ALLIED CAPITAL CORP
Form 497
November 06, 2003

Prospectus Supplement
(To Prospectus dated June 11, 2003)

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

2,600,000 Shares

COMMON STOCK

We are offering for sale 2,600,000 shares of our common stock. Our common stock is traded on the New York Stock Exchange under the symbol ALD. The last reported sales price for our common stock on November 5, 2003 was $24.86 per share.

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

	Per Share	Total
Public offering price	$24.74	$64,324,000
Underwriting discount	$ 0.99	$ 2,574,000
Proceeds to Allied Capital Corporation(1)	$23.75	$61,750,000

(1) Before deducting expenses payable by us estimated to be $50,000.

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

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

The shares of common stock will be ready for delivery on or about November 10, 2003.

JEFFERIES & COMPANY, INC.

The date of this prospectus supplement is November 5, 2003.

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

TABLE OF CONTENTS

Prospectus Supplement

Prospectus

(i)

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

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

FEES AND EXPENSES

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

Shareholders Transaction Expenses	
Sales load (as a percentage of offering price)(1)	4.0%
Dividend reinvestment plan fees(2)	None
Annual Expenses (as a percentage of consolidated net assets attributable to common shares)(3)	
Operating expenses(4)	3.7%
Interest payments on borrowed funds(5)	4.7%
Total annual expenses(6)	8.4%

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

(2) The expenses of our dividend reinvestment plan are included in Operating expenses. We do not have a stock purchase plan. The participants in the dividend reinvestment plan will bear a pro rata share of brokerage commissions incurred with respect to open market purchases, if any. See Dividend Reinvestment Plan in the accompanying prospectus.

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

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

(5) The Interest payments on borrowed funds represents our estimated interest expenses for the year ending December 31, 2003. We had outstanding borrowings of $979.7 million at June 30, 2003. This percentage for the year ended December 31, 2002, was 4.6%. See Risk Factors in the accompanying prospectus.

(6) Total annual expenses as a percentage of consolidated net assets attributable to common stock are higher than the total annual expenses percentage would be for a company that is not leveraged. We borrow money to leverage our net assets and increase our total assets. The SEC requires that the Total annual expenses percentage be calculated as a percentage of net assets, rather than the total assets, including assets that have been funded with borrowed monies. If the Total annual expenses percentage were calculated instead as a percentage of consolidated total assets, our Total annual expenses would be 4.9% of consolidated total assets.

Example

The following example, required by the SEC, demonstrates the projected dollar amount of total cumulative expenses that would be incurred over various periods with respect to a hypothetical investment in us. In calculating the following expense amounts, we assumed we would have no additional leverage and that our operating expenses would remain at the levels set forth in the table above.

	1 Year	3 Years	5 Years	10 Years
You would pay the following expenses on a $1,000 investment, assuming a 5.0% annual return	$122	$285	$449	$861

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

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

USE OF PROCEEDS

The net proceeds from the sale of the shares of our common stock, after deducting estimated expenses of this offering, are estimated to be $61.7 million. We intend to use the net proceeds from selling our common stock for investment in the debt or equity securities of private companies, non-investment grade commercial mortgage-backed securities or collateralized debt obligation bonds and preferred shares and other general corporate purposes. We may also repay a portion of our revolving line of credit. At November 4, 2003, the interest rate on our revolving line of credit was 2.5% and there were no amounts then outstanding. This revolving line of credit terminates in April 2005 and may be extended under substantially similar terms for one additional year at our option.

UNDERWRITING

Subject to the terms and conditions stated in the underwriting agreement with Jefferies & Company, Inc., the underwriter has agreed to purchase, and we have agreed to sell to the underwriter, all 2,600,000 of the shares offered by this prospectus supplement.

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

The underwriter proposes to offer the shares to the public initially at the public offering price set forth on the cover of this prospectus supplement. The public offering price is equal to the volume weighted average price per share of our common stock on the NYSE for each of the 17 trading days beginning on October 14, 2003 and ending on November 5, 2003. After the offering, the public offering price may be changed by the underwriter.

The following table shows the per share and total underwriting discounts and commissions to be paid to the underwriter by us.

Per share	$ 0.99
Total	$ 2,574,000

We estimate that the total expenses of this offering, excluding the underwriting discounts and commissions, will be approximately $50,000, which will be paid by us.

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

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

We have been advised by the underwriter that, in accordance with Regulation M under the Securities Act, some persons participating in this offering may engage in transactions, including syndicate covering transactions or stabilizing bids, that may have the effect of stabilizing or maintaining the market price of the shares at a level above that which might otherwise prevail in the open market.

A syndicate covering transaction is a bid for or the purchase of shares on behalf of the underwriter to reduce a syndicate short position incurred by the underwriter in connection with this offering. The underwriter may create a syndicate short position by making short sales of our shares and must then purchase our shares in the open market to cover the syndicate short positions created by these short sales. Short sales involve the sale by the underwriter of a greater number of shares than it is required to purchase in this offering. A short position is more likely to be created if the underwriter is concerned that there may be downward pressure in the price of the shares in the open market after pricing that could adversely affect investors who purchase in this offering.

A stabilizing bid is a bid for or the purchase of shares on behalf of the underwriter for the purpose of fixing or maintaining the price of our shares.

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

The underwriter expects to deliver the shares through the facilities of The Depository Trust Company in New York, New York, on or about November 10, 2003. At that time, the underwriter will pay us for the shares in immediately available funds.

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

The address for Jefferies & Company, Inc. is 520 Madison Avenue, 8th Floor, New York, NY 10022.

LEGAL MATTERS

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

RECENT DEVELOPMENTS

Operating Results for the Quarter Ended September 30, 2003

For the three months ended September 30, 2003, net investment income was $53.6 million or $0.44 per share, as compared to $45.1 million or $0.44 per share for the three months ended September 30, 2002. Net realized losses were $6.4 million, or $0.05 per share for the quarter ended September 30, 2003, as compared to net realized gains of $48.2 million or $0.47 per share for the quarter ended September 30, 2002. The sum of net investment income and net realized gains or losses was $47.2 million or $0.39 per share for the three months ended September 30, 2003, as compared to $93.3 million or $0.90 per share for the three months ended September 30, 2002.

Net income for the quarter ended September 30, 2003, was $33.7 million or $0.28 per share, after net unrealized depreciation of $13.4 million or $0.11 per share. Net income for the quarter ended September 30, 2002, was $45.5 million or $0.44 per share, after net unrealized depreciation of $47.8 million or $0.46 per share. Net income can vary substantially from quarter to quarter primarily due to changes in unrealized appreciation or depreciation and the recognition of realized gains or losses, which vary from quarter to quarter. As a result, quarterly comparisons of net income may not be meaningful.

During the quarter, we invested a total of $138.4 million. After total repayments of $69.4 million, asset sales of $5.1 million and valuation and other changes during the quarter, total assets were $3.01 billion at September 30, 2003. Shareholders equity increased 15% to $1.78 billion at September 30, 2003, from $1.55 billion at December 31, 2002. Net asset value per share was $14.46 at September 30, 2003.

Portfolio Activity for the Quarter Ended September 30, 2003

New private finance investments totaled $31.7 million and commercial real estate investments totaled $106.7 million for the quarter. At September 30, 2003, the overall weighted average yield on the interest-bearing portfolio was 14.5%, as compared to 14.1% at June 30, 2003.

Private Finance

The private finance portfolio totaled $1.81 billion at September 30, 2003. Loans and debt securities, which totaled $1.16 billion at September 30, 2003, had a weighted average yield of 15.3% as compared to 14.4% at June 30, 2003. Significant new private finance investments during the third quarter of 2003 included:

$6.7 million to Advantage Mayer, Inc., a leading sales and marketing agency specializing in outsourced sales, merchandising, and marketing services to manufacturers, suppliers, and producers of food products and consumer goods, to fund an acquisition;

$5.7 million to Haven Eldercare, LLC, an owner and operator of skilled nursing facilities, to assist the company in gaining control of certain facilities;

$5.0 million to Professional Paint, Inc., a leading manufacturer and distributor of architectural paints and coatings, to finance the company s acquisition of Duckback Products, Inc.;

$3.7 million to Mezzanine Capital Finance, LLC, a company formed to make small real estate mezzanine loans, to help finance additional investments; and

$3.0 million to Foresite Towers, LLC, to fund tower construction and company growth.

