

ALLIED CAPITAL CORP
Form 497
July 17, 2006

The information in this preliminary prospectus supplement is not complete and may be changed. A registration statement relating to these securities has been filed with and declared effective by the Securities and Exchange Commission. This preliminary prospectus supplement and the accompanying prospectus are not an offer to sell and are not soliciting offers to buy these securities in any state where such offer or sale is not permitted.

**Filed Pursuant to Rule 497
Registration Statement No. 333-132515**

**SUBJECT TO COMPLETION
PRELIMINARY PROSPECTUS SUPPLEMENT, DATED JULY 17, 2006**

**PROSPECTUS SUPPLEMENT
(To Prospectus dated April 27, 2006)**

4,500,000 Shares
Common Stock

We are offering 4,500,000 shares of our common stock, par value \$0.0001 per share. We will receive all of the net proceeds from the sale of our common stock.

Our common stock is traded on the New York Stock Exchange under the symbol ALD. The last reported sale price for our common stock on July 14, 2006, was \$28.88 per share.

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 that a prospective investor should know before investing in our common stock. We file annual, quarterly and current reports, proxy statements and other information about us with the Securities and Exchange Commission. This information is available free of charge by contacting us at 1919 Pennsylvania Avenue, NW, Washington, DC, 20006, or by telephone at (202) 721-6100 or on our website at www.alliedcapital.com. The information on this website is not incorporated by reference into this prospectus supplement and the accompanying prospectus. The SEC also maintains a website at www.sec.gov that contains such information.

Before buying any of these shares of our common stock, you should review the information, including the risk of leverage, set forth under Risk Factors on page 10 of the accompanying prospectus.

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.

	Per Share	Total
Public offering price	\$	\$
Underwriting discounts and commissions	\$	\$
Proceeds, before expenses, to us ⁽¹⁾	\$	\$

⁽¹⁾ Expenses payable by us are estimated to be approximately \$460,000.

The underwriters may also purchase from us up to an additional 675,000 shares of our common stock at the public offering price less the underwriting discounts and commissions, to cover over-allotments, if any, within 30 days of the date of this prospectus supplement.

The underwriters are offering the shares of our common stock as described in Underwriting. Delivery of the shares will be made on or about July , 2006.

Merrill Lynch & Co. *Joint Book-Running Managers* **Banc of America Securities LLC** **Citigroup**

Co-Managers

Lehman Brothers

SunTrust Robinson Humphrey

The date of this prospectus supplement is July , 2006

You should rely only on the information contained in this prospectus supplement and the accompanying prospectus. We have not, and the underwriters have 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 underwriters are 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 and results of operations may have changed since those dates. This prospectus supplement supersedes the accompanying prospectus to the extent it contains information that is different from or additional to the information in that prospectus.

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In this prospectus supplement and the accompanying prospectus, unless otherwise indicated, Allied Capital, Company, we, us or our refers 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 negative 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.

(i)

FEES AND EXPENSES

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

Shareholder Transaction Expenses	
Sales load (as a percentage of offering price) ⁽¹⁾	5.0%
Dividend reinvestment plan fees ⁽²⁾	None
Annual Expenses (as a percentage of consolidated net assets attributable to common stock)⁽³⁾	
Operating expenses ⁽⁴⁾	5.5%
Interest payments on borrowed funds ⁽⁵⁾	3.9%
Total annual expenses⁽⁶⁾⁽⁷⁾	9.4%

- (1) Represents the underwriting discounts and commissions with respect to the shares sold by us 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 or sales, 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), which at March 31, 2006, was \$2.7 billion.
- (4) Operating expenses represent our estimated operating expenses for the year ending December 31, 2006, excluding interest on indebtedness. Estimated operating expenses for the year ending December 31, 2006, exclude any expense related to option cancellation payments (OCP) described below under Recent Developments. This percentage for the year ended December 31, 2005, was 5.7%. See Management and Compensation of Executive Officers and Directors in the accompanying prospectus.
- (5) Interest payments on borrowed funds represents our estimated interest expense for the year ending December 31, 2006. We had outstanding borrowings of \$1.3 billion at March 31, 2006. This percentage for the year ended December 31, 2005, was 2.9%. 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 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 6.2% of consolidated total assets.
- (7) The holders of shares of our common stock (and not the holders of our debt securities or preferred stock, if any) indirectly bear the cost associated with our annual expenses.

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	\$ 140	\$ 317	\$ 490	\$ 904

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

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

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RECENT DEVELOPMENTS

At March 31, 2006, we had a \$772.5 million unsecured revolving line of credit. Effective May 22, 2006, we expanded the committed amount under the facility by \$150.0 million, which brought the total committed amount to \$922.5 million. The facility is now fully committed. The revolving line of credit expires on September 30, 2008.

On May 11, 2006, we amended the terms of the facility related to interest rates and certain reporting requirements. The interest rate spread was reduced from 1.30% to 1.05%. At our option, borrowings under the revolving line of credit will now generally bear interest at a rate equal to (i) LIBOR (for the period selected by us) plus 1.05% or (ii) the higher of the Federal Funds rate plus 0.50% or the Bank of America N.A. prime rate. The revolving line of credit continues to require the payment of an annual commitment fee equal to 0.20% of the committed amount (whether used or unused). The revolving line of credit generally requires payments of interest at the end of each LIBOR interest period, but no less frequently than quarterly, on LIBOR based loans, and monthly payments of interest on other loans. All principal is due upon maturity. At May 11, 2006, there was \$99.3 million in outstanding borrowings under the revolving line of credit.

The revolving credit facility continues to provide for a sub-facility for the issuance of letters of credit for up to an amount equal to 16.67% of the committed facility. The letter of credit fee will now be 1.05% per annum on letters of credit issued, which is payable quarterly. At May 11, 2006, there were \$39.8 million of standby letters of credit issued under the facility.

In connection with our 2006 Annual Meeting of Stockholders, the stockholders approved the issuance of up to 2,500,000 shares of our common stock in exchange for the cancellation of vested in-the-money stock options granted to certain officers and directors under the Amended Stock Option Plan. Under the initiative, which has been reviewed and approved by our Board of Directors, all optionees who hold vested stock options with exercise prices below the market value of the stock (or in-the-money options), would be offered the opportunity to receive cash and common stock in exchange for their voluntary cancellation of their vested stock options. The sum of the cash and common stock to be received by each optionee would equal the in-the-money value of the stock option cancelled. As part of this initiative, the Board of Directors is also considering the adoption of a target ownership structure that would establish minimum ownership levels for our senior officers and continue to further align the interests of our officers with those of our stockholders. Unlike the accounting treatment typically associated with a stock option exercise, the option cancellation payment (OCP) would be recorded as an expense for financial reporting purposes, and the expense may be significant. Based on the 13 million vested options outstanding and the market price of \$30.50 of our stock on March 10, 2006, the expense related to the OCP would be approximately \$106 million if all option holders choose to cancel all vested in-the-money options in exchange for the OCP. For income tax purposes, our tax expense resulting from the OCP would be similar to the tax expense that would result from an exercise of stock options in the market. Any tax deduction for us resulting from the OCP or an exercise of stock options in the market would be limited by Section 162(m) of the Code for persons subject to Section 162(m).

On June 22, 2006, the Securities and Exchange Commission declared our registration statement registering debt securities up to an aggregate principal amount of \$1 billion using the shelf registration process effective. We may raise new debt and equity capital from time to time in order to fund our investments and operations.

USE OF PROCEEDS

We estimate that our net proceeds from the sale of the 4,500,000 shares of common stock we are offering will be approximately \$123.0 million and approximately \$141.5 million, if the underwriters' over-allotment option is exercised in full, assuming a public offering price of \$28.88 per share (based on the last reported sale price of our common stock on July 14, 2006) and after deducting the underwriting discounts and commissions and estimated offering expenses payable by us. We may change the size of this offering based on demand and market conditions.

We expect to use the net proceeds from this offering to reduce borrowings under our revolving line of credit, to invest in debt or equity securities in primarily privately negotiated transactions, and for other general corporate purposes. Amounts repaid under our revolving line of credit will remain available for future borrowings. At July 14, 2006, the interest rate on our revolving line of credit was approximately 6.7% and there was approximately \$85.0 million outstanding. This revolving line of credit expires on September 30, 2008.

UNDERWRITING

Subject to the terms and conditions set forth in our underwriting agreement, we are offering the shares of our common stock described in this prospectus supplement through the underwriters named below. Merrill Lynch, Pierce, Fenner & Smith Incorporated, Banc of America Securities LLC and Citigroup Global Markets Inc. are acting as representatives. Each of the underwriters has severally agreed to purchase the number of shares of common stock listed next to its name in the following table:

Underwriters	Number of shares
Merrill Lynch, Pierce, Fenner & Smith Incorporated	
Banc of America Securities LLC	
Citigroup Global Markets Inc.	
Lehman Brothers Inc.	
SunTrust Capital Markets, Inc.	
Total	4,500,000

The underwriting agreement provides that the obligations of the underwriters to purchase the shares of common stock offered hereby are subject to certain conditions precedent and that the underwriters will purchase all of the shares of common stock offered by this prospectus supplement, other than those covered by the over-allotment option described below, if any of these shares are purchased.

The underwriters propose to offer the shares of common stock to the public at the public offering price set forth on the cover of this prospectus supplement and to dealers at a price that represents a concession not in excess of \$ _____ per share under the public offering price. The underwriters may allow, and these dealers may re-allow, a concession of not more than \$ _____ per share to other dealers. If all the shares are not sold at the public offering price, the underwriters may change the offering price and the other selling terms.

The underwriters have the option to purchase up to 675,000 additional shares of common stock from us at the same price they are paying for the 4,500,000 shares offered hereby. The underwriters may purchase additional shares only to cover over-allotments made in connection with this offering and only within 30 days after the date of this prospectus supplement. The underwriters will offer any additional shares that they purchase on the terms described in the preceding section.

The underwriting discounts and commissions per share are equal to the public offering price per share of common stock less the amount paid by the underwriters to us per share of common stock. The underwriting discounts and commissions are 5.0% of the public offering price. We have agreed to pay the underwriters the following discounts and commissions, assuming a public offering price of \$28.88 per share (based on the last reported sale price of our common stock on July 14, 2006). These amounts are shown assuming either no exercise or full exercise by the underwriters of the underwriters' over-allotment option:

	Total Fees		
	Fee Per Share	Without Exercise of Over-Allotment Option	With Full Exercise of Over-Allotment Option
Underwriting discounts and commissions	\$ 1.44	\$ 6,498,000	\$ 7,472,700

We estimate that the total expenses of this offering, which will be paid by us, excluding the underwriting discounts and commissions, will be approximately \$460,000.

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

We and certain of our executive officers have agreed not to offer, sell, contract to sell or otherwise dispose of, or to engage in certain hedging and derivative transactions with respect to, our common stock for a period of 60 days after the date of this prospectus supplement without first obtaining the written consent of Merrill Lynch, Pierce, Fenner & Smith Incorporated, Banc of America Securities LLC and Citigroup Global Markets Inc., except in limited circumstances, including our additional issuance of equity securities through privately negotiated transactions that may or may not involve an underwriter, whether or not registered with the SEC, aggregating not more than \$75 million. This consent may be given at any time without public notice.

The underwriters do not intend to confirm sales to any account over which they exercise discretionary authority.

In connection with this offering, the underwriters may purchase and sell shares of our common stock in the open market. These transactions may include stabilizing transactions, short sales and purchases to cover positions created by short sales and stabilizing transactions.

Short sales involve the sale by the underwriters of a greater number of shares than they are required to purchase in this offering. Covered short sales are sales made in an amount not greater than the underwriters' over-allotment option to purchase additional shares in this offering. The underwriters may close out any covered short position by either exercising their over-allotment option or purchasing shares in the open market. In determining the source of shares to close out the covered short position, the underwriters will consider, among other things, the price of shares available for purchase in the open market as compared to the price at which they may purchase shares through the over-allotment option.

Naked short sales are sales in excess of the over-allotment option. The underwriters must close out any naked short position by purchasing shares in the open market. A naked short position is more likely to be created if the underwriters are concerned there may be downward pressure on the price of shares in the open market prior to the completion of this offering.

Stabilizing transactions consist of various bids for or purchases of our common stock made by the underwriters in the open market prior to the completion of this offering.

The underwriters may impose a penalty bid. This occurs when a particular underwriter repays to the other underwriters a portion of the underwriting discount received by it because the representatives of the underwriters have repurchased shares sold by or for the account of that underwriter in stabilizing or short covering transactions.

Purchase to cover a short position and stabilizing transactions may have the effect of preventing or slowing a decline in the market price of our common stock. Additionally, these purchases, along with the imposition of a penalty bid, may stabilize, maintain or otherwise affect the market price for our common stock. As a result, the price of our common stock may be higher than the price that might otherwise exist in the open market. These transactions may be effected on the New York Stock Exchange, in the over-the-counter market or otherwise.

In the ordinary course of business certain of the underwriters or their affiliates have engaged and may in the future engage in various financing, commercial banking and investment banking services with, and provide financial advisory services to, us and our affiliates, for which they have received or may receive customary fees and expenses. Affiliates of Merrill Lynch, Pierce, Fenner & Smith Incorporated, Banc of America Securities LLC, Citigroup Global Markets Inc. and SunTrust Capital Markets, Inc. are members of the lending syndicate for our unsecured revolving line of credit and will receive proceeds of this offering by reason of the repayment of amounts outstanding thereunder.

Because more than 10% of the net proceeds of the offering may be received by members of the National Association of Securities Dealers, Inc. (NASD) participating in the offering or their affiliates, the offering is being conducted in accordance with NASD Conduct Rule 2710(h).

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

The principal business address of Merrill Lynch, Pierce, Fenner & Smith Incorporated is 4 World Financial Center, 250 Vesey Street, New York, NY 10080. The principal business address of Banc of America Securities LLC is 9 West 57th Street, New York, NY 10019. The principal business address of Citigroup Global Markets Inc. is 388 Greenwich Street, New York, NY 10013.

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 underwriters by Fried, Frank, Harris, Shriver & Jacobson LLP, Washington D.C.

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

The following analysis of the financial condition and results of operations of the Company should be read in conjunction with the Company's Consolidated Financial Statements and the Notes thereto included herein and in the Company's annual report on Form 10-K for the year ended December 31, 2005. In addition, this quarterly report on Form 10-Q contains certain forward-looking statements. These statements include the plans and objectives of management for future operations and financial objectives and can be identified by the use of forward-looking terminology such as may, will, expect, intend, anticipate, estimate, or continue or the negative thereof or 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 below in the Risk Factors section. Other factors that could cause actual results to differ materially include:

changes in the economy and general economic conditions;

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

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

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

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

OVERVIEW

As a business development company, we are in the private equity business. Specifically, we provide long-term debt and equity investment capital to companies in a variety of industries. Our lending and investment activity has generally been focused on private finance and commercial real estate finance, which included 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.

On May 3, 2005, we completed the sale of our portfolio of CMBS and real estate related CDO investments. Upon the completion of this transaction, our lending and investment activity has been focused primarily on private finance investments. Our private finance activity principally involves providing financing to middle market U.S. companies through privately negotiated long-term debt and equity investment capital. Our financing is generally used to fund growth, acquisitions, buyouts, recapitalizations, note purchases, bridge financings, and other types of financings. We generally invest in private companies though, from time to time, we may invest in companies that are public but lack

access to additional public capital. Our investment objective is to achieve current income and capital gains.

Our portfolio composition at March 31, 2006 and 2005, and December 31, 2005, was as follows:

	March 31,		December
	2006	2005	31, 2005
Private finance	96%	74%	96%
Commercial real estate finance	4%	26%	4%

Our earnings depend primarily on the level of interest and dividend income, fee and other income, and net realized and unrealized gains or losses on our investment portfolio after deducting interest expense on borrowed capital, operating expenses and income taxes including excise tax. Interest income results from the stated interest rate earned on a loan or debt security and the amortization of loan origination fees and discounts. The level of interest income is directly related to the balance of the interest-bearing investment portfolio outstanding during the period multiplied by the weighted average yield. Our ability to generate interest income is dependent on economic, regulatory, and competitive factors that influence new investment activity, interest rates on the types of loans we make, the level of repayments in the portfolio, the amount of loans and debt securities for which interest is not accruing and our ability to secure debt and equity capital for our investment activities.

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

PORTFOLIO AND INVESTMENT ACTIVITY

The total portfolio at value, investment activity, and the yield on interest-bearing investments at and for the three months ended March 31, 2006 and 2005, and at and for the year ended December 31, 2005, were as follows:

	At and for the Three Months Ended March 31,		At and for the Year Ended December 31,
	2006	2005	2005
	(\$ in millions)		
Portfolio at value	\$ 3,691.0	\$ 3,195.0	\$ 3,606.4
Investments funded ⁽¹⁾	\$ 797.9	\$ 265.6	\$ 1,675.8
Change in accrued or reinvested interest and dividends ⁽²⁾	\$ (2.1)	\$ 10.5	\$ 6.6
Principal collections related to investment repayments or sales	\$ 340.4	\$ 158.3	\$ 1,503.4
Yield on interest-bearing investments ⁽³⁾	12.3%	13.6%	12.8%

(1) Investments funded for the three months ended March 31, 2006, included a \$150 million subordinated debt investment in Advantage Sales & Marketing, Inc. received in conjunction with the sale of Advantage as discussed below.

(2) Includes a change in accrued or reinvested interest of \$1.1 million for the three months ended March 31, 2006, related to our investments in money market securities.

(3) The weighted average yield on interest-bearing investments is computed as the (a) annual stated interest plus the annual amortization of loan origination fees, original issue discount, and market discount on accruing

interest-bearing investments less the annual amortization of loan origination costs, divided by (b) total interest-bearing investments at value. The weighted average yield is computed as of the balance sheet date.

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Private Finance

The private finance portfolio at value, investment activity, and the yield on loans and debt securities at and for the three months ended March 31, 2006 and 2005, and at and for the year ended December 31, 2005, were as follows:

(\$ in millions)	At and for the Three Months Ended March 31,				At and for the Year Ended December 31, 2005	
	2006		2005		Value	Yield ⁽²⁾
	Value	Yield ⁽²⁾	Value	Yield ⁽²⁾		
Portfolio at value:						
Loans and debt securities:						
Senior loans	\$ 420.1	9.3%	\$ 253.5	8.6%	\$ 239.8	9.5%
Unitranche debt	362.7	11.1%	44.2	14.8%	294.2	11.4%
Subordinated debt	1,747.2	13.6%	1,258.7	14.9%	1,560.9	13.8%
Total loans and debt securities	\$ 2,530.0	12.5%	\$ 1,556.4	13.8%	\$ 2,094.9	13.0%
Equity securities	1,031.6		822.1		1,384.4	
Total portfolio	\$ 3,561.6		\$ 2,378.5		\$ 3,479.3	
Investments funded ⁽¹⁾	\$ 795.9		\$ 168.2		\$ 1,462.3	
Change in accrued or reinvested interest and dividends	\$ (4.2)		\$ 7.9		\$ 24.6	
Principal collections related to investment repayments or sales	\$ 336.6		\$ 151.2		\$ 703.9	

(1) Investments funded for the three months ended March 31, 2006, included a \$150 million subordinated debt investment in Advantage Sales & Marketing, Inc. received in conjunction with the sale of Advantage as discussed below.

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

Our investment activity is focused on making long-term investments in the debt and equity of primarily private middle market companies. Debt investments may include senior loans, unitranche debt (a single debt investment that is a blend of senior and subordinated debt), or subordinated debt (with or without equity features). The junior debt that we invest in that is lower in repayment priority than senior debt is also known as mezzanine debt. Equity investments may include a minority equity stake in connection with a debt investment or a substantial equity stake in connection with a buyout transaction. In a buyout transaction, we generally invest in senior and/or subordinated debt and equity (preferred and/or voting or non-voting common) where our equity ownership represents a significant portion of the equity, but may or may not represent a controlling interest.

In addition, we may fund most or all of the debt and equity capital upon the closing of certain buyout transactions, which may include investments in lower-yielding senior debt. Subsequent to the closing, the portfolio company may

refinance all or a portion of the lower-yielding senior debt, which would reduce our investment. Senior loans at March 31, 2006, included approximately \$200 million of senior loans that are currently in the process of being refinanced. Repayments include repayments of senior debt funded by us that was subsequently refinanced or repaid by the portfolio companies.

We intend to take a balanced approach to private equity investing that emphasizes a complementary mix of debt investments and buyout investments. The combination of these two types of investments provides current interest and related portfolio income and the potential for future capital gains. Recently, we believe many junior debt financing opportunities in the market have become less attractive from a risk/return perspective. To address the current market, our strategy is

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to focus on buyout and recapitalization transactions where we can manage risk through the structure and terms of our debt and equity investments and where we can potentially realize more attractive total returns from both current interest and fee income and future capital gains. We are also focusing our debt investing on smaller middle market companies where we can provide both senior and subordinated debt or unitranche debt, where our current yield may be lower than traditional subordinated debt only. We believe that providing both senior and subordinated debt or unitranche debt provides greater protection in the capital structures of our portfolio companies.

Investments Funded. Investments funded and the weighted average yield on investments funded for the three months ended March 31, 2006 and 2005, and for the year ended December 31, 2005, consisted of the following:

For the Three Months Ended March 31, 2006

	Debt Investments		Buyout Investments		Total	
	Amount	Weighted Average Yield ⁽¹⁾	Amount	Weighted Average Yield ⁽¹⁾	Amount	Weighted Average Yield ⁽¹⁾
(\$ in millions)						
Loans and debt securities:						
Senior loans	\$ 85.0	9.1%	\$ 117.8	8.9%	\$ 202.8	9.0%
Unitranche debt ⁽²⁾	75.0	10.6%			75.0	10.6%
Subordinated debt ⁽³⁾	279.3	12.5%	145.4	13.9%	424.7	13.0%
Total loans and debt securities	439.3	11.5%	263.2	11.6%	702.5	11.6%
Equity	24.6		68.8		93.4	
Total	\$ 463.9		\$ 332.0		\$ 795.9	

For the Three Months Ended March 31, 2005

	Debt Investments		Buyout Investments		Total	
	Amount	Weighted Average Yield ⁽¹⁾	Amount	Weighted Average Yield ⁽¹⁾	Amount	Weighted Average Yield ⁽¹⁾
(\$ in millions)						
Loans and debt securities:						
Senior loans	\$ 5.8	12.5%	\$ 48.1	5.4%	\$ 53.9	6.2%
Unitranche debt ⁽²⁾						
Subordinated debt	87.9	12.1%	11.9	15.5%	99.8	12.5%
Total loans and debt securities	93.7	12.2%	60.0	7.4%	153.7	10.3%
Equity	11.5		3.0		14.5	
Total	\$ 105.2		\$ 63.0		\$ 168.2	

- (1) The weighted average yield on interest-bearing investments is computed as the (a) annual stated interest on accruing interest-bearing investments, divided by (b) total interest-bearing investments funded.
- (2) Unitranche debt is a single debt investment that is a blend of senior and subordinated debt terms. The yield on a unitranche investment reflects the blended yield of senior and subordinated debt combined.
- (3) Debt investments for the three months ended March 31, 2006, included a \$150 million, 12.0% subordinated debt investment in Advantage Sales & Marketing, Inc. received in conjunction with the sale of Advantage as discussed below.
- (4) Buyout senior loans funded included \$174.9 million that was repaid during the year.

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For the Year Ended December 31, 2005

	Debt Investments		Buyout Investments		Total	
	Amount	Weighted Average Yield ⁽¹⁾	Amount	Weighted Average Yield ⁽¹⁾	Amount	Weighted Average Yield ⁽¹⁾
(\$ in millions)						
Loans and debt securities:						
Senior loans ⁽⁴⁾	\$ 76.8	10.0%	\$ 250.2	6.4%	\$ 327.0	7.2%
Unitranche debt ⁽²⁾	259.5	10.5%			259.5	10.5%
Subordinated debt	296.9	12.3%	330.9	12.5%	627.8	12.4%
Total loans and debt securities	633.2	11.3%	581.1	9.9%	1,214.3	10.6%
Equity	82.5		165.5		248.0	
Total	\$ 715.7		\$ 746.6		\$ 1,462.3	

- (1) The weighted average yield on interest-bearing investments is computed as the (a) annual stated interest on accruing interest-bearing investments, divided by (b) total interest-bearing investments funded.
- (2) Unitranche debt is a single debt investment that is a blend of senior and subordinated debt terms. The yield on a unitranche investment reflects the blended yield of senior and subordinated debt combined.
- (3) Debt investments for the three months ended March 31, 2006, included a \$150 million, 12.0% subordinated debt investment in Advantage Sales & Marketing, Inc. received in conjunction with the sale of Advantage as discussed below.

- (4) Buyout senior loans funded included \$174.9 million that was repaid during the year. In April 2006, we funded private finance investments totaling \$254.9 million.

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

The level of investment activity for investments funded and principal repayments for private finance investments can vary substantially from period to period depending on the number and size of investments that we make or that we exit and many other factors, including the amount of debt and equity capital available to middle market companies, the level of merger and acquisition activity for such companies, the general economic environment, and the competitive environment for the types of investments we make. We believe that merger and acquisition activity in the middle market is strong, which has resulted in an increase in private finance investment opportunities, as well as increased repayments. We continue to have an active pipeline of new investments under consideration. We believe that merger and acquisition activity for middle market companies will remain strong in 2006.

Portfolio Yield. The yield on private finance loans and debt securities was 12.5% at March 31, 2006, as compared to 13.8% and 13.0% at March 31, 2005, and December 31, 2005, respectively. The weighted average yield on the private finance loans and debt securities may fluctuate from period to period depending on the yield on new loans and debt securities funded, the yield on loans and debt securities repaid, the amount of loans and debt securities for which interest is not accruing and the amount of lower-yielding senior or unitranche debt in the portfolio at the end of the period. The yield on the private finance portfolio has declined partly due to our strategy to pursue more buyout and recapitalization transactions, which may include investing in lower-yielding senior debt, as well as pursue unitranche investments.

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Outstanding Investment Commitments. At March 31, 2006, we had outstanding private finance investment commitments totaling \$316.3 million, including the following:

\$33.3 million in the form of debt to Promo Works, LLC.

\$30.0 million in the form of debt to Business Loan Express, LLC.

\$29.9 million in the form of equity to eleven private equity and venture capital funds.

\$14.0 million in the form of debt to S.B. Restaurant Company.

\$14.0 million in the form of debt to Integrity Interactive Corp.

\$9.6 million in the form of debt to 3SI Security Systems Inc.

\$8.3 million in the form of debt to Hot Stuff Foods, LLC.

\$7.8 million in the form of debt to Mercury Air Centers, Inc.

\$6.5 million in co-investment commitments to Pine Creek Equity Partners, LLC.

We have various commitments to Callidus Capital Corporation (Callidus), which owns 80% (subject to dilution) of Callidus Capital Management, LLC, an asset management company that structures and manages collateralized debt obligations (CDOs), collateralized loan obligations (CLOs), and other related investments. Our commitment to Callidus consisted of the following at March 31, 2006:

(\$ in millions)	Committed Amount	Amount Drawn	Amount Available to be Drawn
Subordinated debt to support warehouse facilities & warehousing activities ⁽¹⁾	\$ 40.0	\$	\$ 40.0
Revolving line of credit for working capital	4.0	3.8	0.2
Revolving line of credit facility to support warehousing activities ⁽²⁾	50.0	3.7	46.3
Total	\$ 94.0	\$ 7.5	\$ 86.5

(1) Callidus has a secured warehouse credit facility with a third party for up to \$400 million. The facility is used primarily to finance the acquisition of loans pending securitization through a CDO or CLO. In conjunction with this warehouse credit facility, we have agreed to designate our \$40 million subordinated debt commitment for Callidus to draw upon to provide first loss capital as needed to support the warehouse facility.

(2) This facility supports Callidus purchase of middle market senior loans pending the sale of such loans to its warehouse credit facilities.

In addition, at March 31, 2006, we had a commitment to Callidus to purchase preferred equity in future CLO transactions of \$32.4 million.

In addition to these outstanding investment commitments at March 31, 2006, we may be required to fund additional amounts under earn-out arrangements primarily related to buyout transactions in the future if those companies meet agreed-upon performance targets. We also had commitments to private finance portfolio companies in the form of standby letters of credit and guarantees totaling \$184.7 million. See Financial Condition, Liquidity and Capital Resources.

Our largest investment at value at March 31, 2006, was in Business Loan Express, LLC and our largest investments at value at December 31, 2005, were in Advantage Sales & Marketing, Inc. (Advantage) and Business Loan Express, LLC (BLX).

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Business Loan Express, LLC. At March 31, 2006, our investment in BLX totaled \$291.3 million at cost and \$326.2 million at value, or 7.9% of our total assets, which includes unrealized appreciation of \$35.0 million. We acquired BLX in 2000.

Total interest and related portfolio income earned from the Company's investment in BLX for the three months ended March 31, 2006 and 2005, was as follows:

	2006	2005
(\$ in millions)		
Interest income	\$ 3.9	\$ 3.4
Dividend income		2.0
Fees and other income	2.2	2.4
 Total interest and related portfolio income	 \$ 6.1	 \$ 7.8

Interest and dividend income from BLX for the three months ended March 31, 2006 and 2005, included interest and dividend income of \$1.8 million and \$1.6 million, respectively, which was paid in kind. The interest and dividends paid in kind were paid to us through the issuance of additional debt or equity interests. Accrued interest and dividends receivable and other assets at March 31, 2006, included accrued interest and fees due from BLX totaling \$3.4 million, of which \$2.2 million was paid in cash in the second quarter of 2006.

Net change in unrealized appreciation or depreciation included a net decrease in unrealized appreciation on our investment in BLX of \$22.7 million and \$6.3 million for the three months ended March 31, 2006 and 2005, respectively. See Results of Operations for a discussion of the net change in unrealized appreciation or depreciation related to this investment.

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

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

We had a commitment to BLX of \$30.0 million in the form of a subordinated revolving credit facility to provide working capital to the company that expired on April 30, 2006. There were no amounts outstanding under this facility at March 31, 2006.

At December 31, 2005, BLX had a three-year \$275.0 million revolving credit facility provided by third party lenders that was scheduled to mature in January 2007. As the controlling equity owner in BLX, we had provided an unconditional guaranty to the revolving credit facility lenders in an amount equal to 50% of the total obligations (consisting of principal, letters of credit issued under the facility, accrued interest, and other fees) of BLX under the revolving credit facility. At December 31, 2005, the principal amount of loans outstanding on the revolving credit facility was \$228.2 million and

letters of credit issued under the facility were \$41.7 million. The total obligation guaranteed by us at December 31, 2005, was \$135.4 million.

On March 17, 2006, BLX closed on a new three-year \$500.0 million revolving credit facility that matures in March 2009, which replaced the existing facility. The revolving credit facility may be expanded through new or additional commitments up to \$600.0 million at BLX's option. This new facility provides for a sub-facility for the issuance of letters of credit for up to an amount equal to 25% of the committed facility. We have provided an unconditional guaranty to these revolving credit facility lenders in an amount equal to 50% of the total obligations (consisting of principal, letters of credit issued under the facility, accrued interest, and other fees) of BLX under this facility. At March 31, 2006, the principal amount outstanding on the revolving credit facility was \$240.2 million and letters of credit issued under the facility were \$41.7 million. The total obligation guaranteed by us at March 31, 2006, was \$141.1 million. This guaranty can be called by the lenders only in the event of a default under the BLX credit facility, which includes certain defaults under our revolving credit facility. BLX was in compliance with the terms of this facility at March 31, 2006. At March 31, 2006, we had also provided four standby letters of credit totaling \$34.1 million in connection with four term securitization transactions completed by BLX.

Advantage Sales & Marketing, Inc. At December 31, 2005, our investment in Advantage totaled \$257.7 million at cost and \$660.4 million at value, or 16.4% of our total assets, which included unrealized appreciation of \$402.7 million. We completed the purchase of a majority ownership in Advantage in June 2004.

On March 29, 2006, we sold our majority equity interest in Advantage. We were repaid our \$184 million in subordinated debt outstanding and realized a gain on our equity investment sold of \$433.1 million, subject to post-closing adjustments. As consideration for the common stock sold in the transaction, we received a \$150 million subordinated note, with the balance of the consideration paid in cash. Approximately \$34 million of our cash proceeds from the sale of the common stock have been held in escrow, subject to certain holdback provisions. In addition, there is potential for us to receive additional consideration through an earn-out payment that would be based on Advantage's 2006 audited results. Our realized gain of \$433.1 million excludes any earn-out amounts. For tax purposes, the receipt of the \$150 million subordinated note as part of our consideration for the common stock sold will allow us, through installment treatment, to defer the recognition of taxable income for a portion of our realized gain until the note is collected. In connection with the transaction, we retained an equity investment in the business valued at \$15 million as a minority shareholder.

Total interest and related portfolio income earned from our investment in Advantage while we held a majority equity interest for the three months ended March 31, 2006 and 2005, was as follows:

	2006	2005
(\$ in millions)		
Interest income	\$ 7.3	\$ 7.7
Loan prepayment premiums	5.0	
Fees and other income	1.8	1.5
 Total interest and related portfolio income	 \$ 14.1	 \$ 9.2

In addition, we earned structuring fees of \$2.3 million on our new \$150 million subordinated debt investment in Advantage upon the closing of the sale transaction.

After the completion of the sale transaction, our investment in Advantage at March 31, 2006, which was composed of subordinated debt and a minority equity interest, totaled \$151.3 million at cost and \$164.3 million at value, which included unrealized appreciation of \$13.0 million. Subsequent

to the completion of the sale transaction, we estimate that our interest income from our subordinated debt investment in Advantage will be approximately \$4.5 million per quarter.

Advantage is a 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.

STS Operating, Inc. On May 1, 2006, we announced the completion of the sale of STS Operating, Inc. (STS). We were repaid our \$6.8 million in subordinated debt outstanding and we realized a gain on the sale of our common stock in STS of approximately \$94 million, subject to post-closing adjustments. The cost basis of our equity was \$3.5 million. As part of the consideration for the sale of our equity, we received a \$30 million subordinated note. Approximately \$10.7 million of our proceeds are subject to certain holdback provisions and post-closing adjustments. For tax purposes, the receipt of the \$30 million subordinated note as part of our consideration for the common stock sold will allow us, through installment treatment, to defer the recognition of taxable income for a portion of our realized gain until the note is collected.

Commercial Real Estate Finance

The commercial real estate finance portfolio at value, investment activity, and the yield on interest-bearing investments at and for the three months ended March 31, 2006 and 2005, and at and for the year ended December 31, 2005, were as follows:

(\$ in millions)	At and for the Three Months Ended March 31,				At and for the Year Ended December 31,	
	2006		2005		2005	
	Value	Yield ⁽¹⁾	Value	Yield ⁽¹⁾	Value	Yield ⁽¹⁾
Portfolio at value:						
CMBS bonds	\$		\$ 466.1	13.0%	\$	
CDO bonds and preferred shares			227.1	15.8%		
Commercial mortgage loans	102.7	7.6%	89.7	6.4%	102.6	7.6%
Real estate owned	15.0		18.4		13.9	
Equity interests	11.7		15.2		10.6	
Total portfolio	\$ 129.4		\$ 816.5		\$ 127.1	
Investments funded	\$ 2.0		\$ 97.4		\$ 213.5	
Change in accrued or reinvested interest	\$ 1.0		\$ 2.6		\$ (18.0)	
Principal collections related to investment repayments or sales ⁽²⁾	\$ 3.8		\$ 7.1		\$ 799.5	

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

(2) Principal collections related to investment repayments or sales for the year ended December 31, 2005, included \$718.1 million related to the sale of our CMBS and CDO portfolio in May 2005.

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Our commercial real estate investments funded for the three months ended March 31, 2006 and 2005, and for the year ended December 31, 2005, was as follows:

(\$ in millions)	Face Amount	Discount	Amount Funded
<i>For the Three Months Ended March 31, 2006</i>			
Commercial mortgage loans	\$ 0.6	\$	\$ 0.6
Equity interests	1.4		1.4
Total	\$ 2.0	\$	\$ 2.0
<i>For the Three Months Ended March 31, 2005</i>			
CMBS bonds (3 new issuances) ⁽¹⁾	\$ 160.6	\$ (67.4)	\$ 93.2
Commercial mortgage loans	4.1	(0.7)	3.4
Equity interests	0.8		0.8
Total	\$ 165.5	\$ (68.1)	\$ 97.4
<i>For the Year Ended December 31, 2005</i>			
CMBS bonds (4 new issuances) ⁽¹⁾	\$ 211.5	\$ (90.5)	\$ 121.0
Commercial mortgage loans	88.5	(0.8)	87.7
Equity interests	4.8		4.8
Total	\$ 304.8	\$ (91.3)	\$ 213.5

⁽¹⁾ The CMBS bonds invested in during 2005 were sold on May 3, 2005.

At March 31, 2006, we had outstanding funding commitments related to commercial mortgage loans and equity interests of \$13.6 million and commitments in the form of standby letters of credit and guarantees related to equity interests of \$7.0 million.

Sale of CMBS Bonds and Collateralized Debt Obligation Bonds and Preferred Shares. On May 3, 2005, we completed the sale of our portfolio of commercial mortgage-backed securities (CMBS) and real estate related collateralized debt obligation (CDO) bonds and preferred shares to affiliates of Caisse de dépôt et placement du Québec (the Caisse) for cash proceeds of \$976.0 million and a net realized gain of \$227.7 million, after transaction and other costs of \$7.8 million, in the second quarter of 2005. Transaction costs included investment banking fees, legal and other professional fees, and other transaction costs. The CMBS and CDO assets sold had a cost basis at closing of \$739.8 million, including accrued interest of \$21.7 million. Upon the closing of the sale, we settled all the hedge positions relating to these assets, which resulted in a net realized loss of \$0.7 million, which was included in the net realized gain on the sale.

Simultaneous with the sale of our CMBS and CDO portfolio, we entered into a platform assets purchase agreement with CWC Capital Investments LLC, an affiliate of the Caisse (CWC Capital), pursuant to which we agreed to sell certain commercial real estate related assets, including servicer advances, intellectual property, software and other platform assets, subject to certain adjustments. Under this agreement, we have agreed not to invest in CMBS and real estate-related CDOs and refrain from certain other real estate-related investing or servicing activities for a period of three years, or through May 2008, subject to certain limitations and excluding our existing portfolio and related activities.

The real estate securities purchase agreement, under which we sold the CMBS and CDO portfolio, and the platform asset purchase agreement contain customary representations and warranties, and require us to indemnify the affiliates of the Caisse that are parties to the agreements for certain liabilities arising under the agreements, subject to certain limitations and conditions.

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Hedging Activities

We have invested in commercial mortgage loans, which were purchased at prices that were based in part on comparable Treasury rates. We have entered into transactions with one or more financial institutions to hedge against movement in Treasury rates on certain of these commercial mortgage loans. These transactions, referred to as short sales, involve receiving the proceeds from the short sales of borrowed Treasury securities, with the obligation to replenish the borrowed Treasury securities at a later date based on the then current market price, whatever that price may be. Risks in these contracts arise from movements in the value of the borrowed Treasury securities due to changes in interest rates and from the possible inability of counterparties to meet the terms of their contracts. If the value of the borrowed Treasury securities increases, we will incur losses on these transactions. These losses are limited to the increase in value of the borrowed Treasury securities; conversely, the value of the hedged commercial mortgage loans would likely increase. If the value of the borrowed Treasury securities decreases, we will incur gains on these transactions which are limited to the decline in value of the borrowed Treasury securities; conversely, the value of the hedged commercial mortgage loans 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 \$17.5 million and \$17.7 million at March 31, 2006, and December 31, 2005, respectively. The net proceeds related to the sales of the borrowed Treasury securities plus or minus the additional cash collateral provided or received under the terms of the transactions were \$17.5 million and \$17.7 million at March 31, 2006, and December 31, 2005, respectively. The amount of the hedge will vary from period to period depending upon the amount of commercial mortgage loans that we own and have hedged as of the balance sheet date.

Portfolio Asset Quality

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

At March 31, 2006, and December 31, 2005, our portfolio was graded as follows:

Grade	2006		2005	
	Portfolio at Value	Percentage of Total Portfolio	Portfolio at Value	Percentage of Total Portfolio
(\$ in millions)				
1	\$ 1,287.9	34.9%	\$ 1,643.0	45.6%
2	2,183.2	59.2	1,730.8	48.0
3	89.1	2.4	149.1	4.1
4	64.5	1.7	26.5	0.7
5	66.3	1.8	57.0	1.6
	\$ 3,691.0	100.0%	\$ 3,606.4	100.0%

Grade 1 portfolio assets decreased from \$1.6 billion at December 31, 2005, to \$1.3 billion at March 31, 2006, primarily as a result of the sale of Advantage Sales & Marketing, Inc. (Advantage) on March 29, 2006. Advantage had a value of \$660.4 million, including \$402.7 million of unrealized appreciation, at December 31, 2005. Our investment in Advantage after the sale transaction was

\$164.3 million at value, including \$13.0 million of unrealized appreciation, at March 31, 2006, and was included in Grade 1 assets. See Portfolio and Investment Activity above for further discussion. Grade 2 portfolio assets increased from \$1.7 billion at December 31, 2005, to \$2.2 billion at March 31, 2006, primarily as a result of the level of new investments made during the first quarter of 2006, as new investments generally enter the portfolio as Grade 2 assets.

Total Grade 3, 4 and 5 portfolio assets were \$219.9 million and \$232.6 million, respectively, or were 5.9% and 6.4%, respectively, of the total portfolio at value at March 31, 2006, and December 31, 2005.

Grade 4 and 5 assets include loans, debt securities, and equity securities. We expect that a number of portfolio companies will be in the Grades 4 or 5 categories from time to time. Part of the private equity business is working with troubled portfolio companies to improve their businesses and protect our investment. The number of portfolio companies and related investment amount included in Grade 4 and 5 may fluctuate from period to period. We continue to follow our historical practice of working with such companies in order to recover the maximum amount of our investment.

Loans and Debt Securities on Non-Accrual Status. At March 31, 2006, and December 31, 2005, loans and debt securities at value not accruing interest for the total investment portfolio were as follows:

	2006	2005
(\$ in millions)		
Loans and debt securities in workout status (classified as Grade 4 or 5) ⁽¹⁾		
Private finance		
Companies more than 25% owned	\$ 29.0	\$ 15.6
Companies 5% to 25% owned	5.6	
Companies less than 5% owned	51.8	11.4
Commercial real estate finance	12.6	12.9
Loans and debt securities not in workout status		
Private finance		
Companies more than 25% owned	40.6	58.0
Companies 5% to 25% owned	5.1	0.5
Companies less than 5% owned	4.4	49.5
Commercial real estate finance	8.6	7.9
Total	\$ 157.7	\$ 155.8
Percentage of total portfolio	4.3%	4.3%

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

Loans and Debt Securities Over 90 Days Delinquent. Loans and debt securities greater than 90 days delinquent at value at March 31, 2006, and December 31, 2005, were as follows:

	2006	2005
(\$ in millions)		
Private finance	\$ 82.6	\$ 74.6
Commercial mortgage loans	6.0	6.1
Total	\$ 88.6	\$ 80.7

Percentage of total portfolio

2.4%

2.2%

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In general, interest is not accrued on loans and debt securities if we have doubt about interest collection or where the enterprise value of the portfolio company may not support further accrual. In addition, interest may not accrue on loans to portfolio companies that are more than 50% owned by us depending on such company's capital requirements. To the extent interest payments are received on a loan that is not accruing interest, we may use such payments to reduce our cost basis in the investment in lieu of recognizing interest income.

As a result of these and other factors, the amount of the portfolio that is greater than 90 days delinquent or on non-accrual status may vary from period to period. Loans and debt securities on non-accrual status and over 90 days delinquent should not be added together as they are two separate measures of portfolio asset quality. Loans and debt securities that are in both categories (i.e., on non-accrual status and over 90 days delinquent) totaled \$88.6 million and \$60.7 million at March 31, 2006, and December 31, 2005, respectively.

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RESULTS OF OPERATIONS**Comparison of Three Months Ended March 31, 2006 and 2005**

The following table summarizes the Company's operating results for the three months ended March 31, 2006 and 2005.

(\$ in thousands, except per share amounts)	For the Three Months Ended March 31,		Change	Percentage Change
	2006	2005		
	(unaudited)			
Interest and Related Portfolio Income				
Interest and dividends	\$ 88,881	\$ 84,945	3,936	5%
Loan prepayment premiums	5,286	1,677	3,609	215%
Fees and other income	16,844	8,297	8,547	103%
Total interest and related portfolio income	111,011	94,919	16,092	17%
Expenses				
Interest	24,300	20,225	4,075	20%
Employee	21,428	15,456	5,972	39%
Stock options	3,606		3,606	100%
Administrative	11,519	20,754	(9,235)	(44)%
Total operating expenses	60,853	56,435	4,418	8%
Net investment income before income taxes	50,158	38,484	11,674	30%
Income tax expense (benefit), including excise tax	8,858	(268)	9,126	**
Net investment income	41,300	38,752	2,548	7%
Net Realized and Unrealized Gains (Losses)				
Net realized gains	432,835	10,285	422,550	*
Net change in unrealized appreciation or depreciation	(374,548)	70,584	(445,132)	*
Total net gains	58,287	80,869	(22,582)	*
Net income	\$ 99,587	\$ 119,621	(20,034)	(17)%
Diluted earnings per common share	\$ 0.70	\$ 0.88	(0.18)	(20)%
Weighted average common shares outstanding diluted	141,738	135,579	6,159	5%

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

** Percentage change is not meaningful.

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

Interest and Dividends. Interest and dividend income for the three months ended March 31, 2006 and 2005, was composed of the following:

	2006	2005
(\$ in millions)		
Interest		
Private finance loans and debt securities	\$ 82.6	\$ 56.8
CMBS and CDO portfolio		22.1
Commercial mortgage loans	2.8	1.5
Cash and cash equivalents and other	2.9	0.4
Total interest	88.3	80.8
Dividends		
	0.6	4.1
Total interest and dividends	\$ 88.9	\$ 84.9

Our interest income from our private finance loans and debt securities has increased period over period as a result of the growth in this portfolio since March 31, 2005, as shown below. In addition, during the first quarter of 2006, we resumed accruing interest for certain private finance portfolio companies. Such additional interest income totaled \$3.8 million for the three months ended March 31, 2006.

