ALLIED CAPITAL CORP
Form N-2/A
October 16, 2002

As filed with the Securities and Exchange Commission on October 16, 2002

Registration No. 333-87862

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM N-2

REGISTRATION STATEMENT

UNDER
THE SECURITIES ACT OF 1933

x **Pre-Effective Amendment No. 2**
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

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.

PROSPECTUS (Subject to Completion)

Issued , 2002

$300,000,000

Common Stock
Preferred Stock
Debt Securities

We are an internally managed closed-end 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 primarily in private companies in a variety of industries throughout the United States. 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 material incorporated by reference herein and other information about us.

We may offer, from time to time, up to $300,000,000 of our common stock, preferred stock, or debt securities in one or more offerings. All shares of common stock, preferred stock, and debt securities that are offered under this prospectus are collectively referred to herein as the Securities.

Also, shares of our common stock may be offered from time to time by certain of our shareholders. Any selling shareholder will be identified, and the number of shares to be offered by such shareholder will be set forth in a supplement to this prospectus.

The Securities may be offered at prices and on terms to be described in one or more supplements to this prospectus. In the case of common stock offered by us, the offering price per share 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 , 2002, 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 the Securities.

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.

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

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.

, 2002

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 or incorporated by reference 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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ABOUT THIS PROSPECTUS

This prospectus is part of a registration statement that we have filed with the Securities and Exchange Commission using a shelf registration process. Under the shelf registration process, we may offer any combination of the securities described in this prospectus in one or more offerings with a total offering price of up to $300,000,000. The common stock offered in this prospectus may, subject to certain conditions, also be offered and sold from time to time under this prospectus by certain of our current shareholders. This prospectus provides you with a general description of securities we or a selling shareholder may offer. Each time we or a selling shareholder use this prospectus to offer securities, 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 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 55)*

We are a business development company that participates in the private equity market. We generally invest in illiquid securities through privately negotiated transactions. We provide long-term debt and equity investment capital to support the expansion of primarily private companies in a variety of industries. We have been investing in businesses for over 40 years and have financed thousands of companies nationwide. Our investment activity is generally focused in two areas:

- private finance, and
- commercial real estate finance, primarily in non-investment grade commercial mortgage-backed securities.

Our investment portfolio generally includes:

- long-term unsecured loans with or without equity features known as mezzanine financing,
- equity investments in companies, which may or may not constitute a controlling equity interest,
- non-investment grade commercial mortgage-backed securities, and
- commercial mortgage loans.

We identify loans and investments through our numerous relationships with:

- mezzanine and private equity investors,
- investment banks, and
- other intermediaries, including professional services firms.

Our credit and investment approval process is centralized at our headquarters in Washington, DC.

Our tax structure generally allows us to pass-through our income to our shareholders through dividends without the imposition of a corporate level of taxation, if certain requirements are met. See Tax Status.

We are an internally managed diversified closed-end 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. Our investment objective is to achieve current income and capital gains. We seek to achieve our investment objective by investing primarily in private businesses in a variety of industries throughout the United States.

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 and we also have an office in Frankfurt, Germany.

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

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

During the third quarter ended September 30, 2002, private finance new investment activity totaled approximately $148 million, including loans, debt securities, and equity interests.

VALUATION OF PORTFOLIO

INVESTMENTS *(Page 77)*

Our portfolio investments are generally recorded at fair value as determined in good faith by our board of directors in absence of readily ascertainable public market values.

At June 30, 2002, approximately 93% of our total assets represented investments recorded at fair value. 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 ascertainable 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 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. Conversely, we will record unrealized appreciation if we have an indication that the underlying portfolio company has appreciated in value and, therefore, our equity security has also appreciated in value, where appropriate. Without a readily ascertainable 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 unrealized gains (losses).

PLAN OF DISTRIBUTION *(Page 107)*

We may offer, from time to time, up to $300,000,000 of our Securities, on terms to be determined at the time of the offering.

Also, shares of our common stock may be offered from time to time by certain of our shareholders. Any selling shareholder will be identified, and the number of shares to be offered by such shareholder will be set forth in a supplement to this prospectus.

Securities may be offered at prices and on terms described in one or more supplements to this prospectus. In the case of the offering of common stock by us, the offering price per share 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 Securities may be offered directly to one or more purchasers, through agents designated from time to time by us or the selling shareholders, 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 Securities, 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 and the selling shareholders, if any, may not sell Securities without delivering a prospectus supplement describing the method and terms of the offering of our Securities.

USE OF PROCEEDS *(Page 16)*

Unless otherwise specified in the prospectus supplement accompanying this prospectus, we intend to use the net proceeds from selling Securities for general corporate purposes, which include investments in the debt or equity securities of primarily private companies or non-investment grade commercial mortgage-backed securities, repayment of indebtedness, acquisitions and other general corporate purposes.

We will not receive any proceeds from the sale of our common stock by any selling shareholder.

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. Other types of Securities will likely pay distributions in accordance with their terms.

DIVIDEND REINVESTMENT PLAN *(Page 102)*

We maintain a dividend reinvestment plan for our common shareholders. Effective May 1, 2002, we converted from an opt out to an opt in dividend reinvestment plan. As a result, if our board of directors declares a dividend, then our new 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. Existing dividend reinvestment plan accounts will not be affected by this amendment.

RISK FACTORS *(Page 9)*

Investment in our Securities involves certain risks relating to our business and our investment objective that you should consider before purchasing our Securities.

As a business development company, our portfolio includes securities primarily issued by privately held 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.

An economic slowdown may affect the ability of a portfolio company to engage in a liquidity event. 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. Our business of making private equity investments 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 the loss of pass-through tax treatment 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, 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 104)*

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.

LEGAL PROCEEDINGS *(Page 68)*

A series of class action lawsuits have been filed in the United States District Court for the Southern District of New York against us, certain of our directors and officers and our former independent auditors, Arthur Andersen LLP, with respect to alleged violations of the securities laws. These lawsuits allege violations of Sections 10(b) and 20(a) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder, specifically they allege, among other things, that we purportedly misstated the value of certain portfolio investments in our financial statements, which allegedly resulted in the purchase of our common stock by purported class members at artificially inflated prices. Several of the complaints also allege state law claims for common law fraud. The complaints seek compensatory and other damages, and costs and expenses associated with the litigation. The lawsuits have been consolidated into a single proceeding captioned In re Allied Capital Corp. Securities Litigation, 02 CV 3812. We believe that the lawsuit is without merit, and we intend to defend the lawsuit vigorously. While we do not expect these matters to materially affect our financial condition or results of operations, there can be no assurance as to whether any such pending litigation will have a material adverse effect on our financial condition or results of operations in any future reporting period.

FEES AND EXPENSES

This table describes the various costs and expenses that an investor in our Securities will bear directly or indirectly.

Shareholder Transaction Expenses	
Sales load (as a percentage of offering price)(1)	%
Dividend reinvestment plan fees(2)	None
Annual Expenses (as a percentage of consolidated net assets attributable to common stock)(3)	
Operating expenses(4)	3.6%
Interest payments on borrowed funds(5)	5.1%
Total annual expenses(6)	8.7%

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(1) In the event that the Securities 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 have no cash 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) at June 30, 2002.

(4) Operating expenses represent our estimated operating expenses for the year ending December 31, 2002 excluding interest on indebtedness. This percentage for the year ended December 31, 2001 was 3.8%.

(5) The Interest payments on borrowed funds represents our estimated interest expenses for the year ending December 31, 2002. We had outstanding borrowings of $1,009.0 million at June 30, 2002. This percentage for the year ended December 31, 2001 was 5.5%. See Risk Factors.

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

Example

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

	1 Year	3 Years	5 Years	10 Years
You would pay the following expenses on a $1,000 investment, assuming a 5.0% annual return	$87	$261	$436	$876

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. See Dividend Reinvestment Plan.

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, 2001, 2000, 1999, 1998 and 1997 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. Quarterly financial information is derived from unaudited financial data, but in the opinion of management, reflects all adjustments (consisting only of normal recurring adjustments) which are necessary to present fairly the results for such interim periods. Interim results at and for the six months ended June 30, 2002 are not necessarily indicative of the results that may be expected for the year ending December 31, 2002. **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)	**Six Months Ended June 30,**		**Year Ended December 31,**				
	2002	**2001**	**2001**	**2000**	**1999**	**1998**	**1997**
	(unaudited)						
Operating Data:							
Interest and related portfolio income:							
Interest and dividends	$127,665	$113,699	$240,464	$182,307	$121,112	$80,281	$86,882
Premiums from loan dispositions	1,659	1,731	2,504	16,138	14,284	5,949	7,277
Post-merger gain on securitization of commercial mortgage loans			14,812				
Fees and other income	26,260	18,380	46,142	13,144	5,744	5,696	3,246
Total interest and related portfolio income	155,584	133,810	289,110	211,589	141,140	106,738	97,405

Expenses:

Interest
34,984 31,881 65,104 57,412 34,860 20,694 26,952
Employee
16,309 14,056 29,656 26,025 22,889 18,878 10,258
Administrative
7,861 6,027 15,299 15,435 12,350 11,921 8,970
Merger
5,159

Total operating expenses
59,154 51,964 110,059 98,872 70,099 51,493 51,339

Net investment income before income tax benefit (expense) and net realized and unrealized gains
96,430 81,846 179,051 112,717 71,041 55,245 46,066
Income tax benefit (expense)
412 (787) (1,444)

Net investment income before net realized and unrealized gains	96,430	81,846	179,463	112,717	71,041	54,458	44,622
Net realized and unrealized gains:							
Net realized gains	8,850	4,991	661	15,523	25,391	22,541	10,704
Net unrealized gains	24,135	11,297	20,603	14,861	2,138	1,079	7,209
Total net realized and unrealized gains	32,985	16,288	21,264	30,384	27,529	23,620	17,913

