 million. We plan to use the remaining cash proceeds from the sale of the CMBS and CDO portfolio to invest in private finance investments, to repay maturing notes payable, of which \$40 million matures in May 2005, and for general corporate purposes.

We expect that our net investment income will be lower in the near term until the proceeds from the CMBS and CDO asset sale can be redeployed into private finance debt and equity investments, but it is expected that any reduction in net investment income will be offset by the estimated \$216 million net gain realized from the sale.

The CMBS and CDO assets sold had a cost basis at closing of approximately \$740 million, including accrued interest and a CMBS asset with a cost basis of approximately \$28 million that we purchased in April 2005. Estimated transaction and other costs of approximately \$20 million include investment banking fees, legal and other professional fees, employee compensation related costs associated with payments under retention agreements and transition services bonuses, and other transaction costs. The transition services bonuses included in the estimated expenses will be payable upon completion of the performance of services under the transition services agreement to certain

employees in the commercial real estate group, including John Scheurer, Douglas Cooper and Jordan Paul, managing directors. The transition services bonuses total approximately \$3.1 million, which includes \$1.0 million for John Scheurer.

For tax purposes, we estimate that the net gain from the sale of the CMBS and CDO portfolio will be approximately \$229 million, after estimated transaction and other costs. The difference between the net gain for book and tax purposes results from temporary differences in the recognition of income and expenses related to these assets. Our dividend is paid from taxable income. Taxable income for 2005, including this gain, is expected to exceed dividends paid to shareholders in 2005, and we expect to spill over excess taxable income to the next tax year as permitted under the Internal Revenue Code of 1986. We will generally be required to pay a 4% excise tax on any taxable income retained and paid as dividends in the next tax year. See Management's Discussion and Analysis of Financial Condition and Results of Operations - Regulated Investment Company Status.

As discussed above, we previously entered into transactions with financial institutions to hedge against movement in Treasury rates on certain of the higher rated CMBS and CDO bonds, which were purchased at prices that were based in part on comparable Treasury rates. Concurrently with the completion of the sale of our CMBS and CDO portfolio, we settled any hedges relating to these assets, which resulted in a net realized loss of approximately \$0.7 million, which has been included in the estimated net realized gain on the sale.



**RESULTS OF OPERATIONS****Comparison of Three Months Ended March 31, 2005 and 2004**

The following table summarizes the Company's operating results for the three months ended March 31, 2005 and 2004.

(\$ in thousands, except per share amounts)	For the Three Months Ended March 31,		Change	Percentage Change
	2005	2004		
	(unaudited)			
<b>Interest and Related Portfolio Income</b>				
Interest and dividends	\$ 84,945	\$ 73,539	\$ 11,406	16%
Loan prepayment premiums	1,677	950	727	77%
Fees and other income	8,297	7,276	1,021	14%
<b>Total interest and related portfolio income</b>	<b>94,919</b>	<b>81,765</b>	<b>13,154</b>	<b>16%</b>
<b>Expenses</b>				
Interest	20,225	19,113	1,112	6%
Employee	15,456	12,355	3,101	25%
Administrative	20,754	5,827	14,927	256%
<b>Total operating expenses</b>	<b>56,435</b>	<b>37,295</b>	<b>19,140</b>	<b>51%</b>
Net investment income before income taxes	38,484	44,470	(5,986)	(13)%
Income tax expense (benefit)	(268)	(75)	(193)	**
<b>Net investment income</b>	<b>38,752</b>	<b>44,545</b>	<b>(5,793)</b>	<b>(13)%</b>
<b>Net Realized and Unrealized Gains (Losses)</b>				
Net realized gains (losses)	10,285	147,850	(137,565)	*
Net change in unrealized appreciation or depreciation	70,584	(172,087)	242,671	*
<b>Total net gains</b>	<b>80,869</b>	<b>(24,237)</b>	<b>105,106</b>	<b>*</b>
Net income	\$ 119,621	\$ 20,308	\$ 99,313	489%
Diluted earnings per common share	\$ 0.88	\$ 0.15	\$ 0.73	487%
Weighted average common shares outstanding diluted	135,579	131,968	3,611	3%

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

\*\* Percentage change is not meaningful.

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

Interest and dividend income for the three months ended March 31, 2005 and 2004, was composed of the following:

	<b>2005</b>	<b>2004</b>
<b>(\$ in millions)</b>		
Interest	\$ 80.8	\$ 69.9
Dividends	4.1	3.6
<b>Total</b>	<b>\$ 84.9</b>	<b>\$ 73.5</b>

The level of interest income, which includes interest paid in cash and in kind, is directly related to the balance of the interest-bearing investment portfolio outstanding during the period multiplied by the weighted average yield. The weighted average yield varies from period to period based on the current stated interest on interest-bearing investments and the amount of loans and debt securities for which interest is not accruing. The interest-bearing investments in the portfolio at value and the

weighted average yield on the interest-bearing investments in the portfolio at March 31, 2005 and 2004, were as follows:

	2005	2004
(\$ in millions)		
Interest-bearing portfolio	\$ 2,357.7	\$ 1,892.0
Portfolio yield	13.6%	14.3%

Dividend income results from the dividend yield on preferred equity interests, if any, or the declaration of dividends by a portfolio company on preferred or common equity interests. Dividend income will vary from period to period depending upon the level of yield on our preferred equity interests and the timing and amount of dividends that are declared by a portfolio company on preferred or common equity interests. Dividend income for the three months ended March 31, 2005 and 2004, includes \$2.0 million and \$2.0 million, respectively, of dividends from BLX on the Class B equity interests held by us. The dividends for the three months ended March 31, 2004, were paid through the issuance of additional Class B equity interests.

Loan prepayment premiums were \$1.7 million and \$1.0 million for the three months ended March 31, 2005 and 2004, 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. Therefore, we generally structure our loans to require a prepayment premium for the first three to five years of the loan. Accordingly, the amount of prepayment premiums will vary depending on the level of repayments and the age of the loans at the time of repayment.

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

Fees and other income for the three months ended March 31, 2005 and 2004, included fees relating to the following:

	2005	2004
(\$ in millions)		
Structuring and diligence	\$ 1.3	\$ 1.8
Transaction and other services provided to portfolio companies	1.2	0.8
Management services provided to portfolio companies, other advisory services and guaranty fees	4.8	4.4
Other income	1.0	0.3
<b>Total</b>	<b>\$ 8.3</b>	<b>\$ 7.3</b>

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

Advantage and BLX were our largest investments at March 31, 2005, and together represented 19.5% of our total assets. Total interest and related portfolio income earned from Advantage and BLX for the three months ended March 31, 2005, was \$9.2 million and \$7.8 million, respectively. BLX was our largest investment at March 31, 2004, and represented 11.2% of our total assets. Total interest and related portfolio income earned from BLX for the three months ended March 31, 2004, was \$11.1 million. Total interest and related portfolio income for the three months

ended March 31,

2004, included \$3.3 million of income earned from Hillman prior to the sale of our control investment on March 31, 2004, as discussed above.

As outlined above, under the caption Recent Developments, we completed the sale of our portfolio of CMBS bonds and CDO bonds and preferred shares on May 3, 2005. Total interest and related portfolio income related to CMBS and CDO investments for the three months ended March 31, 2005 and 2004, was \$23.8 million and \$22.6 million, respectively.

**Operating Expenses.** Operating expenses include interest, employee, and administrative expenses. The fluctuations in interest expense during the three months ended March 31, 2005 and 2004, were primarily attributable to changes in the level of our borrowings under various notes payable and debentures and our revolving line of credit. Our borrowing activity and weighted average cost of debt, including fees and closing costs, at and for the three months ended March 31, 2005 and 2004, were as follows:

	At and for the Three Months Ended March 31,	
	2005	2004
(\$ in millions)		
Total outstanding debt	\$ 1,296.4	\$ 962.4
Average outstanding debt	\$ 1,125.0	\$ 953.0
Weighted average cost <sup>(1)</sup>	6.4%	7.5%

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

In addition to interest on indebtedness, interest expense includes interest on our obligations to replenish borrowed Treasury securities related to our hedging activities of \$0.5 million and \$0.9 million for the three months ended March 31, 2005 and 2004, respectively.