Commercial Real Estate Finance

At September 30, 2003, our commercial mortgage-backed securities (CMBS) and collateralized debt obligation bonds and preferred shares (CDO) portfolio totaled $688.4 million, and had a weighted average yield of 13.9% as compared to 14.7% at June 30, 2003. We invested a total of $102.7 million in seven new CMBS transactions during the third quarter of 2003, including $79.0 million of investments in BB+, BB and BB-rated bonds. The yield on the CMBS bond portfolio will fluctuate based on the mix of bond classes. The yield will be lower when the portfolio contains more higher-rated, lower-yielding BB+, BB and BB- rated bonds. The unamortized discount on the CMBS bond portfolio totaled $658.2 million at September 30, 2003.

Portfolio Quality

We employ a grading system to monitor the quality of our portfolio. Grade 1 is for those investments from which a capital gain is expected. Grade 2 is for investments performing in accordance with plan. Grade 3 is for investments that require closer monitoring; however, no loss of investment return or principal is expected. Grade 4 is 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 for investments that are in workout and for which some loss of principal is expected.

At September 30, 2003, Grade 1 investments totaled $941.8 million, or 36.2% of the total portfolio at value; Grade 2 investments totaled $1.38 billion, or 53.2% of the total portfolio; Grade 3 investments totaled $165.5 million, or 6.4% of the total portfolio; Grade 4 investments totaled $16.2 million, or 0.6% of the total portfolio; and Grade 5 investments totaled $93.8 million, or 3.6% of the total portfolio. Included in Grade 4 and 5 investments are assets totaling $33.3 million that are secured by commercial real estate.

For the total investment portfolio, loans and debt securities greater than 90 days past due were $134.9 million at value at September 30, 2003, or 5.2% of the total portfolio. Included in this category are loans and debt securities valued at $43.0 million that are secured by commercial real estate. Loans and debt securities not accruing interest totaled $118.2 million at September 30, 2003. At September 30, 2003, our CMBS investments included investments in the first loss, unrated bond class of 33 CMBS issuances. For these issuances, loans over 30 days delinquent or classified as real estate owned totaled 1.1% of the total outstanding principal balance of the underlying collateral pool.

Liquidity and Capital Resources

During the quarter ended September 30, 2003, we raised a total of $153.1 million in new equity. We have a revolving line of credit with a committed amount of $462.5 million. The line of credit may be expanded through new or additional commitments up to $600 million, and is a two-year facility with the option to extend the maturity for one additional year under substantially similar terms. At September 30, 2003, there were no amounts drawn on the revolving line of credit. The amount available under the line was $426.6 million, net of amounts committed for standby letters of credit of $35.9 million.

At September 30, 2003, we had a weighted average cost of debt of 7.5%. Our regulatory asset coverage was 306% and the ratio of debt to equity was 0.54 to 1. We are required to maintain regulatory asset coverage of at least 200%.

Quarterly Dividend

On October 17, 2003, we declared a quarterly dividend of $0.57 per share for the fourth quarter of 2003. The dividend is payable on December 26, 2003 to shareholders of record on December 12, 2003.

Our dividend is paid from taxable income. Our board of directors determines the dividend based on annual estimates of taxable income, which differ from book income due to changes in unrealized appreciation and depreciation and due to temporary and permanent differences in income and expense recognition.

Other Matters

In October 2003, we made the following significant new private finance investments:

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

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

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

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

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

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

Summary Financial Information

(in thousands, except per share amounts)	At September 30, 2003 (unaudited)	At December 31, 2002
Assets		
Portfolio at value:		
Private finance	$1,808,708	$1,743,215
Commercial real estate finance	792,350	744,952
Total portfolio at value	2,601,058	2,488,167
Other assets	117,038	100,221
Deposits of proceeds from sales of borrowed Treasury securities	221,732	194,745
Cash and cash equivalents	69,071	11,186
Total assets	$3,008,899	$2,794,319
Liabilities and Shareholders Equity		
Liabilities:		
Debt	$ 954,200	$ 998,450
Obligations to replenish borrowed Treasury securities	221,853	197,027
Mandatorily redeemable preferred stock	1,000	
Accounts payable and other liabilities	50,259	45,771
Total liabilities	1,227,312	1,241,248
Preferred stock	6,000	7,000
Shareholders Equity:		
Common stock	12	11
Additional paid-in-capital	1,854,253	1,547,183
Notes receivable from sale of common stock	(19,502)	(24,704)
Net unrealized appreciation (depreciation) on portfolio	(38,349)	39,411
Undistributed (distributions in excess of) earnings	(20,827)	(15,830)
Total shareholders equity	1,775,587	1,546,071
Total liabilities and shareholders equity	$3,008,899	$2,794,319
Net asset value per common share	$ 14.46	$ 14.22
Common shares outstanding	122,766	108,698

(in thousands, except per share amounts)	3 Months Ended September 30, 2003	3 Months Ended September 30, 2002	9 Months Ended September 30, 2003	9 Months Ended September 30, 2002
	(unaudited)		(unaudited)	
Interest and Related Portfolio Income:				
Interest and dividends	$ 78,895	$ 67,624	$211,553	$195,289
Premiums from loan dispositions	2,523	392	5,281	2,051
Fees and other income	7,452	8,313	22,380	34,573
Total interest and related portfolio income	88,870	76,329	239,214	231,913
Expenses:				
Interest	20,334	17,430	57,614	52,414
Employee	9,480	8,153	26,859	24,462
Administrative	5,897	5,052	15,395	12,913
Total operating expenses	35,711	30,635	99,868	89,789
Net investment income before income taxes	53,159	45,694	139,346	142,124
Income tax expense (benefit)	(449)	600	(1,530)	600
Net investment income	53,608	45,094	140,876	141,524
Net realized and unrealized gains (losses):				
Net realized gains (losses)	(6,438)	48,222	50,441	57,072
Net change in unrealized appreciation or depreciation	(13,426)	(47,796)	(77,760)	(23,661)
Total net gains (losses)	(19,864)	426	(27,319)	33,411
Net increase in net assets resulting from operations	$ 33,744	$ 45,520	$113,557	$174,935
Earnings per common share diluted	$ 0.28	$ 0.44	$ 0.98	$ 1.70
Weighted average common shares outstanding diluted	120,906	103,302	115,228	103,040

INTERIM MANAGEMENT S DISCUSSION AND ANALYSIS

OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

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

the ongoing global economic downturn;

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

future regulatory actions and conditions in our operating areas.

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

OVERVIEW

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

Our portfolio composition at June 30, 2003, and December 31, 2002, was as follows:

	2003	2002
Private Finance	72%	70%
Commercial Real Estate Finance	28%	30%

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

PORTFOLIO AND INVESTMENT ACTIVITY

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

($ in millions)	At and for the Three Months Ended June 30, 2003	At and for the Three Months Ended June 30, 2002	At and for the Six Months Ended June 30, 2003	At and for the Six Months Ended June 30, 2002	At and for the Year Ended December 31, 2002
	(unaudited)		(unaudited)		
Portfolio at value	$2,546.1	$2,381.0	$2,546.1	$2,381.0	$2,488.2
Investments funded	$ 257.4	$ 115.5	$ 526.4	$ 195.5	$ 506.4
Change in accrued or reinvested interest and dividends	$ 9.3	$ 6.2	$ 20.4	$ 19.5	$ 44.7
Principal repayments	$ 74.3	$ 36.0	$ 150.3	$ 67.0	$ 143.2
Sales	$ 32.6	$ 1.2	$ 276.7	$ 126.3	$ 213.5
Yield[(1)]	14.1%	13.8%	14.1%	13.8%	14.0%

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

Private Finance

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

($ in millions)	At and for the Three Months Ended June 30, 2003	At and for the Three Months Ended June 30, 2002	At and for the Six Months Ended June 30, 2003	At and for the Six Months Ended June 30, 2002	At and for the Year Ended December 31, 2002
	(unaudited)		(unaudited)		
Portfolio at value:					
Loans and debt securities	$1,192.4	$1,050.8	$1,192.4	$1,050.8	$1,151.2
Equity interests	646.8	584.5	646.8	584.5	592.0
Total portfolio	$1,839.2	$1,635.3	$1,839.2	$1,635.3	$1,743.2
Investments funded	$ 163.8	$ 32.2	$ 273.9	$ 69.8	$ 297.2
Change in accrued or reinvested interest and dividends	$ 8.1	$ 7.0	$ 19.4	$ 19.1	$ 42.6
Principal repayments	$ 70.9	$ 27.2	$ 146.0	$ 56.0	$ 129.3
Yield[(1)]	14.4%	13.9%	14.4%	13.9%	14.4%

