

ALLIED CAPITAL CORP  
Form N-2  
March 17, 2004

*As filed with the Securities and Exchange Commission on March 16, 2004*

**Registration No. 333-**

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**SECURITIES AND EXCHANGE COMMISSION**

**WASHINGTON, D.C. 20549**

**FORM N-2**

**REGISTRATION STATEMENT**

**UNDER  
THE SECURITIES ACT OF 1933**

- o Pre-Effective Amendment No.**
- o Post-Effective Amendment No.**

**ALLIED CAPITAL CORPORATION**

*(Exact Name of Registrant as Specified in Charter)*

**1919 Pennsylvania Avenue, N.W.**

**Washington, D.C. 20006-3434  
(202) 331-1112**

*(Address and Telephone Number, including Area Code, of Principal Executive Offices)*

**William L. Walton, Chairman and Chief Executive Officer**

**Allied Capital Corporation  
1919 Pennsylvania Avenue, N.W.  
Washington, D.C. 20006-3434  
*(Name and Address of Agent for Service)***

*Copies of information to:*

**Steven B. Boehm, Esq.  
Cynthia M. Krus, Esq.  
Sutherland Asbill & Brennan LLP  
1275 Pennsylvania Avenue, N.W.  
Washington, D.C. 20004-2415**

*Approximate Date of Proposed Public Offering:*

From time to time after the effective date of the Registration Statement.

*If any securities being registered on this form will be offered on a delayed or continuous basis in reliance on Rule 415 under the Securities Act of 1933, other than securities offered in connection with a dividend reinvestment plan, check the following box. x*

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CALCULATION OF REGISTRATION FEE UNDER THE SECURITIES ACT OF 1933

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Title of Securities Being Registered	Amount Being Registered <sup>(1)</sup>	Proposed Maximum Offering Price Per Share <sup>(2)</sup>	Proposed Maximum Aggregate Offering Price	Amount of Registration Fee <sup>(3)</sup>
Common Stock, \$0.0001 par value per share	16,450,000 shares	\$29.96	\$492,842,000	\$62,444

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- (1) In reliance upon Rule 429 under the Securities Act of 1933, this amount is in addition to the securities previously registered by the Registrant under a registration statement on Form N-2 (File No. 333-104149). All securities unsold under such prior registration (a total of 3,550,000 shares of common stock) are carried forward into this Registration Statement.
- (2) Estimated solely for the purpose of calculating the registration fee pursuant to Rule 457(c) under the Securities Act of 1933 on the basis of the average of the high and low sales prices of the common stock on March 11, 2004 as reported on the New York Stock Exchange.
- (3) In reliance upon Rule 429 under the Securities Act of 1933, all securities unsold under a registration statement on Form N-2 (File No. 333-104149) (a total of 3,550,000 shares of common stock) are carried forward into this Registration Statement. A registration fee of \$5,730 has been paid previously with respect to such securities. The registration fee of \$62,444 relates solely to the registration of 16,450,000 shares of common stock not previously registered.

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**The registrant hereby amends this registration statement on such date or dates as may be necessary to delay its effective date until the registrant shall file a further amendment which specifically states that this registration statement shall thereafter become effective in accordance with Section 8(a) of the Securities Act of 1933, as amended, or until this registration statement shall become effective on such date as the Commission, acting pursuant to Section 8(a), may determine.**

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**The information in this prospectus is not complete and may be changed. We may not sell these securities until the registration statement filed with the Securities and Exchange Commission is effective. This prospectus is not an offer to sell these securities and is not soliciting an offer to buy these securities in any state where the offer or sale is not permitted.**

**PROSPECTUS (SUBJECT TO COMPLETION)  
ISSUED , 2004**

20,000,000 Shares

**Common Stock**

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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 companies in a variety of industries, non-investment grade commercial mortgage-backed securities and collateralized debt obligation bonds and preferred shares. 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. It contains important information about us. The SEC maintains an Internet website (<http://www.sec.gov>) that contains other information about us.

We may offer, from time to time, up to 20,000,000 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.

Our common stock is traded on the New York Stock Exchange under the symbol ALD. As of March , 2004, the last reported sale price on the New York Stock Exchange for the common stock was \$ .

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

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**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 representations to the contrary is a criminal offense.**

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

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, 2004

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We have not authorized any dealer, salesman or other person to give any information or to make any representation other than those contained or incorporated by reference in this prospectus or any accompanying supplement to this prospectus. You must not rely upon any information or representation not contained in this prospectus or the accompanying prospectus supplement as if we had authorized it. This prospectus and any prospectus supplement 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 prospectus supplement is accurate as of the dates on their covers.

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**TABLE OF CONTENTS**

	<b>Page</b>
Prospectus Summary	1
Fees and Expenses	5
Selected Condensed Consolidated Financial Data	6
Where You Can Find Additional Information	8
Risk Factors	9
Use of Proceeds	16
Price Range of Common Stock and Distributions	17
Management's Discussion and Analysis of Financial Condition and Results of Operations	18
Senior Securities	48
Business	52
Portfolio Companies	65
Determination of Net Asset Value	73
Management	76
Compensation of Executive Officers and Directors	82
Control Persons and Principal Holders of Securities	88
Certain Relationships and Related Party Transactions	90
Tax Status	91
Certain Government Regulations	95
Dividend Reinvestment Plan	99
Description of Capital Stock	100
Plan of Distribution	107
Legal Matters	108
Safekeeping, Transfer and Dividend Paying Agent and Registrar	108
Brokerage Allocation and Other Practices	108
Independent Public Accountants	108
Notice Regarding Arthur Andersen LLP	109
Index to Consolidated Financial Statements	F-1

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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 20,000,000 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. The prospectus supplement may also add, update or change information contained in this prospectus. Please carefully read this prospectus and any prospectus supplement together with the additional information described under "Where You Can Find Additional Information" in the Prospectus Summary section and "Risk Factors" 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 document and the documents to which we have referred.*

*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 52)**

As a business development company, we are in the private equity business. We provide long-term debt and equity capital. We have participated in the private equity business for over 40 years and have financed thousands of companies nationwide.

We believe the private equity capital markets are important to the growth of small and middle market companies, which often have difficulty accessing the public debt and equity capital markets because their capital needs are too small to be attractive to the public markets or because they are in need of long-term growth capital, which banks do not generally provide. We believe that we are well positioned to be a source of capital for such companies.

Our investment activity is primarily focused in three areas:

Lending subordinated debt with or without equity features to middle market companies (mezzanine investing),

Buying controlling equity stakes in middle market companies (buyout investing), and

Investing in non-investment grade classes of commercial mortgage-backed securities (CMBS) and collateralized debt obligations (CDOs). Our investment objective is to achieve current income and capital gains.

Our investments are long-term in nature, privately negotiated, and no readily available market exists for them. This makes our investments highly illiquid.

As a private equity investor, we spend significant time and effort identifying, structuring, performing due diligence, monitoring, valuing and ultimately exiting our investments. 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 private finance portfolio is primarily composed of mezzanine loans and equity securities. This capital is used by portfolio companies to fund growth, acquisitions, buyouts, recapitalizations, note purchases, bridge financings, or other types of financings. We generally target companies in less cyclical industries with, among other things, high return on invested capital, management teams with meaningful equity ownership, well-constructed balance sheets, and that have the ability to generate free cash flow.

Our primary commercial real estate investments are in the non-investment grade tranches of CMBS bonds. We generally invest at the initial issuance of the CMBS, and are able to re-underwrite the underlying collateral mortgages and negotiate to acquire the securities at significant discounts from their face value. In addition to our CMBS investments, we have invested in the bonds and preferred shares of CDOs.

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, diligence, structuring, or other fees. We

may also enhance our total return through capital gains.

As a private equity investor, we believe that we have certain competitive advantages including:

Access to public equity markets generally gives us a lower cost of capital than that of other private equity funds, and

Our capital structure is perpetual in nature and may enable us to be a better long-term partner for our portfolio companies than other private equity funds that may have a limited life.

We have elected to be treated 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 pay regular quarterly dividends based upon an estimate of our taxable earnings. Since 1963, our portfolio has 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, which includes private or thinly traded public, U.S.-based entities. A business development company must also maintain a coverage ratio of assets to senior securities of at least 200%. See Certain Government Regulations.

Our executive offices are located at 1919 Pennsylvania Avenue, NW, Washington, DC, 20006 and our telephone number is (202) 331-1112. In addition, we have regional offices in New York and Chicago.

Our Internet website address is [www.alliedcapital.com](http://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 73)**

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. At December 31, 2003, portfolio investments recorded at fair value were approximately 85% of our total assets.

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 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. 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, therefore, our equity security has also appreciated in value. Without a readily available market value and because of the inherent uncertainty of valuation, the fair value of our investments determined in good faith by the board of directors may differ significantly from the values that would have been used had a ready market existed for the investments, and the differences could be material.

We adjust quarterly the valuation of our portfolio to reflect the 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 107)*

We may offer, from time to time, up to 20,000,000 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 without delivering a prospectus supplement describing the method and terms of the offering of such shares.

#### **USE OF PROCEEDS** *(Page 16)*

We intend to use the net proceeds from selling shares of common stock for general corporate purposes, which includes investments in the debt or equity securities of primarily private companies, non-investment grade commercial mortgage-backed securities or the bonds and preferred shares of collateralized debt obligations, 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 17)*

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 99)*

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 9)

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

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. The absence of an active senior lending environment may slow the amount of private equity investment activity generally. As a result, the pace of our investment activity may slow.

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 our total return, if any.

Also, we are subject to certain risks associated with valuing our portfolio, investing in non-investment grade commercial mortgage-backed securities and collateralized debt obligations, 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 103)

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.

<b>Shareholder Transaction Expenses</b>	
Sales load (as a percentage of offering price) <sup>(1)</sup>	%
Dividend reinvestment plan fees <sup>(2)</sup>	None
<b>Annual Expenses (as a percentage of consolidated net assets attributable to common stock)<sup>(3)</sup></b>	
Operating expenses <sup>(4)</sup>	3.1%
Interest payments on borrowed funds <sup>(5)</sup>	4.0%
	<hr/>
Total annual expenses <sup>(6)</sup>	7.1%
	<hr/>

- (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 and preferred stock), which at December 31, 2003, was \$1.9 billion.
- (4) Operating expenses represent our operating expenses for the year ending December 31, 2003, excluding interest on indebtedness.
- (5) The Interest payments on borrowed funds represents our interest expenses for the year ending December 31, 2003. We had outstanding borrowings of \$954.2 million at December 31, 2003.
- (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 4.5% of consolidated total assets.

**Example**

The following example, required by the SEC, demonstrates the projected dollar amount of total cumulative expenses that would be incurred over various periods with respect to a hypothetical investment in us. In calculating the following expense amounts, we assumed we would have no additional leverage and that our operating expenses would remain at the levels set forth in the table above. 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	\$ 72	\$216	\$361	\$731

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 in this prospectus. Financial information for the years ended December 31, 2003 and 2002, has been derived from our financial statements that were audited by KPMG LLP. Financial information for the years ended December 31, 2001, 2000, and 1999, 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** on page 18 for more information.

(in thousands, except per share data)	Year Ended December 31,				
	2003	2002	2001	2000	1999
<b>Operating Data:</b>					
Interest and related portfolio income:					
Interest and dividends	\$ 290,719	\$ 264,042	\$ 240,464	\$ 182,307	\$ 121,112
Premiums from loan dispositions	8,172	2,776	2,504	16,138	14,284
Fees and other income	30,338	43,110	46,142	13,144	5,744
Total interest and related portfolio income	329,229	309,928	289,110	211,589	141,140
Expenses:					
Interest	77,233	70,443	65,104	57,412	34,860
Employee	36,945	33,126	29,656	26,025	22,889
Administrative	22,387	21,504	15,299	15,435	12,350
Total operating expenses	136,565	125,073	110,059	98,872	70,099
Net investment income before income taxes	192,664	184,855	179,051	112,717	71,041
Income tax expense (benefit)	(2,466)	930	(412)		
Net investment income	195,130	183,925	179,463	112,717	71,041
Net realized and unrealized gains (losses):					
Net realized gains	75,347	44,937	661	15,523	25,391
Net change in unrealized appreciation or depreciation	(78,466)	(571)	20,603	14,861	2,138
Total net gains (losses)	(3,119)	44,366	21,264	30,384	27,529
Net increase in net assets resulting from operations	\$ 192,011	\$ 228,291	\$ 200,727	\$ 143,101	\$ 98,570
<b>Per Share:</b>					
Diluted earnings per common share	\$ 1.62	\$ 2.20	\$ 2.16	\$ 1.94	\$ 1.64
Dividends per common share <sup>(1)</sup>	\$ 2.28	\$ 2.23	\$ 2.01	\$ 1.82	\$ 1.60
Weighted average common shares outstanding diluted <sup>(2)</sup>	118,351	103,574	93,003	73,472	60,044

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(in thousands, except per share data)	At December 31,				
	2003	2002	2001	2000	1999
<b>Balance Sheet Data:</b>					
Portfolio at value	\$2,584,599	\$2,488,167	\$2,329,590	\$1,788,001	\$1,228,497
Total assets	3,019,870	2,794,319	2,460,713	1,853,817	1,290,038
Total debt outstanding <sup>(3)</sup>	954,200	998,450	1,020,806	786,648	592,850
Preferred stock issued to Small Business Administration <sup>(3)</sup>	6,000	7,000	7,000	7,000	7,000
Shareholders' equity	1,914,577	1,546,071	1,352,123	1,029,692	667,513
Shareholders' equity per common share (net asset value) <sup>(4)</sup>	\$ 14.94	\$ 14.22	\$ 13.57	\$ 12.11	\$ 10.20
Common shares outstanding at period end <sup>(2)</sup>	128,118	108,698	99,607	85,057	65,414

	Year Ended December 31,				
	2003	2002	2001	2000	1999
<b>Other Data:</b>					
Investments funded	\$931,450	\$506,376	\$680,329	\$901,545	\$751,871
Repayments	338,153	143,167	74,461	111,031	139,561
Sales	445,814	213,474	129,980	280,244	198,368
Realized gains	94,305	95,562	10,107	28,604	31,536
Realized losses	(18,958)	(50,625)	(9,446)	(13,081)	(6,145)

(in thousands, except per share data)	2003				2002			
	Qtr 4	Qtr 3	Qtr 2	Qtr 1	Qtr 4	Qtr 3	Qtr 2	Qtr 1
<b>Quarterly Data (unaudited):</b>								
Total interest and related portfolio income	\$90,015	\$88,870	\$77,214	\$73,130	\$78,015	\$76,329	\$73,193	\$82,391
Net investment income	54,254	53,608	44,598	42,670	42,401	45,094	42,561	53,869
Net increase in net assets resulting from operations	78,454	33,744	59,940	19,873	53,356	45,520	73,454	55,961
Diluted earnings per common share	0.62	0.28	0.52	0.18	0.51	0.44	0.71	0.55
Dividends declared per common share <sup>(5)</sup>	0.57	0.57	0.57	0.57	0.59	0.56	0.55	0.53
Net asset value per common share <sup>(4)</sup>	14.94	14.46	14.23	14.05	14.22	13.95	14.02	13.71

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

(2) Excludes 234,977 and 516,779 common shares held in the deferred compensation trust at and for the years ended December 31, 2000 and 1999, respectively.

(3) See Senior Securities on page 48 for more information regarding our level of indebtedness.

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

(5) Dividends declared per common share for the fourth quarter of 2002 include the regular quarterly dividend of \$0.56 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. You may inspect the registration statement and the exhibits without charge at the SEC at 450 Fifth Street, NW, Washington, DC 20549. You may obtain copies from the SEC at prescribed rates.

We file annual, quarterly and current reports, proxy statements and other information with the SEC. You can inspect our SEC filings, without charge, at the SEC's Public Reference Room at 450 Fifth Street, NW, Washington, DC 20549. The SEC also maintains a web site at <http://www.sec.gov> that contains our SEC filings. You can also obtain copies of these materials from the SEC's Public Reference Room at 450 Fifth Street, NW, Washington, DC 20549, at prescribed rates. Please call the SEC at 1-800-SEC-0330 for further information on the Public Reference Room. Copies may also be obtained, after paying a duplicating fee, by electronic request to [publicinfo@sec.gov](mailto:publicinfo@sec.gov) or by written request to Public Reference Section, Washington, DC 20549. You can also inspect reports and other information we file at the offices of the New York Stock Exchange, and you are able to inspect those at 20 Broad Street, New York, NY 10005.

## RISK FACTORS

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

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

**Investing in private companies involves a high degree of risk.** Our portfolio consists of primarily long-term loans to and investments in private companies. Investments in private businesses involve a high degree of business and financial risk, which can result in substantial losses and accordingly should be considered speculative. There is generally no publicly available information about the companies in which we invest, and we rely significantly on the diligence of our employees and agents to obtain information in connection with our investment decisions. In addition, some smaller businesses have narrower product lines and market shares than their competition and may be more vulnerable to customer preferences, market conditions, loss of key personnel, or economic downturns, which may adversely affect the return on, or the recovery of, our investment in such businesses.

**Substantially all of our portfolio investments are recorded at fair value as determined in good faith by our board of directors and, as a result, there is uncertainty regarding the value of our portfolio investments.** At December 31, 2003, portfolio investments recorded at fair value were approximately 85% 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, therefore, our equity security

has also appreciated in value. Without a readily available market value and because of the inherent uncertainty of valuation, the fair value of our investments determined in good faith by the board of directors may differ significantly from the values that would have been used had a ready market existed for the investments, and the differences could be material.

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

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

Our business of making private equity investments and positioning them for liquidity events also may be affected by current and future market conditions. The absence of an active senior lending environment 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 amount and timing of gains realized on our investments.

**Our borrowers may default on their payments, which may have an effect on our financial performance.** We make long-term unsecured, subordinated loans and invest in equity securities, which may involve a higher degree of repayment risk. We primarily invest in companies that may have limited financial resources and that may be unable to obtain financing from traditional sources. Numerous factors may affect a borrower's ability to repay its loan, including the failure to meet its business plan, a downturn in its industry, or negative economic conditions. Deterioration in a borrower's financial condition and prospects may be accompanied by deterioration in any related collateral.

**Our private finance investments may not produce current returns or capital gains.** Private finance investments are typically structured as debt securities with a relatively high fixed rate of interest and with equity features such as conversion rights, warrants, or options. As a result, 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 Business Loan Express fails to perform as expected.** Business Loan Express, LLC (BLX) is our largest portfolio investment. Our financial results could be negatively affected if BLX, as a portfolio company, fails to perform as expected or if government funding for, or regulations related to the Small Business Administration 7(a) Guaranteed Loan Program change. At December 31, 2003, the investment totaled \$342.2 million at value, or 11.3% of total assets.



In addition, as controlling equity owner of BLX, we have provided an unconditional guaranty to BLX's senior credit facility lenders in an amount equal to 50% of BLX's total obligations on its \$215.0 million revolving credit facility. The amount we have guaranteed at December 31, 2003, was \$78.2 million. This guaranty can only be called in the event of a default by BLX. At December 31, 2003, we had also provided four standby letters of credit in connection with four term securitization transactions completed by BLX totaling \$35.6 million.

**Investments in non-investment grade commercial mortgage-backed securities and collateralized debt obligations may be illiquid, may have a higher risk of default, and may not produce current returns.** The commercial mortgage-backed securities and collateralized debt obligation bonds and preferred shares in which we invest are not investment grade, which means that nationally recognized statistical rating organizations rate them below the top four investment-grade rating categories (i.e., AAA through BBB), and are sometimes referred to as junk bonds. Non-investment grade commercial mortgage-backed securities and collateralized debt obligation bonds and preferred shares tend to be less liquid, may have a higher risk of default and may be more difficult to value. Non-investment grade securities usually provide a higher yield than do investment grade securities, but with the higher return comes greater risk of default. In addition, the fair value of these securities may change as interest rates change over time. Economic recessions or downturns may cause defaults or losses on collateral securing these securities to increase. Non-investment grade securities are considered speculative, and their capacity to pay principal and interest in accordance with the terms of their issue is not ensured.

**We may not borrow money unless we maintain asset coverage for indebtedness of at least 200%, which may affect returns to shareholders.** We must maintain asset coverage for total borrowings of at least 200%. Our ability to achieve our investment objective may depend in part on our continued ability to maintain a leveraged capital structure by borrowing from banks, insurance companies or other lenders on favorable terms. There can be no assurance that we will be able to maintain such leverage. If asset coverage declines to less than 200%, we may be required to sell a portion of our investments when it is disadvantageous to do so. As of December 31, 2003, our asset coverage for senior indebtedness was 322%.

**We borrow money, which magnifies the potential for gain or loss on amounts invested and may increase the risk of investing in us.** Borrowings, also known as leverage, magnify the potential for gain or loss on amounts invested and, therefore, increase the risks associated with investing in our securities. We borrow from and issue senior debt securities to banks, insurance companies, and other lenders. Lenders of these senior securities have fixed dollar claims on our consolidated assets that are superior to the claims of our common shareholders. If the value of our consolidated assets increases, then leveraging would cause the net asset value attributable to our common stock to increase more sharply than it would have had we not leveraged. Conversely, if the value of our consolidated assets decreases, leveraging would cause net asset value to decline more sharply than it otherwise would have had we not leveraged. Similarly, any increase in our consolidated income in excess of consolidated interest payable on the borrowed funds would cause our net income to increase more than it would without the leverage, while any decrease in our consolidated income would cause net income to decline more sharply than it would have had we not borrowed. Such a decline could negatively affect our ability to make common stock dividend payments. Leverage is generally considered a speculative investment technique.

At December 31, 2003, we had \$954.2 million of outstanding indebtedness bearing a weighted average annual interest cost of 7.5%. In order for us to cover these annual interest payments on indebtedness, we must achieve annual returns on our assets of at least 2.4%.

*Illustration.* The following table illustrates the effect of leverage on returns from an investment on 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) \$3,019.9 million in total assets, (ii) an average cost of funds of 7.5%, (iii) \$954.2 million in debt outstanding and (iv) \$1,914.6 million of shareholders' equity.

<b>Assumed Return on Our Portfolio</b>							
(net of expenses)							
	-20%	-10%	-5%	0%	5%	10%	20%
Corresponding return to shareholder	-35.6%	-19.8%	-11.9%	-4.0%	3.9%	11.7%	27.5%

**Changes in interest rates may affect our cost of capital and net investment income.** Because we borrow money to make investments, our net investment income is dependent upon the difference between the rate at which we borrow funds and the rate at which we invest these funds. As a result, there can be no assurance that a significant change in market interest rates will not have a material adverse effect on our net investment income. In periods of rising interest rates, our cost of funds would increase, which would reduce our net investment income. We use a combination of long-term and short-term borrowings and equity capital to finance our investing activities. We utilize our revolving line of credit as a means to bridge to long-term financing. Our long-term fixed-rate investments are financed primarily with long-term fixed-rate debt and equity. We may use interest rate risk management techniques in an effort to limit our exposure to interest rate fluctuations. Such techniques may include various interest rate hedging activities to the extent permitted by the 1940 Act. We have analyzed the potential impact of changes in interest rates on interest income net of interest expense. Assuming that the balance sheet were to remain constant and no actions were taken to alter the existing interest rate sensitivity, a hypothetical immediate 1% change in interest rates would have affected the net income by less than 1% over a one year horizon. Although management believes that this measure is indicative of our sensitivity to interest rate changes, it does not adjust for potential changes in credit quality, size and composition of the assets on the balance sheet and other business developments that could affect net increase in net assets resulting from operations, or net income. Accordingly, no assurances can be given that actual results would not differ materially from the potential outcome simulated by this estimate.

**We will continue to need additional capital to grow because we must distribute our income.** We will continue to need capital to fund growth in our investments. Historically, we have borrowed from financial institutions and have issued equity securities. A reduction in the availability of new capital could limit our ability to grow. We must distribute at least 90% of our taxable ordinary income, which excludes realized net long-term capital gains, to our shareholders to maintain our regulated investment company status. As a result, such earnings will not be available to fund investment originations. We expect to continue to borrow from financial institutions and issue additional debt and equity securities. If we fail to obtain funds from such sources or from other sources to fund our investments, it could limit our ability to grow, which could have a material adverse effect

on the value of our common stock. 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.

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

**There is a risk that you may not receive dividends or distributions.** We intend to make distributions on a quarterly basis to our stockholders. We may not be able to achieve operating results that will allow us to make distributions at a specific level or to increase the amount of these distributions from time to time. In addition, due to the asset coverage test applicable to us as a business development company, we may be limited in our ability to make distributions. Also, our credit facilities limit our ability to declare dividends if we default under certain provisions. If we do not distribute a certain percentage of our income annually, we will suffer adverse tax consequences, including possible loss of our status as a regulated investment company. In addition, in accordance with accounting principles generally accepted in the United States of America and tax regulations, we include in income certain amounts that we have not yet received in cash, such as contractual payment-in-kind interest which represents contractual interest added to the loan balance that becomes due at the end of the loan term. The increases in loan balances as a result of contractual payment-in-kind arrangements are included in income in advance of receiving cash payment and are separately included in the change in accrued or reinvested interest and dividends in our consolidated statement of cash flows. Since we may recognize income before or without receiving cash representing such income, we may have difficulty meeting the requirement to distribute at least 90% of our investment company taxable income to maintain our status as a regulated investment company.

**We operate in a competitive market for investment opportunities.** We compete for investments with a large number of private equity funds and mezzanine funds, investment banks and other equity and non-equity based investment funds, and other sources of financing, including traditional financial services companies such as commercial banks. Some of our competitors 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.

**We depend on 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.

**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.

**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, among others, variations in the investment origination volume and fee income earned, variation in timing of prepayments, variations in and the timing of the recognition of net realized gains or losses and changes in unrealized appreciation or depreciation, the degree to which we encounter competition in our markets, and general economic conditions.

**Our common stock price may be volatile.** The trading price of our common stock may fluctuate substantially. The price of the common stock may be higher or lower than the price you pay for your shares, depending on many factors, some of which are beyond our control and may not be directly related to our operating performance. These factors include the following:

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

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

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

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

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

general economic conditions and trends;

loss of a major funding source; or

departures of key personnel.

**Disclosure Regarding Forward-Looking Statements**

Information contained or incorporated by reference in this prospectus, and the accompanying prospectus supplement, if any, 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 or similar words or phrases. The matters described in Risk Factors and certain other factors noted throughout this prospectus, and the accompanying prospectus supplement, if any, and in any exhibits to the registration statement of which this prospectus, and the accompanying prospectus supplement, if any, 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 or any accompanying prospectus supplement 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 or any accompanying supplement to this prospectus.

**USE OF PROCEEDS**

We intend to use the net proceeds from selling shares of our common stock for general corporate purposes, which include investment in the debt or equity securities of primarily private companies or non-investment grade commercial mortgage-backed securities and collateralized debt obligation bonds and preferred shares, repayment of indebtedness, acquisitions and other general corporate purposes. We typically raise new equity when we have investment opportunities. 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, 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, and high quality debt securities maturing in one year or less from the time of investment. 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 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 March 31, 2004, the last reported closing sale price of our common stock was \$ 28.93 per share.

