

ALLIED CAPITAL CORP
Form 10-Q
November 08, 2005

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

For The Quarterly Period
Ended September 30, 2005

Commission File Number:
0-22832

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

Maryland
(State or Jurisdiction of
Incorporation or Organization)

52-1081052
(IRS Employer
Identification No.)

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

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

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

YES NO

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

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

On November 7, 2005, there were 136,306,052 shares outstanding of the Registrant's common stock, \$0.0001 par value.

ALLIED CAPITAL CORPORATION
FORM 10-Q TABLE OF CONTENTS

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements	
Consolidated Balance Sheet as of September 30, 2005 (unaudited) and December 31, 2004	1
Consolidated Statement of Operations (unaudited) For the Three and Nine Months Ended September 30, 2005 and 2004	2
Consolidated Statement of Changes in Net Assets (unaudited) For the Nine Months Ended September 30, 2005 and 2004	3
Consolidated Statement of Cash Flows (unaudited) For the Nine Months Ended September 30, 2005 and 2004	4
Consolidated Statement of Investments as of September 30, 2005 (unaudited)	5
Notes to Consolidated Financial Statements	14
Report of Independent Registered Public Accounting Firm	41
Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations	42
Item 3. Quantitative and Qualitative Disclosures About Market Risk	78
Item 4. Controls and Procedures	79

PART II. OTHER INFORMATION

Item 1. Legal Proceedings	80
Item 2. Unregistered Sales of Equity Securities and Use of Proceeds	81
Item 3. Defaults Upon Senior Securities	81
Item 4. Submission of Matters to a Vote of Security Holders	81
Item 5. Other Information	81
Item 6. Exhibits	82
Signatures	85

PART I: FINANCIAL INFORMATION

Item 1. Financial Statements

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEET

(in thousands, except per share amounts)	September 30, 2005	December 31, 2004
ASSETS		
Portfolio at value:		
Private finance		
Companies more than 25% owned (cost: 2005-\$1,510,082; 2004-\$1,389,342)	\$ 1,612,914	\$ 1,359,641
Companies 5% to 25% owned (cost: 2005-\$164,007; 2004-\$194,750)	156,840	188,902
Companies less than 5% owned (cost: 2005-\$1,338,370; 2004-\$800,828)	1,311,231	753,543
Total private finance (cost: 2005-\$3,012,459; 2004-\$2,384,920)	3,080,985	2,302,086
Commercial real estate finance (cost: 2005-\$148,623; 2004-\$722,612)	142,765	711,325
Total portfolio at value (cost: 2005-\$3,161,082; 2004-\$3,107,532)	3,223,750	3,013,411
Deposits of proceeds from sales of borrowed Treasury securities	17,933	38,226
Accrued interest and dividends receivable	65,147	79,489
Other assets	81,565	72,712
Cash and cash equivalents	58,081	57,160
Total assets	\$ 3,446,476	\$ 3,260,998
LIABILITIES AND SHAREHOLDERS EQUITY		
Liabilities:		
Notes payable and debentures (maturing within one year: 2005-\$150,000; 2004-\$169,000)	\$ 968,335	\$ 1,064,568
Revolving line of credit		112,000
Obligations to replenish borrowed Treasury securities	17,933	38,226
Accounts payable and other liabilities	93,222	66,426
Total liabilities	1,079,490	1,281,220
Commitments and contingencies		
Shareholders equity:		
Common stock, \$0.0001 par value, 200,000 shares authorized; 136,289 and 133,099 shares issued and outstanding at September 30, 2005, and December 31, 2004, respectively	14	13

Edgar Filing: ALLIED CAPITAL CORP - Form 10-Q

Additional paid-in capital	2,171,063	2,094,421
Common stock held in deferred compensation trust	(17,781)	(13,503)
Notes receivable from sale of common stock	(4,138)	(5,470)
Net unrealized appreciation (depreciation) on portfolio	48,259	(107,767)
Undistributed (distributions in excess of) earnings	169,569	12,084
 Total shareholders equity	 2,366,986	 1,979,778
 Total liabilities and shareholders equity	 \$ 3,446,476	 \$ 3,260,998
 Net asset value per common share	 \$ 17.37	 \$ 14.87

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

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENT OF OPERATIONS

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2005	2004	2005	2004
(in thousands, except per share amounts)				
	(unaudited)		(unaudited)	
Interest and Related Portfolio Income:				
Interest and dividends				
Companies more than 25% owned	\$ 31,137	\$ 27,242	\$ 89,587	\$ 59,112
Companies 5% to 25% owned	5,205	7,582	16,723	19,827
Companies less than 5% owned	40,011	51,004	126,318	154,601
Total interest and dividends	76,353	85,828	232,628	233,540
Loan prepayment premiums				
Companies more than 25% owned				
Companies 5% to 25% owned	691	53	691	765
Companies less than 5% owned	1,414	140	3,944	3,445
Total loan prepayment premiums	2,105	193	4,635	4,210
Fees and other income				
Companies more than 25% owned				
Companies 5% to 25% owned	9,019	7,611	21,777	20,406
Companies less than 5% owned	(14)	934	111	1,404
Companies less than 5% owned	7,394	2,297	16,832	6,568
Total fees and other income	16,399	10,842	38,720	28,378
Total interest and related portfolio income	94,857	96,863	275,983	266,128
Expenses:				
Interest	17,735	20,253	57,114	57,349
Employee	13,969	13,896	52,302	38,171
Administrative	15,130	10,169	58,932	25,072
Total operating expenses	46,834	44,318	168,348	120,592
Net investment income before income taxes	48,023	52,545	107,635	145,536
Income tax expense (benefit), including excise tax	1,889	(200)	7,482	(744)
Net investment income	46,134	52,745	100,153	146,280
Net Realized and Unrealized Gains (Losses):				
Net realized gains (losses)				

Edgar Filing: ALLIED CAPITAL CORP - Form 10-Q

Companies more than 25% owned	64,677	(12,483)	47,192	139,016
Companies 5% to 25% owned	(6)	13,269	4,702	48,965
Companies less than 5% owned	6,043	514	236,601	(12,228)
Total net realized gains	70,714	1,300	288,495	175,753
Net change in unrealized appreciation or depreciation	(3,680)	31,954	156,026	(120,384)
Total net gains	67,034	33,254	444,521	55,369
Net increase in net assets resulting from operations	\$ 113,168	\$ 85,999	\$ 544,674	\$ 201,649
Basic earnings per common share	\$ 0.84	\$ 0.67	\$ 4.06	\$ 1.57
Diluted earnings per common share	\$ 0.82	\$ 0.66	\$ 3.99	\$ 1.53
Weighted average common shares outstanding basic	135,322	129,304	134,110	128,812
Weighted average common shares outstanding diluted	138,058	131,192	136,669	131,487