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

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

($ in millions)	Loans and Debt Securities	Equity Interests	Total
For the Six Months Ended June 30, 2003[(1)]			
Companies more than 25% owned	$ 42.2	$25.2	$ 67.4
Companies 5% to 25% owned	9.5	1.0	10.5
Companies less than 5% owned	190.6	5.4	196.0
Total	$242.3	$31.6	$273.9
For the Six Months Ended June 30, 2002[(1)]			
Companies more than 25% owned	$ 16.0	$ 3.8	$ 19.8
Companies 5% to 25% owned	7.5	7.0	14.5
Companies less than 5% owned	34.0	1.5	35.5
Total	$ 57.5	$12.3	$ 69.8
For the Year Ended December 31, 2002[(1)]			
Companies more than 25% owned	$ 86.1	$18.7	$104.8
Companies 5% to 25% owned	22.3	0.4	22.7
Companies less than 5% owned	154.6	15.1	169.7
Total	$263.0	$34.2	$297.2

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

At June 30, 2003, we had outstanding funding commitments of $103.9 million to portfolio companies, including $27.4 million committed to private venture capital funds. At June 30, 2003, we also had total commitments to portfolio companies in the form of standby letters of credit and guarantees of $96.0 million.

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

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

Control investments provide the opportunity to invest meaningful amounts of capital with the potential for attractive current income returns as well as the potential for future capital gains. Control transactions are typically larger than our mezzanine investments. In some cases for companies that are more than 50% owned, we may not accrue interest on loans and debt securities if such company is in need of additional working capital. In such cases, we may defer current debt service. Our most significant investments acquired through control buyout transactions at June 30, 2003, were Business Loan Express, LLC (BLX), acquired in 2000, and The Hillman Companies, Inc., acquired in 2001.

Business Loan Express, LLC. At June 30, 2003, our investment in BLX totaled $264.7 million at cost and $356.8 million at value, or 12.6% of our total assets, which includes unrealized appreciation of $92.1 million.

BLX is the nation s second largest non-bank, government guaranteed lender utilizing the SBA s 7(a) Guaranteed Loan Program and is licensed by the SBA as a Small Business Lending Company (SBLC). BLX is a preferred lender as designated by the SBA, and originates, sells, and services small business loans. In addition to the SBA 7(a) Guaranteed Loan Program, BLX originates conventional small business loans and originates loans under the USDA Business and Industry Guaranteed Loan Program. BLX has offices across the United States and is headquartered in New York, New York. Changes in the laws or regulations that govern SBLCs or the SBA 7(a) Guaranteed Loan Program or changes in government funding for this program could have a material adverse impact on BLX and, as a result, negatively affect our financial results.

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

In January 2003, BLX completed the acquisition of $128.0 million of performing loans and other assets from AIF. BLX purchased $121.5 million of performing SBA 7(a) unguaranteed loans at par and $6.5 million of other assets. The acquisition increased BLX s serviced portfolio and enhanced its nationwide loan origination platform. We provided $50 million of the capital to fund this acquisition. Our $50 million financing was in the form of a short-term revolving credit facility of $25 million to fund the temporary capital needs of construction loans purchased and loans pending sale, as well as $25 million of preferred equity to support the future growth potential of BLX post acquisition.

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

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

Summary financial data for BLX at and for the twelve months ended June 30, 2003 and 2002, is presented below.

($ in millions)	For the Twelve Months Ended June 30, 2003(1)	For the Twelve Months Ended June 30, 2002
Operating Data		
Total revenue	$ 109.1	$ 84.6
Net income(4)	$ 7.5	$ 2.3
Earnings before interest, taxes and management fees (EBITM)(4)	$ 44.4	$ 43.0
Balance Sheet Data		
Total assets(2)	$ 340.0	$ 277.1
Total debt	$ 166.0	$ 183.0
Total owners equity	$ 137.0	$ 59.9
Other Data		
Total loan originations	$ 718.1	$ 565.1
Serviced loan portfolio	$2,165.5	$1,372.6
Number of loans	3,048	2,083
Loan delinquencies(3)	8.1%	9.4%
Serviced Loan Portfolio by Industry		
Hotels	24%	27%
Gas stations/convenience stores	18	16
Professional and retail services	12	10
Restaurants	9	10
Manufacturing and industrial	9	10
Car wash/auto repair services	7	3
Child care and health care services	6	4
Shrimp/fishing vessels	5	7
Recreation	5	5
Other	5	8
Total	100%	100%

(1) Post reorganization BLX s fiscal year end changed to September 30. The results of operations and loan originations for the twelve months ended June 30, 2003, are not necessarily indicative of the operating results to be expected for the fiscal twelve months ending September 30, 2003.

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

(3) Represents the percentage of loans in the total serviced loan portfolio that are greater than 30 days delinquent, which includes loans in workout status. Loans greater than 30 days delinquent for the SBA 7(a) loan portfolio only, which are included in the total serviced loan portfolio, were 8.2% at June 30, 2003. SBA 7(a) loans greater than one year old at June 30, 2003, had a delinquency rate of 10.5%. BLX will from time to time grant a 90-day deferment to borrowers experiencing short-term cash flow shortfalls. Loans that have been granted a deferment that perform as required are not considered delinquent consistent with SBA practice.

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

(4) As an LLC, BLX is generally not subject to a corporate income tax.

For the twelve months ended June 30, 2003, BLX earned revenue of $109.1 million and EBITM of $44.4 million. EBITM was reduced by $2.3 million due to costs associated

with the AIF acquisition and the LLC reorganization, as well as by $1.3 million because of the increased value of issued and outstanding equity appreciation rights to employees. Adding back these acquisition and reorganization costs, and expenses due to equity appreciation rights, BLX s EBITM increased by 11.6% on a comparative twelve month basis. BLX s revenues consist of cash premiums from guaranteed loan sales, gain on sale income arising from loans sold at par or securitized where BLX will receive future cash flows representing the spread between loan interest and the interest paid on bonds issued including service fee income, interest income on loans remaining in BLX s portfolio, and other income. Gain on sale income is a non-cash source of income when recognized, and as future cash flows are received, the resulting cash reduces the receivable or residual interest that is recognized when the loan is sold. The total of cash loan sale premiums, cash interest income and cash received from residual interests and other cash income is equal to approximately 77% of BLX s revenue of $109.1 million during the twelve months ended June 30, 2003.

BLX s business is to originate small business loans and then sell substantially all of the loans originated for cash proceeds. Loans originated during the twelve months ended June 30, 2003, totaled $718.1 million, including loans purchased from AIF. Proceeds from loan sales during the twelve months ended June 30, 2003, totaled approximately $699.4 million. BLX funds the construction of commercial real estate projects, and as a result is unable to sell a construction loan until the loan is fully-funded and the construction is complete. In addition, BLX typically does not immediately receive the proceeds from the sale of its SBA 7(a) guaranteed and unguaranteed loan strips sold, but receives the cash upon settlement. Therefore until BLX sells construction loans or fully funded loans held for sale, it will finance the origination of the loans through funding on its revolving line of credit, or through financing provided by us.

BLX has a three-year $164.0 million revolving credit facility that matures in March 2004. As the controlling equity owner in BLX, we have provided an unconditional guaranty to the revolving credit facility lenders in an amount of up to 50% of the total obligations (consisting of principal, accrued interest, and other fees) of BLX under the revolving credit facility. The amount guaranteed by us at June 30, 2003, was $53.6 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 June 30, 2003. We have provided three standby letters of credit in connection with three term securitization transactions completed by BLX totaling $25.6 million.

BLX sells the guaranteed piece of guaranteed loans for cash premiums of up to 10% of the guaranteed loan amount plus a retained annual servicing fee generally between 1.0% and 2.0% of the guaranteed loan amount. Cash premiums received from guaranteed loan sales during the twelve months ended June 30, 2003, were approximately $30.3 million in total.

Alternatively, BLX may sell the guaranteed pieces of SBA 7(a) guaranteed loans at par and receive cash only for the face amount of the loan sold, and instead of receiving a cash premium, BLX will receive an annual servicing spread on the loans sold of between 4.0% and 4.8%. In addition, BLX will sell the unguaranteed pieces of the SBA 7(a) loans and conventional loans it originates into a conduit facility. The conduit loans are securitized and BLX retains an interest of up to 2.7% of the loan pool. BLX then receives the excess of loan interest payments on the loans sold over the interest cost on the securities issued in the securitization over the life of the loan pool. BLX generally receives between 4.3% and 4.9% annually on the loans sold into the securitization pools. For the twelve months ended June 30, 2003, BLX received cash payments from securitization pools of approximately $43.2 million.