	NAV <sup>(1)</sup>	Closing Sale Price		Premium of High Sales Price to NAV	Premium of Low Sales Price to NAV	Declared Dividends
		High	Low			
<b>Year ended December 31, 2002</b>						
First Quarter	\$ 13.71	\$ 28.93	\$ 25.84	211%	188%	\$ 0.53
Second Quarter	14.02	27.66	20.88	197	149	0.55
Third Quarter	13.95	24.49	18.90	176	135	0.56
Fourth Quarter	14.22	22.87	18.90	161	133	0.56
Extra Dividend						0.03
<b>Year ended December 31, 2003</b>						
First Quarter	\$ 14.05	\$ 23.85	\$ 19.82	170%	141%	\$ 0.57
Second Quarter	14.23	25.16	19.85	177	139	0.57
Third Quarter	14.46	26.60	22.97	184	159	0.57
Fourth Quarter	14.94	28.16	24.63	188	165	0.57
<b>Year ending December 31, 2004</b>						
First Quarter (through March 31, 2004)	*			*	*	\$ 0.57

(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.

\* Net asset value has not yet been calculated for this period.

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. 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 2003 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 the financial information presented may represent unaudited, projected or pro forma financial information, and therefore may not be indicative of actual results. In addition, the private equity industry uses financial measures such as EBITDA or EBITDAM (Earnings Before Interest, Taxes, Depreciation, Amortization and, in some instances, Management fees) in order to assess a portfolio company's financial performance and to value a portfolio company. EBITDA and EBITDAM are not intended to represent cash flow from operations as defined by accounting principles generally accepted in the United States of America and such information should not be considered as an alternative to net income, cash flow from operations or any other measure of performance prescribed by accounting principles generally accepted in the United States of America.*

**OVERVIEW**

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



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Our portfolio composition at December 31, 2003, 2002, and 2001, was as follows:

	2003	2002	2001
Private finance	74%	70%	68%
Commercial real estate finance	26%	30%	32%

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

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

### PORTFOLIO AND INVESTMENT ACTIVITY

Total portfolio, investment activity, and yields at and for the years ended December 31, 2003, 2002, and 2001, were as follows:

	2003	2002	2001
(\$ in millions)			
Portfolio at value	\$2,584.6	\$2,488.2	\$2,329.6
Investments funded	\$ 931.5	\$ 506.4	\$ 680.3
Change in accrued or reinvested interest and dividends	\$ 45.0	\$ 44.7	\$ 51.6
Principal repayments	\$ 338.2	\$ 143.2	\$ 74.5
Sales	\$ 445.8	\$ 213.5	\$ 130.0
Yield <sup>(1)</sup>	14.7%	14.0%	14.3%

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

#### Private Finance

The private finance portfolio, investment activity, and yields at and for the years ended December 31, 2003, 2002, and 2001, were as follows:

	2003	2002	2001
(\$ in millions)			
Portfolio at value:			
Loans and debt securities	\$1,214.9	\$1,151.2	\$1,107.9
Equity interests	687.8	592.0	487.2
Total portfolio	\$1,902.7	\$1,743.2	\$1,595.1
Investments funded	\$ 498.0	\$ 297.2	\$ 287.7
Change in accrued or reinvested interest and dividends	\$ 41.8	\$ 42.6	\$ 48.9
Principal repayments	\$ 314.3	\$ 129.3	\$ 43.8
Yield <sup>(1)</sup>	15.0%	14.4%	14.8%



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

Investments funded for the years ended December 31, 2003, 2002, and 2001, consisted of the following:

(\$ in millions)	Loans and Debt Securities	Equity Interests	Total
<b><i>For the Year Ended December 31, 2003<sup>(1)</sup></i></b>			
Companies more than 25% owned	\$ 53.0	\$ 34.0	\$ 87.0
Companies 5% to 25% owned	23.8	1.9	25.7
Companies less than 5% owned	377.4	7.9	385.3
Total	\$454.2	\$43.8	\$498.0
<b><i>For the Year Ended December 31, 2002<sup>(1)</sup></i></b>			
Companies more than 25% owned	\$ 86.1	\$ 18.7	\$ 104.8
Companies 5% to 25% owned	22.3	0.4	22.7
Companies less than 5% owned	154.6	15.1	169.7
Total	\$263.0	\$34.2	\$297.2
<b><i>For the Year Ended December 31, 2001<sup>(1)</sup></i></b>			
Companies more than 25% owned	\$ 47.8	\$ 78.3	\$ 126.1
Companies 5% to 25% owned	13.5	4.5	18.0
Companies less than 5% owned	136.9	6.7	143.6
Total	\$ 198.2	\$ 89.5	\$ 287.7

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

The level of investment activity for investments funded and principal repayments for private finance investments can vary substantially from year to year depending on many factors, including the amount of debt and equity capital available to middle market companies, the level of merger and acquisition activity for such companies, the general economic environment, and the competitive environment for the types of investments we make. Over the last three years, we believe that there was a decline in the availability of senior debt capital from banks for middle market companies and there were fewer merger and acquisition transactions for these companies. In mid-2003, we began to see an increase in merger and acquisition activity and debt capital became more available. As a result, investments funded and principal repayments were higher for 2003 than for 2002 and 2001.

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 and then using that cash to make a subsequent investment.



At December 31, 2003, we had outstanding investment commitments to private finance portfolio companies totaling \$445.6 million. In addition, we had commitments to private finance portfolio companies in the form of standby letters of credit and guarantees totaling \$126.2 million.

Significant outstanding investment commitments included the following:

Approximately \$151 million in the form of subordinated debt and equity to recapitalize and acquire a majority interest in Advantage Sales & Marketing, Inc. The closing of this transaction is subject to customary closing conditions, including regulatory and shareholder approvals and certain other adjustments, and is anticipated to close in the first half of 2004.

Approximately \$100 million of financing to Callidus Capital Corporation to fund working capital, support warehouse facilities, and invest in the equity of future collateralized loan obligations issued by Callidus. This commitment will be funded as needed for working capital and growth over time.

Approximately \$70 million in debt and equity financing to acquire Mercury Air Centers, Inc. The closing of this transaction is subject to certain conditions, including the approval of the transaction by the shareholders of Mercury Air Group, Inc. It is anticipated that this transaction will close in early 2004. It is also anticipated that Mercury Air Group, Inc. will repay its \$24.0 million subordinated debt obligation to us as part of the transaction.

Our most significant investments at December 31, 2003, were in Business Loan Express, LLC (BLX), acquired in 2000, and The Hillman Companies, Inc. (Hillman), acquired in 2001.

***Business Loan Express, LLC.*** At December 31, 2003, our investment in BLX totaled \$255.1 million at cost and \$342.2 million at value, or 11.3% of our total assets, which included unrealized appreciation of \$87.1 million.

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

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

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

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\$25 million of preferred equity to support the growth needs of BLX post acquisition. As of December 31, 2003, the short-term revolving credit facility of \$25 million had been fully repaid to us.

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

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

Summary financial data for BLX at and for the three months ended December 31, 2003, and at and for its fiscal year ended September 30, 2003, is presented below. Summary financial data has been provided by BLX and is unaudited.

(\$ in millions)	At and for the Three Months Ended December 31, 2003 <sup>(1)</sup>	At and for the Fiscal Year Ended September 30, 2003
<b>Operating Data</b>		
Total revenue	\$ 36.5	\$ 108.3
Net income <sup>(2)</sup>	\$ 9.8	\$ 4.7
Earnings before interest, taxes and management fees (EBITM) <sup>(2)</sup>	\$ 18.8	\$ 37.5
<b>Balance Sheet Data</b>		
Total assets	\$ 385.2	\$ 353.0
Total debt	\$ 196.3	\$ 178.5
Total owners' equity	\$ 145.9	\$ 136.1
<b>Other Data</b>		
Loan originations		
SBA 7(a) loans	\$ 110.3	\$ 502.4
Conventional loans	66.7	151.6
USDA B&I loans	11.3	31.8
	<u>188.3</u>	<u>685.8</u>
	<b>\$ 188.3</b>	<b>\$ 685.8</b>
Serviced loan portfolio	\$2,339.3	\$2,227.4
Number of loans	3,271	3,136
Loan delinquencies <sup>(3)</sup>	8.4%	8.3%

(\$ in millions)	At and for the Three Months Ended December 31, 2003 <sup>(1)</sup>	At and for the Fiscal Year Ended September 30, 2003
<b>Serviced Loan Portfolio by Industry</b>		
Hotels	23%	24%
Gas stations/convenience stores	19	19
Professional and retail services	12	12
Restaurants	9	9
Manufacturing and industrial	9	9
Car wash/auto repair services	7	7
Child care and health care services	6	6
Recreation	5	5
Shrimp/fishing vessels	4	5
Other	6	4
Total	100%	100%

- (1) The results of operations for the three months ended December 31, 2003, are not necessarily indicative of the operating results to be expected for the full fiscal year.
- (2) For the year ended September 30, 2003, EBITM and net income were reduced by \$2.3 million due to costs associated with the AIF acquisition and the LLC reorganization and \$2.3 million due to the increased value of issued and outstanding equity appreciation rights. In addition, net income for the year ended September 30, 2003, was increased by \$3.4 million due to the reversal of certain net deferred tax liabilities upon the conversion of BLX from a corporation to a limited liability company. As an LLC, BLX is generally not subject to federal income tax; however, BLX is subject to certain state income and franchise taxes, and income taxes associated with a taxable subsidiary corporation.
- (3) Represents the percentage of loans in the total serviced loan portfolio that are greater than 30 days delinquent, which includes loans in workout status. Loans greater than 30 days delinquent for the SBA 7(a) loan portfolio only, which are included in the total serviced loan portfolio, were 8.8% at December 31, 2003. SBA 7(a) loans greater than one year old at December 31, 2003, had a delinquency rate of 11.0%. BLX will from time to time grant a 90-day deferment to borrowers experiencing short-term cash flow shortfalls. Loans that have been granted a deferment that perform as required are not considered delinquent consistent with SBA practice. The ability of small businesses to repay their loans may be adversely affected by numerous factors, including a downturn in their industry or negative economic conditions. Small businesses are also more vulnerable to customer preferences, competition, rising fuel prices and market conditions and, as a result, delinquencies in BLX's portfolio may increase. For instance, the shrimp and fishing industry has been affected by rising fuel costs and competition from imported shrimp. For these reasons, BLX focuses on collateral protection for each loan in addition to the cash flow of the small business and receives personal guarantees from the principal owners of the small business.
- BLX's revenues consist of cash premiums from guaranteed loan sales, gain on sale income arising from loans sold at par or securitized where BLX will receive future cash flows representing the spread between loan interest and the interest paid on bonds issued including service fee income, interest income on loans remaining in BLX's portfolio, and other income. Gain on sale income is a non-cash source of income when recognized, and as future cash flows are received, the resulting cash reduces the receivable or residual interest that is recognized when the loan is sold. The total of cash loan sale premiums, cash interest income and cash received from residual interests and other cash income is equal to approximately 76% of BLX's revenue of \$36.5 million for the three months ended December 31, 2003, and approximately 83% of BLX's revenue of \$108.3 million for the fiscal year ended September 30, 2003.

BLX's business is to originate small business loans and then sell substantially all of the loans originated for cash proceeds. Loans originated during the three months ended December 31, 2003, totaled \$188.3 million. Proceeds from loan sales during the three months ended December 31, 2003, totaled approximately \$193.2 million. Loans originated

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

At December 31, 2003, BLX had a three-year \$169.0 million revolving credit facility that was renewed in February 2004 with commitments of \$215.0 million. The facility matures in January 2007. As the controlling equity owner in BLX, we have provided an unconditional guaranty to the revolving credit facility lenders in an amount of up to 50% of the total obligations (consisting of principal, accrued interest, and other fees) of BLX under the revolving credit facility. The principal amount outstanding on the revolving credit facility at December 31, 2003, was \$156.2 million and the amount guaranteed by us was \$78.2 million. This guaranty can be called by the lenders only in the event of a default by BLX. BLX was in compliance with the terms of the revolving credit facility at December 31, 2003. At December 31, 2003, we had also provided four standby letters of credit in connection with four term securitization transactions completed by BLX totaling \$35.6 million.

BLX sells the guaranteed piece of SBA 7(a) guaranteed loans for cash premiums of up to 10% of the guaranteed loan amount plus a retained annual servicing fee generally between 1.0% and 2.4% of the guaranteed loan amount. Cash premiums received from guaranteed loan sales during the three months ended December 31, 2003, were approximately \$9.5 million in total. Cash premiums received from guaranteed loan sales during the fiscal year ended September 30, 2003, were approximately \$31.3 million in total.

Alternatively, BLX may sell the guaranteed pieces of SBA 7(a) guaranteed loans at par and receive cash only for the face amount of the loan sold, and instead of receiving a cash premium, BLX will receive an annual servicing spread on the loans sold of between 4.0% and 5.0%. In addition, BLX will sell the unguaranteed pieces of the SBA 7(a) loans and conventional loans it originates into a conduit facility. The conduit loans are securitized and BLX retains an interest of up to 5.0% of the loan pool. BLX then receives the excess of loan interest payments on the loans sold over the interest cost on the securities issued in the securitization over the life of the loan pool. BLX generally receives between 4.3% and 4.8% annually on the loans sold into the securitization pools.

When BLX sells a guaranteed piece of an SBA 7(a) loan at par, or when BLX securitizes a loan, it will record a residual interest and servicing asset, together referred to as the Residual Interest, in order to account for the retained interest in the loans sold and the net present value of the future cash flows it will receive from the loans sold or securitized. In computing the Residual Interest, BLX discounts estimated future cash flows after making assumptions as to future loan losses and loan prepayments, which may reduce future cash flows. For the three months ended December 31, 2003, BLX received cash payments from the Residual Interest of approximately \$15.8 million. For the fiscal year ended September 30, 2003, BLX received cash payments from the Residual Interest of approximately \$49.3 million.

At December 31, 2003, BLX's Residual Interest totaled \$181.6 million, representing BLX's estimate of the net present value of future cash flows of scheduled loan payments, after estimated future loan losses and loan prepayments. If scheduled loan payments were



to be received as stated in the loan agreements with no future losses or prepayments, BLX would receive future cash flows of \$780.1 million over time, with approximately \$61.0 million, \$56.2 million, \$54.7 million, and \$53.2 million (or \$225.1 million in the aggregate) scheduled to be received in the next four years ending on December 31, 2004, 2005, 2006, and 2007, respectively.

*The Hillman Companies, Inc.* At December 31, 2003, our investment in Hillman totaled \$94.6 million at cost and \$234.5 million at value, or 7.8% of total assets, which included unrealized appreciation of \$139.9 million.

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

During February 2004, we signed a definitive agreement to sell Hillman. The total transaction value pursuant to the definitive agreement is approximately \$510 million, including repayment of outstanding debt and adding the value of Hillman's outstanding trust preferred shares. As part of the transaction, we expect to be repaid our \$44.0 million in outstanding debt securities. Additionally, we expect to provide up to \$47.5 million in new mezzanine financing in conjunction with the transaction.

Our expected net cash proceeds are estimated to be \$192 million, subject to working capital and other adjustments. Based upon the agreed upon transaction value of \$510 million, we expect to realize a gain on this investment of approximately \$145 million, subject to working capital and other adjustments. The sale transaction is anticipated to close early in the second quarter of 2004 and is subject to certain closing conditions.

Summary financial data for Hillman is as follows. This data has been provided by Hillman and is unaudited. For the year ended December 31, 2003, Hillman had total revenue of \$318.4 million and adjusted earnings before interest, taxes, depreciation, amortization, and management fees, or EBITDAM, of \$54.9 million. Adjusted EBITDAM is before a write-down of \$11.3 million of a note receivable related to an investment made by Hillman. For the year ended December 31, 2003, Hillman had a loss before taxes of \$1.6 million, which includes the write-down of the note receivable. Hillman had total assets of \$355.8 million, total debt of \$148.3 million and trust preferred obligations at par of \$105.4 million at December 31, 2003.

**Commercial Real Estate Finance**

The commercial real estate finance portfolio, investment activity, and yields at and for the years ended December 31, 2003, 2002, and 2001, were as follows:

(\$ in millions)	2003		2002		2001	
	Value	Yield <sup>(1)</sup>	Value	Yield <sup>(1)</sup>	Value	Yield <sup>(1)</sup>
CMBS bonds	\$ 394.0	14.1%	\$ 555.5	14.2%	\$ 558.3	14.7%
CDO bonds and preferred shares	186.6	16.7%	52.8	17.2%	24.2	16.9%
Commercial mortgage loans	83.6	8.6%	63.7	7.5%	79.6	7.7%
Residual interest			69.0	9.4%	69.9	9.4%
Real estate owned	12.8		4.0		2.5	
Equity interests	4.9					
<b>Total portfolio</b>	<b>\$ 681.9</b>		<b>\$ 745.0</b>		<b>\$ 734.5</b>	
Investments funded	\$ 433.5		\$ 209.2		\$ 392.6	
Change in accrued or reinvested interest	\$ 3.2		\$ 2.1		\$ 2.7	
Principal repayments	\$ 23.9		\$ 13.9		\$ 30.7	
CMBS, CDO, and commercial real estate loan sales	\$ 445.8		\$ 213.5		\$ 130.0	

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

Our commercial real estate investment activity for the years ended December 31, 2003, 2002, and 2001, was as follows:

(\$ in millions)	Face Amount	Discount	Amount Funded
<b>For the Year Ended December 31, 2003</b>			
CMBS bonds	\$ 508.5	\$(225.9)	\$ 282.6
CDO bonds and preferred shares	145.8	(0.4)	145.4
Commercial mortgage loans	3.0		3.0
Equity interests	2.5		2.5
<b>Total</b>	<b>\$ 659.8</b>	<b>\$(226.3)</b>	<b>\$ 433.5</b>
<b>For the Year Ended December 31, 2002</b>			
CMBS bonds	\$ 302.5	\$(140.2)	\$ 162.3
CDO preferred shares	29.0		29.0
Commercial mortgage loans	11.7	(1.7)	10.0
Real estate owned	7.9		7.9
<b>Total</b>	<b>\$ 351.1</b>	<b>\$(141.9)</b>	<b>\$ 209.2</b>
<b>For the Year Ended December 31, 2001</b>			
CMBS bonds	\$ 661.4	\$(295.6)	\$ 365.8
CDO preferred shares	24.6		24.6

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Commercial mortgage loans	<u>2.2</u>	<u>          </u>	<u>2.2</u>
Total	<u>\$688.2</u>	<u>\$(295.6)</u>	<u>\$392.6</u>

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At December 31, 2003, we had outstanding funding commitments related to commercial mortgage loans and equity interests of \$1.2 million and commitments in the form of standby letters of credit and guarantees related to equity interests of \$2.7 million.

**CMBS Bonds.** During the year ended December 31, 2003, we invested \$282.6 million in 18 CMBS bond issuances, including \$73.4 million of investments in BB+, BB and BB- rated bonds in 8 CMBS issuances where the below BB- rated bonds were purchased by other parties. During the years ended December 31, 2002 and 2001, we invested \$162.3 million and \$365.8 million in 5 and 8 CMBS bond issuances, respectively. During 2002 and 2001, we did not invest in any CMBS issuances where the below BB- rated bonds were purchased by other parties.

The underlying pools of mortgage loans that are collateral for our investments in new CMBS bond issuances for the years ended December 31, 2003, 2002, and 2001, had respective original underwritten loan to value and underwritten debt service coverage ratios as follows:

Loan to Value Ranges (\$ in millions)	2003		2002		2001	
	Amount	Percentage	Amount	Percentage	Amount	Percentage
Less than 60%	\$ 4,114.3	22%	\$ 909.3	20%	\$ 1,259.7	15%
60-65%	1,582.8	9	287.3	6	941.6	11
65-70%	1,768.0	10	587.9	13	1,140.6	14
70-75%	4,024.3	22	1,214.5	27	2,400.4	29
75-80%	6,560.5	36	1,477.5	33	2,466.4	30
Greater than 80%	138.6	1	47.8	1	119.6	1
<b>Total</b>	<b>\$ 18,188.5</b>	<b>100%</b>	<b>\$ 4,524.3</b>	<b>100%</b>	<b>\$ 8,328.3</b>	<b>100%</b>
Weighted average loan to value	68.5%		68.5%		69.7%	

The underlying collateral for our CMBS bonds consists of pools of senior commercial mortgage loans where the loans, on average, were originally underwritten to achieve a loan to value ratio of approximately 70%. The weighted average original underwritten loan to value ratios of 68.5%, 68.5%, and 69.7% for 2003, 2002, and 2001, respectively, have remained fairly consistent and just below the targeted loan to value ratio of 70%.

Debt Service Coverage Ratio Ranges (\$ in millions)	2003		2002		2001	
	Amount	Percentage	Amount	Percentage	Amount	Percentage
Greater than 2.00	\$ 4,208.7	23%	\$ 366.9	8%	\$ 484.8	6%
1.76 2.00	2,094.6	12	229.6	5	158.2	2
1.51 1.75	3,132.8	17	477.4	11	855.0	10
1.26 1.50	7,362.9	40	2,739.6	60	5,008.3	60
Less than 1.25	1,389.5	8	710.8	16	1,822.0	22
<b>Total</b>	<b>\$ 18,188.5</b>	<b>100%</b>	<b>\$ 4,524.3</b>	<b>100%</b>	<b>\$ 8,328.3</b>	<b>100%</b>
Weighted average debt service coverage ratio	1.73		1.41		1.48	

The weighted average original underwritten debt service coverage ratios, defined as the annual net cash flow before debt service divided by annual debt service payments, were 1.73, 1.41, and 1.48 for 2003, 2002, and 2001, respectively. The higher weighted average underwritten debt service coverage ratio for 2003 as compared to 2002 and 2001 generally



results from a lower interest rate environment in 2003 for the mortgage loans in the underlying collateral pools. Lower interest rates have translated into lower annual debt service payments, which include interest and principal, and thus higher debt service coverage.

From time to time, we may sell lower yielding CMBS bonds rated BB+ through BB-, and to a lesser extent CMBS bonds rated B+ and B, in order to maximize the return on our CMBS bond portfolio. The cost basis of and proceeds from CMBS bonds sold, the related net realized gains from these sales, and the weighted average yield on the CMBS bonds sold for the years ended December 31, 2003, 2002, and 2001, were as follows:

(\$ in millions)	2003	2002	2001
Cost basis	\$412.3	\$205.9	\$124.5
Gross sales proceeds <sup>(1)</sup>	\$446.8	\$225.6	\$126.8
Net realized gains (net of related hedge gains or losses)	\$ 31.6	\$ 19.1	\$ 1.7
Weighted average yield	10.1%	11.5%	10.3%

(1) Gross sales proceeds represent the total cash consideration received, including the repayment of the cost basis of the bonds and proceeds related to the net realized gains on the bonds.

The non-investment grade and unrated tranches of the CMBS bonds in which we invest are junior in priority for payment of interest and principal to the more senior tranches of the related CMBS bond issuance. Cash flow from the underlying mortgages generally is allocated first to the senior tranches, with the most senior tranches having a priority right to the cash flow. Then, any remaining cash flow is allocated, generally, among the other tranches in order of their relative seniority. To the extent there are defaults and unrecoverable losses on the underlying mortgages resulting in reduced cash flows, our most subordinate tranche will bear this loss first. At December 31, 2003, the CMBS bonds were subordinate to 87% to 99% of the tranches of bonds issued in these various CMBS transactions. Given that the non-investment grade CMBS bonds in which we invest are junior in priority for payment of interest and principal, we invest in these CMBS bonds at a discount from the face amount of the bonds. The discount increases with the decrease in the seniority of the CMBS bonds. For the years ended December 31, 2003, 2002, and 2001, the average discount for the CMBS bonds in which we invested was 44%, 46% and 45%, respectively.

At December 31, 2003, the unamortized discount related to the CMBS bond portfolio was \$617.4 million, of which \$295.8 million has been set aside to absorb potential future losses. The yield on the CMBS bonds of 14.1% assumes that this amount that has been set aside will not be amortized. As the amount of future losses and the expected timing of recognition of such losses is difficult to predict and are subject to future events which may alter these assumptions, no assurance can be given that the anticipated yield will be achieved. At December 31, 2003, the CMBS bond portfolio had a fair value of \$394.0 million, which included net unrealized depreciation on the CMBS bonds of \$5.1 million.

The yield on our CMBS bond portfolio at December 31, 2003, 2002, and 2001, was 14.1%, 14.2%, and 14.7%, respectively. The yield on the CMBS bond portfolio at any point in time will vary depending on the concentration of lower yielding BB+, BB, and BB- rated CMBS bonds held in the portfolio. The BB+, BB, and BB- rated CMBS bonds

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totaled \$88.4 million, \$110.9 million, and \$166.2 million at value and had a yield of 8.2%, 8.8%, and 11.2% at December 31, 2003, 2002, and 2001, respectively.

At December 31, 2003 and 2002, we held CMBS bonds in 38 and 27 separate CMBS issuances, respectively. The underlying collateral pool, consisting of commercial mortgage loans and real estate owned ( REO ) properties, for these CMBS bonds consisted of the following:

(\$ in millions)	2003	2002
Approximate number of loans and REO properties <sup>(1)</sup>	5,600	4,500
Total outstanding principal balance	\$38,437	\$24,974
Loans over 30 days delinquent or classified as REO properties <sup>(2)</sup>	1.5% <sup>(3)</sup>	1.0% <sup>(3)</sup>

(1) Includes approximately 22 and 12 REO properties obtained through the foreclosure of commercial mortgage loans at December 31, 2003 and 2002, respectively.

(2) As a percentage of total outstanding principal balance.

(3) At December 31, 2003 and 2002, our investments included bonds in the first loss, unrated bond class in 34 and 27 separate CMBS issuances, respectively. For these issuances, loans over 30 days delinquent or classified as REO properties were 1.7% and 1.0% of the total outstanding principal balance at December 31, 2003 and 2002, respectively.

At December 31, 2003, the age of our bonds with a rating class of B+ and lower was as follows:

(\$ in millions)	2003	
	Value	Percentage
Less than one year old	\$ 83.9	27.5%
One to two years old	41.0	13.4
Two to three years old	43.8	14.3
Three years old or older	136.9	44.8
Total	\$305.6	100.0%

**Collateralized Debt Obligation Bonds and Preferred Shares.** During the years ended December 31, 2003, 2002, and 2001, we invested in the BBB rated bonds, BB rated bonds and preferred shares of 3, 3, and 1 collateralized debt obligations ( CDO ), respectively, which are generally secured by investment grade unsecured debt issued by various real estate investment trusts, or REITs, and investment and non-investment grade CMBS bonds.

During the year ended December 31, 2003, we sold \$13.9 million of CDO bonds and preferred shares for a net realized loss of \$73 thousand, net of the related hedge loss.