Employee expenses include salaries and employee benefits and the individual performance award and bonus. The change in employee expense reflects the effect of wage increases, increased staffing, and the change in mix of employees given their area of responsibility and relevant experience level. Total employees were 158 and 133 at March 31, 2005 and 2004, respectively.

In the first quarter of 2004, we established the Individual Performance Award (IPA) as a long-term incentive compensation program for certain officers. In conjunction with the program, the Board has approved a non-qualified deferred compensation plan (DCP II), which is administered through a trust by an independent third-party trustee.

The IPA, which will generally be determined annually at the beginning of each year, is deposited in the trust in four equal installments, generally on a quarterly basis, in the form of cash. The Compensation Committee of the Board of Directors designed the DCP II to require the trustee to use the cash to purchase shares of our common stock in the open market.

Amounts credited to participants under the DCP II are immediately vested once deposited by us into the trust. A participant's account shall generally become distributable only after his or her termination of employment, or in the event of a change of control of the Company. The Compensation Committee of the Board of Directors may also determine other distributable events and the timing of such distributions.

For the three months ended March 31, 2005, the IPA expense was \$1.9 million. We contributed these amounts into the DCP II trust during the first quarter. For the three months ended March 31, 2004, we accrued \$3.5 million in IPA expense. These amounts were contributed into the DCP II



trust in the second quarter of 2004. Because the IPA is deferred compensation, the cost of this award is not a current expense for purposes of computing our taxable income. The expense is deferred for tax purposes until distributions are made from the trust. The accounts of the DCP II are consolidated with our accounts. Further, we are required to mark to market the liability to pay the employees in our stock and this adjustment is recorded to the IPA compensation expense. The effect of this adjustment for the three months ended March 31, 2005, was to increase the individual performance award expense by \$0.1 million, resulting in a total IPA expense of \$2.0 million. The Compensation Committee and the Board of Directors have determined the IPA for 2005 and it is currently expected to be approximately \$7.5 million.

As a result of recent changes in regulation by the Jobs Creation Act of 2004 associated with deferred compensation arrangements, as well as an increase in the competitive market for recruiting top performers in private equity firms, the Compensation Committee and the Board of Directors have determined for 2005 that a portion of the IPA should be replaced with an individual performance bonus (IPB). For the three months ended March 31, 2005, IPB expense was \$1.5 million. The IPB for 2005 has been determined to be approximately \$7.5 million, and will be distributed in cash to award recipients in equal bi-weekly installments beginning in February 2005 as long as the recipient remains employed by us. If a recipient terminates employment during the year, any remaining cash payments under the IPB would be forfeited.

The total of the IPA and IPB, for the three months ended March 31, 2005, was \$3.5 million. The total IPA and IPB is currently estimated to be \$15.0 million for 2005 before any mark to market adjustment on the IPA. These amounts are subject to change if there is a change in the composition of the pool of award recipients during the year.

Total employee expense related to employees in our commercial real estate group who we expect will terminate employment in 2005 as a result of the sale of our CMBS and CDO portfolio on May 3, 2005, was \$2.0 million and \$1.8 million for the three months ended March 31, 2005 and 2004, respectively. See the caption Recent Developments above.

Administrative expenses include legal and accounting fees, valuation assistance fees, insurance premiums, the cost of leases for our headquarters in Washington, DC, and our regional offices, stock record expenses, directors' fees, and various other expenses. Administrative expenses were \$20.8 million for the three months ended March 31, 2005. This is a \$15.0 million increase over administrative expenses of \$5.8 million for the three months ended March 31, 2004.

Administrative expenses for the three months ended March 31, 2005, include legal and other fees related to the response to requests for information in connection with two government investigations totaling \$12.3 million. We expect that these expenses may remain high and difficult to predict in the near term as the result of ongoing requests for documents and information.

The remaining increase in administrative expenses for 2005 over 2004 was primarily due to increased corporate expenses, including increases in accounting fees, insurance premiums, valuation assistance fees, and stock record expense of \$1.4 million, increased expenses related to portfolio development and workout activities of \$0.6 million, and increased rent of \$0.3 million associated with the opening of an office in Los Angeles, CA and expanding our office space in Chicago, IL and New York, NY.

**Realized Gains and Losses.** Net realized gains primarily result from the sale of equity securities associated with certain private finance investments, the sale of CMBS bonds and CDO bonds and preferred shares, and the realization of unamortized discount resulting from the sale and early

repayment of private finance loans and commercial mortgage loans, offset by losses on investments. Net realized gains for the three months ended March 31, 2005 and 2004, were as follows:

	<b>For the Three Months Ended March 31,</b>	
<b>(\$ in millions)</b>	<b>2005</b>	<b>2004</b>
Realized gains	\$ 14.7	\$ 156.0
Realized losses	(4.4)	(8.1)
Net realized gains	\$ 10.3	\$ 147.9

When we exit an investment and realize a gain or loss, we make an accounting entry to reverse any unrealized appreciation or depreciation, respectively, we had previously recorded to reflect the appreciated or depreciated value of the investment. For the three months ended March 31, 2005 and 2004, we reversed previously recorded unrealized appreciation or depreciation when gains or losses were realized as follows:

	<b>For the Three Months Ended March 31,</b>	
<b>(\$ in millions)</b>	<b>2005</b>	<b>2004</b>
Reversal of previously recorded unrealized appreciation associated with realized gains	\$ (9.9)	\$ (142.8)
Reversal of previously recorded unrealized depreciation associated with realized losses	4.8	7.7
Total reversal	\$ (5.1)	\$ (135.1)

Realized gains and losses for the three months ended March 31, 2005 and 2004, resulted from various private finance and commercial real estate finance transactions.

Realized gains for the three months ended March 31, 2005, primarily resulted from transactions involving five private finance portfolio companies – Polaris Pool Systems, Inc. (\$7.4 million), U.S. Security Holdings, Inc. (\$3.3 million), Oriental Trading Company, Inc. (\$1.0 million), Woodstream Corporation (\$0.9 million), and DCS Business Services, Inc. (\$0.7 million).

Realized gains for the three months ended March 31, 2004, primarily resulted from transactions involving two private finance portfolio companies – The Hillman Companies, Inc. (\$149.0 million) and CBA-Mezzanine Capital Finance, LLC (\$3.9 million).

Realized losses for the three months ended March 31, 2005, primarily resulted from one transaction involving a private finance portfolio company – Alderwoods Group, Inc. (\$0.8 million) and two transactions involving commercial mortgage loans (\$3.3 million).

Realized losses for the three months ended March 31, 2004, primarily resulted from transactions involving two private finance portfolio companies – Logic Bay Corporation (\$5.7 million) and Sure-Tel, Inc. (\$2.3 million).



***Change in Unrealized Appreciation or Depreciation.*** We determine the value of each investment in our portfolio on a quarterly basis, and changes in value result in unrealized appreciation or depreciation being recognized in our statement of operations. Value, as defined in Section 2(a)(41) of the Investment Company Act of 1940, is (i) the market price for those securities for which a market quotation is readily available and (ii) for all other securities and assets, fair value is as determined in good faith by the Board of Directors. Since there is typically no readily

available market value for the investments in our portfolio, we value substantially all of our portfolio investments at fair value as determined in good faith by the Board of Directors pursuant to a valuation policy and a consistently applied valuation process. At March 31, 2005, portfolio investments recorded at fair value were approximately 91% of our total assets. Because of the inherent uncertainty of determining the fair value of investments that do not have a readily available market value, the fair value of our investments determined in good faith by the Board of Directors may differ significantly from the values that would have been used had a ready market existed for the investments, and the differences could be material.