There was no interest income from the CMBS and CDO portfolio in the first quarter of 2006 as we sold this portfolio on May 3, 2005. The CMBS and CDO portfolio sold had a cost basis of \$718.1 million and a weighted average yield on the cost basis of the portfolio of approximately 13.8%. We generally reinvested the principal proceeds from the CMBS and CDO portfolio into our private finance portfolio.

The level of interest income, which includes interest paid in cash and in kind, is directly related to the balance of the interest-bearing investment portfolio outstanding during the period multiplied by the weighted average yield. The interest-bearing investments in the portfolio at value and the weighted average yield on the interest-bearing investments in the portfolio at March 31, 2006 and 2005, were as follows:

	2006		2005	
	Value	Weighted Average Yield ⁽¹⁾	Value	Weighted Average Yield ⁽¹⁾
(\$ in millions)				
Private finance loans and debt securities	\$ 2,530.0	12.5%	\$ 1,556.4	13.8%
CMBS and CDO portfolio			693.2	13.9%
Commercial mortgage loans	102.7	7.6%	89.7	6.4%
Total	\$ 2,632.7	12.3%	\$ 2,339.3	13.6%

⁽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. The weighted average yield is computed as of the balance sheet date.

The private finance portfolio yield at March 31, 2006, of 12.5% as compared to the private finance portfolio yield of 13.8% at March 31, 2005, reflects the mix of debt investments in the private finance portfolio. The weighted average yield varies from period to period based on the current stated

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interest on interest-bearing investments and the amount of loans and debt securities for which interest is not accruing. See the discussion of the private finance portfolio yield above under the caption Private Finance.

Dividend income results from the dividend yield on preferred equity interests, if any, or the declaration of dividends by a portfolio company on preferred or common equity interests. Dividend income will vary from period to period depending upon the timing and amount of dividends that are declared or paid by a portfolio company on preferred or common equity interests. Dividend income for the three months ended March 31, 2006 and 2005, included \$0 and \$2.0 million, respectively, of dividends from BLX on the Class B equity interests held by us, which were paid in cash.

Loan Prepayment Premiums. Loan prepayment premiums were \$5.3 million and \$1.7 million for the three months ended March 31, 2006 and 2005, respectively. Loan prepayment premiums for the three months ended March 31, 2006, included \$5.0 million related to the repayment of our subordinated debt in connection with the sale of our majority equity interest in Advantage. See Portfolio and Investment Activity above for further discussion. While the scheduled maturities of private finance and commercial real estate loans generally range from five to ten years, it is not unusual for our borrowers to refinance or pay off their debts to us ahead of schedule. Therefore, we generally structure our loans to require a prepayment premium for the first three to five years of the loan. Accordingly, the amount of prepayment premiums will vary depending on the level of repayments and the age of the loans at the time of repayment.

Fees and Other Income. Fees and other income primarily include fees related to financial structuring, diligence, transaction services, management and consulting services to portfolio companies, guarantees, and other 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, but is not limited to, management and consulting services related to corporate finance, marketing, human resources, personnel and board member recruiting, business operations, corporate governance, risk management and other general business matters.

Fees and other income for the three months ended March 31, 2006 and 2005, included fees relating to the following:

	2006	2005
(\$ in millions)		
Structuring and diligence	\$ 11.0	\$ 1.3
Transaction and other services provided to portfolio companies	0.1	1.2
Management, consulting and other services provided to portfolio companies and guaranty fees	5.7	4.8
Other income		1.0
Total fees and other income	\$ 16.8	\$ 8.3

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 of investment activity and types of services provided. Loan origination fees that represent yield enhancement on a loan are capitalized and amortized into interest income over the life of the loan.

Structuring and diligence fees for the three months ended March 31, 2006, included structuring fees from Advantage Sales and Marketing, CR Brands, Hot Stuff Foods, and 3SI Security Systems totaling \$8.1 million. Structuring and diligence fees may vary substantially from period to period based on the level of new investment originations and the market rates for these types of fees. Private finance investments funded were \$795.9 million for the three months ended March 31, 2006, as compared to \$168.2 million for the three months ended March 31, 2005.

Management fees for the three months ended March 31, 2006, included \$1.8 million in management fees from Advantage prior to its sale on March 29, 2006. See Portfolio and Investment Activity above for further discussion.

Fees and other income related to the CMBS and CDO portfolio for the three months ended March 31, 2005, were \$1.7 million. As noted above, we sold our CMBS and CDO portfolio on May 3, 2005.

BLX and Advantage. BLX was our largest investment at value at March 31, 2006, and represented 7.9% of our total assets. Advantage and BLX were our largest investments at March 31, 2005, and together represented 19.5% of our total assets.

Total interest and related portfolio income from these investments for the three months ended March 31, 2005 and 2006, was as follows:

	2006	2005
(\$ in millions)		
Advantage ⁽¹⁾	\$ 14.1	\$ 9.2
BLX	\$ 6.1	\$ 7.8

⁽¹⁾ Includes income from the period we held a majority equity interest only. See Portfolio and Investment Activity above for further discussion.

Operating Expenses. Operating expenses include interest, employee, and administrative expenses.

Interest Expense. The fluctuations in interest expense during the three months ended March 31, 2006 and 2005, were primarily attributable to changes in the level of our borrowings under various notes payable and debentures and our revolving line of credit. Our borrowing activity and weighted average cost of debt, including fees and closing costs, at and for the three months ended March 31, 2006 and 2005, were as follows:

	At and for the Three Months Ended March 31,	
	2006	2005
(\$ in millions)		
Total outstanding debt	\$ 1,274.2	\$ 1,296.4
Average outstanding debt	\$ 1,491.5	\$ 1,125.0
Weighted average cost ⁽¹⁾	6.5%	6.4%

⁽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 on the balance sheet date.

In addition, interest expense includes interest on our obligations to replenish borrowed Treasury securities related to our hedging activities of \$0.2 million and \$0.5 million for the three months ended March 31, 2006 and 2005, respectively.

Employee Expense. Employee expenses for the three months ended March 31, 2006 and 2005, were as follows:

	2006	2005
(\$ in millions)		
Salaries and employee benefits ⁽¹⁾	\$ 17.3	\$ 12.0
Individual performance award (IPA)	1.7	1.9
IPA mark to market expense (benefit)	1.0	0.1
Individual performance bonus (IPB)	1.4	1.5
Total employee expense	\$ 21.4	\$ 15.5
Number of employees at end of period	155	158

⁽¹⁾ Salaries and employee benefits included accrued bonuses of \$7.9 million and \$3.7 million for the three months ended March 31, 2006 and 2005, respectively.

The change in salaries and employee benefits reflects the effect of wage increases and the change in mix of employees given their area of responsibility and relevant experience level. Salaries and employee benefits expense has generally increased due to changes in the composition of our employee resources and compensation increases.

The Individual Performance Award (IPA) is a long-term incentive compensation program for certain officers. The IPA, which is generally determined annually at the beginning of each year, is deposited into a deferred compensation trust generally in four equal installments, on a quarterly basis, in the form of cash. The accounts of the trust are consolidated with our accounts. We are required to mark to market the liability of the trust and this adjustment is recorded to the IPA compensation expense. Because the IPA is deferred compensation, the cost of this award is not a current expense for purposes of computing our taxable income. The expense is deferred for tax purposes until distributions are made from the trust.

As a result of changes in regulation by the Jobs Creation Act of 2004 associated with deferred compensation arrangements, as well as an increase in the competitive market for recruiting talent in the private equity industry, the Compensation Committee and the Board of Directors determined that for 2005 and 2006 a portion of the IPA should be replaced with an individual performance bonus (IPB). The IPB is distributed in cash to award recipients in equal bi-weekly installments (beginning in February of each respective year) as long as the recipient remains employed by us.

The Compensation Committee and the Board of Directors have determined the IPA and the IPB for 2006. We currently estimate the IPA and IPB to be approximately \$8.1 million each; however, the Compensation Committee may adjust the IPA or IPB as needed, or make new awards as new officers are hired. If a recipient terminates employment during the year, any further cash contribution for the IPA or remaining cash payments under the IPB would be forfeited.

In connection with our 2006 Annual Meeting of Stockholders, the stockholders are being requested to vote to approve the issuance of up to 2,500,000 shares of our common stock in exchange for the cancellation of vested in-the-money stock options granted to certain officers and directors under the Amended Stock Option Plan. Under the initiative, which has been reviewed and approved by our Board of Directors, all optionees who hold vested stock options with exercise prices below the market value of the stock (or in-the-money options), would be offered the opportunity to receive cash and common stock in exchange for their voluntary cancellation of their vested stock options. The sum of the cash and common stock to be received by each optionee would equal the in-the-money value of the stock option cancelled. As part of this initiative, the Board of Directors is also considering the adoption of a target ownership structure that would establish minimum ownership levels for our senior officers and continue to further align the interests of our officers with those of our stockholders. Unlike the accounting treatment typically associated with a stock option exercise, the

option cancellation payment (OCP) would be recorded as an expense for financial reporting purposes, and the expense may be significant. Based on the 13 million vested options outstanding and the market price of \$30.50 of our stock on March 10, 2006, the expense related to the OCP would be approximately \$106 million if all option holders choose to cancel all vested in-the-money options in exchange for the OCP. For income tax purposes, our tax expense resulting from the OCP would be similar to the tax expense that would result from an exercise of stock options in the market. Any tax deduction for us resulting from the OCP or an exercise of stock options in the market would be limited by Section 162(m) of the Code for persons subject to Section 162(m).

Employee Stock Options Expense. 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 was effective January 1, 2006, and it applies to our stock option plan. Our stock options are typically granted with ratable vesting provisions, and we amortize the compensation cost over the service period. With respect to options granted prior to January 1, 2006, we have used the modified prospective method for adoption of the Statement. Under this method, the unamortized cost of previously awarded options that were unvested as of January 1, 2006, is recognized over the service period in the statement of operations beginning in 2006. With respect to options granted on or after January 1, 2006, compensation cost is recognized in the statement of operations over the service period. The effect of this adoption for the three months ended March 31, 2006, was employee-related stock option expense of \$3.6 million, which included \$3.4 million related to previously awarded options that were unvested as of January 1, 2006, and \$0.2 million related to options granted during the three months ended March 31, 2006.

We estimate that the stock option expense that will be recorded in our statement of operations under the Statement, will be approximately \$14.3 million, \$9.3 million, and \$2.8 million for the years ended December 31, 2006, 2007, and 2008, respectively, which includes stock option expense related to options granted in the first quarter of 2006 of approximately \$0.8 million, \$0.5 million, and \$0.2 million, respectively. This estimate may change if the Company's assumptions related to future option forfeitures change. This estimate does not include any expense related to future stock option grants as the fair value of those stock options will be determined at the time of grant.

Administrative Expense. Administrative expenses include legal and accounting fees, valuation assistance fees, insurance premiums, the cost of leases for our headquarters in Washington, DC, and our regional offices, portfolio origination and development expenses, stock record expenses, directors' fees, and various other expenses. Administrative expenses for the three months ended March 31, 2006 and 2005, were as follows:

	2006	2005
(\$ in millions)		
Administrative expenses, excluding investigation related costs	\$ 8.6	\$ 8.5
Investigation related costs	2.9	12.3
Total administrative expenses	\$ 11.5	\$ 20.8

Investigation related costs include costs associated with requests for information in connection with two government investigations. These expenses remain difficult to predict. See Note 14 to the Consolidated Financial Statements.

Income Tax Expense (Benefit), Including Excise Tax. Income tax expense (benefit) for the three months ended March 31, 2006 and 2005, were as follows:

	2006	2005
(\$ in millions)		
Income tax expense (benefit)	\$ 0.5	\$ (0.3)
Excise tax expense	8.4	
Income tax expense (benefit), including excise tax	\$ 8.9	\$ (0.3)

Our wholly owned subsidiary, A.C. Corporation, is a corporation subject to federal and state income taxes and records a benefit or expense for income taxes as appropriate based on its operating results in a given period. In addition, our estimated annual taxable income for 2006 currently exceeds our estimated dividend distributions to shareholders from such taxable income in 2006, and such estimated excess taxable income will be distributed in 2007. Therefore, we will be required to pay a 4% excise tax on the excess of 98% of our taxable income over the amount of actual distributions from such taxable income. Accordingly, we have accrued an estimated excise tax of \$8.4 million for the three months ended March 31, 2006, based upon our estimated excess taxable income earned for that period. See Financial Condition, Liquidity and Capital Resources.

Realized Gains and Losses. Net realized gains primarily result from the sale of equity securities associated with certain private finance investments, the sale of CMBS bonds and CDO bonds and preferred shares, and the realization of unamortized discount resulting from the sale and early repayment of private finance loans and commercial mortgage loans, offset by losses on investments. Net realized gains for the three months ended March 31, 2006 and 2005, were as follows:

	For the Three Months Ended March 31,	
	2006	2005
(\$ in millions)		
Realized gains	\$ 436.5	\$ 14.7
Realized losses	(3.7)	(4.4)
Net realized gains	\$ 432.8	\$ 10.3

When we exit an investment and realize a gain or loss, we make an accounting entry to reverse any unrealized appreciation or depreciation, respectively, we had previously recorded to reflect the appreciated or depreciated value of the investment. For the three months ended March 31, 2006 and 2005, we reversed previously recorded unrealized appreciation or depreciation when gains or losses were realized as follows:

	For the Three Months Ended March 31,	
(\$ in millions)	2006	2005
Reversal of previously recorded unrealized appreciation associated with realized gains	\$ (393.6)	\$ (9.9)

Reversal of previously recorded unrealized depreciation associated with realized losses	2.7	4.8
Total reversal	\$ (390.9)	\$ (5.1)

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Realized gains for the three months ended March 31, 2006 and 2005, were as follows:
(\$ in millions)

2006		
Portfolio Company	Amount	
Private Finance:		
Advantage Sales & Marketing, Inc.	\$ 433.1	
Nobel Learning Communities, Inc.	1.5	
The Debt Exchange Inc.	1.1	
Other	0.2	
Total private finance	435.9	
Commercial Real Estate:		
Other	0.6	
Total commercial real estate	0.6	
Total gross realized gains	\$ 436.5	

2005		
Portfolio Company	Amount	
Private Finance:		
Polaris Pool Systems, Inc.	\$ 7.4	
U.S. Security Holdings, Inc.	3.3	
Oriental Trading Company, Inc.	1.0	
Woodstream Corporation	0.9	
DCS Business Services, Inc.	0.7	
Other	0.9	
Total private finance	14.2	
Commercial Real Estate:		
Other	0.5	
Total commercial real estate	0.5	
Total gross realized gains	\$ 14.7	

Realized losses for the three months ended March 31, 2006 and 2005, were as follows:
(\$ in millions)

2006

Portfolio Company	Amount
Private Finance:	
Aspen Pet Products, Inc.	\$ 1.5
Nobel Learning Communities, Inc.	1.4
Other	0.5
Total private finance	3.4
Commercial Real Estate:	
Other	0.3
Total commercial real estate	0.3
Total gross realized losses	\$ 3.7

2005

Portfolio Company	Amount
Private Finance:	
Alderwoods Group, Inc.	\$ 0.8
Other	0.3
Total private finance	1.1
Commercial Real Estate:	
Other	3.3
Total commercial real estate	3.3
Total gross realized losses	\$ 4.4

Change in Unrealized Appreciation or Depreciation. We determine the value of each investment in our portfolio on a quarterly basis, and changes in value result in unrealized appreciation or depreciation being recognized in our statement of operations. Value, as defined in Section 2(a)(41) of the Investment Company Act of 1940, is (i) the market price for those securities for which a market quotation is readily available and (ii) for all other securities and assets, fair value is as determined in good faith by the Board of Directors. Since there is typically no readily available market value for the investments in our portfolio, we value substantially all of our portfolio investments at fair value as determined in good faith by the Board of Directors pursuant to our valuation policy and a consistently applied valuation process. At March 31, 2006, portfolio investments recorded at fair value were approximately 90% of our total assets. Because of the inherent uncertainty of determining the fair value of investments that do not have a readily available market value, the fair value of our investments determined in good faith by the Board of Directors may differ significantly from the values that would have been used had a ready market existed for the investments, and the differences could be material.

There is no single standard for determining fair value in good faith. As a result, determining fair value requires that judgment be applied to the specific facts and circumstances of each portfolio investment while employing a consistently applied valuation process for the types of investments we make. Unlike banks, we are not permitted to provide a general reserve for anticipated loan losses. Instead, we are required to specifically value each individual investment on a quarterly basis. We will

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record unrealized depreciation on investments when we believe that an investment has become impaired, including where collection of a loan or realization of an equity security is doubtful, or when the enterprise value of the portfolio company does not currently support the cost of our debt or equity investment. Enterprise value means the entire value of the company to a potential buyer, including the sum of the values of debt and equity securities used to capitalize the enterprise at a point in time. We will record unrealized appreciation if we believe that the underlying portfolio company has appreciated in value and/or our equity security has also appreciated in value. Changes in fair value are recorded in the statement of operations as net change in unrealized appreciation or depreciation.

As a business development company, we have invested in illiquid securities including debt and equity securities of companies. The structure of each 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 may be subject to certain restrictions on resale and generally have no established trading market. Because of the type of investments that we make and the nature of our business, our valuation process requires an analysis of various factors. Our fair value methodology includes the examination of, among other things, the underlying investment performance, financial condition, and market changing events that impact valuation.

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

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

In determining a multiple to use for valuation purposes, we generally look to private merger and acquisition statistics, discounted public trading multiples or industry practices. In estimating a reasonable multiple, we consider not only the fact that our portfolio company may be a private company relative to a peer group of public comparables, but we also consider the size and scope of our portfolio company and its specific strengths and weaknesses. In some cases, the best valuation

methodology may be a discounted cash flow analysis based on future projections. If a portfolio company is distressed, a liquidation analysis may provide the best indication of enterprise value.

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

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

We will continue to work with third-party consultants to obtain assistance in determining fair value for a portion of the private finance portfolio each quarter. We work with these consultants to obtain assistance as additional support in the preparation of our internal valuation analysis for a portion of the portfolio each quarter. In addition, we may receive third-party assessments of a particular private finance portfolio company's value in the ordinary course of business, most often in the context of a prospective sale transaction or in the context of a bankruptcy process. The valuation analysis prepared by management using these third-party valuation resources, when applicable, is submitted to our Board of Directors for its determination of fair value of the portfolio in good faith.

For the three months ended March 31, 2006 and 2005, we received third-party valuation assistance from Duff & Phelps, LLC (Duff & Phelps) and Houlihan Lokey Howard and Zukin (Houlihan Lokey) for our private finance portfolio as follows:

	2006	2005
Number of private finance portfolio companies reviewed:		
Duff & Phelps ⁽¹⁾	76	35
Houlihan Lokey	2	1
Total number of private finance portfolio companies reviewed	78	36
Percentage of private finance portfolio reviewed at value:		
Duff & Phelps ⁽¹⁾	82.2%	59.6%
Houlihan Lokey	4.8%	14.9%
Percentage of private finance portfolio reviewed at value	87.0%	74.5%

⁽¹⁾ During the third quarter of 2005, S&P Corporate Value Consulting merged with Duff & Phelps, LLC, a financial advisory and investment banking firm. The merged company operates under the name of Duff & Phelps, LLC.

Professional fees for third-party valuation assistance were \$1.4 million for the year ended December 31, 2005, and are estimated to be approximately \$1.5 million for 2006.

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

Net Change in Unrealized Appreciation or Depreciation. Net change in unrealized appreciation or depreciation for the three months ended March 31, 2006 and 2005, consisted of the following:

(\$ in millions)	2006 ⁽¹⁾	2005 ⁽¹⁾
Net unrealized appreciation or depreciation	\$ 16.4	\$ 75.7
Reversal of previously recorded unrealized appreciation associated with realized gains	(393.6)	(9.9)
Reversal of previously recorded unrealized depreciation associated with realized losses	2.7	4.8
Net change in unrealized appreciation or depreciation	\$ (374.5)	\$ 70.6

⁽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.

At March 31, 2006, our largest investment was in BLX. The following is a summary of the methodology that we used to determine the fair value of this investment.

Business Loan Express, LLC. To determine the value of our investment in BLX at March 31, 2006, we performed four separate valuation analyses to determine a range of values: (1) analysis of comparable public company trading multiples, (2) analysis of BLX's value assuming an initial public offering, (3) analysis of merger and acquisition transactions for financial services companies, and (4) a discounted dividend analysis. We received valuation assistance from Duff & Phelps for our investment in BLX at March 31, 2006, and December 31, 2005.

With respect to the analysis of comparable public company trading multiples and the analysis of BLX's value assuming an initial public offering, we compute a median trailing and forward price earnings multiple to apply to BLX's pro-forma net income adjusted for certain capital structure changes that we believe would likely occur should the company be sold. Each quarter we evaluate which public commercial finance companies should be included in the comparable group. The comparable group at March 31, 2006, was made up of CIT Group, Inc., Financial Federal Corporation, GATX Corporation, and Marlin Business Services Corporation, which is consistent with the comparable group at December 31, 2005.

Our investment in BLX at March 31, 2006, was valued at \$326.2 million. This fair value was within the range of values determined by the four valuation analyses. Unrealized appreciation on our investment was \$35.0 million at March 31, 2006. We decreased unrealized appreciation in the first quarter of 2006 by \$22.7 million from December 31, 2005. This decrease resulted from a reduction in enterprise value at March 31, 2006, of approximately 4% as compared to the enterprise value at December 31, 2005. BLX has experienced higher loan prepayments in

recent months, which BLX

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management believes is due to a robust economy and increased competition from banks, and as a result, BLX management has scaled back their projected loan originations as a result of this more competitive lending environment.

Per Share Amounts. All per share amounts included in the Management's Discussion and Analysis of Financial Condition and Results of Operations section have been computed using the weighted average common shares used to compute diluted earnings per share, which were 141.7 million and 135.6 million for the three months ended March 31, 2006 and 2005, 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 net capital gains, to the extent that such taxable income or gains are distributed, or deemed to be distributed, to shareholders on a timely basis.

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

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

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

FINANCIAL CONDITION, LIQUIDITY AND CAPITAL RESOURCES

Dividends and Distributions

Dividends to common shareholders for the three months ended March 31, 2006 and 2005, were \$82.5 million and \$76.1 million, respectively, or \$0.59 per common share for the first quarter of 2006 and \$0.57 per common share for the first quarter of 2005. An extra cash dividend of \$0.03 per common share was declared during 2005 and was paid to shareholders on January 27, 2006.

The Board of Directors has declared a dividend of \$0.60 per common share for the second quarter of 2006.

Dividends are generally determined based upon an estimate of annual taxable income and the amount of taxable income carried over from the prior year for distribution in the current year. Taxable income includes our taxable interest, dividend and fee income, as well as taxable net capital gains. As discussed above, taxable income generally differs from net income for financial reporting purposes due to temporary and permanent differences in the recognition of income and expenses, and generally excludes net unrealized appreciation or depreciation, as gains or losses are not included in taxable income until they are realized. Taxable income includes non-cash income, such as changes in accrued and reinvested interest and dividends and the amortization of discounts and fees. Cash collections of income resulting from contractual payment-in-kind interest or the amortization of discounts and fees generally occur upon the repayment of the loans or debt securities that include such items. Non-cash taxable income is reduced by non-cash expenses, such as realized losses and depreciation and amortization expense.

Our Board of Directors reviews the dividend rate quarterly, and may adjust the quarterly dividend throughout the year. Dividends are declared based upon our estimate of annual taxable income available for distribution to shareholders and the amount of taxable income carried over from the prior year for distribution in the current year. Our goal is to declare what we believe to be sustainable increases in our regular quarterly dividends. To the extent that we earn annual taxable income in excess of dividends paid for the year, we may carry over the excess taxable income into the next year and such excess income will be available for distribution in the next year as permitted under the Internal Revenue Code of 1986. Excess taxable income carried over and paid out in the next year may be subject to a 4% excise tax. See *Other Matters* *Regulated Investment Company Status* above. We believe that carrying over excess taxable income into future periods may provide increased visibility with respect to taxable earnings available to pay the regular quarterly dividend. We currently estimate that the taxable income carried over from 2005 for distribution to shareholders in 2006 is \$163.8 million. However, our taxable income for 2005 is an estimate and will not be finally determined until we file our 2005 tax return in September 2006, and therefore, the amount of excess taxable income carried over from 2005 into 2006 may be different from this estimate.

We currently expect that our estimated annual taxable income for 2006 will be in excess of our estimated dividend distributions to shareholders in 2006 from such taxable income, and, therefore, we expect to carry over excess taxable income for distribution to shareholders in 2007. We expect that we will generally be required to pay a 4% excise tax on the excess of 98% of our taxable income for 2006 over the amount of actual distributions from such taxable income in 2006. Accordingly, for the three months ended March 31, 2006, we have accrued an excise tax of \$8.4 million. Excise taxes are accrued based upon estimated excess taxable income as estimated taxable income is earned, therefore, the excise tax accrued to date in 2006 may be adjusted as appropriate in the remainder of 2006 to reflect changes in our estimate of the carry over amount and additional excise tax may be accrued during the remainder of 2006 as additional excess taxable income is earned, if any. Our ability to earn the estimated annual taxable income for 2006 depends on many factors, including our ability to make new investments at attractive yields, the level of repayments in the portfolio, the realization of gains or losses from portfolio exits, and the level of operating expenses incurred. See

Management's Discussion and Analysis of Financial Condition and Results of Operations and *Risk Factors* in the accompanying prospectus.

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

Liquidity and Capital Resources

At March 31, 2006, and December 31, 2005, our liquidity portfolio (see below), cash and investments in money market securities, total assets, total debt outstanding, total shareholders equity, debt to equity ratio and asset coverage for senior indebtedness were as follows:

(\$ in millions)	2006	2005
Liquidity portfolio (including money market securities: 2006-\$101.1; 2005-\$100.0)	\$ 202.4	\$ 200.3
Cash and investments in money market securities (including money market securities: 2006-\$38.7; 2005-\$22.0)	\$ 43.5	\$ 53.3
Total assets	\$ 4,121.2	\$ 4,025.9
Total debt outstanding	\$ 1,274.2	\$ 1,284.8
Total shareholders equity	\$ 2,729.8	\$ 2,620.5
Debt to equity ratio	0.47	0.49
Asset coverage ratio ⁽¹⁾	317%	309%

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

We currently target a debt to equity ratio ranging between 0.50:1.00 to 0.70:1.00 because we believe that it is prudent to operate with a larger equity capital base and less leverage.

During the fourth quarter of 2005, we established a liquidity portfolio that is composed of money market securities and U.S. Treasury bills. At March 31, 2006, the value and yield of the money market securities were \$101.1 million and 4.6%, respectively, and were held in money market funds. The value and yield of the Treasury bills were \$101.3 million and 4.2%, respectively, at March 31, 2006. The Treasury bills are due in June 2006. The liquidity portfolio was established to provide a pool of liquid assets within our balance sheet. Our investment portfolio is primarily composed of private, illiquid assets for which there is no readily available market. Our liquidity was reduced when we sold our portfolio of CMBS assets in May 2005, particularly BB rated bonds, which were generally more liquid than assets in our private finance portfolio. Given the level of taxable income that we estimate has been carried over from 2005 for distribution in 2006, we established the liquidity portfolio to provide a liquid resource from which to distribute this excess taxable income. We will assess the amount held in and the composition of the liquidity portfolio throughout the year.

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 securities. We place our cash with financial institutions and, at times, cash held in checking accounts in financial institutions may be in excess of the Federal Deposit Insurance Corporation insured limit.

During the three months ended March 31, 2006, we sold equity of \$83.0 million. We did not sell new equity in a public offering during the three months ended March 31, 2005, or for the year ended December 31, 2005. In addition, shareholders equity increased by \$7.7 million, \$4.1 million and \$77.5 million through the exercise of employee options, the collection of notes receivable from the sale of common stock, and the issuance of shares through our dividend reinvestment plan for the three months ended March 31, 2006 and 2005, and the year ended December 31, 2005.

We employ an asset-liability management strategy that focuses on matching the estimated maturities of our loan and investment portfolio to the estimated maturities of our borrowings. We use our revolving line of credit facility as a means to bridge to long-term financing in the form of debt or equity capital, which may or may not result in temporary differences in the matching of estimated maturities. Availability on the revolving line of credit, net of amounts committed for standby letters of credit issued under the line of credit facility, was \$641.8 million on March 31, 2006. We evaluate

our interest rate exposure on an ongoing basis. Generally, we seek to fund our primarily fixed-rate investment portfolio with fixed-rate debt or equity capital. To the extent deemed necessary, we may hedge variable and short-term interest rate exposure through interest rate swaps or other techniques.

At March 31, 2006, we had outstanding debt as follows:

(\$ in millions)	Facility Amount	Amount Outstanding	Annual Interest Cost ⁽¹⁾	Annual Return to Cover Interest Payments ⁽⁴⁾
Notes payable and debentures:				
Unsecured notes payable	\$ 1,164.7	\$ 1,164.7	6.2%	1.8%
SBA debentures	16.5	16.5	7.4%	0.0%
Total notes payable and debentures	1,181.2	1,181.2	6.2%	1.8%
Revolving line of credit	772.5	93.0	6.2% ⁽²⁾	0.2%
Total debt	\$ 1,953.7	\$ 1,274.2	6.5% ⁽³⁾	2.0%

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

⁽²⁾ The annual interest cost reflects the interest rate payable for borrowings under the revolving line of credit. In addition to the current interest rate payable, there were annual costs of commitment fees and other facility fees of \$3.3 million at March 31, 2006.

⁽³⁾ The annual interest cost for total debt includes the annual cost of commitment fees and other facility fees on the revolving line of credit regardless of the amount outstanding on the facility as of the balance sheet date.

⁽⁴⁾ The annual portfolio return to cover interest payments is calculated as the March 31, 2006, annualized cost of debt per class of financing outstanding divided by total assets at March 31, 2006.

Unsecured Notes Payable. We have issued unsecured long-term notes to institutional investors, primarily insurance companies. The notes have five- or seven-year maturities, with maturity dates beginning in 2006 and generally have fixed rates of interest. The notes generally require payment of interest only semi-annually, and all principal is due upon maturity.

On May 1, 2006, we issued \$50.0 million of long-term debt with a fixed interest rate of 6.75%. This debt matures in May 2013. The proceeds of this issuance were used to repay \$25 million of 7.49% unsecured long-term debt that matured on May 1, 2006, with the remainder being used to fund new portfolio investments and for general corporate purposes.

Small Business Administration Debentures. Through our small business investment company subsidiary, we have debentures payable to the Small Business Administration (SBA) with contractual maturities of ten years. The notes require payment of interest only semi-annually, and all principal is due upon maturity. During the first quarters of 2006 and 2005, we repaid \$12.0 million and \$31.0 million of this outstanding debt. Under the small business investment company program, we may borrow up to \$124.4 million from the SBA. We currently do not have plans to

borrow additional amounts from the SBA.

Revolving Line of Credit. At March 31, 2006, we had an unsecured revolving line of credit with a committed amount of \$772.5 million. The revolving line of credit expires on September 30, 2008. The revolving line of credit may be expanded through new or additional commitments up to \$922.5 million at our option. The revolving line of credit generally bears interest at a rate equal to (i) LIBOR (for the period we select) plus 1.30% or (ii) the higher of the Federal Funds rate plus 0.50% or the Bank of America N.A. prime rate. The revolving line of credit requires the payment of an annual commitment fee equal to 0.20% of the committed amount. The revolving line of credit generally requires payments of interest at the end of each LIBOR interest period, but no less frequently than quarterly, on LIBOR based loans and monthly payments of interest on other loans. All principal is due upon maturity.

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At March 31, 2006, there was \$93.0 outstanding on our unsecured revolving line of credit. The amount available under the line at March 31, 2006, was \$641.8 million, net of amounts committed for standby letters of credit of \$37.7 million. Net borrowings under the revolving line of credit for the three months ended March 31, 2006, were \$1.3 million.

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. These credit facilities provide for customary events of default, including, but not limited to, payment defaults, breach of representations or covenants, cross-defaults, bankruptcy events, failure to pay judgments, attachment of our assets, change of control and the issuance of an order of dissolution. Certain of these events of default are subject to notice and cure periods or materiality thresholds. Our credit facilities also limit our ability to declare dividends if we default under certain provisions. As of March 31, 2006, we were in compliance with these covenants.

The following table shows our significant contractual obligations for the repayment of debt and payment of other contractual obligations as of March 31, 2006.

(\$ in millions)	Payments Due By Year						
	Total	2006	2007	2008	2009	2010	After 2010
Notes payable and debentures:							
Unsecured long-term notes payable	\$ 1,164.7	\$ 175.0	\$	\$ 153.0	\$ 267.2	\$ 408.0	\$ 161.5
SBA debentures	16.5						16.5
Revolving line of credit ⁽¹⁾	93.0			93.0			
Operating leases	27.9	3.3	4.4	4.5	4.7	4.4	6.6
Total contractual obligations	\$ 1,302.1	\$ 178.3	\$ 4.4	\$ 250.5	\$ 271.9	\$ 412.4	\$ 184.6

⁽¹⁾ At March 31, 2006, \$641.8 million remained unused and available, net of amounts committed for standby letters of credit of \$37.7 million issued under the credit facility.

Off-Balance Sheet Arrangements

The following table shows our contractual commitments that may have the effect of creating, increasing, or accelerating our liabilities as of March 31, 2006.

(\$ in millions)	Amount of Commitment Expiration Per Year						
	Total	2006	2007	2008	2009	2010	After 2010
Guarantees	\$ 154.0	\$ 1.3	\$ 0.6	\$ 3.0	\$ 143.6	\$	\$ 5.5
Standby letters of credit ⁽¹⁾	37.7	0.1		37.6			
Total commitments	\$ 191.7	\$ 1.4	\$ 0.6	\$ 40.6	\$ 143.6	\$	\$ 5.5

(1) Standby letters of credit are issued under our revolving line of credit that expires in September 2008. Therefore, unless a standby letter of credit is set to expire at an earlier date, we have assumed that the standby letters of credit will expire contemporaneously with the expiration of our line of credit in September 2008.

In addition, we had outstanding commitments to fund investments totaling \$329.9 million at March 31, 2006. We intend to fund these commitments and prospective investment opportunities with existing cash, through cash flow from operations before new investments, through borrowings under our line of credit or other long-term debt agreements, or through the sale or issuance of new equity capital.

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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 and CDO and CLO bonds and preferred shares/ income notes. Our investments may be subject to certain restrictions on resale and generally have no established trading market. We value substantially all of our investments at fair value as determined in good faith by the Board of Directors in accordance with our valuation policy. We determine fair value to be the amount for which an investment could be exchanged in an orderly disposition over a reasonable period of time between willing parties other than in a forced or liquidation sale. Our valuation policy considers the fact that no ready market exists for substantially all of the securities in which we invest. Our valuation policy is intended to provide a consistent basis for determining the fair value of the portfolio. We will record unrealized depreciation on investments when we believe that an investment has become impaired, including where collection of a loan or realization of an equity security is doubtful, or when the enterprise value of the portfolio company does not currently support the cost of our debt or equity investments. Enterprise value means the entire value of the company to a potential buyer, including the sum of the values of debt and equity securities used to capitalize the enterprise at a point in time. We will record unrealized appreciation if we believe that the underlying portfolio company has appreciated in value and/or our equity security has also appreciated in value. The value of investments in publicly traded securities is determined using quoted market prices discounted for restrictions on resale, if any.

Loans and Debt Securities. For loans and debt securities, fair value generally approximates cost unless the borrower's enterprise value, overall financial condition or other factors lead to a determination of fair value at a different amount. The value of loan and debt securities may be greater than our cost basis if the amount that would be repaid on the loan or debt security upon the sale of the portfolio company is greater than our cost basis.

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. In general, interest is not accrued on loans and debt securities if we have 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 our internal grading system do not accrue interest. In addition, interest may not accrue on loans or debt securities to portfolio companies that are more than 50% owned by us depending on such company's capital requirements. Loan origination fees, original issue discount, and market discount are capitalized and then amortized into interest income using a method that approximates the effective interest method. Upon the prepayment of a loan or debt security, any unamortized loan origination fees are recorded as interest income and any unamortized original issue discount or market

discount is recorded as a realized gain. Prepayment premiums are recorded on loans and debt securities when received.

Equity Securities. Our equity 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 our 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 we have the option to receive the dividend in cash. Dividend income on common equity securities is recorded on the record date for private companies or on the ex-dividend date for publicly traded companies.

Collateralized Debt Obligations (CDO) and Collateralized Loan Obligations (CLO). CDO and CLO bonds and preferred shares/ income notes (CDO/CLO Assets) are carried at fair value, which is based on a discounted cash flow model that utilizes prepayment and loss assumptions based on historical experience and projected performance, economic factors, the characteristics of the underlying cash flow, and comparable yields for similar bonds and preferred shares/income notes, when available. We recognize unrealized appreciation or depreciation on its CDO/CLO Assets as comparable yields in the market change and/or based on changes in estimated cash flows resulting from changes in prepayment or loss assumptions in the underlying collateral pool. We determine the fair value of its CDO/CLO Assets on an individual security-by-security basis.

We recognize income from the amortization of original issue discount using the effective interest method using the anticipated yield over the projected life of the investment. Yields are revised when there are changes in actual and estimated prepayment speeds or actual and estimated credit losses. Changes in estimated yield are recognized as an adjustment to the estimated yield over the remaining life of the CDO/ CLO Assets 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, the change in the value of U.S. Treasury bills and deposits of proceeds from sales of borrowed Treasury securities, and depreciation on accrued interest and dividends receivable and other assets where collection is doubtful.

Fee Income. Fee income includes fees for guarantees and services rendered by us to portfolio companies and other third parties such as diligence, structuring, transaction services, management 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.

**INTERIM CONSOLIDATED FINANCIAL STATEMENTS
ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEET**

	March 31, 2006	December 31, 2005
(in thousands, except per share amounts)		
(unaudited)		
ASSETS		
Portfolio at value:		
Private finance		
Companies more than 25% owned (cost: 2006-\$1,379,842; 2005-\$1,489,782)	\$ 1,388,855	\$ 1,887,651
Companies 5% to 25% owned (cost: 2006-\$342,144; 2005-\$168,373)	341,645	158,806
Companies less than 5% owned (cost: 2006-\$1,845,529; 2005-\$1,448,268)	1,831,133	1,432,833
Total private finance (cost: 2006-\$3,567,515; 2005-\$3,106,423)	3,561,633	3,479,290
Commercial real estate finance (cost: 2006-\$129,564; 2005-\$131,695)	129,369	127,065
Total portfolio at value (cost: 2006-\$3,697,079; 2005-\$3,238,118)	3,691,002	3,606,355
U.S. Treasury bills	101,289	100,305
Investments in money market securities	139,764	121,967
Deposits of proceeds from sales of borrowed Treasury securities	17,534	17,666
Accrued interest and dividends receivable	50,034	60,366
Other assets	116,746	87,858
Cash	4,856	31,363
Total assets	\$ 4,121,225	\$ 4,025,880
LIABILITIES AND SHAREHOLDERS EQUITY		
Liabilities:		
Notes payable and debentures (maturing within one year: 2006-\$175,000; 2005-\$175,000)	\$ 1,181,245	\$ 1,193,040
Revolving line of credit	93,000	91,750
Obligations to replenish borrowed Treasury securities	17,534	17,666
Accounts payable and other liabilities	99,633	102,878
Total liabilities	1,391,412	1,405,334
Commitments and contingencies		
Shareholders equity:		
Common stock, \$0.0001 par value, 200,000 shares authorized; 139,984 and 136,697 shares issued and outstanding at March 31, 2006, and December 31, 2005, respectively	14	14
Additional paid-in capital	2,271,434	2,177,283
Common stock held in deferred compensation trust	(21,543)	(19,460)
Notes receivable from sale of common stock	(3,738)	(3,868)

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Net unrealized appreciation (depreciation)	(20,223)	354,325
Undistributed earnings	503,869	112,252
Total shareholders equity	2,729,813	2,620,546
Total liabilities and shareholders equity	\$ 4,121,225	\$ 4,025,880
Net asset value per common share	\$ 19.50	\$ 19.17

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

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ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENT OF OPERATIONS

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

2006 2005

(in thousands, except per share amounts)

(unaudited)

Interest and Related Portfolio Income:		
Interest and dividends		
Companies more than 25% owned	\$ 30,146	\$ 28,251
Companies 5% to 25% owned	5,650	5,921
Companies less than 5% owned	53,085	50,773
 Total interest and dividends	 88,881	 84,945
 Loan prepayment premiums		
Companies more than 25% owned	4,960	
Companies 5% to 25% owned		
Companies less than 5% owned	326	1,677
 Total loan prepayment premiums	 5,286	 1,677
 Fees and other income		
Companies more than 25% owned	7,127	4,881
Companies 5% to 25% owned	2,716	70
Companies less than 5% owned	7,001	3,346
 Total fees and other income	 16,844	 8,297
 Total interest and related portfolio income	 111,011	 94,919
 Expenses:		
Interest	24,300	20,225
Employee	21,428	15,456
Stock options	3,606	
Administrative	11,519	20,754
 Total operating expenses	 60,853	 56,435
 Net investment income before income taxes	 50,158	 38,484
Income tax expense (benefit), including excise tax	8,858	(268)
 Net investment income	 41,300	 38,752
 Net Realized and Unrealized Gains (Losses):		
Net realized gains (losses)		
Companies more than 25% owned	433,187	399

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Companies 5% to 25% owned	(343)	(3)
Companies less than 5% owned	(9)	9,889
Total net realized gains	432,835	10,285
Net change in unrealized appreciation or depreciation	(374,548)	70,584
Total net gains (losses)	58,287	80,869
Net increase in net assets resulting from operations	\$ 99,587	\$ 119,621
Basic earnings per common share	\$ 0.72	\$ 0.90
Diluted earnings per common share	\$ 0.70	\$ 0.88
Weighted average common shares outstanding basic	138,759	133,283
Weighted average common shares outstanding diluted	141,738	135,579

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

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

	For the Three Months Ended March 31,	
(in thousands, except per share amounts)	2006	2005
	(unaudited)	
Operations:		
Net investment income	\$ 41,300	\$ 38,752
Net realized gains	432,835	10,285
Net change in unrealized appreciation or depreciation	(374,548)	70,584
Net increase in net assets resulting from operations	99,587	119,621
Shareholder distributions:		
Common stock dividends	(82,518)	(76,100)
Net decrease in net assets resulting from shareholder distributions	(82,518)	(76,100)
Capital share transactions:		
Sale of common stock	82,970	
Issuance of common stock for portfolio investments		7,200
Issuance of common stock in lieu of cash distributions	3,640	1,418
Issuance of common stock upon the exercise of stock options	3,935	2,618
Stock option expense	3,606	
Net decrease in notes receivable from sale of common stock	130	50
Purchase of common stock held in deferred compensation trust	(2,121)	(1,886)
Distribution of common stock held in deferred compensation trust	38	
Other		449
Net increase in net assets resulting from capital share transactions	92,198	9,849
Total increase (decrease) in net assets	109,267	53,370
Net assets at beginning of period	2,620,546	1,979,778
Net assets at end of period	\$ 2,729,813	\$ 2,033,148
Net asset value per common share	\$ 19.50	\$ 15.22
Common shares outstanding at end of period	139,984	133,563

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

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENT OF CASH FLOWS

	For the Three Months Ended March 31,	
(in thousands)	2006	2005
	(unaudited)	
Cash flows from operating activities:		
Net increase in net assets resulting from operations	\$ 99,587	\$ 119,621
Adjustments		
Portfolio investments	(647,851)	(257,957)
Principal collections related to investment repayments or sales	340,410	158,262
Change in accrued or reinvested interest and dividends	2,061	(10,534)
Amortization of discounts and fees	(277)	(1,772)
Change in investments in money market securities	(16,726)	
Stock option expense	3,606	
Changes in other assets and liabilities	2,797	8,158
Depreciation and amortization	433	486
Realized gains from the receipt of notes and other securities as consideration from sale of investments, net of collections	(179,987)	152
Realized losses	3,651	4,418
Net change in unrealized (appreciation) or depreciation	374,548	(70,584)
Net cash provided by (used in) operating activities	(17,748)	(49,750)
Cash flows from financing activities:		
Sale of common stock	82,970	
Sale of common stock upon the exercise of stock options	3,935	2,618
Collections of notes receivable from sale of common stock	130	50
Borrowings under notes payable and debentures		
Repayments on notes payable and debentures	(12,000)	(31,000)
Net borrowings under (repayments on) revolving line of credit	1,250	151,250
Purchase of common stock held in deferred compensation trust	(2,121)	(1,886)
Other financing activities	53	(12)
Common stock dividends and distributions paid	(82,976)	(77,343)
Net cash provided by (used in) financing activities	(8,759)	43,677
Net increase (decrease) in cash	(26,507)	(6,073)
Cash at beginning of period	31,363	57,160
Cash at end of period	\$ 4,856	\$ 51,087

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

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

March 31, 2006

Private Finance Portfolio Company (in thousands, except number of shares)	Investment⁽¹⁾⁽²⁾	Principal	(unaudited)	
			Cost	Value
Companies More Than 25% Owned				
Acme Paging, L.P. ⁽⁴⁾ (Telecommunications)	Senior Loan (6.0%, Due 12/07) ⁽⁶⁾ Subordinated Debt (10.0%, Due 1/08) ⁽⁶⁾ Common Stock (23,513 shares)	\$ 3,750 881	\$ 3,750 881	\$ 27
Alaris Consulting, LLC (Business Services)	Senior Loan (16.5%, Due 12/05 12/07) ⁽⁶⁾ Equity Interests Guaranty (\$1,100)	27,055	27,034 5,305	
American Healthcare Services, Inc. and Affiliates (Healthcare Services)	Senior Loan (0.7%, Due 12/04 12/05) ⁽⁶⁾	4,998	4,600	4,002
Avborne, Inc. ⁽⁷⁾ (Business Services)	Preferred Stock (12,500 shares) Common Stock (27,500 shares)		658	892
Avborne Heavy Maintenance, Inc. ⁽⁷⁾ (Business Services)	Preferred Stock (1,568 shares) Common Stock (2,750 shares) Guaranty (\$2,401)		2,401	
Business Loan Express, LLC (Financial Services)	Class A Equity Interests Class B Equity Interests Class C Equity Interests Guaranty (\$141,118 See Note 3) Standby Letters of Credit (\$34,050 See Note 3)	62,532	62,532 119,436 109,301	62,532 136,090 127,619
Callidus Capital Corporation (Financial Services)	Senior Loan (9.6%, Due 4/06 12/06) Subordinated Debt (18.0%, Due 10/08) Common Stock (10 shares)	7,480 5,049	7,480 5,049 2,058	7,480 5,049 10,355
CR Brands, Inc. (Consumer Products)	Senior Loan (8.1%, Due 2/07)	37,219 38,898	37,048 38,705	37,048 38,705

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	Subordinated Debt (16.6%, Due 2/13)			
	Common Stock (37,200,551 shares)		33,321	37,431
Diversified Group Administrators, Inc.	Preferred Stock (1,000,000 shares)		700	714
(Business Services)	Preferred Stock (1,451,380 shares)		841	841
	Common Stock (1,451,380 shares)			571
Financial Pacific Company (Financial Services)	Subordinated Debt (17.4%, Due 2/12 8/12)	70,525	70,266	70,266
	Preferred Stock (10,964 shares)		10,276	13,771
	Common Stock (14,735 shares)		14,819	43,669
ForeSite Towers, LLC (Tower Leasing)	Equity Interests		7,620	11,294

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- (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.

