

Edgar Filing: ALLIED CAPITAL CORP - Form 10-K

ALLIED CAPITAL CORP  
Form 10-K  
March 21, 2001

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UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549  
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FORM 10-K  
FOR ANNUAL AND TRANSITION REPORTS PURSUANT TO SECTIONS 13 OR 15(d) OF THE  
SECURITIES EXCHANGE ACT OF 1934

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE  
ACT OF 1934

FOR THE FISCAL YEAR ENDED DECEMBER 31, 2000

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES  
EXCHANGE ACT OF 1934

COMMISSION FILE NO. 0-22832

ALLIED CAPITAL CORPORATION  
(EXACT NAME OF REGISTRANT AS SPECIFIED IN ITS CHARTER)

MARYLAND  
(STATE OR OTHER JURISDICTION  
OF INCORPORATION)

52-1081052  
(I.R.S. EMPLOYER  
IDENTIFICATION NO.)

1919 PENNSYLVANIA AVENUE NW  
WASHINGTON, D.C.  
(ADDRESS OF PRINCIPAL EXECUTIVE OFFICE)

20006  
(ZIP CODE)

REGISTRANT'S TELEPHONE NUMBER, INCLUDING AREA CODE: (202) 331-1112

SECURITIES REGISTERED PURSUANT TO SECTION 12(b) OF THE ACT:

TITLE OF EACH CLASS -----	NAME OF EACH EXCHANGE ON WHICH REGISTERED -----
NONE	NONE

SECURITIES REGISTERED PURSUANT TO SECTION 12(g) OF THE ACT:

COMMON STOCK, \$0.0001 PAR VALUE  
(TITLE OF CLASS)

Indicate by check mark whether the registrant (1) has filed all reports required

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to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports) and (2) has been subject to such filing requirements for the past 90 days. YES  NO

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

The aggregate market value of the registrant's common stock held by non-affiliates of the registrant as of March 16, 2001 was approximately \$1,815,780,000 based upon the last sale price for the registrant's common stock on that date. As of March 16, 2001 there were 85,877,875 shares of the registrant's common stock outstanding.

### DOCUMENTS INCORPORATED BY REFERENCE

Portions of the registrant's Annual Report to Shareholders for the year ended December 31, 2000 are incorporated by reference into Parts II and IV of this Report. Portions of the registrant's definitive Proxy Statement for the Annual Meeting of Stockholders to be held on May 8, 2001 are incorporated by reference into Part III of this Report.

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### BUSINESS

As a business development company, we provide private investment capital to private companies and undervalued public companies in a variety of different industries and in diverse geographic locations throughout the United States. We have been investing in growing businesses for over 40 years and have financed thousands of private companies nationwide. Today, our investment activity is focused in two areas:

- Private finance and
- Commercial real estate finance, primarily the purchase of CMBS.

Our investment portfolio consists primarily of long-term unsecured loans with equity features, commercial mortgage-backed securities, and commercial mortgage loans. At December 31, 2000, our investment portfolio totaled \$1.8 billion. The Company's investment objective is to achieve current income and capital gains.

### PRIVATE FINANCE

We provide long-term debt and equity financing to private companies nationwide. Our private finance activities target a market niche between the senior debt financing provided by traditional lenders, such as banks, commercial finance companies and insurance companies, and the equity capital provided by private equity investors.

Our private financing is generally used to fund growth, buyouts, note purchases, acquisitions, recapitalizations, and bridge financings. We generally invest in private companies though, from time to time, we may invest in undervalued public companies that lack access to public capital and whose securities may not be marginable. We target two types of companies when seeking new investments. The first type of company we seek is a market leader in a stable industry that has demonstrated over many years of operations that it can successfully achieve its business plan and thereby achieve our investment objective. The second type of

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company we seek is an emerging company in a growing industry that is positioned for significant growth. We have spent over 40 years refining our highly selective investment discipline, which is founded on seeking portfolio companies having key characteristics and targeting specific industries.

We originate investments generally ranging in size from \$5 million to \$30 million, and for the year ended December 31, 2000 our average investment size was \$14.0 million. Our private finance investments are generally structured as an unsecured, subordinated loan that carries a relatively high fixed interest rate (generally 12% to 18%), with 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. Approximately 98% of the investments in the private finance portfolio have fixed rates of interest. Our private finance investments typically include equity features, such as warrants or options to buy a minority interest in the portfolio company. We also make preferred and common equity investments, particularly when we see unique opportunities to profit from the growth of an emerging company. At December 31, 2000, 75% of the private finance portfolio consisted of debt securities, and 25% consisted of equity securities. Our nationwide private finance portfolio includes investments in a wide variety of industries, including business services, consumer products, education, light industrial products and broadcasting.

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Capital providers for the finance of private companies can be generally categorized as shown in the diagram below:

CAPITAL PROVIDER	Banks	Commercial Finance Companies	Insurance Companies/ High Yield Market	Allied Capital	Private Mezzanine Funds
PRIMARY BUSINESS FOCUS	Senior, short-term debt	Asset-based lending	Large >\$30 million credits	Unsecured long-term debt with equity upside Preferred and common equity	Unsecured long-term debt with equity upside Preferred common equity
TYPICAL PRICING SPECTRUM*	LIBOR+	[graphic of arrow stretching between 'LIBOR+' and '30%+']			

\* Based on market experience of our marketing and investment professionals.

Banks are primarily focused on providing senior secured and unsecured short-term debt. They typically do not provide meaningful long-term unsecured loans. Commercial finance companies are primarily focused on providing senior secured long-term debt. The private insurance company and high-yield debt markets are focused primarily on very large financing transactions, typically in excess of the financings we do. We generally do not compete with banks, commercial finance companies, or the insurance company/high yield market. Instead, we compete directly with the private mezzanine sector of the private equity market. Private mezzanine funds are also focused on providing unsecured long-term debt to private companies for the types of transactions discussed above. We believe that we have key structural and operational advantages when compared to private mezzanine funds.

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Our scale of operations, equity capital base, and successful track record as a private finance investor has enabled us to borrow long-term capital to leverage our returns on our common equity. Therefore, our access to debt capital reduces our total cost of capital. In many cases, a private mezzanine fund is unable to access the debt capital markets, and therefore must achieve an unleveraged equity return for their investors. Our lower cost of capital gives 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 mezzanine fund, which typically has a finite life.