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

At June 30, 2003, BLX s Residual Interest totaled $162 million, representing BLX s estimate of the net present value of future cash flows of scheduled loan payments, after estimated future loan losses and loan prepayments. If scheduled loan payments were to be received as stated in the loan agreements with no future losses or prepayments, BLX would receive future cash flows of $709 million over time, with approximately $52.3 million, $51.7 million, $50.4 million, and $49.0 million (or $203.4 million in the aggregate) scheduled to be received in the next four years ending on June 30, 2004, 2005, 2006, and 2007, respectively.

The Hillman Companies, Inc. At June 30, 2003, our investment in Hillman totaled $93.6 million at cost and $181.8 million at value, or 6.4% of total assets, which includes unrealized appreciation of $88.2 million.

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

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

Commercial Real Estate Finance

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

	At and for the Three Months Ended June 30,				At and for the Six Months Ended June 30,				At and for the Year Ended December 31, 2002	
	2003		2002		2003		2002			
	(unaudited)				(unaudited)					
($ in millions)	Value	Yield*	Value	Yield*	Value	Yield*	Value	Yield*	Value	Yield*
CMBS bonds	$423.6	13.9%	$560.9	14.6%	$423.6	13.9%	$560.9	14.6%	$555.5	14.2%
CDO bonds and preferred shares	167.4	16.6%	52.5	17.2%	167.4	16.6%	52.5	17.2%	52.8	17.2%
Commercial mortgage loans	105.4	7.8%	62.0	7.9%	105.4	7.8%	62.0	7.9%	63.7	7.5%
Residual interest			69.0	9.3%			69.0	9.3%	69.0	9.4%
Real estate owned	10.5		1.3		10.5		1.3		4.0	
Total portfolio	$706.9		$745.7		$706.9		$745.7		$745.0	
Investments funded	$ 93.6		$ 83.3		$252.5		$125.7		$209.2	
Change in accrued or reinvested interest	$ 1.2		$ (0.8)		$ 1.0		$ 0.4		$ 2.1	
Principal repayments	$ 3.4		$ 8.8		$ 4.3		$ 11.0		$ 13.9	
CMBS, CDO, and commercial real estate loan sales	$ 32.6		$ 1.2		$276.7		$126.3		$213.5	

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

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

($ in millions)	Face Amount	Discount	Amount Funded
For the Six Months Ended June 30, 2003			
CMBS bonds	$250.1	$(115.7)	$134.4
CDO bonds and preferred shares	118.4	(0.3)	118.1
Total	$368.5	$(116.0)	$252.5
For the Six Months Ended June 30, 2002			
CMBS bonds	$181.4	$ (83.8)	$ 97.6
CDO preferred shares	28.0		28.0
Commercial mortgage loans	0.1		0.1
Total	$209.5	$ (83.8)	$125.7

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

CMBS Bonds. During the six months ended June 30, 2003 and 2002, we invested $134.4 million in seven CMBS bond issuances and $97.6 million in three CMBS bond issuances, respectively. During the year ended December 31, 2002, we invested $162.3 million in five CMBS bond issuances.

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

	For the Six Months Ended June 30,					
	2003		2002		For the Year Ended December 31, 2002	
Loan to Value Ranges ($ in millions)	**Amount**	**Percentage**	**Amount**	**Percentage**	**Amount**	**Percentage**
Less than 60%	$1,971.8	28%	$ 401.9	16%	$ 909.3	20%
60-65%	527.2	8	178.7	7	287.3	6
65-70%	776.5	11	264.1	11	587.9	13
70-75%	1,217.3	18	799.5	32	1,214.5	27
75-80%	2,364.9	34	812.7	33	1,477.5	33
Greater than 80%	25.2	1	12.0	1	47.8	1
Total	$6,882.9	100%	$2,468.9	100%	$4,524.3	100%
Weighted average loan to value	67.1%		70.4%		68.5%	

	For the Six Months Ended June 30,					
	2003		2002		For the Year Ended December 31, 2002	
Debt Service Coverage Ratio[(1)] Ranges ($ in millions)	**Amount**	**Percentage**	**Amount**	**Percentage**	**Amount**	**Percentage**
Greater than 2.00	$2,042.6	30%	$ 103.3	4%	$ 366.9	8%
1.76-2.00	697.1	10	84.2	3	229.6	5
1.51-1.75	1,264.4	18	240.3	10	477.4	11
1.26-1.50	2,478.3	36	1,631.8	66	2,739.6	60
Less than 1.25	400.5	6	409.3	17	710.8	16
Total	$6,882.9	100%	$2,468.9	100%	$4,524.3	100%
Weighted average debt service coverage ratio	1.75		1.41		1.41	

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

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

($ in millions)	For the Six Months Ended June 30, 2003	For the Six Months Ended June 30, 2002	For the Year Ended December 31, 2002
Cost basis	$253.5	$123.3	$205.9
Sales proceeds	$284.8	$128.8	$225.6
Net realized gains (net of related hedge gains or losses)	$ 24.6	$ 7.1	$ 19.1
Weighted average yield	11.8%	11.2%	11.5%

The non-investment grade and unrated tranches of the CMBS bonds in which we invest are junior in priority for payment of interest and principal to the more senior tranches of the related CMBS bond issuance. Cash flow from the underlying mortgages generally is allocated first to the senior tranches, with the most senior tranches having a priority right to the cash flow. Then, any remaining cash flow is allocated, generally, among the other tranches in order of their relative seniority. To the extent there are defaults and unrecoverable losses on the underlying mortgages resulting in reduced cash flows, our most subordinate tranche will bear this loss first. At June 30, 2003, our CMBS bonds were subordinate to 91% to 99% of the tranches of bonds issued in various CMBS transactions. Given that the non-investment grade CMBS bonds in which we invest are junior in priority for payment of principal and interest, we invest in these CMBS bonds at a discount from the face amount of the bonds. The discount increases with the decrease in the seniority of the CMBS bonds. For the six months ended June 30, 2003 and 2002, and for the year ended December 31, 2002, the average discount for the CMBS bonds in which we invested was 46%.

At June 30, 2003, and December 31, 2002, the unamortized discount related to the CMBS bond portfolio was $580.2 million and $649.5 million, respectively. At June 30, 2003, we have set aside $261.2 million of this unamortized discount to absorb potential future losses, and therefore, the yield on the CMBS bonds of 13.9% assumes that this amount will not be amortized. At June 30, 2003, the CMBS bond portfolio had a fair value of $423.6 million, which included net unrealized appreciation on the CMBS bonds of $16.1 million.

The yield on our CMBS bond portfolio at June 30, 2003, and December 31, 2002, was 13.9% and 14.2%, respectively. The yield on the CMBS bond portfolio at any point in time will vary depending on the concentration of lower yielding BB+, BB, and BB- CMBS bonds held in the portfolio. The BB+, BB and BB- CMBS bonds totaled $147.7 million and $110.9 million and had a yield of 8.0% and 8.8% at June 30, 2003, and December 31, 2002, respectively.

At June 30, 2003, and December 31, 2002, the underlying collateral for our CMBS bonds consisted of approximately 5,100 and 4,500 commercial mortgage loans and real estate properties owned with a total outstanding principal balance of $32.0 billion and $25.0 billion, respectively. At June 30, 2003, and December 31, 2002, 1.2% and 1.0%, respectively, of the loans in the underlying collateral pool for our CMBS bonds were over 30 days delinquent or were classified as real estate owned.

Collateralized Debt Obligation Bonds and Preferred Shares. The yield on our CDO bonds and preferred shares at June 30, 2003, and December 31, 2002, was 16.6% and 17.2%, respectively. The yield on the CDO portfolio at any point in time will vary depending on the amount of lower yielding BBB rated CDO bonds held in the portfolio.