Income before minority interests	129,415	98,134	200,727	143,101	98,570	78,078	62,535
Minority interests							1,231
Net increase in net assets resulting from operations	$129,415	$98,134	$200,727	$143,101	$98,570	$78,078	$61,304

Per Share:

Diluted earnings per common share	$1.26	$1.10	$2.16	$1.94	$1.64	$1.50	$1.24
Dividends per common share(1)	$1.08	$0.99	$2.01	$1.82	$1.60	$1.43	$1.20
Weighted average common shares outstanding diluted(2)	102,900	88,966	93,003	73,472	60,044	51,974	49,251

(in thousands, except per share data)	At June 30,	At December 31,				
	2002	2001	2000	1999	1998	1997
	(unaudited)					
Balance Sheet Data:						
Portfolio at value	$2,380,969	$2,329,590	$1,788,001	$1,228,497	$807,119	$703,331
Portfolio at cost	2,305,252	2,286,602	1,765,895	1,222,901	803,479	697,030
Total assets	2,568,616	2,460,713	1,853,817	1,290,038	856,079	807,775
Total debt outstanding(3)	1,008,950	1,020,806	786,648	592,850	334,350	347,663
Preferred stock issued to Small Business Administration(3)	7,000	7,000	7,000	7,000	7,000	7,000
Shareholders equity	1,434,453	1,352,123	1,029,692	667,513	491,358	420,060
Shareholders equity per common share (net asset value)	$14.02	$13.57	$12.11	$10.20	$8.79	$8.07
Common shares outstanding at period end(2)	102,296	99,607	85,057	65,414	55,919	52,047

	Six Months Ended June 30,		Year Ended December 31,				
	2002	2001	2001	2000	1999	1998	1997
	(unaudited)						
Other Data:							
Investments funded	$195,455	$299,843	$680,329	$901,545	$751,871	$524,530	$364,942
Repayments	67,017	42,544	74,461	111,031	139,561	138,081	233,005
Sales	126,280	74,648	129,980	280,244	198,368	81,013	53,912
Realized gains	15,429	6,596	10,107	28,604	31,536	25,757	15,804
Realized losses	(6,579)	(1,605)	(9,446)	(13,081)	(6,145)	(3,216)	(5,100)
Return on average assets(4)			9.4%	9.1%	9.2%	10.1%	7.9%
Return on average equity(4)			17.0%	17.2%	17.5%	18.0%	14.8%

(1) Distributions are based on taxable income, which differs from income for financial reporting purposes. Dividends for 1997 exclude certain merger-related dividends of $0.51 per common share.

(2) Excludes 234,977, 516,779 and 810,456 common shares held in the deferred compensation trust at and for the years ended December 31, 2000, 1999, and 1998, respectively.

(3) See Senior Securities on page 51 for more information regarding our level of indebtedness.

(4) Return on average assets and return on average equity are only presented on an annual basis as interim period calculations may not be meaningful due to quarterly fluctuations in net increase in net assets from operations.

(in thousands, except per share data)	2002		2001				2000			
	Qtr 2	Qtr 1	Qtr 4	Qtr 3	Qtr 2	Qtr 1	Qtr 4	Qtr 3	Qtr 2	Qtr 1
Quarterly Data (unaudited):										
Total interest and related portfolio income	$73,193	$82,391	$82,666	$72,634	$68,739	$65,071	$61,735	$55,992	$49,965	$43,897
Net investment income before net realized and unrealized gains	42,561	53,869	53,016	44,189	42,118	39,728	34,725	30,719	24,700	22,573
Net increase in net assets resulting from operations	73,454	55,961	42,890	59,703	46,106	52,028	42,281	36,449	34,790	29,581
Diluted earnings per common share	0.71	0.55	0.43	0.63	0.51	0.60	0.52	0.48	0.50	0.45
Dividends declared per common share	0.55	0.53	0.51	0.51	0.50	0.49	0.46	0.46	0.45	0.45
Net asset value per common share(1)	14.02	13.71	13.57	13.42	12.79	12.26	12.11	11.56	10.96	10.44

(1) We determine net asset value per common share as of the last day of the quarter. The net asset values shown are based on outstanding shares at the end of each period, excluding common shares held in our deferred compensation trust.

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 public reference facilities of the SEC 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 public reference section of the SEC 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 or by written request to Public Reference Section, Washington, DC 20549-0102. 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. In addition to the other information contained in this prospectus, you should consider carefully the following information before making an investment in our Securities.

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

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.

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 June 30, 2002, approximately 93% of our total assets represented investments recorded at fair value. 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 ascertainable 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 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. Conversely, we will record unrealized appreciation if we have an indication that the underlying portfolio company has appreciated in value and, therefore, our security has also appreciated in value, where appropriate. Without a readily ascertainable market value and because of the inherent uncertainty of valuation, 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 unrealized gains (losses).

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. Our non-performing 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, Inc. is our largest portfolio investment. Our financial results could be negatively affected if Business Loan Express, 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 June 30, 2002, the investment totaled $251.9 million at value, or 9.8% of total assets.

In addition, as controlling shareholder of Business Loan Express, we have provided an unconditional guaranty to Business Loan Express senior credit facility lenders in an amount equal to 50% of Business Loan Express total obligations on its $124.0 million revolving credit facility. The amount we have guaranteed at June 30, 2002, was $48.1 million. This guaranty can only be called in the event of a default by Business Loan Express. We have also provided two standby letters of credit in connection with two term loan securitization transactions completed by Business Loan Express in the second quarter of 2002 totaling $10.6 million.

Investments in non-investment grade commercial mortgage-backed securities may be illiquid, may have a higher risk of default and may not produce current returns. The commercial mortgage-backed securities 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 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. 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 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 June 30, 2002, our asset coverage for senior indebtedness was 256%.

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 June 30, 2002, we had $1,009.0 million of outstanding indebtedness, bearing a weighted average annual interest cost of 7.2%. In order for us to cover these annual interest payments on indebtedness, we must achieve annual returns on our assets of at least 2.8%.

Illustration. The following table illustrates the effect of leverage on returns from an investment in our common stock assuming various annual returns, net of expenses. The calculations in the table below are hypothetical and actual returns may be higher or lower than those appearing below. The calculation assumes (i) $2,568.6 million in total assets,

(ii) an average cost of funds of 7.2%, (iii) $1,009.0 million in debt outstanding and (iv) $1,434.5 million of shareholders equity.

Assumed Return on Our Portfolio

(net of expenses)

	-20%	-10%	-5%	0%	5%	10%	20%
Corresponding return to shareholder	-40.8%	-23.0%	-14.0%	-5.1%	3.9%	12.8%	30.7%

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 before net realized and unrealized gains or losses, or 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 sharply 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 short-term credit facilities 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 increase in net assets resulting from operations, or 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 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 incremental 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 net realized 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 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 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 pass-through 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 Internal Revenue Code of 1986. If we meet source of income, diversification and distribution requirements, we will qualify for effective pass-through tax treatment. We would cease to qualify for such pass-through 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 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 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 will 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 realized and unrealized gains or losses, 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.

Recently, the trading price of our common stock has been volatile. Due to the continued potential volatility of our stock price, we may be the target of securities litigation in the future. Securities litigation could result in substantial costs and divert management s attention and resources from our business. For information about current securities class action lawsuits filed against us, see Business Legal Proceedings.

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 th 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 should not be regarded as a representation by us that our plans and objectives will be achieved. These risks and uncertainties include those described in Risk Factors and elsewhere in this prospectus and any exhibits of the registration statement of which this prospectus is a part. 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

Unless otherwise specified in the prospectus supplement accompanying this prospectus, we intend to use the net proceeds from selling our Securities 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, repayment of indebtedness, acquisitions and other general corporate purposes. We typically raise new equity when we have attractive investment opportunities.

We anticipate that substantially all of the net proceeds of any offering of our Securities 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 our Securities 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.

We will not receive any of the proceeds from the sale of our common stock by any selling shareholder.

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 October , 2002, the last reported closing sale price of the common stock was $ per share.

	NAV(1)	Closing Sale Price(2) High	Closing Sale Price(2) Low	Premium of High Sales Price to NAV	Premium of Low Sales Price to NAV	Declared Dividends
Year ended December 31, 2000						
First Quarter	$10.44	$19.69	$16.06	189%	154%	$0.45
Second Quarter	10.96	18.69	16.56	171	151	0.45
Third Quarter	11.56	21.13	17.44	183	151	0.46
Fourth Quarter	12.11	21.38	18.50	177	153	0.46
Year ended December 31, 2001						
First Quarter	$12.26	$24.44	$20.13	199%	164%	$0.49
Second Quarter	12.79	25.40	19.57	199	153	0.50
Third Quarter	13.42	24.83	21.50	185	160	0.51
Fourth Quarter	13.57	26.00	21.57	192	159	0.51
Year ending December 31, 2002						
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	*	24.49	18.90			0.56
Fourth Quarter (through October , 2002)	*					

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

(2) Prior to June 6, 2001, our common stock was traded on the Nasdaq National Market under the symbol ALLC. The closing sale prices listed are as reflected on the respective exchanges for the periods presented.

* 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 we will maintain a premium to 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 Equity Capital and Dividends and Tax Status. We cannot assure 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 a dividend reinvestment plan for our common shareholders. Effective May 1, 2002, we converted from an opt out to an opt in dividend reinvestment plan. As a result, if our board of directors declares a dividend, then our new 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. Existing dividend reinvestment plan accounts will not be affected by this amendment. 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 selected condensed consolidated financial data and our consolidated financial statements and notes thereto appearing elsewhere in this prospectus.