We estimate that we fund approximately 2% of all the private finance investments that we review. When assessing a prospective investment, we look for a company that has achieved, or has the potential to achieve, market leadership in a niche, critical mass, and a sustainable cash flow. We also look for companies that, because of their industry and business plan, can demonstrate minimal vulnerability to changes in economic cycles. Since our debt securities are primarily unsecured in nature, we look for companies in industries that are non-cyclical, cash flow intensive, and can demonstrate a high return on their invested capital. We generally do not target companies in industries where businesses tend to be vulnerable to changes in economic cycles, are capital intensive, and have low returns on their invested capital. We generally target and do not target the following industries, though we will consider investments

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in any industry if the prospective company demonstrates unique characteristics that make it an attractive investment opportunity:

INDUSTRIES TARGETED  
NON-CYCLICAL/CASH FLOW INTENSIVE/  
HIGH RETURN ON CAPITAL

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Business services  
Education  
Consumer products  
Light industrial products  
Broadcasting

INDUSTRIES NOT TARGETED  
CYCLICAL/CAPITAL INTENSIVE/  
LOW RETURN ON CAPITAL

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Heavy manufacturing  
Natural resources  
Most retail  
Low value-add distribution  
Agriculture  
Transportation  
Construction

Another critical element of our investment discipline is to invest in companies with a significant equity capital base, and a strong private equity sponsor. For example, in 2000, 75% of our private financings were completed in conjunction with private equity firms, which provided capital that is junior to ours. We believe strong equity sponsorship significantly strengthens our position as a long-term lender. A strong equity sponsor provides not only strong equity capital beneath our investment, but also provides a reliable source of additional equity capital if the portfolio company requires additional financing. Private equity sponsors also help us confirm our own due diligence findings when assessing a new investment opportunity, and they provide

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assistance and leadership to the portfolio company's management team throughout our investment period.

We target a total return of 18% to 25% for our private finance investments. The typical private finance structure focuses, first and foremost, on the protection of our investment principal. Our debt instruments generally provide for a contractual interest rate ranging from 12% to 18%, which provides current interest income. The debt instruments also have restrictive covenants that protect our interests in the transaction. The warrants we receive with our debt securities generally require only a minimal cost to exercise, and thus as the portfolio company appreciates in value, we achieve additional investment return from this equity interest. We seek to achieve additional investment returns of up to 10% from the appreciation and sale of our warrants.

Generally, our warrants expire five years after the related debt is repaid. The warrants typically include registration rights, which allow us to sell the securities if the portfolio company completes a public offering. In most cases, the warrants also have a put option that requires that the borrower repurchase our equity position after a specified period of time at a formula price or at its fair market value. Most of the gains we realize from our warrant portfolio arise as a result of the sale of the portfolio company to another business, or through a recapitalization. Historically, we have not been dependent on the public equity markets for the sale of our warrant positions. With respect to preferred or common equity investments, we target an investment return of 25% to 40%.

We hold a portion of our private finance investments in a wholly owned subsidiary, Allied Investment Corporation. Allied Investment is a BDC and is licensed and regulated by the Small Business Administration to operate as a small business investment company ("SBIC"). See "Certain Government Regulations" below for further information about SBIC regulation.

In addition to funding private finance investments as described above, during the second quarter of 2000 we made commitments to invest in select technology-oriented private equity funds. In addition to the return we expect to achieve from these investments, we believe we can achieve strategic benefits from these funds, including technology expertise from private finance portfolio companies, co-investment opportunities and increased dealflow. We may make additional commitments to other such funds, but expect our total investment in this area to remain a small percentage of our total portfolio.

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### COMMERCIAL REAL ESTATE FINANCE

**COMMERCIAL MORTGAGE LOANS.** We have been a commercial real estate lender for many years, and maintain a small whole commercial mortgage loan portfolio. During 1998, we significantly reduced our middle-market commercial real estate lending activities, because we believed that the market was under-pricing commercial real estate loans, and that the returns on senior commercial real estate loans were below a level that would result in a fair return on equity for our shareholders.

Since 1999, we have been liquidating a significant portion of our whole commercial mortgage loan portfolio. We believe that we can redeploy the proceeds into higher yielding investments. We continue to derive income from the interest charged on the whole commercial mortgage loan portfolio through contractual interest and amortization of discounts.

**COMMERCIAL MORTGAGE-BACKED SECURITIES.** The same pricing pressures that caused us to reduce our origination of commercial mortgage loans in 1998 created

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significant liquidity problems for many other real estate lenders who had remained active lenders as pricing declined throughout 1998. In the fourth quarter of 1998, many of these lenders experienced severe liquidity constraints that caused them to exit the commercial mortgage-backed securities market. This liquidity turmoil in the real estate capital markets created a unique opportunity for us to acquire newly issued, non-investment grade commercial mortgage-backed securities ("Purchased CMBS") at significant discounts from the face amount of the bonds and at attractive yields.

As an investor, we believe that Purchased CMBS has attractive risk/return characteristics. The Purchased CMBS in which we invest are non-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." Unlike most "junk bonds," which are typically unsecured debt instruments, the non-investment grade Purchased CMBS in which we invest are secured by mortgage loans with real estate collateral. Our Purchased CMBS are fully collateralized by senior mortgage loans on commercial real estate properties where the loans are, on average, supported by a 30% equity investment. We acquire our Purchased CMBS on the initial issuance of the CMBS bond offering, and are able to underwrite and negotiate to purchase the securities at a significant discount from their face amount, generally resulting in an estimated yield to maturity ranging from 13% to 16%. Our negotiated discount and estimated yield to maturity assumes a 1% loss rate on the entire underlying commercial mortgage loan collateral pool, which takes into consideration certain business and economic uncertainties and contingencies. We find the yields for Purchased CMBS very attractive given their collateral protection.

We believe this risk/return dynamic exists in this market today because there are significant barriers to entry for a non-investment grade CMBS investor. First, non-investment grade CMBS are long-term investments and require long-term investment capital. Our capital structure, which is in excess of 50% equity capital, is well suited for this asset class. Second, when we purchase CMBS in an initial issuance, we re-underwrite every mortgage loan in the underlying collateral pool, and we meet with the issuer to discuss the nature and type of loans we will accept into the pool. We have significant commercial mortgage loan underwriting expertise, both in terms of the number of professionals we employ and the depth of their commercial real estate experience. Access to this type of expertise is another barrier to entry into this market.

As a non-investment grade CMBS investor, we recognize that non-investment grade securities have a higher degree of risk than do investment grade bonds. 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. They tend to be less liquid, may have a higher risk of default, and may be more difficult to value. We invest in non-investment grade CMBS represented by the "BB" to non-rated tranches of a CMBS issuance. Due to the underlying structure of the CMBS issuances, our CMBS tranches receive principal payments only after the securities that are senior to our securities are repaid. Thus, if losses are incurred in the underlying mortgage loan collateral pool, we would experience these losses.

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To mitigate this risk, we perform extensive due diligence prior to an investment in Purchased CMBS. When we evaluate a CMBS investment, we use the same underwriting procedures and criteria for the mortgage loans in the collateral pool as we do for all of the loans we originate. These underwriting procedures and criteria are described in detail below. We will only invest in CMBS when we believe, as a result of our underwriting procedures, that the underlying mortgage pool adequately secures our position. Our portfolio of CMBS is secured

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by approximately 2,600 commercial real estate properties located in diverse geographic locations across the United States in a wide variety of property types, including retail, multi-family housing, office, and hospitality. See "Management's Discussion and Analysis of Financial Condition and Results of Operations" for a summary of the loan to value ratios and debt service coverage ratios of the mortgage loans securing our Purchased CMBS investments.