March 31, 2006

Private Finance Portfolio Company (in thousands, except number of shares)	Investment ⁽¹⁾⁽²⁾	(unaudited)		
		Principal	Cost	Value
Global Communications, LLC (Business Services)	Senior Loan (10.7%, Due 9/02 11/07) ⁽⁶⁾ Subordinated Debt (17.0%, Due 12/03 9/05) ⁽⁹⁾ Preferred Equity Interest Options	\$ 15,957 11,339	\$ 15,957 11,336 14,067 1,639	\$ 15,957 11,336 554
Gordian Group, Inc. (Business Services)	Senior Loan (10.0%, Due 6/06 12/08) ⁽⁶⁾ Common Stock (1,000 shares)	11,567	11,591 6,762	
Healthy Pet Corp. (Consumer Services)	Senior Loan (10.5%, Due 8/10) Subordinated Debt (15.0%, Due 8/10) Common Stock (30,266 shares)	16,738 43,257	16,738 43,086 30,266	16,738 43,086 30,940
HMT, Inc. (Energy Services)	Preferred Stock (554,052 shares) Common Stock (300,000 shares) Warrants		2,637 3,000 1,155	2,637 5,920 2,280
Impact Innovations Group, LLC (Business Services)	Equity Interests in Affiliate			869
Insight Pharmaceuticals Corporation (Consumer Products)	Subordinated Debt (16.1%, Due 9/12) Preferred Stock (25,000 shares) Common Stock (6,200 shares)	58,912	58,685 25,000 6,325	58,685 24,776
Jakel, Inc. (Industrial Products)	Subordinated Debt (15.5%, Due 3/08) ⁽⁶⁾ Preferred Stock (6,460 shares) Common Stock (158,061 shares)	14,442	14,442 6,460 9,347	1,066
Legacy Partners Group, LLC (Financial Services)	Senior Loan (14.0%, Due 5/09) ⁽⁶⁾ Subordinated Debt (18.0%, Due 5/09) ⁽⁶⁾ Equity Interests	7,646 2,952	7,646 2,952 4,248	5,122
Litterer Beteiligungs-GmbH ⁽⁴⁾ (Business Services)	Subordinated Debt (8.0%, Due 3/07) Equity Interest	633	633 1,810	633 2,989

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Mercury Air Centers, Inc. (Business Services)	Senior Loan (10.0%, Due 4/09)	35,720	35,720	35,720
	Subordinated Debt (16.0%, Due 4/09)	50,872	50,684	50,684
	Common Stock (57,970 shares)		35,053	93,600
	Standby Letters of Credit (\$1,998)			
MVL Group, Inc. (Business Services)	Senior Loan (12.1%, Due 7/09)	27,525	27,286	27,286
	Subordinated Debt (14.4%, Due 7/09)	33,114	32,653	32,653
	Common Stock (648,661 shares)		643	2,033
Powell Plant Farms, Inc. (Consumer Products)	Senior Loan (15.0%, Due 12/06)	38,715	29,867	29,867
	Subordinated Debt (20.0%, Due 6/03) ⁽⁶⁾	19,291	19,224	8,457
	Preferred Stock (1,483 shares)			
	Warrants			

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March 31, 2006

Private Finance Portfolio Company (in thousands, except number of shares)	Investment ⁽¹⁾⁽²⁾	(unaudited)		
		Principal	Cost	Value
Service Champ, Inc. (Business Services)	Subordinated Debt (15.5%, Due 4/12) Common Stock (63,888 shares)	\$ 27,214	\$ 27,084 13,662	\$ 27,084 15,565
Staffing Partners Holding Company, Inc. (Business Services)	Subordinated Debt (13.5%, Due 1/07) ⁽⁶⁾ Preferred Stock (439,600 shares) Common Stock (69,773 shares) Warrants	5,987	5,987 4,968 50 10	4,170
Startec Global Communications Corporation (Telecommunications)	Senior Loan (10.0%, Due 5/07 5/09) Common Stock (19,180,000 shares)	24,283	24,283 37,255	22,987
STS Operating, Inc. (Industrial Products)	Subordinated Debt (15.3%, Due 3/12) Common Stock (3,000,000 shares) Options	6,593	6,593 3,522	6,593 97,002 852
Triview Investments, Inc. ⁽⁸⁾ (Broadcasting & Cable/ Consumer Products)	Senior Loan (8.9%, Due 6/07) Subordinated Debt (15.0%, Due 7/12) Subordinated Debt (16.8%, Due 7/08 7/12) ⁽⁶⁾ Common Stock (202 shares) Guaranty (\$800) Standby Letter of Credit (\$200)	14,325 37,877 19,600	14,295 37,687 19,520 93,906	14,295 37,687 19,520 30,883

Total companies more than 25% owned \$ 1,379,842 \$ 1,388,855

Companies 5% to 25% Owned

Advantage Sales & Marketing, Inc. (Business Services)	Subordinated Debt (12.0%, Due 3/14) Equity Interests	\$ 150,000	\$ 149,258 2,048	\$ 149,258 15,000
Air Evac Lifeteam LLC	Subordinated Debt (13.9%, Due 7/10)	42,627	42,488	42,488

(Healthcare Services)	Equity Interests		3,941	5,400
BB&T Capital Partners/Windsor Mezzanine Fund, LLC ⁽⁵⁾ (Private Equity Fund)	Equity Interests		5,867	5,867
Becker Underwood, Inc. (Industrial Products)	Subordinated Debt (14.5%, Due 8/12)	23,790	23,698	23,698
	Common Stock (5,073 shares)		5,813	1,500
BI Incorporated (Business Services)	Senior Loan (8.1%, Due 2/13)	5,000	4,891	4,891
	Subordinated Debt (13.5%, Due 2/14)	30,000	29,852	29,852
	Common Stock (40,000 shares)		4,000	4,000

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- (8) Triview Investments, Inc. holds investments in Longview Cable & Data, LLC (Broadcasting & Cable) with a cost of \$66.5 million and value of \$15.8 million and Triax Holdings, LLC (Consumer Products) with a cost of \$98.9 million and a value of \$86.6 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.

March 31, 2006

Private Finance Portfolio Company (in thousands, except number of shares)	Investment ⁽¹⁾⁽²⁾	(unaudited)		
		Principal	Cost	Value
MedBridge Healthcare, LLC (Healthcare Services)	Senior Loan (4.0%, Due 8/09) ⁽⁶⁾ Subordinated Debt (10.0%, Due 8/14) ⁽⁶⁾ Convertible Subordinated Debt (2.0%, Due 8/14) ⁽⁶⁾ Equity Interests	\$ 7,164 5,184 2,970	\$ 7,164 5,184 984 1,302	\$ 5,154
Nexcel Synthetics, LLC (Consumer Products)	Subordinated Debt (14.5%, Due 6/09) Equity Interests	10,711	10,685 1,708	10,685 1,482
Pres Air Trol LLC (Industrial Products)	Unitranche Debt (12.0%, Due 4/10) ⁽⁶⁾ Equity Interests	5,911	5,583 1,361	5,583 328
Progressive International Corporation (Consumer Products)	Subordinated Debt (16.0%, Due 12/09) Preferred Stock (500 shares) Common Stock (197 shares) Warrants	7,439	7,415 500 13	7,415 902 300
Soteria Imaging Services, LLC (Healthcare Services)	Subordinated Debt (11.8%, Due 11/10) Equity Interests	14,500	13,480 2,159	13,480 2,354
Universal Environmental Services, LLC (Business Services)	Unitranche Debt (15.5%, Due 2/09) Equity Interests	10,975	10,940 1,810	10,940 1,068
Total companies 5% to 25% owned			\$ 342,144	\$ 341,645
Companies Less Than 5% Owned				
3SI Security Systems, Inc. (Consumer Products)	Senior Loan (8.4%, Due 2/12 2/13) Subordinated Debt (14.4%, Due 8/13)	\$ 48,400 26,300	\$ 47,685 26,170	\$ 47,685 26,170
Advanced Circuits, Inc. (Industrial Products)	Senior Loan (10.5%, Due 9/11 3/12) Common Stock (40,000 shares)	17,821	17,735 1,000	17,735 1,400

Amerex Group, LLC (Consumer Products)	Subordinated Debt (12.0%, Due 1/13) Equity Interests	8,400	8,400 3,600	8,400 3,600
Anthony, Inc. (Industrial Products)	Subordinated Debt (13.0%, Due 8/11 9/12)	14,707	14,650	14,650
Benchmark Medical, Inc. (Healthcare Services)	Warrants		18	30
Border Foods, Inc. (Consumer Products)	Subordinated Debt (13.0%, Due 12/10) ⁽⁶⁾ Preferred Stock (140,214 shares) Common Stock (1,810 shares) Warrants	13,428	12,721 2,893 45 910	
Broadcast Electronics, Inc. (Business Services)	Senior Loan (10.3%, Due 7/12)	5,000	4,963	4,963

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March 31, 2006

Private Finance Portfolio Company (in thousands, except number of shares)	Investment ⁽¹⁾⁽²⁾	(unaudited)		
		Principal	Cost	Value
C&K Market, Inc. (Retail)	Subordinated Debt (14.0%, Due 12/08)	\$ 25,638	\$ 25,536	\$ 25,536
Callidus Debt Partners CDO Fund I, Ltd. ⁽⁴⁾⁽⁹⁾ (Senior Debt Fund)	Class C Notes (12.9%, Due 12/13) Class D Notes (17.0%, Due 12/13)	18,800 9,400	18,968 9,484	18,968 9,484
Callidus Debt Partners CLO Fund III, Ltd. ⁽⁴⁾⁽⁹⁾ (Senior Debt Fund)	Preferred Shares (23,600,000 shares)		24,106	24,106
Callidus MAPS CLO Fund I LLC ⁽⁹⁾ (Senior Debt Fund)	Class E Notes (10.2%, Due 12/17) Income Notes	17,000	17,000 49,836	17,000 49,836
Camden Partners Strategic Fund II, L.P. ⁽⁵⁾ (Private Equity Fund)	Limited Partnership Interest		2,142	3,149
Catterton Partners V, L.P. ⁽⁵⁾ (Private Equity Fund)	Limited Partnership Interest		2,650	2,748
CBS Personnel Holdings, Inc. (Business Services)	Subordinated Debt (14.5%, Due 12/09)	20,749	20,677	20,677
Centre Capital Investors IV, LP ⁽⁵⁾ (Private Equity Fund)	Limited Partnership Interest		1,752	1,639
Commercial Credit Group, Inc. (Financial Services)	Subordinated Debt (14.8%, Due 2/11) Preferred Stock (32,500 shares) Warrants	5,000	4,952 3,900	4,952 3,900
Community Education Centers, Inc. (Education Services)	Subordinated Debt (16.0%, Due 12/10)	33,392	33,284	33,284
Component Hardware Group, Inc. (Industrial Products)	Preferred Stock (18,000 shares) Common Stock (2,000 shares)		2,605 200	2,881 900

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Cooper Natural Resources, Inc. (Industrial Products)	Subordinated Debt (0%, Due 11/07)	675	675	675
	Preferred Stock (6,316 shares)		1,424	20
	Warrants		830	
Coverall North America, Inc. (Business Services)	Subordinated Debt (14.6%, Due 2/11)	27,488	27,443	27,443
	Preferred Stock (6,500 shares)		6,500	6,969
	Warrants		2,950	3,100
Deluxe Entertainment Services Group, Inc. (Business Services)	Subordinated Debt (13.2%, Due 7/11)	30,000	30,000	30,000
Distant Lands Trading Co. (Consumer Products)	Senior Loan (8.6%, Due 1/11)	1,000	976	976
	Unitranche Debt (10.3% Due 1/11)	25,000	24,881	24,881
	Common Stock (1,500 shares)		1,500	1,500

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- (9) The fund is managed by Callidus Capital Corporation, a portfolio company of Allied Capital.

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March 31, 2006

Private Finance Portfolio Company (in thousands, except number of shares)	Investment ⁽¹⁾⁽²⁾	(unaudited)		
		Principal	Cost	Value
Drilltec Patents & Technologies Company, Inc. (Energy Services)	Subordinated Debt (17.5%, Due 8/06) Subordinated Debt (10.0%, Due 8/06) ⁽⁶⁾	\$ 3,952 10,994	\$ 3,952 10,918	\$ 3,952 13,116
DVS VideoStream, LLC (Business Services)	Unitranche Debt (11.0%, Due 2/12) Convertible Subordinated Debt (10.0%, Due 2/16)	20,000 3,500	19,879 3,483	19,879 3,483
Dynamic India Fund IV ⁽⁴⁾⁽⁵⁾ (Private Equity Fund)	Equity Interests		1,650	1,650
eCentury Capital Partners, L.P. ⁽⁵⁾ (Private Equity Fund)	Limited Partnership Interest		5,649	82
Elexis Beta GmbH ⁽⁴⁾ (Industrial Products)	Options		426	50
Event Rentals, Inc. (Consumer Services)	Senior Loans (9.9%, Due 11/11)	18,341	18,248	18,248
Farley s & Sathers Candy Company, Inc. (Consumer Products)	Subordinated Debt (11.0%, Due 3/11)	20,000	19,900	19,900
Frozen Specialties, Inc. (Consumer Products)	Warrants		435	470
Garden Ridge Corporation (Retail)	Subordinated Debt (7.0%, Due 5/12) ⁽⁶⁾	22,500	22,500	15,369
Geotrace Technologies, Inc. (Energy Services)	Subordinated Debt (10.0%, Due 6/09) Warrants	25,293	23,617 2,350	23,617 2,500
Ginsey Industries, Inc. (Consumer Products)	Subordinated Debt (12.5%, Due 3/07)	3,455	3,455	3,455
Grant Broadcasting Systems II (Broadcasting & Cable)	Subordinated Debt (5.0%, Due 6/09)	2,896	2,896	2,896

Grotech Partners, VI, L.P. ⁽⁵⁾ (Private Equity Fund)	Limited Partnership Interest		7,645	5,000
Havco Wood Products LLC (Industrial Products)	Unitranche Debt (10.8%, Due 8/11) Equity Interests	28,376	27,210 1,048	27,210 1,400
Haven Eldercare of New England, LLC ⁽¹⁰⁾ (Healthcare Services)	Subordinated Debt (12.0%, Due 8/09) ⁽⁶⁾	4,020	4,020	4,020
Haven Healthcare Management, LLC ⁽¹⁰⁾ (Healthcare Services)	Subordinated Debt (18.0% Due 4/07) ⁽⁶⁾	508	620	125
HealthASPex Services Inc. (Business Services)	Senior Loan (4.0%, Due 7/08)	500	500	500
The Hillman Companies, Inc. ⁽³⁾ (Consumer Products)	Subordinated Debt (13.5%, Due 9/11)	44,247	44,070	44,070
Homax Holdings, Inc. (Consumer Products)	Subordinated Debt (12.0%, Due 8/11) Preferred Stock (89 shares) Common Stock (28 shares) Warrants	14,000	13,074 89 6 1,106	13,074 85 6 1,384

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

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March 31, 2006

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		Principal	Cost	Value
Hot Stuff Foods, LLC (Consumer Products)	Senior Loan (8.2%, Due 2/11-2/12)	\$ 45,690	\$ 45,690	\$ 45,690
	Subordinated Debt (13.9%, Due 8/12 2/13)	72,500	72,148	72,148
	Common Stock (375,000 shares) ⁽¹¹⁾		37,500	37,500
	Warrants			
Integrity Interactive Corporation (Business Services)	Unitranche Debt (10.5%, Due 2/12)	30,000	29,786	29,786
International Fiber Corporation (Industrial Products)	Subordinated Debt (14.0%, Due 6/12)	21,656	21,574	21,574
	Preferred Stock (25,000 shares)		2,500	1,900
Kodiak Fund LP ⁽⁵⁾ (Private Equity Fund)	Equity Interests		5,000	5,000
Line-X, Inc. (Consumer Products)	Senior Loan (8.4%, Due 8/11)	4,134	4,111	4,111
	Unitranche Debt (10.0% Due 8/11)	50,225	49,990	49,990
	Standby Letter of Credit (\$1,500)			
MedAssets, Inc. (Business Services)	Preferred Stock (227,865 shares)		2,049	3,417
	Warrants		136	55
Meineke Car Care Centers, Inc. (Business Services)	Senior Loan (8.4%, Due 6/11)	28,000	27,871	27,871
	Subordinated Debt (11.9%, Due 6/12 6/13)	72,000	71,690	71,690
	Common Stock (10,696,308 shares) ⁽¹¹⁾		26,985	26,130
	Warrants			
MHF Logistical Solutions, Inc. (Business Services)	Unitranche Debt (10.0%, Due 5/11)	21,922	21,823	21,823
	Preferred Stock (431 shares)		431	465
	Common Stock (1,438 shares)		144	750
Mid-Atlantic Venture Fund IV, L.P. ⁽⁵⁾ (Private Equity Fund)	Limited Partnership Interest		6,600	3,002
Mogas Energy, LLC (Energy Services)	Subordinated Debt (9.5%, Due 3/12 4/12)	16,703	15,355	15,355
	Warrants		1,774	4,000

Network Hardware Resale, Inc. (Business Services)	Unitranche Debt (10.5%, Due 12/11)	38,500	38,739	38,739
	Convertible Subordinated Debt (9.8%, Due 12/15)	12,000	12,074	12,074
N.E.W. Customer Service Companies, Inc. (Business Services)	Subordinated Debt (11.0%, Due 7/12)	40,000	40,014	40,014
Norwesco, Inc. (Industrial Products)	Subordinated Debt (12.6%, Due 1/12 7/12)	82,167	81,805	81,805
	Common Stock (559,603 shares) ⁽¹¹⁾		38,313	44,659
	Warrants			
Novak Biddle Venture Partners III, L.P. ⁽⁵⁾ (Private Equity Fund)	Limited Partnership Interest		1,594	1,703
Oahu Waste Services, Inc. (Business Services)	Stock Appreciation Rights		239	1,120

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- (11) 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.

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March 31, 2006

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		Principal	Cost	Value
Odyssey Investment Partners Fund III, LP ⁽⁵⁾ (Private Equity Fund)	Limited Partnership Interest		\$ 1,552	\$ 1,418
Opinion Research Corporation ⁽³⁾ (Business Services)	Warrants		996	175
Oriental Trading Company, Inc. (Consumer Products)	Common Stock (13,820 shares)			5,200
Palm Coast Data, LLC (Business Services)	Senior Loan (8.0%, Due 8/10)	\$ 15,850	15,778	15,778
	Subordinated Debt (15.5%, Due 8/12 8/15)	29,865	29,731	29,731
	Common Stock (21,743 shares) ⁽¹¹⁾		21,743	19,019
	Warrants			
Performant Financial Corporation (Business Services)	Common Stock (478,816 shares)		734	600
Pro Mach, Inc. (Industrial Products)	Subordinated Debt (13.8%, Due 6/12)	19,359	19,281	19,281
	Equity Interests		1,500	1,500
Promo Works, LLC (Business Services)	Senior Loan (8.9%, Due 12/11)	900	853	853
	Unitranche Debt (10.3%, Due 12/11)	31,000	30,739	30,739
	Guaranty (\$1,500)			
RadioVisa Corporation (Broadcasting & Cable)	Unitranche Debt (15.5%, Due 12/08)	27,405	27,308	27,308
Red Hawk Industries, LLC (Business Services)	Unitranche Debt (11.0%, Due 4/11)	56,328	56,060	56,060
S.B. Restaurant Company (Retail)	Subordinated Debt (14.7%, Due 11/08 12/09)	29,188	28,758	28,758
	Preferred Stock (54,125 shares)		135	135
	Warrants		619	1,200
SBBUT, LLC (Consumer Products)	Equity Interests			

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Soff-Cut Holdings, Inc. (Industrial Products)	Preferred Stock (300 shares) Common Stock (2,000 shares)		300 200	300 72
SPP Mezzanine Fund, L.P. ⁽⁵⁾ (Private Equity Fund)	Limited Partnership Interest		2,993	3,021
Tradesmen International, Inc. (Business Services)	Subordinated Debt (12.0%, Due 12/09) Warrants	15,000	14,357 710	14,357 1,950
TransAmerican Auto Parts, LLC (Consumer Products)	Senior Loan (8.2%, Due 11/11) Subordinated Debt (14.0%, Due 11/12) Equity Interests	8,944 12,780	8,944 12,719 1,190	8,944 12,719 1,190
United Site Services, Inc. (Business Services)	Subordinated Debt (12.6%, Due 8/11) Common Stock (160,588 shares)	49,712	49,515 1,000	49,515 1,200
Universal Air Filter Company (Industrial Products)	Unitranche Debt (11.0%, Due 11/11)	19,867	19,763	19,763

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March 31, 2006

Private Finance Portfolio Company (in thousands, except number of shares)	Investment ⁽¹⁾⁽²⁾	Principal	(unaudited)	
			Cost	Value
Universal Tax Systems, Inc. (Business Services)	Subordinated Debt (14.5%, Due 10/13)	\$ 19,190	\$ 19,120	\$ 19,120
Udata Venture Partners II, L.P. ⁽⁵⁾ (Private Equity Fund)	Limited Partnership Interest		5,277	4,809
Venturehouse-Cibernet Investors, LLC (Business Services)	Equity Interest		42	42
Venturehouse Group, LLC ⁽⁵⁾ (Private Equity Fund)	Equity Interest		598	419
VICORP Restaurants, Inc. ⁽³⁾ (Retail)	Warrants		33	250
Walker Investment Fund II, LLLP ⁽⁵⁾ (Private Equity Fund)	Limited Partnership Interest		1,330	548
Wear Me Apparel Corporation (Consumer Products)	Subordinated Debt (15.0%, Due 12/10) Warrants	40,000	39,088 1,219	39,088 2,400
Wilshire Restaurant Group, Inc. (Retail)	Subordinated Debt (20.0%, Due 6/07) ⁽⁶⁾	23,707	23,166	23,166
Wilton Industries, Inc. (Consumer Products)	Subordinated Debt (16.0%, Due 6/08)	4,800	4,800	4,800
Woodstream Corporation (Consumer Products)	Subordinated Debt (13.3%, Due 11/12 5/13) Common Stock (180 shares) Warrants	52,573	52,432 673	52,432 3,336 2,365
Other companies	Other debt investments Other debt investments ⁽⁶⁾ Other equity investments Guaranty (\$104)	55 468	55 468 8	55 348

Total companies less than 5% owned	\$ 1,845,529	\$ 1,831,133
Total private finance (126 portfolio companies)	\$ 3,567,515	\$ 3,561,633

- (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.

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

			March 31, 2006	
			(unaudited)	
	Interest Rate Ranges	Number of Loans	Cost	Value
Commercial Mortgage Loans				
	Up to 6.99%	4	\$ 22,779	\$ 21,920
	7.00% 8.99%	25	48,564	48,695
	9.00% 10.99%	4	25,816	25,816
	11.00% 14.99%	1	2,293	2,293
	15.00% and above	2	3,970	3,970
Total commercial mortgage loans ⁽¹²⁾		36	\$ 103,422	\$ 102,694
Real Estate Owned			\$ 13,002	\$ 15,006
Equity Interests⁽²⁾ Companies more than 25% owned (Guarantees \$7,004)			\$ 13,140	\$ 11,669
Total commercial real estate finance			\$ 129,564	\$ 129,369
Total portfolio			\$ 3,697,079	\$ 3,691,002

	Yield	Cost	Value
Liquidity Portfolio			
U.S. Treasury bills (Due June 2006)	4.2%	\$ 100,000	\$ 101,289
SEI Daily Income Tr Prime Obligation Fund ⁽¹³⁾	4.6%	101,072	101,072
Total liquidity portfolio		\$ 201,072	\$ 202,361
Other Investments in Money Market Securities⁽¹³⁾			
PNC Bank Corporate Money Market Deposit Account	4.5%	\$ 29,318	\$ 29,318
Columbia Treasury Reserves Money Market Fund	4.5%	\$ 9,374	\$ 9,374

- (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.
- (12) Commercial mortgage loans totaling \$21.2 million at value were on non-accrual status and therefore were considered non-income producing.
- (13) Included in investments in money market securities on the accompanying Consolidated Balance Sheet.

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

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

(Information at and for the three months ended March 31, 2006 and 2005 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 that are single member limited liability companies established primarily to hold real estate properties. ACC also has a subsidiary, A.C. Corporation (AC Corp), that generally provides diligence and structuring services as well as structuring, transaction, management, consulting and other services to the Company and its portfolio companies. AC Corp has a wholly-owned subsidiary, AC Finance LLC (AC Finance), that generally underwrites and arranges senior loans for the Company s portfolio companies and other third parties.

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

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

The investment objective of the Company is to achieve current income and capital gains. In order to achieve this objective, the Company has 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 2005 balances to conform with the 2006 financial statement presentation.

The accompanying unaudited consolidated financial statements of the Company have been prepared in accordance with U.S. generally accepted accounting principles (GAAP) for interim financial information. Accordingly, they do not include all of the information and footnotes required by GAAP for complete consolidated financial statements. In the opinion of management, the unaudited consolidated financial results of the Company included herein contain all adjustments (consisting of only normal recurring accruals) necessary to present fairly the financial position of the Company as of March 31, 2006, and the results of operations, changes in net assets, and cash flows for the three months ended March 31, 2006 and 2005. The results of operations for the three months ended March 31, 2006, 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 and CDO and CLO bonds and preferred shares/income notes. The Company's investments may be subject to certain 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. The value of loan and debt securities may be greater than the Company's cost basis

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

Note 2. Summary of Significant Accounting Policies, continued

if the amount that would be repaid on the loan or debt security upon the sale of the portfolio company is greater than the Company's cost basis.

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 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 a method that approximates 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.

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

Note 2. Summary of Significant Accounting Policies, continued

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

Collateralized Debt Obligations (CDO) and Collateralized Loan Obligations (CLO)

CDO and CLO bonds and preferred shares/ income notes (CDO/ CLO Assets) are carried at fair value, which is based on a discounted cash flow model that utilizes prepayment and loss assumptions based on historical experience and projected performance, economic factors, the characteristics of the underlying cash flow, and comparable yields for similar bonds and preferred shares/income notes, when available. The Company recognizes unrealized appreciation or depreciation on its CDO/ CLO Assets as comparable yields in the market change and/or based on changes in estimated cash flows resulting from changes in prepayment or loss assumptions in the underlying collateral pool. The Company determines the fair value of its CDO/ CLO Assets on an individual security-by-security basis.

The Company recognizes income from the amortization of original issue discount using the effective interest method using the anticipated yield over the projected life of the investment. Yields are revised when there are changes in actual and estimated prepayment speeds or actual and estimated credit losses. Changes in estimated yield are recognized as an adjustment to the estimated yield over the remaining life of the CDO/ CLO Assets 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, the change in the value of U.S. Treasury bills and deposits of proceeds from sales of borrowed Treasury securities, and depreciation on accrued interest and dividends receivable and other assets where collection is doubtful.

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. See Note 5.

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 using a method that approximates the effective interest method. 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.

Dividends to Shareholders

Dividends to shareholders are recorded on the record date.

Stock Compensation Plans

The Company has a stock-based employee compensation plan. See Note 9. Effective January 1, 2006, the Company adopted the provisions of Statement No. 123 (Revised 2004), *Share-Based Payment* (the Statement). With respect to options granted prior to January 1, 2006, the Company has used the modified prospective method for adoption of the Statement. Under this method, the unamortized cost of previously awarded options that were unvested as of January 1, 2006, is recognized over the service period in the statement of operations beginning in 2006. With respect to options granted on or after January 1, 2006, compensation cost is recognized over the service period in the statement of operations. The effect of this adoption for the three months ended March 31, 2006, was employee-related stock option expense of \$3.6 million or \$0.03 per basic and diluted share, which included \$3.4 million related to previously awarded options that were unvested as of January 1, 2006, and \$0.2 million related to options granted during the three months ended March 31, 2006.

Prior to January 1, 2006, the Company accounted for this plan under the recognition and measurement principles of APB Opinion No. 25, *Accounting for Stock Issued to Employees*, and related interpretations. Prior to January 1, 2006, no stock-based employee compensation cost was 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

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

Note 2. Summary of Significant Accounting Policies, continued

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

	For the Three Months Ended March 31, 2005	
(in thousands, except per share amounts)		
Net increase in net assets resulting from operations as reported	\$	119,621
Less total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects		(2,856)
Pro forma net increase in net assets resulting from operations available to common shareholders	\$	116,765
Basic earnings per common share:		
As reported	\$	0.90
Pro forma	\$	0.88
Diluted earnings per common share:		
As reported	\$	0.88
Pro forma	\$	0.86

The stock option expense for 2006 and the pro forma expense for 2005 shown in the table above were based on the underlying value of the options granted by the Company. The fair value of each option grant was estimated on the date of grant using the Black-Scholes option pricing model and expensed over the vesting period. The following assumptions were used to calculate the fair value of options granted during the three months ended March 31, 2006 and 2005:

	For the Three Months Ended March 31,	
	2006	2005⁽¹⁾
Risk-free interest rate	4.3%	%
Expected life	5.0	
Expected volatility	29.6%	%
Dividend yield	9.0%	%
Weighted average fair value per option	\$ 3.35	\$

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

The risk free rate was based on the U.S. Treasury bond yield curve at the date of grant. The Company used historical data to estimate option exercise and employee termination in order to determine the expected life of the

option. The expected life of the options granted represents the period of time that such options are expected to be outstanding. Expected volatilities were determined based on the historical volatility of the Company's common stock. The dividend yield was determined based on the Company's historical dividend yield.

The Company estimates that the stock option expense under the Statement that will be recorded in the Company's statement of operations will be approximately \$14.3 million, \$9.3 million, and \$2.8 million for the years ended December 31, 2006, 2007, and 2008, respectively, which includes

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

Note 2. Summary of Significant Accounting Policies, continued

stock option expense related to options granted in the first quarter of 2006 of approximately \$0.8 million, \$0.5 million, and \$0.2 million, respectively. This estimate may change if the Company's assumptions related to future option forfeitures change. This estimate does not include any expense related to future stock option grants as the fair value of those stock options will be determined at the time of grant. The aggregate total stock option expense is expected to be recognized over an estimated weighted-average period of 1.42 years.

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 (REIT). ACC and its subsidiaries that qualify as a RIC or a REIT intend to distribute or retain through a deemed distribution all of their annual taxable income to shareholders; therefore, the Company has made no provision for income taxes for these entities. Income taxes for AC Corp are accounted for under the asset and liability method. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases as well as operating loss and tax credit carryforwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled.

If the Company does not distribute at least 98% of its annual taxable income in the year earned, the Company will generally be required to pay an excise tax equal to 4% of the amount by which 98% of the Company's annual taxable income exceeds the distributions from such taxable income for the 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 from such taxable income, 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.

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

Note 2. Summary of Significant Accounting Policies, continued

The consolidated financial statements include portfolio investments at value of \$3.7 billion and \$3.6 billion at March 31, 2006, and December 31, 2005, respectively. At both March 31, 2006, and December 31, 2005, 90% 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.

Note 3. Portfolio*Private Finance*

At March 31, 2006, and December 31, 2005, the private finance portfolio consisted of the following:

	2006			2005		
	Cost	Value	Yield ⁽¹⁾	Cost	Value	Yield ⁽¹⁾
(\$ in thousands)						
Loans and debt securities:						
Senior loans	\$ 468,987	\$ 420,065	9.3%	\$ 284,680	\$ 239,838	9.5%
Unitranche debt ⁽²⁾	362,726	362,726	11.1%	294,201	294,201	11.4%
Subordinated debt	1,801,347	1,747,235	13.6%	1,610,228	1,560,851	13.8%
Total loans and debt securities ⁽³⁾	2,633,060	2,530,026	12.5%	2,189,109	2,094,890	13.0%
Equity securities	934,455	1,031,607		917,314	1,384,400	
Total	\$ 3,567,515	\$ 3,561,633		\$ 3,106,423	\$ 3,479,290	

(1) The weighted average yield on loans and debt securities is computed as the (a) annual stated interest plus the annual amortization of loan origination fees, original issue discount, and market discount on accruing loans and debt securities less the annual amortization of loan origination costs, divided by (b) total loans and debt securities at value. At March 31, 2006, and December 31, 2005, the cost and value of subordinated debt 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) Unitranche debt is a single debt investment that is a blend of senior and subordinated debt terms.

(3) The total principal balance outstanding on loans and debt securities was \$2,662.5 million and \$2,216.3 million at March 31, 2006, and December 31, 2005, respectively. The difference between principal and cost is represented by unamortized loan origination fees and costs, original issue discounts, and market discounts totaling \$29.4 million and \$27.2 million at March 31, 2006, and December 31, 2005, 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 may be subject to certain 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

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

Note 3. Portfolio, continued

Company's rights and priority in the portfolio company's capital structure, and will vary depending on many factors, including if the Company has received nominal cost equity or other components of investment return, such as loan origination fees or market discount. The stated interest rate may include some component of contractual payment-in-kind interest, which represents contractual interest accrued and added to the loan balance that generally becomes due at maturity.

At March 31, 2006, 80% of the private finance loans and debt securities had a fixed rate of interest and 20% had a floating rate of interest. At December 31, 2005, 87% of the private finance loans and debt securities had a fixed rate of interest and 13% had a floating rate of interest. Senior loans generally carry a floating rate of interest, usually set as a spread over LIBOR, and generally require payments of both principal and interest throughout the life of the loan. Senior loans generally have maturities of three to five years and interest is generally paid to the Company monthly or quarterly. Loans other than senior loans generally carry a fixed rate of interest with maturities of five to ten years. These loans generally have interest-only payments in the early years and payments of both principal and interest in the later years, although maturities and principal amortization schedules may vary. Interest is generally paid to the Company quarterly.

Equity securities consist primarily of securities issued by private companies and may be subject to certain restrictions on their resale and are generally illiquid. The Company may make equity investments for minority stakes in portfolio companies in conjunction with its debt investments. The Company may also invest in the equity (preferred and/or voting or non-voting common) of a portfolio company where the Company's equity ownership may represent a significant portion of the equity, but may or may not represent a controlling interest. If the Company invests in non-voting equity in a buyout investment, the Company generally has the option to acquire a controlling stake in the voting securities of the portfolio company at fair market value. 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 investment at value at March 31, 2006, was in Business Loan Express, LLC (BLX). The Company's largest investments at value at December 31, 2005, were in Advantage Sales & Marketing, Inc. (Advantage) and BLX. On March 29, 2006, the Company sold its majority equity interest in Advantage.

Business Loan Express, LLC. The Company's investment in BLX totaled \$291.3 million at cost and \$326.2 million at value at March 31, 2006, and \$299.4 million at cost and \$357.1 million at value at December 31, 2005. BLX is a small business lender that participates in the U.S. Small Business Administration's 7(a) Guaranteed Loan Program. At March 31, 2006, and December 31, 2005, 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.

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

Note 3. Portfolio, continued

Total interest and related portfolio income earned from the Company's investment in BLX for the three months ended March 31, 2006 and 2005, was as follows:

(\$ in millions)	2006	2005
Interest income on subordinated debt and Class A equity interests	\$ 3.9	\$ 3.4
Dividend income on Class B equity interests		2.0
Fees and other income	2.2	2.4
 Total interest and related portfolio income	 \$ 6.1	 \$ 7.8

Interest and dividend income from BLX for the three months ended March 31, 2006 and 2005, included interest and dividend income of \$1.8 million and \$1.6 million, respectively, which was paid in kind. The interest and dividends paid in kind were paid to the Company through the issuance of additional debt or equity interests.

Net change in unrealized appreciation or depreciation included a net decrease in unrealized appreciation on the Company's investment in BLX of \$22.7 million and \$6.3 million for the three months ended March 31, 2006 and 2005, respectively.

At March 31, 2006, and December 31, 2005, the Company had a commitment to BLX of \$30.0 million in the form of a subordinated revolving credit facility to provide working capital to BLX. There were no amounts outstanding under this facility at March 31, 2006, and there was \$10.0 million outstanding under this facility at December 31, 2005. This facility matured on April 30, 2006.

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

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

Note 3. Portfolio, continued

to \$40 million. At March 31, 2006, and December 31, 2005, 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.

At December 31, 2005, BLX had a three-year \$275.0 million revolving credit facility provided by third party lenders that was scheduled to mature in January 2007. As the controlling equity owner in BLX, the Company had provided an unconditional guaranty to the revolving credit facility lenders in an amount equal to 50% of the total obligations (consisting of principal, letters of credit issued under the facility, accrued interest, and other fees) of BLX under the revolving credit facility. The total obligation guaranteed by the Company at December 31, 2005, was \$135.4 million.

On March 17, 2006, BLX closed on a new three-year \$500.0 million revolving credit facility that matures in March 2009, which replaced the existing facility. The revolving credit facility may be expanded through new or additional commitments up to \$600.0 million at BLX's option. This new facility provides for a sub-facility for the issuance of letters of credit for up to an amount equal to 25% of the committed facility. The Company has provided an unconditional guaranty to these 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 this facility. The amount guaranteed by the Company at March 31, 2006, was \$141.1 million. This guaranty can be called by the lenders only in the event of a default under the BLX credit facility, which includes certain defaults under the Company's revolving credit facility. BLX was in compliance with the terms of this facility at March 31, 2006.

At March 31, 2006, and December 31, 2005, the Company had also provided four standby letters of credit totaling \$34.1 million in connection with four term securitization transactions completed by BLX. In consideration for providing the revolving credit facility guaranty and the standby letters of credit, BLX paid the Company fees of \$1.6 million for both the three months ended March 31, 2006 and 2005.

Advantage Sales and Marketing, Inc. In June 2004, the Company completed the purchase of a majority voting ownership in Advantage, which was subject to dilution by a management option pool. Advantage is a 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.

At December 31, 2005, the Company's investment in Advantage totaled \$257.7 million at cost and \$660.4 million at value, which included unrealized appreciation of \$402.7 million.

On March 29, 2006, the Company sold its majority equity interest in Advantage. The Company was repaid its \$184 million in subordinated debt outstanding and realized a gain on its equity investment sold of \$433.1 million, subject to post-closing adjustments. As consideration for the common stock sold in the transaction, the Company received a \$150 million subordinated note, with the balance of the consideration paid in cash. Approximately \$34 million of the Company's cash proceeds from the sale of the common stock have been held in escrow, subject to certain holdback provisions. In addition, there is potential for the Company to receive additional consideration through an earn-out payment that would be based on Advantage's 2006 audited results. The Company's realized gain of \$433.1 million excludes any earn-out amounts. In connection with the transaction, the

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

Note 3. Portfolio, continued

Company retained an equity investment in the business valued at \$15 million as a minority shareholder.

After the completion of the sale transaction, the Company's investment in Advantage at March 31, 2006, which was composed of subordinated debt and a minority equity interest, totaled \$151.3 million at cost and \$164.3 million at value. This investment was included in companies 5% to 25% owned in the consolidated financial statements as the Company continues to hold a seat on Advantage's board of directors.

Total interest and related portfolio income earned from the Company's investment in Advantage while the Company held a majority equity interest for the three months ended March 31, 2006 and 2005, was as follows:

(\$ in millions)	2006	2005
Interest income	\$ 7.3	\$ 7.7
Loan prepayment premiums	5.0	
Fees and other income	1.8	1.5
 Total interest and related portfolio income	 \$ 14.1	 \$ 9.2

Net change in unrealized appreciation or depreciation for the three months ended March 31, 2006, included the reversal of \$389.7 million of previously recorded unrealized appreciation associated with the realization of a gain on the sale of the Company's majority equity interest in Advantage and for the three months ended March 31, 2005, included an increase of \$68.9 million in unrealized appreciation related to the Company's investment in Advantage.

STS Operating, Inc. On May 1, 2006, the Company announced the completion of the sale of STS Operating, Inc. (STS). The Company was repaid its \$6.8 million in subordinated debt outstanding and realized a gain on the sale of its common stock in STS of approximately \$94 million, subject to post-closing adjustments. The cost basis of its equity was \$3.5 million. As part of the consideration for the sale of its equity, the Company received a \$30 million subordinated note. Approximately \$10.7 million of its proceeds are subject to certain holdback provisions and post-closing adjustments.

Collateralized Loan Obligations (CLOs) and Collateralized Debt Obligations (CDOs) At March 31, 2006, and December 31, 2005, the Company owned bonds and preferred shares/income notes in two collateralized loan obligations (CLOs) totaling \$90.9 million and \$89.3 million at value, respectively, and bonds in one collateralized debt obligation (CDO) totaling \$28.5 million at value at both periods. These CLOs and CDO are managed by Callidus Capital Corporation.

The bonds, preferred shares and income notes of the CLOs and CDO in which the Company has invested are junior in priority for payment of interest and principal to the more senior notes issued by the CLOs and CDO. Cash flow from the underlying collateral assets in the CLOs and CDO is generally allocated first to the senior bonds in order of priority, then any remaining cash flow is generally distributed to the preferred shareholders and income note holders. To the extent there are defaults and unrecoverable losses on the underlying collateral assets that result in reduced cash flows, the preferred shares/income notes would bear this loss first and then the subordinated bonds would bear any loss after the preferred shares/income notes.

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

Note 3. Portfolio, continued

At both March 31, 2006, and December 31, 2005, the face value of the CLO and CDO bonds held by the Company were subordinate to approximately 82% to 85% of the face value of the securities issued in these CLOs and CDO. At both March 31, 2006, and December 31, 2005, the face value of the CLO preferred shares/income notes held by the Company were subordinate to approximately 86% to 91% of the face value of the securities issued in these CLOs.

At March 31, 2006, and December 31, 2005, the Company owned CLO and CDO investments from three issuances. The underlying collateral assets of these CLO and CDO investments, consisting primarily of senior debt, were issued by 332 issuers and 336 issuers, respectively, and had balances as follows:

	2006	2005
(\$ in millions)		
Bonds	\$ 228.9	\$ 230.7
Syndicated Loans	758.9	704.0
Cash ⁽¹⁾	185.0	238.4
Total underlying collateral assets	\$ 1,172.8	\$ 1,173.1

⁽¹⁾ Includes undrawn liability amounts.

At March 31, 2006, and December 31, 2005, there were no delinquencies in the underlying collateral assets of the CLO and CDO issuances owned by the Company.

The initial yields on the CLO and CDO bonds, preferred shares and income notes are based on the estimated future cash flows from the underlying collateral assets expected to be paid to these CLO and CDO classes. As each CLO and CDO bond, preferred share or income note ages, the estimated future cash flows will be updated based on the estimated performance of the underlying collateral assets, and the respective yield will be adjusted as necessary. As future cash flows are subject to uncertainties and contingencies that are difficult to predict and are subject to future events that may alter current assumptions, no assurance can be given that the anticipated yields to maturity will be achieved.

Loans and Debt Securities on Non-Accrual Status. At March 31, 2006, and December 31, 2005, private finance loans and debt securities at value not accruing interest were as follows:

	2006	2005
(\$ in thousands)		
Loans and debt securities in workout status (classified as Grade 4 or 5)		
Companies more than 25% owned	\$ 29,030	\$ 15,622
Companies 5% to 25% owned	5,583	
Companies less than 5% owned	51,776	11,417
Loans and debt securities not in workout status		
Companies more than 25% owned	40,599	58,047
Companies 5% to 25% owned	5,154	534
Companies less than 5% owned	4,369	49,458
Total	\$ 136,511	\$ 135,078

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

Note 3. Portfolio, continued

Industry and Geographic Compositions. The industry and geographic compositions of the private finance portfolio at value at March 31, 2006, and December 31, 2005, were as follows:

	2006	2005
Industry		
Business services	33%	45%
Consumer products	25	14
Financial services	14	15
Industrial products	11	10
Retail	3	3
Healthcare services	2	2
Energy services	2	2
Broadcasting and cable	1	1
Other ⁽¹⁾	9	8
Total	100%	100%
Geographic Region⁽²⁾		
Mid-Atlantic	30%	29%
Midwest	28	21
West	21	34
Southeast	16	12
Northeast	5	4
Total	100%	100%

(1) Includes investments in senior debt CDO and CLO funds. These funds invest in senior debt representing a variety of industries.

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

Commercial Real Estate Finance

At March 31, 2006, and December 31, 2005, the commercial real estate finance portfolio consisted of the following:

	2006			2005		
	Cost	Value	Yield ⁽¹⁾	Cost	Value	Yield ⁽¹⁾
(\$ in thousands)						
Commercial mortgage loans	\$ 103,422	\$ 102,694	7.6%	\$ 103,878	\$ 102,569	7.6%
Real estate owned	13,002	15,006		14,240	13,932	
Equity interests	13,140	11,669		13,577	10,564	

Total	\$ 129,564	\$ 129,369	\$ 131,695	\$ 127,065
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(1) The weighted average yield on the interest-bearing investments is computed as the (a) annual stated interest plus the annual amortization of loan origination fees, original issue discount, and market discount on accruing interest-bearing investments less the annual amortization of origination costs, divided by (b) total interest-bearing investments at value. The weighted average yield is computed as of the balance sheet date. Interest-bearing investments for the commercial real estate finance portfolio include all investments except for real estate owned and equity interests.