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

OVERVIEW

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

Our portfolio composition at June 30, 2002 and December 31, 2001, 2000 and 1999 was as follows:

	At June 30, 2002	At December 31, 2001	2000	1999
Private Finance	69%	68%	72%	53%
Commercial Real Estate Finance	31%	32%	28%	42%
Small Business Finance	%	%	%	5%

Our earnings depend primarily on the level of interest and related portfolio income, fee income and net realized and unrealized gains or losses earned on our investment portfolio after deducting interest paid on borrowed capital and operating expenses. Interest income results from the stated interest rate earned on a loan and the amortization of loan origination points and discounts. The level of interest income is directly related to the balance of the interest-bearing investment portfolio multiplied by the weighted average yield. Our ability to generate interest income is dependent on economic, regulatory and competitive factors that influence new investment activity, the amount of loans for which

interest is not accruing and our ability to secure debt and equity capital for our investment activities.

PORTFOLIO AND INVESTMENT ACTIVITY

Total portfolio investment activity and yields at and for the six months ended June 30, 2002 and 2001 and at and for the years ended December 31, 2001, 2000 and 1999 were as follows:

($ in millions)	At and for the Six Months Ended June 30, (unaudited)		At and for the Years Ended December 31,		
	2002	2001	2001	2000	1999
Portfolio at value	$2,381.0	$2,000.6	$2,329.6	$1,788.0	$1,228.5
Investments funded	$195.5	$299.8	$680.3	$901.5	$751.9
Change in accrued or reinvested interest and dividends	$19.5	$25.5	$51.6	$32.2	$12.8
Repayments	$67.0	$42.5	$74.5	$111.0	$139.6
Sales	$126.3	$74.6	$130.0	$280.2	$198.4
Yield*	13.8%	14.2%	14.3%	14.1%	13.0%

* 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.

Private Finance

The private finance portfolio, investment activity and yields at and for the six months ended June 30, 2002 and 2001 and at and for the years ended December 31, 2001, 2000 and 1999 were as follows:

($ in millions)	At and for the Six Months Ended June 30, (unaudited)		At and for the Years Ended December 31,		
	2002	2001	2001	2000	1999
Portfolio at value:					
Loans and debt securities	$1,050.8	$1,044.5	$1,107.9	$966.3	$559.7
Equity interests	584.5	360.9	487.2	316.2	87.3

Total portfolio	$1,635.3	$1,405.4	$1,595.1	$1,282.5	$647.0

Investments funded	$69.8	$113.9	$287.7	$600.9	$346.7
Change in accrued or reinvested interest and dividends	$19.1	$24.4	$48.9	$31.8	$10.1
Repayments	$56.0	$23.1	$43.8	$75.7	$83.2
Yield*	13.9%	14.6%	14.8%	14.6%	14.2%

* 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.

Private finance new investment activity across the industry slowed during 2001, largely due to a lack of available senior debt capital and the state of the economy in general. We believe the level of merger and acquisition activity throughout the U.S. has continued to be depressed into 2002, and we have seen fewer opportunities for mezzanine or equity investment in the first six months of 2002 as compared to 2001. We believe the environment for private finance investing appears to be improving and, although the merger and acquisition environment remains slow, we are seeing more new investment opportunities related to recapitalization and growth financings. In the third quarter of 2002, we have completed two financings totaling $51 million to date. We are also beginning to see increasing activity within our own portfolio as there are several companies in the private finance portfolio that are in the process of exploring sale, initial public offering or recapitalization events. This means that we may see opportunities to continue our involvement with some of these companies by financing the buyout or recapitalization transactions. This activity could also result in additional potential realized or unrealized gains for the remainder of 2002 and into 2003.

Investments funded during the six month period ended June 30, 2002 and the years ended December 31, 2001, 2000 and 1999 consisted of the following:

($ in thousands)	Loans and Debt Securities	Equity Interests	Total
For the six months ended June 30, 2002(1)			
Companies more than 25% owned	$15,962	$3,759	$19,721
Companies 5% to 25% owned	7,494	7,046	14,540
Companies less than 5% owned	34,023	1,506	35,529
Total	$57,479	$12,311	$69,790
For the year ended December 31, 2001(1)			
Companies more than 25% owned	$47,860	$78,260	$126,120
Companies 5% to 25% owned	8,203	3,721	11,924
Companies less than 5% owned	142,144	7,548	149,692

Total	$198,207	$89,529	$287,736

For the year ended December 31, 2000(1)

Companies more than 25% owned	$10,807	$111,457	$122,264
Companies 5% to 25% owned	115,594	41,925	157,519
Companies less than 5% owned	294,969	26,108	321,077
Total	$421,370	$179,490	$600,860

For the year ended December 31, 1999(1)

Companies more than 25% owned	$	$3,750	$3,750
Companies 5% to 25% owned	2,103		2,103
Companies less than 5% owned	318,097	22,700	340,797
Total	$320,200	$26,450	$346,650

(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 1940 Act; companies owned 5% to 25% which represent portfolio companies where we directly or indirectly own 5% to 25% of the outstanding voting securities of such portfolio company or where we hold one or more seats on the portfolio company s board of directors and, therefore are deemed to be an affiliated person under the 1940 Act; and companies less than 5% owned which represent portfolio companies where we directly or indirectly own less than 5% of the outstanding voting securities of such portfolio company and where we have no other affiliations with such portfolio company.

At June 30, 2002, we had outstanding funding commitments of $69.0 million to portfolio companies, including $31.6 million committed to private venture capital funds.

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

We may acquire more than 50% of the common stock of a company in a control buyout transaction. Control investments are generally structured such that we earn a current return through a combination of interest income on our senior loans and subordinated debt, dividends on our preferred and common stock, and management or transaction services fees to compensate us for the managerial assistance that we provide to a controlled portfolio company. In some cases for companies that are more than 50% owned, we may not accrue interest on loans and debt securities if such company is in need of additional capital and, therefore, we may defer current debt service. Our most significant investments acquired through control buyout transactions at June 30, 2002 were The Hillman Companies, Inc., (formerly SunSource, Inc.), acquired in 2001, Business Loan Express, Inc., acquired in 2000 and WyoTech Acquisition Corporation, acquired in 1998.

The Hillman Companies, Inc. During 2001, we acquired 93.2% of the common equity of SunSource, Inc. for $71.5 million in cash. Subsequently, SunSource completed the sale of its STS business unit and distributed $16.5 million in cash to us, reducing our common stock cost basis to $57.2 million at December 31, 2001. As part of the STS sale, we invested $3.2 million in the new STS. During the third quarter of 2001, we received fees from SunSource of $2.8 million related to transaction assistance for the SunSource sale and STS sale, and $1.6 million for the syndication of SunSource s senior credit facilities. In addition, we realized a gain of $2.5 million from the sale of warrants prior to the buyout transaction. During the first quarter of 2002, SunSource changed its name to The Hillman Companies, Inc., also referred to as Hillman. At June 30, 2002, our investment in Hillman totaled $131.0 million at value, or 5% of total assets. The value of our investment in Hillman increased by $32.8 million during the second quarter of 2002 as discussed below.

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

For the six months ended June 30, 2002, Hillman had total revenue of $139 million, earnings before interest, taxes, depreciation, amortization and management fees, or EBITDAM, of $23 million, and profits before taxes of $3 million. Hillman is above plan for the year and as of June 30, 2002, is projected to achieve revenues of approximately $276 million, EBITDAM of approximately $50 million, and profits before taxes of approximately $7 million for the year ending December 31, 2002. Hillman had total assets of $360 million and total debt of $141 million at June 30, 2002. Hillman is current on all of its debt obligations and is in compliance with all debt covenants.

Business Loan Express, Inc. On December 31, 2000, we acquired 94.9% of BLC Financial Services, Inc. in a going private buyout transaction for $95.2 million. We issued approximately 4.1 million shares of our common stock, or $86.1 million of new equity, and paid $9.1 million in cash to acquire BLC, which thereafter changed its name to Business Loan Express, Inc.

As part of the transaction, we recapitalized Allied Capital Express, our small business lending operation, as an independently managed private portfolio company and merged it into Business Loan Express. We contributed certain assets, including our online rules-based underwriting technology and fixed assets, and transferred 37 employees to the private portfolio company. Upon completion of the transaction, our investment in Business Loan Express as of December 31, 2000 totaled $204.1 million and consisted of $74.5 million of subordinated debt, $25.1 million of preferred stock, and $104.5 million of common stock. At June 30, 2002, our investment in Business Loan Express totaled $251.9 million at value, or 9.8% of our total assets. During the second quarter of 2002, the value of our investment in Business Loan Express increased by $19.9 million, and as of June 30, 2002, we have recorded total unrealized appreciation of $35.4 million on this investment.

Business Loan Express is the nation s second largest non-bank government guaranteed lender utilizing the Small Business Administration s 7(a) Guaranteed Loan Program and is licensed by the Small Business Administration as a Small Business Lending Company (SBLC). Therefore, changes in the laws or regulations that govern SBLCs or the Small Business Administration s 7(a) Guaranteed Loan Program or changes in government funding for this program could have a material impact on Business Loan Express or its operations. Business Loan Express is a preferred lender as designated by the Small Business Administration in 67 markets across the United States, and originates, sells and services small business loans. In addition to the 7(a) Guaranteed Loan Program, Business Loan Express originates loans under the USDA Business and Industry Guaranteed Loan Program and originates conventional small business loans. Business Loan Express has offices in 35 cities and is headquartered in New York, New York.