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

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

**For the Nine Months
 Ended September 30,**

(in thousands, except per share amounts)	2005	2004
	(unaudited)	
Operations:		
Net investment income	\$ 100,153	\$ 146,280
Net realized gains	288,495	175,753
Net change in unrealized appreciation or depreciation	156,026	(120,384)
Net increase in net assets resulting from operations	544,674	201,649
Shareholder distributions:		
Common stock dividends	(231,163)	(220,832)
Preferred stock dividends		(52)
Net decrease in net assets resulting from shareholder distributions	(231,163)	(220,884)
Capital share transactions:		
Issuance of common stock for portfolio investments	7,200	3,227
Issuance of common stock upon the exercise of stock options	57,805	29,673
Issuance of common stock in lieu of cash distributions	7,456	4,399
Net decrease in notes receivable from sale of common stock	1,332	13,040
Purchase of common stock held in deferred compensation trust	(6,034)	(10,152)
Distribution of common stock held in deferred compensation trust	1,756	183
Other	4,182	28
Net increase in net assets resulting from capital share transactions	73,697	40,398
Total increase in net assets	387,208	21,163
Net assets at beginning of period	1,979,778	1,914,577
Net assets at end of period	\$ 2,366,986	\$ 1,935,740
Net asset value per common share	\$ 17.37	\$ 14.90
Common shares outstanding at end of period	136,289	129,898

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

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENT OF CASH FLOWS

	For the Nine Months Ended September 30,	
(in thousands)	2005	2004
	(unaudited)	
Cash flows from operating activities:		
Net increase in net assets resulting from operations	\$ 544,674	\$ 201,649
Adjustments		
Portfolio investments	(1,320,611)	(1,057,136)
Principal collections related to investment repayments or sales	1,241,827	543,314
Change in accrued or reinvested interest and dividends	(1,905)	(31,652)
Amortization of discounts and fees	(3,339)	(4,736)
Changes in other assets and liabilities	33,399	16,501
Depreciation and amortization	1,404	1,266
Realized gains from the receipt of notes and other securities as consideration from sale of investments, net of collections	(4,605)	(44,515)
Realized losses	50,661	65,828
Net change in unrealized (appreciation) or depreciation	(156,026)	120,384
Net cash provided by (used in) operating activities	385,479	(189,097)
Cash flows from financing activities:		
Sale of common stock upon the exercise of stock options	57,805	29,673
Collections of notes receivable from sale of common stock	1,332	13,040
Borrowings under notes payable and debentures		15,212
Repayments on notes payable and debentures	(94,700)	(129,000)
Net borrowings under (repayments on) revolving line of credit	(112,000)	327,250
Redemption of preferred stock		(7,000)
Purchase of common stock held in deferred compensation trust	(6,034)	(10,152)
Other financing activities	(4,594)	(901)
Common stock dividends and distributions paid	(226,367)	(216,433)
Preferred stock dividends paid		(52)
Net cash provided by (used in) financing activities	(384,558)	21,637
Net increase (decrease) in cash and cash equivalents	921	(167,460)
Cash and cash equivalents at beginning of period	57,160	214,167
Cash and cash equivalents at end of period	\$ 58,081	\$ 46,707

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

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENT OF INVESTMENTS

September 30, 2005

(unaudited)

Private Finance Portfolio Company (in thousands, except number of shares)	Investment ⁽¹⁾⁽²⁾	Principal	Cost	Value
Companies More Than 25% Owned				
Acme Paging, L.P. ⁽⁴⁾ (Telecommunications)	Loan (6.8%, Due 12/07 1/08) ⁽⁶⁾ Equity Interests Common Stock (4,656 shares)	\$ 4,631	\$ 4,631 13,274 27	\$
Advantage Sales & Marketing, Inc. (Business Services)	Loan (12.0%, Due 9/09) Debt Securities (18.5%, Due 12/09) Common Stock (18,957,011 shares)	60,000 124,000	59,773 124,000 73,932	59,773 124,000 251,659
Alaris Consulting, LLC (Business Services)	Loan (16.0%, Due 12/05 12/07) ⁽⁶⁾ Equity Interests Guaranty (\$1,100)	25,835	25,846 5,305	2,065
American Healthcare Services, Inc. and Affiliates (Healthcare Services)	Loan (0.7%, Due 12/04 12/05) ⁽⁶⁾	4,999	4,600	4,097
Avborne, Inc. ⁽⁷⁾ (Business Services)	Preferred Stock (12,500 shares) Common Stock (27,500 shares)		6,969	4,807
Avborne Heavy Maintenance, Inc. ⁽⁷⁾ (Business Services)	Preferred Stock (1,568 shares) Common Stock (2,750 shares)			
Business Loan Express, LLC (Financial Services)	Class A Equity Interests Class B Equity Interests Class C Equity Interests Guaranty (\$136,173 See Note 3)	58,908	58,908 117,436 109,301	58,908 151,090 146,319

Edgar Filing: ALLIED CAPITAL CORP - Form 10-Q

	Standby Letters of Credit (\$35,550 See Note 3)			
Callidus Capital Corporation (Financial Services)	Loan (7.9%, Due 12/05)	52,456	52,456	52,456
	Debt Securities (18.0%, Due 10/08)	4,623	4,623	4,623
	Common Stock (10 shares)		2,049	7,504
Diversified Group Administrators, Inc. (Business Services)	Preferred Stock (1,000,000 shares)		700	657
	Preferred Stock (1,451,380 shares)		841	790
	Common Stock (1,451,380 shares)			
Financial Pacific Company (Financial Services)	Loan (17.4%, Due 2/12 8/12)	69,825	69,544	69,544
	Preferred Stock (10,964 shares)		10,276	12,491
	Common Stock (14,735 shares)		14,819	43,925
ForeSite Towers, LLC (Tower Leasing)	Equity Interests		7,620	8,878