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

Note 3. Portfolio, continued

Commercial Mortgage Loans and Equity Interests. The commercial mortgage loan portfolio contains loans that were originated by the Company or were purchased from third-party sellers. At both March 31, 2006, and December 31, 2005, approximately 97% and 3% of the Company's commercial mortgage loan portfolio was composed of fixed and adjustable interest rate loans, respectively. At March 31, 2006, and December 31, 2005, loans with a value of \$21.2 million and \$20.8 million, respectively, were not accruing interest. Loans greater than 120 days delinquent generally do not accrue interest.

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

The property types and the geographic composition securing the commercial mortgage loans and equity interests at value at March 31, 2006, and December 31, 2005, were as follows:

	2006	2005
Property Type		
Hospitality	40%	37%
Housing	29	30
Retail	16	16
Office	11	11
Other	4	6
Total	100%	100%
Geographic Region		
Mid-Atlantic	31%	31%
Southeast	24	25
Midwest	21	21
West	18	18
Northeast	6	5
Total	100%	100%

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

Note 4. Debt

At March 31, 2006, and December 31, 2005, the Company had the following debt:

	2006			2005		
	Facility Amount	Amount Drawn	Annual Interest Cost ⁽¹⁾	Facility Amount	Amount Drawn	Annual Interest Cost ⁽¹⁾
(\$ in thousands)						
Notes payable and debentures:						
Unsecured notes payable	\$ 1,164,745	\$ 1,164,745	6.2%	\$ 1,164,540	\$ 1,164,540	6.2%
SBA debentures	16,500	16,500	7.4%	28,500	28,500	7.5%
Total notes payable and debentures	1,181,245	1,181,245	6.2%	1,193,040	1,193,040	6.3%
Revolving line of credit	772,500	93,000	6.2% ⁽²⁾	772,500	91,750	5.6% ⁽²⁾
Total debt	\$ 1,953,745	\$ 1,274,245	6.5% ⁽³⁾	\$ 1,965,540	\$ 1,284,790	6.5% ⁽³⁾

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

(2) The annual interest cost reflects the interest rate payable for borrowings under the revolving line of credit. In addition to the current interest rate payable, there were annual costs of commitment fees and other facility fees of \$3.3 million at both March 31, 2006, and December 31, 2005.

(3) The annual interest cost for total debt includes the annual cost of commitment fees and other facility fees on the revolving line of credit regardless of the amount outstanding on the facility as of the balance sheet date.

Notes Payable and Debentures

Unsecured Notes Payable. The Company has issued unsecured long-term notes to institutional investors. The notes require semi-annual interest payments until maturity and have original terms of five or seven years. At March 31, 2006, the notes had remaining maturities of one month to seven years. The notes may be prepaid in whole or in part, together with an interest premium, as stipulated in the note agreement.

On May 1, 2006, the Company issued \$50 million of seven-year, unsecured notes with a fixed interest rate of 6.75%. This debt matures in May 2013. The proceeds from the issuance of the notes were used to repay \$25 million of 7.49% unsecured long-term notes that matured on May 1, 2006, with the remainder being used to fund new portfolio investments and for general corporate purposes.

SBA Debentures. At March 31, 2006, and December 31, 2005, the Company had debentures payable to the SBA with original terms of ten years and at fixed interest rates ranging from 5.9% to 6.3% and 5.9% to 6.4%, respectively. At March 31, 2006, the debentures had remaining maturities of five to six years. The debentures require semi-annual interest-only payments with all principal due upon maturity. The SBA debentures are subject to prepayment penalties if paid prior to the fifth anniversary date of the notes. During the first quarters of 2006 and 2005, the Company repaid

\$12.0 million and \$31.0 million, respectively, of the SBA debentures.

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

Note 4. Debt, continued

Scheduled Maturities. Scheduled future maturities of notes payable and debentures at March 31, 2006, were as follows:

Year	Amount Maturing
	(\$ in thousands)
2006	\$ 175,000
2007	
2008	153,000
2009	267,245
2010	408,000
Thereafter	178,000
Total	\$ 1,181,245

Revolving Line of Credit

At March 31, 2006, and December 31, 2005, the Company had an unsecured revolving line of credit with a committed amount of \$772.5 million. The revolving line of credit expires on September 30, 2008, and may be expanded through new or additional commitments up to \$922.5 million at the Company's option. The revolving line of credit generally bears interest at a rate equal to (i) LIBOR (for the period the Company selects) plus 1.30% or (ii) the higher of the Federal Funds rate plus 0.50% or the Bank of America N.A. prime rate. The revolving line of credit requires the payment of an annual commitment fee equal to 0.20% of the committed amount. The revolving line of credit generally requires payments of interest at the end of each LIBOR interest period, but no less frequently than quarterly, on LIBOR based loans and monthly payments of interest on other loans. All principal is due upon maturity.

The annual cost of commitment fees and other facility fees was \$3.3 million at both March 31, 2006, and December 31, 2005.

The average debt outstanding on the revolving line of credit was \$301.9 million and \$72.3 million for the three months ended March 31, 2006 and 2005, respectively. The maximum amount borrowed under this facility and the weighted average stated interest rate for the three months ended March 31, 2006 and 2005, were \$540.3 million and 5.9%, respectively, and \$263.3 million and 4.1%, respectively. As of March 31, 2006, the amount available under the revolving line of credit was \$641.8 million, net of amounts committed for standby letters of credit of \$37.7 million issued under the credit facility.

Covenant Compliance

The Company has various financial and operating covenants required by the notes payable and debentures and the revolving line of credit. These covenants require the Company to maintain certain financial ratios, including debt to equity and interest coverage, and a minimum net worth. These credit facilities provide for customary events of default, including, but not limited to, payment defaults, breach of representations or covenants, cross-defaults, bankruptcy events, failure to pay judgments, attachment of our assets, change of control and the issuance of an order of dissolution. Certain of these events of default are subject to notice and cure periods or materiality thresholds. The Company's credit facilities limit its ability to declare dividends if the Company defaults under certain

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

Note 4. Debt, continued

provisions. As of March 31, 2006, and December 31, 2005, the Company was in compliance with these covenants.

Note 5. Guarantees and Commitments

In the ordinary course of business, the Company has issued guarantees and has extended standby letters of credit through financial intermediaries on behalf of certain portfolio companies. All standby letters of credit have been issued through Bank of America, N.A. As of March 31, 2006, and December 31, 2005, the Company had issued guarantees of debt, rental obligations, and lease obligations aggregating \$154.0 million and \$148.6 million, respectively, and had extended standby letters of credit aggregating \$37.7 million and \$37.1 million, respectively. Under these arrangements, the Company would be required to make payments to third-party beneficiaries if the portfolio companies were to default on their related payment obligations. The maximum amount of potential future payments was \$191.7 million and \$185.7 million at March 31, 2006, and December 31, 2005, respectively. At both March 31, 2006, and December 31, 2005, \$2.5 million had been recorded as a liability for the Company's guarantees and no amounts had been recorded as a liability for the Company's standby letters of credit.

As of March 31, 2006, the guarantees and standby letters of credit expire as follows:

(in millions)	Total	2006	2007	2008	2009	2010	After 2010
Guarantees	\$ 154.0	\$ 1.3	\$ 0.6	\$ 3.0	\$ 143.6	\$	\$ 5.5
Standby letters of credit ⁽¹⁾	37.7	0.1		37.6			
Total	\$ 191.7	\$ 1.4	\$ 0.6	\$ 40.6	\$ 143.6	\$	\$ 5.5

⁽¹⁾ Standby letters of credit are issued under the Company's revolving line of credit that expires in September 2008.

Therefore, unless a standby letter of credit is set to expire at an earlier date, it is assumed that the standby letters of credit will expire contemporaneously with the expiration of the Company's line of credit in September 2008.

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

At March 31, 2006, the Company had outstanding commitments to fund investments totaling \$329.9 million, including \$316.3 million related to private finance investments and \$13.6 million related to commercial real estate finance investments. In addition, during the fourth quarter of 2004 and the first quarter of 2005, the Company sold certain commercial mortgage loans that the Company may be required to repurchase under certain circumstances. These recourse provisions expire by April 2007. The aggregate outstanding principal balance of these sold loans was \$11.3 million at March 31, 2006.

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

Note 6. Shareholders' Equity

Sales of common stock for the three months ended March 31, 2006 and 2005, were as follows:

(in thousands)	2006	2005 ⁽¹⁾
Number of common shares	3,000	
Gross proceeds	\$ 87,750	\$
Less costs, including underwriting fees	4,780	
Net proceeds	\$ 82,970	\$

⁽¹⁾ The Company did not sell any common stock during the three months ended March 31, 2005.

The Company issued 0.3 million shares of common stock with a value of \$7.2 million as consideration for an additional investment in Mercury Air Center, Inc. during the three months ended March 31, 2005.

The Company issued 0.2 million shares of common stock upon the exercise of stock options during each of the three months ended March 31, 2006 and 2005.

The Company has a dividend reinvestment plan, whereby the Company may buy shares of its common stock in the open market or issue new shares in order to satisfy dividend reinvestment requests. If the Company issues new shares, the issue price is equal to the average of the closing sale prices reported for the Company's common stock for the five consecutive trading days immediately prior to the dividend payment date. For the three months ended March 31, 2006 and 2005, the Company issued new shares in order to satisfy dividend reinvestment requests.

Dividend reinvestment plan activity for the three months ended March 31, 2006 and 2005, was as follows:

(in thousands, except per share amounts)	For the Three Months Ended March 31,	
	2006	2005
Shares issued	120	55
Average price per share	\$ 30.29	\$ 25.65

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

Note 7. Earnings Per Common Share

Earnings per common share for the three months ended March 31, 2006 and 2005, were as follows:

	For the Three Months Ended March 31,	
	2006	2005
(in thousands, except per share amounts)		
Net increase in net assets resulting from operations available to common shareholders	\$ 99,587	\$ 119,621
Weighted average common shares outstanding basic	138,759	133,283
Dilutive options outstanding to officers	2,979	2,296
Weighted average common shares outstanding diluted	141,738	135,579
Basic earnings per common share	\$ 0.72	\$ 0.90
Diluted earnings per common share	\$ 0.70	\$ 0.88

Note 8. Employee Compensation Plans

The Company has a deferred compensation plan. Amounts deferred by participants under the deferred compensation plan are funded to a trust, which is administered by trustees. The accounts of the deferred compensation trust are consolidated with the Company's accounts. The assets of the trust are classified as other assets and the liability to the plan participants is included in other liabilities in the accompanying financial statements. The deferred compensation plan accounts at March 31, 2006, and December 31, 2005, totaled \$17.4 million and \$16.6 million, respectively.

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

The IPA is generally determined annually at the beginning of each year but may be adjusted throughout the year. The IPA is deposited in the trust in four equal installments, generally on a quarterly basis, in the form of cash. The Compensation Committee of the Board of Directors designed the DCP II to require the trustee to use the cash to purchase shares of the Company's common stock in the open market. During both the three months ended March 31, 2006 and 2005, 0.1 million shares were purchased in the DCP II.

All amounts deposited and then credited to a participant's account in the trust, based on the amount of the IPA received by such participant, are credited solely for purposes of accounting and computation and remain assets of the Company and subject to the claims of the Company's general creditors. Amounts credited to participants under the DCP II are immediately vested and generally non-forfeitable once deposited by the Company into the trust. A participant's account shall generally become distributable only after his or her termination of employment, or in the event of a change of control of the Company. Upon the participant's termination of employment, one-third of the

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

Note 8. Employee Compensation Plans, continued

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

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

The IPA amounts are contributed into the DCP II trust and invested in the Company's common stock. The accounts of the DCP II are consolidated with the Company's accounts. The common stock is classified as common stock held in deferred compensation trust in the accompanying financial statements and the deferred compensation obligation, which represents the amount owed to the employees, is included in other liabilities. Changes in the value of the Company's common stock held in the deferred compensation trust are not recognized. However, the liability is marked to market with a corresponding charge or credit to employee compensation expense. At March 31, 2006, and December 31, 2005, common stock held in DCP II was \$21.5 million and \$19.5 million, respectively, and the IPA liability was \$25.4 million and \$22.3 million, respectively.

The IPA expenses for the three months ended March 31, 2006 and 2005, were as follows:

(\$ in millions)	2006	2005
IPA contributions	\$ 1.7	\$ 1.9
IPA mark to market expense	1.0	0.1
Total IPA expense	\$ 2.7	\$ 2.0

The Company also has an individual performance bonus (IPB) plan which is distributed in cash to award recipients in equal bi-weekly installments as long as the recipient remains employed by the Company. If a recipient terminated employment during the year, any remaining cash payments under the IPB would be forfeited. For the three months ended March 31, 2006 and 2005, the IPB expense was \$1.4 million and \$1.5 million, respectively. The IPA and IPB expenses are included in employee expenses.

Note 9. Stock Option Plan

The purpose of the stock option plan (Option Plan) is to provide officers and non-officer directors of the Company with additional incentives. Options are exercisable at a price equal to the fair market value of the shares on the day the option is granted. Each option states the period or

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

Note 9. Stock Option Plan, continued

periods of time within which the option may be exercised by the optionee, which may not exceed ten years from the date the option is granted. The options granted generally vest ratably over a three-to five-year period. Options granted to non-officer directors vest on the grant date.

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

There are 32.2 million shares authorized under the Option Plan. At March 31, 2006, and December 31, 2005, the number of shares available to be granted under the Option Plan was 2.8 million and 3.0 million, respectively.

Information with respect to options granted, exercised and forfeited under the Option Plan for the three months ended March 31, 2006, was as follows:

	Shares	Weighted Average Exercise Price Per Share	Weighted Average Contractual Remaining Term (Years)	Aggregate Intrinsic Value at March 31, 2006 ⁽¹⁾
(in thousands, except per share amounts)				
Options outstanding at January 1, 2006	22,259	\$24.52		
Granted	515	\$29.23		
Exercised	(167)	\$23.53		
Forfeited	(251)	\$27.70		
Outstanding at March 31, 2006	22,356	\$24.60	7.02	\$134,213
Exercisable at March 31, 2006	12,982	\$22.37	5.63	\$106,892
Exercisable and expected to be exercisable at March 31, 2006 ⁽²⁾	21,572	\$24.48	6.95	\$131,930

⁽¹⁾ Represents the difference between the market value of the options at March 31, 2006, and the cost for the option holders to exercise the options.

⁽²⁾ The amount of options expected to be exercisable at March 31, 2006, is calculated based on an estimate of expected forfeitures.

The fair value of the shares vested during the three months ended March 31, 2006 and 2005, was \$6 thousand and \$172 thousand, respectively. The total intrinsic value of options exercised during the three months ended March 31, 2006 and 2005, was \$1.1 million and \$1.0 million, respectively.

Note 10. Dividends and Distributions and Taxes

The Company's Board of Directors declared and the Company paid a dividend of \$0.59 per common share and \$0.57 per common share for the first quarters of 2006 and 2005, respectively. These dividends totaled \$82.5 million

and \$76.1 million for the three months ended March 31, 2006 and 2005, respectively. The Company declared an extra cash dividend of \$0.03 per share during 2005 and this was paid to shareholders on January 27, 2006.

The Company's Board of Directors also declared a dividend of \$0.60 per common share for the second quarter of 2006.

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

Note 10. Dividends and Distributions and Taxes, continued

The Company will generally be required to pay a nondeductible excise tax equal to 4% of the amount by which 98% of the Company's annual taxable income exceeds the distributions for the year. The Company currently estimates that its 2006 annual taxable income will be in excess of its dividend distributions from such taxable income in 2006, and that such estimated excess taxable income will be carried over for distribution in 2007. Accordingly, the Company has accrued an excise tax of \$8.4 million on the estimated excess taxable income earned for the three months ended March 31, 2006. There was no excise tax accrual for the three months ended March 31, 2005.

Note 11. Supplemental Disclosure of Cash Flow Information

For the three months ended March 31, 2006 and 2005, the Company paid \$7.5 million and \$7.0 million, respectively, for interest.

Principal collections related to investment repayments or sales included the collection of discounts previously amortized into interest income and added to the cost basis of a loan or debt security totaling \$0 and \$1.1 million for the three months ended March 31, 2006 and 2005, respectively.

Non-cash operating activities for the three months ended March 31, 2006, included the following:

a note received as consideration from the sale of the Company's investment in Advantage of \$150.0 million; and

the exchange of existing preferred stock and common stock of Redox Brands, Inc. for common stock in CR Brands, Inc. with a cost basis of \$10.2 million.

Non-cash operating activities for the three months ended March 31, 2005, included the following:

the exchange of existing subordinated debt securities and accrued interest of BLX with a cost basis of \$44.8 million for additional Class B equity interests;

the exchange of debt securities and accrued interest of Coverall North America, Inc. with a cost basis of \$24.2 million for new debt securities and warrants with a total cost basis of \$26.8 million, and;

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 third quarter of 2005, GAC changed its name to Triview Investments, Inc.

For the three months ended March 31, 2006 and 2005, the Company's non-cash financing activities included \$3.6 million and \$1.4 million, respectively, related to the issuance of common stock in lieu of cash distributions. In addition, the non-cash financing activities for the three months ended March 31, 2005, also included the issuance of \$7.2 million of the Company's common stock as consideration for an additional investment in Mercury Air Centers, Inc.

Note 12. Hedging Activities

The Company has invested in commercial mortgage loans that were purchased at prices that were based in part on comparable Treasury rates. The Company has entered into transactions with one or more financial institutions to hedge against movement in Treasury rates on certain of these commercial mortgage loans. These transactions, referred to as short sales, involve the Company

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

Note 12. Hedging Activities, continued

receiving the proceeds from the short sales of borrowed Treasury securities, with the obligation to replenish the borrowed Treasury securities at a later date based on the then current market price. Borrowed Treasury securities and the related obligations to replenish the borrowed Treasury securities at value, including accrued interest payable on the obligations, as of March 31, 2006, and December 31, 2005, consisted of the following:

(\$ in thousands)	2006	2005
Description of Issue		
5-year Treasury securities, due April 2010	\$ 17,534	\$ 17,666

As of March 31, 2006, and December 31, 2005, the total obligations to replenish borrowed Treasury securities had decreased since the related original sale dates due to changes in the yield on the borrowed Treasury securities, resulting in unrealized appreciation on the obligations of \$0.7 million and \$0.4 million, respectively.

The net proceeds related to the sales of the borrowed Treasury securities were \$17.9 million at both March 31, 2006, and December 31, 2005. Under the terms of the transactions, the Company had received cash payments of \$0.4 million and \$0.2 million at March 31, 2006, and December 31, 2005, respectively, for the difference between the net proceeds related to the sales of the borrowed Treasury securities and the obligations to replenish the securities.

The Company has deposited the proceeds related to the sales of the borrowed Treasury securities and the additional cash collateral with Wachovia Capital Markets, LLC under repurchase agreements. The repurchase agreements are collateralized by U.S. Treasury securities and are settled weekly. As of March 31, 2006, the repurchase agreements were due on April 5, 2006, and had a weighted average interest rate of 4.0%. The weighted average interest rate on the repurchase agreements as of December 31, 2005, was 3.3%.

Note 13. Financial Highlights

	At and for the Three Months Ended March 31,		At and for the Year Ended December 31,
	2006 ⁽¹⁾	2005	2005
Per Common Share Data			
Net asset value, beginning of period	\$ 19.17	\$ 14.87	\$ 14.87
Net investment income ⁽²⁾	0.29	0.29	1.00
Net realized gains ⁽²⁾⁽³⁾	3.05	0.07	1.99
Net investment income plus net realized gains ⁽²⁾	3.34	0.36	2.99
Net change in unrealized appreciation or depreciation ⁽²⁾⁽³⁾	(2.64)	0.52	3.37
Net increase in net assets resulting from operations ⁽²⁾	0.70	0.88	6.36
Net decrease in net assets from shareholder distributions	(0.59)	(0.57)	(2.33)
Net increase in net assets from capital share transactions ⁽²⁾	0.22	0.04	0.27
Net asset value, end of period	\$ 19.50	\$ 15.22	\$ 19.17

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Market value, end of period	\$	30.60	\$	26.10	\$	29.37
Total return ⁽⁴⁾		6.2%		3.3%		23.5%

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

Note 13. Financial Highlights, continued

	At and for the Three Months Ended March 31,		At and for the Year Ended December 31,
	2006 ⁽¹⁾	2005	2005
Ratios and Supplemental Data			
(\$ and shares in thousands, except per share amounts)			
Ending net assets	\$ 2,729,813	\$ 2,033,148	\$ 2,620,546
Common shares outstanding at end of period	139,984	133,563	136,697
Diluted weighted average common shares outstanding	141,738	135,579	137,274
Employee, stock option and administrative expenses/average net assets	1.37%	1.80%	6.58%
Total operating expenses/average net assets	2.27%	2.81%	9.99%
Net investment income/average net assets	1.54%	1.93%	6.08%
Net increase in net assets resulting from operations/ average net assets	3.72%	5.96%	38.68%
Portfolio turnover rate	9.33%	5.10%	47.72%
Average debt outstanding	\$ 1,491,513	\$ 1,125,007	\$ 1,087,118
Average debt per share ⁽²⁾	\$ 10.52	\$ 8.30	\$ 7.92

(1) The results for the three months ended March 31, 2006, are not necessarily indicative of the operating results to be expected for the full year.

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

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

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

Note 14. Litigation

On June 23, 2004, the Company was notified by the SEC that the SEC is conducting an informal investigation of the Company. On December 22, 2004, the Company received letters from the U.S. Attorney for the District of Columbia requesting the preservation and production of information regarding the Company and Business Loan Express, LLC in connection with a criminal investigation. Based on the information available to the Company at this time, the inquiries appear to primarily pertain to matters related to portfolio valuation and the Company's portfolio company, Business Loan Express, LLC. To date, the Company has produced materials in response to requests from both the SEC and the U.S. Attorney's office, and certain current and former employees have provided testimony and have been interviewed by the staff of the SEC and the U.S. Attorney's Office. The Company is voluntarily cooperating with these investigations.

In addition, the Company is party to certain lawsuits in the normal course of business.

While the outcome of these legal proceedings cannot at this time be predicted with certainty, the Company does not expect that the outcome of these proceedings will have a material effect upon the Company's financial condition or

results of operations.

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Report of Independent Registered Public Accounting Firm

The Board of Directors and Shareholders

Allied Capital Corporation:

We have reviewed the accompanying consolidated balance sheet of Allied Capital Corporation and subsidiaries, including the consolidated statement of investments, as of March 31, 2006, and the related consolidated statements of operations, changes in net assets and cash flows and the financial highlights (included in Note 13) for the three-month periods ended March 31, 2006 and 2005. These consolidated financial statements and financial highlights are the responsibility of the Company's management.

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

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

We have previously audited, in accordance with standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheet of Allied Capital Corporation and subsidiaries as of December 31, 2005, and the related consolidated statements of operations, changes in net assets and cash flows (not presented herein), and the financial highlights (included in Note 14), for the year then ended; and in our report dated March 9, 2006, we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying condensed consolidated balance sheet as of December 31, 2005, is fairly stated, in all material respects, in relation to the consolidated balance sheet from which it has been derived.

Washington, D.C.

May 5, 2006

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ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
SCHEDULE OF INVESTMENTS IN AND ADVANCES TO AFFILIATES

		Amount of Interest or Dividends					
PRIVATE FINANCE							
Portfolio Company		Credited	December	Gross	Gross	March 31,	
(in thousands)	Investment(1)	to	31, 2005	Additions(3)	Reductions(4)	2006	
		Income(6)	Value			Value	
		Other(2)					
Companies More Than 25% Owned							
Acme Paging, L.P. (Telecommunications)	Senior Loan(5) Subordinated Debt(5) Common Stock		\$	\$	\$	\$	
Advantage Sales & Marketing, Inc.(7) (Business Services)	Subordinated Debt Subordinated Debt Common Stock	\$ 1,712 5,555	59,787 124,000 476,578	213 374	(60,000) (124,374) (476,578)		
Alaris Consulting, LLC (Business Services)	Senior Loan(5) Equity Interests	(16)		16	(16)		
American Healthcare Services, Inc. and Affiliates (Healthcare Services)	Senior Loan(5)		4,097		(95)	4,002	
Avborne, Inc. (Business Services)	Preferred Stock Common Stock		892			892	
Avborne Heavy Maintenance, Inc. (Business Services)	Preferred Stock Common Stock						
Business Loan Express, LLC (Financial Services)	Subordinated Debt Class A Equity Interests Class B Equity Interests *	38 3,845	10,000 60,693 146,910 139,521	15,000 1,839	(25,000) (10,820) (11,902)	62,532 136,090 127,619	

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Class C Equity Interests						
Callidus Capital Corporation (Financial Services)	Senior Loan	284	600	6,880		7,480
	Subordinated Debt	227	4,832	217		5,049
	Common Stock		7,968	2,387		10,355
CR Brands, Inc. (Consumer Products)	Senior Loan	341		37,048		37,048
	Subordinated Debt	702		38,705		38,705
	Common Stock			37,431		37,431
Diversified Group Administrators, Inc. (Business Services)	Preferred Stock	33	728		(14)	714
	Preferred Stock		841			841
	Common Stock	68	502	69		571
Financial Pacific Company (Financial Services)	Subordinated Debt	3,080	69,904	362		70,266
	Preferred Stock		13,116	655		13,771
	Common Stock		44,180		(511)	43,669
ForeSite Towers, LLC (Tower Leasing)	Equity Interests	80	9,750	1,544		11,294
Global Communications, LLC (Business Services)	Senior Loan(5)		15,957			15,957
	Subordinated Debt(5)		11,198	138		11,336
	Preferred Equity Interest		4,303		(3,749)	554
	Options					
Gordian Group, Inc. (Business Services)	Senior Loan(5)	(5)	4,161	175	(4,336)	
	Common Stock			220	(220)	
Healthy Pet Corp. (Consumer Services)	Senior Loan	386	4,086	12,652		16,738
	Subordinated Debt	1,623	38,535	4,551		43,086
	Common Stock		25,766	5,174		30,940
HMT, Inc. (Energy Services)	Preferred Stock		2,637			2,637
	Common Stock		5,343	577		5,920
	Warrants		2,057	223		2,280
Impact Innovations Group, LLC (Business Services)	Equity Interests in Affiliate		742	127		869

See related footnotes at the end of this schedule.

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PRIVATE FINANCE		Amount of Interest or Dividends		December 31, 2005	Gross Additions(3)	Gross Reductions(4)	March 31, 2006
		Credited to Income(6)	Other(2)				
Portfolio Company	Investment(1)						
(in thousands)							
Insight Pharmaceuticals Corporation (Consumer Products)	Subordinated Debt	\$ 2,374		\$ 58,298	\$ 387	\$	\$ 58,685
	Preferred Stock			26,791		(2,015)	24,776
	Common Stock			236		(236)	
Jakel, Inc. (Industrial Products)	Subordinated Debt(5)				1,066		1,066
	Preferred Stock						
	Common Stock						
Legacy Partners Group, LLC (Financial Services)	Senior Loan (5)			5,029	93		5,122
	Subordinated Debt(5)						
	Equity Interests				18	(18)	
Litterer Beteiligungs-GmbH (Business Services)	Subordinated Debt	10		621	12		633
	Equity Interest			2,226	763		2,989
Mercury Air Centers, Inc. (Business Services)	Senior Loan	864		31,720	4,000		35,720
	Subordinated Debt	2,007		46,519	4,165		50,684
	Common Stock			88,898	4,702		93,600
MVL Group, Inc. (Business Services)	Senior Loan	884		27,218	68		27,286
	Subordinated Debt	1,223		32,417	236		32,653
	Common Stock			3,211		(1,178)	2,033
Pennsylvania Avenue Investors, L.P. (Private Equity Fund)	Equity Interests			1,864	1,193	(3,057)	
Powell Plant Farms, Inc. (Consumer Products)	Senior Loan	1,157		23,792	6,075		29,867
	Subordinated Debt(5)			7,364	1,093		8,457

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Preferred Stock Warrants						
Redox Brands, Inc. (Consumer Products)	Preferred Stock Warrants	363	12,097 500	1,708 84	(13,805) (584)	
Service Champ, Inc. (Business Services)	Subordinated Debt Common Stock	1,060	26,906 13,319	178 2,246		27,084 15,565
Staffing Partners Holding Company, Inc. (Business Services)	Subordinated Debt(5) Preferred Stock Common Stock Warrants	\$ 355	6,343 1,812		(2,173) (1,812)	4,170
Startec Global Communications Corporation (Telecommunications)	Senior Loan Common Stock	623	21,685	2,244	(942)	22,987
STS Operating, Inc. (Industrial Products)	Subordinated Debt Common Stock Options	251	6,593 64,963 560	32,039 292		6,593 97,002 852
Triview Investments, Inc. (Broadcasting & Cable/ Consumer Products)	Senior Loan Subordinated Debt Subordinated Debt(5) Common Stock	246 1,131	7,449 30,845 19,520 29,171	6,846 6,842		14,295 37,687 19,520 30,883
Total companies more than 25% owned					\$ 30,146	\$ 1,388,855
Companies 5% to 25% Owned						
Advantage Sales & Marketing, Inc.(7) (Business Services)	Subordinated Debt Equity Interests	\$ 158	\$	\$ 149,258 15,000	\$	\$ 149,258 15,000
Air Evac Lifeteam LLC (Healthcare Services)	Subordinated Debt Equity Interests	1,477	42,267 4,025	221 1,375		42,488 5,400
Aspen Pet Products, Inc. (Consumer Products)	Subordinated Debt Preferred Stock	1,130 29	19,959 1,638	399 516	(20,358) (2,154)	

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	Common Stock		17	123	(140)	
	Warrants					
BB&T Capital Partners/Windsor Mezzanine Fund, LLC (Private Equity Fund)	Equity Interests			5,867		5,867
Becker Underwood, Inc. (Industrial Products)	Subordinated Debt	866	23,543	155		23,698
	Common Stock		2,200		(700)	1,500

See related footnotes at the end of this schedule.

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PRIVATE FINANCE Portfolio Company (in thousands)	Investment(1)	Amount of Interest or Dividends		December 31, 2005 Value	Gross Additions(3)	Gross Reductions(4)	March 31, 2006 Value
		Credited to Income(6)	Other(2)				
BI Incorporated (Business Services)	Senior Loan	\$ 60		\$	\$ 14,891	\$ (10,000)	\$ 4,891
	Subordinated Debt	361			29,852		29,852
	Subordinated Debt			16,133	153	(16,286)	
	Common Stock				4,000		4,000
The Debt Exchange Inc. (Business Services)	Preferred Stock			3,219		(3,219)	
MedBridge Healthcare, LLC (Healthcare Services)	Senior Loan(5)			7,093	71	(2,010)	5,154
	Subordinated Debt(5)			534	375	(909)	
	Convertible Subordinated Debt(5) Equity Interests				501	(501)	
Nexcel Synthetics, LLC (Consumer Products)	Subordinated Debt	390		10,588	97		10,685
	Equity Interests			1,367	115		1,482
Pres Air Trol LLC (Industrial Products)	Unitranche Debt(5)	(10)	\$ 184	5,820		(237)	5,583
	Equity Interests			318	10		328
Progressive International Corporation	Subordinated Debt	299		7,376	39		7,415
	Preferred Stock			884	18		902

(Consumer Products)	Common Stock		13	287		300
	Warrants					
Soteria Imaging Services, LLC (Healthcare Services)	Subordinated Debt	462	13,447	33		13,480
	Equity Interests		2,308	46		2,354
Universal Environmental Services, LLC (Business Services)	Unitranche Debt	428	10,862	78		10,940
	Equity Interests		1,328	18	(278)	1,068
Total companies 5% to 25% owned		\$ 5,650				\$ 341,645

This schedule should be read in conjunction with the Company's consolidated financial statements, including the consolidated statement of investments and Note 3 to the consolidated financial statements. Note 3 includes additional information regarding activities in the private finance portfolio.

- (1) Common stock, preferred stock, warrants, options, and equity interests are generally non-income producing and restricted. The principal amount for loans and debt securities and the number of shares of common stock and preferred stock is shown in the consolidated statement of investments as of March 31, 2006.
- (2) Other includes interest, dividend, or other income which was applied to the principal of the investment and therefore reduced the total investment. These reductions are also included in the Gross Reductions for the investment, as applicable.
- (3) Gross additions include increases in the cost basis of investments resulting from new portfolio investments, paid-in-kind interest or dividends, the amortization of discounts and closing fees, the exchange of one or more existing securities for one or more new securities and the movement of an existing portfolio company into this category from a different category. Gross additions also include net increases in unrealized appreciation or net decreases in unrealized depreciation.
- (4) Gross reductions include decreases in the cost basis of investments resulting from principal collections related to investment repayments or sales, the exchange of one or more existing securities for one or more new securities and the movement of an existing portfolio company out of this category into a different category. Gross reductions also include net increases in unrealized depreciation or net decreases in unrealized appreciation.
- (5) Loan or debt security is on non-accrual status at March 31, 2006, and is therefore considered non-income producing. Loans or debt securities on non-accrual status at the end of the period may or may not have been on non-accrual status for the full period.
- (6) Represents the total amount of interest or dividends credited to income for the portion of the year an investment was included in the companies more than 25% owned or companies 5% to 25% owned categories, respectively.

(7) Included in the companies more than 25% owned category while the Company held a majority equity interest. On March 29, 2006, the Company sold its majority equity interest in Advantage. The Company's investment in Advantage after the sale transaction is included in the companies 5% to 25% owned category. See Note 3 to the consolidated financial statements for further information.

* All or a portion of the dividend income on this investment was or will be paid in the form of additional securities. Dividends paid-in-kind are also included in the Gross Additions for the investment, as applicable.

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**NOTICE REGARDING INDEPENDENT PUBLIC ACCOUNTANTS
REVIEW REPORT**

With respect to the unaudited interim financial information as of March 31, 2006 and for the three-month periods ended March 31, 2006 and 2005, included herein, KPMG LLP has reported that they applied limited procedures in accordance with professional standards for a review of such information. However, their separate report included herein states that they did not audit and they do not express an opinion on that interim financial information. Accordingly, the degree of reliance on their report on such information should be restricted in light of the limited nature of the review procedures applied. The accountants are not subject to the liability provisions of Section 11 of the Securities Act of 1933 for their report on the unaudited interim financial information because that report is not a report or a part of the registration statement prepared or certified by the accountants within the meaning of Sections 7 and 11 of the Securities Act of 1933.

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40,000,000 Shares

Common Stock

We may offer, from time to time, up to 40,000,000 shares of our common stock in one or more offerings.

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

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

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

Please read this prospectus and the accompanying prospectus supplement, if any, before investing, and keep it for future reference. The prospectus and the accompanying prospectus supplement contain important information about us that a prospective investor should know before investing in our common stock. We file annual, quarterly and current reports, proxy statements and other information with the Securities and Exchange Commission. This information is available free of charge by contacting us at 1919 Pennsylvania Avenue, NW, Washington, DC, 20006 or by telephone at (202) 721-6100 or on our website at www.alliedcapital.com. The SEC also maintains a website at www.sec.gov that contains such information.

Our common stock is traded on the New York Stock Exchange under the symbol ALD. As of April 26, 2006, the last reported sale price on the New York Stock Exchange for the common stock was \$30.62.

You should review the information, including the risk of leverage, set forth under Risk Factors on page 10 of this prospectus before investing in our common stock.

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

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

April 27, 2006

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

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ABOUT THIS PROSPECTUS

This prospectus is part of a registration statement that we have filed with the Securities and Exchange Commission using the shelf registration process. Under the shelf registration process, we may offer, from time to time, up to 40,000,000 shares of our common stock on the terms to be determined at the time of the offering. Shares of our common stock may be offered at prices and on terms described in one or more supplements to this prospectus. This prospectus provides you with a general description of the shares of our common stock that we may offer. Each time we use this prospectus to offer shares of our common stock, we will provide a prospectus supplement that will contain specific information about the terms of that offering. A prospectus supplement may also add, update or change information contained in this prospectus. Please carefully read this prospectus and any such supplements together with the additional information described under "Where You Can Find Additional Information" in the "Prospectus Summary" and "Risk Factors" sections before you make an investment decision.

PROSPECTUS SUMMARY

The following summary contains basic information about this offering. It may not contain all the information that is important to an investor. For a more complete understanding of this offering, we encourage you to read this entire prospectus and the documents that are referred to in this prospectus, together with any accompanying supplements.

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

BUSINESS (Page 58)

We are a business development company and we are in the private equity business. We provide long-term debt and equity capital to primarily private middle market companies in a variety of industries. We have participated in the private equity business since we were founded in 1958 and have financed thousands of companies nationwide. Our investment objective is to achieve current income and capital gains.

We believe the private equity capital markets are important to the growth of small and middle market companies because such companies often have difficulty accessing the public debt and equity capital markets. We use the term middle market to include companies with annual revenues typically between \$50 million and \$500 million. We believe that we are well positioned to be a source of capital for such companies.

We primarily invest in the American entrepreneurial economy. Our private finance portfolio includes investments in over 100 companies with aggregate annual revenue of over \$10 billion and employ more than 85,000 people.

We generally target companies in less cyclical industries in the middle market with, among other things, high return on invested capital, management teams with meaningful equity ownership, well-constructed balance sheets, and the ability to generate free cash flow. As a private equity investor, we spend significant time and effort identifying, structuring, performing due diligence, monitoring, developing, valuing and ultimately exiting our investments.

Our investment activity is primarily focused on making long-term investments in the debt and equity of primarily private middle market companies. Debt investments may include senior loans, unitranche debt (a single debt investment that is a blend of senior and subordinated debt), or subordinated debt (with or without equity features). Equity investments may include a minority equity stake in connection with a debt investment or a substantial equity stake in connection with a buyout transaction. In a buyout transaction, we generally invest in senior debt, subordinated debt and equity (preferred and/or voting or non-voting common) where our equity ownership represents a significant portion of the equity, but may or may not represent a controlling interest.

Our investments in the debt and equity of primarily private middle market companies are generally long-term in nature and are privately negotiated, and no readily available market exists for them. This makes our investments highly illiquid and, as result, we cannot readily trade them. When we make an investment, we enter into a long-term arrangement where our ultimate exit from that investment may be three to ten years in the future.

The capital we provide is used by portfolio companies to fund buyouts, acquisitions, growth, recapitalizations, note purchases, or other types of financings.

Our investments are typically structured to provide recurring cash flow in the form of interest income to us as the investor. In addition to earning interest income, we may structure our investments to generate income from management, consulting, diligence, structuring, or other fees. We may also enhance our total return from capital gains through equity features, such as nominal cost warrants, or by investing in equity investments.

We provide managerial assistance to our portfolio companies, including management and consulting services related to corporate finance, marketing, human resources, personnel and board member recruiting, business operations, corporate governance, risk management and other general business matters.

We have elected to be taxed as a regulated investment company under the Internal Revenue Code of 1986, as amended, which we refer to as the Code. Our status as a regulated investment company generally eliminates a corporate-level income tax on taxable income we timely distribute to our stockholders as dividends, if certain requirements are met. See [Tax Status](#). We determine our regular quarterly dividends considering our estimate of annual taxable income available for distribution. Since 1963, our portfolio has generally provided sufficient ordinary taxable income and net capital gains to sustain or grow our dividends over time.

We are a Maryland corporation and a closed-end, non-diversified management investment company that has elected to be regulated as a business development company under the Investment Company Act of 1940, which we refer to as the 1940 Act.

As a business development company, we are required to meet certain regulatory tests, the most significant relating to our investments and borrowings. A business development company is required to invest at least 70% of its assets in eligible portfolio companies. A business development company must also maintain a coverage ratio of assets to senior securities of at least 200%. See [Certain Government Regulations and Risk Factors](#).

Our executive offices are located at 1919 Pennsylvania Avenue, NW, Washington, DC, 20006 and our telephone number is (202) 721-6100. In addition, we have regional offices in New York, Chicago and Los Angeles.

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

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

DETERMINATION OF

NET ASSET VALUE (Page 82)

Our portfolio investments are generally recorded at fair value as determined in good faith by our Board of Directors in the absence of readily available public market values.

Pursuant to the requirements of the 1940 Act, we value substantially all of our portfolio investments at fair value as determined in good faith by the Board of Directors on a quarterly basis. Since there is typically no readily available market value for the investments in our portfolio, our Board of Directors determines in good faith the fair value

of these portfolio investments pursuant to our valuation policy and consistently applied valuation process.

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

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

PLAN OF DISTRIBUTION *(Page 127)*

We may offer, from time to time, up to 40,000,000 shares of our common stock, on terms to be determined at the time of the offering.

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

Our shares of common stock may be offered directly to one or more purchasers, through agents designated from time to time by us, or to or through underwriters or dealers. The supplement to this prospectus relating to the offering will identify any agents or underwriters involved in the sale of our shares of common stock, and will set forth any applicable purchase price, fee and commission or discount arrangement or the basis upon which such amount may be calculated.

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

USE OF PROCEEDS *(Page 18)*

We intend to use the net proceeds from selling shares of common stock for general corporate purposes, which includes investing in debt or equity securities in primarily privately negotiated transactions, repayment of indebtedness, acquisitions and other general corporate purposes. The supplement to this prospectus relating to an offering will more fully identify the use of the proceeds from such offering.

PRICE RANGE OF COMMON STOCK AND DISTRIBUTIONS *(Page 19)*

We intend to pay quarterly dividends to holders of our common stock. The amount of our quarterly dividends is determined by our Board of Directors on a quarterly basis.

DIVIDEND REINVESTMENT PLAN *(Page 120)*

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

RISK FACTORS *(Page 10)*

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

Our portfolio of investments is generally illiquid. Our portfolio includes securities primarily issued by private companies. These investments may involve a high degree of business and financial risk; they are illiquid, and may not produce current returns or capital gains. If we were forced to immediately liquidate some or all of the investments in the portfolio, the proceeds of such liquidation could be significantly less than the current value of such investments. We may be required to liquidate some or all of our portfolio investments to meet our debt service obligations or in the event we are required to fulfill our obligations under agreements pursuant to which we guarantee the repayment of indebtedness by third parties.

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

Our total investment in companies may be significant individually or in the aggregate. As a result, if a significant investment in one or more companies fails to perform as expected, our financial results could be more negatively affected and the magnitude of the loss could be more significant than if we had made smaller investments in more companies.

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

A large number of entities and individuals compete for the same kind of investment opportunities as we do. Increased competition would make it more difficult for us to purchase or originate investments at attractive prices. As a result of this competition, sometimes we may be precluded from making otherwise attractive investments.

Our business of making private equity investments and positioning them for liquidity events also may be affected by current and future market conditions.

To maintain our status as a business development company, we must not acquire any assets other than qualifying assets unless, at the time of and after giving effect to such acquisition, at least 70% of our total assets are qualifying assets.

We may not be able to pay dividends and failure to qualify as a regulated investment company for tax purposes could have a material adverse effect on the income available for debt service or distributions to our shareholders, which may have a material adverse effect on our total return to common shareholders, if any.

Also, we are subject to certain risks associated with valuing our portfolio, changing interest rates, accessing additional capital, fluctuating financial results, and operating in a regulated environment.

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

CERTAIN ANTI-TAKEOVER

PROVISIONS *(Page 123)*

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

FEES AND EXPENSES

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

Shareholder Transaction Expenses	
Sales load (as a percentage of offering price) ⁽¹⁾	%
Dividend reinvestment plan fees ⁽²⁾	None
Annual Expenses (as a percentage of consolidated net assets attributable to common stock)⁽³⁾	
Operating expenses ⁽⁴⁾	5.7%
Interest payments on borrowed funds ⁽⁵⁾	2.9%
Total annual expenses⁽⁶⁾⁽⁷⁾	8.6%

- (1) In the event that the shares of common stock to which this prospectus relates are sold to or through underwriters, a corresponding prospectus supplement will disclose the applicable sales load.
- (2) The expenses of our dividend reinvestment plan are included in Operating expenses. We do not have a stock purchase plan. The participants in the dividend reinvestment plan will bear a pro rata share of brokerage commissions incurred with respect to open market purchases or sales, if any. See Dividend Reinvestment Plan.
- (3) Consolidated net assets attributable to common stock equals net assets (*i.e.*, total consolidated assets less total consolidated liabilities), which at December 31, 2005, was \$2,620.5 million.
- (4) Operating expenses represent our operating expenses for the year ending December 31, 2005, excluding interest on indebtedness. See Management and Compensation of Executive Officers and Directors.
- (5) The Interest payments on borrowed funds represents our interest expense for the year ending December 31, 2005. We had outstanding borrowings of \$1,284.8 million at December 31, 2005. See Risk Factors.
- (6) Total annual expenses as a percentage of consolidated net assets attributable to common stock are higher than the total annual expenses percentage would be for a company that is not leveraged. We borrow money to leverage our net assets and increase our total assets. The SEC requires that Total annual expenses percentage be calculated as a percentage of *net* assets, rather than the total assets, including assets that have been funded with borrowed monies. If the Total annual expenses percentage were calculated instead as a percentage of consolidated total assets, our Total annual expenses would be 5.6% of consolidated total assets.
- (7) The holders of shares of our common stock (and not the holders of our debt securities or preferred stock, if any) indirectly bear the cost associated with our annual expenses.

Example

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

	<u>1 Year</u>	<u>3 Years</u>	<u>5 Years</u>	<u>10 Years</u>
You would pay the following expenses on a \$1,000 investment, assuming a 5.0% annual return	\$133	\$297	\$460	\$858

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

The example should not be considered a representation of future expenses, and the actual expenses

may be greater or less than those shown.

SELECTED CONDENSED CONSOLIDATED FINANCIAL DATA

You should read the condensed consolidated financial information below with the Consolidated Financial Statements and Notes thereto included herein. Financial information at and for the years ended December 31, 2005, 2004, 2003, and 2002, has been derived from our financial statements that were audited by KPMG LLP. Financial information at and for the year ended December 31, 2001, has been derived from our financial statements that were audited by Arthur Andersen LLP. For important information about Arthur Andersen LLP, see the section entitled Notice Regarding Arthur Andersen LLP. See **Management's Discussion and Analysis of Financial Condition and Results of Operations** below for more information.