Unaudited financial data for Business Loan Express at and for the year ended June 30, 2002 was as follows:

($ in millions)	At and for the Year Ended June 30, 2002(1) (unaudited)
Operating Data	
Total revenue	$84.6
Profits before taxes	$3.6
Earnings before interest, taxes and management fees (EBITM)	$43.0
Balance Sheet Data	
Total assets(2)	$276.2
Total debt	$183.0
Total shareholders equity	$59.0
Other Data	
Total loan originations	$565.1
Serviced loan portfolio	$1,372.6
Number of loans	2,083
Loan delinquencies(3)	9.4%

(1) Financial results at and for the year ended June 30, 2002 are preliminary and not audited and are therefore subject to adjustment prior to completion of the audit.
(2) Included in total assets is $6 million of goodwill. There is no other goodwill on BLX s balance sheet. We acquired 94.9% of BLC Financial Services, Inc. on December 31, 2000. Push-down accounting was not required with respect to this transaction; accordingly, goodwill was not recorded by BLX.
(3) Represents the percentage of loans in the serviced portfolio that are greater than 30 days delinquent, which includes loans in workout status. Delinquencies for the types of small business loans made by BLX typically range between 8% and 12%.

The loans originated by Business Loan Express, or BLX, are generally secured by commercial real estate. Loans originated under the 7(a) Guaranteed Loan Program also require the personal guarantee of the borrower and, in many cases, the loans are also secured by additional real estate collateral. Because the loans are secured by collateral, Business Loan Express annual loan losses for its SBA 7(a) loans, computed using the unguaranteed balance of the SBA 7(a) serviced portfolio, were 0.6% on average for the last five years.

Business Loan Express sells or securitizes substantially all of the loans it originates. BLX currently 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% and 1.6% of the guaranteed loan amount. Alternatively, BLX may sell the guaranteed piece of SBA 7(a) guaranteed loans at par and retain an annual servicing spread, at current prices, of generally between 4.0% and 4.8%. BLX securitizes the unguaranteed piece of the SBA 7(a) loans and other loans it originates. Typically, BLX retains between 0% and 2.7% of the loan securitization pools and receives a spread from the excess of loan interest received on the loans sold over the interest cost on the securities issued in the securitization generally between 4.7% and 4.8%.

As a result of BLX s guaranteed loan sales and as a result of securitization transactions, BLX had assets at June 30, 2002 totaling approximately $106 million representing the residual interests in and servicing assets for loans sold or securitized, together referred to as Residual Interests. These Residual Interests represent the discounted present value of future cash flow streams to be received from loans sold or securitized after making allowances for prepayments, losses and loan delinquencies.

If loan payments on all loans were to be received as stated in the loan agreements, estimated future cash flows to BLX from loans sold or securitized would total approximately $412 million in the aggregate over the remaining term of these loans. Of the approximate $412 million, estimated cash flows for the years ended June 30, 2003, 2004, 2005, and 2006 would be approximately $33 million, $31 million, $30 million and $29 million, respectively.

Business Loan Express has a three-year $124 million revolving credit facility. As the controlling shareholder of Business Loan Express, 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 Business Loan Express under the revolving credit facility. The amount guaranteed by us at June 30, 2002 was $48.1 million. This guaranty can be called by the lenders only in the event of a default by Business Loan Express. Business Loan Express was in compliance with the terms of the revolving credit facility at June 30, 2002. We have also provided two standby letters of credit in connection with two term securitization transactions completed by Business Loan Express in the second quarter of 2002 totaling $10.6 million.

Business Loan Express is currently contemplating a corporate restructure and recapitalization whereby the company would convert from a corporation to a limited liability company. This restructure would enable the company to have greater flexibility as it grows. Upon such restructure and recapitalization our equity interests would be converted to membership units and the earnings of Business Loan Express would pass through to its members as dividends. There can be no assurance when or if the corporate restructure and recapitalization will occur.

WyoTech Acquisition Corporation. On July 1, 2002, we sold WyoTech Acquisition Corporation for $84.4 million in cash. We acquired WyoTech in December of 1998 and owned 91% of the common equity of WyoTech. At June 30, 2002, our investment had a cost basis of $16.4 million, which represented all of the debt ($12.6 million), preferred stock ($3.7 million) and 91% of the common equity capital ($0.1 million) of WyoTech. Our total cash proceeds from the sale of WyoTech, including the repayment of debt and preferred stock and the sale of our 91% common equity ownership, were approximately $77.0 million, resulting in a realized gain of approximately $60.6 million on the transaction. At June 30, 2002, we determined the fair value of our investment in WyoTech to be $77.0 million, which resulted in an increase in fair value during the second quarter of $6.6 million. The sale of WyoTech is subject to post-closing working capital adjustments, if any, and customary indemnification provisions.

Commercial Real Estate Finance

The commercial real estate finance portfolio, investment activity and yields at and for the six months ended June 30, 2002 and 2001 and at and for the years ended December 31, 2001, 2000 and 1999 were as follows:

	At and for the Six Months Ended June 30,		At and for the Years Ended December 31,		
($ in millions)	2002	2001	2001	2000	1999
	(unaudited)				
Portfolio at value:					
CMBS bonds	$560.9	$405.5	$558.3	$311.3	$277.7
Collateralized debt obligations	52.5	24.9	24.2		
Total CMBS	613.4	430.4	582.5	311.3	277.7
Commercial mortgage loans	62.0	87.8	79.6	106.4	154.1
Residual interest	69.0	74.9	69.9	81.7	81.7
Real estate owned	1.3	2.1	2.5	6.1	6.5
Total Portfolio	$745.7	$595.2	$734.5	$505.5	$520.0

Investments funded	$125.7	$185.9	$392.6	$149.0	$288.7
Change in accrued or reinvested interest	$0.4	$1.1	$2.7	$1.1	$2.8
Repayments	$11.0	$19.4	$30.7	$24.3	$50.8
Sales	$126.3	$74.6	$130.0	$151.7	$86.1
Yield*	13.7%	13.6%	13.5%	13.1%	12.3%

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

Our primary commercial real estate investment activity is the investment in non-investment grade commercial mortgage-backed securities, or CMBS. In 1998, we began to take advantage of a unique market opportunity to acquire non-investment grade CMBS bonds at significant discounts from the face amount of the bonds. We believe that CMBS is an attractive asset class because of the yields that can be earned on a security that is secured by commercial mortgage loans, and ultimately commercial real estate properties. We plan to continue our CMBS investment activity, however, in order to maintain a balanced portfolio, we expect that CMBS will continue to represent approximately 20% to 25% of our total assets. Our CMBS investment activity level will be dependent upon our ability to invest in CMBS at attractive yields.

Our commercial real estate investment activity for the six months ended June 30, 2002 and for the years ended December 31, 2001, 2000 and 1999 was as follows:

	Amount Invested			
($ in millions)	**Face Amount**	**Discount**	**Amount Funded**	**Yield(1)**
For the six months ended June 30, 2002				
CMBS bonds	$181.4	$(83.8)	$97.6	14.7%
CDOs	28.0		28.0	17.5%
Commercial mortgage loans	0.1		0.1	10.0%
Total	$209.5	$(83.8)	$125.7	15.2%

($ in millions)	Amount Invested: Face Amount	Amount Invested: Discount	Amount Invested: Amount Funded	Yield(1)
For the year ended December 31, 2001				
CMBS bonds	$661.4	$(295.6)	$365.8	14.0%
CDOs	24.6		24.6	16.9%
Commercial mortgage loans	2.2		2.2	10.0%
Total	$688.2	$(295.6)	$392.6	14.2%
For the year ended December 31, 2000				
CMBS bonds	$244.6	$(120.3)	$124.3	14.7%
Commercial mortgage loans	25.5	(0.8)	24.7	10.9%
Total	$270.1	$(121.1)	$149.0	14.1%
For the year ended December 31, 1999				
CMBS bonds	$507.9	$(262.0)	$245.9	14.6%
Commercial mortgage loans	43.4	(0.6)	42.8	10.5%

Total	$551.3	$(262.6)	$288.7	14.0%

(1) The yield on new CMBS bond investments will vary from period to period depending on the concentration of lower yielding BB+, BB and BB- CMBS bonds purchased in that period to the total amount invested.

CMBS 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 June 30, 2002, our CMBS bonds were subordinate to 92% to 97% of the tranches of bonds issued in various CMBS transactions. Given that the non-investment grade CMBS bonds in which we invest are junior in priority for payment of principal, we invest in these CMBS bonds at an approximate discount of 50% from the face amount of the bonds.