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

As a business development company, we have invested in illiquid securities including debt and equity securities of companies, non-investment grade CMBS bonds, and CDO bonds and preferred shares. 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 quarterly unaudited financial statements, as well as annual projections for the upcoming fiscal year. Typically in the private equity business, companies are bought and sold based on multiples of EBITDA, cash flow, net income, revenues or, in limited instances, book value. The private equity industry uses financial measures such as EBITDA or EBITDAM (Earnings Before Interest, Taxes, Depreciation, Amortization and, in some instances, Management fees) in order to assess a portfolio

company's financial performance and to value a portfolio company. EBITDA and EBITDAM are not intended to represent cash flow from operations as defined by U.S. generally accepted accounting principles and such information should not be considered as an alternative to net income, cash flow from operations, or any other measure of performance prescribed by U.S. generally accepted accounting principles. When using EBITDA to determine enterprise value, we may adjust EBITDA for non-recurring items. Such adjustments are intended to normalize EBITDA to reflect the portfolio company's earnings power. Adjustments to EBITDA may include compensation to previous owners, acquisition, recapitalization, or restructuring related items or one-time non-recurring income or expense items.

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

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

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

To balance the lack of publicly available information about our private portfolio companies, we will continue to work with independent third-party consultants to obtain assistance in determining fair value for a portion of the private finance portfolio each quarter. We work with these consultants to obtain assistance as additional support in the preparation of our internal valuation analysis for a portion of the portfolio each quarter (for all investments with a cost or value greater than \$250,000). In addition, we may receive independent assessments of a particular private finance portfolio company's value in the ordinary course of business, most often in the context of a prospective sale transaction or in the context of a bankruptcy process. The valuation analysis prepared by management using these independent valuation resources is submitted to our Board of Directors for its determination of fair value of the portfolio in good faith.

At March 31, 2005, S&P Corporate Value Consulting (S&P CVC) assisted us by reviewing our valuations of BLX and 34 other portfolio companies. Additionally, Houlihan Lokey Howard and Zukin (Houlihan Lokey) reviewed our valuation of Advantage. For the remaining quarters in 2005,

we intend to continue to obtain valuation assistance from S&P CVC, Houlihan Lokey and possibly other third parties. We currently anticipate that we will generally obtain assistance for all companies in the portfolio that are more than 50% owned for each of the remaining quarters in 2005 and that we will generally obtain assistance for companies that are equal to or less than 50% owned at least once during the course of the year. Valuation assistance may not be obtained for new companies that enter the portfolio after June 30 of any calendar year during that year. We estimate that professional fees for valuation assistance for all of 2005, including the expense incurred in the first quarter, will be approximately \$1.5 million.

*Valuation Methodology CMBS Bonds and CDO Bonds and Preferred Shares.* CMBS bonds and CDO bonds and preferred shares are carried at fair value, which is based on a discounted cash flow model that utilizes prepayment and loss assumptions based on historical experience and projected performance, economic factors, the characteristics of the underlying cash flow and comparable yields for similar CMBS bonds and CDO bonds and preferred shares. Our assumption with regard to discount rate may be based on the yield of comparable securities, when available. We recognize unrealized appreciation or depreciation on our CMBS bonds and CDO bonds and preferred shares as comparable yields in the market change and/or based on changes in estimated cash flows resulting from changes in prepayment or loss assumptions in the underlying collateral pool. As each CMBS bond ages, the expected amount of losses and the expected timing of recognition of such losses in the underlying collateral pool is updated and the revised cash flows are used in determining the fair value of the bonds. We have determined the fair value of our CMBS bonds and CDO bonds and preferred shares on an individual security-by-security basis. If we were to sell a group of these investments in a pool in one or more transactions, the total value received for that pool may be different than the sum of the fair values of the individual bonds or preferred shares.

*Net Change in Unrealized Appreciation or Depreciation.* For the portfolio, net change in unrealized appreciation or depreciation for the three months ended March 31, 2005 and 2004, consisted of the following:

(\$ in millions)	2005 <sup>(1)</sup>	2004 <sup>(1)</sup>
Net unrealized appreciation or depreciation	\$ 75.7	\$ (37.0)
Reversal of previously recorded unrealized appreciation associated with realized gains	(9.9)	(142.8)
Reversal of previously recorded unrealized depreciation associated with realized losses	4.8	7.7
Net change in unrealized appreciation or depreciation	\$ 70.6	\$ (172.1)

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

For the three months ended March 31, 2005, our two largest investments were in Advantage and BLX. The following is a summary of the methodology that we used to determine the fair value of these investments.

*Advantage Sales & Marketing, Inc.* We determined the enterprise value of Advantage by using its trailing twelve month normalized EBITDA times a multiple. The multiple we used was consistent with our entry multiple when we acquired Advantage in June 2004. Using this enterprise value, we determined the value of our investments in Advantage to be \$353.4 million. Unrealized appreciation on our investment was \$93.1 million at March 31, 2005. This is an increase in unrealized appreciation in the first quarter of 2005 of \$68.9 million, which has primarily resulted from an increase in its trailing twelve month normalized EBITDA since June 2004, related to the realization of integration related cost savings. Houlihan Lokey assisted us with the valuation of our investment in Advantage at March 31, 2005. S&P CVC assisted us with the valuation of our investment in Advantage at December 31, 2004.



**Business Loan Express, LLC.** To determine the value of our investment in BLX at March 31, 2005, we performed four separate valuation analyses to determine a range of values: (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. We received valuation assistance from S&P CVC for our investment in BLX at March 31, 2005 and December 31, 2004.

With respect to the analysis of comparable public company trading multiples and the analysis of BLX's value assuming an initial public offering, we compute a median trailing and forward price earnings multiple to apply to BLX's pro-forma net income adjusted for certain capital structure changes that we believe would likely occur should the company be sold. Each quarter we evaluate which public commercial finance companies should be included in the comparable group. The comparable group at March 31, 2005, was made up of CapitalSource, Inc., CIT Group, Inc., Financial Federal Corporation, GATX Corporation, and Marlin Business Services Corporation, which is consistent with the comparable group at December 31, 2004.

Our investment in BLX at March 31, 2005, was valued at \$330.7 million. This fair value was within the range of values determined by the four valuation analyses. Unrealized appreciation on our investment was \$48.5 million at March 31, 2005. This is a decrease in unrealized appreciation in the first quarter of 2005 of \$6.3 million from December 31, 2004.

#### **OTHER MATTERS**

**Per Share Amounts.** All per share amounts included in the Management's Discussion and Analysis of Financial Condition and Results of Operations section have been computed using the weighted average common shares used to compute diluted earnings per share, which were 135.6 million and 132.0 million for the three months ended March 31, 2005 and 2004, 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 net capital gains, to the extent that such taxable income or gains are distributed, or deemed to be distributed, to shareholders on a timely basis.

Taxable income generally differs from net income for financial reporting purposes due to temporary and permanent differences in the recognition of income and expenses, and generally excludes net unrealized appreciation or depreciation, as gains or losses are not included in taxable income until they are realized. In addition, gains realized for financial reporting purposes may differ from gains included in taxable income as a result of our election to recognize gains using installment sale treatment, which results in the deferment of gains for tax purposes until notes received as consideration from the sale of investments are collected in cash.

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

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 asset diversification requirements as defined in the Internal Revenue Code; and (4) timely distribute to shareholders at least 90% of our annual 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.

**Legal Proceedings.** On June 23, 2004, we were notified by the SEC that they are conducting an informal investigation of us. On December 22, 2004, we received letters from the U.S. Attorney for the District of Columbia requesting the preservation and production of information regarding us and Business Loan Express, LLC in connection with a criminal investigation. Based on the information available to us at this time, the inquiries appear to pertain to matters related to portfolio valuation and our portfolio company, Business Loan Express, LLC. We are cooperating with the SEC's and the U.S. Attorney's investigations.