Our Purchased CMBS activity complements our private finance activity because it provides a steady stream of recurring interest income. In order to maintain a balanced investment portfolio, we expect to limit our Purchased CMBS activity to approximately 20% to 25% of total assets.

### SMALL BUSINESS FINANCE -- ALLIED CAPITAL EXPRESS

On December 31, 2000, Allied Capital and BLC Financial Services, Inc. ("BLC") completed a merger whereby Allied Capital acquired BLC. The effect of the merger was to create an independently managed, private portfolio company of Allied Capital to focus exclusively on small business lending, including the origination of SBA 7(a) loans. BLC has changed its name to Business Loan Express, Inc. ("BLX").

As part of this transaction, on December 28, 2000, we recapitalized our wholly owned small business lending subsidiary, Allied Capital SBLC Corporation, as an independently managed private portfolio company. Allied SBLC established a separate board of directors, and the employees and operations attributed to Allied Capital Express, including the online loan origination technology, were transferred to Allied SBLC. We restructured previous intercompany debt owed to us by Allied SBLC as \$74.8 million in subordinated debt now owed by the new portfolio company. Allied SBLC was subsequently merged into BLX and we received approximately \$25 million in BLX preferred stock in exchange for our equity in Allied SBLC.

BLX is currently financed with a combination of senior and subordinated debt, and preferred and common equity. Allied Capital, directly and indirectly, owns 94.9% of BLX. Allied Capital's investment in BLX is expected to generate interest income, dividends and fee income. In addition, we believe there is opportunity to add value to the new portfolio company and to position the investment for a future capital gain. The Company has entered into a management contract with BLX to provide management services, including certain technology and transition services. Our investment in BLX is included in our private finance portfolio.

BLX is a non-bank small business lender licensed as a participant in the SBA 7(a) Guaranteed Loan Program. BLX has a total of 22 offices nationwide, and SBA Preferred Lender status in 64 markets. BLX believes it will be a technology leader in online small business loan origination, and will have significant online loan origination relationships as well as solid core broker relationships in the small business community. BLX is licensed by the SBA as a Small Business Lending Company ("SBLC"), and therefore, changes in the laws or regulations that govern SBLCs could have a material impact on BLX or its operations.

### INVESTMENT ADVISORY SERVICES

We are a registered investment adviser, pursuant to the Investment Advisers Act of 1940, and have certain investment advisory agreements to manage private investment funds. The revenue generated from these agreements is not material to the Company's operations.

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Over the last two years, we have significantly increased the scope of our sales and marketing activity by opening new regional offices and increasing our sales and marketing staff. To source new investment opportunities, we work with thousands of intermediaries including:

- private mezzanine and equity investors;
- investment banks;
- business and mortgage brokers;
- national retail financial services companies; and
- banks, law firms and accountants.

We believe that our experience and reputation provide a competitive advantage in originating new investments. We have established an extensive network of investment referral relationships over our history. We are recognized as a pioneer in the private finance industry, and have developed a reputation in the commercial real estate finance market for our ability to finance complex transactions.

### INVESTMENT APPROVAL AND UNDERWRITING PROCEDURES

In assessing new investment opportunities, we maintain conservative credit standards based on our underwriting guidelines, a thorough due diligence process, and a centralized credit approval process requiring committee review, all of which are described below. The combination of conservative underwriting standards and our credit-oriented culture has resulted in a record of minimal realized losses.

**PRIVATE FINANCE.** We generally require that the companies in which we invest demonstrate strong market position, sales growth, positive cash flow, and profitability, as discussed above. We emphasize the quality of management, and seek experienced entrepreneurs with a management track record, relevant industry experience and a significant equity stake in the business. In a typical private financing, 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 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. The typical private finance transaction requires two to three months of diligence and structuring before funding occurs.

Private finance transactions are approved by an investment committee consisting of our most senior private finance professionals and chaired by our Chairman and Chief Executive Officer. The private finance approval process benefits from the experience of the investment committee members and from the experience of our other investment professionals who together with the committee members, on average, have over eleven years of professional experience. For every transaction of \$10 million or greater, we also require approval from the Executive Committee of the Board of Directors in addition to the investment committee approval. Even after all such approvals are received, due diligence must be successfully completed with final investment committee approval before funds are disbursed to a new portfolio company.

**PURCHASED CMBS.** We receive extensive packages of information regarding the mortgage loans comprising a CMBS pool. We work with the issuer, the investment bank, and the rating agencies in performing our diligence on a CMBS purchase. The typical CMBS purchase takes between two to three months to complete because



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of the breadth and depth of our diligence procedures. We re-underwrite all of the underlying commercial mortgage loans securing the CMBS. We challenge the estimate of underwritable cash flow and challenge necessary carve-outs, such as replacement reserves. We study the trends of the industry and geographic location of each property, and independently assess our own estimate of the anticipated cash flow over the period of the loan. Our loan officers physically inspect most of the collateral properties, and assess appraised values based on our own opinion of comparable market values.

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Based on the findings of our diligence procedures, we may reject certain mortgage loans from inclusion in the pool. We then formulate our negotiated purchase price and discount to achieve an effective yield on our investment over a ten-year period to approximate 13% to 16%. In computing this estimated yield, we assume a 1% loss rate on the entire underlying mortgage pool.

CMBS transactions are approved by an investment committee and, because of their size, every CMBS transaction is reviewed and approved by the Executive Committee of the Board of Directors. The investment committee for CMBS transactions consists of our most senior commercial real estate professionals and is chaired by our Chairman and Chief Executive Officer.

### PORTFOLIO MANAGEMENT

PORTFOLIO DIVERSITY. We monitor the portfolio to maintain both industry and geographic diversity. 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.

LOAN SERVICING. Our loan servicing staff is responsible for routine loan servicing, which includes:

- delinquency monitoring;
- payment processing;
- borrower inquiries;
- escrow analysis and processing;
- third-party reporting; and
- insurance and tax administration.

In addition, our staff is responsible for special servicing activities including delinquency monitoring and collection, workout administration and management of foreclosed assets.

### PORTFOLIO MONITORING AND VALUATION

We use a grading system in order to help us monitor the credit quality of our portfolio and the potential for capital gains. The grading system assigns grades to investments from 1 to 5, and the portfolio was graded at December 31, 2000 as follows:

PERCENTAGE

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GRADE -----	DESCRIPTION -----	PORTFOLIO AT VALUE ----- (IN MILLIONS)	OF TOTAL PORTFOLIO -----
1	Probable capital gain	\$ 208.3	11.7%
2	Performing security	1,461.7	81.7%
3	Close monitoring -- no loss of principal or interest expected	15.4	0.9%
4	Workout -- Some loss of interest expected	76.0	4.2%
5	Workout -- Some loss of principal expected	26.6	1.5%
		----- \$1,788.0 =====	----- 100.0% =====

The 1940 Act requires that the Board of Directors value each asset in the portfolio on a quarterly basis. We are not permitted to have a general loan loss reserve, but instead must value each specific investment. We have a written valuation policy that governs the valuation of our assets, and we follow a consistent valuation process quarterly. In valuing each individual investment, we consider the financial performance of each portfolio company, loan payment histories, indications of potential equity realization events, current collateral values and determine whether the value of the asset should be increased through unrealized appreciation or decreased through unrealized depreciation. After each investment professional has made his or her determination of value, members of senior management review the valuations. These valuations are then presented to the board of directors for review and approval.