During the six months ended June 30, 2003 and 2002, and the year ended December 31, 2002, we invested in the BBB bonds and preferred shares of one, two, and three collateralized debt obligations, respectively, which are secured by investment grade unsecured debt issued by various real estate investment trusts, or REITs, and investment and non-investment grade CMBS bonds. The investment grade REIT collateral consists of debt with a cut-off balance of $1.2 billion and was issued by 39 REITs. The investment grade CMBS collateral consists of CMBS bonds with a face amount of $496.0 million issued in 41 separate CMBS transactions and the non-investment grade CMBS collateral consists of BB+, BB, BB , B+, and B rated CMBS bonds with a face amount of $873.7 million issued in 42 separate CMBS transactions. Included in the CMBS collateral for the CDOs are $793.7 million of CMBS bonds that are senior in priority of repayment to certain lower rated CMBS bonds held by us, which were issued in 27 separate CMBS transactions.

During the three months ended June 30, 2003, we sold $6.4 million of CDO bonds and preferred shares for a net realized loss of $85 thousand, net of the related hedge loss.

The BBB rated bonds and the preferred shares that we own are junior in priority for payment of principal and interest to the more senior tranches of debt issued by the CDOs. To the extent there are defaults and unrecoverable losses on the underlying collateral resulting in reduced cash flows, the preferred shares will bear this loss first and then the BBB rated bonds would bear any loss after the preferred shares. At June 30, 2003, our BBB bonds and preferred shares in the CDOs were subordinate to 61% to 98% of the more senior tranches of debt issued in various CDO transactions.

Portfolio Asset Quality

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

At June 30, 2003, and December 31, 2002, our portfolio was graded as follows:

	At June 30, 2003		At December 31, 2002	
Grade	Portfolio at Value	Percentage of Total Portfolio	Portfolio at Value	Percentage of Total Portfolio
($ in millions)				
1	$ 839.0	32.9%	$ 801.0	32.1%
2	1,460.9	57.4	1,400.8	56.3
3	124.8	4.9	166.0	6.7
4	20.2	0.8	23.6	1.0
5	101.2	4.0	96.8	3.9
	$2,546.1	100.0%	$2,488.2	100.0%

Total Grade 4 and 5 assets as a percentage of the total portfolio at value at June 30, 2003, and December 31, 2002, were 4.8% and 4.9%, respectively. Included in Grade 4 and 5 assets at June 30, 2003, and December 31, 2002, were assets totaling $32.3 million and $24.1 million, respectively, that are secured by commercial real estate. Grade 4 and 5 assets include loans, debt securities, and equity securities. We expect that a number of portfolio companies will be in the Grade 4 or 5 categories from time to time. Part of the business of private finance is working with troubled portfolio companies to improve their businesses and protect our investment. The number of portfolio companies and related investment amount included in Grade 4 and 5 may fluctuate from period to period. We continue to follow our historical practice of working with a troubled portfolio company in order to recover the maximum amount of our investment, but record unrealized depreciation for the expected amount of the loss when such exposure is identified.

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

For the total investment portfolio, workout loans and debt securities (which excludes equity securities that are included in the total Grade 4 and 5 assets above) not accruing interest that were classified in Grade 4 and 5 were $75.0 million and $89.1 million at value at June 30, 2003, and December 31, 2002, respectively. Included in this category were loans of $17.0 million and $13.0 million, respectively, that were secured by commercial real estate. In addition to Grade 4 and 5 assets that are in workout, loans and debt securities to companies that are more than 50% owned by us that were not accruing interest totaled $72.2 million and $63.6 million at value at June 30, 2003, and December 31, 2002, respectively, and loans and debt securities to companies that are less than 50% owned by us and were not in workout but were not accruing interest totaled $3.9 million and $7.2 million at value at June 30, 2003, and December 31, 2002, respectively.

Loans and Debt Securities Over 90 Days Delinquent. Loans and debt securities greater than 90 days delinquent were $119.2 million and $103.1 million at value at June 30, 2003, and December 31, 2002, respectively, or 4.7% and 4.1% of the total portfolio. Included in this category were loans valued at $43.5 million and $26.0 million, respectively, that were secured by commercial real estate.

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

Hedging Activities

Because we invest in BB+ through B rated CMBS bonds and BBB rated CDO bonds that were purchased at prices based in part on comparable Treasury rates, we have entered into transactions with financial institutions to hedge against movement in Treasury rates on certain of these CMBS and CDO bonds. These transactions, referred to as short sales, involved receiving the proceeds from the short sales of borrowed Treasury securities, with the obligations to replenish the borrowed Treasury securities at a later date based on the then current market price, whatever that price may be. Risks in these contracts arise from movements in the value of the borrowed Treasury securities due to changes in interest rates and from the possible inability of counterparties to meet the terms of their contracts. If the value of the borrowed Treasury securities increases, we will incur losses on these transactions, which are limited only by the increase in value of the borrowed Treasury securities; conversely, the value of the CMBS 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 only by the decline in value of the borrowed Treasury securities; conversely, the value of the 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 $157.0 million and $197.0 million at June 30, 2003, and December 31, 2002, respectively, which included unrealized depreciation on the obligations of $3.9 million and $7.1 million, respectively, due to changes in the yield on the borrowed Treasury securities. The net proceeds related to the sales of the borrowed Treasury securities were $152.2 million and $189.3 million at June 30, 2003, and December 31, 2002, respectively. Under the terms of the transactions, we have provided additional cash collateral of $5.1 million and $5.4 million at June 30, 2003, and December 31, 2002, respectively, for the difference between the net proceeds related to the sales of the borrowed Treasury securities and the obligations to replenish the securities on the weekly settlement date, which is included in deposits of proceeds from sales of borrowed Treasury securities in the accompanying financial statements. The amount of the hedge will vary from period to period depending upon the amount of BB+ through B rated CMBS bonds and BBB rated CDO bonds that we own and have hedged on the balance sheet date.

RESULTS OF OPERATIONS

Comparison of Three Months Ended June 30, 2003 and 2002

The following table summarizes the Company s operating results for the three months ended June 30, 2003 and 2002.

($ in thousands, except per share amounts)	For the Three Months Ended June 30, 2003	2002	Change	Percentage Change
	(unaudited)			
Interest and Related Portfolio Income				
Interest and dividends	$ 67,137	$ 62,692	$ 4,445	7%
Premiums from loan dispositions	1,637	46	1,591	**
Fees and other income	8,440	10,455	(2,015)	(19)%
Total interest and related portfolio income	77,214	73,193	4,021	5%
Expenses				
Interest	19,358	17,515	1,843	11%
Employee	9,258	8,274	984	12%
Administrative	5,081	4,843	238	5%
Total operating expenses	33,697	30,632	3,065	10%
Net investment income before income taxes	43,517	42,561	956	2%
Income tax benefit	(1,081)		(1,081)	**
Net investment income	44,598	42,561	2,037	5%
Net Realized and Unrealized Gains (Losses)				
Net realized gains (losses)	8,540	(755)	9,295	*
Net change in unrealized appreciation or depreciation	6,802	31,648	(24,846)	*
Total net gains (losses)	15,342	30,893	(15,551)	*
Net income	$ 59,940	$ 73,454	$(13,514)	(18)%
Diluted earnings per common share	$ 0.52	$ 0.71	$ (0.19)	(27)%
Weighted average common shares outstanding diluted	114,552	103,440	11,112	11%

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

** Percentage change is not meaningful.

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

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

The level of interest income is directly related to the balance of the interest-bearing investment portfolio multiplied by the weighted average yield. The weighted average yield varies from period to period based on the current stated interest rate earned on interest-bearing investments and the amount of loans and debt securities for which interest is not accruing. Our interest-bearing investments in the portfolio increased by 5.7% to $1,899.3 million at June 30, 2003, from $1,796.5 million at June 30, 2002. The weighted average yield on the interest-bearing investments in the portfolio at June 30, 2003 and 2002, was as follows:

($ in millions)	2003	2002
Interest-bearing portfolio	$1,899.3	$1,796.5
Portfolio yield	14.1%	13.8%

Included in premiums from loan dispositions are prepayment premiums of $1.6 million and $46 thousand for the three months ended June 30, 2003 and 2002, respectively. While the scheduled maturities of private finance and commercial real estate loans range from five to ten years, it is not unusual for our borrowers to refinance or pay off their debts to us ahead of schedule. Because we seek to finance primarily seasoned, performing companies, such companies at times can secure lower cost financing as their balance sheets strengthen, or as more favorable interest rates become available, or a company may enter into a transaction that results in the early repayment of their debt to us. Therefore, we generally structure our loans to require a prepayment premium for the first three to five years of the loan.