The BBB and BB rated bonds and the preferred shares of the seven CDOs in which we have invested are junior in priority for payment of interest and principal to the more senior tranches of debt issued by the CDOs. To the extent there are defaults and unrecoverable losses on the underlying collateral that result in reduced cash flows, the preferred shares will bear this loss first and then the bonds would bear any loss after the preferred shares. At December 31, 2003, our BBB and BB rated bonds in the CDO were subordinate to 61% to 93% of the more senior tranches of debt issued in the CDO transactions and the preferred shares in the CDOs were subordinate to 84% to 98% of the more senior tranches of debt issued in the various CDO transactions. In addition, included

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in the CMBS collateral for the CDOs at December 31, 2003, are certain CMBS bonds that are senior in priority of repayment to certain lower rated CMBS bonds held by us.

The yield on our CDO bonds and preferred shares at December 31, 2003, 2002, and 2001, was 16.7%, 17.2%, and 16.9%, respectively. The yield on the CDO portfolio at any point in time will generally vary depending on the amount of lower yielding BBB and BB rated CDO bonds held in the portfolio.

At December 31, 2003 and 2002, the underlying collateral for our investments in the seven and four outstanding CDO issuances, respectively, had balances as follows:

(\$ in millions)	2003	2002
Investment grade REIT debt <sup>(1)</sup>	\$ 1,338.0	\$ 1,016.9
Investment grade CMBS bonds <sup>(2)</sup>	670.8	494.2
Non-investment grade CMBS bonds <sup>(3)</sup>	1,125.2	438.3
Other collateral	32.4	8.2
<b>Total collateral</b>	<b>\$ 3,166.4</b>	<b>\$ 1,957.6</b>

(1) Issued by 50 and 40 REITs, respectively, for the respective periods presented.

(2) Issued in 79 and 43 transactions, respectively, for the respective periods presented.

(3) Issued in 70 and 33 transactions, respectively, for the respective periods presented.

### Portfolio Asset Quality

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

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

Grade	2003		2002	
	Portfolio at Value	Percentage of Total Portfolio	Portfolio at Value	Percentage of Total Portfolio
(\$ in millions)				
1	\$ 985.1	38.1%	\$ 801.0	32.1%
2	1,271.4	49.2	1,400.8	56.3
3	212.4	8.2	166.0	6.7
4	34.7	1.4	23.6	1.0
5	81.0	3.1	96.8	3.9
	<b>\$ 2,584.6</b>	<b>100.0%</b>	<b>\$ 2,488.2</b>	<b>100.0%</b>

Total Grade 4 and 5 assets as a percentage of the total portfolio at value at December 31, 2003 and 2002, were 4.5% and 4.9%, respectively. Included in Grade 4 and 5 assets at December 31, 2003 and 2002, were assets totaling \$26.8 million and \$24.1 million, respectively, that are secured by commercial real estate. Grade 4 and 5 assets include loans, debt securities, and equity securities. We expect that a number of portfolio companies will be in the Grades 4 or 5 categories from time to time. Part of the





business of private finance is working with troubled portfolio companies to improve their businesses and protect our investment. The number of portfolio companies and related investment amount included in Grades 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. We continue to include our CMBS portfolio in Grade 2 assets, as we are uncertain as to whether the unrealized appreciation or depreciation on our CMBS portfolio at December 31, 2003, will necessarily result in a realized gain or loss.

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

At December 31, 2003 and 2002, loans and debt securities at value not accruing interest for the total investment portfolio were as follows:

	2003	2002
(\$ in millions)		
Loans and debt securities in workout status (classified as Grade 4 or 5) <sup>(1)</sup>	\$ 69.4	\$ 89.1
Not in workout companies more than 50% owned	31.9	63.6
Not in workout companies less than 50% owned	16.7	7.2
	<hr/>	<hr/>
Total	\$118.0	\$159.9
	<hr/>	<hr/>
Percentage of total portfolio	4.6%	6.4%

(1) Workout loans and debt securities exclude equity securities that are included in the total Grade 4 and 5 assets above. Includes commercial real estate loans of \$6.8 million and \$13.0 million at December 31, 2003 and 2002, respectively.

**Loans and Debt Securities Over 90 Days Delinquent.** Loans and debt securities greater than 90 days delinquent were \$129.6 million and \$103.1 million at value, or 5.0% and 4.1% of the total portfolio at December 31, 2003 and 2002, respectively. Included in this category were secured real estate loans and CMBS bonds valued at \$44.0 million and \$26.0 million, respectively.

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

For CMBS bonds, interest payments are made to bondholders from the cash flow on the underlying collateral. To the extent there are defaults and unrecoverable losses on the

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

Given these factors, the amount of loans, debt securities, or CMBS bonds on non-accrual status or greater than 90 days delinquent is not necessarily an indication of future principal loss or loss of anticipated investment return. Our portfolio grading system is used as a means to assess loss of investment return or investment principal.

### **Hedging Activities**

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

The total obligations to replenish borrowed Treasury securities, including accrued interest payable on the obligations, were \$98.5 million and \$197.0 million at December 31, 2003 and 2002, respectively. The net proceeds related to the sales of the borrowed Treasury securities plus the additional cash collateral provided under the terms of the transactions were \$98.5 million and \$194.7 million at December 31, 2003 and 2002, respectively. The amount of the hedge will vary from period to period depending upon the amount of higher rated CMBS bonds and CDO bonds that we own and have hedged on the balance sheet date.

**RESULTS OF OPERATIONS****Comparison of the Years Ended December 31, 2003, 2002, and 2001**

The following table summarizes our operating results for the years ended December 31, 2003, 2002, and 2001.

(in thousands, except per share amounts)	2003	2002	Change	Percent Change	2002	2001	Change	Percent Change
<b>Interest and Related Portfolio Income</b>								
Interest and dividends	\$ 290,719	\$ 264,042	\$ 26,677	10%	\$ 264,042	\$ 240,464	\$ 23,578	10%
Premiums from loan dispositions	8,172	2,776	5,396	194%	2,776	2,504	272	11%
Fees and other income	30,338	43,110	(12,772)	(30)%	43,110	46,142	(3,032)	(7)%
<b>Total interest and related portfolio income</b>	<b>329,229</b>	<b>309,928</b>	<b>19,301</b>	<b>6%</b>	<b>309,928</b>	<b>289,110</b>	<b>20,818</b>	<b>7%</b>
<b>Expenses</b>								
Interest	77,233	70,443	6,790	10%	70,443	65,104	5,339	8%
Employee <sup>(1)</sup>	36,945	33,126	3,819	12%	33,126	29,656	3,470	12%
Administrative <sup>(1)</sup>	22,387	21,504	883	4%	21,504	15,299	6,205	41%
<b>Total operating expenses</b>	<b>136,565</b>	<b>125,073</b>	<b>11,492</b>	<b>9%</b>	<b>125,073</b>	<b>110,059</b>	<b>15,014</b>	<b>14%</b>
<b>Net investment income before income taxes</b>	<b>192,664</b>	<b>184,855</b>	<b>7,809</b>	<b>4%</b>	<b>184,855</b>	<b>179,051</b>	<b>5,804</b>	<b>3%</b>
Income tax expense (benefit)	(2,466)	930	(3,396)	365%	930	(412)	1,342	(326)%
<b>Net investment income</b>	<b>195,130</b>	<b>183,925</b>	<b>11,205</b>	<b>6%</b>	<b>183,925</b>	<b>179,463</b>	<b>4,462</b>	<b>2%</b>
<b>Net Realized and Unrealized Gains (Losses)</b>								
Net realized gains	75,347	44,937	30,410	68%	44,937	661	44,276	6,698%
Net change in unrealized appreciation or depreciation	(78,466)	(571)	(77,895)	*	(571)	20,603	(21,174)	*
<b>Total net gains (losses)</b>	<b>(3,119)</b>	<b>44,366</b>	<b>(47,485)</b>	<b>(107)%</b>	<b>44,366</b>	<b>21,264</b>	<b>23,102</b>	<b>109%</b>
<b>Net income</b>	<b>\$ 192,011</b>	<b>\$ 228,291</b>	<b>\$(36,280)</b>	<b>(16)%</b>	<b>\$ 228,291</b>	<b>\$ 200,727</b>	<b>\$ 27,564</b>	<b>14%</b>
<b>Diluted earnings per common share</b>	<b>\$ 1.62</b>	<b>\$ 2.20</b>	<b>\$ (0.58)</b>	<b>(26)%</b>	<b>\$ 2.20</b>	<b>\$ 2.16</b>	<b>\$ 0.04</b>	<b>2%</b>
<b>Weighted average common shares outstanding diluted</b>	<b>118,351</b>	<b>103,574</b>	<b>14,777</b>	<b>14%</b>	<b>103,574</b>	<b>93,003</b>	<b>10,571</b>	<b>11%</b>

(1) Employee and administrative expenses for the year ended December 31, 2002, include costs associated with the closing of our German office of \$0.5 million and \$2.5 million, respectively, for a total of \$3.0 million, or \$0.03 per common share.

\* Net change in unrealized appreciation or depreciation can fluctuate significantly from year to year.

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

Interest and dividend income for the years ended December 31, 2003, 2002, and 2001, was composed of the following:

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(\$ in millions)	2003	2002	2001
Interest	\$275.3	\$259.4	\$237.1
Dividends	15.4	4.6	3.4
	<u>          </u>	<u>          </u>	<u>          </u>
Total	\$290.7	\$264.0	\$240.5
	<b>          </b>	<b>          </b>	<b>          </b>

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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. The weighted average yield varies from period to period based on the current stated interest rate earned on interest-bearing investments and the amount of loans and debt securities for which interest is not accruing. The interest-bearing investments in the portfolio and the weighted average yield on the interest-bearing investments in the portfolio at December 31, 2003, 2002, and 2001, was as follows:

(\$ in millions)	2003	2002	2001
Interest-bearing portfolio	\$ 1,888.4	\$ 1,896.2	\$ 1,842.4
Portfolio yield	14.7%	14.0%	14.3%

Dividend income results from the dividend yield on preferred equity interests, if any, or the declaration of dividends by a portfolio company on preferred or common equity interests. Dividend income will vary from period to period depending upon the level of yield on our preferred equity interests and the timing and amount of dividends that are declared by a portfolio company on preferred or common equity interests. Dividend income increased in 2003 primarily due to the receipt of dividends from BLX on the Class B equity interests held by us. The total dividend declared by BLX was \$7.8 million and this dividend was paid through the issuance of additional Class B equity interests.

Included in premiums from loan dispositions are prepayment premiums of \$8.2 million, \$2.8 million, and \$2.0 million for the years ended December 31, 2003, 2002, and 2001, respectively. Prepayment premiums increased in 2003 due to an increase in loan prepayments during the prepayment penalty period. While the scheduled maturities of private finance and commercial real estate loans range from five to ten years, it is not unusual for our borrowers to refinance or pay off their debts to us ahead of schedule. Therefore, we generally structure our loans to require a prepayment premium for the first three to five years of the loan.

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

Fees and other income for the years ended December 31, 2003, 2002, and 2001, included fees relating to the following:

(\$ in millions)	2003	2002	2001
Structuring and diligence	\$ 6.1	\$ 15.0	\$ 15.5
Transaction and other services provided to portfolio companies	4.5	4.4	16.6
Management services provided to portfolio companies, other advisory services and guaranty fees	18.7	23.2	13.1
Other income	1.0	0.5	0.9
<b>Total</b>	<b>\$ 30.3</b>	<b>\$ 43.1</b>	<b>\$ 46.1</b>

Fees and other income are generally related to specific transactions or services and therefore may vary substantially from period to period depending on the level and types of

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

BLX and Hillman were our most significant portfolio investments at December 31, 2003, and together represented 19.1%, 15.6%, and 13.2% of our total assets at December 31, 2003, 2002, and 2001, respectively. Total interest and related portfolio income earned from these investments for the years ended December 31, 2003, 2002, and 2001, were \$56.4 million, \$49.5 million, and \$39.6 million, respectively.

In February 2004, we entered into an agreement to sell Hillman. We anticipate the sale transaction to close early in the second quarter of 2004. As part of the transaction, we expect to be repaid in full on our currently outstanding debt securities of \$44.0 million and expect to provide up to \$47.5 million in new debt financing to Hillman in conjunction with the transaction. Upon completion of the sale, we will no longer receive a management fee from Hillman. We estimate that this transaction will result in a net reduction to interest and related portfolio income for 2004 of approximately \$2.4 million.

In July 2002, we sold WyoTech Acquisition Corporation, which was a significant portfolio investment during 2002 and 2001. Total interest and related portfolio income earned on this investment for the years ended December 31, 2002 and 2001, was \$3.6 million and \$5.5 million, respectively.

**Operating Expenses.** Operating expenses include interest, employee, and administrative expenses. Our single largest expense is interest on our indebtedness. The fluctuations in interest expense during the years ended December 31, 2003, 2002, and 2001, are 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 interest cost, including fees and closing costs, at and for the years ended December 31, 2003, 2002, and 2001, were as follows:

(\$ in millions)	2003	2002	2001
Total Outstanding Debt	\$954.2	\$998.5	\$1,020.8
Average Outstanding Debt	\$943.5	\$938.1	\$ 847.1
Weighted Average Interest Cost	7.5%	6.9%	7.0%

In addition to interest on indebtedness, interest expense includes interest on our obligations to replenish borrowed Treasury securities related to our hedging activities of \$5.9 million and \$1.7 million for the years ended December 31, 2003 and 2002, respectively.

Employee expenses include salaries and employee benefits. The change in employee expense reflects the effect of wage increases, increased staffing, and the change in mix of employees given their area of responsibility and relevant experience level. Total employees were 125, 105, and 97 at December 31, 2003, 2002, and 2001, respectively. During the fourth quarter of 2002, we closed our office in Frankfurt, Germany, and as a result, we incurred additional employee costs of \$0.5 million for the year ended December 31, 2002.

Administrative expenses include legal and accounting fees, insurance premiums, the cost of leases for our headquarters in Washington, DC, and our regional offices, stock record expenses, directors' fees, and various other expenses. Administrative expenses have increased over the last two years from \$15.3 million for the year ended December 31, 2001, to \$22.4 million for the year ended December 31, 2003.

Administrative expenses were \$21.5 million for 2002, a \$6.2 million increase over administrative expenses of \$15.3 million for 2001. Higher expenses for 2002 were related to increased costs associated with legal, consulting and other fees related to market activity in

our stock, including costs incurred to defend against class action lawsuits, of approximately \$1.6 million, corporate liability insurance of \$0.9 million, travel costs of \$0.7 million, and outsourced technology assistance of \$0.7 million. In addition, for 2002 we incurred administrative costs of \$2.5 million related to the closing of our office in Frankfurt, Germany. Excluding costs associated with closing the Germany office, administrative expenses for 2002 were \$19.0 million, an increase of \$3.7 million over 2001.

Administrative expenses were \$22.4 million for 2003, a \$0.9 million increase over administrative expenses of \$21.5 million for 2002. Excluding costs associated with closing the Germany office in 2002, administrative expenses for 2003 increased by \$3.4 million over 2002. The net increase in legal, accounting, consulting and other fees for 2003 as compared to 2002 was \$0.8 million. While fees related to market activity in our stock were substantially lower in 2003 as compared to 2002, the level of professional fees incurred in 2003 still increased over 2002 as we incurred significant legal, accounting, consulting and other fees in 2003 related to the implementation of the requirements under the Sarbanes-Oxley Act of 2002. The remaining increase in administrative expenses for 2003 over 2002 was primarily due to increased costs associated with corporate liability insurance of \$1.4 million, travel costs of \$0.6 million, and directors' fees of \$0.5 million.

**Income Tax Expense (Benefit).** Our wholly owned subsidiary, AC Corp, is a corporation subject to federal and state income taxes and records an expense or benefit for income taxes as appropriate. For the years ended December 31, 2003 and 2001, we recorded a tax benefit of \$2.5 million and \$0.4 million, respectively, as a result of AC Corp's operating loss for the periods. For the year ended December 31, 2002, we recorded tax expense of \$0.9 million as a result of AC Corp's operating income for the period.

**Realized Gains and Losses.** Net realized gains result from the sale of equity securities associated with certain private finance investments, the sale of CMBS bonds, and the realization of unamortized discount resulting from the sale and early repayment of private finance loans and commercial mortgage loans, offset by losses on investments. Net realized gains and losses for the years ended December 31, 2003, 2002, and 2001, were as follows:

(\$ in millions)	2003	2002	2001
Realized Gains	\$ 94.3	\$ 95.5	\$ 10.1
Realized Losses	(19.0)	(50.6)	(9.4)
Net Realized Gains	\$ 75.3	\$ 44.9	\$ 0.7

Realized gains and losses for the years ended December 31, 2003, 2002, and 2001, resulted from various private finance and commercial real estate finance transactions.

Realized gains for the year ended December 31, 2003, primarily resulted from transactions involving 11 private finance portfolio companies, including Blue Rhino Corporation (\$12.6 million), CyberRep (\$9.6 million), Morton Grove Pharmaceuticals, Inc. (\$8.5 million), Warn Industries, Inc. (\$8.0 million), Woodstream Corporation (\$6.6 million), Kirkland's Inc. (\$3.0 million), Julius Koch USA, Inc. (\$2.8 million), GC-Sun Holdings II, LP (\$2.5 million), Interline Brands, Inc. (\$1.7 million), WyoTech Acquisition Corporation (\$1.3 million), and Advantage Mayer, Inc. (\$1.2 million). In addition, gains were also realized on CMBS bonds (\$31.6 million, net of a net realized loss of \$2.9 million from hedges related to the CMBS bonds sold) and commercial real estate investments (\$1.7 million).



Realized gains for the year ended December 31, 2002, primarily resulted from transactions involving eight private finance portfolio companies, including WyoTech Acquisition Corporation (\$60.8 million), Aurora Communications, LLC (\$4.9 million), Oriental Trading Company, Inc. (\$2.5 million), Kirkland's, Inc. (\$2.2 million), American Home Care Supply, LLC (\$1.3 million), Autania AG (\$0.8 million), FTI Consulting, Inc. (\$0.7 million), and Cumulus Media, Inc. (\$0.5 million). In addition, gains were also realized on CMBS bonds (\$19.1 million, net of a realized loss of \$0.5 million from a hedge related to the CMBS bonds sold), and one commercial real estate investment (\$1.3 million). The sale of WyoTech in 2002 was subject to post-closing adjustments, and during 2003, we recognized an additional realized gain of \$1.3 million related to post-closing items.

Realized gains for the year ended December 31, 2001, primarily resulted from transactions involving three private finance portfolio companies, including FTI Consulting, Inc. (\$4.6 million), SunSource Inc. (\$2.5 million), and Southwest PCS, LLC (\$0.8 million), and the sale of CMBS bonds (\$1.7 million).

For the years ended December 31, 2003, 2002, and 2001, we reversed previously recorded unrealized appreciation totaling \$78.5 million, \$78.8 million, and \$6.5 million, respectively, when gains were realized. When we exit an investment and realize a gain, we make an accounting entry to reverse any unrealized appreciation we had previously recorded to reflect the appreciated value of the investment.

Realized losses for the year ended December 31, 2003, primarily resulted from transactions involving three private finance portfolio companies, including Allied Office Products, Inc. (\$7.7 million), Candlewood Hotel Company (\$2.7 million), and North American Archery, LLC (\$2.1 million), and eight transactions involving commercial mortgage loans (\$5.9 million).

Realized losses for the year ended December 31, 2002, primarily resulted from transactions involving 11 private finance portfolio companies, including Velocita, Inc. (\$16.0 million), Schwinn Holdings Corporation (\$7.9 million), Convenience Corporation of America (\$5.8 million), Startec Global Communications Corporation (\$4.5 million), The Loewen Group, Inc. (\$2.7 million), Monitoring Solutions, Inc. (\$1.7 million), Most Coniferie (\$1.0 million), NetCare AG (\$1.0 million), iSolve Incorporated (\$0.9 million), Sure-Tel, Inc. (\$0.5 million), and Soff-Cut Holdings, Inc. (\$0.5 million), and also from nine commercial real estate investments (\$4.7 million).

Realized losses for the year ended December 31, 2001, primarily resulted from transactions involving three private finance portfolio companies, including Pico Products, Inc. (\$2.9 million), Allied Office Products, Inc. (\$2.5 million), and Genesis Worldwide, Inc. (\$1.1 million), and the continued liquidation of our whole loan commercial real estate portfolio.

For the years ended December 31, 2003, 2002, and 2001, we reversed previously recorded unrealized depreciation totaling \$20.3 million, \$49.0 million, and \$8.9 million, respectively, when losses were realized. When we exit an investment and realize a loss, we make an accounting entry to reverse any unrealized depreciation we had previously recorded to reflect the depreciated value of the investment.

***Change in Unrealized Appreciation or Depreciation.*** We determine the value of each investment in our portfolio on a quarterly basis, and changes in value result in unrealized appreciation or depreciation being recognized in our statement of operations. Value, as defined in Section 2(a)(41) of the Investment Company Act of 1940, is (i) the market

price for those securities for which a market quotation is readily available and (ii) for all other securities and assets, fair value is as determined in good faith by the board of directors. Since there is typically no readily available market value for the investments in our portfolio, we value substantially all of our portfolio investments at fair value as determined in good faith by the board of directors pursuant to a valuation policy and a consistently applied valuation process. At December 31, 2003, portfolio investments recorded at fair value were approximately 85% 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, therefore, our equity security has also appreciated in value. Changes in fair value are recorded in the statement of operations as net change in unrealized appreciation or depreciation.

As a business development company, we invest in illiquid securities including debt and equity securities of companies, non-investment grade CMBS bonds, and CDO bonds and preferred shares. The structure of each private finance debt and equity security is specifically negotiated to enable us to protect our investment and maximize our returns. We include many terms governing interest rate, repayment terms, prepayment penalties, financial covenants, operating covenants, ownership parameters, dilution parameters, liquidation preferences, voting rights, and put or call rights. Our investments are generally subject to restrictions on resale and generally have no established trading market. Because of the type of investments that we make and the nature of our business, our valuation process requires an analysis of various factors. Our fair value methodology includes the examination of, among other things, the underlying investment performance, financial condition, and market changing events that impact valuation.

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

There is no one methodology to determine enterprise value and, in fact, for any one portfolio company, enterprise value is best expressed as a range of fair values, from which we derive a single estimate of enterprise value. To determine the enterprise value of a

portfolio company, we analyze its historical and projected financial results. We generally require portfolio companies to provide annual audited and 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 accounting principles generally accepted in the United States of America and such information should not be considered as an alternative to net income, cash flow from operations, or any other measure of performance prescribed by accounting principles generally accepted in the United States of America. When using EBITDA to determine enterprise value, we may adjust EBITDA for non-recurring items. Such adjustments are intended to normalize EBITDA to reflect the portfolio company's earnings power. Adjustments to EBITDA may include compensation to previous owners, acquisition, recapitalization, or restructuring related items or one-time non-recurring income or expense items.

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

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

*Valuation Methodology* CMBS Bonds and CDO Bonds and Preferred Shares CMBS bonds and CDO bonds and preferred shares are carried at fair value, which is based on a discounted cash flow model that utilizes prepayment and loss assumptions based on historical experience and projected performance, economic factors, the characteristics of the underlying cash flow and comparable yields for similar CMBS bonds and CDO bonds and preferred shares. Our assumption with regard to discount rate is based on the yield of comparable securities. We recognize unrealized appreciation or depreciation on our CMBS bonds and CDO bonds and preferred shares as comparable yields in the market change and/or based on changes in estimated cash flows resulting from changes in prepayment or loss assumptions in the underlying collateral pool.

*Net Change in Unrealized Appreciation or Depreciation.* For the portfolio, net change in unrealized appreciation or depreciation for the years ended December 31, 2003, 2002, and 2001, consisted of the following:

(\$ in millions)	2003	2002	2001
Net unrealized appreciation or depreciation	\$(20.3)	\$ 29.2	\$ 18.2
Reversal of previously recorded unrealized appreciation associated with realized gains	(78.5)	(78.8)	(6.5)
Reversal of previously recorded unrealized depreciation associated with realized losses	20.3	49.0	8.9
Net change in unrealized appreciation or depreciation	\$(78.5)	\$ (0.6)	\$20.6

At December 31, 2003, our two most significant portfolio investments were in BLX and Hillman. The following is a summary of the methodology that we used to determine the fair value of these investments.

**Business Loan Express, LLC.** To determine the value of our investment in BLX at December 31, 2003, 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 performed the analyses with the assistance of a consultant, JMP Securities LLC.

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. Since December 31, 2002, we have consistently used CIT Group, Inc., Financial Federal Corporation, GATX Corporation, PMC Capital, Inc., and HPSC, Inc. in the comparable group. At December 31, 2002, we also included DVI, Inc. and Vestin Group, Inc. in the group; however, beginning with the quarter ended September 30, 2003, these companies were no longer included in the group because they were no longer deemed comparable due to specific matters related to those companies. Beginning with the quarter ended September 30, 2003, we added CapitalSource Inc. to the group as this company went public during the third quarter of 2003. Beginning with December 31, 2003, we added Marlin Business Services Corp. to the comparable group since this company went public during the fourth quarter of 2003. As of December 31, 2003, PMC Capital, Inc. and HSPC, Inc. were removed from the public comparable group and instead included with the merger and acquisitions transactions for financial services companies group because both companies announced agreements to sell their respective company.

The SBA 7(a) Guaranteed Loan Program is currently operating under certain limitations due to a high demand for 7(a) loans and an inadequate federal budget authority. At this time, based upon our analysis of BLX's position in the market, the strength of its non-SBA conventional loan program and the current state of the SBA 7(a) loan program, we do not believe there will be any long-term adverse effect on BLX. At December 31, 2003, we did, however, take an additional discount in determining the value of our investment in BLX to account for the recent uncertainty surrounding the SBA 7(a) program. After this discount, our investment in BLX at December 31, 2003, was valued at \$342.2 million. This fair value was within the range of values determined by the four

valuation analyses. Unrealized appreciation on our investment was \$87.1 million at December 31, 2003, an increase in unrealized appreciation of \$51.7 million for the year ended December 31, 2003.

The value of our investment in BLX's Class B and Class C equity interests was \$254.3 million at December 31, 2003. The value of our Class B and Class C equity interests are at an implied trailing price to pro-forma earnings ratio of approximately 10.8 times and on an implied forward projected price to pro-forma earnings ratio of approximately 8.7 times. The fair value of BLX's Class B and Class C equity interests is at an implied multiple of investor cost basis of approximately 1.5 times.

**The Hillman Companies, Inc.** In February of 2004, a definitive agreement was signed to sell Hillman that indicated an enterprise value for the company of \$510 million. At December 31, 2003, we estimated the enterprise value for Hillman to be approximately \$500 million, given that the sale is still subject to working capital and other adjustments and certain closing conditions. At an enterprise value of \$500 million, our investment in Hillman at value totaled \$234.5 million at December 31, 2003. This included unrealized appreciation of \$139.9 million, an increase in unrealized appreciation of \$52.0 million for the year ended December 31, 2003.

## OTHER MATTERS

**Per Share Amounts.** All per share amounts included in the Management's Discussion and Analysis of Financial Condition and Results of Operations section have been computed using the weighted average shares used to compute diluted earnings per share, which were 118.4 million, 103.6 million, and 93.0 million for the years ended December 31, 2003, 2002, and 2001, respectively.