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

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

		September 30, 2005		
		(unaudited)		
Private Finance Portfolio Company (in thousands, except number of shares)	Investment ⁽¹⁾⁽²⁾	Principal	Cost	Value
Global Communications, LLC (Business Services)	Loan (14.5%, Due 12/03 12/06) ⁽⁶⁾ Debt Securities (13.0%, Due 9/02 9/05) ⁽⁹⁾ Preferred Equity Interest Options	\$ 6,393 18,446	\$ 6,393 18,443 14,067 1,639	\$ 6,393 18,443 13,582
Gordian Group, Inc. (Business Services)	Loan (10.0%, Due 12/05 12/08) ⁽⁶⁾ Common Stock (1,000 shares)	11,392	11,425 6,542	4,622
Healthy Pet Corp. (Consumer Services)	Loans (14.6%, Due 8/10) Common Stock (25,766 shares)	42,249	42,059 25,766	42,059 25,766
HMT, Inc. (Energy Services)	Preferred Stock (554,052 shares) Common Stock (300,000 shares) Warrants		2,637 3,000 1,155	2,637 6,498 2,502
Impact Innovations Group, LLC (Business Services)	Equity Interests in Affiliate			841
Insight Pharmaceuticals Corporation (Consumer Products)	Loan (16.0%, Due 9/12) Preferred Stock (25,000 shares) Common Stock (6,200 shares)	58,159	57,914 25,000 6,325	57,914 25,433 245
Jakel, Inc. (Industrial Products)	Loan (15.5%, Due 3/08) ⁽⁶⁾ Debt Securities (15.5%, Due 3/08) ⁽⁶⁾ Preferred Stock (6,460 shares) Common Stock (158,061 shares)	5,412 8,330	5,412 8,330 6,460 9,347	
Legacy Partners Group, LLC (Financial Services)	Loan (14.0%, Due 5/09) ⁽⁶⁾ Debt Securities (18.0%, Due 5/09) ⁽⁶⁾ Equity Interests	7,646 2,952	7,646 2,952 2,729	4,982
Litterer Beteiligungs-GmbH ⁽⁴⁾ (Business Services)	Debt Securities (8.0%, Due 3/07) Equity Interest	632	632 1,756	632 1,958

Edgar Filing: ALLIED CAPITAL CORP - Form 10-Q

Maui Body Works, Inc. (Healthcare Services)	Common Stock (100 shares)		2,655	
Mercury Air Centers, Inc. (Business Services)	Senior Loan (10.0%, Due 4/09)	23,500	23,500	23,500
	Loan (16.0%, Due 4/09)	39,301	39,140	39,140
	Common Stock (57,068 shares)		33,723	32,013
	Standby Letters of Credit (\$1,397)			
MVL Group, Inc. (Business Services)	Loan (12.9%, Due 7/09)	41,829	41,403	41,403
	Debt Securities (14.4%, Due 7/09)	18,380	17,929	17,929
	Common Stock (648,661 shares)		643	3,401
Pennsylvania Avenue Investors, L.P. ⁽⁵⁾ (Private Equity Fund)	Equity Interests		2,477	2,065

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

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

September 30, 2005

(unaudited)

Private Finance Portfolio Company (in thousands, except number of shares)	Investment⁽¹⁾⁽²⁾	Principal	Cost	Value
Powell Plant Farms, Inc. (Consumer Products)	Loan (15.0%, Due 12/05) Debt Securities (20.0%, Due 6/03) ⁽⁶⁾ Preferred Stock (1,483 shares) Warrants	\$ 31,840 19,291	\$ 22,992 19,224	\$ 22,992 8,242
Redox Brands, Inc. (Consumer Products)	Preferred Stock (2,726,444 shares) Warrants		7,903 584	8,885 350
Service Champ, Inc. (Business Services)	Loan (15.5%, Due 4/12) Common Stock (63,888 Shares)	26,869	26,729 13,662	26,729 13,662
Staffing Partners Holding Company, Inc. (Business Services)	Loan (13.5%, Due 10/06) ⁽⁶⁾ Debt Securities (13.5%, Due 10/06) ⁽⁶⁾ Preferred Stock (439,600 shares) Common Stock (69,773 shares) Warrants	917 5,517	917 5,517 4,968 50 10	917 5,517 1,264
Startec Global Communications Corporation (Telecommunications)	Loan (10.0%, Due 5/07 5/09) Common Stock (19,180,000 shares)	25,226	25,226 37,255	25,226 694
STS Operating, Inc. (Industrial Products)	Loan (15.3%, Due 3/12) Common Stock (3,000,000 shares) Options	8,436	8,436 3,522	8,436 39,575 493
Triview Investments, Inc. ⁽⁸⁾ (Broadcasting & Cable/ Consumer Products)	Loan (15.0%, Due 7/12) Loans (16.8%, Due 7/08 7/12) ⁽⁶⁾ Common Stock (182 shares) Guaranty (\$800) Standby Letter of Credit (\$200)	31,000 19,600	30,845 19,520 86,693	30,845 19,520 22,023
Total companies more than 25% owned			\$ 1,510,082	\$ 1,612,914

Companies 5% to 25% Owned

Air Evac Lifeteam (Healthcare Services)	Debt Securities (13.6%, Due 7/10) Equity Interests	\$ 42,197	\$ 42,041 3,941	\$ 42,041 3,866
Aspen Pet Products, Inc. (Consumer Products)	Loan (19.0%, Due 6/08) Preferred Stock (2,877 shares) Common Stock (1,400 shares) Warrants	19,748	19,656 2,154 140	19,656 1,542
Becker Underwood, Inc. (Industrial Products)	Loan (14.5%, Due 8/12) Common Stock (5,073 shares)	23,489	23,390 5,813	23,390 3,600
The Debt Exchange Inc. (Business Services)	Preferred Stock (921,875 shares)		1,250	2,139

- (1) Interest rates represent the weighted average annual stated interest rate on loans and debt securities, which are presented by nature of indebtedness for a single issuer. The maturity dates represent the earliest and the latest maturity dates.
- (2) Common stock, preferred stock, warrants, options, and equity interests are generally non-income producing and restricted.
- (3) Public company.
- (4) Non-U.S. company or principal place of business outside the U.S.
- (5) Non-registered investment company.
- (6) Loan or debt security is on non-accrual status and therefore is considered non-income producing.
- (8) Triview Investments, Inc. (formerly GAC Investments, Inc.) holds investments in Longview Cable & Data, LLC (Broadcasting & Cable) with a cost of \$59.1 million and value of \$9.0 million and Triax Holdings, LLC (Consumer Products) with a cost of \$78.0 million and a value of \$63.4 million. The guaranty and standby letter of credit relate to Longview Cable & Data, LLC.

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

September 30, 2005

(unaudited)

Private Finance Portfolio Company (in thousands, except number of shares)	Investment⁽¹⁾⁽²⁾	Principal	Cost	Value
MedBridge Healthcare, LLC (Healthcare Services)	Loan (4.0%, Due 8/09) Loan (10.0%, Due 8/14) ⁽⁶⁾ Convertible Debenture (2.0%, Due 8/14) ⁽⁶⁾	\$ 7,035 4,412 2,970	\$ 7,035 4,412 984	\$ 7,035 2,268
Nexcel Synthetics, LLC (Consumer Products)	Loan (14.5%, Due 6/09) Equity Interests	10,522	10,492 1,708	10,492 953
Pres Air Trol LLC (Industrial Products)	Debt Securities (12.0%, Due 4/10) Equity Interests	6,180	5,863 1,356	5,863 318
Progressive International Corporation (Consumer Products)	Loan (16.0%, Due 12/09) Preferred Stock (500 shares) Common Stock (197 shares) Warrants	7,364	7,336 500 13	7,336 867 42
Soteria Imaging Services, LLC (Healthcare Services)	Loans (12.1%, Due 11/10) Equity Interests	11,906	10,834 2,153	10,834 2,264
Universal Environmental Services, LLC (Business Services)	Loan (15.5%, Due 2/09) Equity Interests	11,150	11,108 1,828	11,108 1,226
Total companies 5% to 25% owned			\$ 164,007	\$ 156,840
Companies Less Than 5% Owned				
Advanced Circuits, Inc. (Industrial Products)	Loans (11.3%, Due 9/11 3/12) Common Stock (40,000 shares)	\$ 19,000	\$ 18,906 1,000	\$ 18,906 1,000
Anthony, Inc. (Industrial Products)	Loans (12.7%, Due 9/11 9/12)	14,633	14,571	14,571
Benchmark Medical, Inc. (Healthcare Services)	Debt Securities (14.0%, Due 12/08) Warrants	13,823	13,773 18	13,773 18
BI Incorporated	Loan (14.0%, due 2/12)	16,121	16,048	16,048