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

Fees and other income for the quarters ended June 30, 2003 and 2002, primarily included fees of $3.1 million and $2.6 million, respectively, related to structuring and diligence; fees of $0.8 million and $1.8 million, respectively, related to transaction and other services provided to portfolio companies; and fees of $4.3 million and $6.0 million, respectively, related to management services provided to portfolio companies, other advisory services, and guaranty fees. Fees and other income are generally related to specific transactions or services, and therefore may vary substantially from period to period depending on the level and types of services provided. Points or loan origination fees that represent yield enhancement on a loan are capitalized and amortized into interest income over the life of the loan.

Business Loan Express and Hillman are our most significant portfolio investments and together represented 19.0% of our total assets at June 30, 2003. Total interest and related portfolio income earned from these investments for the three months ended June 30, 2003 and 2002, were $12.1 million and $12.2 million, respectively. In July 2002, we sold WyoTech Acquisition Corporation, which was a significant portfolio investment during 2002. Total interest and related portfolio income earned on this investment for the three months ended June 30, 2002, was $1.8 million.

Operating Expenses. Operating expenses include interest, employee, and administrative expenses. Our single largest expense is interest on our indebtedness. The fluctuations in interest expense during the three months ended June 30, 2003 and 2002, were attributable to changes in the level of our borrowings under various notes payable and debentures and our revolving line of credit. Our borrowing activity and weighted average interest cost, including fees and closing costs, were as follows:

($ in millions)	At and for the Three Months Ended June 30, 2003	2002
Total Outstanding Debt	$ 979.7	$ 1,009.0
Average Outstanding Debt	$ 962.3	$ 942.3
Weighted Average Cost	7.4%	7.2%
BDC Asset Coverage*	286%	256%

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

Employee expenses include salaries and employee benefits. The change in employee expenses reflects the effect of wage increases, increased staffing, and the change in mix of employees given their area of responsibility and relevant experience level. Total employees were 116 and 103 at June 30, 2003 and 2002, respectively. We no longer provide loans to our employees to exercise stock options because of recent legislation. This was an important benefit to our employees and as a result, we are considering compensation alternatives and expect to have a new program in place by the end of 2003.

Administrative expenses include the leases for our headquarters in Washington, DC, and our regional offices, travel costs, stock record expenses, directors fees, legal and accounting fees, insurance premiums, and various other expenses.

Income Tax Benefit. The Company s wholly owned subsidiary, AC Corp, is a corporation subject to federal and state income taxes and records a benefit or expense for income taxes as appropriate. For the three months ended June 30, 2003, we recorded a tax benefit of $1.1 million as a result of AC Corp s operating loss for the period.

Realized Gains and Losses. Net realized gains result from the sale of equity securities associated with certain private finance investments, the sale of CMBS bonds, and the realization of unamortized discount resulting from the sale and early repayment of private finance loans and commercial mortgage loans, offset by losses on investments. Net realized gains and losses for the three months ended June 30, 2003 and 2002, were as follows:

($ in millions)	For the Three Months Ended June 30, 2003	2002
Realized gains	$ 12.7	$ 2.5
Realized losses	(4.2)	(3.3)
Net realized gains (losses)	$ 8.5	$ (0.8)

Realized gains and losses for the three months ended June 30, 2003, resulted from various private finance and commercial real estate finance transactions. Realized gains for the three months ended June 30, 2003, primarily resulted from transactions involving three private finance portfolio companies, including Woodstream Corporation ($6.6 million), Kirkland s Inc. ($1.8 million), and Interline Brands, Inc. ($1.7 million). For the three months ended June 30, 2003 and 2002, we reversed previously recorded unrealized appreciation totaling $7.9 million and $2.1 million, respectively, when gains were realized. When we exit an investment and realize a gain, we make an accounting entry to reverse any unrealized appreciation we had previously recorded to reflect the appreciated value of the investment.

Realized losses for the three months ended June 30, 2003, primarily resulted from one transaction involving North American Archery, LLC ($2.1 million), and two transactions involving commercial mortgage loans ($2.0 million). For the three months ended June 30, 2003 and 2002, we reversed previously recorded unrealized depreciation totaling $4.7 million and $2.0 million, respectively, when losses were realized. When we exit an investment and realize a loss, we make an accounting entry to reverse any unrealized depreciation we had previously recorded to reflect the depreciated value of the investment.

Change in Unrealized Appreciation or Depreciation. We determine the value of each investment in our portfolio on a quarterly basis, and changes in value result in unrealized appreciation or depreciation being recognized. At June 30, 2003, approximately 89% of our total assets represented portfolio investments recorded at fair value. Value, as defined in Section 2(a)(41) of the Investment Company Act of 1940, is (i) the market price for those securities for which a market quotation is readily available and (ii) for all other securities and assets, fair value is as determined in good faith by the board of directors. Since there is typically no readily available market value for the investments in our portfolio, we value substantially all of our portfolio investments at fair value as determined in good faith by the board of directors pursuant to a valuation policy and a consistently applied valuation process. Because of the inherent uncertainty of determining the fair value of investments that do not have a readily available market value, the fair value of our investments determined in good faith by the board of directors may differ significantly from the values that would have been used had a ready market existed for the investments, and the differences could be material.

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

As a business development company, we invest in illiquid securities including debt and equity securities of companies, 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 monthly unaudited financial statements, as well as annual projections for the upcoming fiscal year. Typically in the private equity business, companies are bought and sold based on multiples of EBITDA, cash flow, net income, revenues or, in limited instances, book value. The private equity industry uses financial measures such as EBITDA or EBITDAM (Earnings Before Interest, Taxes, Depreciation, Amortization and, in some instances, Management fees) in order to assess a portfolio company s financial performance and to value a portfolio company. EBITDA and EBITDAM are not intended to represent cash flow from operations as defined by accounting principles generally accepted in the United States of America and such information should not be considered as an alternative to net income, cash flow from operations, or any other measure of performance prescribed by accounting principles generally accepted in the United States of America. When using EBITDA to determine enterprise value, we may adjust EBITDA for non-recurring items. Such adjustments are intended to normalize EBITDA to reflect the portfolio company s earnings power. Adjustments to EBITDA may include compensation to previous owners, acquisition, recapitalization, or restructuring related items or one-time non-recurring income or expense items.

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

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

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

For the portfolio, net change in unrealized appreciation or depreciation for the three months ended June 30, 2003 and 2002, consisted of the following:

($ in millions)	**2003(1)**	**2002(1)**
Net unrealized appreciation or depreciation	$10.0	$31.7
Reversal of previously recorded unrealized appreciation associated with realized gains	(7.9)	(2.1)
Reversal of previously recorded unrealized depreciation associated with realized losses	4.7	2.0
Net change in unrealized appreciation or depreciation	$6.8	$31.6

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

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

Business Loan Express, LLC. The most significant change in the value of our portfolio this quarter was in our investment in BLX, which increased in value by $50.5 million. BLX continues to make solid progress in its business. EBITM increased by 11.6% for the twelve months ended June 30, 2003, as compared to the twelve months ended June 30, 2002, adjusted for certain non-recurring expenses and the expense of equity appreciation rights. In addition, BLX has significantly strengthened its loan origination platform by increasing its preferred lender designation to 74 out of 79 SBA markets and as a result of the AIF acquisition.

To determine the value of our investment in BLX at June 30, 2003, we performed four separate valuation analyses to determine its enterprise value: (1) analysis of comparable public company trading multiples, (2) analysis of BLX s value assuming an initial public offering, (3) analysis of merger and acquisition transactions for financial services companies, and (4) a discounted dividend analysis. In arriving at the value of our investment, we estimated that the total enterprise value of BLX increased from $407 million at March 31, 2003, to $465 million at June 30, 2003. This results in a total value of the Class B and Class C equity interests of $262.7 million at June 30, 2003, as compared to a total value for the Class B and Class C equity interests of $207.2 million at March 31, 2003, or an increase of 27%.

The 27% increase in the value of the Class B and Class C equity interests is a result of BLX s continued progress as well as the fact that there has been an overall increase in the market valuations for financial services companies during the quarter. We benchmarked the valuation of BLX against a public comparable group consisting of six public financial services companies, and during this quarter the median trailing price to earnings ratio for this comparable group increased by 29% and the median forward price to earnings ratio for this comparable group increased by 52%. The increases in the comparable group market valuations indicate that the fair value of BLX has increased by current market standards.