**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 capital gains, to the extent that such taxable income or gains are distributed, or deemed to be distributed, as dividends to our shareholders on a timely basis. Annual tax distributions generally differ from net income for the fiscal year due to temporary and permanent differences in the recognition of income and expenses, returns of capital and net unrealized appreciation or depreciation, which are not included in taxable income.

In order to maintain our status as a regulated investment company, we must, in general, (1) continue to qualify as a business development company; (2) derive at least 90% of our gross income from dividends, interest, gains from the sale of securities and other specified types of income; (3) meet asset diversification requirements as defined in the Code; and (4) distribute annually to shareholders at least 90% of our 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

### Cash Flow From Operating Activities

Our portfolio has historically generated significant 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, repayments

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of investment principal, and proceeds from investment sales. Cash flow provided by our operating activities before new investment activity for the years ended December 31, 2003, 2002, and 2001 was as follows:

(\$ in millions)	2003	2002	2001
Net cash provided by (used in) operating activities	\$ 79.9	\$ 65.3	\$(344.4)
Add: portfolio investments funded	930.6	506.4	675.2
Total cash provided by operating activities before new investments	\$1,010.5	\$571.7	\$ 330.8

Because of the significant amount of cash provided by operating activities before new investments, we generate sufficient cash flow to fund our operating activities as well as pay dividends to shareholders.

Dividends to common shareholders for the years ended December 31, 2003, 2002, and 2001, were \$267.8 million, \$229.9 million and \$186.2 million, respectively, for total regular quarterly dividends of \$2.28, \$2.20 and \$2.01 per common share, respectively. An extra cash dividend of \$0.03 per common share was declared during 2002 and was paid to shareholders on January 9, 2003. For the first quarter of 2004, the board of directors has declared a dividend of \$0.57 per common share. The first quarter 2004 dividend is payable on March 31, 2004, with a record date of March 12, 2004.

Dividends are paid based on our 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 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. Non-cash taxable income is reduced by non-cash expenses, such as realized losses and depreciation and amortization expense.

Our board of directors evaluates whether to retain or distribute taxable net capital gains on an annual basis. Our dividend policy allows us to continue to distribute capital gains, but will also allow us to retain gains to support future growth. Our board of directors reviews the dividend rate quarterly, and may adjust the quarterly dividend throughout the year.

Because of the level of cash flow provided in 2003, we ended the year with \$214.2 million in cash and cash equivalents. We invest otherwise uninvested cash in U.S. government- or agency-issued or guaranteed securities that are backed by the full faith and credit of the United States, or in high quality, short-term repurchase agreements fully collateralized by such securities.

At December 31, 2003, we had significant outstanding commitments to fund investments totaling \$446.8 million. 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.

**Debt and Equity Capital**

Because we are a regulated investment company, we distribute our taxable income and, therefore, require external capital for asset growth. As a result, from time to time we will raise growth capital in the form of new debt or equity capital.

At December 31, 2003, 2002, and 2001, our total assets, total debt outstanding, total shareholders' equity, debt to equity ratio and asset coverage for senior indebtedness were as follows:

(\$ in millions)	2003	2002	2001
Total assets	\$3,019.9	\$2,794.3	\$2,460.7
Total debt outstanding	\$ 954.2	\$ 998.5	\$1,020.8
Total shareholders' equity	\$1,914.6	\$1,546.1	\$1,352.1
Debt to equity ratio	0.50	0.65	0.75
Asset coverage ratio <sup>(1)</sup>	322%	270%	245%

(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 0.65:1.00, and over the past three years, we have intentionally deleveraged the balance sheet to move the leverage ratio to the low end of the target debt to equity ratio range. We have been in a period of economic uncertainty, and we believe that it is prudent to operate with a larger equity capital base and less leverage. For the years ended December 31, 2003 and 2002, we raised equity of \$422.9 million and \$172.8 million, respectively, including \$86.5 million raised through a non-transferable rights offering during 2002. In addition, we raised \$21.2 million and \$22.1 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, 2003 and 2002, respectively.

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 \$487.0 million on December 31, 2003. 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 December 31, 2003, we had outstanding debt as follows:

(\$ in millions)	Facility Amount	Amount Outstanding	Annual Interest Cost <sup>(1)</sup>	Annual Portfolio Return to Cover Interest Payments <sup>(2)</sup>
Notes payable and debentures:				
Unsecured long-term notes payable	\$ 854.0	\$854.0	7.2%	2.0%
SBA debentures	101.8	94.5	8.1%	0.3%
OPIC loan	5.7	5.7	6.6%	0.0%
	<u>961.5</u>	<u>954.2</u>		
Total notes payable and debentures	961.5	954.2	7.3%	2.3%
Revolving line of credit	532.5		(3)	0.1%
	<u>532.5</u>	<u>0</u>		
Total debt	\$1,494.0	\$954.2	7.5% <sup>(3)</sup>	2.4%

- (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.
- (2) The annual portfolio return to cover interest payments is calculated as the December 31, 2003, annualized cost of debt per class of financing outstanding divided by total assets at December 31, 2003.
- (3) There were no amounts drawn on the revolving line of credit at December 31, 2003. 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. The annual cost of commitment fees and other facility fees on the revolving line of credit is currently \$2.7 million.

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

**Small Business Administration Debentures.** We, through our small business investment company subsidiary, have debentures payable to the Small Business Administration with contractual maturities of ten years. The notes require payment of interest only semi-annually, and all principal is due upon maturity. Under the small business investment company program, we may borrow up to \$116.0 million from the Small Business Administration. At December 31, 2003, we had a commitment from the Small Business Administration to borrow up to an additional \$7.3 million above the current amount outstanding. The commitment expires on September 30, 2005.

**Revolving Line of Credit.** We have an unsecured revolving line of credit with a committed amount of \$532.5 million. The committed amount may be further expanded through new or additional commitments up to \$600 million at our option. The revolving line of credit expires in April 2005, with the right to extend the maturity for one additional year at our option under substantially similar terms. As of December 31, 2003, \$487.0 million remained unused and available, net of amounts committed for standby letters of credit of \$45.5 million issued under the line of credit facility. Net repayments on the revolving line of credit for the year ended December 31, 2003, were \$204.3 million. The credit facility generally bears interest at a rate, at our option, equal to (i) the one-month LIBOR plus 1.50%, (ii) the Bank of America, N.A. cost of funds plus 1.50% or (iii) the higher of the Bank of America, N.A. prime rate or the Federal Funds rate plus



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0.50%. The line of credit generally requires monthly payments of interest, and all principal is due upon maturity.

We have various financial and operating covenants required by the revolving line of credit and notes payable and debentures. These covenants require us to maintain certain financial ratios, including debt to equity and interest coverage, and a minimum net worth. Our credit facilities limit our ability to declare dividends if we default under certain provisions. As of December 31, 2003, 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, 2003.

(\$ in millions)	Payments Due By Year						
	Total	2004	2005	2006	2007	2008	After 2008
<b>Notes payable and debentures:</b>							
Unsecured long-term notes payable	\$854.0	\$214.0	\$165.0	\$175.0	\$	\$153.0	\$147.0
SBA debentures	94.5	7.0	14.0				73.5
OPIC loan	5.7			5.7			
<b>Revolving line of credit<sup>(1)</sup></b>							
Operating leases	18.4	2.7	2.7	2.6	2.5	2.6	5.3
<b>Total contractual obligations</b>	<b>\$972.6</b>	<b>\$223.7</b>	<b>\$181.7</b>	<b>\$183.3</b>	<b>\$2.5</b>	<b>\$155.6</b>	<b>\$225.8</b>
Total due within 1 year	\$223.7	\$223.7	\$	\$	\$	\$	\$
Total due 1 to 3 years	365.0		181.7	183.3			
Total due 3 to 5 years	158.1				2.5	155.6	
Total due more than 5 years	225.8						225.8
<b>Total contractual obligations</b>	<b>\$972.6</b>	<b>\$223.7</b>	<b>\$181.7</b>	<b>\$183.3</b>	<b>\$2.5</b>	<b>\$155.6</b>	<b>\$225.8</b>

(1) The revolving line of credit expires in April 2005 and may be extended under substantially similar terms for one additional year at our option. We assume that we would exercise our option to extend the revolving line of credit resulting in an assumed maturity of April 2006. At December 31, 2003, there were no amounts drawn under the facility and \$487.0 million remained unused and available, net of amounts committed for standby letters of credit of \$45.5 million issued under the credit facility.

The following table shows our contractual commitments that may have the effect of creating, increasing, or accelerating our liabilities as of December 31, 2003.

(\$ in millions)	Amount of Commitment Expiration Per Year						
	Total	2004	2005	2006	2007	2008	After 2008
Guarantees	\$ 83.4	\$79.0	\$0.4	\$ 0.2	\$0.2	\$	\$3.6
Standby letters of credit	45.5		3.0	42.5			
<b>Total commitments</b>	<b>\$128.9</b>	<b>\$79.0</b>	<b>\$3.4</b>	<b>\$42.7</b>	<b>\$0.2</b>	<b>\$</b>	<b>\$3.6</b>

**CRITICAL ACCOUNTING POLICIES**

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

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

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

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

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

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

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

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

**Commercial Mortgage-Backed Securities ( CMBS ) and Collateralized Debt Obligations ( CDO ).** CMBS bonds and CDO bonds and preferred shares are carried at fair value, which is based on a discounted cash flow model that utilizes prepayment and loss assumptions based on historical experience and projected performance, economic factors, the characteristics of the underlying cash flow, and comparable yields for similar CMBS bonds and CDO bonds and preferred shares. We recognize unrealized appreciation or depreciation on our CMBS bonds and CDO bonds and preferred shares as comparable yields in the market change and/or based on changes in estimated cash flows resulting from changes in prepayment or loss assumptions in the underlying collateral pool.

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

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

**Fee Income.** Fee income includes fees for guarantees and services rendered by us to portfolio companies and other third parties such as diligence, structuring, transaction services, management services, and investment advisory services. Guaranty fees are recognized as income over the related period of the guaranty. Diligence, structuring, and transaction services fees are generally recognized as income when services are rendered or when the related transactions are completed. Management and investment advisory 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 the fiscal year ended December 31, unless otherwise noted. The <sup>(5)</sup> 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 <sup>(1)</sup>	Asset Coverage Per Unit <sup>(2)</sup>	Involuntary Liquidating Preference Per Unit <sup>(3)</sup>	Average Market Value Per Unit <sup>(4)</sup>
<b>Unsecured Long-term Notes Payable</b>				
1994	\$ 0	\$ 0	\$	N/A
1995	0	0		N/A
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
<b>Small Business Administration Debentures</b>				
<sup>(5)</sup>				
1994	\$ 54,800,000	\$3,695	\$	N/A
1995	61,300,000	2,868		N/A
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
<b>Overseas Private Investment Corporation Loan</b>				
1994	\$ 0	\$ 0	\$	N/A
1995	0	0		N/A
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

Class and Year	Total Amount Outstanding Exclusive of Treasury Securities <sup>(1)</sup>	Asset Coverage Per Unit <sup>(2)</sup>	Involuntary Liquidating Preference Per Unit <sup>(3)</sup>	Average Market Value Per Unit <sup>(4)</sup>
<b>Revolving Lines of Credit</b>				
1994	\$ 32,226,000	\$ 3,695	\$	N/A
1995	20,414,000	2,868		N/A
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
<b>Auction Rate Reset Note</b>				
1994	\$ 0	\$ 0	\$	N/A
1995	0	0		N/A
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
<b>Master Repurchase Agreement and Master Loan and Security Agreement</b>				
1994	\$ 23,210,000	\$ 3,695	\$	N/A
1995	0	0		N/A
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

Class and Year	Total Amount Outstanding Exclusive of Treasury Securities <sup>(1)</sup>	Asset Coverage Per Unit <sup>(2)</sup>	Involuntary Liquidating Preference Per Unit <sup>(3)</sup>	Average Market Value Per Unit <sup>(4)</sup>
<b>Senior Note Payable<sup>(6)</sup></b>				
1994	\$20,000,000	\$3,695	\$	N/A
1995	20,000,000	2,868		N/A
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
<b>Bonds Payable</b>				
1994	\$ 0	\$ 0	\$	N/A
1995	98,625,000	2,868		N/A
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
<b>Redeemable Cumulative Preferred Stock<sup>(5)(7)</sup></b>				
1994	\$ 1,000,000	\$ 351	\$100	N/A
1995	1,000,000	277	100	N/A
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
<b>Non-Redeemable Cumulative Preferred Stock<sup>(5)</sup></b>				
1994	\$ 6,000,000	\$ 351	\$100	N/A
1995	6,000,000	277	100	N/A
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

- (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

As a business development company, or BDC, we are in the private equity business. Specifically, we provide long-term debt and equity capital. We believe the private equity capital markets are important to the growth of small and middle market companies, which often have difficulty accessing the public debt and equity capital markets because their capital needs are too small to be attractive to the public markets or because they are in need of long-term growth capital, which banks do not generally provide. We believe that we are well positioned to be a source of capital for such companies.

We have participated in the private equity business since Allied Capital was founded in 1958. We have financed thousands of companies nationwide. We generally invest in established, middle market companies with adequate cash flow for debt service. We are not venture capitalists, and we generally do not provide seed, or early stage, capital.

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, non-investment grade commercial mortgage-backed securities (CMBS) and collateralized debt obligation bonds and preferred shares (CDOs).

### Private Equity Investing

As a private equity investor, we spend significant time and effort identifying, structuring, performing due diligence, monitoring, valuing and ultimately exiting our investments. We generally target companies in less cyclical industries with, among other things, high return on invested capital, management teams with meaningful equity ownership, well-constructed balance sheets, and that have 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 in three areas:

Lending subordinated debt with or without equity features to middle market companies (also known as mezzanine investing),

Buying controlling equity stakes in middle market companies (also known as buyout investing), and

Investing in non-investment grade classes of commercial mortgage-backed securities (CMBS) and collateralized debt obligations (CDO).

We have chosen these investment classes because the investments 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, diligence, structuring or other fees. We may also enhance our total return through capital gains through equity features, such as nominal

cost warrants, or by investing in equity instruments. Net realized capital gains received over the past twenty years as a percentage of total assets are shown in the chart below.

Our investments in mezzanine loans, equity investments in middle market companies, and non-investment grade tranches of CMBS and CDO pools are generally long-term in nature and privately negotiated, and no readily available market exists for them. This makes our investments highly illiquid and, as a result, we cannot trade them. When we make an investment, we enter into a long-term arrangement where our ultimate exit from that investment may be five 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, public debt instruments, or large syndicated senior loans, because of the increased 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, consistent monitoring and portfolio diversification. Our investment management processes have been designed to incorporate these tools.

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 manage through difficult market conditions without the 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 long-term under-leveraged capital structure is well suited for long-term illiquid investments.

In general, we compete with a large number of financial services companies, including specialty and commercial financial companies, commercial banks and private equity funds. However, we primarily compete with private equity funds because they are also focused on

providing long-term debt and equity capital to middle market companies. We believe that we have key structural and operational advantages when compared to private equity funds.

Many private equity funds operate with a more expensive cost structure than ours because of carried interest fees paid to the management of the funds. In addition, our access to the public equity markets generally allows us the opportunity to raise equity capital at a lower cost than that of private equity funds. Our lower cost of capital may give us a pricing advantage when competing for new investments. In addition, the perpetual nature of our corporate structure enables us to be a better long-term partner for our portfolio companies than a traditional private equity fund, which typically has a limited life. For additional information concerning the competitive risks we face, see Risk Factors We operate in a competitive market for investment opportunities.

**Private Finance Portfolio**

Our private finance portfolio is primarily composed of mezzanine loans (junior capital in the form of subordinated debt, with or without equity features) and equity securities. Our capital is used to fund:

growth acquisitions	note purchases
buyouts	bridge financings
recapitalizations	other types of financings

At December 31, 2003, 64% of the private finance portfolio consisted of loans and debt securities and 36% consisted of equity securities.

We focus on mezzanine and buyout investments where we can select investments that are structured to generate current returns as well as potential future capital gains. It is our preference to structure our investments with a focus on current recurring income, with a lesser emphasis on future capital gains. Our loans generally have interest-only payments in the early years and payments of both principal and interest in the later years with maturities of five to ten years, although maturities and principal amortization schedules may vary. Our loans are also generally unsecured. We target a minimum 10% current yield on the debt component of our private finance portfolio and such payments are generally made to us quarterly. The weighted average yield on our private finance loans and debt securities was 15.0% at December 31, 2003.

To the extent that we buy a controlling equity stake in a company, we generally structure our investments such that we earn a current return through a combination of interest income on our senior loans and subordinated debt, dividends on our preferred and common equity, and management or transaction services fees to compensate us for the managerial assistance that we provide to a controlled portfolio company.

We generally invest in private companies though, from time to time, we may invest in public companies that lack access to public capital or whose securities may not be marginable. These investments are also generally illiquid. We generally target companies in less cyclical industries that tend to generate free cash flow and high returns on invested capital.

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The industry and geographic compositions of the private finance portfolio at value at December 31, 2003 and 2002, were as follows:

	2003	2002
<b>Industry</b>		
Consumer products	30%	34%
Business services	22	24
Financial services	19	16
Healthcare services	8	6
Industrial products	6	8
Retail	4	4
Energy Services	4	2
Telecommunications	2	2
Broadcasting & cable	2	1
Other	3	3
	100%	100%
<b>Geographic Region</b>		
Mid-Atlantic	40%	33%
Midwest	26	30
West	16	15
Southeast	13	17
Northeast	4	4
International	1	1
	100%	100%

We monitor the portfolio to maintain diversity within the industries in which we invest. We currently do not have a policy with respect to concentrating (i.e., investing 25% or more of our total assets) in any industry or group of industries and currently our portfolio is not concentrated. We may or may not concentrate in any industry or group of industries in the future.

*Target Characteristics.* When assessing a prospective private finance investment, we look for companies 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

### **Commercial Real Estate Portfolio**

Our commercial real estate investments are generally in the non-investment grade tranches of commercial mortgage-backed securities, also known as 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. Unlike most junk bonds, which are

typically unsecured debt instruments, the non-investment grade CMBS

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bonds in which we invest are secured by an underlying collateral pool of commercial mortgage loans, which are, in turn, secured by commercial real estate. The underlying collateral for our CMBS bonds consist of senior mortgage loans on commercial real estate properties where the loans, on average, were underwritten to achieve a loan to value ratio of approximately 70%. We generally invest at the initial issuance of the CMBS, and are able to re-underwrite the underlying collateral mortgages and negotiate to acquire the securities at significant discounts from their face amount. At December 31, 2003, our CMBS portfolio had a weighted average yield to maturity of 14.1%.

Our CMBS bonds by rating classification at December 31, 2003, were as follows:

(\$ in thousands)	2003		
	Cost	Value	Percentage of Total Value
BB+	\$ 49,477	\$ 51,157	13.0%
BB	22,031	23,008	5.9
BB-	13,538	14,266	3.6
B+	54,464	54,246	13.8
B	38,416	38,362	9.7
B-	84,986	83,859	21.3
CCC+	15,935	15,494	3.9
CCC	13,323	11,413	2.9
CCC-	3,133	2,410	0.6
Unrated	103,803	99,764	25.3
<b>Total</b>	<b>\$399,106</b>	<b>\$393,979</b>	<b>100.0%</b>

At December 31, 2003, the age of our bonds with a rating class of B+ and lower was as follows:

(\$ in thousands)	Value	Percentage
Less than one year old	\$ 83,925	27.5%
One to two years old	40,967	13.4
Two to three years old	43,760	14.3
Three years old or older	136,896	44.8
	<b>\$305,548</b>	<b>100.0%</b>

At December 31, 2003, the underlying pools of mortgage loans that are collateral for our CMBS consisted of approximately 5,600 commercial mortgage loans. The underlying mortgage loans securing the CMBS, calculated using the outstanding principal balance, at December 31, 2003 and 2002, were diversified over the following property types and geographic locations:

	2003	2002
<b>Property Type</b>		
Retail	35%	32%
Housing	25	27
Office	24	21
Industrial real estate	5	7
Hospitality	5	6
Other	6	7

Total	<u>100%</u>	<u>100%</u>
-------	-------------	-------------

	<u>2003</u>	<u>2002</u>
<b>Geographic Region</b>		
West	31%	31%
Mid-Atlantic	27	25
Midwest	21	22
Southeast	17	17
Northeast	4	5
	—	—
Total	100%	100%
	—	—

In addition to our CMBS investments, we have invested in the bonds and preferred shares of collateralized debt obligations, or CDOs, which are secured by investment grade unsecured debt issued by various real estate investment trusts, or REITs, investment grade and non-investment grade CMBS, and other real estate related collateral. The bonds and the preferred shares of the CDOs in which we have invested are junior in priority for payment of interest and principal to the more senior tranches of debt issued by the CDOs. The yield on our CDO bonds and preferred shares at December 31, 2003, was 16.7%.

### Business Processes

**Investment Sourcing.** Over the years, we have developed and maintained relationships with other 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, especially those with private equity sponsors, we have been able to strengthen our position as a long-term investor. We are well known in the private capital markets, and we believe that our experience and reputation provide a competitive advantage in originating new investments.

**Underwriting Process and Investment Approval.** In assessing new investment opportunities, we follow a documented process that includes centralized credit approval.

**Private Finance.** The typical mezzanine transaction requires two to six months of diligence and structuring before funding occurs. The typical buyout transaction may take up to one year to complete. The due diligence process is significantly longer for those transactions in which we take a controlling interest or substantial equity stake in the company.

In a typical private finance transaction, we thoroughly review, analyze, and substantiate, through due diligence, the business plan and operations of the potential portfolio company. We perform financial due diligence, often with the assistance of an accounting firm; perform operational due diligence, often with the assistance of an industry consultant; study the industry and competitive landscape; and conduct numerous reference checks with current and former employees, customers, suppliers, and competitors. We typically work with a number of external 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 how our investment is expected to perform relative to the other capital in the portfolio company's capital structure.

Our mezzanine debt instruments are tailored to the facts and circumstances of the deal. The specific structure is negotiated over a period of several months and is designed to



protect our rights and manage our risk in the transaction. We may structure the debt instrument to require restrictive affirmative and negative covenants, default penalties, lien protection, equity calls and take control provisions. Our mezzanine 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, as 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.

The key steps in our private finance investment process are:

Initial investment screening;

Initial investment committee approval;

Due diligence, structuring and negotiation;

Independent internal review of diligence results;

Final investment committee approval;

Approval by the Executive Committee of the Board of Directors (for all mezzanine investments that are equal to or greater than \$20 million and every buyout transaction); and

Funding of the investment.

The investment process benefits from the significant professional experience of investment committee members.

Mezzanine transactions are approved by the mezzanine investment committee, which is chaired by our Chief Executive Officer and includes our Chief Financial Officer and other senior investment officers.

Buyout transactions are approved by the buyout investment committee, which is also chaired by our Chief Executive Officer and includes our Chief Operating Officer and other senior investment officers.

Every mezzanine transaction that represents a commitment equal to or greater than \$20 million and every buyout transaction requires approval by the Executive Committee of the Board of Directors in addition to the respective investment committee approval. Due diligence must be successfully completed with final investment committee approval before funds are disbursed to a portfolio company.

**CMBS and CDOs.** The typical CMBS or CDO investment takes between two to three months to complete. We receive extensive underwriting information regarding the mortgage loans and other securities comprising a CMBS or CDO pool from the issuer. We then work with the issuer, the investment bank, and the rating agencies to underwrite the collateral securing our investment. For instance when we re-underwrite the underlying commercial mortgage loans securing a CMBS transaction, we analyze the estimate of cash flow and debt service coverage, and assess the collateral value and loan-to-value ratios. We study the local real estate market trends and form an opinion as to whether the loan as originally underwritten by the issuer is sound. Based on the findings of our diligence procedures, we may reject certain mortgage loans from inclusion in the pool.

The key steps in our CMBS and CDO investment process are:

Initial assessment of collateral pool data;

Preparation of preliminary bid letter;

Due diligence, structuring and negotiation;

Investment committee approval;

Approval by the Executive Committee of the Board of Directors (for all investments that are equal to or greater than \$20 million); and

Funding of the investment.

The investment process benefits from the significant professional experience of our real estate investment committee members. CMBS and CDO transactions are approved by the commercial real estate investment committee, which is chaired by our Chief Executive Officer and includes our Chief Operating Officer, our Chief Financial Officer and our most senior real estate investment officers. CMBS and CDO transactions that are equal to or greater than \$20 million are also reviewed and approved by the Executive Committee of the Board of Directors.

**Portfolio Management.** We monitor the progress of each portfolio company or collateral loan underlying a CMBS or CDO investment. 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 to acquire other companies, to optimize their cost structures, to recruit management talent, to develop their marketing strategies, and to provide a variety of other services. We also support our portfolio companies' efforts to structure and attract additional capital.

With respect to our private finance portfolio, investment professionals regularly monitor the status and performance of each individual investment. This portfolio company monitoring process includes review of the 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. We typically have board observation rights, which allows us to attend portfolio company board meetings.

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 gauge our progress against the strategy at periodic portfolio management committee meetings. Our portfolio management committee is chaired by our Chief Executive Officer and includes our Chief Operating Officer, our Chief Financial Officer, and other senior professionals.

Private finance investments are priced 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.

With respect to our CMBS and CDO portfolio, we monitor the performance of the underlying collateral pool through data provided by third party master and special servicers. These master servicers are responsible for the day-to-day loan servicing functions, including billing, payment processing, collections on loans less than 60 days past due, tax

and insurance escrow processing, and property inspections. Special servicers are responsible for collections on loans greater than 60 days past due, including workout administration and management of foreclosed properties, and loans less than 60 days past due that have had a transfer event.

When a loan moves to the designated special servicer, a workout plan is formulated by the special servicer and reviewed by us when we hold the controlling interest in the lowest rated tranche outstanding, which is generally the non-rated tranche at issuance. Once reviewed by us, the special servicer carries out the workout plan, updating us on the status. With respect to certain CMBS issuances, where we own the controlling class of securities, we are the named special servicer and we generally have the ability to replace the existing named special servicer at any time. In addition, we act as the disposition consultant with respect to certain of our CDO investments, which allows us to approve disposition plans for individual collateral securities.

**Portfolio Grading.** We employ a standard 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. At December 31, 2003, portfolio investments recorded at fair value were approximately 85% 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, therefore, our

equity security has also appreciated in value. Changes in fair value are recorded in the statement of operations as net change in unrealized appreciation or depreciation.

As a business development company, we invest in illiquid securities including debt and equity securities of companies, non-investment grade CMBS, and CDO bonds and preferred shares. The structure of each private finance debt and equity security is specifically negotiated to enable us to protect our investment and maximize our returns. We include many terms governing interest rate, repayment terms, prepayment penalties, financial covenants, operating covenants, ownership parameters, dilution parameters, liquidation preferences, voting rights, and put or call rights. Our investments are generally subject to restrictions on resale and generally have no established trading market. Because of the type of investments that we make and the nature of our business, our valuation process requires an analysis of various factors. Our fair value methodology includes the examination of, among other things, the underlying investment performance, financial condition, and market changing events that impact valuation.