Edgar Filing: ALLIED CAPITAL CORP - Form 10-Q

(Business Services)				
Border Foods, Inc. (Consumer Products)	Loan (13.0%, Due 12/10) ⁽⁶⁾	3,100	3,043	2,239
	Debt Securities (13.0%, Due 12/10) ⁽⁶⁾	10,329	9,681	7,121
	Preferred Stock (140,214 shares)		2,893	
	Common Stock (1,810 shares)		45	
	Warrants		910	
C&K Market, Inc. (Retail)	Loan (13.0%, due 12/08)	14,582	14,521	14,521
Callidus Debt Partners CDO Fund I, Ltd. ⁽⁴⁾ (Senior Debt CDO Fund)	Class C Notes (12.9%, Due 12/13)	18,800	18,979	18,979
	Class D Notes (17.0%, Due 12/13)	9,400	9,489	9,489
Callidus Debt Partners CLO Fund III, Ltd. ⁽⁴⁾ (Senior Debt CLO Fund)	Preferred Shares (23,600,000 shares)		24,271	24,271
Camden Partners Strategic Fund II, L.P. ⁽⁵⁾ (Private Equity Fund)	Limited Partnership Interest		2,142	2,674

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

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

		September 30, 2005		
		(unaudited)		
Private Finance Portfolio Company (in thousands, except number of shares)	Investment⁽¹⁾⁽²⁾	Principal	Cost	Value
Catterton Partners V, L.P. ⁽⁵⁾ (Private Equity Fund)	Limited Partnership Interest		\$ 2,871	\$ 2,767
CBS Personnel Holdings, Inc. (Business Services)	Loan (14.5%, Due 12/09)	\$ 20,486	20,405	20,405
Community Education Centers, Inc. (Education Services)	Loan (15.0%, Due 12/10)	32,275	32,154	32,154
Component Hardware Group, Inc. (Industrial Products)	Preferred Stock (18,000 shares) Common Stock (2,000 shares)		2,605 200	2,775 500
Cooper Natural Resources, Inc. (Industrial Products)	Debt Securities (0%, Due 11/07) Preferred Stock (6,316 shares) Warrants	1,005	1,005 1,424 830	1,005 20
Coverall North America, Inc. (Business Services)	Loans (14.6%, Due 2/11) Preferred Stock (6,500 shares) Warrants	27,132	27,082 6,500 2,950	27,082 6,758 3,500
Drilltec Patents & Technologies Company, Inc. (Energy Services)	Loan (10.0%, Due 8/06) ⁽⁶⁾ Debt Securities (16.5%, Due 8/06) ⁽⁶⁾	10,994 1,500	10,918 1,500	277
eCentury Capital Partners, L.P. ⁽⁵⁾ (Private Equity Fund)	Limited Partnership Interest		5,649	795
Elexis Beta GmbH ⁽⁴⁾ (Industrial Products)	Options		426	50
Frozen Specialties, Inc. (Consumer Products)	Warrants		435	530
Garden Ridge Corporation (Retail)	Loan (7.0%, Due 5/12) ⁽⁶⁾	22,500	22,500	16,935
Geotrace Technologies, Inc.	Debt Securities (12.0%, Due 6/09)	18,400	16,561	16,561

Edgar Filing: ALLIED CAPITAL CORP - Form 10-Q

(Energy Services)	Warrants		2,350	2,500
Ginsey Industries, Inc. (Consumer Products)	Loans (12.5%, Due 3/06)	3,896	3,896	3,896
Grant Broadcasting Systems II (Broadcasting & Cable)	Loan (5.0%, Due 6/09)	2,756	2,756	2,756
Grotech Partners, VI, L.P. ⁽⁵⁾ (Private Equity Fund)	Limited Partnership Interest		6,573	4,167
Havco Wood Products LLC (Industrial Products)	Loans (10.7%, Due 8/11) Equity Interests	39,000	37,755 1,048	37,755 1,048
Haven Eldercare of New England, LLC ⁽⁹⁾ (Healthcare Services)	Loans (9.3%, Due 10/05) ⁽⁶⁾	46,671	46,670	47,465
Haven Healthcare Management, LLC ⁽⁹⁾ (Healthcare Services)	Loan (18.0% Due 8/06) ⁽⁶⁾	5,541	5,541	2,000
HealthASPex Services Inc. (Business Services)	Loans (4.0%, Due 7/08)	500	500	500

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

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

		September 30, 2005		
		(unaudited)		
Private Finance Portfolio Company (in thousands, except number of shares)	Investment⁽¹⁾⁽²⁾	Principal	Cost	Value
The Hillman Companies, Inc. ⁽³⁾ (Consumer Products)	Loan (13.5%, Due 9/11)	\$ 43,754	\$ 43,561	\$ 43,561
Homax Holdings, Inc. (Consumer Products)	Debt Securities (12.0%, Due 8/11)	14,000	13,006	13,006
	Preferred Stock (89 shares)		89	88
	Common Stock (28 shares)		6	6
	Warrants		1,106	1,428
Icon International, Inc. (Business Services)	Common Stock (25,707 shares)		76	
Interline Brands, Inc. ⁽³⁾ (Business Services)	Common Stock (10,122 shares)		152	210
International Fiber Corporation (Industrial Products)	Loans (14.0%, Due 6/12)	21,436	21,348	21,348
	Preferred Stock (25,000 shares)		2,500	1,900
Line-X, Inc. (Consumer Products)	Loans (9.9% Due 8/11)	53,234	52,953	52,953
	Standby Letter of Credit (\$1,500)			
MedAssets, Inc. (Business Services)	Preferred Stock (227,865 shares)		2,049	2,850
	Warrants		136	136
Meineke Car Care Centers, Inc. (Business Services)	Senior Loan (7.4%, Due 6/11)	28,000	27,858	27,858
	Loans (11.9%, Due 6/12 6/13)	72,000	71,660	71,660
	Common Stock (10,696,308 shares) ⁽¹⁰⁾		26,985	26,985
	Warrants			
MHF Logistical Solutions, Inc. (Business Services)	Loan (10.0%, Due 5/11)	22,653	22,544	22,544
	Preferred Stock (431 shares)		431	431
	Common Stock (1,438 shares)		144	144
Mid-Atlantic Venture Fund IV, L.P. ⁽⁵⁾ (Private Equity Fund)	Limited Partnership Interest		6,600	3,477
Mogas Energy, LLC		17,005	15,587	15,587