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As a general rule, we do not value our loans above principal balance, but loans are subject to depreciation events when the asset is considered impaired. Also as a general rule, equity securities may be assigned appreciation if circumstances warrant. With respect to private equity securities, each investment is valued using industry valuation benchmarks, and then the value is assigned a discount reflecting the illiquid nature of the investments as well as our minority, non-control position. When an external event such as a purchase transaction, public offering, or subsequent equity sale occurs, the pricing indicated by the external event is used to corroborate our private equity valuation. Equity securities in public companies that carry certain restrictions on sale are generally valued at a discount from the public market value of the securities. Restricted and unrestricted publicly traded stocks may also be valued at discounts due to the size of our investment, restrictions on trading or market liquidity concerns.

We monitor loan delinquencies in order to assess the appropriate course of action and overall portfolio quality. With respect to our private finance portfolio, investment professionals closely monitor the status and performance of each individual investment throughout each quarter. Through the process, investments that may require closer monitoring are generally detected early, and for each such investment, an appropriate course of action is determined. For the private finance portfolio, loan delinquencies or payment default is not necessarily an indication of credit quality or the need to pursue active workout of a portfolio investment. Because we are a provider of long-term privately negotiated investment capital, it is not atypical for us to defer payment of principal or interest from time to time. As a result, the amount of our private finance portfolio that is delinquent may vary. The terms of our private finance agreements frequently provide an opportunity for our portfolio companies to restructure their debt and equity capital. During such restructuring, we may not

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receive or accrue interest or dividend payments. Our senior investment professionals actively work with the portfolio company in these instances to negotiate an appropriate course of action.

We price our private finance investment portfolio to provide adequate current returns for our shareholders assuming that a portion of the portfolio at any time may not be accruing interest currently. We also price our investments for a total return including current interest or dividends plus capital gains from sale of equity securities. Therefore, the amount of loans that are delinquent is not necessarily an indication of future principal loss or loss of anticipated investment return. The Company's portfolio grading system is used as a means to assess loss of investment return (Grade 4 assets) or loss of investment principal (Grade 5 assets).

With respect to our commercial real estate portfolio, the following outlines the treatment of each delinquency category:

30 Days Past Due	Our loan servicing staff monitors loans and contacts borrowers for collection.
60 Days Past Due	We generally transfer loans to professionals responsible for special servicing activity for monitoring, collection and development of a workout plan, if necessary.
90 Days Past Due	Our accounting department reviews loans in conjunction with the professional responsible for special servicing to determine whether the loans should be placed on a non-accrual status or whether a valuation adjustment is required.
120 Days Past Due	Generally, we place such loans on non-accrual status and the loan is an active workout.

### INVESTMENT GAINS AND LOSSES

As an investor focused primarily on debt investments, our investment decisions are based on credit dynamics. Our underwriting focuses on the preservation of principal, and we will pursue our available means to recover our capital investment. As a result of this investment discipline and credit culture, we have a history of low levels of loan losses, and have a demonstrated track record of successfully resolving

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troubled credit situations with minimal losses. Our realized gains from the sale of our equity interests have historically exceeded losses, as is reflected in the chart below.

	YEAR ENDED DECEMBER 31,			
	2000	1999	1998	1997
Realized gains.....	\$ 28,604	\$ 31,536	\$ 25,757	\$ 15,804
Realized losses.....	\$ (13,081)	\$ (6,145)	\$ (3,216)	\$ (5,100)
Net realized gains.....	\$ 15,523	\$ 25,391	\$ 22,541	\$ 10,704
Total assets.....	\$1,853,817	\$1,290,038	\$856,079	\$807,775
Realized losses/ Total assets.....	0.7%	0.5%	0.4%	0.6%

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### EMPLOYEES

At December 31, 2000, we employed 97 individuals including investment and portfolio management professionals, operations professionals and administrative staff. The majority of these individuals are located in the Washington, DC office. As part of the BLC merger, 37 Allied Capital employees were transferred to BLX as full-time employees of the new portfolio company. We believe that our relations with our employees are excellent.

### LEGAL PROCEEDINGS

We are a 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.

### CERTAIN GOVERNMENT REGULATIONS

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

**BUSINESS DEVELOPMENT COMPANY ("BDC").** A business development company is defined and regulated by the Investment Company Act of 1940. It is a unique kind of investment company that primarily focuses on investing in or lending to small private companies and making managerial assistance available to them. A BDC may use capital provided by public shareholders and from other sources to invest in long-term, private investments in growing small businesses. A BDC provides shareholders the ability to retain the liquidity of a publicly traded stock, while sharing in the possible benefits, if any, of investing in privately owned growth companies.

As a BDC, we may not acquire any asset other than "Qualifying Assets" unless, at the time it makes the acquisition, our Qualifying Assets represent at least 70% of the value of our total assets (the "70% test"). The principal categories of Qualifying Assets relevant to our business are:

- (1) Securities purchased in transactions not involving any public offering, the issuer of which is an eligible portfolio company. An eligible portfolio company is defined to include any issuer that (a) is organized and has its principal place of business in the United States, (b) is not an investment company other than an SBIC wholly owned by a BDC (our investments in Allied Investment, Allied SBLC and certain other subsidiaries generally are Qualifying Assets), and (c) does not have any class of publicly traded securities with respect to which a broker may extend margin credit;
- (2) Securities received in exchange for or distributed with respect to securities described in (1) above or pursuant to the exercise of options, warrants, or rights relating to such securities; and
- (3) 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.

To include certain securities described above as Qualifying Assets for the purpose of the 70% test, a BDC must make available to the issuer of those securities significant managerial assistance such as providing significant

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guidance and counsel concerning the management, operations, or business objectives and policies of a portfolio company, or making loans to a portfolio company. We will provide managerial assistance on a continuing basis to any portfolio company that requests it, whether or not difficulties are perceived.

As a BDC, the Company is entitled to issue senior securities in the form of stock or senior securities representing indebtedness, as long as each class of senior security has an asset coverage of at least 200% immediately after each such issuance. This limitation is not applicable to borrowings by our SBIC or SBLC subsidiaries, and therefore any borrowings by these subsidiaries are not included in this asset coverage test. See "Risk Factors."

We may not change the nature of our business so as to cease to be, or withdraw our election as, a BDC unless authorized by vote of a "majority of the outstanding voting securities," as defined in the 1940 Act, of our shares. Since we made our BDC election, we have not made any substantial change in the nature of our business.