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

While the outcome of these legal proceedings and other matters cannot at this time be predicted with certainty, we do not expect that the outcome of these matters will have a material effect upon our financial condition or results of operations.

#### **FINANCIAL CONDITION, LIQUIDITY AND CAPITAL RESOURCES**

Our portfolio has historically generated cash flow from which we pay dividends to shareholders and fund new investment activity. Cash generated from the portfolio includes cash flow from net investment income and net realized gains and principal collections related to investment repayments or sales. Cash flow provided by our operating activities before new investment activity for the three months ended March 31, 2005 and 2004, was as follows:

(\$ in millions)	2005	2004
Net cash provided by (used in) operating activities	\$ (49.8)	\$ 207.9
Add: portfolio investments funded	258.0	170.6
Total cash provided by operating activities before new investments	\$ 208.2	\$ 378.5

From the cash provided by operating activities before new investments, we make new portfolio investments, fund our operating activities, and pay dividends to shareholders. We also raise new debt and equity capital from time to time in order to fund our investments and operations.

Dividends to common shareholders for the three months ended March 31, 2005 and 2004, were \$76.1 million and \$73.4 million, respectively, or \$0.57 per common share for both quarters. An extra cash dividend of \$0.02 per common share was declared during 2004 and was paid to shareholders on January 28, 2005.

Dividends are generally determined based upon an estimate of annual taxable income, which includes our taxable interest, dividend and fee income, as well as taxable net capital gains. As discussed above, taxable income generally differs from net income for financial reporting purposes due to temporary and permanent differences in the recognition of income and expenses, and generally excludes net unrealized appreciation or depreciation, as gains or losses are not included in taxable

income until they are realized. Taxable income includes non-cash income, such as changes in accrued and reinvested interest and dividends and the amortization of discounts and fees. Cash collections of income resulting from contractual payment-in-kind interest or the amortization of discounts and fees generally occur upon the repayment of the loans or debt securities that include such items. Non-cash taxable income is reduced by non-cash expenses, such as realized losses and depreciation and amortization expense.

Our Board of Directors reviews the dividend rate quarterly, and may adjust the quarterly dividend throughout the year. Dividends are declared based upon our estimate of annual taxable income available for distribution to shareholders. Our goal is to declare what we believe to be sustainable increases in our regular quarterly dividends. To the extent that we earn annual taxable income in excess of dividends paid for the year, we may spill over the excess taxable income into the next year and such excess income will be available for distribution in the next year. Excess taxable income spilled over and paid out in the next year may be subject to a 4% excise tax (see "Other Matters - Regulated Investment Company Status" above). We believe that spilling over excess taxable income into future periods may provide increased visibility with respect to taxable earnings available to pay the regular quarterly dividend.

Because we are a regulated investment company, we distribute our taxable income and, therefore, from time to time we will raise new debt or equity capital in order to fund our investments and operations.

At March 31, 2005, and December 31, 2004, our total assets, total debt outstanding, total shareholders' equity, debt to equity ratio and asset coverage for senior indebtedness were as follows:

(\$ in millions)	2005	2004
Total assets	\$ 3,504.6	\$ 3,261.0
Total debt outstanding	\$ 1,296.4	\$ 1,176.6
Total shareholders' equity	\$ 2,033.1	\$ 1,979.8
Debt to equity ratio	0.64	0.59
Asset coverage ratio <sup>(1)</sup>	263%	280%

<sup>(1)</sup> As a business development company, we are generally required to maintain a minimum ratio of 200% of total assets to total borrowings.

We currently target a debt to equity ratio ranging between 0.50:1.00 to 0.65:1.00. We believe that it is prudent to operate with a larger equity capital base and less leverage. We did not raise equity during the three months ended March 31, 2005 or 2004. For the year ended December 31, 2004, we raised equity of \$73.5 million. In addition, shareholders' equity increased by \$4.1 million, \$18.5 million and \$51.3 million through the exercise of employee options, the collection of notes receivable from the sale of common stock, and the issuance of shares through our dividend reinvestment plan for the three months ended March 31, 2005 and 2004, and the year ended December 31, 2004.

We employ an asset-liability management strategy that focuses on matching the estimated maturities of our loan and investment portfolio to the estimated maturities of our borrowings. We use our revolving line of credit facility as a means to bridge to long-term financing in the form of debt or equity capital, which may or may not result in temporary differences in the matching of estimated maturities. Availability on the revolving line of credit, net of amounts committed for standby letters of credit issued under the line of credit facility, was \$287.2 million on March 31, 2005. We evaluate our interest rate exposure on an ongoing basis. Generally, we seek to fund our primarily fixed-rate investment portfolio with fixed-rate debt or equity capital. To the extent deemed necessary, we may hedge variable and short-term interest rate exposure through interest rate swaps or other techniques.



At March 31, 2005, we had outstanding debt as follows:

(\$ in millions)	Facility Amount	Amount Outstanding	Annual Interest Cost <sup>(1)</sup>
Notes payable and debentures:			
Unsecured notes payable	\$ 980.9	\$ 980.9	6.5%
SBA debentures	53.8	46.5	7.8%
OPIC loan	5.7	5.7	6.6%
<b>Total notes payable and debentures</b>	<b>1,040.4</b>	<b>1,033.1</b>	<b>6.6%</b>
Revolving line of credit	587.5	263.3	5.7% <sup>(2)</sup>
<b>Total debt</b>	<b>\$ 1,627.9</b>	<b>\$ 1,296.4</b>	<b>6.4%<sup>(2)</sup></b>

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

(2) The current interest rate payable on the revolving line of credit was 4.4% at March 31, 2005, which excluded the annual cost of commitment fees and other facility fees of \$3.3 million. The annual cost of commitment fees and other facility fees of \$3.3 million at March 31, 2005, include the extension fee of \$1.8 million that we paid on April 18, 2005, as discussed below. The annual interest cost for total debt includes the annual cost of commitment fees and other facility fees on the revolving line of credit regardless of the amount outstanding on the facility as of the balance sheet date.

**Unsecured Notes Payable.** 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 2005 and generally have fixed rates of interest. The notes generally require payment of interest only semi-annually, and all principal is due upon maturity.

We have issued five-year unsecured long-term notes denominated in Euros and Sterling for a total U.S. dollar equivalent of \$15.2 million. The notes have fixed interest rates and have substantially the same terms as our existing unsecured long-term notes. Simultaneous with issuing the notes, we entered into a cross currency swap with a financial institution which fixed our interest and principal payments in U.S. dollars for the life of the debt.

**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. During the first quarter of 2005, we repaid \$31.0 million of this outstanding debt. Under the small business investment company program, we may borrow up to \$119.0 million from the Small Business Administration. At March 31, 2005, we had a commitment from the Small Business Administration to borrow up to an additional \$7.3 million above the current amount outstanding. The commitment expires on September 30, 2005.

**Revolving Line of Credit.** We increased the committed amount on the unsecured revolving line of credit to \$587.5 million during the first quarter of 2005. The committed amount may be further expanded through new or additional commitments up to \$600 million at our option. In addition, during the second quarter of 2005, we exercised our option to extend the maturity for one additional year from the expiration date of April 2005 under substantially similar terms. In connection with the extension, we paid an extension fee of 0.3% on the existing commitments. In addition, the interest rate on outstanding borrowings will increase by 0.5% during the extension period.

After the extension notice, the credit facility generally bears interest at a rate, at our option, equal to (i) the one-month LIBOR plus 2.00%, (ii) the Bank of America, N.A. cost of funds plus 2.00% or (iii) the higher of the Bank of America, N.A. prime rate or the Federal Funds rate plus 1.00%. The line of credit generally requires monthly payments of interest, and all principal is due upon maturity.

Outstanding borrowings on the unsecured revolving line of credit at March 31, 2005, were \$263.3 million. The amount available under the line at March 31, 2005, was \$287.2 million, net of amounts committed for standby letters of credit of \$37.1 million. Net borrowings under the revolving line of credit for the three months ended March 31, 2005, were \$151.3 million.