Edgar Filing: ALLIED CAPITAL CORP - Form 10-Q

(Energy Services)	Debt Securities (9.5%, Due 3/12 4/12) Warrants		1,774	2,800
N.E.W. Customer Service Companies, Inc. (Business Services)	Loans (11.0%, Due 7/12)	40,000	40,018	40,018
Nobel Learning Communities, Inc. ⁽³⁾ (Education)	Preferred Stock (1,214,356 shares) Warrants		2,764 575	2,564 1,323
Norwesco, Inc. (Industrial Products)	Loan (12.6%, Due 1/12 7/12) Common Stock (573,561 shares) ⁽¹⁰⁾ Warrants	84,005	83,601 39,268	83,601 39,268
Novak Biddle Venture Partners III, L.P. ⁽⁵⁾ (Private Equity Fund)	Limited Partnership Interest		1,519	1,678
Oahu Waste Services, Inc. (Business Services)	Stock Appreciation Rights		239	780

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

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

		September 30, 2005		
		(unaudited)		
Private Finance Portfolio Company (in thousands, except number of shares)	Investment⁽¹⁾⁽²⁾	Principal	Cost	Value
Onyx Television GmbH ⁽⁴⁾ (Broadcasting & Cable)	Preferred Units		\$ 201	\$
Opinion Research Corporation ⁽³⁾ (Business Services)	Warrants		996	450
Oriental Trading Company, Inc. (Consumer Products)	Common Stock (13,820 shares)			5,200
Packaging Advantage Corporation (Business Services)	Debt Securities (18.5%, Due 7/06)	\$ 17,039	16,521	16,521
	Common Stock (232,168 shares)		2,386	1,003
	Warrants		963	405
Palm Coast Data, LLC (Business Services)	Senior Loan (7.3%, Due 8/10)	16,100	16,020	16,020
	Loan (15.5%, Due 8/12 8/15)	29,600	29,455	29,455
	Common Stock (21,743 shares) ⁽¹⁰⁾		21,743	21,743
	Warrants			
Performant Financial Corporation (Business Services)	Common Stock (478,816 shares)		734	2,500
Pro Mach, Inc. (Industrial Products)	Loan (13.8%, Due 6/12)	19,191	19,106	19,106
	Equity Interests		1,500	1,200
RadioVisa Corporation (Broadcasting & Cable)	Loan (15.5%, Due 12/08)	26,785	26,682	26,682
Red Hawk Industries, LLC (Business Services)	Loan (11.0%, Due 4/11)	41,624	41,407	41,407
Resun Leasing, Inc. (Business Services)	Loan (15.5%, Due 11/07)	30,000	30,000	30,000
S.B. Restaurant Company (Retail)	Debt Securities (15.0%, Due 11/08)	20,483	20,017	20,017
	Preferred Stock (54,125 shares)		135	135
	Warrants		619	619

Edgar Filing: ALLIED CAPITAL CORP - Form 10-Q

SBBUT, LLC (Consumer Products)	Equity Interests		52	52
Soff-Cut Holdings, Inc. (Industrial Products)	Preferred Stock (300 shares) Common Stock (2,000 shares)		300 200	300
SPP Mezzanine Fund, L.P. ⁽⁵⁾ (Private Equity Fund)	Limited Partnership Interest		2,470	2,373
Tradesmen International, Inc. (Business Services)	Debt Securities (12.0%, Due 12/09) Warrants	15,000	14,290 710	14,290 1,270
United Site Services, Inc. (Business Services)	Loan (11.9%, Due 8/11) Common Stock (160,588 shares)	49,712	49,492 1,000	49,492 1,000
Universal Tax Systems, Inc. (Business Services)	Loan (14.5%, Due 7/11)	18,947	18,870	18,870
Udata Venture Partners II, L.P. ⁽⁵⁾ (Private Equity Fund)	Limited Partnership Interest		5,471	5,223
Venturehouse-Cibernet Investors, LLC (Business Services)	Equity Interest		34	34

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

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

		September 30, 2005		
		(unaudited)		
Private Finance Portfolio Company (in thousands, except number of shares)	Investment⁽¹⁾⁽²⁾	Principal	Cost	Value
Venturehouse Group, LLC ⁽⁵⁾ (Private Equity Fund)	Equity Interest		\$ 598	\$ 395
VICORP Restaurants, Inc. ⁽³⁾ (Retail)	Warrants		33	758
Walker Investment Fund II, LLLP ⁽⁵⁾ (Private Equity Fund)	Limited Partnership Interest		1,330	695
Wear Me Apparel Corporation (Consumer Products)	Debt Securities (15.0%, Due 12/10) Warrants	\$ 45,000	43,878 1,219	43,878 1,520
Wilshire Restaurant Group, Inc. (Retail)	Debt Securities (20.0%, Due 6/07) ⁽⁶⁾ Warrants	19,107	18,566 735	18,566 660
Wilton Industries, Inc. (Consumer Products)	Loan (19.3%, Due 6/08)	4,800	4,800	4,800
Woodstream Corporation (Consumer Products)	Loans (13.0%, Due 11/12 5/13) Common Stock (180 shares) Warrants	52,188	52,037 673	52,037 3,231 2,269
Other companies	Other debt investments Other debt investments ⁽⁶⁾ Other equity investments ⁽³⁾ Guaranty (\$118)	651 474	651 474 59	651 349 40
Total companies less than 5% owned			\$ 1,338,370	\$ 1,311,231
Total private finance (118 portfolio companies)			\$ 3,012,459	\$ 3,080,985

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

maturity dates.

- (2) Common stock, preferred stock, warrants, options, and equity interests are generally non-income producing and restricted.
- (3) Public company.
- (4) Non-U.S. company or principal place of business outside the U.S.
- (5) Non-registered investment company.
- (6) Loan or debt security is on non-accrual status and therefore is considered non-income producing.

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

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

		September 30, 2005		
Interest Rate Ranges		Number of Loans	(unaudited) Cost Value	
Commercial Mortgage Loans				
Up to 6.99%		5	\$ 47,056	\$ 46,575
7.00% 8.99%		25	50,448	49,469
9.00% 10.99%		4	11,094	11,036
11.00% 12.99%		2	8,159	7,820
13.00% 14.99%		1	2,296	2,296
15.00% and above		2	3,970	3,970
Total commercial mortgage loans ⁽¹¹⁾		39	\$ 123,023	\$ 121,166
Real Estate Owned			\$ 14,147	\$ 15,088
Equity Interests⁽²⁾ Companies more than 25% owned (Guarantees \$7,054)			\$ 11,453	\$ 6,511
Total commercial real estate finance			\$ 148,623	\$ 142,765
Total portfolio			\$ 3,161,082	\$ 3,223,750

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

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

(3) Public company.