(in thousands, except per share data)	Year Ended December 31,				
	2005	2004	2003	2002	2001
Operating Data:					
Interest and related portfolio income:					
Interest and dividends	\$317,153	\$319,642	\$290,719	\$264,042	\$240,464
Loan prepayment premiums	6,250	5,502	8,172	2,776	2,504
Fees and other income	50,749	41,946	30,338	43,110	46,142
Total interest and related portfolio income	374,152	367,090	329,229	309,928	289,110
Expenses:					
Interest	76,798	75,650	77,233	70,443	65,104
Employee	78,300	53,739	36,945	33,126	29,656
Administrative	70,267	34,686	22,387	21,504	15,299
Total operating expenses	225,365	164,075	136,565	125,073	110,059
Net investment income before income taxes	148,787	203,015	192,664	184,855	179,051
Income tax expense (benefit), including excise tax	11,561	2,057	(2,466)	930	(412)
Net investment income	137,226	200,958	195,130	183,925	179,463
Net realized and unrealized gains (losses):					
Net realized gains	273,496	117,240	75,347	44,937	661
Net change in unrealized appreciation or depreciation	462,092	(68,712)	(78,466)	(571)	20,603
Total net gains (losses)	735,588	48,528	(3,119)	44,366	21,264
Net increase in net assets resulting from operations	\$872,814	\$249,486	\$192,011	\$228,291	\$200,727
Per Share:					
Diluted earnings per common share	\$ 6.36	\$ 1.88	\$ 1.62	\$ 2.20	\$ 2.16
Dividends per common share ⁽¹⁾	\$ 2.33	\$ 2.30	\$ 2.28	\$ 2.23	\$ 2.01
Weighted average common shares outstanding diluted	137,274	132,458	118,351	103,574	93,003

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(in thousands, except per share data)	At December 31,				
	2005	2004	2003	2002	2001
Balance Sheet Data:					
Portfolio at value	\$3,606,355	\$3,013,411	\$2,584,599	\$2,488,167	\$2,329,590
Total assets	4,025,880	3,260,998	3,019,870	2,794,319	2,460,713
Total debt outstanding ⁽²⁾	1,284,790	1,176,568	954,200	998,450	1,020,806
Preferred stock issued to Small Business Administration ⁽²⁾			6,000	7,000	7,000
Shareholders' equity	2,620,546	1,979,778	1,914,577	1,546,071	1,352,123
Shareholders' equity per common share (net asset value) ⁽³⁾	\$ 19.17	\$ 14.87	\$ 14.94	\$ 14.22	\$ 13.57
Common shares outstanding at end of year	136,697	133,099	128,118	108,698	99,607
Asset coverage ratio ⁽⁴⁾	309%	280%	322%	270%	245%
Debt to equity ratio	0.49	0.59	0.50	0.65	0.75

(in thousands, except per share data)	Year Ended December 31,				
	2005	2004	2003	2002	2001
Other Data:					
Investments funded	\$1,675,773	\$1,524,523	\$931,450	\$506,376	\$680,329
Principal collections related to investment repayments or sales	1,503,388	909,189	788,328	356,641	204,441
Realized gains	343,061	267,702	94,305	95,562	10,107
Realized losses	(69,565)	(150,462)	(18,958)	(50,625)	(9,446)

(in thousands, except per share data)	2005				2004			
	Qtr 4	Qtr 3	Qtr 2	Qtr 1	Qtr 4	Qtr 3	Qtr 2	Qtr 1
Quarterly Data (unaudited):								
Total interest and related portfolio income	\$ 98,169	\$ 94,857	\$ 86,207	\$ 94,919	\$ 100,962	\$ 96,863	\$ 87,500	\$ 81,765
Net investment income	37,073	46,134	15,267	38,752	54,678	52,745	48,990	44,545
Net increase in net assets resulting from operations	328,140	113,168	311,885	119,621	47,837	85,999	95,342	20,308
Diluted earnings per common share	\$ 2.36	\$ 0.82	\$ 2.29	\$ 0.88	\$ 0.35	\$ 0.66	\$ 0.73	\$ 0.15
Dividends declared per common share ⁽⁵⁾	0.61	0.58	0.57	0.57	0.59	0.57	0.57	0.57
Net asset value per common share ⁽³⁾	19.17	17.37	17.01	15.22	14.87	14.90	14.77	14.60

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

(2) See Senior Securities for more information regarding our level of indebtedness.

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

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

(5) Dividends declared per common share for the fourth quarter of 2004 included the regular quarterly dividend of \$0.57 per common share and an extra dividend of \$0.02 per common share. Dividends declared per common share for the fourth quarter of 2005 included the regular quarterly dividend of \$0.58 per common share and an extra dividend of \$0.03 per common share.

WHERE YOU CAN FIND

ADDITIONAL INFORMATION

We have filed with the SEC a registration statement on Form N-2 together with all amendments and related exhibits under the Securities Act of 1933. The registration statement contains additional information about us and the securities being offered by this prospectus.

We file annual, quarterly and current reports, proxy statements and other information with the Securities and Exchange Commission under the Securities Exchange Act of 1934. You can inspect any materials we file with the Securities and Exchange Commission, without charge, at the Securities and Exchange Commission's Public Reference Room at 100 F Street, N.E., Washington, D.C. 20549. Please call the Securities and Exchange Commission at 1-800-SEC-0330 for further information on the Public Reference Room. The Securities and Exchange Commission maintains a web site that contains reports, proxy statements and other information regarding registrants, including us, that file such information electronically with the Securities and Exchange Commission. The address of the Securities and Exchange Commission's web site is www.sec.gov. Information contained on the Securities and Exchange Commission's web site about us is not incorporated into this prospectus and you should not consider information contained on the Securities and Exchange Commission's web site to be part of this prospectus.

RISK FACTORS

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

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

Investing in private companies involves a high degree of risk. Our portfolio primarily consists of long-term loans to and investments in middle market private companies. Investments in private businesses involve a high degree of business and financial risk, which can result in substantial losses for us in those investments and accordingly should be considered speculative. There is generally no publicly available information about the companies in which we invest, and we rely significantly on the diligence of our employees and agents to obtain information in connection with our investment decisions. If we are unable to identify all material information about these companies, among other factors, we may fail to receive the expected return on our investment or lose some or all of the money invested in these companies. In addition, these businesses may have shorter operating histories, narrower product lines, smaller market shares and less experienced management than their competition and may be more vulnerable to customer preferences, market conditions, loss of key personnel, or economic downturns, which may adversely affect the return on, or the recovery of, our investment in such businesses. As an investor, we are subject to the risk that a portfolio company may make a business decision that does not serve our interest, which could decrease the value of our investment. Deterioration in a portfolio company's financial condition and prospects may be accompanied by deterioration in any collateral for the loan.

Substantially all of our portfolio investments are recorded at fair value as determined in good faith by our Board of Directors and, as a result, there is uncertainty regarding the value of our portfolio investments. At December 31, 2005, portfolio investments recorded at fair value were approximately 90% of our total assets. Pursuant to the requirements of the 1940 Act, we value substantially all of our investments at fair value as determined in good faith by our Board of Directors on a quarterly basis. Since there is typically no readily available market value for the investments in our portfolio, our Board of Directors determines in good faith the fair value of these investments pursuant to a valuation policy and a consistently applied valuation process.

There is no single standard for determining fair value in good faith. As a result, determining fair value requires that judgment be applied to the specific facts and circumstances of each portfolio investment while employing a consistently applied valuation process for the types of investments we make. Unlike banks, we are not permitted to provide a general reserve for anticipated loan losses; we are instead required by the 1940 Act to specifically value each individual investment on a quarterly basis and record

unrealized depreciation for an investment that we believe has become impaired, including where collection of a loan or realization of an equity security is doubtful, or when the enterprise value of the portfolio company does not currently support the cost of our debt or equity investment. Enterprise value means the entire value of the company to a potential buyer, including the sum of the values of debt and equity securities used to capitalize the enterprise at a point in time. We will record unrealized appreciation if we believe that the underlying portfolio company has appreciated in value and/or our equity security has appreciated in value. Without a readily available market value and because of the inherent uncertainty of valuation, the fair value of our investments determined in good faith by the Board of Directors may differ significantly from the values that would have been used had a ready market existed for the investments, and the differences could be material. Our net asset value could be affected if our determination of the fair value of our investments is materially different than the value that we ultimately realize.

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

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

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

Our borrowers may default on their payments, which may have a negative effect on our financial performance. We primarily make long-term unsecured, subordinated loans and invest in equity securities, which may involve a higher degree of repayment risk. We primarily invest in companies that may have limited financial resources, may be highly leveraged and may be unable to obtain financing from traditional sources. Numerous factors may affect a borrower's ability to repay its loan, including the failure to meet its business plan, a downturn in its industry, or negative economic conditions. A portfolio company's failure to satisfy financial or operating covenants imposed by us or other lenders could lead to defaults and, potentially, termination of its loans or foreclosure on its secured assets, which could trigger cross defaults under other agreements and jeopardize our portfolio company's ability to meet its obligations under the loans or debt securities that we hold. In addition, our portfolio companies may have, or may be permitted to incur, other debt that ranks senior to or equally with our securities. This means that payments on such senior-ranking securities may have to be made before we receive any payments on

our loans or debt securities. Deterioration in a borrower's financial condition and prospects may be accompanied by deterioration in any related collateral and may have a negative effect on our financial results.

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

Our financial results could be negatively affected if a significant portfolio investment fails to perform as expected. Our total investment in companies may be significant individually or in the aggregate. As a result, if a significant investment in one or more companies fails to perform as expected, our financial results could be more negatively affected and the magnitude of the loss could be more significant than if we had made smaller investments in more companies. At December 31, 2005, our largest investments at value were in Advantage Sales & Marketing, Inc. and Business Loan Express, LLC (BLX) and represented 16.4% and 8.9% of our total assets, respectively, and each individually represented 10.0% of our total interest and related portfolio income for the year ended December 31, 2005. BLX is a lender under the Small Business Administration 7(a) Guaranteed Loan Program. Our financial results could be negatively affected if government funding for, or regulations related to, this program change.

We borrow money, which magnifies the potential for gain or loss on amounts invested and may increase the risk of investing in us. Borrowings, also known as leverage, magnify the potential for gain or loss on amounts invested and, therefore, increase the risks associated with investing in our securities. We borrow from and issue senior debt securities to banks, insurance companies, and other lenders or investors. Holders of these senior securities have fixed dollar claims on our consolidated assets that are superior to the claims of our common shareholders. If the value of our consolidated assets increases, then leveraging would cause the net asset value attributable to our common stock to increase more sharply than it would have had we not leveraged. Conversely, if the value of our consolidated assets decreases, leveraging would cause net asset value to decline more sharply than it otherwise would have had we not leveraged. Similarly, any increase in our consolidated income in excess of consolidated interest payable on the borrowed funds would cause our net income to increase more than it would without the leverage, while any decrease in our consolidated income would cause net income to decline more sharply than it would have had we not borrowed. Such a decline could negatively affect our ability to make common stock dividend payments. Leverage is generally considered a speculative investment technique. We and, indirectly, our stockholders will bear the cost associated with our leverage activity. Our revolving line of credit, notes payable and debentures contain financial and operating covenants that could restrict our business activities, including our ability to declare dividends if we default under certain provisions.

At December 31, 2005, we had \$1.3 billion of outstanding indebtedness bearing a weighted average annual interest cost of 6.5%. If our portfolio of investments fails to produce adequate returns, we may be unable to make interest or principal payments on our indebtedness when they are due. In order for us to cover annual interest payments on

indebtedness, we must achieve annual returns on our assets of at least 2.1% as of December 31, 2005.

Illustration. The following table illustrates the effect of leverage on returns from an investment in our common stock assuming various annual returns, net of expenses. The calculations in the table below are hypothetical and actual returns may be higher or lower than those appearing below. The calculation assumes (i) \$4,025.9 million in total assets, (ii) an average cost of funds of 6.5%, (iii) \$1,284.8 million in debt outstanding and (iv) \$2,620.5 million of shareholders' equity.

Assumed Return on Our Portfolio							
(net of expenses)							
	-20%	-10%	-5%	0%	5%	10%	20%
Corresponding return to shareholder	-33.66%	-18.29%	-10.61%	-2.93%	4.75%	12.43%	27.79%

We may not borrow money unless we maintain asset coverage for indebtedness of at least 200%, which may affect returns to shareholders. We must maintain asset coverage for total borrowings of at least 200%. Our ability to achieve our investment objective may depend in part on our continued ability to maintain a leveraged capital structure by borrowing from banks, insurance companies or other lenders or investors on favorable terms. There can be no assurance that we will be able to maintain such leverage. If asset coverage declines to less than 200%, we may be required to sell a portion of our investments when it is disadvantageous to do so. As of December 31, 2005, our asset coverage for senior indebtedness was 309%.

Changes in interest rates may affect our cost of capital and net investment income. Because we borrow money to make investments, our net investment income is dependent upon the difference between the rate at which we borrow funds and the rate at which we invest these funds. As a result, there can be no assurance that a significant change in market interest rates will not have a material adverse effect on our net investment income. In periods of rising interest rates, our cost of funds would increase, which would reduce our net investment income. We use a combination of long-term and short-term borrowings and equity capital to finance our investing activities. We utilize our revolving line of credit as a means to bridge to long-term financing. Our long-term fixed-rate investments are financed primarily with long-term fixed-rate debt and equity. We may use interest rate risk management techniques in an effort to limit our exposure to interest rate fluctuations. Such techniques may include various interest rate hedging activities to the extent permitted by the 1940 Act. We have analyzed the potential impact of changes in interest rates on interest income net of interest expense.

Assuming that the balance sheet as of December 31, 2005, were to remain constant and no actions were taken to alter the existing interest rate sensitivity, a hypothetical immediate 1% change in interest rates would have affected net income by less than 1% over a one year horizon. Although management believes that this measure is indicative of our sensitivity to interest rate changes, it does not adjust for potential changes in credit quality, size and composition of the assets on the balance sheet and other business developments that could affect net increase in net assets resulting from operations, or net income. Accordingly, no assurances can be given that actual results would not differ materially from the potential outcome simulated by this estimate.

We will continue to need additional capital to grow because we must distribute our income. We will continue to need capital to fund growth in our investments. Historically, we have borrowed from financial institutions and have issued equity securities to grow our portfolio. A reduction in the availability of new debt or equity capital could limit our ability to grow. We must distribute at least 90% of our taxable ordinary income, which excludes realized net long-term capital gains, to our shareholders to maintain our eligibility for the tax benefits available to regulated investment companies. As a result, such earnings will not be available to fund investment originations. In addition, as a business development company, we are generally required to maintain a ratio of at least 200% of total assets to total borrowings, which may restrict our ability to borrow in certain circumstances. We expect to continue to borrow from financial institutions or other investors and issue additional debt and equity securities. If we fail to obtain funds from such sources or from other sources to fund our investments, it could limit our ability to grow, which could have a material adverse effect on the value of our common stock.

Loss of regulated investment company tax treatment would substantially reduce net assets and income available for debt service and dividends. We have operated so as to qualify as a regulated investment company under Subchapter M of the Code. If we meet source of income, asset diversification, and distribution requirements, we will not be subject to corporate-level income taxation on income we timely distribute to our stockholders as dividends. We would cease to qualify for such tax treatment if we were unable to comply with these requirements. In addition, we may have difficulty meeting the requirement to make distributions to our shareholders because in certain cases we may recognize income before or without receiving cash representing such income. If we fail to qualify as a regulated investment company, we will have to pay corporate-level taxes on all of our income whether or not we distribute it, which would substantially reduce the amount of income available for debt service and distributions to our stockholders. Even if we qualify as a regulated investment company, we generally will be subject to a corporate-level income tax on the income we do not distribute. If we do not distribute at least 98% of our annual taxable income in the year earned, we generally will be required to pay an excise tax on amounts carried over and distributed to shareholders in the next year equal to 4% of the amount by which 98% of our annual taxable income exceeds the distributions for the current year.

There is a risk that our common stockholders may not receive dividends or distributions. We intend to make distributions on a quarterly basis to our stockholders. We may not be able to achieve operating results that will allow us to make distributions at a specific level or to increase the amount of these distributions from time to time. In addition, due to the asset coverage test applicable to us as a business development company, we may be limited in our ability to make distributions. Also, certain of our credit facilities limit our ability to declare dividends if we default under certain provisions. If we do not distribute a certain percentage of our income annually, we will suffer adverse tax consequences, including possible loss of the tax benefits available to us as a regulated investment company. In addition, in accordance with U.S. generally accepted accounting principles and tax regulations, we include in income certain amounts that we have not yet received in cash, such as contractual payment-in-kind interest, which represents contractual interest added to the loan balance that becomes due at the end of the loan term, or the accrual of original issue discount. The increases in loan balances as a result of contractual payment-in-kind arrangements are included in income in advance of receiving cash payment and are separately included in the change in accrued or reinvested interest and dividends in our consolidated statement of cash flows. Since we may recognize income

before or without receiving cash representing such income, we may have difficulty meeting the requirement to distribute at least 90% of our investment company taxable income to obtain tax benefits as a regulated investment company.

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

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

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

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

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

Until the question raised by the staff of the SEC pertaining to the Federal Reserve's 1998 change to its margin rules has been addressed by legislative, administrative or judicial action, we intend to treat as qualifying assets only those debt and equity securities that are issued by a private company that has no marginable securities outstanding at the time we purchase such securities or those that otherwise qualify as an eligible portfolio company under the 1940 Act.

In November 2004, the SEC issued proposed rules to correct the unintended consequence of the Federal Reserve's 1998 margin rule amendments of apparently limiting the investment opportunities of business development companies. In general, the SEC's proposed rules would define an eligible portfolio company as any company that does not have securities listed on a national securities exchange or association. We currently do not believe that these proposed rules will have a material adverse effect on our operations.

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

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

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

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

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

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

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

general economic conditions and trends;

loss of a major funding source; or

departures of key personnel.

Disclosure Regarding Forward-Looking Statements

Information contained or incorporated by reference in this prospectus, and any prospectus supplement accompanying this prospectus contains 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 con the negative thereof or other variations thereon or comparable terminology. These forward-looking statements are subject to the inherent uncertainties in predicting future results and conditions. Certain factors that could cause actual results and conditions to differ materially from those projected in these forward-looking statements are set forth above in the Risk Factors section. Other factors that could cause actual results to differ materially include:

changes in the economy and general economic conditions;

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

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

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

The matters described in Risk Factors and certain other factors noted throughout this prospectus, and any prospectus supplement accompanying this prospectus and in any exhibits to the registration statement of which this prospectus is a part, constitute cautionary statements identifying important factors with respect to any such forward-looking statements, including certain risks and uncertainties, that could cause actual results to differ materially from those in such forward-looking statements.

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

USE OF PROCEEDS

We intend to use the net proceeds from selling shares of our common stock for general corporate purposes, which may include investing in debt or equity securities in primarily privately negotiated transactions, repayment of indebtedness, acquisitions and other general corporate purposes. Because our primary business is to provide long-term debt and equity capital to primarily middle-market companies, we are continuously identifying, reviewing and, to the extent consistent with our investment objective, funding new investments. As a result, we typically raise equity capital as we deem appropriate to fund such new investments. The supplement to this prospectus relating to an offering will more fully identify the use of the proceeds from such offering.

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

PRICE RANGE OF COMMON STOCK AND DISTRIBUTIONS

Our common stock is traded on the New York Stock Exchange under the symbol ALD. The following table lists the high and low closing sales prices for our common stock, the closing sales price as a percentage of net asset value (NAV) and quarterly dividends per share. On April 26, 2006, the last reported closing sale price of our common stock was \$30.62 per share.

	NAV ⁽¹⁾	Closing Sales Price		Premium of High Sales Price to NAV ⁽²⁾	Premium of Low Sales Price to NAV ⁽²⁾	Declared Dividends
		High	Low			
Year ending December 31, 2004						
First Quarter	\$ 14.60	\$ 30.85	\$ 27.15	211%	186%	\$ 0.57
Second Quarter	\$ 14.77	\$ 30.25	\$ 23.06	205%	156%	\$ 0.57
Third Quarter	\$ 14.90	\$ 25.80	\$ 22.22	173%	149%	\$ 0.57
Fourth Quarter	\$ 14.87	\$ 28.47	\$ 24.46	191%	164%	\$ 0.57
Extra Dividend						\$ 0.02
Year ended December 31, 2005						
First Quarter	\$ 15.22	\$ 27.84	\$ 24.89	183%	164%	\$ 0.57
Second Quarter	\$ 17.01	\$ 29.29	\$ 25.83	172%	152%	\$ 0.57
Third Quarter	\$ 17.37	\$ 29.17	\$ 26.92	168%	155%	\$ 0.58
Fourth Quarter	\$ 19.17	\$ 30.80	\$ 26.11	161%	136%	\$ 0.58
Extra Dividend						\$ 0.03
Year ended December 31, 2006						
First Quarter	*	\$ 30.68	\$ 28.51	*	*	\$ 0.59
Second Quarter (through April 26, 2006)	*	\$ 31.09	\$ 30.13	*	*	\$ 0.60

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

(2) Calculated as the respective high or low closing sales price divided by NAV.

* Not determinable at the time of filing.

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

We intend to pay quarterly dividends to shareholders of our common stock. The amount of our quarterly dividends is determined by our Board of Directors. Our Board of Directors has established a dividend policy to review the dividend rate quarterly, and may adjust the quarterly dividend rate throughout the year. See Management's Discussion and Analysis of Financial Condition and Results of Operations Debt and Equity Capital and Tax Status. There can be no assurance that we will achieve investment results or maintain a tax status that will permit any particular level of dividend payment. Certain of our credit facilities limit our ability to declare dividends if we default under certain provisions.

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

MANAGEMENT'S DISCUSSION AND ANALYSIS

OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

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

changes in the economy;

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

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

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

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

OVERVIEW

As a business development company, we are in the private equity business. Specifically, we provide long-term debt and equity investment capital to companies in a variety of industries. Our lending and investment activity has generally been focused on private finance and commercial real estate finance, which included 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.

On May 3, 2005, we completed the sale of our portfolio of CMBS and real estate related CDO investments. Upon the completion of this transaction, our lending and investment activity has been focused primarily on private finance investments. Our private finance activity principally involves providing financing to middle market U.S. companies through privately negotiated long-term debt and equity investment capital. Our financing is generally used to fund growth, acquisitions, buyouts, recapitalizations, note purchases, bridge financings, and other types of financings. We generally invest in private companies though, from time to time, we may invest in companies that are public but lack access to additional public capital. Our investment objective is to achieve current income and capital gains.

Our portfolio composition at December 31, 2005, 2004, and 2003, was as follows:

	<u>2005</u>	<u>2004</u>	<u>2003</u>
Private finance	96%	76%	74%
Commercial real estate finance	4%	24%	26%

Our earnings depend primarily on the level of interest and dividend income, fee and other income, and net realized and unrealized gains or losses on our investment portfolio after deducting interest expense on borrowed capital, operating expenses and income taxes, including excise tax. Interest income results from the stated interest rate earned on a loan or debt security and the amortization of loan origination fees and discounts. The level of interest income is directly related to the balance of the interest-bearing investment portfolio outstanding during the year 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, interest rates on the types of loans we make, the level of repayments in the portfolio, the amount of loans and debt securities for which interest is not accruing and our ability to secure debt and equity capital for our investment activities.

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

PORTFOLIO AND INVESTMENT ACTIVITY

The total portfolio at value, investment activity, and the yield on interest-bearing investments at and for the years ended December 31, 2005, 2004, and 2003, were as follows:

(\$ in millions)	At and for the Years Ended December 31,		
	2005	2004	2003
Portfolio at value	\$3,606.4	\$3,013.4	\$2,584.6
Investments funded	\$1,675.8	\$1,524.5	\$ 931.5
Change in accrued or reinvested interest and dividends	\$ 6.6	\$ 52.2	\$ 45.0
Principal collections related to investment repayments or sales	\$1,503.4	\$ 909.2	\$ 788.3
Yield on interest-bearing investments ⁽¹⁾	12.8%	14.0%	14.7%

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

Private Finance

The private finance portfolio at value, investment activity, and the yield on loans and debt securities at and for the years ended December 31, 2005, 2004, and 2003, were as follows:

(\$ in millions)	At and for the Years Ended December 31,		
	2005	2004	2003
Portfolio at value:			
Loans and debt securities	\$2,094.9	\$1,602.9	\$1,214.9
Equity securities	1,384.4	699.2	687.8
Total portfolio	\$3,479.3	\$2,302.1	\$1,902.7
Investments funded ⁽¹⁾	\$1,462.3	\$1,140.8	\$ 498.0
Change in accrued or reinvested interest and dividends	\$ 24.6	\$ 45.6	\$ 41.8
Principal collections related to investment repayments or sales	\$ 703.9	\$ 551.9	\$ 318.6
Yield on interest-bearing investments ⁽²⁾	13.0%	13.9%	15.0%

- (1) Investments funded for the year ended December 31, 2004, included a \$47.5 million subordinated debt investment in The Hillman Companies, Inc. received in conjunction with the sale of Hillman as discussed below.
- (2) The weighted average yield on loans and debt securities is computed as the (a) annual stated interest plus the annual amortization of loan origination fees, original issue discount, and market discount on accruing loans and debt securities less the annual amortization of loan origination costs, divided by (b) total loans and debt securities at value. The weighted average yield is computed as of the balance sheet date.

Our investment activity is focused on making long-term investments in the debt and equity of primarily private middle market companies. Debt investments may include senior loans, unitranche debt (a single debt investment that is a blend of senior and subordinated debt), or subordinated debt (with or without equity features). The junior debt that we invest in that is lower in repayment priority than senior debt is also known as mezzanine

debt. Equity investments may include a minority equity stake in connection with a debt investment or a substantial equity stake in connection with a buyout transaction. In a buyout transaction, we generally invest in senior and/or subordinated debt and equity (preferred and/or voting or non-voting common) where our equity ownership represents a significant portion of the equity, but may or may not represent a controlling interest. In addition, we may fund most or all of the debt and equity capital upon the closing of certain buyout transactions, which may include investments in lower-yielding senior debt. Subsequent to the closing, the portfolio company may refinance all or a portion of the lower-yielding senior debt, which would reduce our investment. Repayments include repayments of senior debt funded by us that was subsequently refinanced or repaid by the portfolio companies.

We intend to take a balanced approach to private equity investing that emphasizes a complementary mix of debt investments and buyout investments. The combination of these two types of investments provides current interest and related portfolio income and the potential for future capital gains. Recently, we have seen junior debt financing opportunities in the market that we believe are unattractive from a risk/return perspective. We believe many of these transactions employ too much leverage and are priced too low relative to the risks inherent in junior debt instruments. To address the currently active merger and acquisition market for private companies, our strategy is to focus on buyout and recapitalization transactions where we can manage risk through the structure and terms of our debt and equity investments and where we can potentially realize more attractive total returns from both current interest and fee income and future capital gains. We are also focusing our debt investing on smaller middle market companies where we can provide both senior and subordinated debt or unitranche debt, where our current yield may be lower than traditional subordinated debt. We believe that providing both senior and subordinated debt or unitranche debt provides greater protection in the capital structures of our portfolio companies.

Investments Funded. Investments funded and the weighted average yield on investments funded for the years ended December 31, 2005, 2004, and 2003, consisted of the following:

	2005 Investments Funded					
	Debt Investments		Buyout Investments		Total	
	Amount	Weighted Average Yield ⁽¹⁾	Amount	Weighted Average Yield ⁽¹⁾	Amount	Weighted Average Yield ⁽¹⁾
(\$ in millions)						
Loans and debt securities:						
Senior loans ⁽³⁾	\$ 76.8	10.0%	\$250.2	6.4%	\$ 327.0	7.2%
Unitranche debt ⁽²⁾	259.5	10.5%			259.5	10.5%
Subordinated debt	296.9	12.3%	330.9	12.5%	627.8	12.4%
Total loans and debt securities	633.2	11.3%	581.1	9.9%	1,214.3	10.6%
Equity	82.5		165.5		248.0	
Total	\$715.7		\$746.6		\$1,462.3	

(1) The weighted average yield on interest-bearing investments is computed as the (a) annual stated interest on accruing interest-bearing investments, divided by (b) total interest-bearing investments funded.

(2) Unitranche debt is a single debt investment that is a blend of senior and subordinated debt. The yield on a unitranche investment reflects the blended yield of senior and subordinated debt combined.

(3) Buyout senior loans funded include \$174.9 million which was repaid during the year.

2004 Investments Funded

(\$ in millions)	Debt Investments		Buyout Investments		Total	
	Amount	Weighted Average Yield ⁽¹⁾	Amount	Weighted Average Yield ⁽¹⁾	Amount	Weighted Average Yield ⁽¹⁾
Loans and debt securities:						
Senior loans	\$ 25.1	9.1%	\$ 140.8	7.2%	\$ 165.9	7.5%
Unitranche debt ⁽²⁾	18.9	13.0%			18.9	13.0%
Subordinated debt	396.4	13.4%	320.1	15.5%	716.5	14.4%
Total loans and debt securities	440.4	13.2%	460.9	13.0%	901.3	13.1%
Equity	72.3		167.2		239.5	
Total	\$ 512.7		\$ 628.1		\$ 1,140.8	

2003 Investments Funded

(\$ in millions)	Debt Investments		Buyout Investments		Total	
	Amount	Weighted Average Yield ⁽¹⁾	Amount	Weighted Average Yield ⁽¹⁾	Amount	Weighted Average Yield ⁽¹⁾
Loans and debt securities:						
Senior loans	\$ 44.6	9.4%	\$ 28.6	2.6%	\$ 73.2	6.7%
Unitranche debt ⁽²⁾	25.0	15.5%			25.0	15.5%
Subordinated debt	354.8	14.6%	1.2	25.0%	356.0	14.6%
Total loans and debt securities	424.4	14.1%	29.8	3.5%	454.2	13.4%
Equity	15.6		28.2		43.8	
Total	\$ 440.0		\$ 58.0		\$ 498.0	

(1) The weighted average yield on interest-bearing investments is computed as the (a) annual stated interest on accruing interest-bearing investments, divided by (b) total interest-bearing investments funded.

(2) Unitranche debt is a single debt investment that is a blend of senior and subordinated debt. The yield on a unitranche investment reflects the blended yield of senior and subordinated debt combined.

In January and February 2006, we funded private finance investments totaling \$525.4 million.

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

The level of investment activity for investments funded and principal repayments for private finance investments can vary substantially from period to period depending on the number and size of investments that we make or that we exit and many other factors, including the

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amount of debt and equity capital available to middle market companies, the level of merger and acquisition activity for such companies, the general economic environment, and the competitive environment for the types of investments we make. We believe that merger and acquisition activity in the middle market was strong in 2004 and continued into 2005, which has resulted in an increase in private finance investment opportunities, as well as increased repayments. We currently have an active pipeline of new investments under consideration. We believe that merger and acquisition activity for middle market companies will continue to be strong into 2006.

Portfolio Yield. The yield on the private finance loans and debt securities was 13.0% at December 31, 2005, as compared to 13.9% and 15.0% at December 31, 2004 and 2003, respectively. The weighted average yield on the private finance loans and debt securities may fluctuate from year to year depending on the yield on new loans and debt securities funded, the yield on loans and debt securities repaid, the amount of loans and debt securities for which interest is not accruing and the amount of lower-yielding senior or unitranche debt in the portfolio at the end of the year. The yield on the private finance portfolio has declined partly due to our strategy to pursue more buyout and recapitalization transactions, which may include investing in senior debt, as well as pursue unitranche investments.

Outstanding Investment Commitments. At December 31, 2005, we had outstanding private finance investment commitments totaling \$221.6 million, including the following:

\$33.3 million in the form of debt to Promo Works, LLC.

\$20.0 million in the form of debt to Business Loan Express, LLC.

\$14.0 million in the form of debt to S.B. Restaurant Company.

\$12.5 million in the form of equity to eight private venture capital funds.

\$12.0 million in the form of debt and equity to Amerex Group, LLC.

\$7.8 million in the form of debt to Mercury Air Centers, Inc.

\$7.5 million in the form of equity to Pennsylvania Avenue Investors, L.P., a limited partnership controlled by us that invests in private equity buyout funds.

\$6.5 million in co-investment commitments to Pine Creek Equity Partners, LLC.

We have various commitments to Callidus Capital Corporation (Callidus), which owns 80% of Callidus Capital Management, LLC, an asset management company that structures and manages collateralized debt obligations (CDOs), collateralized loan obligations (CLOs), and other related investments. Our commitment to Callidus consisted of the following at December 31, 2005:

(\$ in millions)	Committed Amount	Amount Drawn	Amount Available to be Drawn
Subordinated debt to support warehouse facilities & warehousing activities ⁽¹⁾	\$40.0	\$	\$40.0
Revolving line of credit for working capital	4.0	0.6	3.4
Total⁽²⁾	\$44.0	\$0.6	\$43.4

(1) Callidus has a secured warehouse credit facilities with a third party for up to \$400 million. The facility is used primarily to finance the acquisition of loans pending securitization through a CDO or CLO. In conjunction with this warehouse credit facility, we have agreed to designate our \$40 million subordinated debt commitment for Callidus to draw upon to provide first loss capital as needed to support the warehouse facility.

(2) Subsequent to December 31, 2005, we provided Callidus with a new \$50.0 million revolving credit facility to support its purchase of middle market senior loans pending the sale of such loans to its warehouse credit facilities.

In addition, we had a commitment to Callidus to purchase preferred equity in future CLO transactions of \$32.4 million at December 31, 2005.

In addition to these outstanding investment commitments at December 31, 2005, we may be required to fund additional amounts under earn-out arrangements primarily related to buyout transactions in the future if those companies meet agreed-upon performance targets. We also had commitments to private finance portfolio companies in the form of standby letters of credit and guarantees totaling \$178.6 million. See Financial Condition, Liquidity and Capital Resources.

Our largest investments at value at December 31, 2005, were in Advantage Sales & Marketing, Inc. and Business Loan Express, LLC (BLX). See Results of Operations for a discussion of the net change in unrealized appreciation or depreciation related to these investments.

Advantage Sales & Marketing, Inc. At December 31, 2005, our investment in Advantage Sales & Marketing, Inc. (Advantage) totaled \$257.7 million at cost and \$660.4 million at value, or 16.4% of our total assets, which included unrealized appreciation of \$402.7 million. We completed the purchase of a majority ownership in Advantage in June 2004.

Total interest and related portfolio income earned from our investment in Advantage for the years ended December 31, 2005 and 2004, was as follows:

(\$ in millions)	2005	2004
Interest income	\$30.9	\$15.5
Fees and other income	6.5	5.8
Total	\$37.4	\$21.3

Interest income from Advantage for the year ended December 31, 2004, included interest income of \$2.2 million which was paid in kind. The interest paid in kind was paid to us through the issuance of additional debt in 2004, which was subsequently paid in cash in 2005.

Net change in unrealized appreciation or depreciation included a net increase in unrealized appreciation on our investment in Advantage of \$378.4 million and \$24.3 million for the years ended December 31, 2005 and 2004, respectively.

Advantage is a 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.

On March 29, 2006, we sold our majority equity interest in Advantage. We retained an equity investment valued at \$15 million as a minority shareholder. Advantage sold for an enterprise value of \$1.05 billion, subject to post-closing adjustments and we realized a gain on our equity sold of approximately \$430 million, also subject to post-closing adjustments. In connection with the transaction, we were repaid our \$184 million in subordinated debt outstanding. As consideration for the common stock sold in the transaction, we received a \$150 million subordinated note, with the balance of the consideration paid in cash. Approximately \$34 million of our proceeds are subject to certain holdback provisions. In addition, there is potential for us to receive additional consideration through an earn-out payment that would be based on Advantage's 2006 audited results. Our realized gain of approximately \$430 million excludes any earn-out amounts.

Business Loan Express, LLC. At December 31, 2005, our investment in BLX totaled \$299.4 million at cost and \$357.1 million at value, or 8.9% of our total assets, which includes unrealized appreciation of \$57.7 million. We acquired BLX in 2000.

Total interest and related portfolio income earned from the Company's investment in BLX for the years ended December 31, 2005, 2004, and 2003, was as follows:

(\$ in millions)	2005	2004	2003
Interest income	\$ 14.3	\$ 23.2	\$ 21.9
Dividend income	14.0	14.8	7.8
Loan prepayment premiums			0.1
Fees and other income	9.2	12.0	16.9
Total	\$ 37.5	\$ 50.0	\$ 46.7

Interest and dividend income from BLX for the years ended December 31, 2005, 2004, and 2003, included interest and dividend income of \$8.9 million, \$25.4 million, and \$17.5 million, respectively, which was paid in kind. The interest and dividends paid in kind were paid to us through the issuance of additional debt or equity interests. Accrued interest and dividends receivable at December 31, 2005, included accrued interest and fees due from BLX totaling \$5.7 million, of which \$5.5 million was paid in cash in the first quarter of 2006.

Net change in unrealized appreciation or depreciation included a net increase in unrealized appreciation on our investment in BLX of \$2.9 million for the year ended December 31, 2005, a net decrease in unrealized appreciation of \$32.3 million for the year ended December 31, 2004, and a net increase in unrealized appreciation of \$51.7 million for the year ended December 31, 2003.

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

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

We have a commitment to BLX of \$30.0 million in the form of a subordinated revolving credit facility to provide working capital to the company that matures on April 30, 2006. There was \$10.0 million outstanding under this facility at December 31, 2005.

At December 31, 2005, BLX had a three-year \$275.0 million revolving credit facility provided by third party lenders that was scheduled to mature in January 2007. As the controlling equity owner in BLX, we had provided an unconditional guaranty to the revolving credit facility lenders in an amount equal to 50% of the total obligations (consisting of principal, letters of credit issued under the facility, accrued interest, and other fees) of BLX under the revolving credit facility. At December 31, 2005, the principal amount outstanding on the revolving credit facility was \$228.2 million and letters of credit issued under the facility were \$41.7 million. The total obligation guaranteed by us at December 31, 2005, was \$135.4 million. On March 17, 2006, BLX closed on a new three-year \$500.0 million revolving credit facility that matures in March 2009, which replaced the existing facility. The revolving credit facility may be expanded through new or additional commitments up to \$600.0 million at BLX's option. This new facility provides for a sub-facility for the issuance of letters of credit for up to an amount equal to 25% of the committed facility. We have provided an unconditional guaranty to these revolving credit facility lenders in an amount equal to 50% of the total obligations (consisting of principal, letters of credit issued under the facility, accrued interest, and other fees) of BLX under this facility. At March 17, 2006, the principal amount outstanding on the revolving credit facility was \$217.6 million and letters of credit issued under the facility were \$41.7 million. The total obligation guaranteed by us on March 17, 2006, was \$130.0 million. This guaranty can be called by the lenders only in the event of a default under the BLX credit facility. BLX was in compliance with the terms of this facility at March 17, 2006.

At December 31, 2005, we had also provided four standby letters of credit totaling \$34.1 million in connection with four term securitization transactions completed by BLX.

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

Commercial Real Estate Finance

The commercial real estate finance portfolio at value, investment activity, and the yield on interest-bearing investments at and for the years ended December 31, 2005, 2004, and 2003, were as follows:

At and for the Years Ended December 31,

	2005		2004		2003	
	Value	Yield ⁽¹⁾	Value	Yield ⁽¹⁾	Value	Yield ⁽¹⁾
(\$ in millions)						
Portfolio at value:						
CMBS bonds	\$		\$373.8	14.6%	\$394.0	14.1%
CDO bonds and preferred shares			212.6	16.8%	186.6	16.7%
Commercial mortgage loans	102.6	7.6%	95.0	6.8%	83.6	8.6%
Real estate owned	13.9		16.9		12.8	
Equity interests	10.6		13.0		4.9	
Total portfolio	\$127.1		\$711.3		\$681.9	
Investments funded	\$213.5		\$383.7		\$433.5	
Change in accrued or reinvested interest	\$ (18.0)		\$ 6.6		\$ 3.2	
Principal collections related to investment repayments or sales ⁽²⁾	\$799.5		\$357.3		\$469.7	

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

(2) Principal collections related to investment repayments or sales for the year ended December 31, 2005, included \$718.1 million related to the sale of our CMBS and CDO portfolio.

Our commercial real estate investments funded for the years ended December 31, 2005, 2004, and 2003, were as follows:

(\$ in millions)	Face Amount	Discount	Amount Funded
For the Year Ended December 31, 2005			
CMBS bonds (4 new issuances) ⁽²⁾	\$211.5	\$ (90.5)	\$121.0
Commercial mortgage loans	88.5	(0.8)	87.7
Equity interests	4.8		4.8
Total	\$304.8	\$ (91.3)	\$213.5
For the Year Ended December 31, 2004			
CMBS bonds (13 new issuances ⁽¹⁾)	\$419.1	\$(183.7)	\$235.4
CDO bonds and preferred shares (3 issuances)	40.5	(0.1)	40.4
Commercial mortgage loans	112.1	(8.2)	103.9
Equity interests	4.0		4.0
Total	\$575.7	\$(192.0)	\$383.7

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For the Year Ended December 31, 2003

CMBS bonds (15 new issuances ⁽¹⁾)	\$508.5	\$(225.9)	\$282.6
CDO bonds and preferred shares (3 issuances)	145.8	(0.4)	145.4
Commercial mortgage loans	3.0		3.0
Equity interests	2.5		2.5
	<u> </u>	<u> </u>	<u> </u>
Total	\$659.8	\$(226.3)	\$433.5
	<u> </u>	<u> </u>	<u> </u>

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

(2) The CMBS bonds invested in during the year ended December 31, 2005, were sold on May 3, 2005.

At December 31, 2005, we had outstanding funding commitments related to commercial mortgage loans and equity interests of \$81.2 million, including \$59.7 million to Timarron Capital, Inc., and commitments in the form of standby letters of credit and guarantees related to equity interests of \$7.1 million. In January 2006, certain assets of Timarron Capital, Inc. were sold and this outstanding commitment was canceled.

Sale of CMBS Bonds and Collateralized Debt Obligation Bonds and Preferred Shares. On May 3, 2005, we completed the sale of our portfolio of commercial mortgage-backed securities (CMBS) and real estate related collateralized debt obligation (CDO) bonds and preferred shares to affiliates of Caisse de dépôt et placement du Québec (the Caisse) for cash proceeds of \$976.0 million and a net realized gain of \$227.7 million, after transaction and other costs of \$7.8 million. Transaction costs included investment banking fees, legal and other professional fees, and other transaction costs. The CMBS and CDO assets sold had a cost basis at closing of \$739.8 million, including accrued interest of \$21.7 million. Upon the closing of the sale, we settled all the hedge positions relating to these assets, which resulted in a net realized loss of \$0.7 million, which has been included in the net realized gain on the sale.

For tax purposes, we estimate that the net gain from the sale of the CMBS and CDO portfolio will be approximately \$244 million, after transaction and other costs of \$7.8 million. The difference between the net gain for book and tax purposes results from temporary differences in the recognition of income and expenses related to these assets.

Simultaneous with the sale of our CMBS and CDO portfolio, we entered into a platform assets purchase agreement with CWCapital Investments LLC, an affiliate of the Caisse (CWCapital), pursuant to which we agreed to sell certain commercial real estate related assets, including servicer advances, intellectual property, software and other platform assets, subject to certain adjustments. This transaction was completed on July 13, 2005, and we received total cash proceeds of approximately \$5.3 million. No gain or loss resulted from the transaction. Under this agreement, we have agreed not to invest in CMBS and real estate-related CDOs and refrain from certain other real estate-related investing or servicing activities for a period of three years, subject to certain limitations and excluding our existing portfolio and related activities.

The real estate securities purchase agreement, under which we sold the CMBS and CDO portfolio, and the platform asset purchase agreement contain customary representations and warranties, and require us to indemnify the affiliates of the Caisse that are parties to the agreements for certain liabilities arising under the agreements, subject to certain limitations and conditions.

We also entered into a transition services agreement with CWCapital pursuant to which we provided certain transition services to CWCapital for a limited transition period to facilitate the transfer of various servicing and other rights related to the CMBS and CDO portfolio. During the transition period, we agreed, among other things, to continue to act as servicer or special servicer with respect to the CMBS and CDO portfolio. Services provided under the transition services agreement, except for certain information technology services, were completed on July 13, 2005. For the year ended December 31, 2005, we received a total of \$1.4 million under the transition services agreement as reimbursement for employee and administrative expenses. These amounts reduced our employee expenses by \$1.1 million and administrative expenses by \$0.3 million.

Hedging Activities

We have invested in commercial mortgage loans and CMBS and CDO bonds, which were purchased at prices that were based in part on comparable Treasury rates. We have entered into transactions with one or more financial institutions to hedge against movement in Treasury rates on certain of the commercial mortgage loans and CMBS and CDO bonds. These transactions, referred to as short sales, involve receiving the proceeds from the short sales of borrowed Treasury securities, with the obligation to replenish the borrowed Treasury securities at a later date based on the then current market price, whatever that price may be. Risks in these contracts arise from movements in the value of the borrowed Treasury securities due to changes in interest rates and from the possible inability of counterparties to meet the terms of their contracts. If the value of the borrowed Treasury securities increases, we will incur losses on these transactions. These losses are limited to the increase in value of the borrowed Treasury securities; conversely, the value of the hedged commercial real estate assets would likely increase. If the value of the borrowed Treasury securities decreases, we will incur gains on these transactions which are limited to the decline in value of the borrowed Treasury securities; conversely, the value of the hedged commercial real estate assets 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 \$17.7 million and \$38.2 million at December 31, 2005 and 2004, respectively. The net proceeds related to the sales of the borrowed Treasury securities plus or minus the additional cash collateral provided or received under the terms of the transactions were \$17.7 million and \$38.2 million at December 31, 2005 and 2004, respectively. The hedge at December 31, 2005, related to commercial mortgage loans and the hedge at December 31, 2004, related primarily to CMBS and CDO bonds. The amount of the hedge will vary from period to period depending upon the amount of commercial real estate assets that we own and have hedged as of the balance sheet date.

Accrued Interest and Dividends Receivable

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

(\$ in millions)	2005	2004
Private finance	\$58.7	\$59.8
Commercial real estate finance		
CMBS and CDO bonds		18.9
Commercial mortgage loans and other	1.7	0.8
	\$60.4	\$79.5
Total	\$60.4	\$79.5

Total accrued interest and dividends receivable declined from December 31, 2004, to December 31, 2005, primarily as a result of the sale of our portfolio of CMBS and CDO assets on May 3, 2005. See [Commercial Real Estate Finance](#) above.