In connection with the sale of CMBS and CDO assets, as outlined above under the caption Recent Developments, outstanding borrowings under the revolving line of credit were repaid subsequent to March 31, 2005.

We have various financial and operating covenants required by the revolving line of credit and notes payable and debentures. These covenants require us to maintain certain financial ratios, including debt to equity and interest coverage, and a minimum net worth. Our credit facilities limit our ability to declare dividends if we default under certain provisions. As of March 31, 2005, we were in compliance with these covenants.

The following table shows our significant contractual obligations for the repayment of debt and payment of other contractual obligations as of March 31, 2005.

(\$ in millions)	Payments Due By Year						
	Total	2005	2006	2007	2008	2009	After 2009
Notes payable and debentures:							
Unsecured long-term notes payable	\$ 980.9	\$ 165.0	\$ 175.0	\$	\$ 153.0	\$ 268.4	\$ 219.5
SBA debentures	46.5						46.5
OPIC loan	5.7		5.7				
Revolving line of credit <sup>(1)</sup>	263.3		263.3				
Operating leases	33.5	4.6	4.5	4.4	4.4	4.6	11.0
<b>Total contractual obligations</b>	<b>\$ 1,329.9</b>	<b>\$ 169.6</b>	<b>\$ 448.5</b>	<b>\$ 4.4</b>	<b>\$ 157.4</b>	<b>\$ 273.0</b>	<b>\$ 277.0</b>

<sup>(1)</sup> As discussed above, we exercised our option to extend the maturity of the revolving line of credit to April 2006. At March 31, 2005, \$287.2 million remained unused and available, net of amounts committed for standby letters of credit of \$37.1 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 March 31, 2005.

(\$ in millions)	Amount of Commitment Expiration Per Year						
	Total	2005	2006	2007	2008	2009	After 2009
Guarantees	\$ 109.5	\$ 0.3	\$ 0.9	\$ 104.6	\$ 0.1	\$ 2.5	\$ 1.1
Standby letters of credit <sup>(1)</sup>	37.1		37.1				
<b>Total commitments</b>	<b>\$ 146.6</b>	<b>\$ 0.3</b>	<b>\$ 38.0</b>	<b>\$ 104.6</b>	<b>\$ 0.1</b>	<b>\$ 2.5</b>	<b>\$ 1.1</b>

(1) Standby letters of credit are issued under our revolving line of credit. As discussed above, we exercised our option to extend the maturity of the revolving line of credit to April 2006. Therefore, unless a standby letter of credit is set to expire at an earlier date, we have assumed that the standby letters of credit will expire contemporaneously with the expiration of our line of credit in April 2006.

In addition, we had outstanding commitments to fund investments totaling \$360.7 million at March 31, 2005. We intend to fund these commitments and prospective investment opportunities with existing cash, through cash flow from operations before new investments, through borrowings under our line of credit or other long-term debt agreements, or through the sale or issuance of new equity capital.

**CRITICAL ACCOUNTING POLICIES**

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

**Valuation of Portfolio Investments.** As a business development company, we invest in illiquid securities including debt and equity securities of companies, non-investment grade CMBS, and the bonds and preferred shares of CDOs. 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 portfolio company does not currently support the cost of our debt or equity investments. Enterprise value means the entire value of the company to a potential buyer, including the sum of the values of debt and equity securities used to capitalize the enterprise at a point in time. We will record unrealized appreciation if we believe that the underlying portfolio company has appreciated in value and our equity security has also appreciated in value. The value of investments in publicly traded securities is determined using quoted market prices discounted for restrictions on resale, if any.

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

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 that are classified as Grade 4 or 5 assets under our internal grading system do not accrue interest. In addition, interest may not accrue on loans or debt securities to portfolio companies that are more than 50% owned by us depending on such company's capital requirements. Loan origination fees, original issue discount, and market discount are capitalized and then amortized into interest income using the effective interest method. Upon the prepayment of a loan or debt security, any unamortized loan origination fees are recorded as interest income and any unamortized original issue discount or market discount is recorded as a realized gain. Prepayment premiums are recorded on loans and debt securities when received.

**Equity Securities.** Our equity 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, recent transactions involving the purchase or sale of the portfolio company's equity securities, or other liquidation events. The determined equity values are generally discounted to account for restrictions on resale or minority ownership positions.

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

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

**Commercial Mortgage-Backed Securities (CMBS) and Collateralized Debt Obligations (CDO).** CMBS bonds and CDO bonds and preferred shares are carried at fair value, which is based on a discounted cash flow model that utilizes prepayment and loss assumptions based on historical experience and projected performance, economic factors, the characteristics of the underlying cash flow, and comparable yields for similar CMBS bonds and CDO bonds and preferred shares, when available. We recognize unrealized appreciation or depreciation on our CMBS bonds and CDO bonds and preferred shares as comparable yields in the market change and/or based on changes in estimated cash flows resulting from changes in prepayment or loss assumptions in the underlying collateral pool. We have determined the fair value of our CMBS bonds and CDO bonds and preferred shares on an individual security-by-security basis. If we were to sell a group of these investments in a pool in one or more transactions, the total value received for that pool may be different than the sum of the fair values of the individual bonds or preferred shares.

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 actual and estimated prepayment speeds or actual and estimated credit losses. Changes in estimated yield are recognized as an adjustment to the estimated yield over the remaining life of the CMBS bonds and CDO bonds and preferred shares from the date the estimated yield is changed.

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

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

## RISK FACTORS

*Investing in Allied Capital involves a number of significant risks relating to our business and investment objective. As a result, there can be no assurance that we will achieve our investment objective.*

**Our portfolio of investments is illiquid.** We generally acquire our investments directly from the issuer in privately negotiated transactions. The majority of the investments in our portfolio are 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.

**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, these businesses generally have narrower product lines and market shares than their competition and may be more vulnerable to customer preferences, market conditions, loss of key personnel, or economic downturns, which may adversely affect the return on, or the recovery of, our investment in such businesses.

**Substantially all of our portfolio investments are recorded at fair value as determined in good faith by our Board of Directors and, as a result, there is uncertainty regarding the value of our portfolio investments.** At March 31, 2005, portfolio investments recorded at fair value were approximately 91% of our total assets. Pursuant to the requirements of the 1940 Act, we value substantially all of our investments at fair value as determined in good faith by our Board of Directors on a quarterly basis. Since there is typically no readily available market value for the investments in our portfolio, our Board of Directors determines in good faith the fair value of these investments pursuant to a valuation policy and a consistently applied valuation process.

There is no single standard for determining fair value in good faith. As a result, determining fair value requires that judgment be applied to the specific facts and circumstances of each portfolio investment while employing a consistently applied valuation process for the types of investments we make. Unlike banks, we are not permitted to provide a general reserve for anticipated loan losses; we are instead required by the 1940 Act to specifically value each individual investment on a quarterly basis and record unrealized depreciation for an investment that we believe has become impaired, including where collection of a loan or realization of an equity security is doubtful, or when the enterprise value of the portfolio company does not currently support the cost of our debt or equity investment. Enterprise value means the entire value of the company to a potential buyer, including the sum of the values of debt and equity securities used to capitalize the enterprise at a point in time. We will record unrealized appreciation if we believe that the underlying portfolio company has appreciated in value and our equity security has also appreciated in value. Without a readily available market value and because of the inherent uncertainty of valuation, the fair value of our investments determined in good faith by the Board of Directors may differ significantly from the values that would have been used had a ready market existed for the investments, and the differences could be material.

We adjust quarterly the valuation of our portfolio to reflect the Board of Directors' determination of the fair value of each investment in our portfolio. Any changes in fair value are recorded in our statement of operations as net change in unrealized appreciation or depreciation.