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

(5) Non-registered investment company.

(11) Commercial mortgage loans totaling \$20.7 million at value were on non-accrual status and therefore were considered non-income producing.

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

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

(Information at and for the three and nine months ended September 30, 2005 and 2004 is unaudited)

Note 1. Organization

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

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

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

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

Note 2. Summary of Significant Accounting Policies

Basis of Presentation

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

The accompanying unaudited consolidated financial statements of the Company have been prepared in accordance with U.S. generally accepted accounting principles (GAAP) for interim financial information. Accordingly, they do not include all of the information and footnotes required by GAAP for complete consolidated financial statements. In the opinion of management, the unaudited consolidated financial results of the Company included herein contain all adjustments (consisting of only normal recurring accruals) necessary to present fairly the financial position of the Company as of September 30, 2005, the results of operations for the three and nine months ended September 30, 2005 and 2004, and changes in net assets and cash flows for the nine months ended September 30, 2005 and 2004. The results of operations for the three and nine months ended September 30, 2005, are not necessarily indicative of the operating results to be expected for the full year.

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

Note 2. Summary of Significant Accounting Policies, continued

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

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

Valuation Of Portfolio Investments

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

Loans and Debt Securities

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

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

Note 2. Summary of Significant Accounting Policies, continued

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

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

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

Equity Securities

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

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

Dividend income on preferred equity securities is recorded as dividend income on an accrual basis to the extent that such amounts are expected to be collected and to the extent that the Company has the option to receive the dividend in cash. Dividend income on common equity

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

Note 2. Summary of Significant Accounting Policies, continued

securities is recorded on the record date for private companies or on the ex-dividend date for publicly traded companies.

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

On May 3, 2005, the Company completed the sale of its portfolio of CMBS bonds and CDO bonds and preferred shares. See Note 3.

Prior to the sale on May 3, 2005, CMBS bonds and CDO bonds and preferred shares were carried at fair value, which was based on a discounted cash flow model that utilized prepayment and loss assumptions based on historical experience and projected performance, economic factors, the characteristics of the underlying cash flow, and comparable yields for similar CMBS bonds and CDO bonds and preferred shares, when available. The Company recognized unrealized appreciation or depreciation on its CMBS bonds and CDO bonds and preferred shares as comparable yields in the market changed and/or based on changes in estimated cash flows resulting from changes in prepayment or loss assumptions in the underlying collateral pool. The Company determined the fair value of its CMBS bonds and CDO bonds and preferred shares on an individual security-by-security basis.

The Company recognized 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 were revised when there were changes in actual and estimated prepayment speeds or actual and estimated credit losses. Changes in estimated yield were 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 was changed.

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

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

Fee Income

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

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

Note 2. Summary of Significant Accounting Policies, continued

Guarantees

Guarantees meeting the characteristics described in FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others* (the Interpretation) and issued or modified after December 31, 2002, are recognized at fair value at inception. However, certain guarantees are excluded from the initial recognition provisions of the Interpretation.

Financing Costs

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

Cash and Cash Equivalents

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

Dividends to Shareholders

Dividends to shareholders are recorded on the record date.

Stock Compensation Plans

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

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

Note 2. Summary of Significant Accounting Policies, continued

Statement No. 123, *Accounting for Stock-Based Compensation*, to stock-based employee compensation for the three and nine months ended September 30, 2005 and 2004.

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2005	2004	2005	2004
(in thousands, except per share amounts)				
Net increase in net assets resulting from operations as reported	\$ 113,168	\$ 85,999	\$ 544,674	\$ 201,649
Less total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	(2,546)	(3,226)	(9,511)	(13,822)
Pro forma net increase in net assets resulting from operations	110,622	82,773	535,163	187,827
Less preferred stock dividends				(52)
Pro forma net income available to common shareholders	\$ 110,622	\$ 82,773	\$ 535,163	\$ 187,775
Basic earnings per common share:				
As reported	\$ 0.84	\$ 0.67	\$ 4.06	\$ 1.57
Pro forma	\$ 0.82	\$ 0.64	\$ 3.99	\$ 1.46
Diluted earnings per common share:				
As reported	\$ 0.82	\$ 0.66	\$ 3.99	\$ 1.53
Pro forma	\$ 0.80	\$ 0.63	\$ 3.92	\$ 1.43

Pro forma expenses are based on the underlying value of the options granted by the Company. The fair value of each option grant is estimated on the date of grant using the Black-Scholes option pricing model and expensed over the vesting period. The following weighted average assumptions were used to calculate the fair value of options granted during the three and nine months ended September 30, 2005 and 2004:

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2005	2004⁽¹⁾	2005	2004
Risk-free interest rate	4.1%		4.1%	2.9%
Expected life in years	5.0		5.0	5.0
Expected volatility	35.0%		35.1%	37.0%
Dividend yield	9.0%		9.0%	8.8%
Weighted average fair value per option	\$ 3.96		\$ 3.94	\$ 4.19

(1) There were no stock options granted during the three months ended September 30, 2004.

Federal and State Income Taxes and Excise Tax

The Company intends to comply with the requirements of the Internal Revenue Code (Code) that are applicable to regulated investment companies (RIC) and real estate investment trusts

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

Note 2. Summary of Significant Accounting Policies, continued

(REIT). The Company and its subsidiaries that qualify as a RIC or a REIT intend to distribute or retain through a deemed distribution all of their annual taxable income to shareholders; therefore, the Company has made no provision for regular corporate income taxes for these entities. AC Corp is a corporation subject to federal and state income taxes and records a benefit or expense for income taxes as appropriate.

If the Company does not distribute at least 98% of its annual taxable income in the year earned, the Company will generally be subject to a 4% excise tax on such income carried over for distribution in the following year. To the extent that the Company determines that its estimated current year annual taxable income will be in excess of estimated current year dividend distributions, the Company accrues excise taxes, if any, on estimated excess taxable income as taxable income is earned using an annual effective excise tax rate. The annual effective excise tax rate is determined by dividing the estimated annual excise tax by the estimated annual taxable income.

Per Share Information

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

Use of Estimates in the Preparation of Financial Statements

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

The consolidated financial statements include portfolio investments at value of \$3.2 billion and \$3.0 billion at September 30, 2005, and December 31, 2004, respectively. At September 30, 2005, and December 31, 2004, 93% and 92%, respectively, of the Company's total assets represented portfolio investments whose fair values have been determined by the Board of Directors in good faith in the absence of readily available market values. Because of the inherent uncertainty of valuation, the Board of Directors' determined values may differ significantly from the values that would have been used had a ready market existed for the investments, and the differences could be material.