At a value of $262.7 million for the Class B and Class C equity interests, we are valuing BLX at a trailing price to pro-forma earnings ratio of approximately 10.5 times and on a forward projected price to pro-forma earnings ratio of approximately 9.4 times. The fair value of BLX s Class B and Class C equity interests is at a multiple of investor cost basis of 1.6 times.

The Hillman Companies, Inc. In performing our valuation analysis of Hillman at June 30, 2003, we determined normalized 2003 EBITDAM to be approximately $61.5 million. We believe the current enterprise value for Hillman is approximately $430.5 million, or 7.0 times 2003 normalized EBITDAM of $61.5 million. The multiple was determined by obtaining a range of multiples representing the multiple of enterprise value to EBITDA for comparable public companies and the multiple of enterprise value to EBITDA for acquisition transactions involving companies in Hillman s peer group. From this market comparable analysis, we selected a 7.0 times multiple for our valuation. Using an enterprise value of $430.5 million, the value of our equity investment in Hillman is approximately $138.8 million, or $88.2 million greater than our cost basis of $50.6 million at June 30, 2003.

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 common share, which were 114.6 million and 103.4 million for the three months ended June 30, 2003 and 2002, respectively.

OTHER MATTERS

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

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

RESULTS OF OPERATIONS

Comparison of Six Months Ended June 30, 2003 and 2002

The following table summarizes our condensed operating results for the six months ended June 30, 2003 and 2002.

($ in thousands, except per share amounts)	For the Six Months Ended June 30, 2003	For the Six Months Ended June 30, 2002	Change	Percentage Change
	(unaudited)			
Interest and Related Portfolio Income				
Interest and dividends	$132,658	$127,665	$ 4,993	4%
Premiums from loan dispositions	2,758	1,659	1,099	66%
Fees and other income	14,928	26,260	(11,332)	(43)%
Total interest and related portfolio income	150,344	155,584	(5,240)	(3)%
Expenses				
Interest	37,280	34,984	2,296	7%
Employee	17,379	16,309	1,070	7%
Administrative	9,498	7,861	1,637	21%
Total operating expenses	64,157	59,154	5,003	8%
Net investment income before income taxes	86,187	96,430	(10,243)	(11)%
Income tax benefit	(1,081)		(1,081)	**
Net investment income	87,268	96,430	(9,162)	(10)%
Net Realized and Unrealized Gains (Losses)				
Net realized gains (losses)	56,879	8,850	48,029	*
Net change in unrealized appreciation or depreciation	(64,334)	24,135	(88,469)	*
Total net gains (losses)	(7,455)	32,985	(40,440)	*
Net income	$ 79,813	$129,415	$(49,602)	(38)%
Diluted earnings per common share	$ 0.71	$ 1.26	$ (0.55)	(44)%
Weighted average common shares outstanding diluted	112,291	102,900	9,391	9%

* Net realized gains and losses and net change in unrealized appreciation or depreciation can fluctuate significantly from period to period. As a result, year-to-date comparisons of net gains and losses may not be meaningful.

** Percentage change is not meaningful.

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

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

The level of interest income is directly related to the balance of the interest-bearing investment portfolio multiplied by the weighted average yield. The weighted average yield varies from period to period based on the current stated interest rate earned on interest-bearing investments and the amount of loans and debt securities for which interest is not accruing. Our interest-bearing investments in the portfolio increased by 5.7% to $1,899.3 million at June 30, 2003, from $1,796.5 million at June 30, 2002. The weighted average yield on the interest-bearing investments in the portfolio at June 30, 2003 and 2002, was as follows:

($ in millions)	2003	2002
Interest-bearing portfolio	$1,899.3	$1,796.5
Portfolio yield	14.1%	13.8%

Included in premiums from loan dispositions are prepayment premiums of $2.8 million and $1.6 million for the six months ended June 30, 2003 and 2002, respectively. While the scheduled maturities of private finance and commercial real estate loans range from five to ten years, it is not unusual for our borrowers to refinance or pay off their debts to us ahead of schedule. Because we seek to finance primarily seasoned, performing companies, such companies at times can secure lower cost financing as their balance sheets strengthen, or as more favorable interest rates become available or a company may enter into a transaction that results in early repayment of their debt to us. Therefore, we generally structure our loans to require a prepayment premium for the first three to five years of the loan.

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

Fees and other income for the six months ended June 30, 2003 and 2002, included fees of $3.4 million and $10.6 million, respectively, related to structuring and diligence, fees of $1.2 million and $3.8 million, respectively, related to transaction and other services provided to portfolio companies, and fees of $9.9 million and $11.7 million, related to management services provided to portfolio companies, other advisory services and guaranty fees. Fees and other income are generally related to specific transactions or services, and therefore may vary substantially from period to period depending on the level and types of services provided. Points or loan origination fees that represent yield enhancement on a loan are capitalized and amortized into interest income over the life of the loan.

Business Loan Express and Hillman are our most significant portfolio investments and together represented 19.0% of our total assets at June 30, 2003. Total interest and related portfolio income earned from these investments for the six months ended June 30, 2003 and 2002, was $27.5 million and $24.5 million, respectively. Total interest and related portfolio income earned from WyoTech for the six months ended June 30, 2002 was $3.6 million, which no longer occurred after the sale of the investment on July 1, 2002.

Operating Expenses. Operating expenses include interest, employee, and administrative expenses. Our single largest expense is interest on our indebtedness. The fluctuations in interest expense during the six months ended June 30, 2003 and 2002, were attributable to changes in the level of our borrowings under various notes payable and debentures and our revolving line of credit. Our borrowing activity and weighted average interest cost, including fees and closing costs, were as follows:

($ in millions)	At and for the Six Months Ended June 30, 2003	2002
Total Outstanding Debt	$ 979.7	$ 1,009.0
Average Outstanding Debt	$ 927.0	$ 940.4
Weighted Average Cost	7.4%	7.2%
BDC Asset Coverage*	286%	256%

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

Employee expenses include salaries and employee benefits. The change in employee expenses 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 116 and 103 at June 30, 2003 and 2002, respectively. We no longer provide loans to our employees to exercise stock options because of recent legislation. This was an important benefit to our employees and as a result, we are considering compensation alternatives and expect to have a new program in place by the end of 2003.

Administrative expenses include the leases for our headquarters in Washington, DC, and our regional offices, travel costs, stock record expenses, directors fees, legal and accounting fees, insurance premiums, and various other expenses. The increase in administrative expenses as compared to the six months ended June 30, 2002, includes approximately $0.8 million from directors fees, legal and accounting fees, and consulting fees, and $0.8 million due to increased costs for corporate liability insurance.

Income Tax Benefit. The Company s wholly owned subsidiary, AC Corp, is a corporation subject to federal and state income taxes and records a benefit or expense for income taxes as appropriate. For the six months ended June 30, 2003, we recorded a tax benefit of $1.1 million as a result of AC Corp s operating loss for the period.

Realized Gains and Losses. Net realized gains result from the sale of equity securities associated with certain private finance investments, the sale of CMBS bonds, and the realization of unamortized discount resulting from the sale and early repayment of private finance loans and commercial mortgage loans, offset by losses on investments. Net realized gains and losses for the six months ended June 30, 2003 and 2002, were as follows:

($ in millions)	For the Six Months Ended June 30, 2003	2002
Realized gains	$61.3	$15.4
Realized losses	(4.4)	(6.5)
Net realized gains	$56.9	$ 8.9

Realized gains and losses for the six months ended June 30, 2003, resulted from various private finance and commercial real estate finance transactions. Realized gains for the six months ended June 30, 2003, primarily resulted from transactions involving seven private finance portfolio companies, including Morton Grove Pharmaceuticals, Inc.

($8.4 million), CyberRep ($8.3 million), Woodstream Corporation ($6.6 million), Blue Rhino Corporation ($3.9 million), Kirkland s Inc. ($3.0 million), GC-Sun Holdings II, LP ($2.5 million), and Interline Brands, Inc. ($1.7 million). In addition, gains were also realized on CMBS bonds ($24.6 million, net of a realized loss of $6.7 million from hedges related to the CMBS bonds sold). For the six months ended June 30, 2003 and 2002, we reversed previously recorded unrealized appreciation totaling $50.8 million and $7.3 million, respectively, when gains were realized. When we exit an investment and realize a gain, we make an accounting entry to reverse any unrealized appreciation we had previously recorded to reflect the appreciated value of the investment.