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

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

**Our borrowers may default on their payments, which may have a negative effect on our financial performance.** We make long-term unsecured, subordinated loans and invest in equity securities, which may involve a higher degree of repayment risk. We primarily invest in companies that may have limited financial resources 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 and may have a negative effect on our financial results.

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

**Our financial results could be negatively affected if a significant portfolio investment fails to perform as expected.** We purchase controlling equity positions in companies and our total debt and equity investment in controlled companies may be significant individually or in the aggregate. Investments in controlled portfolio companies are generally larger and in fewer companies than our investments in companies that we do not control. As a result, if a significant investment in one or more controlled companies fails to perform as expected, our financial results could be more negatively affected and the magnitude of the loss could be more significant than if we had made smaller investments in more companies. At March 31, 2005, our largest investments were in Advantage Sales & Marketing, Inc. and Business Loan Express, LLC and represented 10.1% and 9.4% of our total assets, respectively, and 9.7% and 8.2% of our total interest and related portfolio income, respectively.

**Our financial results could be negatively affected if Business Loan Express fails to perform as expected.** Business Loan Express, LLC (BLX) is one of our largest portfolio investments. 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.

**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 bonds and 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 bonds and 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. In addition, the fair value of these securities may change as interest rates change over time. 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 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 March 31, 2005, we had \$1,296.4 million of outstanding indebtedness bearing a weighted average annual interest cost of 6.4%. In order for us to cover these annual interest payments on indebtedness, we must achieve annual returns on our assets of at least 2.4%.

**We may not borrow money unless we maintain asset coverage for indebtedness of at least 200%, which may affect returns to shareholders.** We must maintain asset coverage for total borrowings of at least 200%. Our ability to achieve our investment objective may depend in part on our continued ability to maintain a leveraged capital structure by borrowing from banks, insurance companies or other lenders on favorable terms. There can be no assurance that we will be able to maintain such leverage. If asset coverage declines to less than 200%, we may be required to sell a portion of our investments when it is disadvantageous to do so. As of March 31, 2005, our asset coverage for senior indebtedness was 263%.

**Changes in interest rates may affect our cost of capital and net investment income.** Because we borrow money to make investments, our net investment income is dependent upon the difference between the rate at which we borrow funds and the rate at which we invest these funds. As a result, there can be no assurance that a significant change in market interest rates will not have a material adverse effect on our net investment income. In periods of rising interest rates, our cost of funds

would increase, which would reduce our net investment income. We use a combination of long-term and short-term borrowings and equity capital to finance our investing activities. We utilize our revolving line of credit as a means to bridge to long-term financing. Our long-term fixed-rate investments are financed primarily with long-term fixed-rate debt and equity. We may use interest rate risk management techniques in an effort to limit our exposure to interest rate fluctuations. Such techniques may include various interest rate hedging activities to the extent permitted by the 1940 Act. We have analyzed the potential impact of changes in interest rates on interest income net of interest expense.

Assuming that the balance sheet 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 net assets resulting from operations, or net income. Accordingly, no assurances can be given that actual results would not differ materially from the potential outcome simulated by this estimate.

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

**Loss of regulated investment company 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 Code. If we meet source of income, asset diversification, and distribution requirements, we will not be subject to corporate level income taxation on income we timely distribute to our stockholders as dividends. We would cease to qualify for such tax treatment if we were unable to comply with these requirements. In addition, we may have difficulty meeting the requirement to make distributions to our 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 annual taxable income in the year earned, we generally will be subject to a 4% excise tax on such income carried forward and distributed in the next tax year.

**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 U.S. generally accepted accounting principles and tax regulations, we include in income certain amounts that we have not yet received in cash, such as contractual payment-in-kind interest which represents contractual interest added to the loan balance that becomes due at the end of the loan term. 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, other business development companies, investment banks, other equity and non-equity based investment funds, and other sources of financing, including specialty finance companies and traditional financial services companies such as commercial banks. Some of our competitors may have greater resources than we do. Increased competition would make it more difficult for us to purchase or originate investments at attractive prices. As a result of this competition, sometimes we may be precluded from making otherwise attractive investments.

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

**Changes in the law or regulations that govern us could have a material impact on us or our operations.** We are regulated by the SEC 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, which may have a material effect on our operations.

**Our ability to invest in private companies may be limited in certain circumstances.** If we are to maintain our status as a business development company, we must not acquire any assets other than qualifying assets unless, at the time of and after giving effect to such acquisition, at least 70% of our total assets are qualifying assets. If we acquire debt or equity securities from an issuer that has outstanding marginable securities at the time we make an investment, these acquired assets cannot be treated as qualifying assets. This result is dictated by the definition of eligible portfolio company under the 1940 Act, which in part looks to whether a company has outstanding marginable securities.

Amendments promulgated in 1998 by the Federal Reserve expanded the definition of a marginable security under the Federal Reserve's margin rules to include any non-equity security. Thus, any debt securities issued by any entity are marginable securities under the Federal Reserve's current margin rules. As a result, the staff of the SEC has raised the question as to whether a private company that has outstanding debt securities would qualify as an eligible portfolio company under the 1940 Act.

Until the question raised by the staff of the SEC pertaining to the Federal Reserve's 1998 change to its margin rules has been addressed by legislative, administrative or judicial action, we

intend to treat as qualifying assets only those debt and equity securities that are issued by a private company that has no marginable securities outstanding at the time we purchase such securities or those that otherwise qualify as an eligible portfolio company under the 1940 Act.

The SEC has recently issued proposed rules to correct the unintended consequence of the Federal Reserve's 1998 margin rule amendments of apparently limiting the investment opportunities of business development companies. In general, the SEC's proposed rules would define an eligible portfolio company as any company that does not have securities listed on a national securities exchange or association. We are currently in the process of reviewing the SEC's proposed rules and assessing its impact, to the extent such proposed rules are subsequently approved by the SEC, on our investment activities. We do not believe that these proposed rules will have a material adverse effect on our operations.

**Results may fluctuate and may not be indicative of future performance.** Our operating results may fluctuate and, therefore, you should not rely on current or historical period results to be indicative of our performance in future reporting periods. Factors that could cause operating results to fluctuate include, but are not limited to, variations in the investment origination volume and fee income earned, variation in timing of prepayments, variations in and the timing of the recognition of net realized gains or losses and changes in unrealized appreciation or depreciation, the 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, but are not limited to, the following:

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

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

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

changes in 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.

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

There has been no material change in quantitative or qualitative disclosures about market risk since December 31, 2004.

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

(a) As of the end of the period covered by this quarterly report on Form 10-Q, the Company's chief executive officer and chief financial officer conducted an evaluation of the Company's disclosure controls and procedures (as defined in Rules 13a-15 and 15d-15 of the Securities Exchange Act of

1934). Based upon this evaluation, the Company's chief executive officer and chief financial officer concluded that the Company's disclosure controls and procedures are effective in timely alerting them of any material information relating to the Company that is required to be disclosed by the Company in the reports it files or submits under the Securities Exchange Act of 1934.

(b) There have been no changes in the Company's internal control over financial reporting that occurred during the quarter ended March 31, 2005, that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

## PART II. OTHER INFORMATION

### Item 1. *Legal Proceedings*

On June 23, 2004, we were notified by the SEC that they are conducting an informal investigation of us. On December 22, 2004, we received letters from the U.S. Attorney for the District of Columbia requesting the preservation and production of information regarding us and Business Loan Express, LLC in connection with a criminal investigation. Based on the information available to us at this time, the inquiries appear to pertain to matters related to portfolio valuation and our portfolio company, Business Loan Express, LLC. We are cooperating with the SEC's and the U.S. Attorney's investigations.