Recent Accounting Pronouncements

In December 2004, the FASB issued Statement No. 123 (Revised 2004), *Share-Based Payment* (the Statement), which requires companies to recognize the grant-date fair value of stock options and other equity-based compensation issued to employees in the income statement. The Statement expresses no preference for a type of valuation model and was originally effective for most public companies' interim or annual periods beginning after June 15, 2005. In April 2005, the Securities and Exchange Commission issued a rule deferring the effective date to January 1, 2006. The scope of the Statement includes a wide range of share-based compensation arrangements including share options,

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

Note 2. Summary of Significant Accounting Policies, continued

restricted share plans, performance-based awards, share appreciation rights, and employee share purchase plans. The Statement replaces FASB Statement No. 123, *Accounting for Stock-Based Compensation*, and supersedes APB Opinion No. 25, *Accounting for Stock Issued to Employees*. The Company has not yet selected a valuation model to value its stock based awards or adopted accounting policies regarding the method of recognizing the fair value of awards over the requisite service period. As a result, the Company has not yet determined the effects of the Statement on its financial position and results of operations. See Note 2 Summary of Significant Accounting Policies Stock Compensation Plans.

Note 3. Portfolio*Private Finance*

At September 30, 2005, and December 31, 2004, the private finance portfolio consisted of the following:

	2005			2004		
	Cost	Value	Yield ⁽¹⁾	Cost	Value	Yield ⁽¹⁾
(\$ in thousands)						
Loans and debt securities ⁽²⁾	\$ 2,132,770	\$ 2,039,642	13.0%	\$ 1,679,855	\$ 1,602,869	13.9%
Equity securities	879,689	1,041,343		705,065	699,217	
Total	\$ 3,012,459	\$ 3,080,985		\$ 2,384,920	\$ 2,302,086	

(1) The weighted average yield on loans and debt securities is computed as the (a) annual stated interest plus the annual amortization of loan origination fees, original issue discount, and market discount on accruing loans and debt securities less the annual amortization of loan origination costs, divided by (b) total loans and debt securities at value. At September 30, 2005, and December 31, 2004, the cost and value of loans and debt securities include the Class A equity interests in BLX and the guaranteed dividend yield on these equity interests is included in interest income. The weighted average yield is computed as of the balance sheet date.

(2) The principal balance outstanding on loans and debt securities was \$2.2 billion and \$1.7 billion at September 30, 2005, and December 31, 2004, respectively. The difference between principal and cost is represented by unamortized loan origination fees and costs, original issue discounts, and market discounts totaling \$28.0 million and \$29.8 million at September 30, 2005, and December 31, 2004, respectively.

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

Private finance debt investments are generally structured as loans and debt securities that carry a relatively high fixed rate of interest, which may be combined with equity features, such as conversion privileges, or warrants or options to purchase a portion of the portfolio company's equity at a pre-determined strike price, which is generally a nominal price for warrants or options in a private company. The annual stated interest rate is only one factor in pricing the investment relative to the Company's rights and priority in the portfolio company's capital structure, and will vary depending on many factors, including if the Company has received nominal cost equity or other components of investment return, such as loan origination fees or market discount. The stated interest rate may include some component of contractual payment-in-kind interest, which represents contractual interest accrued and added to the

loan balance that generally becomes due at maturity. At

21

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

Note 3. Portfolio, continued

September 30, 2005, and December 31, 2004, approximately 87% and 94%, respectively, of the Company's loans and debt securities had fixed interest rates, with the remaining having variable interest rates. Variable interest rates are generally set as a spread over LIBOR. Loans and debt securities generally have a maturity of five to ten years, with interest-only payments in the early years and payments of both principal and interest in the later years, although debt maturities and principal amortization schedules vary.

Equity securities consist primarily of securities issued by private companies and may be subject to restrictions on their resale and are generally illiquid. The Company may incur costs associated with making buyout investments, such as legal, accounting and other professional fees associated with diligence, referral and investment banking fees, and other costs, which will be added to the cost basis of the Company's equity investment. Equity securities generally do not produce a current return, but are held with the potential for investment appreciation and ultimate gain on sale.

The Company's largest investments at value at September 30, 2005, and December 31, 2004, were in Advantage Sales & Marketing, Inc. (Advantage) and Business Loan Express, LLC (BLX).

In June 2004, the Company completed the purchase of a majority voting ownership in Advantage, which is subject to dilution by a management option pool. The Company's investment totaled \$257.7 million at cost and \$435.4 million at value at September 30, 2005, and \$258.7 million at cost and \$283.0 million at value at December 31, 2004. Advantage is a leading sales and marketing agency providing outsourced sales, merchandising, and marketing services to the consumer packaged goods industry. Advantage has offices across the United States and is headquartered in Irvine, CA.

Total interest and related portfolio income earned from the Company's investment in Advantage for the three and nine months ended September 30, 2005 and 2004, was as follows:

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2005	2004	2005	2004
(\$ in millions)				
Interest income	\$ 7.8	\$ 5.9	\$ 23.3	\$ 6.0
Fees and other income	1.8	1.5	4.9	4.4
Total interest and related portfolio income	\$ 9.6	\$ 7.4	\$ 28.2	\$ 10.4

Interest income from Advantage for the three and nine months ended September 30, 2005, included interest income of \$1.1 million and \$3.4 million, respectively, that was paid in kind. Interest income from Advantage for the three and nine months ended September 30, 2004, included interest income of \$1.1 million for both periods which was paid in kind. The interest paid in kind was paid to the Company through the issuance of additional debt.

Net change in unrealized appreciation or depreciation for the three and nine months ended September 30, 2005, included \$33.6 million and \$153.5 million, respectively, of unrealized appreciation related to the Company's investment in Advantage. Net change in unrealized appreciation or depreciation for the three and nine months ended September 30, 2004, did not include any change in unrealized appreciation or depreciation related to the Company's investment in Advantage.

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

Note 3. Portfolio, continued

The Company's investment in BLX totaled \$285.6 million at cost and \$356.3 million at value at September 30, 2005, and \$280.4 million at cost and \$335.2 million at value at December 31, 2004. BLX is a small business lender that participates in the U.S. Small Business Administration's 7(a) Guaranteed Loan Program. At September 30, 2005, and December 31, 2004, the Company owned 94.9% of the voting Class C equity interests. BLX has an equity appreciation rights plan for management which will dilute the value available to the Class C equity interest holders. BLX is headquartered in New York, NY.