The underlying pools of mortgage loans that are collateral for our new CMBS bond investments for the six months ended June 30, 2002 and for the years ended December 31, 2001, 2000 and 1999 had respective underwritten loan to value and underwritten debt service coverage ratios as follows:

	For the Six Months Ended June 30,		For the Year Ended December 31,					
	2002		2001		2000		1999	
Loan to Value Ranges ($ in millions)	**Amount**	**Percentage**	**Amount**	**Percentage**	**Amount**	**Percentage**	**Amount**	**Percentage**
Less than 60%	$401.9	16%	$1,259.7	15%	$577.1	14%	$813.7	11%
60-65%	178.7	7	941.6	11	402.8	10	439.6	6
65-70%	264.1	11	1,140.6	14	648.1	16	1,342.5	17
70-75%	799.5	32	2,400.4	29	1,450.9	36	2,396.0	31
75-80%	812.7	33	2,466.4	30	958.9	23	2,500.8	33
Greater than 80%	12.0	1	119.6	1	36.6	1	150.7	2

Total	$2,468.9	100%	$8,328.3	100%	$4,074.4	100%	$7,643.3	100%
Weighted average loan to value	70.4%		69.7%		70.2%		71.1%	

Debt Service Coverage Ratio(1) Ranges ($ in millions)	For the Six Months Ended June 30,		For the Year Ended December 31,					
	2002		2001		2000		1999	
	Amount	Percentage	Amount	Percentage	Amount	Percentage	Amount	Percentage
Greater than 2.00	$103.3	4%	$484.8	6%	$197.0	5%	$246.1	3%
1.76-2.00	84.2	3	158.2	2	99.1	3	182.3	2
1.51-1.75	240.3	10	855.0	10	341.8	8	893.8	12
1.26-1.50	1,631.8	66	5,008.3	60	2,204.5	54	4,452.9	58
1.00-1.25	409.3	17	1,822.0	22	1,232.0	30	1,868.2	25
Total	$2,468.9	100%	$8,328.3	100%	$4,074.4	100%	$7,643.3	100%

Weighted average debt service coverage ratio				
	1.41	1.48	1.35	1.29

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

As a part of our strategy to maximize our return on equity capital, we sold CMBS bonds rated BB+, BB and BB- during the six months ended June 30, 2002, and during 2001 and 2000 totaling $123.3 million, $124.5 million and $98.7 million, respectively. These bonds had an effective yield of 11.2%, 10.3% and 11.5%, and were sold for $128.8 million, $126.8 million and $102.5 million, respectively, resulting in realized gains on the sales. The sales of these lower-yielding bonds increased our overall liquidity. We did not sell any CMBS bonds during the second quarter of 2002.

The effective yield on our CMBS portfolio at June 30, 2002 and December 31, 2001, 2000 and 1999 was 14.6%, 14.7%, 15.4% and 14.6%, respectively. The yield on the CMBS portfolio at any point in time will vary depending on the concentration of lower yielding BB+, BB and BB- CMBS bonds held in the portfolio. At June 30, 2002, December 31, 2001, 2000 and 1999, the unamortized discount related to the CMBS portfolio was $645.0 million, $611.9 million, $364.9 million and $291.5 million, respectively. At June 30, 2002, the CMBS bond portfolio had a fair value of $560.9 million, which included net unrealized appreciation on the CMBS bonds of $23.9 million.

At June 30, 2002, the underlying pools of mortgage loans that are collateral for our CMBS bonds consisted of approximately 4,100 commercial mortgage loans with a total outstanding principal balance of $22.9 billion. At June 30, 2002, December 31, 2001 and 2000, 0.75%, 0.52% and 0.22%, respectively, of the loans in the underlying collateral pool for our CMBS bonds were over 30 days delinquent or were classified as real estate owned.

On July 31, 2002, we sold $129.8 million of face amount of CMBS bonds, with a cost basis of $82.7 million, and recognized a gain on the sale of approximately $12 million. The CMBS bonds sold represent a strip of BB+ through B from our portfolio and had a weighted average yield to maturity of 12%. The CMBS bonds were sold to institutional investors. We had recorded approximately $5 million in net unrealized appreciation, which is net of unrealized depreciation on the related hedge of approximately $1 million, related to these CMBS bonds in the second quarter of 2002. Therefore, this sale will contribute earnings of approximately $7 million to the third quarter of 2002. Upon completion of the CMBS bond sale, we continue to own $471.3 million of non-investment grade CMBS bonds at value with a yield to maturity of 15.2%.

Collateralized Debt Obligations. During the six months ended June 30, 2002, and the year ended December 31, 2001, we invested in the preferred shares of two and one, respectively, collateralized debt obligations, or CDOs, which are secured by investment grade unsecured debt issued by various real estate investment trusts, or REITs, and investment and non-investment grade CMBS bonds. The investment grade REIT debt collateral consists of $852.8 million issued by 39 REITs. The investment grade CMBS collateral consists of CMBS bonds with a face amount of $402.1 million issued in 26 separate CMBS transactions. The non-investment grade CMBS collateral consists of BB+, BB and BB- CMBS bonds with a face amount of $405.0 million that were issued in 30 separate CMBS transactions. Included in the CMBS collateral for the CDOs are $393.8 million of CMBS bonds that are senior in priority of repayment to certain lower rated CMBS bonds held by us, which were issued in 22 separate CMBS transactions. The preferred shares are junior in priority for payment of 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 resulting in reduced cash flows, the preferred shares will bear this loss first. At June 30, 2002, our preferred shares in the CDOs were subordinate to approximately 95% of the more senior tranches of debt issued by the CDOs. The yield on the CDOs was 17.2% and 16.9% at June 30, 2002, and December 31, 2001, respectively.

Commercial Mortgage Loans. We have been liquidating much of our whole commercial mortgage loan portfolio so that we can redeploy the proceeds into higher yielding assets. For the six months ended June 30, 2002, and for the years ended December 31, 2001, 2000 and 1999, we sold $3.0 million, $5.5 million, $53.0 million and $86.1 million, respectively, of commercial mortgage loans. At June 30, 2002, our whole commercial real estate loan portfolio had been reduced to $62.0 million from $79.6 million at December 31, 2001.

Residual Interests. The residual interest primarily consists of a retained interest totaling $68.9 million from a 1998 asset securitization whereby bonds were sold in three classes rated AAA, AA and A. The residual interest represents a right to cash flows from the underlying collateral pool of loans after these senior bond obligations are satisfied. At June 30, 2002, two classes of bonds rated AAA and AA+ are outstanding, for total bonds outstanding of $29.6 million. On August 9, 2002, the bonds rated AA+ were upgraded to AAA. We have the right to call the bonds when the outstanding bond balance is less than $23.9 million. Once the bonds are fully repaid, either through the cash flows from the securitized loans or due to us calling the bonds, the remaining loans in the trust will be returned to us as payment on the residual interest. At June 30, 2002, the residual interest had a fair value of $69.0 million.

Portfolio Asset Quality

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

At June 30, 2002, and December 31, 2001 and 2000, our portfolio was graded as follows:

Grade	2002 Portfolio at Value	2002 Percentage of Total Portfolio	2001 Portfolio at Value	2001 Percentage of Total Portfolio	2000 Portfolio at Value	2000 Percentage of Total Portfolio
($ in millions)						
1	$793.6	33.3%	$603.3	25.9%	$208.3	11.7%
2	1,400.0	58.8	1,553.8	66.7	1,461.7	81.7
3	46.7	2.0	79.5	3.4	15.4	0.9
4	43.6	1.8	44.5	1.9	76.0	4.2
5	97.1	4.1	48.5	2.1	26.6	1.5
	$2,381.0	100.0%	$2,329.6	100.0%	$1,788.0	100.0%

Total Grades 4 and 5 assets as a percentage of the total portfolio at value at June 30, 2002 and December 31, 2001 and 2000 were 5.9%, 4.0% and 5.7%, respectively. 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 significantly from period to period. We continue to follow our historical practice of working with a troubled portfolio company in order to recover the maximum amount of our investment, but record unrealized depreciation for the expected full amount of the potential loss when such exposure is identified.

For the total investment portfolio, workout loans not accruing interest, or those loans in Grade 4 and 5, were $121.4 million at value at June 30, 2002, or 5.1% of the total portfolio. Included in this category at June 30, 2002, were assets valued at $8.9 million that represent receivables related to companies in liquidation and loans of $16.2 million that were secured by commercial real estate. Workout loans not accruing interest were $109.0 million and $87.4 million at value at December 31, 2001 and 2000, or 4.7% and 4.9% of the total portfolio, respectively, of which $8.9 million and $16.2 million, respectively, represented receivables related to companies in liquidation, and $15.2 million and $14.4 million, respectively, represented loans secured by commercial real estate. In addition to Grade 4 and 5 assets that are in workout, we may not accrue interest on loans to companies which are more than 50% owned by us from time to time if such companies are in need of additional capital and, therefore, we may defer current debt service. Loans and debt securities to such companies totaled $61.3 million at value at June 30, 2002. Loans greater than 90 days delinquent were $89.4 million at value at June 30, 2002, or 3.8% of the total portfolio. Included in this category are loans valued at $22.0 million that are secured by commercial real estate. Loans greater than 90 days delinquent were $39.1 million and $57.3 million at value at December 31, 2001, and December 31, 2000, or 1.7% and 3.2% of the total portfolio, respectively. Included in this category are loans valued at $14.1 million and $14.1 million, respectively, that were secured by commercial real estate.

As a provider of long-term privately negotiated investment capital, we may defer payment of principal or interest from time to time. As a result, the amount of the portfolio that is greater than 90 days delinquent or on non-accrual status may vary from quarter to quarter. The nature of our private finance portfolio company relationships frequently provide an opportunity for portfolio companies to amend the terms of payment to us or to restructure their debt and equity capital. During such restructuring, we may not receive or accrue interest or dividend payments. The investment portfolio is priced to provide current returns for shareholders assuming that a portion of the portfolio at any time may not be accruing interest currently. We also price our investments for a total return including interest or dividends plus capital gains from the sale of equity securities. Therefore, the amount of loans greater than 90 days delinquent or on non-accrual status is not necessarily an indication of future principal loss or loss of anticipated investment return. Our portfolio grading system is used as a means to assess loss of investment principal (Grade 5 assets).

At June 30, 2002, December 31, 2001 and 2000, 0.75%, 0.52% and 0.22%, respectively, of the loans in the underlying collateral pool for our CMBS bond portfolio were over 30 days delinquent or were classified as real estate owned. We closely monitor the performance of all of the loans in the underlying collateral pools securing our CMBS investments.