On May 28, 2004, Ferolie Corporation, a food broker with business and contractual relationships with an entity that is now affiliated with one of our portfolio companies, Advantage Sales & Marketing Inc., filed suit against us, Advantage Sales & Marketing and the affiliated entity in the United States District Court for the District of Columbia alleging that, among other things, we and Advantage Sales & Marketing had tortiously interfered with Ferolie's contract with the affiliated entity by causing the affiliated entity (i) to breach its obligations to Ferolie regarding Ferolie's participation in a reorganization transaction involving the affiliated entity and (ii) to induce clients of Ferolie to transfer their business to the affiliated entity. Ferolie sought actual and punitive damages against us and Advantage Sales & Marketing and declaratory and injunctive relief. On July 15, 2004, the United States District Court for the District of Columbia dismissed the lawsuit for lack of jurisdiction. On August 17, 2004, Ferolie filed a Petition to Compel Arbitration in the United States District Court for the Northern District of Illinois naming us, Advantage Sales & Marketing and the affiliated entity as respondents. Ferolie attached to its petition an Amended Demand for Arbitration and Statement of Claims that asserts essentially the same claims as were asserted in the lawsuit that was dismissed by the United States District Court for the District of Columbia. On October 29, 2004, the United States District Court for the Northern District of Illinois dismissed Ferolie's petition after finding that Ferolie had failed to adequately allege the existence of subject matter jurisdiction.

On November 4, 2004, Ferolie refiled its Petition to Compel Arbitration in the Circuit Court of Cook County, Illinois. The allegations and relief requested in this proceeding are identical to the assertions made by Ferolie in the two previously dismissed proceedings. On February 15, 2005, the Circuit Court of Cook County, Illinois entered an order denying Ferolie's motion for an order compelling the Company to arbitrate the claims asserted by Ferolie against it. In the same order, the Circuit Court of Cook County, Illinois granted Ferolie's motion to compel arbitration of the claims asserted against Advantage Sales & Marketing and the affiliated entity and the arbitration is proceeding. Allied is not a party to the arbitration.

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

While the outcome of these legal proceedings and other matters cannot at this time be predicted with certainty, we do not expect that the outcome of these matters will have a material effect upon our financial condition or results of operations.

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

During the three months ended March 31, 2005, we issued a total of 55,262 shares of common stock under our dividend reinvestment plan pursuant to an exemption from the registration requirements of the Securities Act of 1933. The aggregate offering price for the shares of common stock sold under the dividend reinvestment plan was approximately \$1.4 million.

On February 15, 2005, we issued 279,720 shares of our common stock in connection with Mercury Air Center, Inc.'s acquisition of Corporate Wings. Such shares were issued pursuant to an

exemption from the registration requirements of the Securities Act of 1933 under Section 4(2) of the Securities Act or Regulation D promulgated thereunder as transactions by an issuer not involving any public offering.

The following table provides information as of and for the quarter ended March 31, 2005, regarding shares of our common stock that were purchased under our Non-Qualified Deferred Compensation Plan I (DCP I) and Non-Qualified Deferred Compensation Plan II (DCP II), which are administered by independent third-party trustees.

	<b>Total Number of Shares Purchased</b>	<b>Average Price Paid Per Share</b>
<b>DCP I<sup>(1)</sup></b>		
1/1/2005 to 1/31/2005	1	\$ 26.97
2/1/2005 to 2/28/2005		
3/1/2005 to 3/31/2005	1,045	\$ 26.60
<b>DCP II<sup>(2)</sup></b>		
1/1/2005 to 1/31/2005	375	\$ 26.43
2/1/2005 to 2/28/2005		
3/1/2005 to 3/31/2005	69,398	\$ 26.63
<b>Total</b>	<b>70,819</b>	<b>\$ 26.63</b>

(1) The DCP I is an unfunded plan, as defined by the Internal Revenue Code of 1986, that provides for the deferral of compensation by our directors, employees, and consultants. Our directors, employees, or consultants are eligible to participate in the plan at such time and for such period as designated by the Board of Directors. The DCP I is administered through a trust by an independent third-party trustee, and we fund this plan through cash contributions. Directors may choose to defer director's fees through the DCP I, and may choose to invest such deferred income in shares of our common stock. To the extent a director elects to invest in our common stock, the trustee of the DCP I will be required to use such deferred director's fees to purchase shares of our common stock in the market.

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

**Item 3. Defaults Upon Senior Securities**

Not applicable.

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

None.

**Item 5. Other Information**

In connection with the sale of our CMBS and CDO assets, we have awarded transition services bonuses to certain employees in the commercial real estate group including John Scheurer, Douglas Cooper and Jordan Paul, managing

directors. These bonuses are included in the estimated transaction expenses and total approximately \$3.1 million, which includes \$1.0 million for John Scheurer. These bonuses will be payable upon completion of the performance of services under the transition services agreement.



**Item 6. Exhibits**

## (a) List of Exhibits

Exhibit Number	Description
3.1	Restated Articles of Incorporation. <i>(Incorporated by reference to Exhibit a.1 filed with Allied Capital's Post-Effective Amendment No. 2 to registration statement on Form N-2 (File No. 333-67336) filed on March 22, 2002).</i>
3.2	Amended and Restated Bylaws. <i>(Incorporated by reference to Exhibit 3.1. filed with Allied Capital's Form 8-K on December 15, 2004).</i>
4.1	Specimen Certificate of Allied Capital's Common Stock, par value \$0.0001 per share. <i>(Incorporated by reference to Exhibit d. filed with Allied Capital's registration statement on Form N-2 (File No. 333-51899) filed on May 6, 1998).</i>
4.2	Form of debenture between certain subsidiaries of Allied Capital and the U.S. Small Business Administration. <i>(Incorporated by reference to Exhibit 4.2 filed by a predecessor entity to Allied Capital on Form 10-K for the year ended December 31, 1996).</i>
10.1	Dividend Reinvestment Plan, as amended. <i>(Incorporated by reference to Exhibit e. filed with Allied Capital's registration statement on Form N-2 (File No. 333-87862) filed on May 8, 2002).</i>
10.2	Third Amended and Restated Credit Agreement, dated April 18, 2003. <i>(Incorporated by reference to Exhibit 10.2 filed with Allied Capital's Form 10-Q for the period ended March 31, 2003).</i>
10.2(a)	First Amendment to Credit Agreement, dated as of October 6, 2003. <i>(Incorporated by reference to Exhibit 10.2(a) filed with Allied Capital's Form 10-Q for the period ended September 30, 2003).</i>
10.2(b)	Second Amendment to Credit Agreement, dated as of December 17, 2003. <i>(Incorporated by reference to Exhibit 10.2(b) filed with Allied Capital's Form 10-K for the year ended December 31, 2003).</i>
10.2(c)	Third Amendment to Credit Agreement, dated May 28, 2004. <i>(Incorporated by reference to Exhibit 10.2(c) filed with Allied Capital's Form 10-Q for the period ended June 30, 2004).</i>
10.2(d)	Fourth Amendment to Credit Agreement, dated March 29, 2005. <i>(Incorporated by reference to Exhibit f.2(d) filed with Allied Capital's registration statement on Form N-2 filed on April 7, 2005).</i>
10.2(e)*	<i>Fifth Amendment to Credit Agreement, dated April 15, 2005.</i>
10.3	Note Agreement, dated as of April 30, 1998. <i>(Incorporated by reference to Exhibit 10.2 filed with Allied Capital's Form 10-Q for the period ended June 30, 1998).</i>
10.4	Loan Agreement between a predecessor entity to Allied Capital and Overseas Private Investment Corporation, dated April 10, 1995. <i>(Incorporated by reference to Exhibit f.7 filed by a predecessor entity to Allied Capital to Pre-Effective Amendment No. 2 to registration statement on Form N-2 (File No. 333-64629) filed on January 24, 1996).</i> Letter, dated December 11, 1997, evidencing assignment of Loan Agreement from the predecessor entity of Allied Capital to Allied Capital. <i>(Incorporated by reference to Exhibit 10.3 to Allied Capital's Form 10-K for the year ended December 31, 1997).</i>
10.5	Note Agreement, dated as of May 1, 1999. <i>(Incorporated by reference to Exhibit 10.5 filed with Allied Capital Form 10-Q for the period ended June 30, 1999).</i>
10.12	Note Agreement, dated as of October 15, 2000. <i>(Incorporated by reference to Exhibit 10.4b filed with Allied Capital's Form 10-Q for the period ended September 30, 2000).</i>