Portfolio Asset Quality

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

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

Grade	2005		2004	
	Portfolio at Value	Percentage of Total Portfolio	Portfolio at Value ⁽¹⁾	Percentage of Total Portfolio
(\$ in millions)				
1	\$ 1,643.0	45.6%	\$ 952.5	31.6%
2	1,730.8	48.0	1,850.5	61.4
3	149.1	4.1	121.2	4.0
4	26.5	0.7	11.7	0.4
5	57.0	1.6	77.5	2.6
	<u>\$ 3,606.4</u>	<u>100.0%</u>	<u>\$ 3,013.4</u>	<u>100.0%</u>

(1) The value of the CMBS and CDO assets sold on May 3, 2005, was \$586.4 million at December 31, 2004, and this value was included in Grade 2 assets. See *Commercial Real Estate Finance* above.

Grade 1 portfolio assets increased from \$952.5 million at December 31, 2004, to \$1.6 billion at December 31, 2005, primarily as a result of the appreciation in value of our investment in Advantage Sales & Marketing, Inc. (Advantage) as well as certain other companies. Advantage had a value of \$660.4 million, including \$402.7 million of unrealized appreciation, at December 31, 2005, as compared to a value of \$283.0 million, including \$24.3 million of unrealized appreciation, at December 31, 2004. See further discussion of the valuation of Advantage below. In March 2006, we announced that we had signed a definitive agreement to sell a majority interest in Advantage. See *Portfolio and Investment Activity* above for further discussion.

Total Grade 3, 4 and 5 portfolio assets were \$232.6 million and \$210.4 million, respectively, or were 6.4% and 7.0%, respectively, of the total portfolio at value at December 31, 2005 and 2004.

Grade 4 and 5 assets include loans, debt securities, and equity securities. We expect that a number of portfolio companies will be in the Grades 4 or 5 categories from time to time. Part of the private equity business is working with troubled portfolio companies to improve their businesses and protect our investment. The number of portfolio companies and related investment amount included in Grade 4 and 5 may fluctuate from period to period. We continue to follow our historical practice of working with such companies in order to recover the maximum amount of our investment.

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

(\$ in millions)	2005	2004
Loans and debt securities in workout status (classified as Grade 4 or 5) ⁽¹⁾		
Private finance		
Companies more than 25% owned	\$ 15.6	\$ 34.4
Companies less than 5% owned	11.4	16.5
Commercial real estate finance	12.9	5.6
Loans and debt securities not in workout status		
Private finance		
Companies more than 25% owned	58.0	29.4
Companies 5% to 25% owned	0.5	0.7
Companies less than 5% owned	49.5	15.8
Commercial real estate finance	7.9	12.5
	\$ 155.8	\$ 114.9
	4.3%	3.8%

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

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

(\$ in millions)	2005	2004
Private finance	\$ 74.6	\$ 73.5
Commercial real estate finance		
CMBS bonds		49.0
Commercial mortgage loans	6.1	10.1
	\$ 80.7	\$ 132.6
	2.2%	4.4%

In general, interest is not accrued on loans and debt securities if we have doubt about interest collection or where the enterprise value of the portfolio company may not support further accrual. In addition, interest may not accrue on loans to portfolio companies that are more than 50% owned by us depending on such company's capital requirements. To the extent interest payments are received on a loan that is not accruing interest, we may use such payments to reduce our cost basis in the investment in lieu of recognizing interest income.

Our loans and debt securities on non-accrual status increased by \$40.9 million during 2005. This net increase during the year resulted primarily from the move of two loans to non-accrual status totaling \$46.7 million at value at December 31, 2005, offset by a net decrease in the value of loans that were on non-accrual status at both December 31, 2005 and 2004.

As a result of these and other factors, the amount of the private finance portfolio that is greater than 90 days delinquent or on non-accrual status may vary from period to period. Loans and debt securities on non-accrual status and over 90 days delinquent should not be added together as they are two separate measures of portfolio asset quality. Loans and debt securities that are in both categories (i.e., on non-accrual status and over 90 days delinquent) totaled \$60.7 million and \$43.9 million at December 31, 2005 and 2004, respectively.

RESULTS OF OPERATIONS**Comparison of the Years Ended December 31, 2005, 2004, and 2003**

The following table summarizes our operating results for the years ended December 31, 2005, 2004, and 2003.

(in thousands, except per share amounts)	2005	2004	Change	Percent Change	2004	2003	Change	Percent Change
Interest and Related Portfolio Income								
Interest and dividends	\$ 317,153	\$ 319,642	\$ (2,489)	(1)%	\$ 319,642	\$ 290,719	\$ 28,923	10%
Loan prepayment premiums	6,250	5,502	748	14%	5,502	8,172	(2,670)	(33)%
Fees and other income	50,749	41,946	8,803	21%	41,946	30,338	11,608	38%
Total interest and related portfolio income	374,152	367,090	7,062	2%	367,090	329,229	37,861	11%
Expenses								
Interest	76,798	75,650	1,148	2%	75,650	77,233	(1,583)	(2)%
Employee	78,300	53,739	24,561	46%	53,739	36,945	16,794	45%
Administrative	70,267	34,686	35,581	103%	34,686	22,387	12,299	55%
Total operating expenses	225,365	164,075	61,290	37%	164,075	136,565	27,510	20%
Net investment income before income taxes	148,787	203,015	(54,228)	(27)%	203,015	192,664	10,351	5%
Income tax expense (benefit), including excise tax	11,561	2,057	9,504	**	2,057	(2,466)	4,523	**
Net investment income	137,226	200,958	(63,732)	(32)%	200,958	195,130	5,828	3%
Net Realized and Unrealized Gains (Losses)								
Net realized gains	273,496	117,240	156,256	133%	117,240	75,347	41,893	56%
Net change in unrealized appreciation or depreciation	462,092	(68,712)	530,804	*	(68,712)	(78,466)	9,754	*
Total net gains (losses)	735,588	48,528	687,060	*	48,528	(3,119)	51,647	*
Net income	\$ 872,814	\$ 249,486	\$ 623,328	250%	\$ 249,486	\$ 192,011	\$ 57,475	30%
Diluted earnings per common share	\$ 6.36	\$ 1.88	\$ 4.48	238%	\$ 1.88	\$ 1.62	\$ 0.26	16%
Weighted average common shares outstanding diluted	137,274	132,458	4,816	4%	132,458	118,351	14,107	12%

* Net change in unrealized appreciation or depreciation and net gains (losses) can fluctuate significantly from year to year.

** Percentage change is not meaningful.

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

Interest and dividend income for the years ended December 31, 2005, 2004, and 2003, was composed of the following:

(\$ in millions)	2005	2004	2003
Interest			
Private finance loans and debt securities	\$251.0	\$195.2	\$177.3
CMBS and CDO portfolio	29.4	93.3	86.2
Commercial mortgage loans	7.6	9.4	9.0
Cash and cash equivalents and other	9.4	3.1	2.8
Total interest	297.4	301.0	275.3
Dividends	19.8	18.6	15.4
Total interest and dividends	\$317.2	\$319.6	\$290.7

The level of interest income, which includes interest paid in cash and in kind, is directly related to the balance of the interest-bearing investment portfolio outstanding during the period multiplied by the weighted average yield. The weighted average yield varies from period to period based on the current stated interest on interest-bearing investments and the amount of loans and debt securities for which interest is not accruing. The interest-bearing investments in the portfolio at value and the weighted average yield on the interest-bearing investments in the portfolio at December 31, 2005, 2004, and 2003, were as follows:

(\$ in millions)	2005	2004	2003
Interest-bearing portfolio at value	\$2,211.4	\$2,301.2	\$1,891.9
Portfolio yield	12.8%	14.0%	14.7%

We sold our CMBS and CDO portfolio on May 3, 2005. As a result of this transaction, our interest income for the year ended December 31, 2005, was reduced due to the loss of interest from the portfolio sold (net of interest income earned on short-term excess cash investments). The CMBS and CDO portfolio sold on May 3, 2005, had a cost basis of \$718.1 million and a weighted average yield on the cost basis of the portfolio of approximately 13.8%. Excess cash proceeds from the sale that were not used for the repayment of debt or other general corporate purposes were held in cash and money market securities until the cash was reinvested in the portfolio.

The portfolio yield at December 31, 2005, of 12.8% as compared to the portfolio yield of 14.0% and 14.7% at December 31, 2004 and 2003, respectively, reflects the sale of the CMBS and CDO portfolio on May 3, 2005, as well as the mix of debt investments in the private finance portfolio. See the discussion of the private finance portfolio yield above under the caption Private Finance.

Dividend income results from the dividend yield on preferred equity interests, if any, or the declaration of dividends by a portfolio company on preferred or common equity interests. Dividend income will vary from period to period depending upon the timing and amount of dividends that are declared or paid by a portfolio company on preferred or common equity interests. Dividend income included dividends from BLX on the Class B equity interests held by us of \$14.0 million, \$14.8 million, and \$7.8 million for the years ended December 31, 2005, 2004, and 2003, respectively. For the year ended December 31, 2005, \$12.0 million of these dividends were paid in cash and \$2.0 million of these dividends were paid through the issuance of additional Class B equity interests. For the

years ended December 31, 2004 and 2003, these dividends were paid through the issuance of additional Class B equity interests.

Loan prepayment premiums were \$6.3 million, \$5.5 million, and \$8.2 million for the years ended December 31, 2005, 2004, and 2003, respectively. While the scheduled maturities of private finance and commercial real estate loans generally range from five to ten years, it is not unusual for our borrowers to refinance or pay off their debts to us ahead of schedule. Therefore, we generally structure our loans to require a prepayment premium for the first three to five years of the loan. Accordingly, the amount of prepayment premiums will vary depending on the level of repayments and the age of the loans at the time of repayment.

Fees and other income primarily include fees related to financial structuring, diligence, transaction services, management and consulting services to portfolio companies, guarantees, and other 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, but is not limited to, management and consulting services related to corporate finance, marketing, human resources, personnel and board member recruiting, business operations, corporate governance, risk management and other general business matters.

Fees and other income for the years ended December 31, 2005, 2004, and 2003, included fees relating to the following:

(\$ in millions)	2005	2004	2003
Structuring and diligence	\$24.6	\$18.4	\$ 6.1
Transaction and other services provided to portfolio companies	2.9	3.2	4.5
Management, consulting and other services provided to portfolio companies and guaranty fees	20.8	17.4	18.7
Other income	2.4	2.9	1.0
	<u> </u>	<u> </u>	<u> </u>
Total fees and other income	\$50.7	\$41.9	\$30.3
	<u> </u>	<u> </u>	<u> </u>

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 of investment activity and types of services provided. Loan origination fees that represent yield enhancement on a loan are capitalized and amortized into interest income over the life of the loan.

Fees and other income for the year ended December 31, 2005, included structuring fees from Norwesco, Inc., Callidus Capital Corporation, Triax Holdings, LLC, and Meineke Car Care Centers, Inc. totaling \$9.4 million. Fees and other income for the year ended December 31, 2004, included structuring fees from Advantage, Financial Pacific Company, Mercury Air Centers, Inc. and Insight Pharmaceutical Corporation totaling \$10.0 million.

Fees and other income related to the CMBS and CDO portfolio were \$4.1 million, \$6.2 million, and \$2.8 million for the years ended December 31, 2005, 2004, and 2003, respectively.

Advantage and BLX were our largest investments at value at December 31, 2005 and 2004, and together represented 25.3% and 19.0%, of our total assets, respectively. BLX and

Hillman were our largest portfolio investments at December 31, 2003, and together represented 19.1% of our total assets at December 31, 2003.

Total interest and related portfolio income from these investments for the years ended December 31, 2005, 2004, and 2003, was as follows:

	2005	2004	2003
(\$ in millions)			
Advantage ⁽¹⁾	\$ 37.4	\$ 21.3	\$
BLX	\$ 37.5	\$ 50.0	\$ 46.7
Hillman ⁽¹⁾	\$	\$ 2.5	\$ 9.7

(1) Includes income from our controlled investments only.

Operating Expenses. Operating expenses include interest, employee, and administrative expenses.

Interest Expense. The fluctuations in interest expense during the years ended December 31, 2005, 2004, and 2003, were primarily attributable to changes in the level of our borrowings under various notes payable and debentures and our revolving line of credit. Our borrowing activity and weighted average cost of debt, including fees and closing costs, at and for the years ended December 31, 2005, 2004, and 2003, were as follows:

	2005	2004	2003
(\$ in millions)			
Total outstanding debt	\$ 1,284.8	\$ 1,176.6	\$ 954.2
Average outstanding debt	\$ 1,087.1	\$ 985.6	\$ 943.5
Weighted average cost ⁽¹⁾	6.5%	6.6%	7.5%

(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 on the balance sheet date.

In addition, interest expense includes interest on our obligations to replenish borrowed Treasury securities related to our hedging activities of \$1.4 million, \$5.2 million, and \$5.9 million for the years ended December 31, 2005, 2004, and 2003, respectively.

Employee Expense. Employee expenses for the years ended December 31, 2005, 2004, and 2003, were as follows:

	2005	2004	2003
(\$ in millions)			
Salaries and employee benefits	\$ 57.3	\$ 40.7	\$ 28.3
Individual performance award (IPA)	7.0	13.4	
IPA mark to market expense (benefit)	2.0	(0.4)	
Individual performance bonus (IPB)	6.9		
Transition compensation, net	5.1		
Retention award			8.6
	—	—	—
Total employee expense	\$ 78.3	\$ 53.7	\$ 36.9
	—	—	—
Number of employees at end of period	131	162	125

The change in salaries and employee benefits reflects the effect of wage increases, the change in mix of employees given their area of responsibility and relevant experience level, and the termination of certain employees in our commercial real estate group as discussed

below. Salaries and employee benefits expense has generally increased due to changes in the composition of our employee resources and compensation increases.

Transition compensation costs were \$5.1 million for the year ended December 31, 2005, including \$3.1 million of costs under retention agreements and \$3.1 million of transition services bonuses awarded to certain employees in the commercial real estate group as a result of the sale of the CMBS and CDO portfolio. Transition compensation costs of \$5.1 million for the year ended December 31, 2005, reflect a reduction for salary reimbursements from CWC Capital under the transition services agreement of \$1.1 million. See the caption "Commercial Real Estate Finance" above for additional information.

Employee expense, excluding transition compensation, related to the 31 employees in our commercial real estate group who terminated employment in the third quarter of 2005 as a result of the sale of our CMBS and CDO portfolio, was \$4.5 million, \$6.8 million, and \$3.4 million for the years ended December 31, 2005, 2004, and 2003, respectively.

The Individual Performance Award (IPA) is a long-term incentive compensation program for certain officers. The IPA, which is generally determined annually at the beginning of each year, is deposited into a deferred compensation trust generally in four equal installments, on a quarterly basis, in the form of cash. The accounts of the trust are consolidated with our accounts. We are required to mark to market the liability of the trust and this adjustment is recorded to the IPA compensation expense. Because the IPA is deferred compensation, the cost of this award is not a current expense for purposes of computing our taxable income. The expense is deferred for tax purposes until distributions are made from the trust.

As a result of changes in regulation by the Jobs Creation Act of 2004 associated with deferred compensation arrangements, as well as an increase in the competitive market for recruiting talent in the private equity industry, the Compensation Committee and the Board of Directors have determined for 2005 and 2006 that a portion of the IPA should be replaced with an individual performance bonus (IPB). The IPB is distributed in cash to award recipients in equal bi-weekly installments (beginning in February of each respective year) as long as the recipient remains employed by us.

The Compensation Committee and the Board of Directors have determined the IPA and the IPB for 2006 and they are currently estimated to be approximately \$6.8 million each; however, the Compensation Committee may adjust the IPA or IPB as needed, or make new awards as new officers are hired. If a recipient terminates employment during the year, any further cash contribution for the IPA or remaining cash payments under the IPB would be forfeited.

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 was effective January 1, 2006, and it applies to our stock option plan. Our stock options are typically granted with ratable vesting provisions, and we intend to amortize the compensation cost over the service period. We will use the modified prospective method upon adoption. Under the modified prospective method, previously awarded but unvested options are accounted for in accordance with FASB Statement No. 123, except that amounts must be recognized in the income statement beginning January 1, 2006, instead of simply being disclosed. Awards granted on or after January 1, 2006, will be recognized in the income statement. Upon adoption, we estimate

that the stock based compensation expense on a pre-tax basis, as measured under the Statement, will be approximately \$13 million, \$10 million, and \$3 million for the years ended December 31, 2006, 2007, and 2008, respectively, for stock-based compensation related to options granted prior to January 1, 2006, that has not historically been recorded in our statement of operations. This does not include any expense related to stock options that will be granted in the future as the fair value of those stock options will be determined at the time of grant. See Note 2, Summary of Significant Accounting Policies of our Notes to Consolidated Financial Statements.

Administrative Expense. Administrative expenses include legal and accounting fees, valuation assistance fees, insurance premiums, the cost of leases for our headquarters in Washington, DC, and our regional offices, portfolio origination and development expenses, stock record expenses, directors fees, and various other expenses. Administrative expenses for the years ended December 31, 2005, 2004, and 2003, were as follows:

(\$ in millions)	2005	2004	2003
Administrative expenses, excluding investigation related costs	\$33.9	\$30.1	\$22.4
Investigation related costs	36.4	4.6	—
	—	—	—
Total administrative expenses	\$70.3	\$34.7	\$22.4
	—	—	—

The increase in administrative expenses, excluding investigation related costs, for the year ended December 31, 2005, over the year ended December 31, 2004, was primarily due to increased expenses related to evaluating potential new investments of \$2.0 million, accounting fees of \$0.8 million, recruiting and employee training costs of \$0.6 million, and valuation assistance fees of \$0.5 million, offset by a decrease in expenses related to a decline in portfolio workout expenses of \$0.6 million.

Administrative expenses, excluding investigation related costs, were \$30.1 million for the year ended December 31, 2004, a \$7.7 million increase over administrative expenses of \$22.4 million for the year ended December 31, 2003. The increase in expenses primarily resulted from:

a net increase in accounting, consulting, and other fees of \$1.7 million. This increase is primarily attributable to fees associated with the implementation of the requirements under the Sarbanes-Oxley Act of 2002 (including Section 404) and valuation assistance,

an increase in deal costs related to evaluating potential new investments of \$1.6 million. Costs related to mezzanine lending are generally paid by the borrower, however, costs related to buyout investments are generally funded by us. Accordingly, if a prospective deal does not close, we incur expenses that are not recoverable,

an increase in expenses related to portfolio development and workout activities of \$1.5 million,

an increase in rent of \$1.4 million associated with the opening of an office in Los Angeles, CA and expanding our office space in Chicago, IL and New York, NY, and

an increase in other expenses, including stock record expense, insurance premiums and directors fees of \$1.1 million, and travel expenses of \$0.8 million.

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In addition, administrative expenses for the years ended December 31, 2005 and 2004, included costs associated with requests for information in connection with two government investigations. These expenses remain difficult to predict. See Legal Proceedings.

Income Tax Expense (Benefit), Including Excise Tax. Income tax expense (benefit) for the years ended December 31, 2005, 2004, and 2003, were as follows:

(\$ in millions)	2005	2004	2003
Income tax expense (benefit)	\$ 5.4	\$ 1.1	\$(2.5)
Excise tax expense	6.2	1.0	—
Income tax expense (benefit), including excise tax	\$ 11.6	\$ 2.1	\$(2.5)

Our wholly owned subsidiary, A.C. Corporation, is a corporation subject to federal and state income taxes and records a benefit or expense for income taxes as appropriate based on its operating results in a given period. In addition, our estimated annual taxable income for 2005 exceeded our dividend distributions to shareholders for 2005 from such taxable income, and such estimated excess taxable income will be distributed in 2006. Therefore, we will be required to pay a 4% excise tax on the excess of 98% of our taxable income for 2005 over the amount of actual distributions for 2005. Accordingly, we accrued an estimated excise tax of \$6.2 million for the year ended December 31, 2005, based upon our current estimate of annual taxable income for 2005. See Financial Condition, Liquidity and Capital Resources.

Realized Gains and Losses. Net realized gains primarily result from the sale of equity securities associated with certain private finance investments, the sale of CMBS bonds and CDO bonds and preferred shares, and the realization of unamortized discount resulting from the sale and early repayment of private finance loans and commercial mortgage loans, offset by losses on investments. Net realized gains for the years ended December 31, 2005, 2004, and 2003, were as follows:

(\$ in millions)	2005	2004	2003
Realized gains	\$ 343.1	\$ 267.7	\$ 94.3
Realized losses	(69.6)	(150.5)	(19.0)
Net realized gains	\$ 273.5	\$ 117.2	\$ 75.3

When we exit an investment and realize a gain or loss, we make an accounting entry to reverse any unrealized appreciation or depreciation, respectively, we had previously recorded to reflect the appreciated or depreciated value of the investment. For the years ended December 31, 2005, 2004, and 2003, we reversed previously recorded unrealized appreciation or depreciation when gains or losses were realized as follows:

(\$ in millions)	2005 ⁽¹⁾	2004	2003
Reversal of previously recorded net unrealized appreciation associated with realized gains	\$(108.0)	\$(210.5)	\$(78.5)
Reversal of previously recorded net unrealized depreciation associated with realized losses	68.0	151.8	20.3
Total reversal	\$ (40.0)	\$ (58.7)	\$(58.2)

(1) Includes the reversal of net unrealized appreciation of \$6.5 million on the CMBS and CDO assets sold and the related hedges. The net unrealized appreciation recorded on these assets prior to their sale was determined on an individual security-by-security basis.

The net gain realized upon the sale of \$227.7 million reflects the total value received for the portfolio as a whole.

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Realized gains for the years ended December 31, 2005, 2004, and 2003, were as follows:

(\$ in millions)

2005	
Portfolio Company	Amount
Private Finance:	
Housecall Medical Resources, Inc.	\$ 53.7
Fairchild Industrial Products Company	16.2
Apogen Technologies Inc.	9.0
Polaris Pool Systems, Inc.	7.4
MasterPlan, Inc.	3.7
U.S. Security Holdings, Inc.	3.3
Ginsey Industries, Inc.	2.8
E-Talk Corporation	1.6
Professional Paint, Inc.	1.6
Oriental Trading Company, Inc.	1.0
Woodstream Corporation	0.9
Impact Innovations Group, LLC	0.8
DCS Business Services, Inc.	0.7
Other	3.4
Total private finance	106.1
Commercial Real Estate:	
CMBS/CDO assets, net ⁽¹⁾	227.7
Other	9.3
Total commercial real estate	237.0
Total gross realized gains	\$343.1

2004	
Portfolio Company	Amount
Private Finance:	
The Hillman Companies, Inc.	\$150.3
CorrFlex Graphics, LLC	25.7
Professional Paint, Inc.	13.7
Impact Innovations Group, LLC	11.1
The Hartz Mountain Corporation	8.3
Housecall Medical Resources, Inc.	7.2
International Fiber Corporation	5.2
CBA-Mezzanine Capital Finance, LLC	4.1
United Pet Group, Inc.	3.8
Oahu Waste Services, Inc.	2.8
Grant Broadcasting Systems II	2.7
Matrics, Inc.	2.1
SmartMail, LLC	2.1
Other	7.6

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Total private finance	246.7
Commercial Real Estate:	
CMBS/CDO assets, net ⁽¹⁾	17.4
Other	3.6
Total commercial real estate	21.0
Total gross realized gains	\$267.7

2003

Portfolio Company	Amount
Private Finance:	
Blue Rhino Corporation	\$ 12.6
CyberRep	9.6
Morton Grove Pharmaceuticals, Inc.	8.5
Warn Industries, Inc.	8.0
Woodstream Corporation	6.6
Kirkland's Inc.	3.0
Julius Koch USA, Inc.	2.8
GC-Sun Holdings II, LP	2.5
Interline Brands, Inc.	1.7
WyoTech Acquisition Corporation	1.3
Advantage Mayer, Inc.	1.2
Other	3.2
Total private finance	61.0
Commercial Real Estate:	
CMBS/CDO assets, net ⁽¹⁾	31.6
Other	1.7
Total commercial real estate	33.3
Total gross realized gains	\$94.3

(1) Net of net realized losses from related hedges of \$0.7 million, \$3.8 million, and \$2.9 million for the years ended December 31, 2005, 2004, and 2003, respectively.

Realized losses for the years ended December 31, 2005, 2004, and 2003, were as follows:

(\$ in millions)

2005

Portfolio Company	Amount
Private Finance:	
Norstan Apparel Shops, Inc.	\$ 18.5

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Acme Paging, L.P.	13.8
E-Talk Corporation	9.0
Garden Ridge Corporation	7.1
HealthASPex, Inc.	3.5
MortgageRamp, Inc.	3.5
Maui Body Works, Inc.	2.7
Packaging Advantage Corporation	2.2
Other	3.7
	<hr/>
Total private finance	64.0
	<hr/>
Commercial Real Estate:	
Other	5.6
	<hr/>
Total commercial real estate	5.6
	<hr/>
Total gross realized losses	\$ 69.6
	<hr/>

2004

Portfolio Company	Amount
Private Finance:	
American Healthcare Services, Inc.	\$ 32.9
The Color Factory, Inc.	24.5
Executive Greetings, Inc.	19.3
Sydran Food Services II, L.P.	18.2
Ace Products, Inc.	17.6
Prosperco Finanz Holding AG	7.5
Logic Bay Corporation	5.0
Sun States Refrigerated Services, Inc.	4.7
Chickasaw Sales & Marketing, Inc.	3.8
Sure-Tel, Inc.	2.3
Liberty-Pittsburgh Systems, Inc.	2.0
EDM Consulting, LLC	1.9
Pico Products, Inc.	1.7
Impact Innovations Group, LLC	1.7
Interline Brands, Inc.	1.3
Startec Global Communications Corporation	1.1
Other	2.7
	<hr/>
Total private finance	148.2
	<hr/>
Commercial Real Estate:	
Other	2.3
	<hr/>
Total commercial real estate	2.3
	<hr/>
Total gross realized losses	\$ 150.5
	<hr/>

2003

Portfolio Company	Amount
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Private Finance:	
Allied Office Products, Inc.	\$ 7.7
Candlewood Hotel Company	2.7
North American Archery, LLC	2.1
Other	0.5
	<hr/>
Total private finance	13.0
	<hr/>
Commercial Real Estate:	
Other	6.0
	<hr/>
Total commercial real estate	6.0
	<hr/>
Total gross realized losses	\$19.0
	<hr/>

Change in Unrealized Appreciation or Depreciation. We determine the value of each investment in our portfolio on a quarterly basis, and changes in value result in unrealized appreciation or depreciation being recognized in our statement of operations. Value, as defined in Section 2(a)(41) of the Investment Company Act of 1940, is (i) the market price for those securities for which a market quotation is readily available and (ii) for all other securities and assets, fair value is as determined in good faith by the Board of Directors. Since there is typically no readily available market value for the investments in our portfolio, we value substantially all of our portfolio investments at fair value as determined in good faith by the Board of Directors pursuant to our valuation policy and a consistently applied valuation process. At December 31, 2005, portfolio investments recorded at fair value were approximately 90% of our total assets. Because of the inherent uncertainty of determining the fair value of investments that do not have a readily available market value, the fair value of our investments determined in good faith by the Board of Directors may differ significantly from the values that would have been used had a ready market existed for the investments, and the differences could be material.

There is no single standard for determining fair value in good faith. As a result, determining fair value requires that judgment be applied to the specific facts and circumstances of each portfolio investment while employing a consistently applied valuation process for the types of investments we make. Unlike banks, we are not permitted to provide a general reserve for anticipated loan losses. Instead, we are required to specifically value each individual investment on a quarterly basis. We will record unrealized depreciation on investments when we believe that an investment has become impaired, including where collection of a loan or realization of an equity security is doubtful, or when the enterprise value of the portfolio company does not currently support the cost of our debt or equity investment. Enterprise value means the entire value of the company to a potential buyer, including the sum of the values of debt and equity securities used to capitalize the enterprise at a point in time. We will record unrealized appreciation if we believe that the underlying portfolio company has appreciated in value and/or our equity security has 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. The structure of each 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 may be subject to certain restrictions on resale and generally have no established trading market. Because of the type of investments that we make and the nature of our business, our valuation process requires an analysis of various factors. Our fair value methodology includes the examination of, among other things, the underlying investment performance, financial condition, and market changing events that impact valuation.

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

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

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

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

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

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

about our portfolio companies, unless required, because we believe doing so may put them at an economic or competitive disadvantage, regardless of our level of ownership or control.

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

For the years ended December 31, 2005 and 2004, we received third-party valuation assistance from Duff & Phelps, LLC (Duff & Phelps) and Houlihan Lokey Howard and Zukin (Houlihan Lokey) for our private finance portfolio as follows:

	2005				2004			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Number of private finance portfolio companies reviewed:								
Duff & Phelps ⁽¹⁾	35	72	88	78	22	33	28	22
Houlihan Lokey ⁽²⁾	1	1	3	3				
Total number of private finance portfolio companies reviewed ⁽³⁾	36	72	89	80	22	33	28	22
Percentage of private finance portfolio reviewed at value:								
Duff & Phelps ⁽¹⁾	59.6%	83.0%	86.6%	87.9%	19.9%	21.6%	26.6%	42.2%
Houlihan Lokey ⁽²⁾	14.9%	14.9%	18.9%	23.5%				
Percentage of private finance portfolio reviewed at value ⁽³⁾	74.5%	83.0%	89.3%	92.4%	19.9%	21.6%	26.6%	42.2%

(1) During the third quarter of 2005, S&P Corporate Value Consulting merged with Duff & Phelps, LLC, a financial advisory and investment banking firm. The merged company operates under the name of Duff & Phelps, LLC.

(2) Houlihan Lokey was initially engaged in the first quarter of 2005.

(3) Duff & Phelps and Houlihan Lokey both reviewed Advantage Sales & Marketing, Inc. in Q2, Q3 and Q4 2005. In addition, Duff & Phelps and Houlihan Lokey both reviewed one other portfolio company in Q3 2005.

Professional fees for third-party valuation assistance for the years ended December 31, 2005 and 2004, were \$1.4 million and \$0.9 million, respectively.

Valuation Methodology CMBS Bonds and CDO and CLO Bonds and Preferred Shares/Income Notes (CMBS/CDO/CLO Assets). CMBS/CDO/CLO Assets are carried at fair value, which is based on a discounted cash flow model that utilizes prepayment and loss assumptions based on historical experience and projected performance, economic factors, the characteristics of the underlying cash flow and comparable yields for similar bonds and preferred shares/income notes, when available. We recognize unrealized appreciation or depreciation on our CMBS/CDO/CLO Assets as comparable yields in the market change and/ or based on changes in estimated cash flows resulting from changes in prepayment or loss assumptions in the underlying collateral pool. As each bond ages, the expected amount of losses and the expected timing of recognition of such losses in the underlying collateral pool is updated and the revised cash flows are used in determining the fair value of the bonds. We determine the fair value of our CMBS/CDO/CLO Assets on an individual security-by-

security basis. When we sold a group of these real estate related investments in a pool in one or more transactions, the total value received for that pool was generally different than the sum of the fair values of the individual bonds or preferred shares.

Net Change in Unrealized Appreciation or Depreciation. For the portfolio, net change in unrealized appreciation or depreciation for the years ended December 31, 2005, 2004, and 2003, consisted of the following:

(\$ in millions)	2005 ⁽¹⁾	2004 ⁽¹⁾	2003 ⁽¹⁾
Net unrealized appreciation or depreciation	\$ 502.1	\$ (10.0)	\$ (20.3)
Reversal of previously recorded unrealized appreciation associated with realized gains	(108.0)	(210.5)	(78.5)
Reversal of previously recorded unrealized depreciation associated with realized losses	68.0	151.8	20.3
Net change in unrealized appreciation or depreciation	\$ 462.1	\$ (68.7)	\$ (78.5)

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

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

Advantage Sales & Marketing, Inc. On March 2, 2006, a definitive agreement was signed to sell our majority equity interest in Advantage that indicated an enterprise value of approximately \$1.05 billion. See Portfolio and Investment Activity above. At December 31, 2005, we estimated the enterprise value of Advantage to be \$1.02 billion given that the closing of the transaction is subject to certain closing conditions and the sales price is subject to pre- and post-closing adjustments and certain holdback provisions. Using the enterprise value at December 31, 2005, we determined the value of our investments in Advantage to be \$660.4 million, which resulted in unrealized appreciation on our investment of \$402.7 million at December 31, 2005. This is an increase in unrealized appreciation in the fourth quarter of 2005 of \$224.9 million and an increase of \$378.4 million for the year ended December 31, 2005. Net change in unrealized appreciation or depreciation included a net increase in unrealized appreciation on our investment in Advantage of \$24.3 million for the year ended December 31, 2004. Both Houlihan Lokey and Duff & Phelps assisted us by reviewing our valuation of our investment in Advantage at December 31, 2005. Duff & Phelps also assisted us by reviewing our valuation of our investment in Advantage at December 31, 2004.

Business Loan Express, LLC. To determine the value of our investment in BLX at December 31, 2005, we performed four separate valuation analyses to determine a range of values: (1) analysis of comparable public company trading multiples, (2) analysis of BLX's value assuming an initial public offering, (3) analysis of merger and acquisition transactions for financial services companies, and (4) a discounted dividend analysis. We received valuation assistance from Duff & Phelps for our investment in BLX at December 31, 2005 and 2004.

With respect to the analysis of comparable public company trading multiples and the analysis of BLX's value assuming an initial public offering, we compute a median trailing and forward price earnings multiple to apply to BLX's pro-forma net income adjusted for certain capital structure changes that we believe would likely occur should the company be sold. Each quarter we evaluate which public commercial finance companies should be included in the comparable group. The comparable group at December 31, 2005, was

made up of CIT Group, Inc., Financial Federal Corporation, GATX Corporation, and Marlin Business Services Corporation. The December 31, 2004, comparable group included CapitalSource, Inc., however, it has been excluded from the December 31, 2005, comparable group as it elected REIT status and no longer trades as a commercial finance company. The remaining comparable group for December 31, 2005, is consistent with the comparable group at December 31, 2004.

Our investment in BLX at December 31, 2005, was valued at \$357.1 million. This fair value was within the range of values determined by the four valuation analyses. Unrealized appreciation on our investment was \$57.7 million at December 31, 2005. Net change in unrealized appreciation or depreciation included a net increase in net unrealized appreciation of \$2.9 million for the year ended December 31, 2005, a net decrease in unrealized appreciation of \$32.3 million for the year ended December 31, 2004, and a net increase in unrealized appreciation of \$51.7 million for the year ended December 31, 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 share, which were 137.3 million, 132.5 million, and 118.4 million for the years ended December 31, 2005, 2004, and 2003, respectively.

OTHER MATTERS

Regulated Investment Company Status. We have elected to be taxed as a regulated investment company under Subchapter M of the Code. As long as we qualify as a regulated investment company, we are not taxed on our investment company taxable income or realized net capital gains, to the extent that such taxable income or gains are distributed, or deemed to be distributed, to shareholders on a timely basis.

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

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

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

FINANCIAL CONDITION, LIQUIDITY AND CAPITAL RESOURCES

Our portfolio has historically generated cash flow from which we pay dividends to shareholders and fund new investment activity. Cash generated from the portfolio includes cash flow from net investment income and net realized gains and principal collections related to investment repayments or sales. Cash flow provided by our operating activities before new investment activity for the years ended December 31, 2005, 2004, and 2003, was as follows:

(\$ in millions)	2005	2004	2003
Net cash provided by (used in) operating activities	\$ 116.0	\$ (179.3)	\$ 80.3
Add: portfolio investments funded	1,668.1	1,472.4	930.6
Total cash provided by operating activities before new investments	\$1,784.1	\$1,293.1	\$1,010.9

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

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 securities. We place our cash with financial institutions and, at times, cash held in checking accounts in financial institutions may be in excess of the Federal Deposit Insurance Corporation insured limit.

Dividends to common shareholders for the years ended December 31, 2005, 2004, and 2003, were \$314.5 million, \$299.3 million, and \$267.8 million, respectively. Total regular quarterly dividends were \$2.30, \$2.28, and \$2.28 per common share for the years ended December 31, 2005, 2004, and 2003, respectively. An extra cash dividend of \$0.03 and \$0.02 per common share was declared during 2005 and 2004, respectively, and was paid to shareholders on January 27, 2006, and January 28, 2005, respectively.

Dividends are generally determined based upon an estimate of annual taxable income, which includes our taxable interest, dividend and fee income, as well as taxable net capital gains. As discussed above, taxable income generally differs from net income for financial reporting purposes due to temporary and permanent differences in the recognition of income and expenses, and generally excludes net unrealized appreciation or depreciation, as gains or losses are not included in taxable income until they are realized. Taxable income includes non-cash income, such as changes in accrued and reinvested interest and dividends and the amortization of discounts and fees. Cash collections of income resulting

from contractual payment-in-kind interest or the amortization of discounts and fees generally occur upon the repayment of the loans or debt securities that include such items. Non-cash taxable income is reduced by non-cash expenses, such as realized losses and depreciation and amortization expense.

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

Our estimated annual taxable income for 2005 exceeded our dividend distributions to shareholders for 2005 from such taxable income, and, therefore, we will carry over excess taxable income, which is currently estimated to be \$163.8 million, for distribution to shareholders in 2006. Accordingly, for the year ended December 31, 2005, we have accrued an estimated excise tax of \$6.2 million. However, our taxable income for 2005 is an estimate and will not be finally determined until we file our 2005 tax return in September 2006, and therefore, the amount of excess taxable income carried over from 2005 into 2006 may be different than this estimate. See **Risk Factors** and Note 10, **Dividends and Distributions and Excise Taxes** of our Notes to Consolidated Financial Statements.

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

At December 31, 2005 and 2004, our liquidity portfolio, cash and investments in money market securities, total assets, total debt outstanding, total shareholders' equity, debt to equity ratio and asset coverage for senior indebtedness were as follows:

(\$ in millions)	2005	2004
Liquidity portfolio (including money market securities: 2005-\$100.0; 2004-\$0)	\$ 200.3	\$
Cash and investments in money market securities (including money market securities: 2005-\$22.0; 2004-\$0)	\$ 53.3	\$ 57.2
Total assets	\$4,025.9	\$3,261.0
Total debt outstanding	\$1,284.8	\$1,176.6
Total shareholders' equity	\$2,620.5	\$1,979.8
Debt to equity ratio	0.49	0.59
Asset coverage ratio ⁽¹⁾	309%	280%

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

We currently target a debt to equity ratio ranging between 0.50:1.00 to 0.70:1.00 because we believe that it is prudent to operate with a larger equity capital base and less leverage.

During the fourth quarter of 2005, we established a liquidity portfolio that is composed of money market securities and U.S. Treasury bills. The value and yield of the money market securities were \$100.0 million and 4.1% and were held in money market funds, at December 31, 2005. The value and yield of the Treasury bills were \$100.3 million and 4.3%, respectively, at December 31, 2005. The Treasury bills are due in June 2006. The liquidity portfolio was established to provide a pool of liquid assets within our balance sheet. Our investment portfolio is primarily composed of private, illiquid assets for which there is no readily available market. Our liquidity was reduced when we sold our portfolio of CMBS assets, particularly BB rated bonds, which were generally more liquid than assets in our private finance portfolio. Given the level of taxable income we are carrying over from 2005 for distribution in 2006, we established the liquidity portfolio to ensure that we had ample resources from which to distribute this excess taxable income in 2006. We will assess the amount held in and the composition of the liquidity portfolio throughout the year.

We did not sell new equity in a public offering during the year ended December 31, 2005. For the years ended December 31, 2004 and 2003, we sold equity of \$73.5 million and \$422.9 million, respectively. Shareholders' equity increased by \$77.5 million, \$51.3 million, and \$21.2 million through the exercise of employee options, the collection of notes receivable from the sale of common stock, and the issuance of shares through our dividend reinvestment plan for the years ended December 31, 2005, 2004, and 2003, respectively. On January 31, 2006, we sold 3.0 million shares of our common stock for proceeds of \$83.0 million, net of underwriting discounts and estimated offering expenses. We primarily used the proceeds from the equity offering to repay outstanding borrowings under our revolving line of credit and for general corporate purposes.

We employ an asset-liability management approach that focuses on matching the estimated maturities of our loan and investment portfolio to the estimated maturities of our borrowings. We use our revolving line of credit facility as a means to bridge to long-term financing in the form of debt or equity capital, which may or may not result in temporary differences in the matching of estimated maturities. Availability on the revolving line of credit, net of amounts committed for standby letters of credit issued under the line of credit facility, was \$643.6 million on December 31, 2005. We evaluate our interest rate exposure on an ongoing basis. Generally, we seek to fund our primarily fixed-rate investment portfolio with fixed-rate debt or equity capital. To the extent deemed necessary, we may hedge variable and short-term interest rate exposure through interest rate swaps or other techniques.

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At December 31, 2005 and 2004, we had outstanding debt as follows:

	2005				2004			
	Facility Amount	Amount Outstanding	Annual Interest Cost ⁽¹⁾	Annual Return to Cover Interest Payments ⁽²⁾	Facility Amount	Amount Outstanding	Annual Interest Cost ⁽¹⁾	Annual Return to Cover Interest Payments ⁽²⁾
(\$ in millions)								
Notes payable and debentures:								
Unsecured notes payable	\$ 1,164.5	\$ 1,164.5	6.2%	1.8%	\$ 981.4	\$ 981.4	6.5%	2.0%
SBA debentures	28.5	28.5	7.5%	0.1%	84.8	77.5	8.2%	0.2%
OPIC loan					5.7	5.7	6.6%	
Total notes payable and debentures	1,193.0	1,193.0	6.3%	1.9%	1,071.9	1,064.6	6.6%	2.2%
Revolving line of credit	772.5	91.8	5.6% ⁽³⁾	0.2%	552.5	112.0	4.7% ⁽³⁾	0.2%
Total debt	\$ 1,965.5	\$ 1,284.8	6.5%⁽⁴⁾	2.1%	\$ 1,624.4	\$ 1,176.6	6.6%⁽⁴⁾	2.4%

- (1) The weighted average annual interest cost is computed as the (a) annual stated interest on the debt plus the annual amortization of commitment fees and other facility fees that are recognized into interest expense over the contractual life of the respective borrowings, divided by (b) debt outstanding on the balance sheet date.
- (2) The annual portfolio return to cover interest payments is calculated as the December 31, 2005 and 2004, annualized cost of debt per class of financing outstanding divided by total assets at December 31, 2005 and 2004.
- (3) The annual interest cost reflects the interest rate payable for borrowings under the revolving line of credit. In addition to the current interest rate payable, there were annual costs of commitment fees and other facility fees of \$3.3 million and \$1.8 million at December 31, 2005 and 2004, respectively.
- (4) The annual interest cost for total debt includes the annual cost of commitment fees and other facility fees regardless of the amount outstanding on the facility as of the balance sheet date.

Unsecured Notes Payable. We have issued unsecured long-term notes to institutional investors, primarily insurance companies. The notes have five- or seven-year maturities, with maturity dates beginning in 2006 and generally have fixed rates of interest. The notes generally require payment of interest only semi-annually, and all principal is due upon maturity.

On October 13, 2005, we issued \$261.0 million of five-year and \$89.0 million of seven-year unsecured long-term notes, primarily to insurance companies. The five- and seven-year notes have fixed interest rates of 6.2% and 6.3%, respectively, and have substantially the same terms as our existing unsecured long-term notes. We used a portion of the proceeds from the new long-term note issuance to repay \$125.0 million of our existing unsecured long-term notes that matured on October 15, 2005, and had an annual weighted average interest cost of 8.3%. During the second quarter of 2005, we repaid \$40.0 million of the unsecured notes payable.

Small Business Administration Debentures. Through our small business investment company subsidiary, we have debentures payable to the Small Business Administration with contractual maturities of ten years. The notes require payment of interest only semi-annually, and all principal is due upon maturity. During the years ended December 31, 2005 and 2004, we repaid \$49.0 million and \$17.0 million, respectively, of this outstanding debt. Under the small business investment company program, we may borrow up to \$124.4 million from the Small Business Administration.

Revolving Line of Credit. At December 31, 2005, we had an unsecured revolving line of credit with a committed amount of \$772.5 million. The revolving line of credit, which closed on September 30, 2005, replaced our previous revolving line of credit and expires on September 30, 2008. The revolving line of credit may be expanded through new or additional commitments up to \$922.5 million at our option. The revolving line of credit generally bears interest at a rate equal to (i) LIBOR (for the period we select) plus 1.30%

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or (ii) the higher of the Federal Funds rate plus 0.50% or the Bank of America N.A. prime rate. The revolving line of credit requires the payment of an annual commitment fee equal to 0.20% of the committed amount. The revolving line of credit generally requires payments of interest at the end of each LIBOR interest period, but no less frequently than quarterly, on LIBOR based loans and monthly payments of interest on other loans. All principal is due upon maturity.

At December 31, 2005, there was \$91.8 million outstanding on our unsecured revolving line of credit. The amount available under the line at December 31, 2005, was \$643.6 million, net of amounts committed for standby letters of credit of \$37.1 million. Net borrowings under the revolving lines of credit for the year ended December 31, 2005, were \$20.3 million.

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 December 31, 2005 and 2004, we were in compliance with these covenants.

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

(\$ in millions)	Payments Due By Year						
	Total	2006	2007	2008	2009	2010	After 2010
Notes payable and debentures:							
Unsecured long-term notes payable	\$ 1,164.5	\$ 175.0	\$	\$ 153.0	\$ 267.0	\$ 408.0	\$ 161.5
SBA debentures	28.5						28.5
Revolving line of credit ⁽¹⁾	91.8			91.8			
Operating leases	29.0	4.5	4.4	4.5	4.6	4.4	6.6
Total contractual obligations	\$ 1,313.8	\$ 179.5	\$ 4.4	\$ 249.3	\$ 271.6	\$ 412.4	\$ 196.6

(1) At December 31, 2005, \$643.6 million remained unused and available, net of amounts committed for standby letters of credit of \$37.1 million issued under the credit facility.

Off-Balance Sheet Arrangements

The following table shows our contractual commitments that may have the effect of creating, increasing, or accelerating our liabilities as of December 31, 2005.

(\$ in millions)	Amount of Commitment Expiration Per Year						
	Total	2006	2007	2008	2009	2010	After 2010
Guarantees	\$ 148.6	\$ 1.3	\$ 136.2	\$ 3.1	\$ 2.5	\$	\$ 5.5
Standby letters of credit ⁽¹⁾	37.1	0.1		37.0			
Total commitments	\$ 185.7	\$ 1.4	\$ 136.2	\$ 40.1	\$ 2.5	\$	\$ 5.5

(1) Standby letters of credit are issued under our revolving line of credit that expires in September 2008. Therefore, unless a standby letter of credit is set to expire at an earlier date, we have assumed that the standby letters of credit will expire contemporaneously with the expiration of our line of credit in September 2008.