Other Assets and Other Liabilities

Because we invest in BB+, BB and BB- rated CMBS bonds, which are purchased at prices that are based on the 10-year Treasury rate, we have entered into transactions with financial institutions to hedge against movement in Treasury rates on certain of these CMBS bonds. These transactions involved receiving the proceeds from the sales of the borrowed Treasury securities, with the obligations to replenish the borrowed Treasury securities at a later date based on the then current market price.

The total obligations to replenish borrowed Treasury securities were $84.8 million and $47.3 million at June 30, 2002, and December 31, 2001, respectively, which included unrealized depreciation on the obligations of $2.2 million and unrealized appreciation on the obligations of $1.2 million, respectively, due to changes in the yield on the borrowed Treasury securities. The obligations have been recorded as an other liability. The proceeds related to the sales of the borrowed Treasury securities were $82.6 million and $48.5 million at June 30, 2002, and December 31, 2001, respectively, and have been recorded as an other asset.

RESULTS OF OPERATIONS

Comparison of Six Months Ended June 30, 2002 and 2001

The following table summarizes our condensed operating results for the six months ended June 30, 2002 and 2001.

($ in thousands, except per share amounts)	For the Six Months Ended June 30, 2002	2001	Change	Percent Change
	(unaudited)			
Interest and Related Portfolio Income				
Interest and dividends	$127,665	$113,699	$13,966	12%
Premiums from loan dispositions	1,659	1,731	(72)	(4%)
Fees and other income	26,260	18,380	7,880	43%
Total interest and related portfolio income	155,584	133,810	21,774	16%
Expenses				
Interest	34,984	31,881	3,103	10%
Employee	16,309	14,056	2,253	16%
Administrative	7,861	6,027	1,834	30%

Total operating expenses	59,154	51,964	7,190	14%
Net investment income before net realized and unrealized gains	96,430	81,846	14,584	18%
Net Realized and Unrealized Gains				
Net realized gains	8,850	4,991	3,859	*
Net unrealized gains	24,135	11,297	12,838	*
Total net realized and unrealized gains	32,985	16,288	16,697	*
Net increase in net assets resulting from operations	$129,415	$98,134	$31,281	32%

Diluted earnings per share	$1.26	$1.10	$0.16	15%
Weighted average shares outstanding diluted	102,900	88,966	13,934	16%

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

Net increase in net assets resulting from operations, or net income, results from total interest and related portfolio income earned, less total expenses incurred in our operations, plus net realized and unrealized gains or losses.

Total interest and related portfolio income. Total interest and related portfolio income includes interest income, premiums from loan dispositions and fees and other income.

($ in millions, except per share amounts)	For the Six Months Ended June 30, 2002	2001
Total Interest and Related Portfolio Income	$155.6	$133.8
Per share	$1.51	$1.50

The increase in interest income earned results primarily from the growth of our investment portfolio. Our investment portfolio, excluding non-interest bearing equity interests in portfolio companies, increased by 10% to $1,796.5 million at June 30, 2002 from $1,639.7 million at June 30, 2001. The weighted average yield on the interest-bearing investments in the portfolio at June 30, 2002 and 2001 was as follows:

	June 30, 2002	2001
Private Finance	13.9%	14.6%
Commercial Real Estate Finance	13.7%	13.6%
Total Portfolio	13.8%	14.2%

Included in net premiums from loan dispositions are prepayment premiums of $1.6 million and $1.0 million for the six months ended June 30, 2002 and 2001, respectively. While the scheduled maturities of private finance and commercial real estate loans range from five to ten years, it is not unusual for our borrowers to refinance or pay off their debts to us ahead of schedule. Because we seek to finance primarily seasoned, performing companies, such companies at times can secure lower cost financing as their balance sheets strengthen, or as more favorable interest rates become available. 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, management services to portfolio companies, guaranty and other advisory services. We generate fee income for the transaction services and management services that we provide. As a business development company, we are required to make significant managerial assistance available to the companies in our investment portfolio. Managerial assistance includes management and consulting services including, but not limited to, information technology, web site development, marketing, human resources, personnel recruiting, board recruiting, corporate governance and risk management.

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

Business Loan Express, Hillman and WyoTech are our most significant portfolio investments and together represent 17.9% of our total assets at June 30, 2002. Total interest and related portfolio income earned from these investments for the six months ended June 30, 2002 and 2001 was $28.1 million and $17.8 million, respectively. Total interest and related portfolio income earned from WyoTech for the six months ended June 30, 2002 was $3.6 million, which will no longer occur due to the sale of the investment.

Operating Expenses. Operating expenses include interest, employee and administrative expenses. Our single largest expense is interest on our indebtedness. The fluctuations in interest expense during the six months ended June 30, 2002 and 2001 are attributable to changes in the level of our borrowings under various notes payable and debentures and our revolving credit facility. Our borrowing activity and weighted average interest cost, including fees and closing costs, were as follows:

	At and for the Six Months Ended June 30,	
($ in millions)	**2002**	**2001**
Total Outstanding Debt	$1,009.0	$881.1
Average Outstanding Debt	$940.4	$801.3
Weighted Average Cost	7.2%	7.4%
BDC Asset Coverage*	256%	247%

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

Employee expenses include salaries and employee benefits. The increase in salaries and employee benefits for the periods presented reflects wage increases and the experience level of employees hired. Total employees were 103 and 101 at June 30, 2002 and 2001, respectively.

Administrative expenses include the leases for our headquarters in Washington, DC, and our regional offices, travel costs, stock record expenses, directors fees, legal and accounting fees, insurance premiums and various other expenses. The increase in administrative expenses as compared to the same period in 2001 includes approximately $1.2 million from legal, consulting and other fees, including costs incurred to defend against class action lawsuits alleging violations of securities laws and to respond to market activity in our stock. Administrative expenses also increased by approximately $0.1 million due to increased costs for corporate liability insurance and $0.5 million due to outsourced technology assistance.

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

($ in millions)	For the Six Months Ended June 30, 2002	2001
Realized Gains	$15.4	$6.6
Realized Losses	(6.5)	(1.6)
Net Realized Gains	$8.9	$5.0
Net Unrealized Gains	$24.1	$11.3

Realized gains and losses for the six months ended June 30, 2002, resulted from various private finance and commercial real estate finance transactions. Realized gains for the six months ended June 30, 2002, primarily resulted from transactions involving three private finance portfolio companies, Aurora Communications, LLC ($4.9 million), Cumulus Media, Inc. ($0.5 million) and Alderwoods Group, Inc. ($0.1 million), the sale of CMBS bonds ($7.1 million, including a realized gain from the related hedge of $1.6 million) and one commercial real estate investment ($1.3 million). For the six months ended June 30, 2002 and 2001, we reversed previously recorded unrealized appreciation totaling $7.3 million and $4.0 million, respectively, when gains were realized.

Realized losses for the six months ended June 30, 2002 primarily resulted from transactions involving four private finance portfolio companies, The Loewen Group, Inc. ($2.7 million), iSolve Incorporated ($0.9 million), Sure-Tel, Inc. ($0.5 million) and Soff-Cut Holdings, Inc. ($0.5 million), and one commercial real estate investment ($1.1 million). In January 2002, The Loewen Group, Inc. emerged from bankruptcy and as a result, we exchanged our debt securities for cash, new debt securities and publicly traded common stock in the reorganized company, which resulted in a realized loss. The Loewen Group, Inc. changed its name to Alderwoods Group, Inc. For the six months ended June 30, 2002 and 2001, we reversed previously recorded unrealized depreciation totaling $5.2 million and $2.2 million, respectively, when losses were realized.

Unrealized Gains and Losses. We determine the fair value of each investment in our portfolio on a quarterly basis, and changes in fair value result in unrealized gains or losses being recognized. At June 30, 2002, approximately 93% of our total assets represented investments recorded at fair value. Value, as defined in Section 2(a)(41) of the Investment Company Act of 1940, is (i) the market price for those securities for which a market quotation is readily available and (ii) for all other securities and assets, fair value is as determined in good faith by the board of directors.

Since there is typically no readily ascertainable market value for the investments in our portfolio, we value substantially all of our 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 ascertainable 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 must determine the fair value of 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. Conversely, we will record unrealized appreciation if we have an indication that the underlying portfolio company has appreciated in value and, therefore, our equity security has also appreciated in value, where appropriate. Changes in fair value are recorded in the statement of operations as unrealized gains and losses.

As a business development company, we invest primarily in illiquid securities including debt and equity securities of private companies and non-investment grade CMBS. The structure of each debt and equity security is specifically negotiated to enable us to protect our investment and maximize our returns. We include many terms governing interest rate, repayment terms, prepayment penalties, financial covenants, operating covenants, ownership parameters, dilution parameters, liquidation preferences, voting rights, and put or call rights. Our investments 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 upon the enterprise value at which the portfolio company could be sold in an orderly disposition over a reasonable period of time between willing parties other than in a forced or liquidation sale. The liquidity event whereby we exit a private finance investment is generally the sale, the recapitalization or, in some cases, the initial public offering of the portfolio company.

There is no one methodology to determine enterprise value and, in fact, for any one portfolio company, enterprise value is best expressed as a range of fair values, from which we derive a single estimate of enterprise value. To determine the enterprise value of a portfolio company, we analyze its historical and projected financial results. We generally require portfolio companies to provide annual audited and monthly unaudited financial statements, as well as annual projections for the upcoming fiscal year. Typically in the private equity business, companies are bought and sold based upon multiples of EBITDA, cash flow, net income, revenues or, in limited instances, book value. 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, or acquisition, recapitalization or restructuring related 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 private relative to a peer group, but 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 upon future projections. If a portfolio company is distressed, a liquidation analysis may provide the best indication of enterprise value.