REGULATED INVESTMENT COMPANY ("RIC"). Our status as a RIC enables us to avoid the cost of federal and state taxation, and as a result achieve pre-tax investment returns. We believe that this tax advantage enables us to achieve strong equity returns without having to aggressively leverage our balance sheet.

In order to qualify as a RIC, the Company must, among other things:

- (1) Derive at least 90% of its 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 its business of investing in such stock or securities.
- (2) Diversify its holdings so that
  - (a) at least 50% of the value of the Company's assets consists of cash, cash items, U.S. government securities, securities of other RICs and other securities if such other securities of any one issuer do not represent more than 5% of the Company's assets and 10% of the outstanding voting securities of the issuer, and
  - (b) no more than 25% of the value of the Company's assets are invested in securities (other than U.S. government securities) of one issuer, or of two or more issuers that are controlled by the Company.
- (3) Distribute at least 90% of its "investment company taxable income" each tax year to its shareholders. In addition, if a RIC distributes in a timely manner (or treats as "deemed distributed") 98% of its capital gain net income for each one year period ending on December 31 and distributes 98% of its ordinary income for each calendar year, it will not be subject to the 4% nondeductible federal excise tax on certain undistributed income of RICs.

SBA REGULATIONS. Allied Investment, a wholly owned subsidiary of the Company, is licensed by the SBA as an SBIC under Section 301(c) of the Small Business Investment Act of 1958, as amended (the "1958 Act"), and has elected to be regulated as a BDC.

SBICs are authorized to stimulate the flow of private equity capital to eligible small businesses. Under present SBA regulations, eligible small businesses include businesses that have a net worth not exceeding \$18 million and have average annual fully taxed net income not exceeding \$6 million for the most recent two fiscal years. In addition, an SBIC must devote 20% of its investment activity to "smaller" concerns as defined by the SBA. A smaller concern is one that has a net worth not exceeding \$6 million and has average annual fully taxed

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net income not exceeding \$2 million for the most recent two fiscal years. SBA 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 SBA regulations, SBICs may make long-term loans to small businesses, invest in

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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 SBA staff to determine its compliance with SBIC regulations.

Allied Investment has the opportunity to sell to the SBA subordinated debentures with a maturity of up to ten years, up to an aggregate principal amount of \$108.8 million. This limit generally applies to all financial assistance provided by the SBA to any licensee and its "associates," as that term is defined in SBA regulations. Historically, an SBIC was also eligible to sell preferred stock to the SBA. Allied Investment had received \$78.3 million of subordinated debentures and \$7.0 million of preferred stock investments from the SBA at December 31, 2000; as a result of the \$108.8 million limit, the Company is limited on its ability to apply for additional financing from the SBA. Interest rates on the SBA debentures currently outstanding have a weighted average interest cost of 8.3%.

### FORWARD-LOOKING STATEMENTS

You should read the information contained in this Form 10-K in conjunction with the Company's 2000 Consolidated Financial Statements and Notes thereto contained in the Company's 2000 Annual Report to Shareholders. The 2000 Annual Report to Shareholders and this Form 10-K contain certain forward-looking statements. These statements include management's plans and objectives for future operations and financial objectives, loan portfolio growth and availability of funds. There are inherent uncertainties in predicting future results and conditions, and certain factors could cause actual results and conditions to differ materially from those projected in these forward-looking statements. These factors are described in the "Risk Factors" section below. Other factors that could cause actual results to differ materially include the uncertainties of economic, competitive and market conditions, and future business decisions, all of which are difficult or impossible to predict accurately and many of which are beyond our control. Although we believe that the assumptions underlying the forward-looking statements included or incorporated by reference in this document are reasonable, any of the assumptions could be inaccurate and therefore, we cannot assure you that the forward-looking statements included or incorporated by reference in this document will prove to be accurate. Therefore, you should not regard the inclusion of this information as an assurance that the Company's plans and objectives will be achieved.

### RISK FACTORS

INVESTING IN PRIVATE COMPANIES INVOLVES A HIGH DEGREE OF RISK. Our portfolio consists primarily of 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

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the Company's 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 or economic downturns, which may adversely affect the return on, or the recovery of, our investment in such businesses.

OUR FINANCIAL RESULTS COULD BE NEGATIVELY AFFECTED IF BLX FAILS TO PERFORM AS EXPECTED. Business Loan Express, Inc. ("BLX") is our largest portfolio investment. Our financial results could be negatively affected if BLX, as a portfolio company, fails to perform as expected.

OUR BORROWERS MAY DEFAULT ON THEIR PAYMENTS. We make unsecured, subordinated loans and invest in equity securities, which may involve a higher degree of repayment risk. We primarily invest in and lend to 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 collateral for the loan.

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OUR PORTFOLIO OF INVESTMENTS IS ILLIQUID. We acquire most of our investments directly from private companies. The majority of the investments in our portfolio will be subject to restrictions on resale or otherwise have no established trading market. The illiquidity of most of our portfolio may adversely affect our ability to dispose of loans and securities at times when it may be advantageous for us to liquidate such investments.

INVESTMENTS IN NON-INVESTMENT GRADE COMMERCIAL MORTGAGE-BACKED SECURITIES MAY BE ILLIQUID AND MAY HAVE A HIGHER RISK OF DEFAULT. The commercial mortgage-backed securities ("CMBS") in which we invest are non-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." The non-investment grade CMBS 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 bonds, but with the higher return comes greater risk. 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.

OUR PORTFOLIO INVESTMENTS ARE RECORDED AT FAIR VALUE AS DETERMINED BY THE BOARD OF DIRECTORS IN ABSENCE OF READILY ASCERTAINABLE PUBLIC MARKET VALUES. Pursuant to the requirements of the Investment Company Act of 1940 ("1940 Act"), the Board of Directors is required to value each asset quarterly, and we are required to carry our portfolio at fair value as determined by the Board of Directors. Since there is typically no public market for the loans and equity securities of the companies in which we make investments, our Board of Directors estimates the fair value of these loans and equity securities pursuant to a written valuation policy and a consistently applied valuation process. 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 and record an unrealized loss for an asset that we believe has become impaired. Without a readily ascertainable market value, the estimated value of our portfolio of loans and equity securities may differ significantly from the values that would be placed on the portfolio if there existed a ready market for the loans and equity securities. We adjust quarterly the valuation of our portfolio to reflect the Board of Directors' estimate of the current realizable value of each investment in our portfolio. Any changes in estimated value are recorded in the Company's statement of operations as "Net unrealized

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gains (losses)."

WE BORROW MONEY WHICH MAGNIFIES THE POTENTIAL FOR GAIN OR LOSS ON AMOUNTS INVESTED AND MAY INCREASE THE RISK OF INVESTING IN OUR COMPANY. 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. 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. If the value of our consolidated assets increases, then leveraging would cause the net asset value attributable to the Company's 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, 2000, the Company had \$786.6 million of outstanding indebtedness, bearing a weighted annual interest cost of 8.3%. In order for us to cover these annual interest payments on indebtedness, we must achieve annual returns on our December 31, 2000 portfolio of at least 3.4%.