In addition, we had outstanding commitments to fund investments totaling \$302.8 million at December 31, 2005. We intend to fund these commitments and

prospective investment opportunities with existing cash, through cash flow from operations before new investments, through borrowings under our line of credit or other long-term debt agreements, or through the sale or issuance of new equity capital.

CRITICAL ACCOUNTING POLICIES

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

Valuation of Portfolio Investments. As a business development company, we invest in illiquid securities including debt and equity securities of companies. Our investments may be subject to certain restrictions on resale and generally have no established trading market. We value substantially all of our investments at fair value as determined in good faith by the Board of Directors in accordance with our valuation policy. We determine fair value to be the amount for which an investment could be exchanged in an orderly disposition over a reasonable period of time between willing parties other than in a forced or liquidation sale. Our valuation policy considers the fact that no ready market exists for substantially all of the securities in which we invest. Our valuation policy is intended to provide a consistent basis for determining the fair value of the portfolio. We will record unrealized depreciation on investments when we believe that an investment has become impaired, including where collection of a loan or realization of an equity security is doubtful, or when the enterprise value of the portfolio company does not currently support the cost of our debt or equity investments. Enterprise value means the entire value of the company to a potential buyer, including the sum of the values of debt and equity securities used to capitalize the enterprise at a point in time. We will record unrealized appreciation if we believe that the underlying portfolio company has appreciated in value and/ or our equity security has appreciated in value. The value of investments in publicly traded securities is determined using quoted market prices discounted for restrictions on resale, if any.

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

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

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

Equity Securities. Our equity 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 our 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 we have the option to receive the dividend in cash. Dividend income on common equity securities is recorded on the record date for private companies or on the ex-dividend date for publicly traded companies.

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

Fee Income. Fee income includes fees for guarantees and services rendered by us to portfolio companies and other third parties such as diligence, structuring, transaction services, management 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.

SENIOR SECURITIES

Information about our senior securities is shown in the following tables as of December 31 for the years indicated in the table, unless otherwise noted. The report of our independent registered public accounting firm on the senior securities table as of December 31, 2005, is attached as an exhibit to the registration statement of which this prospectus is a part. The indicates information which the SEC expressly does not require to be disclosed for certain types of senior securities.

Class and Year	Total Amount Outstanding Exclusive of Treasury Securities ⁽¹⁾	Asset Coverage Per Unit ⁽²⁾	Involuntary Liquidating Preference Per Unit ⁽³⁾	Average Market Value Per Unit ⁽⁴⁾
Unsecured Long-term Notes Payable				
1996	\$ 0	\$ 0	\$	N/A
1997	0	0		N/A
1998	180,000,000	2,734		N/A
1999	419,000,000	2,283		N/A
2000	544,000,000	2,445		N/A
2001	694,000,000	2,453		N/A
2002	694,000,000	2,704		N/A
2003	854,000,000	3,219		N/A
2004	981,368,000	2,801		N/A
2005	1,164,540,000	3,086		N/A
Small Business Administration Debentures				
⁽⁵⁾				
1996	\$ 61,300,000	\$2,485	\$	N/A
1997	54,300,000	2,215		N/A
1998	47,650,000	2,734		N/A
1999	62,650,000	2,283		N/A
2000	78,350,000	2,445		N/A
2001	94,500,000	2,453		N/A
2002	94,500,000	2,704		N/A
2003	94,500,000	3,219		N/A
2004	77,500,000	2,801		N/A
2005	28,500,000	3,086		N/A
Overseas Private Investment Corporation Loan				
1996	\$ 8,700,000	\$2,485	\$	N/A
1997	8,700,000	2,215		N/A
1998	5,700,000	2,734		N/A
1999	5,700,000	2,283		N/A
2000	5,700,000	2,445		N/A
2001	5,700,000	2,453		N/A
2002	5,700,000	2,704		N/A
2003	5,700,000	3,219		N/A
2004	5,700,000	2,801		N/A
2005	0	0		N/A

Class and Year	Total Amount Outstanding Exclusive of Treasury Securities ⁽¹⁾	Asset Coverage Per Unit ⁽²⁾	Involuntary Liquidating Preference Per Unit ⁽³⁾	Average Market Value Per Unit ⁽⁴⁾
Revolving Lines of Credit				
1996	\$ 45,099,000	\$2,485	\$	N/A
1997	38,842,000	2,215		N/A
1998	95,000,000	2,734		N/A
1999	82,000,000	2,283		N/A
2000	82,000,000	2,445		N/A
2001	144,750,000	2,453		N/A
2002	204,250,000	2,704		N/A
2003	0	0		N/A
2004	112,000,000	2,801		N/A
2005	91,750,000	3,086		N/A
Auction Rate Reset Note				
1996	\$ 0	\$ 0	\$	N/A
1997	0	0		N/A
1998	0	0		N/A
1999	0	0		N/A
2000	76,598,000	2,445		N/A
2001	81,856,000	2,453		N/A
2002	0	0		N/A
2003	0	0		N/A
2004	0	0		N/A
2005	0	0		N/A
Master Repurchase Agreement and Master Loan and Security Agreement				
1996	\$ 85,775,000	\$2,485	\$	N/A
1997	225,821,000	2,215		N/A
1998	6,000,000	2,734		N/A
1999	23,500,000	2,283		N/A
2000	0	0		N/A
2001	0	0		N/A
2002	0	0		N/A
2003	0	0		N/A
2004	0	0		N/A
2005	0	0		N/A
Senior Note Payable⁽⁶⁾				
1996	\$ 20,000,000	\$2,485	\$	N/A
1997	20,000,000	2,215		N/A
1998	0	0		N/A
1999	0	0		N/A
2000	0	0		N/A
2001	0	0		N/A
2002	0	0		N/A
2003	0	0		N/A
2004	0	0		N/A
2005	0	0		N/A

Class and Year	Total Amount Outstanding Exclusive of Treasury Securities ⁽¹⁾	Asset Coverage Per Unit ⁽²⁾	Involuntary Liquidating Preference Per Unit ⁽³⁾	Average Market Value Per Unit ⁽⁴⁾
Bonds Payable				
1996	\$ 54,123,000	\$ 2,485	\$	N/A
1997	0	0		N/A
1998	0	0		N/A
1999	0	0		N/A
2000	0	0		N/A
2001	0	0		N/A
2002	0	0		N/A
2003	0	0		N/A
2004	0	0		N/A
2005	0	0		N/A
Redeemable Cumulative Preferred Stock⁽⁵⁾⁽⁷⁾				
1996	\$ 1,000,000	\$ 242	\$ 100	N/A
1997	1,000,000	217	100	N/A
1998	1,000,000	267	100	N/A
1999	1,000,000	225	100	N/A
2000	1,000,000	242	100	N/A
2001	1,000,000	244	100	N/A
2002	1,000,000	268	100	N/A
2003	1,000,000	319	100	N/A
2004	0	0		N/A
2005	0	0		N/A
Non-Redeemable Cumulative Preferred Stock⁽⁵⁾				
1996	\$ 6,000,000	\$ 242	\$ 100	N/A
1997	6,000,000	217	100	N/A
1998	6,000,000	267	100	N/A
1999	6,000,000	225	100	N/A
2000	6,000,000	242	100	N/A
2001	6,000,000	244	100	N/A
2002	6,000,000	268	100	N/A
2003	6,000,000	319	100	N/A
2004	0	0		N/A
2005	0	0		N/A

(1) Total amount of each class of senior securities outstanding at the end of the period presented.

(2) The asset coverage ratio for a class of senior securities representing indebtedness is calculated as our consolidated total assets, less all liabilities and indebtedness not represented by senior securities, divided by senior securities representing indebtedness. This asset coverage ratio is multiplied by \$1,000 to determine the Asset Coverage Per Unit. The asset coverage ratio for a class of senior securities that is preferred stock is calculated as our consolidated total assets, less all liabilities and indebtedness not represented by senior securities, divided by senior securities representing indebtedness, plus the involuntary liquidation preference of the preferred stock (see footnote 3). The Asset Coverage Per Unit for preferred stock is expressed in terms of dollar amounts per share.

(3) The amount to which such class of senior security would be entitled upon the involuntary liquidation of the issuer in preference to any security junior to it.

(4) Not applicable, as senior securities are not registered for public trading.

- (5) Issued by our small business investment company subsidiary to the Small Business Administration. These categories of senior securities are not subject to the asset coverage requirements of the 1940 Act. See Certain Government Regulations Small Business Administration Regulations.
- (6) We were the obligor on \$15 million of the senior notes. Our small business investment company subsidiary was the obligor on the remaining \$5 million, which is not subject to the asset coverage requirements of the 1940 Act.
- (7) The Redeemable Cumulative Preferred Stock was reclassified to Other Liabilities on the accompanying financial statements during 2003 in accordance with SFAS No. 150.

BUSINESS

General

We are a business development company, or BDC, and we are in the private equity business. Specifically, we provide long-term debt and equity capital to primarily private middle market companies in a variety of industries. We believe the private equity capital markets are important to the growth of small and middle market companies because such companies often have difficulty accessing the public debt and equity capital markets. We believe that we are well positioned to be a source of capital for such companies. We provide our investors the opportunity to participate in the U.S. private equity industry through an investment in our publicly traded stock.

We have participated in the private equity business since we were founded in 1958. Since then, we have invested more than \$9 billion in thousands of companies nationwide. We primarily invest in the American entrepreneurial economy, helping to build middle market businesses and support American jobs. We generally invest in established companies with adequate cash flow for debt service. We are not venture capitalists, and we generally do not provide seed, or early stage, capital. At December 31, 2005, our private finance portfolio included investments in over 100 companies that generate aggregate annual revenues of over \$10 billion and employ more than 85,000 people.

Our investment objective is to achieve current income and capital gains. In order to achieve this objective, we invest in companies in a variety of industries.

Private Equity Investing

As a private equity investor, we spend significant time and effort identifying, structuring, performing due diligence, monitoring, developing, valuing, and ultimately exiting our investments. We generally target companies in less cyclical industries with, among other things, high returns on invested capital, management teams with meaningful equity ownership, well-constructed balance sheets, and the ability to generate free cash flow. Each investment is subject to an extensive due diligence process. It is not uncommon for a single investment to take from two months to a full year to complete, depending on the complexity of the transaction.

Our investment activity is primarily focused on making long-term investments in the debt and equity of primarily private middle market companies. We have chosen these investments because they can be structured to provide recurring cash flow to us as the investor. In addition to earning interest income, we may earn income from management, consulting, diligence, structuring or other fees. We may also enhance our total return with capital gains realized from equity features, such as nominal cost warrants, or by investing in equity instruments. For the years 1998 through 2005, we have realized \$575.1 million in

cumulative net realized gains from our investment portfolio. Net realized gains for this period as a percentage of total assets are shown in the chart below.

Our investments in the debt and equity of primarily private middle market companies are generally long-term in nature and are privately negotiated, and no readily available market exists for them. This makes our investments highly illiquid and, as a result, we cannot readily trade them. When we make an investment, we enter into a long-term arrangement where our ultimate exit from that investment may be three to ten years in the future.

We believe illiquid investments generally provide better investment returns on average over time than do more liquid investments, such as public equities and public debt instruments, because of the increased liquidity risk in holding such investments. Investors in illiquid investments cannot manage risk through investment trading techniques. In order to manage our risk, we focus on careful investment selection, thorough due diligence, portfolio monitoring and portfolio diversification. Our investment management processes have been designed to incorporate these disciplines. We are led by an experienced management team with our senior officers possessing, on average, 20 years of experience in the private equity industry.

One measure of the performance of a private equity investor is the internal rate of return generated by the investor's portfolio. Since our merger on December 31, 1997, through December 31, 2005, our combined aggregate cash flow Internal Rate of Return (IRR) has been approximately 20% for private finance and CMBS/ CDO investments exited during this period. The IRR is calculated using the aggregate portfolio cash flow for all investments exited over this period. For investments exited during this period, we invested capital totaling \$3.2 billion, earned \$1.6 billion on this invested capital, and therefore, received \$4.8 billion in total investment proceeds from the exits of these investments. The weighted average holding period of these investments was 34 months. Investments are considered to be exited when the original investment objective has been achieved through the receipt of cash and/or non-cash consideration upon the repayment of our debt investment or sale of an equity investment, or through the determination that no further consideration was collectible and, thus, a loss may have been realized. The aggregate cash flow IRR for private finance investments was approximately 18% and for

CMBS/ CDO investments was approximately 24% for the same period. These IRR results represent historical results. Historical results are not necessarily indicative of future results.

We believe our business model is well suited for long-term illiquid investing. Our balance sheet is capitalized with significant equity capital and we use only a modest level of debt capital, which allows us the ability to be patient and to manage through difficult market conditions with less risk of liquidity issues. Under the Investment Company Act of 1940, we are restricted to a debt to equity ratio of approximately one-to-one. Thus, our capital structure, which includes a modest level of long-term leverage, is well suited for long-term illiquid investments.

In general, we compete for investments with a large number of private equity funds and mezzanine funds, other business development companies, hedge funds, investment banks, other equity and non-equity based investment funds, and other sources of financing, including specialty finance companies and traditional financial services companies such as commercial banks. However, we primarily compete with other providers of long-term debt and equity capital to middle market companies, including private equity funds and other business development companies.

Private Finance Portfolio. Our private finance portfolio is primarily composed of debt and equity securities. We generally invest in private companies though, from time to time, we may invest in companies that are public but lack access to additional public capital. These investments are also generally illiquid.

Our capital is generally used to fund:

Buyouts	Recapitalizations
Acquisitions	Note purchases
Growth	Other types of financings

When assessing a prospective private finance investment, we generally look for companies in less cyclical industries in the middle market (i.e., generally \$50 million to \$500 million in revenues) with certain target characteristics, which may or may not be present in the companies in which we invest. Our target investments generally are in companies with the following characteristics:

Management team with meaningful equity ownership

Dominant or defensible market position

High return on invested capital

Stable operating margins

Ability to generate free cash flow

Well-constructed balance sheet

We generally target investments in the following industries as they tend to be less cyclical, cash flow intensive and generate a high return on invested capital:

Business Services	Healthcare Services
Financial Services	Energy Services
Consumer Products	

We intend to take a balanced approach to private equity investing that emphasizes a complementary mix of debt investments and buyout investments. The combination of these two types of investments provides current interest and related portfolio income and the potential for future capital gains. It is our preference to structure our investments with a focus on current recurring interest and other income, which may include management, consulting or other fees. We generally target debt investments of \$10 million to \$100 million and buyout investments of up to \$250 million of invested capital.

Debt investments may include senior loans, unitranche debt (a single debt investment that is a blend of senior and subordinated debt), or subordinated debt (with or without equity features). The junior debt that we invest in that is lower in repayment priority than senior debt is also known as subordinated or mezzanine debt. We may make equity investments for a minority equity stake in portfolio companies in conjunction with our debt investments. We generally target a minimum weighted average portfolio yield of 10% on the debt component of our private finance portfolio. The weighted average yield on our private finance loans and debt securities was 13.0% at December 31, 2005.

Senior loans generally carry a floating rate of interest, usually set as a spread over LIBOR, and generally require payments of both principal and interest throughout the life of the loan. Interest is generally paid to us monthly or quarterly. Senior loans generally have maturities of three to five years. Unitranche debt and subordinated debt generally carry a fixed rate of interest generally with maturities of five to ten years and generally have interest-only payments in the early years and payments of both principal and interest in the later years, although maturities and principal amortization schedules may vary. Interest is generally paid to us quarterly. At December 31, 2005, 87% of our private finance loans and debt securities carried a fixed rate of interest and 13% carried a floating rate of interest.

Through our wholly owned subsidiary, AC Finance LLC, (AC Finance) we may underwrite senior loans related to our portfolio investments or for other companies that are not in our portfolio. When AC Finance underwrites senior loans, we may earn a fee for such loan underwriting activities. Senior loans originated and underwritten by AC Finance may or may not be funded by us at closing. When these senior loans are closed, we may fund all or a portion of the underwritten commitment pending sale of the loan to other investors, which may include loan sales to Callidus Capital Corporation (Callidus) or funds managed by Callidus, a portfolio company controlled by us. After completion of the sale process, we may or may not retain a position in these senior loans. We may also invest in the bonds or preferred shares/income notes of collateralized loan obligations (CLOs) or collateralized debt obligations (CDOs), where the underlying collateral pool consists of senior loans. Certain of the CLOs and CDOs in which we invest may be managed by Callidus Capital Management, a subsidiary of Callidus.

In a buyout transaction, we generally invest in senior debt, subordinated debt and equity (preferred and/or voting or non-voting common) where our equity ownership represents a significant portion of the equity, but may or may not represent a controlling interest. If we invest in non-voting equity in a buyout investment, we generally have an option to acquire a controlling stake in the voting securities of the portfolio company at fair market value. We generally structure our buyout investments such that we seek to earn a blended current return on our total capital invested of approximately 10% through a combination of interest income on our senior loans and subordinated debt, dividends on our preferred and common equity, and management, consulting, or transaction services fees to compensate us for the managerial assistance that we may provide to the portfolio company.

We believe that the transaction fees charged for the services we provide to portfolio companies are generally comparable with transaction fees charged by others in the private equity industry for performing similar services. As a result of our significant equity investment in a buyout investment there is potential to realize larger capital gains through buyout investing as compared to debt or mezzanine investing.

The structure of each debt and equity security is specifically negotiated to enable us to protect our investment, with a focus on preservation of capital, 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 senior loans and unintranche debt are generally secured, however in a liquidation scenario, the collateral may not be sufficient to support our outstanding investment. Our junior or mezzanine loans are generally unsecured. Our investments may be subject to certain restrictions on resale and generally have no established trading market.

At December 31, 2005, 60.2% of the private finance portfolio at value consisted of loans and debt securities and 39.8% consisted of equity securities (equity securities included 26.4% in investment cost basis and 13.4% in net unrealized appreciation). At December 31, 2005, 54.2% of the private finance investments at value were in companies more than 25% owned, 4.6% were in companies 5% to 25% owned, and 41.2% were in companies less than 5% owned.

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Our ten largest investments at value at December 31, 2005, were as follows:

(\$ in millions)		At December 31, 2005		
		Cost	Value	Percentage of Total Assets
Portfolio Company	Company Information			
Advantage Sales & Marketing, Inc. ⁽¹⁾⁽²⁾	Sales and marketing agency providing outsourced sales, merchandising, and marketing services to the consumer packaged goods industry.	\$257.7	\$660.4	16.4%
Business Loan Express, LLC ⁽¹⁾	Originates, sells, and services primarily real estate secured small business loans specifically for businesses with financing needs of up to \$4.0 million. Provides SBA 7(a) loans, conventional small business loans and small investment real estate loans. Nationwide non-bank preferred lender in the SBA's 7(a) guaranteed loan program.	\$299.4	\$357.1	8.9%
Mercury Air Centers, Inc.	Owns and operates fixed base operations under long-term leases from local airport authorities, which generally consist of terminal and hangar complexes that service the needs of the general aviation community.	\$113.3	\$167.1	4.2%
Financial Pacific Company	Specialized commercial finance company that leases business-essential equipment to small businesses nationwide.	\$95.0	\$127.2	3.2%
Meineke Car Care Centers, Inc.	Business format franchisor in the car care sector of the automotive aftermarket industry with approximately 900 locations worldwide.	\$126.5	\$126.2	3.1%
Norwesco, Inc.	Designs, manufactures and markets a broad assortment of polyethylene tanks primarily to the agricultural and septic tank markets.	\$120.0	\$120.0	3.0%
Triview Investments, Inc.	Holds investments in Triax Holdings, LLC, a developer and marketer of specialty pharmaceutical products with a focus on dermatology, and Longview Cable & Data LLC, a multi-system cable operator.	\$151.7	\$87.0	2.2%

(\$ in millions)		At December 31, 2005		
		Cost	Value	Percentage of Total Assets
Portfolio Company	Company Information			
Insight Pharmaceuticals Corporation	Over-the-counter pharmaceutical company with a broad portfolio of 20 brands, including Sucrets, Anacin, NIX and Bonine.	\$89.6	\$85.3	2.1%
STS Operating, Inc.	Distributes systems, components and engineering services for hydraulic, pneumatic, electronic and filtration systems.	\$10.1	\$72.1	1.8%
Healthy Pet Corp.	Veterinary hospitals offering medical and surgical services, specialized treatments, diagnostic services, pharmaceutical products, as well as routine health exams and vaccinations.	\$68.4	\$68.4	1.7%

(1) See Management's Discussion and Analysis of Financial Condition and Results of Operations.

(2) In March 2006, we sold our majority interest in Advantage. See Management's Discussion and Analysis of Financial Condition and Results of Operations for further detail.

We monitor the portfolio to maintain diversity within the industries in which we invest. Our portfolio is not concentrated and we currently do not have a policy with respect to concentrating (i.e., investing 25% or more of our total assets) in any particular industry. We may or may not concentrate in any industry or group of industries in the future. The industry composition of the private finance portfolio at value at December 31, 2005 and 2004, was as follows:

	2005	2004
Industry		
Business services	45%	32%
Financial services	15	21
Consumer products	14	20
Industrial products	10	8
Retail	3	2
Healthcare services	2	8
Energy services	2	2
Broadcasting and cable	1	2
Other ⁽¹⁾	8	5
Total	100%	100%

(1) Includes investments in senior debt CDO and CLO funds. These funds invest in senior debt representing a variety of industries.

Commercial Real Estate Finance Portfolio. Since 1998, our commercial real estate investments have generally been in the non-investment grade tranches of commercial mortgage-backed securities, also known as CMBS, and in the bonds and preferred shares of collateralized debt obligations, also known as CDOs. With regard to CMBS, non-investment grade means that nationally recognized statistical rating organizations rate these securities below the top four investment-grade rating categories (i.e., AAA

through BBB), and are sometimes referred to as junk bonds. On May 3, 2005, we completed the sale of our portfolio of CMBS and CDO investments to affiliates of Caisse de dépôt et placement du Québec (the Caisse). See Management's Discussion and Analysis of Financial Condition and Results of Operations. After the completion of this sale, our commercial real estate finance portfolio consists of commercial mortgage loans, real estate owned and equity interests, which totaled \$127.1 million at value on December 31, 2005.

Simultaneous with the sale of our CMBS and CDO portfolio, we entered into a platform assets purchase agreement with CWC Capital Investments LLC, an affiliate of the Caisse (CWC Capital), pursuant to which we sold certain commercial real estate related assets, including servicer advances, intellectual property, software and other platform assets, subject to certain adjustments. Under this agreement, we have agreed not to invest in CMBS and real estate related CDOs and refrain from certain other real estate related investing or servicing activities for a period of three years, subject to certain limitations and excluding our existing portfolio and related activities.

Business Processes

Business Development and New Deal Origination. Over the years, we believe we have developed and maintained a strong industry reputation and an extensive network of relationships with numerous private equity investors, investment banks, business brokers, merger and acquisition advisors, financial services companies, banks, law firms and accountants through whom we source investment opportunities. Through these relationships, we believe we have been able to strengthen our position as a private equity investor. We are well known in the private equity industry, and we believe that our experience and reputation provide a competitive advantage in originating new investments.

From time to time, we may receive referrals for new prospective investments from our portfolio companies as well as other participants in the capital markets. We generally pay referral fees to those who refer transactions to us that we consummate.

New Deal Underwriting and Investment Execution. In a typical transaction, we review, analyze, and substantiate through due diligence, the business plan and operations of the potential portfolio company. We perform financial due diligence, perform operational due diligence, study the industry and competitive landscape, and conduct reference checks with company management or other employees, customers, suppliers, and competitors, as necessary. We may work with external consultants, including accounting firms and industry or operational consultants, in performing due diligence and in monitoring our portfolio investments.

Once we have determined that a prospective portfolio company is suitable for investment, we work with the management and the other capital providers, including senior, junior, and equity capital providers, to structure a deal. We negotiate among these parties to agree on the rights and terms of our investment relative to the other capital in the portfolio company's capital structure. The typical debt transaction requires approximately two to six months of diligence and structuring before funding occurs. The typical buyout transaction may take up to one year to complete because the due diligence and structuring process is significantly longer when investing in a substantial equity stake in the company.

Our investments are tailored to the facts and circumstances of each deal. The specific structure is designed to protect our rights and manage our risk in the transaction. We generally structure the debt instrument to require restrictive affirmative and negative covenants, default penalties, lien protection, or other protective provisions. In addition, each debt investment is individually priced to achieve a return that reflects our rights and priorities in the portfolio company's capital structure, the structure of the debt instrument, and our perceived risk of the investment. Our loans and debt securities have an annual stated interest rate; however, that interest rate is only one factor in pricing the investment. The annual 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 or upon prepayment. In addition to the interest earned on loans and debt securities, our debt investments may include equity features, such as warrants or options to buy a minority interest in the portfolio company. The warrants we receive with our debt securities generally require only a nominal cost to exercise, and thus, if the portfolio company appreciates in value, we achieve additional investment return from this equity interest. We may structure the warrants to provide minority rights provisions and event-driven puts. In many cases, we will also obtain registration rights in connection with these equity interests, which may include demand and piggyback registration rights.

We have a centralized, credit-based approval process. The key steps in our investment process are:

Initial investment screening;

Initial investment committee approval;

Due diligence, structuring and negotiation;

Internal review of diligence results;

Final investment committee approval;

Approval by the Executive Committee of the Board of Directors (for all debt investments that represent a commitment equal to or greater than \$20 million and every buyout transaction); and

Funding of the investment (due diligence must be completed with final investment committee approval and Executive Committee approval, as needed, before funds are disbursed).

The investment process benefits from the significant professional experience of the members of our investment committee, which is chaired by our Chief Executive Officer and includes our Chief Operating Officer, our Chief Financial Officer, and certain of our Managing Directors.

Portfolio Monitoring and Development. Middle market companies often lack the management expertise and experience found in larger companies. As a BDC, we are required by the 1940 Act to make available significant managerial assistance to our portfolio companies. Our senior level professionals work with portfolio company management teams to assist them in building their businesses. Managerial assistance includes, but is not limited to, management and consulting services related to corporate finance, marketing, human resources, personnel and board member recruiting, business operations, corporate governance, risk management and other general business matters. Our corporate finance assistance includes supporting our portfolio companies' efforts to structure and

attract additional capital. We believe our extensive network of industry relationships and our internal resources help make us a collaborative partner in the development of our portfolio companies.

Our team of investment professionals regularly monitors the status and performance of each investment. This portfolio company monitoring process generally includes review of the portfolio company's financial performance against its business plan, review of current financial statements and compliance with financial covenants, evaluation of significant current developments and assessment of future exit strategies. For debt investments we may have board observation rights that allow us to attend portfolio company board meetings. For buyout investments, we generally hold a majority of the seats on the board of directors where we own a controlling interest in the portfolio company and we have board observation rights where we do not own a controlling interest in the portfolio company.

Our portfolio management committee oversees the overall performance of the portfolio, including reviewing the performance of selected portfolio companies, overseeing portfolio companies in workout status, reviewing and approving certain amendments or modifications to existing investments, reviewing and approving certain portfolio exits, and reviewing and approving certain actions by portfolio companies whose voting securities are more than 50% owned by us. Our portfolio management committee is chaired by our Chief Executive Officer and includes our Chief Operating Officer, Chief Financial Officer, Chief Valuation Officer (non-voting member), and three Managing Directors. From time to time we will identify investments that require closer monitoring or become workout assets. We develop a workout strategy for workout assets and the portfolio management committee gauges our progress against the strategy.

We seek to price our investments to provide an investment return considering the fact that certain investments in the portfolio may underperform or result in loss of investment return or investment principal. As a private equity investor, we will incur losses from our investing activities, however we have a history of working with troubled portfolio companies in order to recover as much of our investments as is practicable.

Portfolio Grading

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.

Portfolio Valuation

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

portfolio investments at fair value as determined in good faith by the Board of Directors pursuant to a valuation policy and a consistently applied valuation process. Because of the inherent uncertainty of determining the fair value of investments that do not have a readily available market value, the fair value of our investments determined in good faith by the Board of Directors may differ significantly from the values that would have been used had a ready market existed for the investments, and the differences could be material.

There is no single standard for determining fair value in good faith. As a result, determining fair value requires that judgment be applied to the specific facts and circumstances of each portfolio investment while employing a consistently applied valuation process for the types of investments we make. Unlike banks, we are not permitted to provide a general reserve for anticipated loan losses. Instead, we are required to specifically value each individual investment on a quarterly basis. We will record unrealized depreciation on investments when we believe that an investment has become impaired, including where collection of a loan or realization of an equity security is doubtful, or when the enterprise value of the portfolio company does not currently support the cost of our debt or equity investment. Enterprise value means the entire value of the company to a potential buyer, including the sum of the values of debt and equity securities used to capitalize the enterprise at a point in time. We will record unrealized appreciation if we believe that the underlying portfolio company has appreciated in value and/or our equity security has 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. The structure of each 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 may be subject to certain 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. Our process for determining the fair value of a private finance investment begins with determining the enterprise value of the portfolio company. The fair value of our investment is based on the enterprise value at which the portfolio company could be sold in an orderly disposition over a reasonable period of time between willing parties other than in a forced or liquidation sale. The liquidity event whereby we exit a private finance investment is generally the sale, the recapitalization or, in some cases, the initial public offering of the portfolio company.

There is no one methodology to determine enterprise value and, in fact, for any one portfolio company, enterprise value is best expressed as a range of fair values, from which we derive a single estimate of enterprise value. To determine the enterprise value of a portfolio company, we analyze its historical and projected financial results. We generally require portfolio companies to provide annual audited and quarterly unaudited financial statements, as well as annual projections for the upcoming fiscal year. Typically in the private equity business, companies are bought and sold based on multiples of EBITDA, cash flow, net income, revenues or, in limited instances, book value. The private equity industry uses financial measures such as EBITDA or EBITDAM (Earnings Before

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

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

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

As a participant in the private equity business, we invest primarily in private middle market companies for which there is generally no publicly available information. Because of the private nature of these businesses, there is a need to maintain the confidentiality of the financial and other information that we have for the private companies in our portfolio. We believe that maintaining this confidence is important, as disclosure of such information could disadvantage our portfolio companies and could put us at a disadvantage in attracting new investments. Therefore, we do not intend to disclose financial or other information about our portfolio companies, unless required, because we believe doing so may put them at an economic or competitive disadvantage, regardless of our level of ownership or control. To balance the lack of publicly available information about our private portfolio companies, we will continue to work with third-party consultants to obtain assistance in determining fair value for a portion of the private finance portfolio each quarter as discussed below.

Valuation Process. The portfolio valuation process is managed by our Chief Valuation Officer (CVO). The CVO works with the investment professionals responsible for each investment. The following is a description of the steps we take each quarter to determine the value of our portfolio.

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

The CVO reviews the preliminary valuation as determined by the deal team.

The CVO, members of the valuation team, and third-party consultants, as applicable (see below), meet with each Managing Director or responsible senior officer to discuss the preliminary valuation determined and documented by the deal team for each of their respective investments.

The CEO, COO, CFO and the managing directors meet with the CVO to discuss the preliminary valuation results.

Valuation documentation is distributed to the members of the Board of Directors.

The Audit Committee of the Board of Directors meets with the third-party consultants (see below) to discuss the assistance provided and results.

The Board of Directors and the CVO meet to discuss and review valuations.

To the extent there are changes or if additional information is deemed necessary, a follow-up Board meeting may take place.

The Board of Directors determines the fair value of the portfolio in good faith.

In connection with our valuation process to determine the fair value of a private finance investment, we work with third-party consultants to obtain assistance and advice as additional support in the preparation of our internal valuation analysis for a portion of the portfolio each quarter. In addition, we may receive other third-party assessments of a particular private finance portfolio company's value in the ordinary course of business, most often in the context of a prospective sale transaction or in the context of a bankruptcy process. The valuation analysis prepared by management using these third-party valuation resources, when applicable, is submitted to our Board of Directors for its determination of fair value of the portfolio in good faith.

During 2005, we received third-party valuation assistance from Duff & Phelps, LLC (Duff & Phelps) and Houlihan Lokey Howard and Zukin (Houlihan Lokey). We currently intend to continue to obtain valuation assistance from third parties. We currently anticipate that we will generally obtain valuation assistance for all companies in the portfolio where we own more than 50% of the outstanding voting equity securities on a quarterly basis and that we will generally obtain assistance for companies where we own equal to or less than 50% of the outstanding voting equity securities at least once during the course of the calendar year. Valuation assistance may or may not be obtained for new companies that enter the portfolio after June 30 of any calendar year during that year or for investments with a cost and value less than \$250,000. For the quarter ended December 31, 2005, Duff & Phelps and Houlihan Lokey assisted us by reviewing our valuation of 80 portfolio companies, which represented 92.4% of the private finance portfolio at value. See Management's Discussion and Analysis of Financial Condition and Results of Operations.

Disposition of Investments

We manage our portfolio of investments in an effort to maximize our expected returns. Our portfolio is large and we frequently are repaid by our borrowers and exit our debt and equity investments as portfolio companies are sold, recapitalized or complete an initial public offering. In our debt investments where we have equity features, we frequently are in a minority ownership position in a portfolio company, and as a result, generally exit the investment when the majority equity stakeholder decides to sell or recapitalize the company. Where we have a control position in an investment, as we may have in buyout investments, we have more flexibility and can determine whether or not we should exit our investment. Our most common exit strategy for a buyout investment is the sale of a portfolio company to a strategic or financial buyer. If an investment has appreciated in value, we may realize a gain when we exit the investment. If an investment has depreciated in value, we may realize a loss when we exit the investment.

We are in the investment business, which includes acquiring and exiting investments. It is our policy not to comment on potential transactions in the portfolio prior to reaching a definitive agreement or, in many cases, prior to consummating a transaction. To the extent we enter into any material transactions, we would provide disclosure as required.

Dividends

We have elected to be taxed as a regulated investment company under Subchapter M of the Code. As such, we are not subject to corporate-level income taxation on income we timely distribute to our stockholders as dividends. We determine our regular quarterly dividends based upon an estimate of annual taxable income, which includes our taxable interest, dividend, and fee income, as well as taxable net capital gains. Taxable income generally differs from net income for financial reporting purposes due to temporary and permanent differences in the recognition of income and expenses and generally excludes net unrealized appreciation or depreciation, as gains or losses are not included in taxable income until they are realized. Taxable income includes non-cash income, such as changes in accrued and reinvested interest and dividends, which includes contractual payment-in-kind interest, and the amortization of discounts and fees. Cash collections of income resulting from contractual payment-in-kind interest or the amortization of discounts and fees generally occur upon the repayment of the loans or debt securities that include such items. Non-cash taxable income is reduced by non-cash expenses, such as realized losses and depreciation and amortization expense.

As a regulated investment company, we distribute substantially all of our annual taxable income to shareholders through the payment of cash dividends. Our Board of Directors reviews the dividend rate quarterly, and may adjust the quarterly dividend throughout the year. Dividends are declared considering our estimate of annual taxable income available for distribution to shareholders. Our goal is to declare what we believe to be sustainable increases in our regular quarterly dividends. To the extent that we earn annual taxable income in excess of dividends paid for the year, we may carry over the excess taxable income into the next year and such excess income will be available for distribution in the next year as permitted under the Code. The amount of excess taxable income that may be carried over for distribution in the next year under the Code is approximately three quarters of dividend payments. Excess taxable income carried over and paid out in the next year may be subject to a 4% excise tax (see Other Matters Regulated Investment Company Status). We believe that carrying over excess taxable

income into future periods may provide increased visibility with respect to taxable earnings available to pay the regular quarterly dividend.

We began paying quarterly dividends in 1963, and our portfolio has provided sufficient ordinary taxable income and realized net capital gains to sustain or grow our dividends over time. Since inception, our average annual total return to shareholders (assuming all dividends were reinvested) was 18.0%. Over the past one, three, five and ten years, our total return to shareholders (assuming all dividends were reinvested) has been 23.5%, 20.6%, 17.1% and 19.8%, respectively, with the dividend providing a meaningful portion of this return.

The percentage of our dividend generated by ordinary taxable income versus capital gain income will vary from year to year. The percentage of ordinary taxable income versus net capital gain income supporting the dividend since 1986 is shown below.

Corporate Structure and Offices

We are a Maryland corporation and a closed-end, non-diversified management investment company that has elected to be regulated as a business development company under the 1940 Act. Our predecessor corporation was incorporated under the laws of the District of Columbia in 1958 and we reorganized as a Maryland corporation in 1993. We have a wholly owned subsidiary, Allied Investments L.P. (Allied Investments), that is licensed under the Small Business Investment Act of 1958 as a Small Business Investment Company. We own all of the partnership interests in Allied Investments. The assets held by Allied Investments represented 2.6% of our total assets at December 31, 2005. See [Certain Government Regulations](#) below for further information about small business investment company regulation.

In addition, we have a real estate investment trust subsidiary, Allied Capital REIT, Inc., and several subsidiaries that are single-member limited liability companies established for specific purposes, including holding real estate property. We also have a subsidiary, A.C. Corporation, that generally provides diligence and structuring services on our transactions, as well as structuring, transaction, management, and other services to Allied Capital and our portfolio companies. A.C. Corporation has a wholly owned subsidiary, AC

Finance LLC, that generally underwrites and arranges senior loans for our portfolio companies and other third parties.

Our executive offices are located at 1919 Pennsylvania Avenue, 3rd Floor, NW, Washington, DC 20006-3434 and our telephone number is (202) 721-6100. In addition, we have regional offices in Chicago, Los Angeles, and New York.

Employees

At December 31, 2005, we employed 131 individuals including investment and portfolio management professionals, operations professionals and administrative staff. The majority of our employees are located in our Washington, DC office. We believe that our relations with our employees are excellent.

Legal Proceedings

On June 23, 2004, we were notified by the SEC that they are conducting an informal investigation of us. On December 22, 2004, we received letters from the U.S. Attorney for the District of Columbia requesting the preservation and production of information regarding us and Business Loan Express, LLC in connection with a criminal investigation. Based on the information available to us at this time, the inquiries appear to primarily pertain to matters related to portfolio valuation and our portfolio company, Business Loan Express, LLC. To date, we have produced materials in response to requests from both the SEC and the U.S. Attorney's office, and certain current and former employees have provided testimony and have been interviewed by the staff of the SEC and the U.S. Attorney's Office. We are voluntarily cooperating with these investigations.

On May 28, 2004, Ferolie Corporation, a food broker with business and contractual relationships with an entity that is now affiliated with one of our portfolio companies, Advantage Sales & Marketing Inc., filed suit against us, Advantage Sales & Marketing and the affiliated entity in the United States District Court for the District of Columbia alleging that, among other things, we and Advantage Sales & Marketing had tortiously interfered with Ferolie's contract with the affiliated entity by causing the affiliated entity (i) to breach its obligations to Ferolie regarding Ferolie's participation in a reorganization transaction involving the affiliated entity and (ii) to induce clients of Ferolie to transfer their business to the affiliated entity. Ferolie sought actual and punitive damages against us and Advantage Sales & Marketing and declaratory and injunctive relief. On July 15, 2004, the United States District Court for the District of Columbia dismissed the lawsuit for lack of jurisdiction. On August 18, 2004, Ferolie filed a Petition to Compel Arbitration in the United States District Court for the Northern District of Illinois naming us, Advantage Sales & Marketing and the affiliated entity as respondents. Ferolie attached to its petition an Amended Demand for Arbitration and Statement of Claims that asserts essentially the same claims as were asserted in the lawsuit that was dismissed by the United States District Court for the District of Columbia. On October 29, 2004, the United States District Court for the Northern District of Illinois dismissed Ferolie's petition after finding that Ferolie had failed to adequately allege the existence of subject matter jurisdiction.

On November 4, 2004, Ferolie refiled its Petition to Compel Arbitration in the Circuit Court of Cook County, Illinois. The allegations and relief requested in this proceeding were identical to the assertions made by Ferolie in the two previously dismissed proceedings. On February 15, 2005, the Circuit Court of Cook County, Illinois entered an

order denying Ferolie's motion for an order compelling us to arbitrate the claims asserted by Ferolie against us. In the same order, the Circuit Court of Cook County, Illinois granted Ferolie's motion to compel arbitration of the claims asserted against Advantage Sales & Marketing and the affiliated entity. The arbitration is proceeding. We are not a party to the arbitration.

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

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

PORTFOLIO COMPANIES

The following is a listing of each portfolio company or its affiliate, together referred to as portfolio companies, in which we had an equity investment at December 31, 2005. Percentages shown for class of securities held by us represent percentage of the class owned and do not necessarily represent voting ownership or economic ownership. Percentages shown for equity securities other than warrants or options represent the actual percentage of the class of security held before dilution. Percentages shown for warrants and options held represent the percentage of class of security we may own assuming we exercise our warrants or options before dilution.

The portfolio companies are presented in three categories: companies more than 25% owned which represent portfolio companies where we directly or indirectly own more than 25% of the outstanding voting securities of such portfolio company and, therefore, are deemed controlled by us under the 1940 Act; companies owned 5% to 25% which represent portfolio companies where we directly or indirectly own 5% to 25% of the outstanding voting securities of such portfolio company or where we hold one or more seats on the portfolio company's board of directors and, therefore, are deemed to be an affiliated person under the 1940 Act; and companies less than 5% owned which represent portfolio companies where we directly or indirectly own less than 5% of the outstanding voting securities of such portfolio company and where we have no other affiliations with such portfolio company. We make available significant managerial assistance to our portfolio companies. We generally receive rights to observe the meetings of our portfolio companies' board of directors, and may have one or more voting seats on their boards.

For information relating to the amount and nature of our investments in portfolio companies, see our consolidated statement of investments at December 31, 2005, at pages F-7 to F-16.