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

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

Net unrealized gains for the six months ended June 30, 2002 were $24.1 million, which included $121.2 million of unrealized gains and $97.1 million of unrealized losses.

Private Finance. We increased the fair value of our investment in The Hillman Companies, Inc. by $32.8 million in the six months ended June 30, 2002. The fair value of our investment in Hillman is based upon our estimate of Hillman s enterprise value of approximately $350 million, including all debt. As discussed above, there is no one methodology to determine enterprise value. As multiples or EBITDAM fluctuate over time, this may or may not impact our estimate of Hillman s enterprise value. The following is a simplified summary of the methodology that we used to determine the fair value of our investment in Hillman.

Since Hillman s results can be affected by seasonal changes, we believe using projected 2002 results for valuation purposes is most appropriate. Hillman is performing better than Hillman s originally projected 2002 revenue and EBITDAM estimates, resulting in part from the closing of a former corporate headquarters for cost savings, the completion of an acquisition and successful expansion into Canada. Hillman is above its original projections for the year as of June 30, 2002, and its 2002 revenue and EBITDA is expected to exceed revenue and EBITDA for 2001.

We believe the current enterprise value for Hillman is approximately $350 million, or approximately 7 times 2002 projected EBITDAM of $50 million. The 7 times multiple was determined by obtaining the average multiple of enterprise value to EBITDA for comparable public companies in Hillman s peer group and discounting that average multiple to arrive at a private company multiple. We then subtracted Hillman s debt (including $41.0 million of subordinated debt owed to us) and Hillman s trust preferred securities estimated to be currently outstanding to arrive at a common equity value of approximately $102 million. We then took our 78% fully diluted share of the resulting equity value and added to it the cost basis of our share of two securities, including a note receivable from GC-Sun Holdings II, LP (Kar Products, LP) and preferred stock of STS Operating, Inc., owned by Hillman that are anticipated to be distributed to us in the third quarter of 2002. We arrived at a total fair value of our common equity of approximately $90 million. We compared the $90 million fair value to our basis in Hillman s common equity of $57.2 million and recorded an unrealized gain of $32.8 million.

We increased the fair value of our investment in Business Loan Express, or BLX, by $19.9 million in the second quarter of 2002 or just slightly under 10% of the total amount invested. BLX has just completed its first full fiscal year of operations since our acquisition of the company in December 2000. During 2002, BLX achieved most of its goals including launching a conventional small business loan product. The fair value for our investment in BLX is based upon our estimate of BLX s enterprise value of approximately $390 million, including all debt. As discussed above, there is no one methodology to determine enterprise value. The following is a simplified summary of the methodology that we used to determine the fair value of our investment in BLX.

To determine the enterprise value of BLX, we determined that financial services companies are generally valued using multiples of net income. We have capitalized BLX with $87 million of subordinated debt. For purposes of valuation, we assumed in a sale transaction that a portion of this $87 million would be considered equity and that BLX would increase the size of its senior debt facility to approximately $155 million. Given this assumption, we then computed a pro forma net income for BLX taking its preliminary, unaudited 2002 earnings before interest, taxes and management fees, and subtracting pro forma interest, assuming the higher level of senior debt and no outstanding subordinated debt. We then computed taxes at a rate of 40 percent, which resulted in pro forma net income for BLX of approximately $23 million for fiscal year 2002 and a projected pro forma net income for fiscal year 2003 of approximately $26 million. We then performed three valuation analyses to determine the fair value of BLX assuming an initial public offering of BLX, assuming the sale of BLX, and, lastly, considering discounted trading ranges for similar companies in the public markets. In performing these analyses, we used a publicly traded peer group and reviewed merger and acquisition transactions that occurred in the last five years in the commercial finance sector. These analyses resulted in a range of estimated enterprise values, and we selected $390 million, which was at the low end of the range. After deducting outstanding debt and preferred stock from the enterprise value to reach an equity value, we determined the value of our 92.8% fully diluted common equity interest to be approximately $140.0 million. We compared the $140.0 million fair value to the fair value of our common equity at March 31, 2002 of $120.1 million, and recorded an unrealized gain of $19.9 million in the second quarter of 2002. As multiples or pro forma net income fluctuate over time, this may or may not impact our determination of the fair value of our investment in BLX.

During the six months ended June 30, 2002, we also increased the fair value of: WyoTech Acquisition Corporation by $16.6 million based on the proceeds received from the sale of this investment in July 2002; Blue Rhino and Kirkland s by $11.5 million and $5.7 million, respectively, based on the public market valuations of each company s stock; and CorrFlex Graphics LLC by $11.8 million based on strong earnings growth and upon indicative valuation estimates received from third parties. In addition, we recorded unrealized appreciation totaling $14.0 million on nine other investments in our portfolio.

During the six months ended June 30, 2002, we decreased the fair value of our investment in Startec Global Communications Corporation by $10.2 million to reflect the current plan of reorganization filed with the bankruptcy court this quarter. We also decreased the fair value of our investment in Velocita, Inc. by $15.3 million. Velocita filed for bankruptcy under Chapter 11 in June 2002, and, based upon the assessment of an independent third party regarding Velocita s liquidation value, we do not expect to recover our investment. Our investment has a fair value of zero at June 30, 2002. We also decreased the value of Alderwoods Group, Inc. by $2.3 million.

We also recorded $74.8 million in unrealized losses during the six months ended June 30, 2002, largely due to conditions in the manufacturing, technology and media sectors, and the continuing effects of the events of September 11th, 2001. Portfolio companies for which unrealized depreciation was recorded this quarter include five companies in the portfolio that have been affected by weakness in the manufacturing sector for which we decreased fair value by $20.6 million; five companies that have been affected by lower levels of technology spending for which we decreased fair value by $16.7 million; two companies in the media sector that have declined in fair value due to declining values in this sector for which we decreased fair value by $7.7 million; and two companies that continued to endure difficulties during the second quarter of 2002 as a result of the attacks of September 11th that have declined in fair value by $11.3 million. As the economy improves, the financial performance of these portfolio companies may also improve. However, there can be no assurance when or if these companies performance may improve.

CMBS Bonds. We recorded a net increase in the fair value of our CMBS bond portfolio by $20.7 million in the second quarter of 2002. We determined the fair value of our CMBS bond portfolio using a discounted cash flow model based upon (i) the current performance of the underlying collateral loans, which utilizes prepayment and loss assumptions based upon historical and projected experience, economic factors and the characteristics of the underlying cash flow, and (ii) current market yields for comparable CMBS bonds, based upon Treasury rates and market spreads.

Cash flow assumptions. With respect to the cash flows of the underlying collateral loans securing the CMBS bonds, the performance of the collateral loans to date is generally consistent with our original assumptions. We continue to assume no prepayments on the collateral loans prior to maturity, as prepayments on the loans prior to maturity are generally prohibited or there are significant penalties, such as prepayment premiums, yield maintenance and/or defeasance requirements. Our credit loss assumptions for the underlying collateral loans at the time of investment in the CMBS bonds were generally estimated to assume that approximately 1% of the underlying collateral loan principal would be lost, and that one-third of the losses would be realized in year three, one-third in year six, and one-third in year nine. We believe that this is an appropriate approach to setting loss assumptions, as losses are expected to occur throughout the life of the CMBS bonds. As of June 30, 2002, total estimated losses in the underlying collateral pools over the life of the CMBS bonds were assumed to total approximately $220 million.

Through June 30, 2002, $0.5 million in actual losses have been realized, and we have specifically identified approximately $25.1 million of additional potential losses. The actual losses and potential expected losses of approximately $25.6 million to date as of June 30, 2002 are less than the losses originally estimated to have been realized by this point, which were estimated at approximately $51.8 million. While the losses identified as of June 30, 2002 are less than our originally estimated losses, we have not reduced the original estimates of the total expected losses over the life of the CMBS bonds as we continue to believe they are reasonable. Loss assumptions affecting future cash flows are updated quarterly to reflect the estimated current and expected performance of the collateral loans on a loan-by-loan basis.

Yield assumptions. During the second quarter of 2002, the overall yields on newly-issued CMBS bonds rated BB+ through B declined due to the decline in Treasury yields combined with the narrowing of spreads, resulting in market yields for these bond classes being lower than the yields-to-maturity on our CMBS bonds for the same classes. More buyers of CMBS bonds have recently entered the market, particularly buyers for BB+ through BB rated CMBS bonds, which has contributed to the decline in spreads for these bond classes during the second quarter. Historically, we have found yields on new issuances to be in the same range as the CMBS bonds we own. We confirmed our CMBS bond portfolio pricing estimates with respect to spreads for our BB+ through B rated bonds with other CMBS bond market participants. Lower yields imply an increase in the value of our BB+ through B rated CMBS bond portfolio. The yields on B- through the non-rated classes have generally remained relatively consistent with the yields on our CMBS bonds in these classes. Pricing for these deeply subordinated classes of bonds are generally much more a function of the credit quality of a single issuance than market conditions.

Fair Value. We have determined the fair value of our CMBS bonds based upon a discounted cash flow model using expected future cash flows and current market yields, as discussed above, to be approximately $560.9 million, and as a result have recorded net unrealized appreciation on the CMBS bonds of $23.9 million at June 30, 2002.