WE MAY NOT BORROW MONEY UNLESS WE MAINTAIN ASSET COVERAGE FOR INDEBTEDNESS OF AT LEAST 200% WHICH MAY AFFECT RETURNS TO SHAREHOLDERS. We must maintain asset coverage for a class of senior security representing indebtedness 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

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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, 2000, our asset coverage for indebtedness was 245%.

CHANGES IN INTEREST RATES MAY AFFECT OUR COST OF CAPITAL AND NET OPERATING INCOME. Because we borrow money to make investments, our net operating 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 portfolio income. In periods of sharply rising interest rates, our cost of funds would increase, which would reduce our net operating income before net realized and unrealized gains. However, there would be no effect on the return, if any, that could be generated from our equity interests. We use a combination of long-term and short-term borrowings and equity capital to finance our investing activities. The Company utilizes its short-term credit facilities only 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.

BECAUSE WE MUST DISTRIBUTE INCOME, WE WILL CONTINUE TO NEED ADDITIONAL CAPITAL TO GROW. We will continue to need capital to fund incremental growth in our



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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 net operating income excluding net realized long-term capital gains to our stockholders to maintain our regulated investment company ("RIC") status. As a result such earnings will not be available to fund investment originations. We expect to continue to borrow from financial institutions and sell additional 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 the Company's common stock. In addition, as a business development company ("BDC"), 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.

OUR PRIVATE FINANCE INVESTMENTS MAY NOT PRODUCE CAPITAL GAINS. Private finance investments are typically structured as debt securities with a relatively high fixed rate of interest and with an equity feature such as conversion rights, warrants or options. As a result, private finance investments 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.

LOSS OF PASS-THROUGH TAX TREATMENT WOULD SUBSTANTIALLY REDUCE NET ASSETS AND INCOME AVAILABLE FOR DIVIDENDS. We have operated the Company so as to qualify to be taxed as a RIC under Subchapter M of the Internal Revenue Code of 1986, as amended ("Code"). If we meet source of income, diversification and distribution requirements, the Company qualifies for pass-through tax treatment. If the Company fails to qualify as a RIC, the Company would become subject to federal income tax as if it were an ordinary corporation, which would substantially reduce our net assets and the amount of income available for distribution to our shareholders. The Company would cease to qualify for pass-through tax treatment if it were unable to comply with these requirements, or if it ceased to qualify as a BDC under the 1940 Act. We also could be subject to a 4% excise tax and/or corporate level income tax if we fail to make required distributions.

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WE OPERATE IN A COMPETITIVE MARKET FOR INVESTMENT OPPORTUNITIES. We compete for investments with many other companies and individuals, some of whom 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.

CHANGES IN THE LAW OR REGULATIONS THAT GOVERN THE COMPANY COULD HAVE A MATERIAL IMPACT ON THE COMPANY OR OUR OPERATIONS. We are regulated by the Securities and Exchange Commission and the SBA. In addition, changes in the laws or regulations that govern BDCs, RICs, real estate investment trusts ("REITs") and SBICs may significantly affect our business. Any change in the law or regulations that govern our business could have a material impact on the Company or its 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.

QUARTERLY RESULTS MAY FLUCTUATE AND MAY NOT BE INDICATIVE OF FUTURE QUARTERLY PERFORMANCE. The Company's quarterly operating results could fluctuate and therefore, you should not rely on quarterly results to be indicative of the Company's performance in future quarters. Factors that could cause quarterly operating results to fluctuate include, among others, variations in the investment origination volume, variation in timing of prepayments, variations in and the timing of the recognition of realized and unrealized gains or losses, the degree to which we encounter competition in our markets and general economic

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conditions.

### ITEM 2. PROPERTIES

Our principal offices are located on the third floor of 1919 Pennsylvania Avenue, N.W., Washington, DC, in the heart of Washington's business and financial district. Our lease for approximately 32,000 square feet of office space at that location expires in July 2008. The office is equipped with an integrated network of computers for word processing, financial analysis, accounting and loan servicing. We believe our office space is suitable for our needs for the foreseeable future. The Company also maintains offices in Chicago, New York, San Francisco and Frankfurt, Germany.

### ITEM 3. LEGAL PROCEEDINGS

We are a 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 actions will have a material effect upon our financial condition or results of operations.

### ITEM 4. SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

On November 15, 2000, the Company held a Special Meeting of Shareholders to amend the Company's charter to increase the number of authorized shares from 100,000,000 to 200,000,000. A total of 68,445,878 shares voted "for" the proposal, 3,051,986 voted "against" the proposal and 533,465 shares abstained from voting. No other matters were submitted for a vote.

### ADDITIONAL ITEM. EXECUTIVE OFFICERS OF THE REGISTRANT

The following table sets forth the names, ages and positions of the executive officers of the Company as of March 16, 2001, as well as certain other information with respect to those persons. Periods of employment by the Company include periods of employment by predecessor companies.

William L. Walton, age 51, has been the Chairman, Chief Executive Officer and President of the Company since 1997. He has served on Allied Capital's board of directors since 1986, and was named Chairman and CEO in February 1997. Mr. Walton has an extensive background in general management, marketing, strategic planning, mergers and acquisitions and financial analysis. Mr. Walton previously served as Managing Director of New York-based Butler Capital Corporation (1987-1991) and was the personal venture capital advisor for William S. Paley, founder and Chairman of CBS. In addition, he was

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a Senior Vice President in Lehman Brother Kuhn Loeb's Investment Banking Group. Mr. Walton also founded and managed two start-up businesses in the emerging education industry (1992-1996). Mr. Walton is a director of Nobel Learning Communities, Inc. and Riggs National Corporation. He received both a B.A. and a M.B.A. from Indiana University.

Joan M. Sweeney, age 41, Managing Director and Chief Operating Officer, has been employed by the Company since 1993. Ms. Sweeney oversees all company operations and is responsible for strategic planning, financial management, information technology, marketing, investor relations, and all regulatory compliance. Prior to joining the Company, Ms. Sweeney spent ten years of her career consulting with private and small public companies at both Ernst & Young and Coopers & Lybrand. Ms. Sweeney was a member of the SEC Division of Enforcement in the late 1980s.

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Scott S. Binder, age 46, Managing Director, has worked with the Company since 1991 and is responsible for the Company's telecommunications and new media investments within the private finance group. Prior to joining the Company, Mr. Binder formed and was President of Overland Communications Group, which owned and operated cable television systems and radio stations. He also has worked in the specialty finance and leasing industry.

Samuel B. Guren, age 54, Managing Director, joined the Company in 1999. He joined the Company to develop the Company's private equity investment business. Mr. Guren has more than 26 years of venture capital investing experience. Prior to joining the Company, Mr. Guren was the Senior Managing Partner at Baird Capital. He also served as a Senior Managing Partner at William Blair Venture Partners for 15 years.