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

There is no one methodology to determine enterprise value and, in fact, for any given 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 accounting principles generally accepted in the United States of America and such information should not be considered as an alternative to net income, cash flow from operations, or any other measure of performance prescribed by accounting principles generally accepted in the United States of America. When using EBITDA to determine enterprise value, we may adjust EBITDA for non-recurring items. Such adjustments are intended to normalize EBITDA to reflect the portfolio company's earnings power. Adjustments to EBITDA may include compensation to previous owners, acquisition, recapitalization, or restructuring related items or one-time non-recurring income or expense items.

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

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

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

**Valuation Methodology – CMBS and CDO Bonds and Preferred Shares.** CMBS and CDO bonds and preferred shares are carried at fair value, which is based on a discounted cash flow model that utilizes prepayment and loss assumptions based on historical experience and projected performance, economic factors, the characteristics of the underlying cash flow and comparable yields for similar instruments. Our assumption with regard to discount rate is based on the yield of comparable securities. We recognize unrealized appreciation or depreciation on our CMBS and CDO bonds and preferred shares as comparable yields in the market change and/or based on changes in estimated cash flows resulting from changes in prepayment or loss assumptions in the underlying collateral pool.

**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 Allied Capital deal team, led by the Managing Director or senior officer who is responsible for the portfolio company relationship.

The CVO meets 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 CVO reviews the valuation data and conclusions.

Each investment committee meets with the CVO to discuss the valuation results. Members of the investment committees have the opportunity to discuss the valuation of each portfolio investment and to question the valuation conclusions arrived at by the CVO and the respective deal teams.

Valuation documentation is distributed to the members of the Board of Directors.

The Board of Directors meets to discuss valuations and review the input of the CVO and management.

To the extent changes or 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 may receive independent assessments of a particular private finance portfolio company's value in the ordinary course of business, most often in the context of a prospective sale transaction or in the context of the bankruptcy process, or we may work with independent third-party consultants to obtain assistance and advice as additional support in the preparation of our internal valuation analysis. The valuation analysis prepared by management using these independent valuation resources is submitted to our Board of Directors for their determination of fair value of the portfolio in good faith.

**Disposition of Investments.** We manage our portfolio of investments in an effort to maximize our expected returns. Our portfolio is large and diverse and we frequently are repaid by our borrowers and exit our debt and equity investments as portfolio companies are sold or recapitalized. In our mezzanine investments, 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 our investment, as we frequently have in buyout investments and in CMBS and CDO investments, we have more flexibility and can determine whether or not we should exit our investment. Our most common exit strategy is the sale of a portfolio company to a strategic or financial buyer. If an investment has appreciated in value, we may realize a capital gain when we exit the investment. If an investment has depreciated in value, we may realize a loss when we exit the investment.

### **Dividends**

We are a regulated investment company for tax purposes. As such, we are not subject to corporate level income taxation on income we timely distribute to our stockholders as dividends. We pay regular quarterly dividends based upon an estimate of our taxable income, which generally differs from net income for financial reporting purposes due to temporary and permanent differences in the recognition of income and expenses. We believe that because our illiquid private equity portfolio generates substantial cash returns and cash flow to support our regular quarterly dividend, our stock has consistently traded at a premium to net asset value.

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. The percentage of our dividend generated by ordinary taxable income versus capital gain income will vary from year to year, but we believe that the ability to generate both ordinary and capital gain income builds predictability in the dividends we pay. The percentage of ordinary taxable income versus capital gain income supporting the dividend for the past five years is shown below.

### **Corporate Structure and Offices**

We were founded in 1958. 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. We are a registered investment adviser. We have a subsidiary, Allied Investment Corporation, which has also elected to be regulated as a BDC and is licensed under the Small Business Investment Act of 1958 as a Small Business Investment Company. 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 primarily to hold real estate properties. We also have a subsidiary, A.C. Corporation, that provides diligence and structuring services on private finance and commercial real estate transactions, as well as structuring, transaction, management and advisory services to Allied Capital, our portfolio companies and other third parties.

Our executive offices are located at 1919 Pennsylvania Avenue, NW, Washington, DC 20006 and our telephone number is (202) 331-1112. In addition, we have regional offices in New York and Chicago.

### **Employees**

At December 31, 2003, we employed 125 individuals including investment and portfolio management professionals, operations professionals and administrative staff. The majority of these individuals are located in our Washington, DC office. We believe that our relations with our employees are excellent.

### **Legal Proceedings**

We are party to certain lawsuits in the normal course of our business. While the outcome of these legal proceedings cannot at this time be predicted with certainty, we do not expect that these proceedings 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, 2003. Percentages shown for class of securities held by us represent percentage of the class owned and do not necessarily represent voting 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, 2003, at pages F-6 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
<b>Companies More Than 25% Owned</b>			
ACE Products, Inc. <sup>(1)</sup> 850 Industrial Boulevard Newport, TN 37821	Rubber and Plastic Tire Manufacturer	Class A Common Stock Class B Common Stock	47.4% 100.0%
Acme Paging, L.P. <sup>(1)</sup> 6080 SW 40th Street, Suite 3 Miami, FL 33155	Paging Services	Class A Equity Interests Class B Equity Interests Common Stock in Affiliate	100.0% 1.7% 11.1%
Alaris Consulting, LLC <sup>(1)(2)</sup> 360 W. Butterfield Road Suite 400 Elmhurst, IL 60126	Consulting Firm	Equity Interest	100.0%
American Healthcare Services, Inc. <sup>(1)</sup> 3600 Mansell Road Suite 150 Alpharetta, GA 30022	Consumer Health Services Provider	Common Stock	68.6%
Avborne, Inc. <sup>(1)</sup> c/o Trivest, Inc. 7500 NW 26th Street Miami, FL 33122	Aviation Services	Series B Preferred Stock Common Stock	23.8% 27.2%
Business Loan Express, LLC <sup>(1)</sup> 645 Madison Ave. 19th Floor New York, NY 10022	Small Business Lender	Class A Equity Interests Class B Equity Interests Class C Equity Interests Equity Interest in BLX Subsidiary	100.0% 100.0% 94.9% 20.0%



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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
Callidus Capital Corporation <sup>(1)(3)</sup> 527 Madison Avenue 17th floor New York, NY 10022	Asset Manager and Finance Company	Common stock	100.0%
The Color Factory Inc. <sup>(1)</sup> 11312 Penrose Street Sun Valley, CA 91352	Cosmetic Manufacturer	Redeemable Preferred Stock	100.0%
Foresite Towers, LLC <sup>(1)</sup> 22 Iverness Center Parkway Suite 50 Birmingham, AL 35242	Tower Leasing	Common Stock	100.0%
		Series A Preferred	
		Equity Interest	100.0%
		Series B Preferred	
		Equity Interest	100.0%
		Series D Preferred Equity Interest	100.0%
		Common Equity Interest	70.0%
Global Communications, LLC <sup>(1)</sup> 201 East 69th Street New York, NY 10021	Muzak Franchisee	Preferred Equity Interest	77.8%
		Options for Common Membership Interest	59.3%
Gordian Group, Inc. <sup>(1)</sup> 499 Park Avenue 5th Floor New York, NY 10022	Financial Advisory Services	Common Stock	100.0%
HealthASPex, Inc. <sup>(1)</sup> Foxpointe Centre Building 1; Suite 301 201 South Johnson Road Houston, PA 15342	Third Party Administrator	Class A Convertible Preferred Stock	69.9%
		Class B Convertible Preferred Stock	64.8%
		Common Stock	45.8%
The Hillman Companies, Inc. <sup>(1)</sup> 10590 Hamilton Avenue Cincinnati, OH 45231	Merchandiser of Retail Hardware Supplies	Common Stock	96.8%
HMT, Inc. 4422 FM 1960 West Suite 350 Houston, TX 77068	Storage Tank Maintenance & Repair	Class B Preferred Stock	33.2%
		Common Stock	26.1%
		Warrants to Purchase Common Stock	10.0%
Housecall Medical Resources, Inc. <sup>(1)</sup> 6501 Deane Hill Drive Knoxville, TN 37919	Home Healthcare Services	Preferred Stock	76.8%
		Common Stock	70.6%
Jakel, Inc. <sup>(1)</sup> 400 Broadway Highlands, IL 62249	Manufacturer of Electric Motors and Blowers	Series A-1 Preferred Stock	32.3%
		Class B Common Stock	100.0%
Litterer Beteiligungs-GmbH Uhlandstrasse 1 69493 Hirschberg Germany	Scaffolding Company	Equity Interest	20.5%
MVL Group, Inc. <sup>(1)</sup> 1061 E. Indiantown Road Suite 300 Jupiter, FL 33477	Market Research Services	Common Stock	64.9%
Powell Plant Farms, Inc. <sup>(1)</sup> Route 3, Box 1058 Troup, TX 75789	Plant Retailer	Preferred Stock	100.0%
		Warrants to Purchase Common Stock	83.5%
Redox Brands, Inc. <sup>(1)</sup> 9100 Centre Point Drive Suite 200 West Chester, OH 45069	Household Cleaning Products	Series A Convertible Preferred Stock	100.0%
		Warrants to Purchase Class A Common Stock	8.2%



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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
Staffing Partners Holding <sup>(1)</sup> Company, Inc. 104 Church Lane, #100 Baltimore, MD 21208	Temporary Employee Services	Redeemable Preferred Stock Class A-1 Common Stock Class A-2 Common Stock Class B Common Stock Warrants to purchase Class B Preferred Stock Warrants to purchase Class B Common Stock	48.3%  50.0% 24.4% 24.0%  71.4% 54.1%
STS Operating, Inc. (d/b/a SunSource Technology Services, Inc.) <sup>(1)</sup> 2301 Windsor Court Addison, IL 60101	Engineering Design and Services	Preferred Stock Common Stock Options to Purchase Common Stock	96.2% 40.2%  0.3%
Sure-Tel, Inc. <sup>(1)</sup> 5 North McCormick Oklahoma City, OK 73127	Prepaid Telephone Services Company	Preferred Stock Common Stock	50.0% 37.0%
<b>Companies 5% to 25% Owned</b>			
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% 7.0%  2.8%
Border Foods, Inc. J Street Deming Industrial Park Deming, NM 88030	Mexican Ingredient & Food Product Manufacturer	Series A Convertible Preferred Stock Common Stock Warrants to Purchase Common Stock	9.4% 12.4%  73.8%
CorrFlex Graphics, LLC <sup>(1)</sup> 701 Rickert Street Statesville, NC 28677	Packaging Manufacturer	Warrants to Purchase Common Stock Options to Purchase Common Stock	6.4%  7.0%
The Debt Exchange, Inc. <sup>(1)</sup> 101 Arch Street, Suite 410 Boston, MA 02110	Online Sales of Distressed Assets	Series B Convertible Preferred Stock	40.0%
EDM Consulting, LLC 81 Two Bridges Road Fairfield, NJ 07004	Environmental Consulting	Equity Interest	25.0%
International Fiber Corporation 50 Bridge Street North Tonawanda, NY 14120	Cellulose and Fiber Producer	Common Stock Warrants to Purchase Common Stock	11.7%  3.0%
Liberty-Pittsburgh Systems, Inc. 3498 Grand Avenue Pittsburgh, PA 15225	Business Forms Printing	Class A Common Stock Class B Common Stock	10.4%  44.1%
MasterPlan, Inc. 21540 Plummer Street Chatsworth, CA 91311	Healthcare Outsourcing	Common Stock	7.5%
MortgageRamp.com, Inc. <sup>(1)</sup> 116 Welsh Road	Internet Based Loan Origination	Class A Common Stock	7.7%



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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
Nobel Learning Communities, Inc. <sup>(1)</sup> 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	
Packaging Advantage Corporation 4633 Downey Road Los Angeles, CA 90058	Personal Care, Household and Disinfectant Product Packager	Common Stock	7.4%
		Warrants to Purchase	11.3%
		Common Stock	5.4%
Professional Paint, Inc. 8600 Park Meadow Drive, #300 Lone Tree, CO 80124	Paint Manufacturer	Series A-1 Senior	
		Exchangeable Preferred	
		Stock	50.0%
Progressive International Corporation 6111 S. 228th Street Kent, WA 98064	Retail Kitchenware	Common Stock	11.6%
		Series A Redeemable	
		Preferred Stock	12.5%
		Warrants to Purchase	
Sidarus Holdings, Inc. 7450-B Boston Blvd. Springfield, VA 22153	Government Information Technology Services	Common Stock	45.8%
		Series A	
		Preferred Stock	5.6%
		Common Stock	5.5%
		Warrant to Purchase	
Total Foam, Inc. <sup>(1)</sup> P.O. Box 688 Ridgefield, CT 06877	Packaging Systems	Series A	
		Preferred Stock	2.0%
		Warrant to Purchase	
		Common Stock	2.3%
Alderwoods Group, Inc. 311 Elm Street, Suite 1000 Cincinnati, OH 45202	Death Care Services	Common Stock	8.8%
		Common Stock	0.9%
American Barbecue & Grill, Inc. 7300 W. 110th Street, Suite 570 Overland Park, KS 66210	Restaurant Chain	Warrants to Purchase	
		Common Stock	18.7%
Benchmark Medical, Inc. 101 Lindin Drive, Suite 420 Malvern, PA 19355	Outpatient Physical Therapy Services	Warrant to Purchase	
		Common Stock	2.2%
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, CN 06830	Private Equity Fund	Limited Partnership	
		Interest	0.8%
Colibri Holding Corporation 2201 S. Walbash Street Denver, CO 80231	Outdoor Living Products	Preferred Stock	5.9%
		Common Stock	4.2%
		Warrants to Purchase	
Component Hardware Group, Inc. 1890 Swarthmore Ave. Lakewood, NJ 08701	Designer & Developer of Hardware Components	Common Stock	2.4%
		Class A Preferred Stock	9.7%
		Class B Common Stock	13.5%



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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
Cooper Natural Resources, Inc. P.O. Box 1477 Seagraves, TX 79360	Sodium Sulfate Producer	Series A Convertible Preferred Stock	100.0%
		Warrants to Purchase Series A Convertible Preferred Stock	36.8%
		Warrants to Purchase Common Stock	6.5%
		Limited Partnership Interest	25.0%
eCentury Capital Partners, L.P. 8270 Greensboro Drive Suite 1025 McLean, VA 22102	Private Equity Fund		
Elexis Beta GmbH Ulmenstraße 22 60325 Frankfurt am Main Germany	Distance Measurement Device Manufacturer	Options to Purchase Shares	9.8%
E-Talk Corporation 4040 West Royal Lane Suite 100 Irving, TX 75063	Telecommunications Software Provider	Series B Preferred Stock	66.6%
		Series B Common Stock	66.6%
		Warrants to Purchase Common Stock	1.5%
Executive Greetings, Inc. 120 Industrial Park Access Road New Hartford, CT 06057	Personalized Business Products		
Fairchild Industrial Products Company 3920 Westpoint Boulevard Winston-Salem, NC 27013	Industrial Controls Manufacturer	Warrants to Purchase Common Stock	25.3%
Frozen Specialties, Inc. 720 Barre Road Archbold, OH 43502	Private Label Frozen Food Manufacturer	Warrants to Purchase Class A Common Stock	2.7%
Garden Ridge Corporation 19411 Atrium Place Suite 170 Houston, TX 77084	Home Decor Retailer	Series A Preferred Stock	2.6%
		Class A Common Stock	4.7%
		Class B Common Stock	4.7%
Geotrace Technologies, Inc. 1011 Highway 6 South, Suite 220 Houston, TX 77077	Oil and Gas Reservoir Analysis	Warrant to Purchase Preferred Stock	8.9%
		Warrant to Purchase Common Stock	8.9%
Gibson Guitar Corporation 1818 Elm Hill Pike Nashville, TN 37210	Guitar Manufacturer	Warrants to Purchase Class A Common Stock	3.0%
		Warrants to Purchase Class B Common Stock	3.0%
Ginsey Industries, Inc. 281 Benigno Boulevard Bellmawr, NJ 08031	Bathroom Accessories Manufacturer	Convertible Debentures	8.3%
		Warrants to Purchase Common Stock	17.1%
Grant Broadcasting Systems II 919 Middle River Drive Suite 409 Ft. Lauderdale, FL 33304	Television Stations	Warrants to Purchase Common Stock	25.0%
		Warrants to Purchase Common Stock in Affiliate Company	25.0%
Grotech Partners VI, L.P. c/o Grotech Capital Group 9690 Deereco Road Suite 800 Timonium, MD 21093	Private Equity Fund	Limited Partnership Interest	2.6%
The Hartz Mountain Corporation 400 Plaza Drive	Pet Supply Manufacturer	Common Stock	2.1%
		Warrants to Purchase	

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Secaucus, NJ 07094		Common Stock	4.3%
HealthMarket, Inc.	Health Insurance	Warrants to Purchase	
20 Glover Avenue		Common Stock	18.5%
Norwalk, CT 06850			



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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
Hotelevision, Inc. 599 Lexington Avenue Suite 2300 New York, NY 10022	Hotel Cable-TV Network	Common Stock	0.0%
Icon International, Inc. 281 Tressor Boulevard 8th Floor Stamford, CT 06901	Corporate Barter Services	Class C Common Stock	2.0%
Impact Innovations Group, LLC 2500 Northwinds Parkway Suite 200 Alpharetta, GA 30004	Information Technology Services Provider	Warrants to Purchase Common Stock	3.5%
Interline Brands, Inc. 303 Harper Drive Moorestown, NJ 08057	Repair and Maintenance Product Distributor	Senior Preferred Stock Common Stock Warrants to Purchase Common Stock	0.8% 0.9% 1.4%
JRI Industries, Inc. 2958 East Division Springfield, MO 65803	Machinery Manufacturer	Warrants to Purchase Common Stock	6.5%
Kirker Enterprises, Inc. 55 East 6th Street Paterson, NJ 07524	Nail Enamel Manufacturer	Equity Interest in Affiliate Company Warrants to Purchase Series B Common Stock	22.5% 22.5%
Logic Bay Corporation 7900 International Drive Suite 750 Minneapolis, MN 55425	Computer-Based Training Developer	Common Stock	26.4%
Love Funding Corporation 1220 19th Street, NW, Suite 801 Washington, DC 20036	Mortgage Services	Series D Preferred Stock	26.0%
Matrics, Inc. 8850 Stanford Boulevard Suite 3000 Columbia, MD 21045	Radio Frequency Identification Technology	Series B Convertible Preferred Stock Warrants to Purchase Common Stock	3.4% 0.4%
MedAssets Inc. 100 Northpoint Center East #150 Alpharetta, GA 30022	Healthcare Outsourcing	Series B Convertible Preferred Stock Warrants to Purchase Common Stock	7.8% 0.7%
Mercury Air Group, Inc. 5456 McConnell Avenue Los Angeles, CA 90066	Aircraft Services	Warrant to Purchase Common Stock	6.4%
Mid-Atlantic Venture Fund IV, L.P. 128 Goodman Drive Bethlehem, PA 18015	Private Equity Fund	Limited Partnership Interest	6.7%
Midview Associates, L.P. 2 Eaton Street, Suite 1101 Hampton, VA 23669	Residential Land Development	Warrants to Purchase Partnership Interests	35.0%
Mogas Energy, LLC 13137 Thunderhead Falls Lane Rapid City, SD 57702	Natural Gas Pipeline Operator	Warrant to Purchase Equity Interests	20.0%
Norstan Apparel Shops, Inc. 33-00 47th Avenue Long Island City, NY 11101	Women's Apparel Retailer	Common Stock Warrants to Purchase Common Stock	26.4% 8.0%
Novak Biddle Venture Partners III, L.P. 7501 Wisconsin Avenue	Private Equity Fund	Limited Partnership Interest	2.5%

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Bethesda, MD 20814

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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
Nursefinders, Inc. 1200 Copeland Road, Suite 200 Arlington, TX 76011	Healthcare Services	Warrants to Purchase Common Stock	4.1%
Onyx Television GmbH Immedia Park 6b 50670 Koln Germany	Cable Television	Preferred Units	12.0%
Opinion Research Corporation P.O. Box 183 Princeton, NJ 08542	Corporate Marketing Research Firm	Warrants to Purchase Common Stock	6.7%
Oriental Trading Company, Inc. 108th Street, 4206 South Omaha, NE 68137	Direct Marketer of Toys	Class A Common Stock	1.5%
Polaris Pool Systems, Inc. P.O. Box 1149 San Marcos, CA 92079-1149	Pool Cleaner Manufacturer	Warrants to Purchase Class B Common Stock	4.6%
Prosperco Finanz Holding AG Schützengasse 25 CH-8001 Zürich Switzerland	Financial Services	Debt Convertible into Common Stock Common Stock Warrants to Purchase Common Stock	13.0% 2.6% 5.0%
S.B. Restaurant Company (d/b/a Elephant Bar) 6326-A Lindmar Drive Goleta, CA 93117	Restaurant Chain	Warrant to Purchase Series A Common Stock	13.1%
SBUTTS, LLC (f/k/a Tubbs Snowshoe Company, LLC) 52 River Road Stowe, VT 05672	Snowshoe Manufacturer	Warrants to Purchase Common Units Equity Interests in Affiliate Company	16.7% 10.4%
Smart Mail, LLC 1500 Southpoint Drive, Suite 200 Forest Park, GA 30297	Ground and Expedited Delivery Services for Mail	Common Equity Interests Warrant to Purchase Series A Convertible Equity Interests Warrant to Purchase Series B Convertible Equity Interests Warrant to Purchase Series C Convertible Equity Interests Warrant to Purchase Common Equity Interests	1.4% 1.0% 1.0% 1.0% 1.0% 0.7%
SPP Mezzanine Fund, L.P. 330 Madison Avenue, 28th Floor New York, NY 10017	Private Equity Fund	Limited Partnership Interest	50.0%
Soff-Cut Holdings, Inc. 1112 Olympic Drive Corona, CA 91719	Concrete Sawing Equipment Manufacturer	Series A Preferred Stock Common Stock	14.3% 2.7%
Sydran Food Services II, L.P. Bishop Ranch 8 3000 Executive Parkway Ste. 515 San Ramon, CA 94583-4254	Fast Food Franchise	Class A Preferred Units Class B Common Units Warrants to Purchase Class B Common Units	3.4% 1.7% 12.0%
United Pet Group, Inc. 463 Ohio Pike Suite 303	Manufacturer of Pet Products	Warrants to Purchase Common Stock	5.6%

Cincinnati, OH 45255

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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
Updata Venture Partners II, L.P. 11600 Sunrise Valley Drive Reston, VA 20191	Private Equity Fund	Limited Partnership Interest	15.0%
U.S. Security Associates Holdings, Inc. 200 Mansell Court East Suite 500 Roswell, GA 30076	Outsourced Facility Services Provider	Warrants to Purchase Preferred Stock Warrants to Purchase Class B Common Stock	3.5% 29.3%
Venturehouse-Cibernet Investors, LLC 509 Seventh Street, NW Washington, DC 20004	Third Party Billing	Membership Interest	3.3%
Venturehouse Group, LLC 1780 Tysons Boulevard, Suite 400 McLean, VA 22102	Private Equity Fund	Common Equity Interest	2.2%
VICORP Restaurants, Inc. 400 W. 48th Avenue Denver, CO 80216	Restaurant Chain	Warrant to Purchase Preferred Stock Warrant to Purchase Common Stock	0.2% 3.5%
Walker Investment Fund II, LLLP 3060 Washington Road Suite 200 Glenwood, MD 21738	Private Equity Fund	Limited Partnership Interest	5.3%
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	Restaurant Chain	Warrants to Purchase Common Stock Warrants to Purchase Preferred Stock	2.7% 2.7%
Woodstream Corporation 69 North Locust Street Lititz, PA 17543	Pest Control Manufacturer	Common Stock Warrants to Purchase Common Stock	4.4% 3.7%

- (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) Callidus Capital Corporation owns 80% of Callidus Capital Management, LLC.

### DETERMINATION OF NET ASSET VALUE

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 and preferred stock divided by the total number of common shares outstanding.

At December 31, 2003, portfolio investments recorded at fair value were approximately 85% of our total assets. 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, therefore, our equity security has also appreciated in value. Changes in fair value are recorded in the statement of operations as net change in unrealized appreciation or depreciation.

As a business development company, we invest in illiquid securities including debt and equity securities of companies, non-investment grade CMBS bonds, and CDO bonds and preferred shares. The structure of each private finance debt and equity security is specifically negotiated to enable us to protect our investment and maximize our returns. We include many terms governing interest rate, repayment terms, prepayment penalties, financial covenants, operating covenants, ownership parameters, dilution parameters, liquidation preferences, voting rights, and put or call rights. Our investments are generally subject to restrictions on resale and generally have no established trading market. Because of the type of investments that we make and the nature of our business, our valuation process requires an analysis of various factors. Our fair value methodology includes the examination of, among other things, the underlying investment performance, financial condition, and market changing events that impact valuation.

*Valuation Methodology Private Finance* Our process for determining the fair value of a private finance investment begins with determining the enterprise value of the portfolio company. The fair value of our investment is based on the enterprise value at which the portfolio company could be sold in an orderly disposition over a reasonable

period of time between willing parties other than in a forced or liquidation sale. The liquidity event whereby we exit a private finance investment is generally the sale, the recapitalization or, in some cases, the initial public offering of the portfolio company.

There is no one methodology to determine enterprise value and, in fact, for any one portfolio company, enterprise value is best expressed as a range of fair values, from which we derive a single estimate of enterprise value. To determine the enterprise value of a portfolio company, we analyze its historical and projected financial results. We generally require portfolio companies to provide annual audited and 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 accounting principles generally accepted in the United States of America and such information should not be considered as an alternative to net income, cash flow from operations, or any other measure of performance prescribed by accounting principles generally accepted in the United States of America. When using EBITDA to determine enterprise value, we may adjust EBITDA for non-recurring items. Such adjustments are intended to normalize EBITDA to reflect the portfolio company's earnings power. Adjustments to EBITDA may include compensation to previous owners, acquisition, recapitalization, or restructuring related items or one-time non-recurring income or expense items.

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

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

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

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

*Valuation Methodology CMBS Bonds and CDO Bonds and Preferred Shares* CMBS bonds and CDO bonds and preferred shares are carried at fair value, which is based on a discounted cash flow model that utilizes prepayment and loss assumptions based on historical experience and projected performance, economic factors, the characteristics of the underlying cash flow and comparable yields for similar CMBS bonds and CDO bonds and preferred shares. Our assumption with regard to discount rate is based on the yield of comparable securities. We recognize unrealized appreciation or depreciation on our CMBS bonds and CDO bonds and preferred shares as comparable yields in the market change and/or based on changes in estimated cash flows resulting from changes in prepayment or loss assumptions in the underlying collateral pool.



## 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.

Our investment decisions in each business area are made by investment committees composed of our most senior investment officers. No one person is primarily responsible for making recommendations to a committee.