Exhibit Number	Description
10.13	Note Agreement, dated as of October 15, 2001. <i>(Incorporated by reference to Exhibit f.10 filed with Allied Capital's Post-Effective Amendment No. 1 to registration statement on Form N-2 (File No. 333-67336) filed on November 14, 2001).</i>
10.15	Control Investor Guaranty Agreement, dated as of March 28, 2001, between Allied Capital and Fleet National Bank and Business Loan Express, Inc. <i>(Incorporated by reference to Exhibit f.14 filed with Allied Capital's Post-Effective Amendment No. 3 to registration statement on Form N-2 (File No. 333-43534) filed on May 15, 2001).</i>
10.17	Non-Qualified Deferred Compensation Plan II. <i>(Incorporated by reference to Exhibit A filed with Allied Capital's Proxy Statement filed on March 30, 2004).</i>
10.18	Amended and Restated Deferred Compensation Plan, dated January 30, 2004. <i>(Incorporated by reference to Exhibit 10.16 filed with Allied Capital's Form 10-K for the year ended December 31, 2003).</i>
10.19	Amended Stock Option Plan. <i>(Incorporated by reference to Exhibit B of Allied Capital's definitive proxy statement for Allied Capital's 2004 Annual Meeting of Stockholders filed on March 30, 2004).</i>
10.20(a)	Allied Capital Corporation 401(k) Plan, dated September 1, 1999. <i>(Incorporated by reference to Exhibit 4.4 filed with Allied Capital's registration statement on Form S-8 (File No. 333-88681) filed on October 8, 1999).</i>
10.20(b)	Amendment to Allied Capital Corporation 401(k) Plan, dated April 15, 2004. <i>(Incorporated by reference to Exhibit 10.20(b) filed with Allied Capital's Form 10-Q for the period ended June 30, 2004).</i>
10.21	Employment Agreement, dated January 1, 2004, between Allied Capital and William L. Walton. <i>(Incorporated by reference to Exhibit 10.21 filed with Allied Capital's Form 10-K for the year ended December 31, 2003).</i>
10.22	Employment Agreement, dated January 1, 2004, between Allied Capital and Joan M. Sweeney. <i>(Incorporated by reference to Exhibit 10.22 filed with Allied Capital's Form 10-K for the year ended December 31, 2003).</i>
10.23	Retention Agreement, dated March 21, 2005, between Allied Capital and John M. Scheurer. <i>(Incorporated by reference to Exhibit 99.1 filed with Allied Capital's current report on Form 8-K filed on March 24, 2005).</i>
10.25	Form of Custody Agreement with Riggs Bank N.A. <i>(Incorporated by reference to Exhibit j.1 filed with Allied Capital's registration statement on Form N-2 (File No. 333-51899) filed on May 6, 1998).</i>
10.26	Form of Custody Agreement with LaSalle National Bank. <i>(Incorporated by reference to Exhibit j.2 filed with Allied Capital's registration statement on Form N-2 (File No. 333- 51899) filed on May 6, 1998).</i>
10.27	Custodian Agreement with LaSalle National Bank Association dated July 9, 2001. <i>(Incorporated by reference to Exhibit j.3 filed with Allied Capital's registration statement on Form N-2 (File No. 333-67336) filed on August 10, 2001).</i>
10.28	Code of Ethics. <i>(Incorporated by reference to Exhibit 10.28 filed with Allied Capital's Form 10-K for the year ended December 31, 2003.)</i>
10.30	Agreement and Plan of Merger by and among Allied Capital, Allied Capital Lock Acquisition Corporation, and Sunsource, Inc dated June 18, 2001. <i>(Incorporated by reference to Exhibit k.1 filed with Allied Capital's registration statement on Form N-2 (File No. 333-67336) filed on August 10, 2001).</i>

- 10.31 Note Agreement, dated as of May 14, 2003. *(Incorporated by reference to Exhibit 10.31 filed with Allied Capital's Form 10-Q for the period ended March 31, 2003).*

Exhibit Number	Description
10.32	Amendment, dated as of April 30, 2003, to Note Agreement, dated as of April 30, 1998. <i>(Incorporated by reference to Exhibit 10.32 filed with Allied Capital's Form 10-Q for the period ended March 31, 2003).</i>
10.33	Amendment, dated as of April 30, 2003, to Note Agreement, dated as of May 1, 1999. <i>(Incorporated by reference to Exhibit 10.33 filed with Allied Capital's Form 10-Q for the period ended March 31, 2003).</i>
10.35	Amendment, dated as of April 30, 2003, to Note Agreement, dated as of October 15, 2000. <i>(Incorporated by reference to Exhibit 10.35 filed with Allied Capital's Form 10-Q for the period ended March 31, 2003).</i>
10.36	Amendment, dated as of April 30, 2003, to Note Agreement, dated as of October 15, 2001. <i>(Incorporated by reference to Exhibit 10.36 filed with Allied Capital's Form 10-Q for the period ended March 31, 2003).</i>
10.37	Form of Indemnification Agreement between Allied Capital and its directors and certain officers. <i>(Incorporated by reference to Exhibit 10.37 filed with Allied Capital's Form 10-K for the year ended December 31, 2003).</i>
10.38	Note Agreement, dated as of March 25, 2004. <i>(Incorporated by reference to Exhibit 10.38 filed with Allied Capital's Form 10-Q for the period ended March 31, 2004).</i>
10.39	Note Agreement, dated as of November 15, 2004. <i>(Incorporated by reference to Exhibit 99.1 filed with Allied Capital's current report on Form 8-K filed on November 18, 2004).</i>
10.40	Real Estate Securities Purchase Agreement. <i>(Incorporated by reference to Exhibit 2.1 filed with Allied Capital's Form 8-K filed on May 4, 2005.)</i>
10.41	Platform Assets Purchase Agreement. <i>(Incorporated by reference to Exhibit 2.2 filed with Allied Capital's Form 8-K filed on May 4, 2005.)</i>
10.42	Transition Services Agreement. <i>(Incorporated by reference to Exhibit 10.1 filed with Allied Capital's Form 8-K filed on May 4, 2005.)</i>
15.*	Letter regarding Unaudited Interim Financial Information
31.1*	Certification of Chief Executive Officer Pursuant to Rule 13a-14 of the Securities Exchange Act of 1934.
31.2*	Certification of Chief Financial Officer Pursuant Rule 13a-14 of the Securities Exchange Act of 1934.
32.1*	Certification of Chief Executive Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, 18 U.S.C. Section 1350.
32.2*	Certification of Chief Financial Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, 18 U.S.C. Section 1350.

\* Filed herewith.

**SIGNATURES**

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

ALLIED CAPITAL CORPORATION  
(Registrant)

Dated: May 9, 2005

/s/ William L. Walton

William L. Walton  
Chairman and Chief Executive Officer

/s/ Penni F. Roll

Penni F. Roll  
Chief Financial Officer

**EXHIBIT INDEX**

<b>Exhibit Number</b>	<b>Description</b>
10.2(e)*	Fifth Amendment to Credit Agreement, dated April 15, 2005.
15.*	Letter regarding Unaudited Interim Financial Information
31.1*	Certification of Chief Executive Officer Pursuant to Rule 13a-14 of the Securities Exchange Act of 1934.
31.2*	Certification of Chief Financial Officer Pursuant to Rule 13a-14 of the Securities Exchange Act of 1934.
32.1*	Certification of Chief Executive Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, 18 U.S.C. Section 1350.
32.2*	Certification of Chief Financial Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002, 18 U.S.C. Section 1350.

\* Filed herewith.