Philip A. McNeill, age 41, Managing Director, has been employed by the Company since 1993 and is responsible for co-managing the Company's private finance group. Before joining the Company, he served as a vice president of M&T Capital Corporation. Prior to entering the private finance industry, he was founding director of Western Oklahoma National Bank, and structured and managed numerous privately negotiated investments.

John M. Scheurer, age 48, Managing Director, has been employed by the Company since 1991 and manages the Company's real estate finance group. He has more than 22 years of experience in commercial finance and real estate lending and management. Prior to joining the Company, Mr. Scheurer worked in various capacities with Capital Recovery Advisors, Inc. and First American Bank. He also started his own company, The Scheurer Company, and co-founded Hunter & Associates, a major leasing and consulting real estate firm in the Washington, DC area.

Thomas H. Westbrook, age 37, Managing Director, has been with the Company since 1991 and is responsible for the Company's business services investments within the private finance group. Prior to joining the Company, Mr. Westbrook worked with North Carolina Enterprise Fund and was a lending officer in NationsBank's corporate lending unit. He is the former president of the southern RASBIC and has served on the NASBIC Board of Governors.

G. Cabell Williams, III, age 46, Managing Director, has been employed by the Company since 1981, and is responsible for co-managing the operations of the Company's private finance group. He has over 19 years of private finance experience, and has structured numerous types of private debt and equity finance transactions. Mr. Williams has served in many capacities during his tenure with the Company.

Penni F. Roll, age 35, Executive Vice President and Chief Financial Officer, has been employed by the Company since 1995. Ms. Roll is responsible for the Company's financial management and reporting, accounting, loan servicing, special servicing, portfolio monitoring and regulatory compliance activities. Prior to joining the Company, she spent seven years in the financial services practice at KPMG Peat Marwick, including serving as a Manager from 1993 to 1995.

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### PART II

#### ITEM 5. MARKET FOR REGISTRANT'S COMMON EQUITY AND RELATED STOCKHOLDER MATTERS

Information in response to this Item is incorporated herein by reference to the "Stockholder Information" and to the "Selected Consolidated Financial Data" section of the Company's Annual Report to Shareholders for the year ended December 31, 2000 (the "2000 Annual Report") as well as Note 12, "Dividends and

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Distributions" from the Company's 2000 Notes to the Consolidated Financial Statements. The quarterly stock prices quoted therein represent interdealer quotations and do not include markups, markdowns, or commissions and may not necessarily represent actual transactions. During 2000, the Company issued 254,317 shares of common stock pursuant to a dividend reinvestment plan. This plan is not registered and relies on an exemption from registration in the Securities Act of 1933. See Note 7, "Shareholders' Equity" for additional information.

### ITEM 6. SELECTED FINANCIAL DATA

Information in response to this Item is incorporated herein by reference to the table in the "Selected Consolidated Financial Data" Section of the 2000 Annual Report.

### ITEM 7. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Information in response to this Item is incorporated herein by reference to the "Management's Discussion and Analysis of Financial Condition and Results of Operations" section of the 2000 Annual Report.

### ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURE ABOUT MARKET RISK

The Company's business activities contain elements of risk. The Company considers the principal types of market risk to be interest rate risk and valuation risk. The Company considers the management of risk essential to conducting its businesses and to maintaining profitability. Accordingly, the Company's risk management systems and procedures are designed to identify and analyze the Company's risks, to set appropriate policies and limits and to continually monitor these risks and limits by means of reliable administrative and information systems and other policies and programs.

The Company manages its market risk by maintaining a portfolio of equity interests that is diverse by industry, geographic area, property type, size of individual investment and borrower. The Company does not have a significant exposure to public market price fluctuations as the Company primarily invests in private business enterprises. Since there is typically no public market for the equity interests of the companies in which the Company invests, the valuation of the equity interests in the Company's portfolio is subject to the estimate of the Company's Board of Directors. In the absence of a readily ascertainable market value, the estimated value of the Company's portfolio of equity interests may differ significantly from the values that would be placed on the portfolio if a ready market for the equity interests existed. Any changes in estimated value are recorded in the Company's statement of operations as "Net unrealized gains (losses)." Each hypothetical 1% increase or decrease in value of the Company's portfolio of equity interests of \$316.2 million at December 31, 2000 would have resulted in unrealized gains or losses and would have increased or decreased net income in 2000 by 2%.

The Company's sensitivity to changes in interest rates is regularly monitored and analyzed by measuring the characteristics of assets and liabilities. The Company utilizes various methods to assess interest rate risk in terms of the potential effect on interest income net of interest expense, the value of net assets and the value at risk in an effort to ensure that the Company is insulated from any significant adverse effects from changes in interest rates. Based on the model used for the sensitivity of interest income net of interest expense, if 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 net income by less than 1% over a six month horizon. Although management believes that this measure is indicative of the Company's sensitivity to interest rate changes, it does not adjust for

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potential changes in credit quality, size and composition of the balance sheet and other business developments that could affect

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net income. Accordingly, no assurances can be given that actual results would not differ materially from the potential outcome simulated by this estimate.

### ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

Information in response to this Item is incorporated by reference to the Consolidated Financial Statements, Notes thereto, and Report of Independent Public Accountants thereon contained in the 2000 Annual Report.

### ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

None.

## PART III

### ITEM 10. DIRECTORS AND EXECUTIVE OFFICERS OF THE REGISTRANT

Information in response to this Item is incorporated by reference to the identification of directors and nominees contained in the "Election of Directors" section and the subsection captioned "Section 16(a) Beneficial Ownership Reporting Compliance" of the Company's definitive proxy statement in connection with its 2001 Annual Meeting of Stockholders, scheduled to be held on May 8, 2001 (the "2001 Proxy Statement"), and from "Additional Item" in Part I.

### ITEM 11. EXECUTIVE COMPENSATION

Information in response to this Item is incorporated by reference to the subsections captioned "Compensation of Executive Officers and Directors" of the 2001 Proxy Statement.

### ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT.

Information in response to this Item is incorporated by reference to the subsection captioned "Security Ownership of Management and Certain Beneficial Owners" in the 2001 Proxy Statement.

### ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS.

Information in response to this Item is incorporated by reference to the section captioned "Certain Transactions" of the 2001 Proxy Statement.

## PART IV

### ITEM 14. EXHIBITS, FINANCIAL STATEMENT SCHEDULES AND REPORTS ON FORM 8-K

(a) Documents filed as part of this Report:

1. A. The following financial statements are incorporated by reference from the Consolidated Financial Statements, Notes thereto and Report of Independent Public Accountants thereon contained in the Company's 2000 Annual Report, filed herewith.

Consolidated Balance Sheet as of December 31, 2000 and 1999.

Consolidated Statement of Operations for the years ended December 31, 2000, 1999 and 1998.