We are internally managed and our investment professionals manage 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 investment advisory fees, but instead we pay the operating costs associated with employing investment management professionals.

### 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

Information regarding our Board of Directors is as follows:

Name	Age	Position	Director Since <sup>(1)</sup>	Expiration of Term
<b>Interested Directors<sup>(2)</sup></b>				
William L. Walton	54	Chairman, Chief Executive Officer and President	1986	2004
Joan M. Sweeney	44	Chief Operating Officer	2004	2004
Robert E. Long	72	Director	1972	2004
<b>Independent Directors</b>				
Brooks H. Browne	54	Director	1990	2004
John D. Firestone	60	Director	1993	2005
Anthony T. Garcia	47	Director	1991	2005
Ann Torre Grant	45	Director	2003	2006
Lawrence I. Hebert	57	Director	1989	2005
John I. Leahy	73	Director	1994	2006
Alex J. Pollock	61	Director	2003	2006
Guy T. Steuart II	72	Director	1984	2006
Laura W. van Roijen	51	Director	1992	2005

(1) Includes service as a director of any of the predecessor companies.

(2) Interested persons of Allied Capital, as defined in the Investment Company Act of 1940.

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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:

<u>Name</u>	<u>Age</u>	<u>Position</u>
William L. Walton	54	Chairman, Chief Executive Officer and President
Joan M. Sweeney	44	Chief Operating Officer
Penni F. Roll	38	Chief Financial Officer
Scott S. Binder	49	Chief Valuation Officer and Managing Director
Douglas L. Cooper	42	Managing Director
Michael J. Grisius	40	Managing Director
Robert D. Long	47	Managing Director
Edward H. Ross	38	Managing Director
John M. Scheurer	51	Managing Director
John D. Shulman	41	Managing Director
Paul R. Tanen	37	Managing Director
Thomas H. Westbrook	40	Managing Director
Kelly A. Anderson	50	Executive Vice President and Treasurer
Suzanne V. Sparrow	38	Executive Vice President and Secretary
Timothy H. Pease	44	Senior Vice President and Director of Financial Operations

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 as defined in the Investment Company Act of 1940.

#### **Interested Directors**

*William L. Walton* has been the Chairman, Chief Executive Officer, and President of Allied Capital since 1997. Mr. Walton's previous work experience includes serving as a Managing Director of Butler Capital Corporation, a mezzanine buyout firm, and working as the personal advisor to William S. Paley, founder and Chairman of CBS. In addition, he was a Senior Vice President in Lehman Brothers Kuhn Loeb's Investment Banking Group and was the founder of two education service companies: Language Odyssey and SuccessLab. Mr. Walton is a director of Riggs National Corporation and The Hillman Companies, Inc.

*Joan M. Sweeney* has been Chief Operating Officer of Allied Capital since 1998 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 SEC Division of Enforcement.

*Robert E. Long* has been the Chief Executive Officer and a director of Goodwyn, Long & Black Investment Management, Inc. since 1997, and 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., Advanced Solutions International, Inc. and Graphic Computer Solutions, Inc. Mr. Long is the father of Robert D. Long, an executive officer of Allied Capital.

#### **Independent Directors**

*Brooks H. Browne* is a private investor. Mr. Browne was the President of Environmental Enterprises Assistance Fund from 1993 to 2002 and is currently a director of the Fund. He is a director of SEAF and Winrock International.

*John D. Firestone* has been a Partner of Secor Group since 1978. Mr. Firestone is a director of Security Storage Company of Washington, DC, and served as a director of Bryn Mawr Bank Corporation from 1998 to 2001. Mr. Firestone is currently a member of the board of several non-profit organizations.

*Anthony T. Garcia* is currently a private investor. 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 December 2003. Mr. Garcia was a private investor from 2000 to 2001, the General Manager of Breen Capital Group (investor in tax liens) from 1997 to 2000, and a Senior Vice President of Lehman Brothers Inc. from 1985 to 1996.

*Ann Torre Grant* is a strategic and financial consultant. From 1995 to 1997, Ms. Grant served as Executive Vice President, CFO and Treasurer of NHP, Inc., a national real estate services firm. From 1991 to 1995, Ms. Grant was Vice President and Treasurer of US Airways. She serves on the boards of Franklin Mutual Series and SLM Corporation (Sallie Mae).

*Lawrence I. Hebert* has been a director and President and Chief Executive Officer of Riggs Bank N.A. (a subsidiary of Riggs National Corporation) since February 2001, and has served as a director of Riggs National Corporation since 1988. Mr. Hebert also serves as a director of Riggs Investment Advisors and Riggs Bank Europe Limited (both indirect subsidiaries of Riggs National Corporation). Mr. Hebert is the President and a director of Perpetual Corporation (owner of Allbritton Communications Company and ALLNEWSCO, Inc.). Mr. Hebert is a director of ALLNEWSCO, Inc. (news programming service), the President of Westfield News Advertiser, Inc. (owner of a television station and newspapers), a Trustee of The Allbritton Foundation, and Vice Chairman of Allbritton Communications Company. Mr. Hebert previously served as Vice Chairman (1983 to 1998), President (1984 to 1998), and Chairman and Chief Executive Officer (1998 to 2001) of Allbritton Communications Company. Riggs Bank N.A. has a \$60 million commitment under our revolving line of credit.

*John I. Leahy* has been the President of Management and Marketing Associates, a management consulting firm, since 1986. Mr. Leahy was the President and Group Executive Officer, Western Hemisphere of Black & Decker Corporation from 1982 to 1985. Mr. Leahy is 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 President and Chief Executive Officer of the Federal Home Loan Bank of Chicago since 1991. He also serves as a director of the Great Lakes Higher Education Corporation and the Great Books Foundation. Mr. Pollock is Past President of the International Union for Housing Finance and the Bankers Club of Chicago.

*Guy T. Steuart II* has been a director and President of Steuart Investment Company, which manages, operates, and leases real and personal property and holds stock in operating subsidiaries engaged in various businesses, since 1960 and has been Chairman of Steuart Investment Company since 2003. Mr. Steuart is Trustee Emeritus of Washington and Lee University.

*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***

*Penni F. Roll*, Chief Financial Officer, has been employed by Allied Capital since 1995. Ms. Roll is responsible for Allied Capital's financial operations. Prior to joining Allied Capital, Ms. Roll was employed by KPMG LLP.

*Scott S. Binder*, Chief Valuation Officer and Managing Director, has been employed by Allied Capital in the private finance investment group since 1997 and was a consultant to Allied Capital from 1991 until 1997. Prior to joining Allied Capital, Mr. Binder formed and was President of Overland Communications Group. He has also worked in the specialty finance and leasing industries.

*Douglas L. Cooper*, Managing Director, has been employed by Allied Capital in its commercial real estate investment group since 1999. Prior to joining Allied Capital, Mr. Cooper was a Senior Vice President at Criimi Mae, a real estate investment trust.

*Michael J. Grisius*, Managing Director, is co-head of the mezzanine group and has been employed by Allied Capital since 1992. Prior to joining Allied Capital, Mr. Grisius worked in corporate finance at Chemical Bank and was employed by KPMG LLP.

*Robert D. Long*, Managing Director, joined Allied Capital in its private finance investment group in 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.

*Edward H. Ross*, Managing Director, is co-head of the mezzanine group and joined Allied Capital in its private finance investment group in 2002. Prior to joining Allied Capital, Mr. Ross co-founded and served as a Managing Director of Leveraged Capital at Wachovia Securities (previously First Union Securities) from 1998 to 2002, a merchant banking arm for the firm. He also held management positions in First Union's Leveraged Finance Group from 1994 to 1998.

*John M. Scheurer*, Managing Director, heads the commercial real estate group and has been employed by Allied Capital in the commercial real estate investment group since 1991. Prior to joining Allied Capital, Mr. Scheurer worked in the commercial real estate business with his own company, The Scheurer Company, and co-founded Hunter

Associates, a leasing and consulting real estate firm in the Washington, DC area. He worked for First American Bank in Washington, DC from 1977 to 1984.

*John D. Shulman*, Managing Director, heads the buyout group and has been employed by Allied Capital in the private finance investment group since 2001. Prior to joining Allied Capital, Mr. Shulman served as the President and CEO of Onyx International, LLC from 1995 to 2001. 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.

*Paul R. Tanen*, Managing Director, has been employed by Allied Capital in the private finance investment group since 2000. Prior to joining Allied Capital, Mr. Tanen served as a Managing Director at Ridgefield Partners from 1998 to 2000, and was a Founding Member of the private equity group at Charter Oak Partners from 1992 to 1998.

*Thomas H. Westbrook*, Managing Director, is co-head of the mezzanine group and has been employed by Allied Capital in the private finance investment group since 1991. Prior to joining Allied Capital, Mr. Westbrook worked with the North Carolina Enterprise Fund and was a Lending Officer in NationsBank's corporate lending unit.

*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 and cash management operations and infrastructure operations.

*Suzanne V. Sparrow*, Executive Vice President and Corporate Secretary, has been employed by Allied Capital since 1987. Ms. Sparrow manages Allied Capital's corporate governance activities.

*Timothy H. Pease*, Senior Vice President and Director of Financial Operations, has been employed by Allied Capital since 2003. Prior to joining Allied Capital, Mr. Pease was the Principal Accounting Officer for Amicus Holdings, Inc. from 2001 to 2002. He has also held senior accounting positions at Broadband Residential, Inc. from 2000 to 2001 and Host Marriott Services Corporation from 1998 to 2000. Mr. Pease also served as a senior manager at Arthur Andersen LLP. Mr. Pease is responsible for managing the accounting, financial reporting and loan servicing 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 operate pursuant to a committee charter. The charter of each Committee is available on our web site at [www.alliedcapital.com](http://www.alliedcapital.com) in the Investor Resources section.

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 SEC, or our charter or bylaws. The Executive Committee reviews and approves certain investments. The Executive Committee met 43 times during 2003. The Executive Committee members currently are Messrs. Walton, Firestone, Hebert, Leahy, Long, and Stuart.

The Audit Committee operates pursuant to a charter approved by the Board of Directors, which was amended as of March 10, 2004. 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 oversight responsibilities for our accounting and reporting processes and the audits of our financial statements through oversight and monitoring. The Audit Committee met 15 times during 2003. The Audit Committee is presently composed of four persons including Messrs. Browne and Garcia and Mmes. Grant and van Roijen, all of whom are considered independent under the rules promulgated by the New York Stock Exchange.

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 our other officers and employees. In addition, the Compensation Committee approves stock option grants for our officers under our Stock Option Plan and will determine individual performance awards for participants. The Compensation Committee met eight times during 2003. The Compensation Committee members currently are Messrs. Leahy, Browne, and Garcia.

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 four times during 2003. The Corporate Governance/Nominating Committee members currently are Messrs. Hebert, Browne, and Pollock and Ms. van Roijen.

### 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 paid during the year ended December 31, 2003, to 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 <sup>(1,2)</sup>	Securities Underlying Options/SARs <sup>(3)</sup>	Pension or Retirement Benefits Accrued as Part of Company Expenses <sup>(2)</sup>	Directors Fees by the Company <sup>(4)</sup>
<b>Interested Directors:</b>				
William L. Walton, <i>Chairman and CEO</i>	\$2,602,005		\$	\$
Joan M. Sweeney, <i>Chief Operating Officer</i>	1,875,715			
Robert E. Long, <i>Director</i>	75,000	5,000		75,000
<b>Independent Directors:</b>				
Brooks H. Browne, <i>Director</i>	90,500	5,000		90,500
John D. Firestone, <i>Director</i>	80,000	5,000		80,000
Anthony T. Garcia, <i>Director</i>	82,500	5,000		82,500
Ann Torre Grant, <i>Director</i>	67,500	10,000		67,500
Lawrence I. Hebert, <i>Director</i>	85,000	5,000		85,000
John I. Leahy, <i>Director</i>	94,000	5,000		94,000
Alex J. Pollock, <i>Director</i>	43,000	10,000		43,000
Guy T. Steuart II, <i>Director</i>	68,000	5,000		68,000
Laura W. van Roijen, <i>Director</i>	76,500	5,000		76,500
<b>Executive Officers:</b>				
Thomas H. Westbrook, <i>Managing Director</i>	1,855,945			

(1) We paid no perquisites in excess of the lesser of \$50,000 or 10% of the Compensated Person's total salary and bonus for the year.

(2) The following table provides detail as to aggregate compensation paid during 2003 to our three highest paid executive officers:

	Salary	Bonus and Awards	Other Benefits
Mr. Walton	\$571,154	\$1,935,000	\$95,851
Ms. Sweeney	397,308	1,410,000	68,407
Mr. Westbrook	269,204	1,525,000	61,741

Included for each executive officer in Bonus and Awards is an annual bonus and retention award. 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, and health and dental insurance. See also Employment Agreements.

(3) See Stock Option Awards for terms of options granted in 2003. We do not maintain a restricted stock plan or a long-term incentive plan.

(4) Consists only of directors' fees we paid during 2003. Such fees are also included in the column titled Aggregate Compensation from the Company.

## Compensation of 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 \$1,000 per meeting; Audit Committee members receive \$2,500 per meeting; and members of the Compensation and Corporate Governance/Nominating Committees receive \$1,500 per meeting. Directors may choose to defer such fees through our Deferred Compensation Plan I, and may choose to invest such deferred income in shares of our common stock through a trust.

Non-officer directors are eligible for stock option awards under our stock option plan pursuant to an exemptive order from the SEC. 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 Stock Option Plan.

## Stock Option Awards

The following table sets forth the details relating to option grants in 2003 to Compensated Persons under our Stock Option Plan, and the potential realizable value of each grant, as prescribed to be calculated by the SEC. See Stock Option Plan.

### Options Grants During 2003

Name	Number of Securities Underlying Options Granted	Percent of Total Options Granted in 2003 <sup>(1)</sup>	Exercise Price Per Share	Expiration Date	Potential Realizable Value at Assumed Annual Rates of Stock Appreciation Over 10-Year Term <sup>(2)</sup>	
					5%	10%
<b>Interested Directors:</b>						
William L. Walton						
Joan M. Sweeney						
Robert E. Long	5,000	0.4785%	\$ 21.62	05/13/13	\$ 67,984	\$ 172,284
<b>Independent Directors:</b>						
Brooks H. Browne	5,000	0.4785%	21.62	05/13/13	67,984	172,284
John D. Firestone	5,000	0.4785%	21.62	05/13/13	67,984	172,284
Anthony T. Garcia	5,000	0.4785%	21.62	05/13/13	67,984	172,284
Ann Torre Grant	10,000	0.9569%	21.62	05/13/13	135,967	344,567
Lawrence I. Hebert	5,000	0.4785%	21.62	05/13/13	67,984	172,284
John I. Leahy	5,000	0.4785%	21.62	05/13/13	67,984	172,284
Alex J. Pollock	10,000	0.9569%	21.62	05/13/13	135,967	344,567
Guy T. Steuart II	5,000	0.4785%	21.62	05/13/13	67,984	172,284
Laura W. van Roijen	5,000	0.4785%	21.62	05/13/13	67,984	172,284
<b>Executive Officers:</b>						
Thomas H. Westbrook						

(1) In 2003, we granted options to purchase a total of 1,045,000 shares.

(2) Potential realizable value is calculated on 2003 options granted, and is net of the option exercise price but before any tax liabilities that may be incurred. These amounts represent certain assumed rates of appreciation, as mandated by the SEC. Actual gains, if any, on stock option exercises are dependent on the future performance of the shares, overall market conditions, and the continued employment by us of the option holder. The potential realizable value will not necessarily be realized.



The following table sets forth the details of option exercises by Compensated Persons during 2003 and the values of those unexercised options at December 31, 2003.

### Option Exercises and Year-End Option Values

Name	Shares Acquired on Exercise	Value Realized <sup>(1)</sup>	Number of Securities Underlying Unexercised Options as of 12/31/03		Value of Unexercised In-the-Money Options as of 12/31/03 <sup>(2)</sup>	
			Exercisable	Unexercisable	Exercisable	Unexercisable
<b>Interested Directors:</b>						
William L. Walton			1,931,118	508,983	\$ 16,452,500	\$ 3,291,866
Joan M. Sweeney			956,874	371,346	7,861,451	2,405,666
Robert E. Long			30,000		176,420	
<b>Independent Directors:</b>						
Brooks H. Browne			30,000		176,420	
John D. Firestone			30,000		176,420	
Anthony T. Garcia			30,000		176,420	
Ann Torre Grant			10,000		62,600	
Lawrence I. Hebert			30,000		176,420	
John I. Leahy			30,000		176,420	
Alex J. Pollock	3,200	\$ 8,146	6,800		42,568	
Guy T. Steuart II			30,000		176,420	
Laura W. van Roijen			30,000		176,420	
<b>Executive Officers:</b>						
Thomas H. Westbrook			579,101	315,810	5,127,000	2,025,857

(1) Value realized is calculated as the closing market price on the date of exercise, net of option exercise price, but before any tax liabilities or transaction costs. This is the deemed market value, which may actually be realized only if the shares are sold at that price.

(2) Value of unexercised options is calculated as the closing market price on December 31, 2003, (\$27.88), net of the option exercise price, but before any tax liabilities or transaction costs. In-the-Money Options are options with an exercise price that is less than the market price as of December 31, 2003.

### Employment Agreements

We have entered into employment agreements with William L. Walton, our Chairman and CEO, and Joan M. Sweeney, our Chief Operating Officer, each of whom is a Compensated Person. We have also entered into an employment agreement with Penni F. Roll, our Chief Financial Officer. Each of the agreements provides for a three-year term that extends one day at the end of every day during its length, unless either party provides written notice of termination of such extension. In that case, the agreement would terminate three years from such notification.

Each agreement specifies each executive's base salary compensation during the term of the agreement. The Compensation Committee has the right to increase the base salary during the term of the employment agreement. In addition, each employment agreement states that the Compensation Committee may provide, at their sole discretion, an annual cash bonus. This bonus is to be determined with reference to each executive's performance in accordance with performance criteria to be determined by the Compensation Committee in its sole discretion. Under each agreement, each executive is also entitled to participate in our Stock Option Plan, and to receive all other awards and benefits previously granted to each executive including life insurance premiums.

The executive has the right to voluntarily terminate employment at any time with 30 days' notice, and in such case, the employee will not receive any severance pay. Among

other things, the employment agreements prohibit the solicitation of our employees in the event of an executive's departure for a period of two years.

If employment is terminated with cause, the employee will not receive any severance pay. If employment is terminated without cause during the term of the agreement, or within 24 months after a change in control, the executive shall be entitled to severance pay for a period not to exceed 36 months. Severance pay shall include three times the average base salary for the preceding three years, plus three times the average bonus compensation for the preceding three years, plus a lump sum amount equal to \$3,178,000 for Mr. Walton and \$2,831,000 for Ms. Sweeney. Such severance pay shall be paid in two installments: 75% of such pay shall be paid at the time of separation, and 25% shall be paid on the second anniversary of such separation. Stock options would cease to vest during the severance period.

Under the employment agreements, a Change in Control means (i) the sale or other disposition of all or substantially all of Allied Capital's assets; or (ii) the acquisition, whether directly, indirectly, beneficially (within the meaning of Rule 13d-3 of the 1934 Act), or of record, as a result of a merger, consolidation or otherwise, of Allied Capital's securities representing fifteen percent (15%) or more of the aggregate voting power of Allied Capital's then outstanding common stock by any person (within the meaning of Section 13(d) and 14(d) of the 1934 Act), including, but not limited to, any corporation or group of persons acting in concert, other than (A) Allied Capital or our subsidiaries and/or (B) any employee pension benefit plan (within the meaning of Section 3(2) of the Employee Retirement Income Security Act of 1974) of Allied Capital or our subsidiaries, including a trust established pursuant to any such plan; or (iii) the individuals who were members of the Board of Directors as of the Effective Date (the Incumbent Board) cease to constitute at least two-thirds (2/3) of the Board; provided, however, that any director appointed by at least two-thirds (2/3) of the then Incumbent Board or nominated by at least two-thirds (2/3) of the Corporate Governance/Nominating Committee of the Board of Directors (a majority of the members of the Corporate Governance/Nominating Committee shall be members of the then Incumbent Board or appointees thereof), other than any director appointed or nominated in connection with, or as a result of, a threatened or actual proxy or control contest, shall be deemed to constitute a member of the Incumbent Board.

Under the terms of the agreement, we would also provide compensation to offset any applicable excise tax penalties imposed on the executive under Section 4999 of the Internal Revenue Code.

#### **Indemnification Agreements**

In February 2004, we entered into indemnification agreements with our directors and 12 senior officers. The indemnification agreements attempt to provide these directors and senior officers the maximum indemnification permitted under Maryland law and the Investment Company Act of 1940. Each indemnification agreement provides that Allied Capital shall indemnify the director or senior officer who is a party to the agreement (an Indemnitee) if, by reason of his corporate status, the Indemnitee is, or is threatened to be, made a party to or a witness in any threatened, pending, or completed proceeding, other than a proceeding by or in the right of Allied Capital.

At present, there is no pending litigation or proceeding involving an Indemnitee where indemnification would be required or permitted under the indemnification agreement.

## **Compensation Plans**

### ***Stock Option Plan***

Our Stock Option Plan is intended to encourage stock ownership in Allied Capital by officers and directors, thus giving them a proprietary interest in our performance. The Stock Option Plan was most recently approved by stockholders on May 7, 2002. Stockholders will be asked to approve an amendment to the Stock Option Plan at the Annual Meeting of Stockholders on May 12, 2004.

The Compensation Committee's principal objective in awarding stock options to our eligible officers is to align each optionee's interests with our success and the financial interests of our stockholders by linking a portion of such optionee's compensation with the performance of our stock and the value delivered to stockholders.

Stock options are granted under the Stock Option Plan at a price not less than the prevailing market value at the time of grant and will have realizable value only if our stock price increases. The Compensation Committee determines the amount and features of the stock options, if any, to be awarded to optionees. The Compensation Committee evaluates a number of criteria, including the past service of each such optionee to Allied Capital, the present and potential contributions of such optionee to the success of Allied Capital and such other factors as the Compensation Committee shall deem relevant in connection with accomplishing the purposes of the Stock Option Plan, including the recipient's current stock holdings, years of service, position with Allied Capital and other factors. The Compensation Committee does not apply a formula assigning specific weights to any of these factors when making its determination. The Compensation Committee awards stock options on a subjective basis and such awards depend in each case on the performance of the officer under consideration, and in the case of new hires, their potential performance.

We have received approval from the SEC to grant options under the Stock Option Plan to non-officer directors. Initially, each incumbent non-officer director received options to purchase 10,000 shares, and pursuant to the SEC order, each will receive options to purchase 5,000 shares each year thereafter on the date of the annual meeting of stockholders. New non-officer directors receive options to purchase 10,000 shares upon election by stockholders to the Board of Directors, and options to purchase 5,000 shares each year thereafter on the date of our annual meeting.

The Stock Option Plan is designed to satisfy the conditions of Section 422 of the Code so that options granted under the Stock Option Plan may qualify as incentive stock options. To qualify as incentive stock options, options may not become exercisable for the first time in any year if the number of incentive options first exercisable in that year multiplied by the exercise price exceeds \$100,000.

### **401(k) Plan**

We maintain a 401(k) plan (the 401(k) Plan). All full-time employees who are at least 21 years of age have the opportunity to contribute pre-tax salary deferrals into the 401(k) Plan up to \$13,000 annually for the 2004 plan year, and to direct the investment of these contributions. Plan participants who reach the age of 50 during the 2004 plan year will be eligible to defer an additional \$3,000 during 2004. The 401(k) Plan allows eligible participants to invest in shares of our common stock, among other investment options. In addition, for the 2004 plan year, we expect to contribute up to 5% of each participant's eligible compensation for the year, up to a maximum compensation of \$205,000, to each

participant's plan account on the participant's behalf, which fully vests at the time of the contribution. The contribution with respect to compensation in excess of \$205,000 is made to the Deferred Compensation Plan I. On March 5, 2004, the 401(k) Plan held less than 1% of our outstanding shares.

#### **Deferred Compensation Plan I**

We maintain a deferred compensation plan (the DCP I). The DCP I is an unfunded plan, as defined by the Code, that provides for the deferral of compensation by our directors, employees, and consultants. Our directors, employees, or consultants are eligible to participate in the plan at such time and for such period as designated by the Board of Directors. The DCP I is administered through a trust, and we fund this plan through cash contributions. Directors may choose to defer director's fees through the DCP I, and may choose to invest such deferred income in shares of our common stock.

#### **Deferred Compensation Plan II**

The Compensation Committee of our Board of Directors has established a long-term incentive compensation program whereby the Compensation Committee will determine an individual performance award for certain officers annually at the beginning of each year. In determining the award for any one officer, it is anticipated that the Compensation Committee will consider individual performance factors, as well as the individual's contribution to the returns generated for stockholders, among other factors.

In conjunction with the program, the Compensation Committee has recommended and the Board of Directors has approved the adoption of a non-qualified deferred compensation plan (DCP II), which will be administered through a trust. The individual performance awards will be deposited in the trust in four equal installments on a quarterly basis in the form of cash and the Compensation Committee has designed the DCP II to require the trustee to use the cash exclusively to purchase shares of our common stock in the market. A participant will only vest in the award as it is deposited to the trust. Although no new shares will be issued as part of the plan, DCP II is considered an equity compensation plan under the NYSE rules. As a result of this requirement to invest in our common stock, the plan is being submitted to stockholders for approval at our Annual Meeting of Stockholders that will be held on May 12, 2004.

If stockholders do not approve the DCP II, then the trust will not be required to purchase shares of our common stock and DCP II will be amended to provide for alternative investment options.

**CONTROL PERSONS AND PRINCIPAL HOLDERS OF SECURITIES**

As of March 5, 2004, there were no persons that owned 25% or more of our outstanding voting securities, and no person would be deemed to control us, as such term is defined in the 1940 Act.

The following table sets forth, as of March 5, 2004, each stockholder who owned more than 5% of our outstanding shares of common stock, each director, the chief executive officer, our executive officers and our directors and executive officers as a group. Unless otherwise indicated, we believe that each beneficial owner set forth in the table has sole voting and investment power.

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.