Name and Address of Portfolio Company	Nature of its Principal Business	Title of Securities Held by the Company	Percentage of Class Held
PRIVATE FINANCE			
Companies More Than 25% Owned			
Acme Paging, L.P. ⁽¹⁾ 6080 SW 40th Street, Suite 3 Miami, FL 33155	Paging Services	Common Stock in Affiliate	80.0%
Advantage Sales & Marketing, Inc. ⁽¹⁾⁽⁶⁾ 19100 Von Karman Avenue Suite 600 Irvine, CA 92612	Sales and Marketing Agency	Class A Common Stock	100.0%
Alaris Consulting, LLC ⁽¹⁾⁽²⁾ 360 W. Butterfield Road Suite 400 Elmhurst, IL 60126	Consulting Firm	Equity Interests	100.0%
Avborne, Inc. ⁽¹⁾⁽⁷⁾ c/o Trivest, Inc. 7500 NW 26th Street Miami, FL 33122	Aviation Services	Series B Preferred Stock Common Stock	23.8% 27.2%
Avborne Heavy Maintenance, Inc. ⁽¹⁾⁽⁷⁾ c/o Trivest, Inc. 7500 26th Street N.W. Miami, FL 33122	Aviation Services	Series A Preferred Stock Common Stock	27.5% 27.5%
Business Loan Express, LLC ⁽¹⁾ 1633 Broadway New York, NY 10019	Small Business Lender	Class A Equity Interests Class B Equity Interests Class C Equity Interests Equity Interest in BLX Subsidiary ⁽³⁾	100.0% 100.0% 94.9% 20.0%
Callidus Capital Corporation ⁽¹⁾⁽⁴⁾ 520 Madison Avenue New York, NY 10022	Asset Manager and Finance Company	Common stock	100.0%

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Name and Address of Portfolio Company	Nature of its Principal Business	Title of Securities Held by the Company	Percentage of Class Held
Diversified Group Administrators, Inc. 201 Johnson Rd Building #1 Houston, PA 15342	Third Party Administrator for Self-funded Health Benefit Plan	Series B Preferred Stock Series A Preferred Stock Common Stock	64.7% 69.9% 45.8%
Financial Pacific Company ⁽¹⁾ 3455 South 344th Way, Suite 300 Federal Way, WA 98001	Commercial Finance Leasing	Series A Preferred Stock Common Stock	99.4% 99.4%
ForeSite Towers, LLC ⁽¹⁾ 22 Iverness Center Parkway Suite 50 Birmingham, AL 35242	Tower Leasing	Series A Preferred Equity Interest Series B Preferred Equity Interest Series E Preferred Equity Interest Common Equity Interest	100.0% 100.0% 100.0% 77.3%
Global Communications, LLC ⁽¹⁾ 1000 North Dixie Highway West Palm Beach, FL 33401	Muzak Franchisee	Preferred Equity Interest Options for Common Equity Interest	77.8% 59.3%
Gordian Group, Inc. ⁽¹⁾ 499 Park Avenue New York, NY 10022	Financial Advisory Services	Common Stock	100.0%
Healthy Pet Corp. ⁽¹⁾ 1720 Post Road Fairfield, CT 06430	Comprehensive Veterinary Services	Common Stock	99.0%
HMT, Inc. 4422 FM 1960 West Suite 350 Houston, TX 77068	Storage Tank Maintenance & Repair	Class B Preferred Stock Common Stock Warrants to Purchase Common Stock	33.5% 25.0% 9.7%
Impact Innovations Group, LLC 12 Piedmont Center, Suite 210 Atlanta, GA 30305	Information Technology Services Provider	Equity Interest in Affiliate ⁽⁵⁾	50.0%
Insight Pharmaceuticals Corporation ⁽¹⁾ 550 Township Line Road, Suite 300 Blue Bell, PA 19422	Marketer of Over-The- Counter Pharmaceuticals	Preferred Stock Common Stock	100.0% 100.0%
Jakel, Inc. ⁽¹⁾ 400 Broadway Highlands, IL 62249	Manufacturer of Electric Motors and Blowers	Series A-1 Preferred Stock Class B Common Stock	32.3% 100.0%
Legacy Partners Group, LLC ⁽¹⁾ 520 Madison Avenue, 27th Floor New York, NY 10022	Merger and Acquisition Advisor	Equity Interests	100.0%
Litterer Beteiligungs-GmbH Uhlandstrasse 1 69493 Hirschberg Germany	Scaffolding Company	Equity Interest	25.0%
Mercury Air Centers, Inc. ⁽¹⁾ 1951 Airport Road Atlanta, GA 30341	Fixed Base Operations	Series A Common Stock Common Stock	100.0% 95.0%
MVL Group, Inc. ⁽¹⁾ 1061 E. Indiantown Road Suite 300 Jupiter, FL 33477	Market Research Services	Common Stock	64.9%
Pennsylvania Avenue Investors, L.P. ⁽¹⁾ 1919 Pennsylvania Ave., N.W. Washington, DC 20006	Private Equity Fund	Equity Interests	100.0%

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Powell Plant Farms, Inc. ⁽¹⁾ Route 3, Box 1058 Troup, TX 75789	Plant Producer & Wholesaler	Preferred Stock Warrants to Purchase Common Stock	100.0% 83.5%
Redox Brands, Inc. ⁽¹⁾ 9100 Centre Point Drive Suite 200 West Chester, OH 45069	Household Cleaning Products	Series A Convertible Preferred Stock Warrants to Purchase Class A Common Stock	99.2% 8.7%

Name and Address of Portfolio Company	Nature of its Principal Business	Title of Securities Held by the Company	Percentage of Class Held
Service Champ, Inc. ⁽¹⁾ 180 New Britain Boulevard Chalfont, PA 18914	Wholesale Distributor of Auto Parts	Common Stock	63.9%
Staffing Partners Holding Company, Inc. ⁽¹⁾ 104 Church Lane, #100 Baltimore, MD 21208	Temporary Employee Services	Series B Preferred Stock Redeemable Preferred Stock Class A-1 Common Stock Class A-2 Common Stock Class B Common Stock Warrants to purchase Class B Common Stock	71.4% 48.3% 50.0% 24.4% 48.8% 30.3%
Startec Global Communications Corporation ⁽¹⁾ 7631 Calhoun Drive Rockville, MD 20850	Telecommunications Services	Common Stock	68.5%
STS Operating, Inc. (d/b/a SunSource Technology Services, Inc.) ⁽¹⁾ 2301 Windsor Court Addison, IL 60101	Industrial Distribution	Common Stock Options to Purchase Common Stock	77.1% 1.0%
Triview Investments, Inc. ⁽¹⁾⁽¹¹⁾ 1919 Pennsylvania Ave, N.W. Washington, DC 20006	Multi-system Cable Operator and Pharmaceutical Marketer	Common Stock	99.5%
Companies 5% to 25% Owned			
Air Evac Lifeteam 1448 W. Eighth Street West Plains, MO 65775	Air Ambulance Service	Series A Preferred Equity Interest Series B Preferred Equity Interest	6.6% 6.2%
Aspen Pet Products, Inc. 4735 North Florence Street Denver, CO 80238	Pet Product Provider	Series B Preferred Stock Series D Preferred Stock Series A Common Stock Warrants to purchase Series A Common Stock	8.7% 6.5% 6.5% 4.1%
Becker Underwood, Inc. 801 Dayton Avenue Ames, IA 50010	Speciality Chemical Manufacturer	Common Stock	6.1%
The Debt Exchange Inc. ⁽¹⁾ 101 Arch Street, Suite 410 Boston, MA 02110	Online Sales of Financial Assets	Series B Convertible Preferred Stock	40.0%
MedBridge Healthcare, LLC ⁽¹⁾ 110 West North Street, Suite 100 Greenville, SC 29601	Sleep Diagnostic Facilities	Debt Convertible into Equity Interests	75.0%
Nexcel Synthetics, LLC 6076 Southern Industrial Drive Birmingham, AL 35235	Manufacturer of Carpet Backing	Class A Equity Interest Class B Equity Interest	6.8% 6.8%
Pres Air Trol LLC 1009 W. Boston Post Road Mamaroneck, NY 10543	Pressure Switch Manufacturer	Class A Equity Interests	32.8%
Progressive International Corporation 6111 S. 228th Street Kent, WA 98064	Retail Kitchenware	Series A Redeemable Preferred Stock Class A Common Stock Warrants to Purchase Class A Common Stock	12.5% 1.0% 42.0%
Soteria Imaging Services, LLC	Diagnostic Imaging	Class A Preferred Equity	

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6009 Brownsboro Park Blvd., Suite H Louisville, KY 40207	Facilities Operator	Interest	10.8%
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Name and Address of Portfolio Company	Nature of its Principal Business	Title of Securities Held by the Company	Percentage of Class Held
Universal Environmental Services, LLC 411 Dividend Drive Peachtree City, GA 30269	Used Oil Recycling	Preferred Equity Interests	15.0%
Companies Less Than 5% Owned			
Advanced Circuits, Inc. 30 South Wacker Drive, Suite 3700 Chicago, IL 60606	Printed Circuit Boards Manufacturer	Common Stock	3.0%
Benchmark Medical, Inc. 101 Lindin Drive, Suite 420 Malvern, PA 19355	Outpatient Physical Therapy Services	Warrant to Purchase Common Stock	2.5%
Border Foods, Inc. 1750 Valley View Lane, Suite 350 Farmer s Branch, TX 75234	Mexican Ingredient & Food Product Manufacturer	Series A Preferred Stock Series B-2 Preferred Stock Warrants to Purchase Series B-2 Preferred Stock Common Stock Warrants to Purchase Common Stock	9.4% 100.0% 100.0% 12.4% 73.8%
Callidus Debt Partners CLO Fund III, Ltd. ⁽⁸⁾ 135 Lasalle Street Chicago, IL 60694	Senior Debt Fund	Preferred Shares	68.4%
Camden Partners Strategic Fund II, L.P. One South Street Suite 2150 Baltimore, MD 21202	Private Equity Fund	Limited Partnership Interest	3.9%
Catterton Partners V, L.P. 7 Greenwich Office Park Greenwich, CT 06830	Private Equity Fund	Limited Partnership Interest	0.8%
Component Hardware Group, Inc. 1890 Swarthmore Ave. Lakewood, NJ 08701	Designer & Developer of Hardware Components	Class A Preferred Stock Class B Common Stock	7.4% 13.5%
Cooper Natural Resources, Inc. P.O. Box 1477 Seagraves, TX 79360	Sodium Sulfate Producer	Series A Convertible Preferred Stock Warrants to Purchase Series A Convertible Preferred Stock Warrants to Purchase Common Stock	100.0% 36.8% 6.5%
Coverall North America, Inc. 5201 Congress Avenue, Suite 275 Boca Raton, FL 33487	Contract Cleaning Services	Preferred Stock Warrant to Purchase Common Stock	100.0% 21.4%
eCentury Capital Partners, L.P. 8270 Greensboro Drive Suite 1025 McLean, VA 22102	Private Equity Fund	Limited Partnership Interest	25.0%
Elaxis Beta GmbH Ulmenstraße 22 60325 Frankfurt am Main Germany	Distance Measurement Device Manufacturer	Options to Purchase Shares	9.8%
Frozen Specialties, Inc. 720 Barre Road Archbold, OH 43502	Private Label Frozen Food Manufacturer	Warrants to Purchase Class A Common Stock	2.7%
Geotrace Technologies, Inc. 1011 Highway 6 South, Suite 220	Oil and Gas Reservoir Analysis	Warrant to Purchase Preferred Stock	8.4%

Houston, TX 77077

Warrant to Purchase
Common Stock

8.4%

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Name and Address of Portfolio Company	Nature of its Principal Business	Title of Securities Held by the Company	Percentage of Class Held
Grotech Partners, VI, L.P. c/o Grotech Capital Group 9690 Deereco Road Suite 800 Timonium, MD 21093	Private Equity Fund	Limited Partnership Interest	2.4%
Havco Wood Products LLC P.O. BOX 1342 Cape Girardeau, MO 63702	Hardwood Flooring Products Manufacturer	Equity Interests	4.5%
Homax Holdings, Inc. 468 West Horton Road Bellingham, WA 98226	Supplier of Branded Consumer Products	Preferred Stock	0.1%
		Common Stock	0.1%
		Warrant to Purchase Preferred Stock	1.1%
		Warrant to Purchase Common Stock	1.1%
Icon International, Inc. 281 Tressor Boulevard 8th Floor Stamford, CT 06901	Corporate Barter Services	Class C Common Stock	2.0%
International Fiber Corporation 50 Bridge Street North Tonawanda, NY 14120	Cellulose and Fiber Producer	Series A Preferred Stock	4.7%
MedAssets, Inc. 100 Northpoint Center East #150 Alpharetta, GA 30022	Healthcare Outsourcing	Series B Convertible Preferred Stock	7.8%
		Warrants to Purchase Common Stock	0.6%
		Class B Common Stock ⁽¹⁰⁾	99.6%
Meineke Car Care Centers, Inc. 128 South Tryon Street Suite 900 Charlotte, NC 28202	Franchisor of Car Care Centers	Warrant to Purchase Class A Common Stock	51.0%
		Series A Preferred Stock Common Stock	3.6% 3.6%
MHF Logistical Solutions, Inc. 800 Cranberry Woods Drive Suite 450 Cranberry Township, PA 16066	Third-Party Environmental Logistics	Series A Preferred Stock Common Stock	3.6% 3.6%
Mid-Atlantic Venture Fund IV, L.P. 128 Goodman Drive Bethlehem, PA 18015	Private Equity Fund	Limited Partnership Interest	6.7%
Mogas Energy, LLC 13137 Thunderhead Falls Lane Rapid City, SD 57702	Natural Gas Pipeline Operator	Warrants to Purchase Equity Interests	20.0%
Network Hardware Resale, Inc. 26 Castilian Drive, Suite A Santa Barbara, CA 93117	Provider of Pre-Owned Networking Equipment	Debt Convertible into Common Stock	21.8%
Nobel Learning Communities, Inc. 1400 N. Providence Road Suite 3055 Media, PA 19063	Educational Services	Series D Preferred Stock	100.0%
		Series F Convertible Preferred Stock	25.6%
		Warrants to Purchase Common Stock	6.6%
		Class B Nonvoting Common Stock	96.3%
Norwesco, Inc. P.O. BOX 439 4365 Steiner St. St. BoniFacijs, MN 55375	Polyethylene Tanks Manufacturer	Warrants to Purchase Class A Common Stock	50.2%
Novak Biddle Venture Partners III, L.P. 7501 Wisconsin Avenue East Tower, Suite 1380	Private Equity Fund	Limited Partnership Interest	2.5%

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Bethesda, MD 20814

Opinion Research Corporation
P.O. Box 183
Princeton, NJ 08542

Corporate Marketing
Research Firm

Warrants to Purchase
Common Stock

6.4%

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Name and Address of Portfolio Company	Nature of its Principal Business	Title of Securities Held by the Company	Percentage of Class Held
Oriental Trading Company, Inc. 108th Street, 4206 South Omaha, NE 68137	Direct Marketer of Toys	Class A Common Stock	1.7%
Palm Coast Data, LLC 11 Commerce Blvd Palm Coast, FL 32164	Magazines and Subscribers Relationship Management	Class B Common Stock Warrants to Purchase Class A Common Stock	100.0% 56.9%
Performant Financial Corporation 333 N. Canyon Pkwy Suite 100 Livermore, CA 94551	Collections and Default Prevention Services	Common Stock	2.9%
Pro Mach, Inc. 1000 Abernathy Road, Suite 1110 Atlanta, GA 30328	Packaging Machinery Manufacturer	Equity Interests	2.3%
S.B. Restaurant Company (d/b/a Elephant Bar) 6326-A Lindmar Drive Goleta, CA 93117	Restaurants	Series B Convertible Preferred Stock Warrant to Purchase Series A Common Stock	2.5% 13.1%
SBBUT, LLC 52 River Road Stowe, VT 05672	Holding Company	Equity Interests in Affiliate Company	10.4%
Soff-Cut Holdings, Inc. 1112 Olympic Drive Corona, CA 91719	Concrete Sawing Equipment Manufacturer	Series A Preferred Stock Common Stock	14.3% 2.7%
SPP Mezzanine Fund, L.P. 330 Madison Avenue, 28th Floor New York, NY 10017	Private Equity Fund	Limited Partnership Interest	35.7%
Tradesmen International, Inc. 9760 Shepard Road Macedonia, OH 44056	Outsourced Skilled Construction Craftsmen	Warrant to Purchase Common Stock	4.5%
TransAmerican Auto Parts, LLC 801 West Artesia Blvd Compton, CA 90220	Auto Parts and Accessories Retailer and Wholesaler	Preferred Equity Interests Common Equity Interests	1.4% 1.4%
United Site Services, Inc. 200 Friberg Parkway, Suite 4000 Westborough, MA 01582	Portable Rest Room Services	Common Stock	1.3%
Updata Venture Partners II, L.P. 11600 Sunrise Valley Drive Reston, VA 20191	Private Equity Fund	Limited Partnership Interest	15.0%
Venturehouse-Cibernet Investors, LLC 509 Seventh Street, NW Washington, DC 20004	Third-Party Billing	Equity Interest	3.3%
Venturehouse Group, LLC 1780 Tysons Boulevard, Suite 400 McLean, VA 22102	Private Equity Fund	Common Equity Interest	3.1%
VICORP Restaurants, Inc. 400 W. 48th Avenue Denver, CO 80216	Restaurants	Warrant to Purchase Preferred Stock Warrant to Purchase Common Stock	1.0% 3.4%
Walker Investment Fund II, LLLP 3060 Washington Road Suite 200 Glenwood, MD 21738	Private Equity Fund	Limited Partnership Interest	5.1%

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Name and Address of Portfolio Company	Nature of its Principal Business	Title of Securities Held by the Company	Percentage of Class Held
Wear Me Apparel Corporation 31 West 34th Street New York, NY 10001	Marketer of Children's Apparel	Warrant to Purchase Common Stock	2.0%
Wilshire Restaurant Group, Inc. 1100 Town & Country Road Suite 1300 Orange, CA 92868-4654	Restaurants	Warrants to Purchase Preferred Stock Warrants to Purchase Common Stock	14.2% 14.2%
Woodstream Corporation 69 North Locust Street Lititz, PA 17543	Pest Control Manufacturer	Common Stock Warrants to Purchase Common Stock	4.4% 3.7%
COMMERCIAL REAL ESTATE FINANCE⁽⁹⁾			
8830 Macon Highway Holding Company, LLC ⁽¹⁾ 1919 Pennsylvania Ave, N.W. Washington, DC 20006	Mobile Home Park	Equity Interests	100.0%
WSALD-CEH, LLC ⁽¹⁾ 1919 Pennsylvania Ave, N.W. Washington, DC 20006	Commercial Real Estate Developer	Equity Interest	50.0%
NPH, Inc. ⁽¹⁾ 1919 Pennsylvania Ave, N.W. Washington, DC 20006	Commercial Real Estate Developer	Common Stock	100.0%
Stemmons Freeway Hotel, LLC ⁽¹⁾ 1919 Pennsylvania Ave, N.W. Washington, DC 20006	Hotel	Equity Interests	100.0%
Timarron Capital, Inc. ⁽¹⁾ 804 Worthington Court Southlake, TX 76092	Commercial Real Estate Loan Origination and Securitization	Preferred Stock	100.0%
WSA Commons LLC 421 East 4th Street Cincinnati, OH 45202	Residential Real Estate Development	Equity Interests	50.0%
Van Ness Hotel, Inc. ⁽¹⁾ 1919 Pennsylvania Ave, N.W. Washington, DC 20006	Hotel	Common Stock	100.0%

- (1) The portfolio company is deemed to be an affiliated person under the 1940 Act because we hold one or more seats on the portfolio company's board of directors, are the general partner, or are the managing member.
- (2) Alaris Consulting, LLC owns 95% of Alaris Consulting, Inc.
- (3) Included in Class C Equity Interests in the Consolidated Statement of Investments.
- (4) Callidus Capital Corporation owns 80% of Callidus Capital Management, LLC.
- (5) The affiliate holds subordinated debt issued by Impact Innovations Group, LLC. We made an investment in and exchanged our existing subordinated debt for equity interests in the affiliate.
- (6) Advantage Sales & Marketing, Inc. has issued two classes of common stock. We owned 100% of the Class A common stock and our economic ownership is diluted by the Class B common stock and is subject to further dilution by management options, performance shares and certain adjustments provided for in the stockholder agreements. In March 2006, we sold our majority interest in Advantage. See Management's Discussion and Analysis of Financial Condition and Results of Operations for further detail.
- (7) Avborne, Inc. and Avborne Heavy Maintenance, Inc. are affiliated companies.

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- (8) Callidus Capital Management, LLC is the manager of the fund (see Note 4 above).
- (9) These portfolio companies are included in the Commercial Real Estate Finance Equity Interests in the Consolidated Statement of Investments.
- (10) Common stock is non-voting. In addition to non-voting stock ownership, we have an option to acquire a majority of the voting securities of the portfolio company at fair market value.
- (11) Triview Investments Inc. holds investments in Longview Cable & Data, LLC and Triax Holdings, LLC.

DETERMINATION OF NET ASSET VALUE

Quarterly Net Asset Value Determination

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

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 our valuation policy and a consistently applied valuation process. At December 31, 2005, portfolio investments at fair value were approximately 90% of our total assets. Because of the inherent uncertainty of determining the fair value of investments that do not have a readily available market value, the fair value of our investments determined in good faith by the Board of Directors may differ significantly from the values that would have been used had a ready market existed for the investments, and the differences could be material.

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

As a business development company, we have invested in illiquid securities including debt and equity securities of companies. 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 may be subject to certain 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. Our process for determining the fair value of an investment begins with determining the enterprise value of the portfolio company. The fair value of

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

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

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

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

Loans and Debt Securities. For loans and debt securities, fair value generally approximates cost unless the borrower's enterprise value, 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.

Equity Securities. Our 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 our 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.

Determinations In Connection With Offerings

In connection with each offering of shares of our common stock, the Board of Directors or a committee thereof is required to make the determination that we are not selling shares of our common stock at a price below our then current net asset value at the time at which the sale is made. The Board of Directors considers the following factors, among others, in making such determination:

the net asset value of our common stock disclosed in the most recent periodic report we filed with the SEC;

our management's assessment of whether any material change in the net asset value has occurred (including through the realization of net gains on the sale of our portfolio investments) from the period beginning on the date of the most recently disclosed net asset value to the period ending two days prior to the date of the sale of our common stock; and

the magnitude of the difference between the net asset value disclosed in the most recent periodic report we filed with the SEC and our management's assessment of any material change in the net asset value since the date of the most recently disclosed net asset value, and the offering price of the shares of our common stock in the proposed offering.

Importantly, this determination does not require that we calculate net asset value in connection with each offering of shares of our common stock, but instead it involves the determination by the Board of Directors or a committee thereof that we are not selling shares of our common stock at a price below the then current net asset value at the time at which the sale is made.

Moreover, to the extent that there is even a remote possibility that we may (i) issue shares of our common stock at a price below the then current net asset value of our common stock at the time at which the sale is made or (ii) trigger the undertaking (which we provided to the SEC in the registration statement to which this prospectus is a part) to

suspend the offering of shares of our common stock pursuant to this prospectus if the net asset value fluctuates by certain amounts in certain circumstances until the prospectus is amended, the Board of Directors or a committee thereof will elect, in the case of clause (i) above, either to postpone the offering until such time that there is no longer the possibility of the occurrence of such event or to undertake to determine net asset value within two days prior to any such sale to ensure that such sale will not be below our then current net asset value, and, in the case of clause (ii) above, to comply with such undertaking or to undertake to determine net asset value to ensure that such undertaking has not been triggered.

These processes and procedures are part of our compliance policies and procedures. Records will be made contemporaneously with all determinations described in this section and these records will be maintained with other records we are required to maintain under the 1940 Act.

MANAGEMENT

Our Board of Directors oversees our management. The responsibilities of each director include, among other things, the oversight of our investment activity, the quarterly valuation of our assets, and oversight of our financing arrangements. The Board of Directors maintains an Executive Committee, Audit Committee, Compensation Committee, and Corporate Governance/Nominating Committee, and may establish additional committees in the future. All of our directors also serve as directors of our subsidiaries.

The management of our company and our investment portfolio is the responsibility of various corporate committees, including the management committee, the investment committee, and the portfolio management committee. See Portfolio Management.

Structure of Board of Directors

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

Directors

Our directors have been divided into two groups interested directors and independent directors. Interested directors are interested persons of Allied Capital as defined in the 1940 Act. Information regarding our Board of Directors is as follows:

Name	Age	Position	Director Since ⁽¹⁾	Expiration of Term
Interested Directors				
William L. Walton	56	Chairman, Chief Executive Officer and President	1986	2007
Joan M. Sweeney	46	Chief Operating Officer	2004	2007
Robert E. Long	74	Director	1972	2007
Independent Directors				
Ann Torre Bates	47	Director	2003	2006
Brooks H. Browne	56	Director	1990	2007
John D. Firestone	62	Director	1993	2008
Anthony T. Garcia	49	Director	1991	2008
Edwin L. Harper	64	Director	2006	2006
Lawrence I. Hebert	59	Director	1989	2008
John I. Leahy	75	Director	1994	2006
Alex J. Pollock	63	Director	2003	2006
Marc F. Racicot	57	Director	2005	2008
Guy T. Steuart II	74	Director	1984	2006
Laura W. van Roijen	53	Director	1992	2008

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

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

Executive Officers

Information regarding our executive officers is as follows:

Name	Age	Position
William L. Walton	56	Chairman, Chief Executive Officer and President
Joan M. Sweeney	46	Chief Operating Officer
Kelly A. Anderson	52	Executive Vice President and Treasurer
Scott S. Binder	51	Chief Valuation Officer
Michael J. Grisius	42	Managing Director
Jeri J. Harman	48	Managing Director
Thomas C. Lauer	38	Managing Director
Robert D. Long	49	Managing Director
Justin S. Maccarone	46	Managing Director
Diane E. Murphy	52	Executive Vice President and Director of Human Resources
Penni F. Roll	40	Chief Financial Officer
Daniel L. Russell	41	Managing Director
John M. Scheurer	53	Managing Director
John D. Shulman	43	Managing Director
Suzanne V. Sparrow	40	Chief Compliance Officer, Executive Vice President and Secretary

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

Biographical Information**Directors**

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

Interested Directors

William L. Walton has been the Chairman, Chief Executive Officer, and President of Allied Capital since 1997. Mr. Walton's previous experience includes serving as a Managing Director of Butler Capital Corporation, a mezzanine buyout firm, the personal investment advisor to William S. Paley, founder of CBS, and a Senior Vice President in Lehman Brothers Kuhn Loeb's Merger and Acquisition Group. He also founded two education service companies Language Odyssey and SuccessLab. Mr. Walton currently serves on the Board of Directors for the National Foundation for Teaching Entrepreneurship and the National Symphony Orchestra. He is a member of the World Economic Forum and an Advisory Board member for the Center for Strategic & International Studies. Mr. Walton also serves on The Kelley School of Business Board of Advisors at Indiana University.

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

Coopers & Lybrand, and the Division of Enforcement of the Securities and Exchange Commission.

Robert E. Long has been the Chief Executive Officer and a director of GLB Group, Inc., an investment management firm, since 1997 and President of Ariba GLB Group, Inc., the parent company of GLB Group, Inc., since 2005. He has been the Chairman of Emerald City Radio Partners, LLC since 1997. Mr. Long was the President of Business News Network, Inc. from 1995 to 1998, the Chairman and Chief Executive Officer of Southern Starr Broadcasting Group, Inc. from 1991 to 1995, and a director and the President of Potomac Asset Management, Inc. from 1983 to 1991. Mr. Long is a director of AmBase Corporation, CSC Scientific, Inc., and Advanced Solutions International, Inc. Mr. Long is the father of Robert D. Long, an executive officer of Allied Capital.

Independent Directors

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

Brooks H. Browne has been a private investor since 2002. Mr. Browne was the President of Environmental Enterprises Assistance Fund from 1993 to 2002 and served as a director from 1991 to 2005. He currently serves as Vice Chairman of the Board for Winrock International, a non-profit organization.

John D. Firestone has been a Partner of Secor Group, a venture capital firm since 1978. Mr. Firestone has also served as a director of Security Storage Company of Washington, DC, since 1978. He is currently a director of Cuisine Solutions, Inc., and four non-profit organizations, including the National Rehabilitation Hospital, The Washington Ballet and the Tudor Place Foundation of which he is the past president. From 1997 to 2001 he was a director of The Bryn Mawr Trust Corporation.

Anthony T. Garcia has been a private investor since 2003. Mr. Garcia was Vice President of Finance of Formity Systems, Inc., a developer of software products for business management of data networks, from January 2002 through 2003. Mr. Garcia was a private investor from 2000 to 2001, the General Manager of Breen Capital Group, an investor in tax liens, from 1997 to 2000, and a Senior Vice President of Lehman Brothers Inc. from 1985 to 1996.

Edwin L. Harper has been an executive for Assurant, Inc., a financial services and insurance provider, since 1998. He currently serves as Senior Vice President, Public Affairs and Government Relations and previously served as Chief Operating Officer and Chief Financial Officer for Assurant's largest subsidiary. From 1992 to 1997, Mr. Harper served as President and Chief Executive Officer of the Association of American Railroads. He also spent five years with Campbell Soup Company, serving as Chief Financial Officer from 1986 to 1991. Earlier in his career, Mr. Harper served on the White House staffs of both President Reagan and President Nixon. Mr. Harper currently serves as Director for the Council for Excellence in Government.

Lawrence I. Hebert is Senior Advisor for PNC Bank, N.A., and was a director and President and Chief Executive Officer of Riggs Bank N.A., a subsidiary of Riggs National

Corporation, from 2001 to 2005. Mr. Hebert also served as Chief Executive Officer of Riggs National Corporation during 2005 and served as a director of Riggs National Corporation from 1988 to 2005. Mr. Hebert served as a director of Riggs Investment Advisors and Riggs Bank Europe Limited (both indirect subsidiaries of Riggs National Corporation). Mr. Hebert previously served as Vice Chairman from 1983 to 1998, President from 1984 to 1998, and Chairman and Chief Executive Officer from 1998 to 2001 of Allbritton Communications Company.

John I. Leahy has been the President of Management and Marketing Associates, a management consulting firm, since 1986. Previously, Mr. Leahy spent 34 years of his career with Black & Decker Corporation, where he served as President and CEO of the United States subsidiary from 1979 to 1981 and President and Group Executive Officer of the Western Hemisphere of Black & Decker Corporation from 1982 to 1985. Mr. Leahy is currently a director of B&L Sales, Inc. and is Trustee Emeritus of the Sellinger School of Business, Loyola College, Maryland.

Alex J. Pollock has been a Resident Fellow at the American Enterprise Institute since 2004. He was President and Chief Executive Officer of the Federal Home Loan Bank of Chicago from 1991 to 2004. He serves as a director of the Chicago Mercantile Exchange, Great Lakes Higher Education Corporation, the Great Books Foundation, the Illinois Council on Economic Education and the International Union for Housing Finance. Allied Capital has contributed \$25 thousand to the American Enterprise Institute.

Marc F. Racicot was named President and Chief Executive Officer of the American Insurance Association in August 2005. Prior to that, he was an attorney at the law firm of Bracewell & Giuliani, LLP from 2001 to 2005. He is a former Governor (1993 to 2001) and Attorney General (1989 to 1993) of the State of Montana. Mr. Racicot was appointed by President Bush to serve as the Chairman of the Republican National Committee (2002 to 2003) and he served as Chairman of the Bush/Cheney Re-election Committee from 2003 to 2004. He presently serves on the Board of Directors for Burlington Northern Santa Fe Corporation, Massachusetts Mutual Life Insurance Company, Jobs for America's Graduates, and the Board of Visitors for the University of Montana School of Law.

Guy T. Stewart II has been a director and President of Stewart Investment Company, which manages, operates, and leases real and personal property and holds stock in operating subsidiaries engaged in various businesses, since 1960 where he served as President until 2003 and currently serves as Chairman. Mr. Stewart has served as Trustee Emeritus of Washington and Lee University since 1992.

Laura W. van Roijen has been a private investor since 1992. Ms. van Roijen was a Vice President at Citicorp from 1982 to 1992.

Executive Officers who are not Directors

Kelly A. Anderson, Executive Vice President and Treasurer, has been employed by Allied Capital since 1987. Ms. Anderson is responsible for Allied Capital's treasury, cash management and infrastructure operations.

Scott S. Binder, Chief Valuation Officer, has been employed by Allied Capital since 1997. He has served as Chief Valuation Officer since 2003. He served as a consultant to the Company from 1991 until 1997. Prior to joining the Company, Mr. Binder formed and was President of Overland Communications Group. He also served as a board member and financial consultant for a public affairs and lobbying firm in Washington, DC. Mr. Binder

founded Lonestar Cablevision in 1986, serving as President until 1991. In the early 1980 s, Mr. Binder worked for two firms specializing in leveraged lease transactions. From 1976 to 1981, he was employed by Coopers & Lybrand.

Michael J. Grisius, Managing Director, has been employed by the Company since 1992. Prior to joining Allied Capital, Mr. Grisius worked in leveraged finance at Chemical Bank from 1989 to 1992 and held senior accountant and consultant positions with KPMG LLP from 1985 to 1988.

Jeri J. Harman, Managing Director, has been employed by the Company since 2004. Prior to joining Allied Capital, Ms. Harman served as a Managing Director and Principal for American Capital Strategies, Ltd., a business development company, from 2000 until 2004. She worked as a Managing Director and Head of Private Placements for First Security Van Kasper from 1996 to 2000 and a Managing Director of Coopers & Lybrand from 1993 to 1996. From 1982 to 1993, Ms. Harman held various senior level positions in the private placement arm of The Prudential Insurance Company of America. She has served on the Board of Directors for the Association of Corporate Growth since 2000.

Thomas C. Lauer, Managing Director, has been employed by the Company since 2004. Prior to joining Allied Capital, Mr. Lauer worked in GE Capital s sponsor finance group from 2003 to 2004 and in the merchant banking and leveraged finance groups of Wachovia Securities (previously First Union Securities) from 1997 to 2003. He also held senior analyst positions at Intel Corporation and served as a corporate lender and credit analyst at National City Corporation.

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

Justin S. Maccarone, Managing Director, has been employed by the Company since April 2005. Prior to joining Allied Capital, Mr. Maccarone served as a partner with UBS Capital Americas, LLC, a private equity fund focused on middle market investments from 1993 to 2005. Prior to that, Mr. Maccarone served as a Senior Vice President at GE Capital specializing in merchant banking and leveraged finance from 1989 to 1993 and served as Vice President of the Leveraged Finance Group at HSBC/ Marine Midland Bank from 1981 to 1989.

Diane E. Murphy, Ms. Murphy, Executive Vice President and Director of Human Resources, has been employed by the Company since 2000. Prior to joining the Company, Ms. Murphy was employed by Allfirst Financial from 1982 to 1999 and served in several capacities including head of the retail banking group in the Greater Washington Metro Region from 1994 to 1996 and served as the senior human resources executive from 1996 to 1999.

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

Daniel L. Russell, Managing Director, has been employed by the Company since 1998. Prior to joining Allied Capital, Mr. Russell was employed by KPMG LLP in the firm's financial services group.

John M. Scheurer, Managing Director, has been employed by the Company since 1991. Earlier in his career, Mr. Scheurer managed his own commercial real estate company, served as executive vice president of Hunter Companies, a full service commercial real estate leasing, investment and management company, and spent seven years with First American Bank in Washington DC. Mr. Scheurer is currently a member of the Board of Governors of the Commercial Mortgage Securities Association. He has also served as Chairman and as a Vice Chair of the Capital Markets Committee for the Commercial Real Estate Finance Committee of the Mortgage Bankers Association.

John D. Shulman, Managing Director, has been employed by the Company since 2001. Prior to joining Allied Capital, Mr. Shulman served as the President and CEO of Onyx International, LLC, a venture capital firm, from 1994 to 2001. Prior to his involvement with Onyx, Mr. Shulman served as Director of Development for the Tower Companies, a diversified portfolio of private equity and real estate investments. He currently serves as a director of ChemLink Laboratories LLC and as a member of the investment committees of Taiwan Mezzanine Fund and Greater China Private Equity Fund.

Suzanne V. Sparrow, Executive Vice President, Chief Compliance Officer and Corporate Secretary, has been employed by the Company since 1987. Ms. Sparrow manages Allied Capital's compliance and corporate governance activities.

Committees of the Board of Directors

Our Board of Directors has established an Executive Committee, an Audit Committee, a Compensation Committee, and a Corporate Governance/ Nominating Committee. The Audit Committee, Compensation Committee, and Corporate Governance/ Nominating Committee each operate pursuant to a committee charter. The charter of each Committee is available on our web site at www.alliedcapital.com in the Investor Resources section and is also available in print to any stockholder who requests a copy.

The Executive Committee has and may exercise those rights, powers, and authority that the Board of Directors from time to time grants to it, except where action by the Board is required by statute, an order of the Securities and Exchange Commission (the Commission), or Allied Capital's charter or bylaws. The Executive Committee has been delegated authority from the Board to review and approve certain investments. The Executive Committee met 42 times during 2005. The Executive Committee members currently are Messrs. Walton, Harper, Hebert, Leahy, Long, Pollock and Steuart. Messrs. Harper, Hebert, Leahy, Pollock, and Steuart are independent directors for purposes of the 1940 Act. Messrs. Walton and Long are interested persons of the Company, as defined in the 1940 Act.

The Audit Committee operates pursuant to a charter approved by the Board of Directors. The charter sets forth the responsibilities of the Audit Committee. The primary function of the Audit Committee is to serve as an independent and objective party to assist the Board of Directors in fulfilling its responsibilities for overseeing and monitoring the quality and integrity of our financial statements, the adequacy of our system of internal controls, the review of the independence, qualifications and performance of our

independent registered public accounting firm, and the performance of our internal audit function. The Audit Committee met 18 times during 2005. The Audit Committee is presently composed of four persons, including Messrs. Browne (Chairman) and Garcia and Mmes. Bates and van Roijen, all of whom are considered independent under the rules promulgated by the New York Stock Exchange. Our Board of Directors has determined that Messrs. Browne and Garcia and Ms. Bates are audit committee financial experts as defined under Item 401 of Regulation S-K of the Securities Exchange Act of 1934, as each meets the current independence and experience requirements of Rule 10A-3 of the Exchange Act and, in addition, are not interested persons of the Company as defined in Section 2(a)(19) of the Investment Company Act of 1940.

The Compensation Committee approves management's recommendations for the compensation of our executive officers and reviews the amount of salary and bonus for each of the Company's other officers and employees. In addition, the Compensation Committee approves stock option grants for our officers under our Amended Stock Option Plan, determines the Individual Performance Awards (IPA) and Individual Performance Bonuses (IPB) for participants and determines other compensation arrangements for employees. The Compensation Committee met 11 times during 2005. The Compensation Committee members currently are Messrs. Leahy (Chairman), Browne, Firestone, Garcia, and Racicot, each of whom is not an interested person as defined in Section 2(a)(19) of the Investment Company Act of 1940.

The Corporate Governance/ Nominating Committee recommends candidates for election as directors to the Board of Directors and makes recommendations to the Board as to our corporate governance policies. The Corporate Governance/ Nominating Committee met five times during 2005. The Corporate Governance/ Nominating Committee members currently are Messrs. Hebert (Chairman), Firestone, Pollock, and Racicot, each of whom is not an interested person as defined in Section 2(a)(19) of the Investment Company Act of 1940.

PORTFOLIO MANAGEMENT

The management of our company and our investment portfolio is the responsibility of various corporate committees, including the management committee, the investment committee, and the portfolio management committee. In addition, the Executive Committee of the Board of Directors approves certain investment decisions.

Our management committee is responsible for, among other things, business planning and the establishment and review of general investment criteria. The management committee is chaired by William Walton, our Chief Executive Officer (CEO), and includes Joan Sweeney, our Chief Operating Officer (COO), Penni Roll, our Chief Financial Officer (CFO), Scott Binder, our Chief Valuation Officer (CVO), and Michael Grisius, Jeri Harman, Thomas Lauer, Robert D. Long, Justin Maccarone, Daniel Russell, John Scheurer, and John Shulman, all managing directors.

Our investment committee is responsible for approving new investments. Our investment committee is chaired by William Walton, CEO, and includes Joan Sweeney, COO, Penni Roll, CFO, Scott Binder, CVO (non-voting) and James Fisher, John Fruehwirth, Michael Grisius, Jeri Harman, Thomas Lauer, Robert D. Long, Justin Maccarone, Robert Monk, Daniel Russell, John Scheurer and John Shulman, all managing directors.

In addition to approval by the investment committee, each transaction that represents a commitment equal to or greater than \$20 million, every buyout transaction, and any other investment that in our judgment demonstrates unusual risk/reward characteristics also requires the approval of the Executive Committee of the Board of Directors. Our Executive Committee is currently comprised of Messrs. Walton, Harper, Hebert, Leahy, Long, Pollock and Stuart.

Our portfolio management committee oversees the overall performance of the portfolio, including reviewing the performance of selected portfolio companies, overseeing portfolio companies in workout status, reviewing and approving certain amendments or modifications to existing investments, reviewing and approving certain portfolio exits, and reviewing and approving certain actions by portfolio companies whose voting securities are more than 50% owned by us. From time to time we will identify investments that require closer monitoring or become workout assets. We develop a workout strategy for workout assets and the portfolio management committee gauges our progress against the strategy. Our portfolio management committee is chaired by William Walton, CEO, and includes Joan Sweeney, COO, Penni Roll, CFO, Scott Binder, CVO (non-voting), and Christina DelDonna, John Fontana, and John Scheurer, all managing directors.

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

Biographical Information for Non-Executive Officers

Information regarding the business experience of the additional investment professionals who are directors or executive officers is contained under the caption Management Biographical Information.

Christina L. DelDonna, Managing Director, has been employed by the Company since 1992. Ms. DelDonna has previously worked in a number of other managerial roles during her tenure with the Company. Prior to joining Allied Capital, Ms. DelDonna held several accounting, audit, and financial analyst roles within a variety of industries.

James A. Fisher, Managing Director, has been employed by the Company since January 2006 and manages Allied Capital's senior loan origination and underwriting activities. Prior to joining Allied Capital, Mr. Fisher managed the senior loan origination group at Callidus Capital Management, a specialized asset management company, from 2004 to 2006. Previously, Mr. Fisher was a Senior Vice President at JP Morgan Chase in charge of the Middle Market Structured Finance Division from 2000 to 2003, where he also served as a member of the Middle Market Banking Group's senior management team. He began his career in 1981 with the middle market lending group at JP Morgan Chase and served in various credit and management positions.

N. John Fontana, Managing Director, has been employed by the Company since 2004. Prior to joining Allied Capital, Mr. Fontana was a Principal of Tigris, an operations consulting firm in the consumer products and manufacturing industries from 2002 to 2004. From 1999 to 2002, Mr. Fontana was a turnaround manager working for a series of private equity and venture capital firms. He participated in the buyout and served as Chief

Operating Officer of Electrolux, LLC from 1998 to 1999. From 1994 to 1998, he served as a Partner with Deloitte & Touche Consulting Group where he led turnaround and operating improvement engagements for private equity firms.

John M. Fruehwirth, Managing Director, has been employed by the Company since 2003. Previously, he worked at Wachovia (formerly First Union) in several merchant banking groups including Wachovia Capital Partners, Leveraged Capital and Middle Market Capital from 1999 to 2003. Prior to that, Mr. Fruehwirth worked in First Union's Leveraged Finance Group from 1996 to 1998.

Robert M. Monk, Managing Director, has been employed by the Company since 1993. Prior to joining Allied Capital, Mr. Monk worked in the leveraged finance group at First Union National Bank (currently Wachovia Securities).

Compensation

The compensation for the members of our management committee, investment committee, and portfolio management committee includes: (i) base salary; (ii) annual bonus; (iii) individual performance award and/or individual performance bonus; and (iv) stock options. Compensation for the members of our Executive Committee, with the exception of Mr. Walton, consists of: (i) annual retainer; (ii) attendance fee per committee meeting; and (iii) stock options. See Management and Compensation of Executive Officers and Directors.

Beneficial Ownership

Each member of the Executive Committee, excluding Messrs. Harper and Pollock, beneficially owns shares of our common stock with a value of more than \$1,000,000, based on the closing price of \$30.94 on April 21, 2006, on the New York Stock Exchange. Messrs. Harper and Pollock beneficially own shares of our common stock with a value of less than \$50,000 and with a value of \$500,000 to \$1,000,000, respectively, based on the closing price of \$30.94 on April 21, 2006, on the New York Stock Exchange. Each member of the management committee and the portfolio management committee beneficially owns shares of our common stock with a value of more than \$1,000,000, based on the closing price of \$30.94 on April 21, 2006, on the New York Stock Exchange. Each member of the investment committee, excluding Mr. Fisher, beneficially owns shares of our common stock with a value of more than \$1,000,000, based on the closing price of \$30.94 on April 21, 2006, on the New York Stock Exchange. Mr. Fisher beneficially owns shares of our common stock with a value of \$50,000 to \$100,000 based on the closing price of \$30.94 on April 21, 2006, on the New York Stock Exchange.

Conflicts of Interest

Because each of the members of the Executive Committee, the management committee, the investment committee, and the portfolio management committee provide portfolio management services of this type only to us, there are no conflicts of interest with respect to their management of other accounts or investment vehicles.

COMPENSATION OF EXECUTIVE OFFICERS AND DIRECTORS

Under SEC rules applicable to business development companies, we are required to set forth certain information regarding the compensation of certain executive officers and directors. The following table sets forth compensation earned during the year ended December 31, 2005, by all of our directors and our three highest paid executive officers (collectively, the *Compensated Persons*) in each capacity in which each *Compensated Person* served. Certain of the *Compensated Persons* served as both officers and directors.

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

Compensation Table

Name	Aggregate Compensation from the Company ^(1,2)	Securities Underlying Options/SARs ⁽³⁾	Pension or Retirement Benefits Accrued as Part of Company Expenses ⁽¹⁾	Directors Fees Paid by the Company ⁽⁴⁾
Interested Directors:				
William L. Walton, <i>Chairman & CEO</i>	\$7,381,605		\$	\$
Joan M. Sweeney, <i>Chief Operating Officer</i>	4,119,587			
Robert E. Long, <i>Director</i>	84,000	5,000		84,000
Independent Directors:				
Ann Torre Bates, <i>Director</i>	88,500	5,000		88,500
Brooks H. Browne, <i>Director</i>	113,500	5,000		113,500
John D. Firestone, <i>Director</i>	66,000	5,000		66,000
Anthony T. Garcia, <i>Director</i>	107,000	5,000		107,000
Lawrence I. Hebert, <i>Director</i>	101,000	5,000		101,000
John I. Leahy, <i>Director</i>	112,500	5,000		112,500
Alex J. Pollock, <i>Director</i>	73,500	5,000		73,500
Marc F. Racicot, <i>Director</i>	50,000	10,000		50,000
Guy T. Steuart II, <i>Director</i>	83,500	5,000		83,500
Laura W. van Roijen, <i>Director</i>	92,000	5,000		92,000
Executive Officers:				
John M. Scheurer, <i>Managing Director</i>	4,167,568	50,000		

(1) The following table provides detail as to aggregate compensation paid for 2005 to our three highest paid executive officers, including the Chief Executive Officer:

	Salary	Bonus ⁽⁵⁾	IPA	IPB	Other Benefits
Mr. Walton	\$1,528,846	\$2,750,000	\$1,475,000	\$1,475,000	\$152,759
Ms. Sweeney	1,019,231	1,500,000	750,000	750,000	100,356
Mr. Scheurer	611,538	2,350,000	550,000	550,000	106,030

For 2005, the Company established individual performance awards (IPA) and individual performance bonuses (IPB). See also *Individual Performance Award* and *Individual Performance Bonus*. Included for each executive officer in *Other Benefits* is, among other things, an employer contribution to the 401(k) Plan, a contribution to the Deferred Compensation Plan I, amounts attributed to travel of non-employee family members when they have accompanied a *Compensated Person* on a business trip, and health and dental insurance. See also *Employment Agreements*.

(2) Messrs. Walton, Pollock and Scheurer and Ms. Sweeney deferred \$1.6 million, \$28 thousand, \$0.6 million, and \$0.8 million, respectively, of the compensation earned during the year ended December 31, 2005.

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- (3) See [Stock Option Awards](#) for terms of options granted in 2005.
- (4) Consists only of directors' fees paid by Allied Capital for 2005. Such fees are also included in the column titled [Aggregate Compensation from the Company](#).
- (5) Mr. Scheurer's 2005 bonus included two one-time lump sum bonuses totaling \$1,500,000. See [Retention Agreements](#) for further discussion.

Compensation of Non-Officer Directors

Each non-officer director receives an annual retainer of \$40,000. In addition, committee chairs receive an annual retainer of \$5,000. For each committee meeting attended, Executive Committee members receive \$1,500 per meeting; Audit Committee members receive \$3,000 per meeting; and members of the Compensation and Corporate Governance/Nominating Committees receive \$2,000 per meeting.

Directors may choose to defer such fees through our Deferred Compensation Plan, and may choose to have invested such deferred income in shares of our common stock through a trust.

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

Stock Option Awards

The following table sets forth the details relating to option grants in 2005 to Compensated Persons under our Amended Stock Option Plan, and the potential realizable value of each grant, as prescribed to be calculated by the SEC. See Amended Stock Option Plan.

Options Granted During 2005

Name	Number of Securities Underlying Options Granted	Percent of Total Options Granted in 2005 ⁽¹⁾	Exercise Price Per Share	Market Value	Expiration Date	Potential Realizable Value at Assumed Annual Rates of Stock Price Appreciation Over 10-Year Term ⁽²⁾	
						5%	10%
Interested Directors:							
William L. Walton ⁽³⁾							
Joan M. Sweeney ⁽³⁾							
Robert E. Long ⁽⁴⁾	5,000	0.07%	\$26.80	\$26.80	5/17/2015	\$84,272	\$213,561
Independent Directors:							
Ann Torre Bates ⁽⁴⁾	5,000	0.07	26.80	26.80	5/17/2015	84,272	213,561
Brooks H. Browne ⁽⁴⁾	5,000	0.07	26.80	26.80	5/17/2015	84,272	213,561
John D. Firestone ⁽⁴⁾	5,000	0.07	26.80	26.80	5/17/2015	84,272	213,561
Anthony T. Garcia ⁽⁴⁾	5,000	0.07	26.80	26.80	5/17/2015	84,272	213,561
Lawrence I. Hebert ⁽⁴⁾	5,000	0.07	26.80	26.80	5/17/2015	84,272	213,561
John I. Leahy ⁽⁴⁾	5,000	0.07	26.80	26.80	5/17/2015	84,272	213,561