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Consolidated Statement of Changes in Net Assets for the years ended December 31, 2000, 1999 and 1998.

Consolidated Statement of Cash Flows for the years ended December 31, 2000, 1999 and 1998.

Consolidated Statement of Investments as of December 31, 2000.

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Notes to Consolidated Financial Statements.

B. The Report of Independent Public Accountants from Arthur Andersen LLP is incorporated by reference to the Report of Independent Public Accountants contained in the Company's 2000 Annual Report filed herewith.

2. No financial statement schedules are filed herewith because (i) such schedules are not required or (ii) the information required has been presented in the aforementioned financial statements.

3. The following exhibits are filed herewith or incorporated by reference as set forth below:

EXHIBIT NUMBER -----	DESCRIPTION -----
3(i)(a)(1)	Articles of Amendment and Restatement of the Articles of Incorporation.
3(i)(b)(2)	Articles of Merger.
3(i)(c)(14)	Amendment to the Amended and Restated Articles of Incorporation.
3(ii)10	Bylaws.
4.1(4)	Specimen certificate of the Company's Common stock, par value \$0.0001 per share. See exhibits 3(i), 3(ii) and 3(iii) for other instruments defining the rights of security holders.
4.2(2)	Form of debenture between certain subsidiaries of the Company and the U.S. Small Business Administration.
5	Not applicable.
9	Not applicable.
10.1(14)	Amended and Restated Credit Agreement dated May 17, 2000.
10.2(5)	Note Agreement dated as of April 30, 1998.
10.3(3)	Loan Agreement between Allied I and Overseas Private Investment Corporation, dated April 10, 1995. Letter dated December 11, 1997 evidencing assignment of Loan Agreement from Allied I to the Company.
10.4(8)	Note Agreement dated as of May 1, 1999.
10.4a(10)	Note Agreement dated as of November 15, 1999.
10.4b(13)	Note Agreement dated as of October 15, 2000.
10.5(14)	Amendment and Consent Agreement to the Amended and Restated Credit Agreement dated December 11, 2000.
10.6(4)	Sale and Servicing Agreement dated as of January 1, 1998 among Allied Capital CMT, Inc., Allied Capital Commercial Mortgage Trust 1998-1 and the Company and LaSalle National Bank Inc. and ABN AMRO Bank N.V.
10.7(4)	Indenture dated as of January 1, 1998 between Allied Capital Commercial Mortgage Trust 1998-1 and LaSalle National Bank.



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\* Filed herewith.

- (1) Incorporated by reference to the exhibit of the same name filed with the Company's Annual Report on Form 10-K for the year ended December 31, 1997.
- (2) Incorporated by reference to the exhibit of the same name filed with Allied I's Annual Report on Form 10-K for the year ended December 31, 1996.
- (3) Incorporated by reference to Exhibit f.7 of Allied I's Pre-Effective Amendment No. 2 filed with the registration statement on Form N-2 on January 24, 1996 (File No. 33-64629). Assignment to Company is incorporated by reference to Exhibit 10.3 of the Company's Annual Report on Form 10-K for the year ended December 31, 1997.
- (4) Incorporated by reference to the exhibit of the same name to the Company's registration statement on Form N-2 filed on the Company's behalf with the Commission on May 5, 1998 (File No. 333-51899).
- (5) Incorporated by reference to the exhibit of the same name filed with the Company's Quarterly Report on Form 10-Q for the period ended September 30, 1998.

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- (6) Incorporated by reference to Exhibit A of the Company's definitive proxy materials for the Company's 2000 Annual Meeting of Stockholders filed with the Commission on March 29, 2000.
- (7) Incorporated by reference to the exhibit of the same name filed with the Company's Annual Report on Form 10-K for the year ended December 31, 1998.
- (8) Incorporated by reference to the exhibit of the same name filed with the Company's Quarterly Report on Form 10-Q for the period ended June 30, 1999.
- (9) Incorporated by reference to Exhibit 4.4 of the Allied Capital 401(k) Plan registration statement on Form S-8, filed on behalf of such Plan on October 8, 1999 (File No. 333-88681).
- (10) Incorporated by reference to the exhibit of the same name filed with the Company's Annual Report on Form 10-K for the year ended December 31, 1999.
- (11) Incorporated by reference to Appendix A to the Company's registration statement on Form N-14 filed on the Company's behalf with the Commission on November 6, 2000.
- (12) Incorporated by reference to the exhibit of the same name to the Company's registration statement on Form N-14 filed on the Company's behalf with the Commission on November 6, 2000.
- (13) Incorporated by reference to the exhibit of the same name to the Company's Quarterly Report on Form 10-Q for the period ended September 30, 2000.
- (14) Incorporated by reference to the exhibit of the same name to Post-Effective Amendment No. 2 to the Company's registration statement on Form N-2 (File No. 333-43534).



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(b) Reports on Form 8-K.

The Company filed no reports on Form 8-K during the quarter ended December 31, 2000.

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SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this Report to be signed on its behalf by the undersigned, thereunto duly authorized on March 19, 2001.

/s/ WILLIAM L. WALTON

-----  
 William L. Walton  
 Chairman of the Board, President and  
 Chief Executive Officer

Pursuant to the requirements of the Securities Exchange Act of 1934, this Report has been signed below by the following persons on behalf of the Registrant in the capacities and on the dates indicated.

SIGNATURE -----	TITLE (CAPACITY) -----	DATE ---
/s/ WILLIAM L. WALTON ----- William L. Walton	Chairman, President, and Chief Executive Officer	March 19
/s/ BROOKS H. BROWNE ----- Brooks H. Browne	Director	March 19
/s/ JOHN D. FIRESTONE ----- John D. Firestone	Director	March 19
/s/ ANTHONY T. GARCIA ----- Anthony T. Garcia	Director	March 19
/s/ LAWRENCE I. HEBERT ----- Lawrence I. Hebert	Director	March 19
/s/ JOHN I. LEAHY ----- John I. Leahy	Director	March 19
/s/ ROBERT E. LONG ----- Robert E. Long	Director	March 19
/s/ WARREN K. MONTOURI ----- Warren K. Montouri	Director	March 19

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/s/ GUY T. STEUART II ----- Guy T. Steuart II	Director	March 19
/s/ T. MURRAY TOOMEY ----- T. Murray Toomey	Director	March 19

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SIGNATURE -----	TITLE (CAPACITY) -----	DATE -----
/s/ LAURA W. VAN ROIJEN ----- Laura W. van Roijen	Director	March 19
/s/ GEORGE C. WILLIAMS, JR. ----- George C. Williams, Jr.	Director	March 19
/s/ PENNI F. ROLL ----- Penni F. Roll	Executive Vice President and Chief Financial Officer (Principal Financial and Accounting Officer)	March 19

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EXHIBIT INDEX

EXHIBIT NUMBER -----	DESCRIPTION -----
13	Excerpts from the 2000 Annual Report to Shareholders.
23	Consent of Arthur Andersen LLP, independent public accountants

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