Name of Beneficial Owner	Number of Shares Owned Beneficially <sup>(8)</sup>	Percentage of Class <sup>(1)</sup>	Dollar Range of Equity Securities Beneficially Owned by Directors <sup>(9)</sup>
Capital Research and Management Company 333 South Hope Street, 55th Floor Los Angeles, CA 90071-1447	8,273,100(11)	6.43%	
<b>Interested Directors:</b>			
William L. Walton	2,655,279(2,4,7)	2.03%	over \$ 100,000
Joan M. Sweeney	1,269,617(2)	*	over \$ 100,000
Robert E. Long	42,111(3)	*	over \$ 100,000
<b>Independent Directors:</b>			
Brooks H. Browne	73,713(3,7)	*	over \$ 100,000
John D. Firestone	61,756(3,7)	*	over \$ 100,000
Anthony T. Garcia	88,512(3)	*	over \$ 100,000
Ann Torre Grant	13,500(3,7)	*	over \$ 100,000
Lawrence I. Hebert	51,800(3)	*	over \$ 100,000
John I. Leahy	47,318(3)	*	over \$ 100,000
Alex J. Pollock	13,200(3,7)	*	over \$ 100,000
Guy T. Steuart II	354,244(3,5)	*	over \$ 100,000
Laura W. van Roijen	61,093(3,7)	*	over \$ 100,000
<b>Executive Officers:</b>			
Penni F. Roll	373,583(2)	*	
Scott S. Binder	626,042(2,7)	*	
Douglas L. Cooper	201,204(2)	*	
Michael J. Grisius	393,415(2,7)	*	
Robert D. Long	369,542(2,7,10)	*	
Edward H. Ross	101,946(2)	*	
John M. Scheurer	1,046,688(2)	*	
John D. Shulman	411,470(2)	*	
Paul R. Tanen	371,225(2)	*	
Thomas H. Westbrook	769,642(2,7)	*	
Kelly A. Anderson	201,508(2)	*	
Suzanne V. Sparrow	193,556(2)	*	

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Name of Beneficial Owner	Number of Shares Owned Beneficially(8)	Percentage of Class(1)
Timothy H. Pease	17,767(2)	*
All directors and executive officers as a group (25 in number)	9,707,695(6)	7.14%

\* Less than 1%

(1) Based on a total of 128,696,288 shares of our common stock issued and outstanding on March 5, 2004, and 7,206,932 shares of our common stock issuable upon the exercise of stock options that are exercisable within 60 days held by executive officers and non-officer directors.

(2) Share ownership for the following directors and executive officers includes:

	Owned Directly	Options Exercisable Within 60 Days of March 5, 2004	Allocated to 401(k) Plan
<b>Interested Directors:</b>			
William L. Walton	444,797	1,931,118	3,966
Joan M. Sweeney	298,966	956,874	13,777
<b>Executive Officers:</b>			
Penni F. Roll	83,096	282,034	8,453
Scott S. Binder	77,709	546,647	1,686
Douglas L. Cooper	15,045	185,660	499
Michael J. Grisius	55,435	322,023	15,957
Robert D. Long	19,000	349,119	1,423
Edward H. Ross		101,946	
John M. Scheurer	279,936	733,730	33,022
John D. Shulman	4,799	406,671	
Paul R. Tanen	5,161	366,064	
Thomas H. Westbrook	190,541	579,101	
Kelly A. Anderson	112,160	84,706	4,642
Suzanne V. Sparrow	78,907	92,072	22,577
Timothy H. Pease	1,100	16,667	

(3) Beneficial ownership for these non-officer directors includes exercisable options to purchase 10,000 shares for Ms. Grant and 2,500 for Mr. Pollock and 30,000 shares for all others.

(4) Includes 279,364 shares held by the 401(k) Plan, of which Mr. Walton is trustee. Mr. Walton disclaims beneficial ownership of such shares.

(5) Includes 276,691 shares held by a corporation for which Mr. Steuart serves as an executive officer.

(6) Includes a total of 7,206,932 shares underlying stock options exercisable within 60 days of March 5, 2004, which are assumed to be outstanding for the purpose of calculating the group's percentage ownership, and 279,364 shares held by the 401(k) Plan.

(7) Includes certain shares held in IRA or Keogh accounts: Walton 12,015 shares; Browne 12,280 shares; Firestone 2,745 shares; Grant 3,500 shares; Pollock 1,000 shares; van Roijen 5,637 shares; Binder 273 shares; Grisius 974 shares; R.D. Long 15,000 shares; Westbrook 16,365 shares.

(8) Beneficial ownership has been determined in accordance with Rule 13d-3 of the Securities Exchange Act of 1934.

(9) Beneficial ownership has been determined in accordance with Rule 16-1(a)(2) of the Securities Exchange Act of 1934.

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(10) Includes 4,000 shares held by a trust for the benefit of Mr. Long's children.

(11) Information regarding share ownership was obtained from the Schedule 13G that Capital Research and Management Company filed with the SEC on February 13, 2004.

**CERTAIN RELATIONSHIPS AND RELATED PARTY TRANSACTIONS**

The following table sets forth certain information, as of March 5, 2004, regarding indebtedness to Allied Capital in excess of \$60,000 of any person serving as a director or executive officer of Allied Capital at any time since January 1, 2003. All of such indebtedness results from loans we made to enable the exercise of stock options. The loans are required to be fully collateralized and are full recourse against the borrower and have varying terms not exceeding ten years. The interest rates charged generally reflect the applicable federal rate on the date of the loan. As of December 31, 2003, the total loans outstanding to such executive officers of Allied Capital was \$18.6 million or 0.6% of Allied Capital's total assets at December 31, 2003.

As a business development company under the Investment Company Act of 1940, we are entitled to provide and have provided loans to our officers in connection with the exercise of options. However, as a result of provisions of the Sarbanes-Oxley Act of 2002, we are prohibited from making new loans to our executive officers in the future.

Name and Position with Company	Highest Amount Outstanding During 2003	Range of Interest Rates		Amount Outstanding at March 5, 2004
<b>Executive Officers who are Interested Directors<sup>(1)</sup>:</b>				
William L. Walton, <i>Chairman and CEO</i>	\$2,997,228	4.45%	6.24%	\$2,416,230
Joan M. Sweeney, <i>Chief Operating Officer</i>	\$2,231,157	4.45%	6.63%	\$2,231,157
<b>Executive Officers:</b>				
Penni F. Roll, <i>Chief Financial Officer</i>	\$1,273,924	4.45%	6.24%	\$1,273,924
Scott S. Binder, <i>Chief Valuation Officer and Managing Director</i>	\$ 979,492	4.93%	5.89%	\$ 170,000
Douglas L. Cooper, <i>Managing Director</i>	\$ 289,345	4.45%	4.98%	\$ 282,845
Michael J. Grisius, <i>Managing Director</i>	\$ 266,988	3.91%	4.68%	\$ 242,788
John M. Scheurer, <i>Managing Director</i>	\$2,345,719	4.73%	6.63%	\$2,058,996
John D. Shulman, <i>Managing Director</i>	\$ 99,991	2.85%	2.85%	\$ 99,991
Paul R. Tanen, <i>Managing Director</i>	\$ 99,994	3.91%	3.91%	\$ 99,994
Thomas H. Westbrook, <i>Managing Director</i>	\$1,809,292	4.98%	4.98%	\$ 370,134
Kelly A. Anderson, <i>Executive Vice President and Treasurer</i>	\$1,523,360	3.91%	6.34%	\$1,432,225
Suzanne V. Sparrow, <i>Executive Vice President and Secretary</i>	\$ 753,506	4.45%	6.18%	\$ 653,809

(1) Interested directors are interested persons as defined by the Investment Company Act of 1940.



## TAX STATUS

*The following discussion is a general summary of the material United States federal income tax considerations applicable to us and to an investment in our common stock. This summary does not purport to be a complete description of the income tax considerations applicable to such an investment. The discussion is based upon the Internal Revenue Code, Treasury Regulations, and administrative and judicial interpretations, each as of the date of this prospectus and all of which are subject to change. You should consult your own tax advisor with respect to tax considerations that pertain to your purchase of our common stock.*

*This summary is intended to apply to investments in our common stock and assumes that investors hold our common stock as capital assets. This summary does not discuss all aspects of federal income taxation relevant to holders of our common stock in light of particular circumstances, or to certain types of holders subject to special treatment under federal income tax laws, including dealers in securities, pension plans and trusts and financial institutions. This summary does not discuss any aspects of U.S. estate and gift tax or foreign, state or local tax. It does not discuss the special treatment under federal income tax laws that could result if we invested in tax-exempt securities or certain other investment assets.*

*Except as specifically indicated herein, this summary is intended to apply to U.S. Stockholders (as defined below) and does not purport to discuss all U.S. federal income tax consequences to persons who are not U.S. Stockholders ( Non-U.S. Stockholders ) from an investment in our common stock. (A U.S. Stockholder is a stockholder who is (i) a citizen or resident of the United States, (ii) a corporation or partnership created in or organized under the laws of the United States or any political subdivision thereof, (iii) an estate, the income of which is subject to United States federal income taxation regardless of its source, or (iv) a trust subject to the supervision of a court within the United States and the control of a United States person.) Non-U.S. Stockholders should consult their own tax advisors to discuss the consequences of an investment in our common stock.*

### ***Taxation as a Regulated Investment Company***

We intend to be treated for tax purposes as a regulated investment company under Subchapter M of the Code. If we (i) qualify as a regulated investment company and (ii) distribute to stockholders in a timely manner at least 90% of our investment company taxable income, as defined in the Internal Revenue Code (i.e., net ordinary investment income, including accrued original issue discount, and net short-term capital gain in excess of net long-term capital loss) (the 90% Distribution Requirement ) each year, we generally will not be subject to federal income tax on the portion of our investment company taxable income and net capital gain (i.e., net long-term capital gain in excess of net short-term capital loss) we distribute (or treat as deemed distributed ) to stockholders. (We will, however, be subject to such tax to the extent that, prior to February 2, 2013, BLX sells property held by BLX, Inc. on the date of its corporate reorganization, but only to the extent (i) such property had a built-in gain (that is, value in excess of tax basis) on such date and (ii) such built-in gain is recognized on such sale.) In addition, if we distribute in a timely manner an amount at least equal to the sum of (i) 98% of our ordinary income for each calendar year, (ii) 98% of our capital gain net income for the one-year period ending December 31 of that calendar year, and (iii) any

income not distributed in prior years, we will not be subject to the 4% nondeductible federal excise tax on certain undistributed income of regulated investment companies (the Excise Tax Avoidance Requirements ). We generally will endeavor to distribute (or treat as deemed distributed) to stockholders all of our investment company taxable income and our net capital gains, if any, for each taxable year so that we will not incur federal income or excise taxes on our earnings. We will be subject to federal income tax at the regular corporate rate for any amounts of investment company taxable income or net capital gain not distributed (or deemed distributed) to our stockholders.

In order to qualify as a regulated investment company for federal income tax purposes, we must, among other things: (a) continue to qualify as a business development company under the 1940 Act; (b) derive in each taxable year at least 90% of our gross income from dividends, interest, payments with respect to securities loans, gains from the sale of stock or other securities, or other income derived with respect to our business of investing in such stock or securities (the 90% Income Test ); and (c) diversify our holdings so that at the end of each quarter of the taxable year (i) at least 50% of the value of our assets consists of cash, cash items, U.S. government securities, securities of other regulated investment companies, and other securities if such other securities of any one issuer do not represent more than 5% of our assets or more than 10% of the outstanding voting securities of the issuer, and (ii) no more than 25% of the value of our assets is invested in the securities (other than U.S. government securities or securities of other regulated investment companies) of any one issuer or of two or more issuers that are controlled (as determined under applicable Code rules) by us and are engaged in the same or similar or related trades or businesses (the Diversification Tests ). The failure of one or more of our subsidiaries to continue to qualify as regulated investment companies could adversely affect our ability to satisfy the Diversification Tests.

If we acquire or are deemed to have acquired debt obligations that were issued originally at a discount or that otherwise are treated under applicable tax rules as having original issue discount, we must include in income each year a portion of the original issue discount that accrues over the life of the obligation regardless of whether cash representing such income is received by us in the same taxable year. Any amount accrued as original issue discount will be included in our investment company taxable income for the year of accrual and may have to be distributed to our stockholders in order to satisfy the 90% Distribution Requirement or the Excise Tax Avoidance Requirements even though we have not received any cash representing such income.

Although we do not currently intend to do so, if we were to invest in certain options, futures, or forward contracts, we may be required to report income from such investments on a mark-to-market basis, which could result in us recognizing unrealized gains and losses for federal income tax purposes even though we may not realize such gains and losses when we ultimately dispose of such investments. We could also be required to treat such gains and losses as 60% long-term capital gain or loss and 40% short-term capital gain or loss regardless of our holding period for the investments. In addition, if we were to engage in certain hedging transactions, including hedging transactions in options, future contracts, and straddles, or other similar transactions, we could be subject to special tax rules (including constructive sale, mark-to-market, straddle, wash sale, and short sale rules), the effect of which may be to accelerate our income, defer our losses, cause adjustments in the holding periods of our securities, convert long-term capital gains into short-term capital gains or convert short-term capital losses into long-term capital losses. These rules could affect our investment company taxable income or net capital gain for a taxable year and

thus affect the amounts that we would be required to distribute to our stockholders pursuant to the 90% Distribution Requirement and the Excise Tax Avoidance Requirements for such year.

Although we do not presently expect to do so, we are authorized to borrow funds and to sell assets in order to satisfy distribution requirements. However, under the 1940 Act, we are not permitted to make distributions to stockholders while our debt obligations and other senior securities are outstanding unless certain asset coverage tests are met. Moreover, our ability to dispose of assets to meet our distribution requirements may be limited by other requirements relating to our status as a regulated investment company, including the Diversification Tests. If we dispose of assets in order to meet the 90% Distribution Requirement or the Excise Tax Avoidance Requirements, we may make such dispositions at times that, from an investment standpoint, are not advantageous.

If we fail to satisfy the 90% Distribution Requirement or otherwise fail to qualify as a regulated investment company in any taxable year, we will be subject to tax in that year on all of our taxable income, regardless of whether we make any distributions to our stockholders. In that case, all of our distributions to our stockholders will be characterized as ordinary income (to the extent of our current and accumulated earnings and profits). In contrast, as is explained below, if we qualify as a regulated investment company, a portion of our distributions or deemed distributions may be characterized as long-term capital gain in the hands of our stockholders.

*The remainder of this summary assumes that we qualify as a regulated investment company and satisfy the 90% Distribution Requirement.*

#### **Taxation of Stockholders**

Our distributions generally are taxable to stockholders as ordinary income or capital gains. Our distributions of investment company taxable income will be taxable as ordinary income to stockholders to the extent of our current or accumulated earnings and profits, whether paid in cash or reinvested in additional common stock (including any dividends reinvested through our dividend reinvestment plan). Under new tax legislation, a portion of such distributions of investment company taxable income may constitute qualified dividends paid by us. Individual shareholders will incur a lower rate of tax on such qualified dividends than the rate of tax imposed on the remainder of our distributions of investment company taxable income. Our distributions of net capital gains properly designated by us as capital gain dividends will be taxable to each stockholder as long-term capital gains regardless of the stockholder's holding period for his or her common stock and regardless of whether paid in cash or reinvested in additional common stock (including any dividends reinvested through our dividend reinvestment plan). Distributions in excess of the Company's earnings and profits first will reduce a stockholder's adjusted tax basis in such stockholder's common stock and, after the adjusted basis is reduced to zero, will constitute capital gains to such stockholder.

At our option, we may elect to retain some or all of our net capital gains for a tax year, but designate the retained amount as a deemed distribution. In that case, among other consequences, we will pay tax on the retained amount for the benefit of our stockholders, the stockholders will be required to report their share of the deemed distribution on their tax returns as if it had been distributed to them, and the stockholders will report a credit for the tax paid thereon by us. The amount of the deemed distribution net of such tax will be added to the stockholder's cost basis for his or her common stock.

Since we expect to pay tax on any retained net capital gains at our regular corporate capital gain tax rate, and since that rate is in excess of the maximum rate currently payable by individuals on long-term capital gains, the amount of tax that individual stockholders will be treated as having paid and for which they will receive a credit will exceed the amount of tax that such stockholders would be required to pay on the retained net capital gains. Such excess generally will be available to offset other tax liabilities of the stockholders. A stockholder that does not have a sufficient amount of other tax liabilities or that is not subject to U.S. federal income tax should be able to file a return on the appropriate form or a claim for refund that allows such stockholder to recover the taxes paid on his or her behalf. In the event we select this option, we must provide written notice to the stockholders prior to the expiration of 60 days after the close of the relevant tax year.

Any dividend declared by us in October, November, or December of any calendar year, payable to stockholders of record on a specified date in such a month and actually paid during January of the following year, will be treated as if it had been received by the stockholders on December 31 of the year in which the dividend was declared.

You should consider the tax implications of buying common stock just prior to a distribution. Even if the price of the common stock includes the amount of the forthcoming distribution, you may be taxed upon receipt of the distribution and will not be entitled to offset the distribution against the tax basis in your common stock.

You may recognize taxable gain or loss if you sell or exchange your common stock. The amount of the gain or loss will be measured by the difference between your adjusted tax basis in your common stock and the amount of the proceeds you receive in exchange for such stock. Any gain or loss arising from (or, in the case of distributions in excess of earnings and profits, treated as arising from) the sale or exchange of common stock generally will be a capital gain or loss. This capital gain or loss normally will be treated as a long-term capital gain or loss if you have held your common stock for more than one year; otherwise, it will be classified as short-term capital gain or loss. However, any capital loss arising from the sale or exchange of common stock held for six months or less generally will be treated as a long-term capital loss to the extent of the amount of capital gain dividends received (or treated as deemed distributed) with respect to such stock and, for this purpose, the special rules of Section 852(b)(4)(C) of the Code generally apply in determining the holding period of such stock. In addition, all or a portion of any loss realized upon a taxable disposition of common stock will be disallowed if other shares of our common stock are purchased (under our dividend reinvestment plan or otherwise) within 30 days before or after the disposition.

In general, non-corporate stockholders currently are subject to a maximum federal income tax rate on their net long-term capital gain (the excess of net long-term capital gain over net short-term capital loss) for a taxable year (including a long-term capital gain derived from an investment in our common stock) that is lower than the maximum rate for other income (excluding other income that constitutes a qualified dividend). Corporate taxpayers currently are subject to federal income tax on net capital gains at a maximum rate equal to the maximum rate applied to ordinary income. Non-corporate stockholders with net capital losses for a year (i.e., capital losses in excess of capital gains) generally may deduct up to \$3,000 of such losses against their ordinary income each year; any net capital losses of a non-corporate stockholder in excess of \$3,000 generally may be carried forward and used in subsequent years as provided in Section 1212(b) of the Code.

Corporate stockholders generally may not deduct any net capital losses for a year, but may carryback such losses for three years or carry forward such losses for five years.

We will send to each of our stockholders, as promptly as possible after the end of each calendar year, a notice detailing, on a per share and per distribution basis, the amounts includible in such stockholder's taxable income for such year as ordinary income (including the amount of any qualified dividends) and as long-term capital gains. In addition, the federal tax status of each year's distributions generally will be reported to the IRS. Distributions may also be subject to additional state, local, and foreign taxes depending on a stockholder's particular situation. Our ordinary income dividends to corporate stockholders may, if certain conditions are met, qualify for the dividends received deduction to the extent that we have received qualifying dividend income during the taxable year; capital gain dividends distributed by us are not eligible for the dividends received deduction.

A Non-U.S. Stockholder may be subject to withholding of U.S. federal tax at a 30% rate (or lower applicable treaty rate) on distributions (including certain redemptions of common stock) from us. Accordingly, investment in us may be appropriate for a Non-U.S. Stockholder only if such person can utilize a foreign tax credit or corresponding tax benefit in respect of such withholding tax. Non-U.S. Stockholders should consult their own tax advisors with respect to the U.S. federal income and withholding tax, and state, local, and foreign tax, consequences of an investment in our common stock.

We may be required to withhold U.S. federal income tax ( backup withholding ) from all taxable distributions payable to (i) any stockholder who fails to furnish us with its correct taxpayer identification number or a certificate that the stockholder is exempt from backup withholding, and (ii) any stockholder with respect to whom the IRS notifies us that the stockholder has failed to properly report certain interest and dividend income to the IRS and to respond to notices to that effect. We may be required to report annually to the IRS and to each Non-U.S. Stockholder the amount of dividends paid to such stockholder and the amount, if any, of tax withheld pursuant to the backup withholding rules with respect to such dividends. This information may also be made available to the tax authorities in the Non-U.S. Stockholder's country of residence. Backup withholding is not an additional tax. Any amounts withheld under the backup withholding rules from payments made to a stockholder may be refunded or credited against such stockholder's United States federal income tax liability, if any, provided that the required information is furnished to the IRS.

*You should consult your own tax advisor with respect to the particular tax consequences to you of an investment in us, including the possible effect of any pending legislation or proposed regulation.*

#### **CERTAIN GOVERNMENT REGULATIONS**

We operate in a highly regulated environment. The following discussion generally summarizes certain government regulations.

**Business Development Company.** A business development company is defined and regulated by the 1940 Act. A business development company must be organized in the United States for the purpose of investing in or lending to primarily private companies and making managerial assistance available to them. A business development company may use capital provided by public shareholders and from other sources to invest in long-term,

private investments in businesses. A business development company provides shareholders the ability to retain the liquidity of a publicly traded stock, while sharing in the possible benefits, if any, of investing in primarily privately owned companies.

As a business development company, we may not acquire any asset other than qualifying assets unless, at the time we make the acquisition, the value of our qualifying assets represent at least 70% of the value of our total assets. The principal categories of qualifying assets relevant to our business are:

Securities purchased in transactions not involving any public offering, the issuer of which is an eligible portfolio company;

Securities received in exchange for or distributed with respect to securities described in the bullet above or pursuant to the exercise of options, warrants or rights relating to such securities; and

Cash, cash items, government securities or high quality debt securities (within the meaning of the 1940 Act), maturing in one year or less from the time of investment.

An eligible portfolio company is generally a domestic company that is not an investment company (other than a small business investment company wholly owned by a business development company, such as our investment in Allied Investment Corporation) and that:

does not have a class of securities registered on an exchange or a class of securities with respect to which a broker may extend margin credit;

is actively controlled by the business development company and has an affiliate of a business development company on its board of directors; or

meets such other criteria as may be established by the SEC.

Control as defined by the 1940 Act is presumed to exist where a business development company beneficially owns more than 25% of the outstanding voting securities of the portfolio company.

To include certain securities described above as qualifying assets for the purpose of the 70% test, a business development company must make available to the issuer of those securities significant managerial assistance such as providing significant guidance and counsel concerning the management, operations, or business objectives and policies of a portfolio company or, in the case of a small business investment company licensed by the Small Business Administration, making loans to its portfolio companies. We offer to provide significant managerial assistance to each of our portfolio companies.

As a business development company, we are entitled to issue senior securities in the form of stock or senior securities representing indebtedness, including debt securities and preferred stock, as long as each class of senior security has an asset coverage of at least 200% immediately after each such issuance. In addition, while any senior securities remain outstanding, we must make provisions to prohibit any distribution to our shareholders unless we meet the applicable asset coverage ratio at the time of the distribution. This limitation is not applicable to borrowings by our small business investment company subsidiary, and therefore any borrowings by this subsidiary are not included in this asset coverage test. See Risk Factors.

We may also be prohibited under the 1940 Act from knowingly participating in certain transactions with our affiliates without the prior approval of our Board of Directors who are not interested persons and, in some cases, prior approval by the SEC. We have been granted an exemptive order by the SEC permitting us to engage in certain transactions that would be permitted if we and our subsidiaries were one company and permitting certain transactions among our subsidiaries, subject to certain conditions and limitations.

We have designated a chief compliance officer pursuant to the requirements of the 1940 Act. We are periodically examined by the SEC for compliance with the 1940 Act.

As with other companies regulated by the 1940 Act, a business development company must adhere to certain substantive regulatory requirements. A majority of our directors must be persons who are not interested persons, as that term is defined in the 1940 Act. Additionally, we are required to provide and maintain a bond issued by a reputable fidelity insurance company to protect us against larceny and embezzlement. Furthermore, as a business development company, we are prohibited from protecting any director or officer against any liability to us or our shareholders arising from willful misfeasance, bad faith, gross negligence or reckless disregard of the duties involved in the conduct of such person's office.

We maintain a code of ethics that establishes procedures for personal investment and restricts certain transactions by our personnel. Our code of ethics generally does not permit investment by our employees in securities that may be purchased or held by us. The code of ethics is filed as an exhibit to our registration statement of which this prospectus is a part. You may read and copy the code of ethics at the SEC's Public Reference Room in Washington, D.C. You may obtain information on operations of the Public Reference Room by calling the SEC at (202) 942-8090. In addition, the code of ethics is available on the EDGAR Database on the SEC Internet site at <http://www.sec.gov>. You may obtain copies of the code of ethics, after paying a duplicating fee, by electronic request at the following email address: [publicinfo@sec.gov](mailto:publicinfo@sec.gov), or by writing to the SEC's Public Reference Section, 450 5th Street, NW, Washington, D.C. 20549. Our code of ethics is also posted on our website at [www.alliedcapital.com](http://www.alliedcapital.com).

As a business development company under the 1940 Act, we are entitled to provide and have provided loans to our officers in connection with the exercise of options. However, as a result of provisions of the Sarbanes-Oxley Act of 2002, we are prohibited from making new loans to our executive officers in the future.

We may not change the nature of our business so as to cease to be, or withdraw our election as, a business development company unless authorized by vote of a majority of the outstanding voting securities, as defined in the 1940 Act. A majority of the outstanding voting securities of a company is defined under the 1940 Act as the lesser of: (i) 67% or more of such company's shares present at a meeting if more than 50% of the outstanding shares of such company are present and represented by proxy or (ii) more than 50% of the outstanding shares of such company.

***Small Business Administration Regulations.*** Allied Investment Corporation, a wholly owned subsidiary of Allied Capital, is licensed by the Small Business Administration as a small business investment company under Section 301(c) of the Small Business Investment Act of 1958, and has elected to be regulated as a business development company.

Small business investment companies are designed to stimulate the flow of private equity capital to eligible small businesses. Under present Small Business Administration regulations, eligible small businesses include businesses that have a tangible net worth not exceeding \$18 million and have average annual fully taxed net income not exceeding \$6 million for the two most recent fiscal years. In addition, a small business investment company must devote 20% of its investment activity to smaller concerns as defined by the Small Business Administration. A smaller concern is one that has a tangible net worth not exceeding \$6 million and has average annual fully taxed net income not exceeding \$2 million for the two most recent fiscal years. Small Business Administration regulations also provide alternative size standard criteria to determine eligibility, which depend on the industry in which the business is engaged and are based on such factors as the number of employees and gross sales. According to Small Business Administration regulations, small business investment companies may make long-term loans to small businesses, invest in the equity securities of such businesses, and provide them with consulting and advisory services. Allied Investment provides long-term loans to qualifying small businesses; equity investments and consulting and advisory services are typically provided only in connection with such loans.

Allied Investment is periodically examined and audited by the Small Business Administration's staff to determine its compliance with small business investment company regulations.

We, through Allied Investment, have debentures payable to the Small Business Administration with contractual maturities of ten years. The notes require payment of interest only semi-annually, and all principal is due upon maturity. Under the small business investment company program, we may borrow up to \$116.0 million from the Small Business Administration. At December 31, 2003, the Small Business Administration had a commitment to lend up to an additional \$7.3 million above the amount outstanding. The commitment expires on September 30, 2005.

**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 capital gains, to the extent that such taxable income or gains are distributed, or deemed to be distributed, to shareholders on a timely basis. Annual tax distributions generally differ from net income for the fiscal year due to temporary and permanent differences in the recognition of income and expenses, returns of capital and net unrealized appreciation or depreciation, which are not included in taxable income.