Total interest and related portfolio income earned from the Company's investment in BLX for the three and nine months ended September 30, 2005 and 2004, was as follows:

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2005	2004	2005	2004
(\$ in millions)				
Interest income on subordinated debt and Class A equity interests	\$ 3.6	\$ 5.9	\$ 10.5	\$ 17.2
Dividend income on Class B equity interests	4.0	3.5	9.0	8.2
Fees and other income	2.3	2.8	7.0	9.7
 Total interest and related portfolio income	 \$ 9.9	 \$ 12.2	 \$ 26.5	 \$ 35.1

Interest and dividend income from BLX for the three and nine months ended September 30, 2005, included interest and dividend income of \$1.7 million and \$5.1 million, respectively, which was paid in kind. Interest and dividend income from BLX for the three and nine months ended September 30, 2004, included interest and dividend income of \$6.2 million and \$16.1 million, respectively, which was paid in kind. The interest and dividends paid in kind were paid to the Company through the issuance of additional debt or equity interests.

Net change in unrealized appreciation or depreciation included a net increase in unrealized appreciation on the Company's investment in BLX of \$14.6 million and \$15.9 million for the three and nine months ended September 30, 2005, respectively, and a net increase in unrealized appreciation of \$3.1 million and a net decrease in unrealized appreciation of \$6.2 million for the three and nine months ended September 30, 2004, respectively.

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

The Company had provided BLX with a \$20 million revolving credit facility for working capital which matured on June 30, 2005. At December 31, 2004, there were no amounts outstanding under this facility.

As a limited liability company, BLX's taxable income flows through directly to its members. BLX's annual taxable income generally differs from its book income for the fiscal year due to

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

Note 3. Portfolio, continued

temporary and permanent differences in the recognition of income and expenses. The Company holds all of BLX's Class A and Class B interests, and 94.9% of the Class C interests. BLX's taxable income is first allocated to the Class A interests to the extent that dividends are paid in cash or in kind on such interests, with the remainder being allocated to the Class B and Class C interests. BLX declares dividends on its Class B interests based on an estimate of its annual taxable income allocable to such interests.

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

While the Company has no obligation to pay the built-in gains tax until these assets are disposed of in the future, it may be necessary to record a liability for these taxes in the future should the Company intend to sell the assets of BLX within the 10-year period. The Company estimates that its future tax liability resulting from the built-in gains at the date of BLX's reorganization may total up to \$40 million. At September 30, 2005, and December 31, 2004, the Company considered the increase in fair value of its investment in BLX due to BLX's tax attributes as an LLC and has also considered the reduction in fair value of its investment due to these estimated built-in gain taxes in determining the fair value of its investment in BLX.

As the controlling equity owner of BLX, the Company has provided an unconditional guaranty to the BLX credit facility lenders in an amount equal to 50% of the total obligations (consisting of principal, letters of credit issued under the facility, accrued interest, and other fees) on BLX's three-year \$275.0 million revolving credit facility, which includes a sub-facility for the issuance of letters of credit for up to a total of \$50.0 million. The facility matures in January 2007. The amount guaranteed by the Company at September 30, 2005, was \$136.2 million. This guaranty can be called by the lenders only in the event of a default by BLX. BLX was in compliance with the terms of its credit facility at September 30, 2005. At September 30, 2005, the Company had also provided four standby letters of credit totaling \$35.6 million in connection with four term securitization transactions completed by BLX. In consideration for providing the guaranty and the standby letters of credit, BLX paid the Company fees of \$1.6 million for both the three months ended September 30, 2005 and 2004, and \$4.7 million and \$4.4 million for the nine months ended September 30, 2005 and 2004, respectively.

Other activities (at cost) in portfolio companies more than 25% owned, excluding changes in unrealized appreciation or depreciation, during the nine months ended September 30, 2005, included:

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

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

Note 3. Portfolio, continued

fundings of \$94.3 million on Callidus Capital Corporation's (Callidus) revolving line of credit related to its middle market underwriting and syndication facility, including \$52.5 million to fund a senior loan to Triax Holdings, LLC (see below). Callidus repaid borrowings under this facility totaling \$84.0 million during the nine months ended September 30, 2005, for a net increase in borrowings under the facility during the nine months ended September 30, 2005, of \$10.3 million. Outstanding borrowings under this facility were \$52.5 million and \$42.2 million at September 30, 2005, and December 31, 2004, respectively.

the repayment of the Company's debt and equity investment of \$12.8 million in Fairchild Industrial Products Company;

a partial repayment of \$14.6 million of the Company's investment in ForeSite Towers, LLC (ForeSite) as a result of the sale of a portion of ForeSite's assets during the second quarter of 2005 and an additional investment of \$3.5 million during the third quarter of 2005;

the contribution to capital of existing debt securities of GAC Investments, Inc. (GAC) with a cost basis of \$11.0 million, resulting in a decrease in the Company's debt cost basis and an increase in the Company's common stock cost basis in GAC during the first quarter of 2005. In addition, during the third quarter of 2005, the Company made an investment of \$27.6 million in the common stock of GAC to fund the purchase of Triax Holdings, LLC (Triax), a new subsidiary of GAC, and also made subordinated loans of \$50.4 million to Triax. Triax used the proceeds of the financing to acquire Tretinoin, the generic equivalent of a leading topical prescription acne medication, and other related assets, as well as to pay certain closing costs. Subsequent to September 30, 2005, Triax negotiated a purchase price adjustment of \$45 million that reduced Triax's purchase price. The proceeds from the \$45 million purchase price adjustment were used to repay a portion of the senior loan made by Callidus. Following GAC's investment in Triax, GAC changed its name to Triview Investments, Inc. (Triview);

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

the distribution of Diversified Group Administrators, Inc. from HealthASPex, Inc. (HealthASPex) to its shareholders (including the Company) and the redemption of the Company's equity interest in HealthASPex;

a debt and equity investment of \$67.8 million in Healthy Pet Corp.;

the repayment of the Company's debt and equity investment of \$15.9 million in Housecall Medical Resources, Inc.;

the repayment of the Company's debt investment of \$9.3 million in HMT, Inc.;

the repayment of the Company's \$66.1 million senior loan investment in Insight Pharmaceuticals Corporation (Insight) as a result of Insight's senior debt refinancing;

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

an additional \$27.4 million debt investment in MVL Group, Inc. to finance an acquisition;

fundings of \$7.7 million on Powell Plant Farms, Inc. s (Powell) revolving credit facility for working capital. Powell repaid borrowings under this facility totaling \$7.9 million, for net repayments under the facility during the nine months ended September 30, 2005, of \$0.2 million;

25

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

Note 3. Portfolio, continued

the sale of the assets out of bankruptcy of Norstan Apparel Shops, Inc. (Norstan), which resulted in a realized loss during the second quarter of 2005. During the first quarter of 2005, the Company appointed three members to Norstan s board of directors and had control of the board. Accordingly, the realized loss was included in the portfolio companies more than 25% owned category;

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

a debt and equity investment of \$40.4 million in Service Champ Inc.;

an additional investment of \$8.8 million in Startec Global Communications Corporation to finance an acquisition;
and

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

The Company paid a fee to Callidus of \$0.6 million in the second quarter of 2005 for the referral of Service Champ Inc. (Service Champ) and a fee of \$1.2 million in