Realized losses for the six months ended June 30, 2003, primarily resulted from one transaction involving North American Archery, LLC ($2.1 million), and two transactions involving commercial mortgage loans ($2.0 million). For the six months ended June 30, 2003 and 2002, we reversed previously recorded unrealized depreciation totaling $4.9 million and $5.2 million, respectively, when losses were realized. When we exit an investment and realize a loss, we make an accounting entry to reverse any unrealized depreciation we had previously recorded to reflect the depreciated value of the investment.

Change in Unrealized Appreciation or Depreciation. For a discussion of our fair value methodology and how it affects the net change in unrealized appreciation or depreciation, see Change in Unrealized Appreciation or Depreciation included in the Comparison of Three Months Ended June 30, 2003 and 2002.

For the portfolio, net change in unrealized appreciation or depreciation for the six months ended June 30, 2003 and 2002, consisted of the following:

($ in millions)	2003(1)	2002(1)
Net unrealized appreciation or depreciation	$(18.4)	$26.2
Reversal of previously recorded unrealized appreciation associated with realized gains	(50.8)	(7.3)
Reversal of previously recorded unrealized depreciation associated with realized losses	4.9	5.2
Net change in unrealized appreciation or depreciation	$(64.3)	$24.1

(1) The net change in unrealized appreciation or depreciation can fluctuate significantly from period to period. As a result year-to-date comparisons may not be meaningful.

Net change in unrealized appreciation or depreciation for the six months ended June 30, 2003 included those discussed under the caption Change in Unrealized Appreciation or Depreciation included in the Comparison of Three Months Ended June 30, 2003 and 2002.

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 common share, which were 112.3 million and 102.9 million for the six months ended June 30, 2003 and 2002, respectively.

FINANCIAL CONDITION, LIQUIDITY AND CAPITAL RESOURCES

Cash and Cash Equivalents

At June 30, 2003, we had $7.5 million in cash and cash equivalents. We invest otherwise uninvested cash in U.S. government- or agency-issued or guaranteed securities that are backed by the full faith and credit of the United States, or in high quality, short-term repurchase agreements fully collateralized by such securities. Our objective is to manage to a low cash balance and fund new originations with our revolving line of credit, and through the issuance of debt and equity securities.

Debt

At June 30, 2003, we had outstanding debt as follows:

($ in millions)	Facility Amount	Amount Outstanding	Annual Interest Cost[(1)]
Notes payable and debentures:			
Unsecured long-term notes	$ 854.0	$854.0	7.2%
SBA debentures	101.8	94.5	8.1%
OPIC loan	5.7	5.7	6.6%
Total notes payable and debentures	961.5	954.2	7.3%
Revolving line of credit	462.5	25.5	11.7%[(2)]
Total debt	$1,424.0	$979.7	7.4%

(1) 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.

(2) The current interest rate payable on the revolving line of credit is 2.6%, which excludes the annual cost of commitment fees and other facility fees of $2.3 million.

Unsecured Long-Term Notes. We have issued long-term debt to institutional lenders, primarily insurance companies. The notes have five-or seven-year maturities, with maturity dates beginning in 2004. The notes require payment of interest only semi-annually, and all principal is due upon maturity. On May 14, 2003, we issued $153 million of five-year and $147 million of seven-year unsecured long-term notes, primarily to insurance companies. The five- and seven-year notes have fixed interest rates of 5.45% and 6.05%, respectively, and have substantially the same terms as our existing unsecured long-term notes. On May 30, 2003, $140 million of our existing unsecured long-term notes matured and we used the proceeds from the new long-term note issuance to repay this amount.

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

Revolving Line of Credit. We have a $462.5 million unsecured revolving line of credit that expires in April 2005, with the right to extend maturity for one additional year at our option under substantially similar terms. The revolving line of credit may be expanded through new or additional commitments up to $600 million at our option. As of June 30, 2003, $399.9 million remained unused and available, net of amounts committed for standby letters of credit of $37.1 million issued under the line of credit facility. Net repayments on the revolving line of credit for the six months ended June 30, 2003, were $178.8 million. The credit facility bears interest at a rate equal to (i) the one-month LIBOR plus 1.25%, (ii) the Bank of America, N.A. prime rate, or (iii) the Federal Funds rate plus 0.50% at our option. The line of credit generally requires monthly payments of interest, and all principal is due upon maturity.

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 June 30, 2003, we were in compliance with these covenants.

The following table shows our significant contractual obligations as of June 30, 2003.

		Payments Due By Year					
($ in millions)	Total	2003	2004	2005	2006	2007	After 2007
Notes payable and debentures:							
Unsecured long-term notes	$854.0	$	$214.0	$165.0	$175.0	$	$300.0
Small Business Administration debentures	94.5		7.0	14.0			73.5
Overseas Private Investment Corporation loan	5.7				5.7		
Revolving line of credit[(1)]	25.5				25.5		
Operating Leases	19.7	1.3	2.7	2.7	2.6	2.5	7.9
Total contractual obligations	$999.4	$1.3	$223.7	$181.7	$208.8	$2.5	$381.4

(1) The revolving line of credit expires in April 2005 and may be extended under substantially similar terms for one additional year at our option. We assume that we would exercise our option to extend the revolving line of credit resulting in an assumed maturity of April 2006. At June 30, 2003, $399.9 million remains 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 June 30, 2003.

		Amount of Commitment Expiration Per Year					
($ in millions)	Total	2003	2004	2005	2006	2007	After 2007
Guarantees	$58.9	$0.4	$54.3	$0.4	$ 0.1	$0.1	$3.6
Standby letters of credit	37.1			4.5	32.6		
Total commitments	$96.0	$0.4	$54.3	$4.9	$32.7	$0.1	$3.6

Equity Capital and Dividends

Because we are a regulated investment company, we distribute our income and require external capital for growth. Because we are a business development company, we are limited in the amount of debt capital we may use to fund our growth, since we are generally required to maintain a minimum ratio of 200% of total assets to total borrowings, or approximately a 1 to 1 debt to equity ratio. At June 30, 2003, our asset coverage for senior indebtedness was 286% and our debt to equity ratio was 0.59 to 1.00.

To support our growth during the six months ended June 30, 2003 and 2002, we raised $145.1 million and $49.9 million, respectively, in new equity capital. In July 2003, we raised an additional $9.7 million in new equity capital. We issue equity from time to time when we have attractive investment opportunities. In addition, we raised $3.3 million and $3.1 million in new equity capital through the issuance of shares through our dividend reinvestment plan during the six months ended June 30, 2003 and 2002, respectively. During the six months ended June 30, 2003, total shareholder s equity had increased 6.8% to $1.7 billion.

Our Board of Directors reviews the dividend rate quarterly, and may adjust the quarterly dividend throughout the year. For the first, second and third quarters of 2003, the Board of Directors declared a dividend of $0.57 per common share. The third quarter dividend is payable on September 26, 2003, with a record date of September 12, 2003. Dividends are paid based on our taxable income, which includes our taxable interest and fee income as well as taxable net realized capital gains. Our Board of Directors evaluates whether to retain or distribute capital gains on an annual basis. Our dividend policy allows us to continue to distribute capital gains, but will also allow us to retain gains to support future growth.

Liquidity and Capital Resources. We plan to maintain a strategy of financing our business and related debt maturities with cash from operations, through borrowings under short- or long-term credit facilities or other debt securities, through asset sales, or through the sale or issuance of new equity capital. The need for private investment capital has increased in 2003 and we have funded new investments totaling $526.4 million for the six months ended June 30, 2003, as compared to $506.4 million for the year ended December 31, 2002. Although there can be no assurance that we will secure new investments, we plan to raise new debt and equity capital as appropriate to fund investment growth.

Dividends to shareholders for the six months ended June 30, 2003 and 2002, were $127.5 million and $109.5 million, respectively. Cash flow from operations before new investments has historically been sufficient to finance our operating expenses and pay dividends to shareholders.

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

At June 30, 2003, our debt to equity ratio was 0.59 to 1.00 and our weighted average cost of funds was 7.4%. Availability on the revolving line of credit, net of amounts committed for standby letters of credit issued under the line of credit facility, was $399.9 million on June 30, 2003. We believe that we have access to capital sufficient to fund our ongoing investment and operating activities.

CRITICAL ACCOUNTING POLICIES

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

Valuation of Portfolio Investments. As a business development company, we invest in illiquid securities including debt and equity securities of companies, non-investment grade CMBS, and 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 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, therefore, our equity security has also appreciated in value. The value of investments in publicly traded securities are determined using quoted market prices discounted for restrictions on resale, if any.

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

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

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