In order to maintain our status as a regulated investment company, we must, in general, (1) continue to qualify as a business development company; (2) derive at least 90% of our gross income from dividends, interest, gains from the sale of securities and other specified types of income; (3) meet asset diversification requirements as defined in the Code; and (4) distribute annually to shareholders at least 90% of our 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. For a detailed discussion of the requirements we must meet to continue to qualify as a regulated investment company, see *Tax Status - Taxation as a Regulated Investment Company*.

**Compliance with the Sarbanes-Oxley Act of 2002 and NYSE Corporate Governance Regulations.** On July 30, 2002, President Bush signed into law the Sarbanes-Oxley Act of



2002 (the Sarbanes-Oxley Act ). The Sarbanes-Oxley Act imposes a wide variety of new regulatory requirements on publicly held companies and their insiders. Many of these requirements have affected us. For example:

Our chief executive officer and chief financial officer certify the accuracy of the financial statements contained in our periodic reports;

Our periodic reports disclose our conclusions about the effectiveness of our disclosure controls and procedures;

Our periodic reports disclose whether there were significant changes in our internal controls or in other factors that could significantly affect these controls subsequent to the date of their evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses; and

We may not make any loan to any director or executive officer and we may not materially modify any existing loans.

The Sarbanes-Oxley Act has required us to review our current policies and procedures to determine whether we comply with the Sarbanes-Oxley Act and the new regulations promulgated thereunder. We will continue to monitor our compliance with all future regulations that are adopted under the Sarbanes-Oxley Act and will take actions necessary to ensure that we are in compliance therewith.

In addition, the New York Stock Exchange has adopted corporate governance changes to its listing standards. We have adopted certain policies and procedures intended to comply with the New York Stock Exchange s corporate governance rules. We will continue to monitor our compliance with all future listing standards that are approved by the SEC and will take actions necessary to ensure that we are in compliance therewith.

#### **DIVIDEND REINVESTMENT PLAN**

We currently maintain a dividend reinvestment plan that provides for reinvestment of our distributions on behalf of our shareholders by our transfer agent. The dividend reinvestment plan is an opt in plan, which means that if our Board of Directors declares a cash dividend then our shareholders that have not opted in to our dividend reinvestment plan will receive cash dividends, rather than reinvesting dividends in additional shares of common stock.

To enroll in the dividend reinvestment plan, each shareholder must complete an enrollment status form and return it to the plan agent. The plan agent shall then automatically reinvest any dividend in additional shares of common stock. You may change your status in the dividend reinvestment plan at any time by contacting our transfer agent and plan administrator in writing.

A shareholder s ability to participate in a dividend reinvestment plan may be limited according to how the shares of common stock are held. A nominee may preclude beneficial owners holding shares in street name from participating in the dividend reinvestment plan. Shareholders who wish to participate in a dividend reinvestment plan may need to hold their shares of common stock in their own name. Shareholders who hold shares in the name of a nominee should contact the nominee for details.

All distributions to investors who do not participate (or whose nominee elects not to participate) in the dividend reinvestment plan will be paid directly, or through the nominee, to the record holder by or under the discretion of the plan agent. The plan agent is American Stock Transfer and Trust Company, 59 Maiden Lane, New York, New York 10038. Their telephone number is (800) 937-5449.

Under the dividend reinvestment plan, we may issue new shares unless the market price of the outstanding shares of common stock is less than 110% of the last reported net asset value. Alternatively, the plan agent may buy shares of common stock in the market. We value newly issued shares of common stock for the dividend reinvestment plan at the average of the reported last sale prices of the outstanding shares of common stock on the last five trading days prior to the payment date of the distribution, but not less than 95% of the opening bid price on such date. The price in the case of shares bought in the market will be the average actual cost of such shares of common stock, including any brokerage commissions. There are no other fees charged to shareholders in connection with the dividend reinvestment plan. Any distributions reinvested under the plan will nevertheless remain taxable to the shareholders.

### DESCRIPTION OF CAPITAL STOCK

*The following summary description is based on relevant portions of the Maryland General Corporation Law and our charter and bylaws. This summary is not necessarily complete, and we refer you to the Maryland General Corporation Law and our charter and bylaws for a detailed description of the provisions summarized below.*

#### Capital Stock

Our authorized capital stock consists of 200,000,000 shares, \$0.0001 par value per share, all of which has been initially designated as common stock. Our Board of Directors may classify and reclassify any unissued shares of our capital stock by setting or changing in one or more respects the preferences, conversion or other rights, voting powers, restrictions, limitations as to dividends, qualifications, terms or conditions or redemption or other rights of such shares of capital stock.

#### Common Stock

At March , 2004, there were shares of common stock outstanding and shares of common stock reserved for issuance under our amended stock option plan. The following are the outstanding classes of securities of Allied Capital as of March , 2004:

	(1) Title of Class	(2) Amount Authorized	(3) Amount Held by Us or for Our Account	(4) Amount Outstanding Exclusive of Amounts Shown Under(3)
Allied Capital Corporation	Common Stock	200,000,000		

All shares of common stock have equal rights as to earnings, assets, dividends and voting and all outstanding shares of common stock are fully paid and non-assessable. Distributions may be paid to the holders of common stock if and when declared by our Board of Directors out of funds legally available therefor. Our common stock has no preemptive, exchange, conversion, or redemption rights and is freely transferable, except where their transfer is restricted by federal and state securities law or by contract. In the event of liquidation, dissolution or winding-up of Allied Capital, each share of common stock is entitled to share ratably in all of our assets that are legally available for distributions after payment of all debts and liabilities and subject to any prior rights of holders of preferred stock, if any, then outstanding. Each share of common stock is entitled to one vote on all matters submitted to a vote of shareholders, including the election of directors. Except as provided with respect to any other class or series of capital stock, the holders of our common stock will possess exclusive voting power. There is no cumulative voting in the election of directors, which means that holders of a majority of the shares, if they so choose, could elect all of the directors, and holders of less than a majority of the shares would, in that case, be unable to elect any director. All shares of common stock offered hereby will be, when issued and paid for, fully paid and non-assessable.

### **Preferred Stock**

Our charter authorizes our Board of Directors to classify and reclassify any unissued shares of stock into other classes or series of stock, including preferred stock. Prior to issuance of shares of each class or series, the Board of Directors is required by Maryland law and by our charter to set the terms, preferences, conversion or other rights, voting powers, restrictions, limitations as to dividends or other distributions, qualifications and terms or conditions of redemption for each class or series. Thus, the Board of Directors could authorize the issuance of shares of preferred stock with terms and conditions which could have the effect of delaying, deferring or preventing a transaction or a change in control that might involve a premium price for holders of our common stock or otherwise be in their best interest.

In addition, any issuance of preferred stock must comply with the requirements of the 1940 Act. The 1940 Act requires, among other things, that (1) immediately after issuance and before any dividend or other distribution is made with respect to our common stock, such preferred stock together with all other senior securities must not exceed an amount equal to 50% of our total assets after deducting the amount of such dividend or distribution, as the case may be, and (2) the holders of shares of preferred stock, if any are issued, must be entitled as a class to elect two directors at all times and to elect a majority of the directors if dividends on such preferred stock are in arrears by two years or more.

### **Limitation on Liability of Directors and Officers; Indemnification and Advance of Expenses**

We have adopted provisions in our charter limiting the liability of our directors and officers for monetary damages. The effect of these provisions in the charter is to eliminate the rights of Allied Capital and its shareholders (through shareholders' derivative suits on our behalf) to recover monetary damages against a director or officer for breach of the fiduciary duty of care as a director or officer (including breaches resulting from negligent behavior) except for liability resulting from (i) actual receipt of an improper benefit or profit in money, property or services or (ii) active and deliberate dishonesty established by

a final judgment as being material to the cause of action. These provisions do not limit or eliminate the rights of Allied Capital or any shareholder to seek non-monetary relief such as an injunction or rescission in the event of a breach of a director's or officer's duty of care. These provisions will not alter the liability of directors or officers under federal securities laws.

Our charter and bylaws authorize us, to the maximum extent permitted by Maryland law and subject to the requirements of the 1940 Act, to indemnify any present or former director or officer or any individual who, while a director and at our request, serves or has served another corporation, real estate investment trust, partnership, joint venture, trust, employee benefit plan or other enterprise as a director, officer, partner or trustee, from and against any claim or liability to which that person may become subject or which that person may incur by reason of his or her status as a present or former director or officer and to pay or reimburse their reasonable expenses in advance of final disposition of a proceeding. The charter and bylaws also permit us to indemnify and advance expenses to any person who served a predecessor of us in any of the capacities described above and any of our employees or agents or any employees or agents of our predecessor. In accordance with the 1940 Act, we will not indemnify any person for any liability to which such person would be subject by reason of such person's willful misfeasance, bad faith, gross negligence or reckless disregard of the duties involved in the conduct of his or her office.

Maryland law requires a corporation (unless its charter provides otherwise, which our charter does not) to indemnify a director or officer who has been successful, on the merits or otherwise, in the defense of any proceeding to which he or she is made a party by reason of his or her service in that capacity. Maryland law permits a corporation to indemnify its present and former directors and officers, among others, against judgments, penalties, fines, settlements and reasonable expenses actually incurred by them in connection with any proceeding to which they may be made a party by reason of their service in those or other capacities unless it is established that (a) the act or omission of the director or officer was material to the matter giving rise to the proceeding and (1) was committed in bad faith or (2) was the result of active and deliberate dishonesty, (b) the director or officer actually received an improper personal benefit in money, property or services or (c) in the case of any criminal proceeding, the director or officer had reasonable cause to believe that the act or omission was unlawful. However, under Maryland law, a Maryland corporation may not indemnify for an adverse judgment in a suit by or in the right of the corporation or for a judgment of liability on the basis that a personal benefit was improperly received, unless in either case a court orders indemnification, and then only for expenses. In addition, Maryland law permits a corporation to advance reasonable expenses to a director or officer upon the corporation's receipt of (a) a written affirmation by the director or officer of his or her good faith belief that he or she has met the standard of conduct necessary for indemnification by the corporation and (b) a written undertaking by him or her or on his or her behalf to repay the amount paid or reimbursed by the corporation if it is ultimately determined that the standard of conduct was not met.

In February 2004, we entered into indemnification agreements with our directors and certain our of senior officers. The indemnification agreements provide these directors and senior officers the maximum indemnification permitted under Maryland law and the 1940 Act.

### **Certain Anti-Takeover Provisions**

Our charter and bylaws and certain statutory and regulatory requirements contain certain provisions that could make more difficult the acquisition of Allied Capital by means of a tender offer, a proxy contest or otherwise. These provisions are expected to discourage certain types of coercive takeover practices and inadequate takeover bids and to encourage persons seeking to acquire control of us to negotiate first with the board of directors. We believe that the benefits of these provisions outweigh the potential disadvantages of discouraging such proposals because, among other things, negotiation of such proposals might result in an improvement of their terms. The description set forth below is intended only to be a summary of certain of our anti-takeover provisions and is qualified in its entirety by reference to our charter and the bylaws.

#### *Classified Board of Directors*

Our bylaws provide for our Board of Directors to be divided into three classes of directors serving staggered three-year terms, with each class to consist as nearly as possible of one-third of the directors then elected to the board. A classified board may render more difficult a change in control of Allied Capital or removal of incumbent management. We believe, however, that the longer time required to elect a majority of a classified Board of Directors helps to ensure continuity and stability of our management and policies.

#### *Issuance of Preferred Stock*

Our board of directors, without shareholder approval, has the authority to reclassify authorized but unissued common stock as preferred stock and to issue preferred stock. Such stock could be issued with voting, conversion or other rights designed to have an anti-takeover effect.

#### *Number of Directors; Vacancies; Removal*

Our charter provides that the number of directors will be set only by the Board of Directors in accordance with our bylaws. Our bylaws provide that a majority of our entire Board of Directors may at any time increase or decrease the number of directors. However, unless our bylaws are amended, the number of directors may never be less than three nor more than fifteen. Except as may be provided by the Board of Directors in setting the terms of any class or series of preferred stock, any and all vacancies on the Board of Directors may be filled only by the affirmative vote of a majority of the remaining directors in office, even if the remaining directors do not constitute a quorum, and any director elected to fill a vacancy will serve for the remainder of the full term of the directorship in which the vacancy occurred and until a successor is elected and qualified.

Our bylaws provides that a director may be removed by shareholders only with cause and then only by the affirmative vote of at least a majority of the votes entitled to be cast in the election of directors.

#### *Action by Shareholders*

Under the Maryland General Corporation Law, shareholder action can be taken only at an annual or special meeting of shareholders or by unanimous written consent in lieu of a meeting. These provisions, combined with the requirements of our bylaws regarding the

calling of a shareholder-requested special meeting of shareholders discussed below, may have the effect of delaying consideration of a shareholder proposal until the next annual meeting.

*Advance Notice Provisions for Shareholder Nominations and Shareholder Proposals*

Our bylaws provide that with respect to an annual meeting of shareholders, nominations of persons for election to the Board of Directors and the proposal of business to be considered by shareholders may be made only (1) pursuant to our notice of the meeting, (2) by the Board of Directors or (3) by a shareholder who is entitled to vote at the meeting and who has complied with the advance notice procedures of the bylaws. With respect to special meetings of shareholders, only the business specified in our notice of the meeting may be brought before the meeting. Nominations of persons for election to the Board of Directors at a special meeting may be made only (1) pursuant to our notice of the meeting, (2) by the Board of Directors or (3) provided that the Board of Directors has determined that directors will be elected at the meeting, by a shareholder who is entitled to vote at the meeting and who has complied with the advance notice provisions of the bylaws.

The purpose of requiring shareholders to give us advance notice of nominations and other business is to afford our Board of Directors a meaningful opportunity to consider the qualifications of the proposed nominees and the advisability of any other proposed business and, to the extent deemed necessary or desirable by our Board of Directors, to inform shareholders and make recommendations about such qualifications or business, as well as to provide a more orderly procedure for conducting meetings of shareholders. Although our bylaws do not give our Board of Directors any power to disapprove shareholder nominations for the election of directors or proposals recommending certain action, they may have the effect of precluding a contest for the election of directors or the consideration of shareholder proposals if proper procedures are not followed and of discouraging or deterring a third party from conducting a solicitation of proxies to elect its own slate of directors or to approve its own proposal without regard to whether consideration of such nominees or proposals might be harmful or beneficial to us and our shareholders.

*Calling of Special Meetings of Shareholders*

Our bylaws provide that special meetings of shareholders may be called by our Board of Directors and certain of our officers. Additionally, our bylaws provide that, subject to the satisfaction of certain procedural and informational requirements by the shareholders requesting the meeting, a special meeting of shareholders will be called by our Corporate Secretary upon the written request of shareholders entitled to cast not less than a majority of all the votes entitled to be cast at such meeting.

*Amendments; Supermajority Vote Requirements*

Our bylaws impose supermajority vote requirements in connection with the amendment of provisions of our bylaws, including those provisions relating to the classified Board of Directors, the ability of shareholders to call special meetings and the advance notice provisions for shareholder meetings.

*Maryland General Corporation Law*

We are subject to the Maryland Business Combination Statute and the Control Share Acquisition Statute, as defined below. The partial summary of the foregoing statutes contained in this prospectus is not intended to be complete and reference is made to the full text of such statutes for their entire terms.

***Business Combination Statute.*** Certain provisions of the Maryland General Corporation Law establish special requirements with respect to business combinations between Maryland corporations and interested shareholders unless exemptions are applicable (the Business Combination Statute). Among other things, the Business Combination Statute prohibits for a period of five years a merger or other specified transactions between a company and an interested shareholder and requires a supermajority vote for such transactions after the end of such five-year period.

Interested shareholders are all persons owning beneficially, directly or indirectly, 10% or more of the outstanding voting stock of a Maryland corporation. Business combinations include certain mergers or similar transactions subject to a statutory vote and additional transactions involving transfer of assets or securities in specified amounts to interested shareholders or their affiliates.

Unless an exemption is available, a business combination may not be consummated between a Maryland corporation and an interested shareholder or its affiliates for a period of five years after the date on which the shareholder first became an interested shareholder and thereafter may not be consummated unless recommended by the board of directors of the Maryland corporation and approved by the affirmative vote of at least 80% of the votes entitled to be cast by all holders of outstanding shares of voting stock and 66 2/3% of the votes entitled to be cast by all holders of outstanding shares of voting stock other than the interested shareholder or its affiliates or associates, unless, among other things, the corporation's shareholders receive a minimum price (as defined in the Business Combination Statute) for their shares and the consideration is received in cash or in the same form as previously paid by the interested shareholder for its shares.

A business combination with an interested shareholder which is approved by the board of directors of a Maryland corporation at any time before an interested shareholder first becomes an interested shareholder is not subject to the five-year moratorium or special voting requirements. An amendment to a Maryland corporation's charter electing not to be subject to the foregoing requirements must be approved by the affirmative vote of at least 80% of the votes entitled to be cast by all holders of outstanding shares of voting stock and 66 2/3% of the votes entitled to be cast by holders of outstanding shares of voting stock who are not interested shareholders. Any such amendment is not effective until 18 months after the vote of shareholders and does not apply to any business combination of a corporation with a shareholder who became an interested shareholder on or prior to the date of such vote.

***Control Share Acquisition Statute.*** The Maryland General Corporation Law imposes limitations on the voting rights of shares acquired in a control share acquisition. The control share statute defines a control share acquisition to mean the acquisition, directly or indirectly, of control shares subject to certain exceptions. Control shares of a Maryland corporation are defined to be voting shares of stock which, if aggregated with all other shares of stock previously acquired by the acquiror, would entitle the acquiror to exercise voting power in electing directors with one of the following ranges of voting power:

- (1) one-tenth or more but less than one-third;
- (2) one-third or more but less than a majority; or
- (3) a majority of all voting power.

The requisite shareholder approval must be obtained each time an acquiror crosses one of the thresholds of voting power set forth above. Control shares do not include shares which the acquiring person is entitled to vote as a result of having previously obtained shareholder approval. Control shares of a Maryland corporation acquired in a control share acquisition have no voting rights except to the extent approved by a vote of two-thirds of the votes entitled to be cast by shareholders in the election of directors, excluding shares of stock as to which the acquiring person, officers of the corporation and directors of the corporation who are employees of the corporation are entitled to exercise or direct the exercise of the voting power of the shares in the election of the directors.

The control share statute also requires Maryland corporations to hold a special meeting at the request of an actual or proposed control share acquiror generally within 50 days after a request is made with the submission of an acquiring person statement, but only if the acquiring person:

- (1) gives a written undertaking and, if required by the directors of the issuing corporation, posts a bond for the cost of the meeting; and
- (2) submits definitive financing agreements for the acquisition of the control shares to the extent that financing is not provided by the acquiring person.

In addition, unless the issuing corporation's charter or bylaws provide otherwise, the control share statute provides that the issuing corporation, within certain time limitations, shall have the right to redeem control shares (except those for which voting rights have previously been approved) for fair value as determined pursuant to the control share statute in the event:

- (1) there is a shareholder vote and the grant of voting rights is not approved; or
- (2) an acquiring person statement is not delivered to the target within 10 days following a control share acquisition.

Moreover, unless the issuing corporation's charter or bylaws provide otherwise, the control share statute provides that if, before a control share acquisition occurs, voting rights are accorded to control shares which result in the acquiring person having majority voting power, then all shareholders other than the acquiring person have appraisal rights as provided under the Maryland General Corporation Law. An acquisition of shares may be exempted from the control share statute provided that a charter or bylaw provision is adopted for such purpose prior to the control share acquisition by any person with respect to Allied Capital. The control share acquisition statute does not apply to shares acquired in a merger, consolidation or share exchange to which the corporation is a party.

#### *Regulatory Restrictions*

Allied Investment, our wholly owned subsidiary, is a small business investment company. The Small Business Administration prohibits, without prior Small Business Administration approval, a change of control or transfers which would result in any person (or group of persons acting in concert) owning 10% or more of any class of capital stock of a small business investment company. A change of control is any event which



would result in a transfer of the power, direct or indirect, to direct the management and policies of a small business investment company, whether through ownership, contractual arrangements or otherwise.

#### **PLAN OF DISTRIBUTION**

We may offer, from time to time, up to 20,000,000 shares of our common stock. We may sell the shares of our common stock through underwriters or dealers, directly to one or more purchasers, through agents or through a combination of any such methods of sale. Any underwriter or agent involved in the offer and sale of the shares of our common stock will be named in the applicable prospectus supplement.

The distribution of the shares of our common stock may be effected from time to time in one or more transactions at a fixed price or prices, which may be changed, at prevailing market prices at the time of sale, at prices related to such prevailing market prices, or at negotiated prices, provided, however, that the offering price per share of our common stock, less any underwriting commissions or discounts, must equal or exceed the net asset value per share of our common stock at the time of the offering.

In connection with the sale of the shares of our common stock, underwriters or agents may receive compensation from us or from purchasers of the shares of our common stock, for whom they may act as agents, in the form of discounts, concessions or commissions. Underwriters may sell shares of our common stock to or through dealers and such dealers may receive compensation in the form of discounts, concessions or commissions from the underwriters and/or commissions from the purchasers for whom they may act as agents. Underwriters, dealers and agents that participate in the distribution of shares of our common stock may be deemed to be underwriters under the Securities Act, and any discounts and commissions they receive from us and any profit realized by them on the resale of shares of our common stock may be deemed to be underwriting discounts and commissions under the Securities Act. Any such underwriter or agent will be identified and any such compensation received from us will be described in the applicable prospectus supplement.

Any common stock sold pursuant to a prospectus supplement will be quoted on the New York Stock Exchange, or another exchange on which the common stock is traded.

Under agreements into which we may enter, underwriters, dealers and agents who participate in the distribution of shares of our common stock may be entitled to indemnification by us against certain liabilities, including liabilities under the Securities Act. Underwriters, dealers and agents may engage in transactions with, or perform services for, us in the ordinary course of business.

If so indicated in the applicable prospectus supplement, we will authorize underwriters or other persons acting as our agents to solicit offers by certain institutions to purchase shares of our common stock from us pursuant to contracts providing for payment and delivery on a future date. Institutions with which such contracts may be made include commercial and savings banks, insurance companies, pension funds, investment companies, educational and charitable institutions and others, but in all cases such institutions must be approved by us. The obligations of any purchaser under any such contract will be subject to the condition that the purchase of shares of our common stock shall not at the time of delivery be prohibited under the laws of the jurisdiction to which such purchaser is subject. The underwriters and such other agents will not have any responsibility in respect of the

validity or performance of such contracts. Such contracts will be subject only to those conditions set forth in the prospectus supplement, and the prospectus supplement will set forth the commission payable for solicitation of such contracts.

The maximum commission or discount to be received by any member of the National Association of Securities Dealers, Inc. or independent broker-dealer will not be greater than 10% for the sale of any securities being registered and 0.5% for due diligence.

In order to comply with the securities laws of certain states, if applicable, shares of our common stock offered hereby will be sold in such jurisdictions only through registered or licensed brokers or dealers.

#### **LEGAL MATTERS**

The legality of shares of our common stock offered hereby will be passed upon for us by Sutherland Asbill & Brennan LLP, Washington, D.C. Certain legal matters will be passed upon for underwriters, if any, by the counsel named in the prospectus supplement.

#### **SAFEKEEPING, TRANSFER AND DIVIDEND PAYING AGENT**

#### **AND REGISTRAR**

Our investments are held in safekeeping by Riggs Bank, N.A., 808 17th Street, N.W., Washington, D.C. 20006, as well as by LaSalle National Bank, 25 Northwest Point Boulevard, Suite 800, Elk Grove Village, Illinois 60007. American Stock Transfer and Trust Company, 59 Maiden Lane, New York, New York 10038 acts as our transfer, dividend paying and reinvestment plan agent and registrar.

#### **BROKERAGE ALLOCATION AND OTHER PRACTICES**

Since we generally acquire and dispose of our investments in privately negotiated transactions, we infrequently use brokers in the normal course of business.

#### **INDEPENDENT PUBLIC ACCOUNTANTS**

The consolidated financial statements as of December 31, 2003 and 2002, and for each of the years then ended, have been included herein in reliance upon the reports of KPMG LLP, independent accountants, appearing elsewhere herein, and upon the authority of said firm as experts in accounting and auditing.

Certain of the audited financial statements and schedules included in this prospectus and elsewhere in the registration statement have been audited by Arthur Andersen LLP, independent public accountants, as indicated in their report with respect to the financial statements and schedules. For important information about Arthur Andersen LLP, see Notice Regarding Arthur Andersen LLP below.

On March 29, 2002, we selected KPMG LLP to serve as our independent public accountants for the fiscal year ending December 31, 2002. We dismissed Arthur Andersen LLP as our independent accountants effective upon completion of the December 31, 2001, audit. The decision to change accountants was approved by our Audit Committee and Board of Directors and was ratified by our stockholders on May 7, 2002.

In connection with the audit for the 2001 fiscal year and through April 3, 2002, (1) there were no disagreements with Arthur Andersen LLP on any matter of accounting principle or practice, financial statement disclosure, auditing scope or procedure, whereby such disagreements, if not resolved to the satisfaction of Arthur Andersen LLP, would have caused them to make reference thereto in their report on the financial statements for such years; and (2) there have been no reportable events (as defined in Item 304(a)(1)(v) of Regulation S-K).

The report of Arthur Andersen LLP on our financial statements for fiscal year ended December 31, 2001, contained no adverse opinion or disclaimer of opinion and was not qualified or modified as to uncertainty, audit scope or accounting principle, except for the emphasis of matter related to the inherent uncertainty of determining the value of investments whose values have been determined by the board of directors in good faith in the absence of readily ascertainable market values.

We had not consulted with KPMG LLP during 2001 or the period from January 1, 2002, through March 29, 2002, on either the application of accounting principles to a specified transaction, either completed or proposed, or the type of audit opinion KPMG LLP might issue on our financial statements.

#### **NOTICE REGARDING ARTHUR ANDERSEN LLP**

Section 11(a) of the Securities Act provides that if any part of a registration statement at the time it becomes effective contains an untrue statement of a material fact or an omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading, any person acquiring a security pursuant to such registration statement, unless it is proved that at the time of such acquisition such person knew of such untruth or omission, may sue, among others, every accountant who has consented to be named as having prepared or certified any part of the registration statement or as having prepared or certified any report or valuation which is used in connection with the registration statement with respect to the statement in such registration statement, report or valuation which purports to have been prepared or certified by the accountant.

Our consolidated financial statements as of December 31, 2001, and for the year ended December 31, 2001, included in this prospectus were audited by our former independent auditor, Arthur Andersen LLP. However, we have not been able to obtain, after reasonable efforts, the written consent of Arthur Andersen LLP with respect to the inclusion of such consolidated financial statements in this prospectus. Under these circumstances, Rule 437a under the Securities Act permits us to file this registration statement without a consent of Arthur Andersen LLP. As a result, you will not be able to sue Arthur Andersen LLP pursuant to Section 11(a) of the Securities Act and therefore your right of recovery under that section may