Because we invest in BB+, BB and BB- rated CMBS bonds, which are purchased at prices that are based on the 10-year Treasury rate, we have entered into transactions with financial institutions to hedge against movement in Treasury rates on certain of these CMBS bonds. These transactions involved receiving the proceeds from the sales of borrowed Treasury securities, with the obligations to replenish the borrowed Treasury securities at a later date based on the then current market price. The net proceeds related to the sales of the borrowed Treasury securities and the related obligations to replenish the borrowed Treasury securities totaled $82.6 million and $84.8 million, respectively, and have been included in other assets and other liabilities, respectively, at June 30, 2002. As of June 30, 2002, the total obligations on the hedge had increased to $84.8 million due to changes in the yield on the borrowed Treasury securities, resulting in unrealized depreciation on the obligation of $2.2 million. The decrease in the value of the hedge during the six months ended June 30, 2002 was $2.3 million and was recorded as an unrealized loss.

The net unrealized gain on the CMBS bonds of $23.9 million, net of the unrealized loss on the hedge of $3.2 million, resulted in a net unrealized gain from the CMBS bond portfolio of $21.6 million for the six months ended June 30, 2002.

Given that Treasury yields fluctuate, it is possible that there may be future adjustments to the fair value of the CMBS bonds. As a result, we have not classified the appreciated CMBS bonds as Grade 1 assets at June 30, 2002, since they may not result in any future capital gain. Therefore, CMBS bonds remain in Grade 2.

Other Matters. 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

102.9 million and 89.0 million for the six months ended June 30, 2002 and 2001, respectively.

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

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

Comparison of the Years Ended December 31, 2001, 2000 and 1999

The following table summarizes our condensed operating results for the years ended December 31, 2001, 2000 and 1999:

	2001	2000	Change	Percent Change	2000	1999	Change	Percent Change
	(in thousands, except per share amounts)							
Interest and Related Portfolio Income								
Interest and dividends	$240,464	$182,307	$58,157	32%	$182,307	$121,112	$61,195	51%
Premiums from loan dispositions	2,504	16,138	(13,634)	(84%)	16,138	14,284	1,854	13%
Fees and other income	46,142	13,144	32,998	251%	13,144	5,744	7,400	129%
Total interest and related portfolio income	289,110	211,589	77,521	37%	211,589	141,140	70,449	50%
Expenses								

Interest	65,104	57,412	7,692	13%	57,412	34,860	22,552	65%
Employee	29,656	26,025	3,631	14%	26,025	22,889	3,136	14%
Administrative	15,299	15,435	(136)	(1%)	15,435	12,350	3,085	25%
Total operating expenses	110,059	98,872	11,187	11%	98,872	70,099	28,773	41%
Net investment income before income tax benefit and net realized and unrealized gains	179,051	112,717	66,334	59%	112,717	71,041	41,676	59%

Income tax benefit	412		412	%				
Net investment income before net realized and unrealized gains	179,463	112,717	66,746	59%	112,717	71,041	41,676	59%
Net Realized and Unrealized Gains								
Net realized gains (losses)	661	15,523	(14,862)	*	15,523	25,391	(9,868)	*
Net unrealized gains	20,603	14,861	5,742	*	14,861	2,138	12,723	*
Total net realized and unrealized gains	21,264	30,384	(9,120)	*	30,384	27,529	2,855	*

Net increase in net assets resulting from operations	$200,727	$143,101	$57,626	40%	$143,101	$98,570	$44,531	45%
Diluted earnings per share	$2.16	$1.94	$0.22	11%	$1.94	$1.64	$0.30	18%
Weighted average shares outstanding diluted	93,003	73,472	19,531	27%	73,472	60,044	13,428	22%

* Net realized and net unrealized gains and losses can fluctuate significantly from year to year. As a result, comparisons of net realized and net unrealized gains and losses may not be meaningful.

Net increase in net assets resulting from operations, or net income, results from total interest and related portfolio income earned, less total expenses incurred in our operations, plus net realized and unrealized gains or losses.

Total interest and related portfolio income includes interest income, premiums from loan dispositions and fees and other income.

	For the Years Ended December, 31,		
($ in millions, except per share amounts)	2001	2000	1999
Total Interest and Related Portfolio Income	$289.1	$211.6	$141.1
Per share	$3.11	$2.88	$2.35

The increase in interest income earned results primarily from continued growth of our investment portfolio and our focus on increasing our overall portfolio yield. Our investment portfolio, excluding non-interest bearing equity interests in portfolio companies, increased by 25% to $1,842.4 million at December 31, 2001 from $1,471.8 million at December 31, 2000, and increased by 29% during 2000 from $1,141.2 million at December 31, 1999. The weighted average yield on the interest bearing investments in the portfolio at December 31, 2001, 2000 and 1999 was as follows:

	December 31,		
	2001	**2000**	**1999**
Private Finance	14.8%	14.6%	14.2%
Commercial Real Estate Finance	13.5%	13.1%	12.3%
Total Portfolio	14.3%	14.1%	13.0%

Included in net premiums from loan dispositions are premiums from loan sales and premiums received on the early repayment of loans. Premiums from loan sales were $0.5 million, $13.3 million and $10.5 million for the years ended December 31, 2001, 2000 and 1999, respectively. This premium income for 2000 and 1999 was higher primarily due to the loan sale activities of Allied Capital Express prior to its merger with Business Loan Express.

Prepayment premiums were $2.0 million, $2.8 million and $3.8 million for the years ended December 31, 2001, 2000 and 1999, respectively. While the scheduled maturities of private finance and commercial real estate loans range from five to ten years, it is not unusual for our borrowers to refinance or pay off their debts to us ahead of schedule. Because we seek to finance primarily seasoned, performing companies, such companies at times can secure lower cost financing as their balance sheets strengthen, or as more favorable interest rates become available. 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, management services to portfolio companies, guaranties and other advisory services. We generate fee income for the transaction services and management services that we provide. As a business development company, we are required to make significant managerial assistance available to the companies in our investment portfolio.

Fees and other income for the year ended December 31, 2001 primarily included fees of $15.5 million related to structuring and diligence, fees of $16.6 million related to transaction services provided to portfolio companies, and fees of $13.1 million related to management services provided to portfolio companies, other advisory services and guaranty fees. Fees and other income for the years ended December 31, 2000 and 1999 primarily included structuring and diligence fees of $6.0 million and $0.3 million, respectively, and management services and advisory fees of $3.1 million and $3.2 million, respectively. Fees and other income are generally related to specific transactions or services, and therefore may vary substantially from period to period. Points or loan origination fees that represent yield enhancement on a loan are capitalized and amortized into interest income over the life of the loan.

Operating expenses include interest, employee and administrative expenses. Our single largest expense is interest on our indebtedness. The fluctuations in interest expense during 2001, 2000 and 1999 are attributable to changes in the level of our borrowings and the related interest rate charged thereon. Our borrowing activity and weighted average interest cost, including related fees and expenses, were as follows:

($ in millions)	2001	2000	1999
Total outstanding debt	$1,020.8	$786.6	$592.9
Average outstanding debt	$847.1	$707.4	$461.5
Weighted average cost	7.0%	8.3%	7.9%
Business development company asset coverage*	245%	245%	228%

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

Employee expenses include salaries and employee benefits. The increases in salaries and employee benefits for the periods presented reflect wage increases and the experience level of employees hired. Total employees were 97, 97 and 129 at December 31, 2001, 2000 and 1999, respectively. As part of the recapitalization of Allied Capital Express discussed above, 37 of our employees were transferred to Business Loan Express at the end of 2000. Expenses related to these employees are reflected in employee expense for the years ended December 31, 2000 and 1999.

Administrative expenses include the leases for our headquarters in Washington, DC and our regional offices, travel costs, stock record expenses, directors fees, legal and accounting fees and various other expenses. Administrative expenses for the years ended December 31, 2000 and 1999 included expenses related to regional offices of Allied Capital Express. The cost of these regional offices was transferred to Business Loan Express at the beginning of 2001. For the years ended December 31, 2001, 2000 and 1999, employee and administrative costs as a percentage of total interest and related portfolio income less interest expense plus net realized and unrealized gains was 18%, 19% and 21%, respectively.

Net realized gains resulted from the sale of equity securities associated with certain private finance investments and the realization of unamortized discount resulting from the sale and early repayment of private finance loans, commercial mortgage loans and CMBS, offset by losses on investments. Net realized and unrealized gains for the years ended December 31, 2001, 2000 and 1999 were as follows:

(in millions)	2001	2000	1999
Realized gains	$10.1	$28.6	$31.5
Realized losses	(9.4)	(13.1)	(6.1)
Net realized gains	$0.7	$15.5	$25.4

Net unrealized gains	$20.6	$14.9	$2.1

Realized gains during 2001 primarily resulted from transactions involving three private finance portfolio companies - 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). We reversed previously recorded unrealized appreciation of $6.5 million when these gains were realized in 2001. Realized gains during 2000 and 1999 resulted primarily from transactions involving eight and six portfolio companies, respectively, and we reversed previously recorded unrealized appreciation of $7.5 million and $14.6 million, respectively, when these gains were realized.

Realized losses in 2001, 2000 and 1999 represented 0.4%, 0.7% and 0.5% of our total assets, respectively. Realized losses during 2001 resulted primarily from three private finance portfolio investments - 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. Losses realized in 2001 had been recognized in net increase in net assets resulting from operations, or net income, over time as unrealized depreciation when we determined that the respective portfolio security s value had become impaired. Thus, we reversed previously recorded unrealized depreciation totaling $8.9 million, $12.0 million and $5.4 million when the related losses were realized in 2001, 2000 and 1999, respectively.

As discussed in the Portfolio and Investment Activity Private Finance section above, merger and acquisition activity for 2001 was at a slower pace than prior years. This lower level of activity is reflected in the lower amount of net realized gains in 2001 as compared to 2000 and 1999.

For a discussion of our fair value methodology and how it affects unrealized gains and losses, see Unrealized Gains and Losses included in the Comparison of Six Months Ended June 30, 2002 and 2001.

During 2001, we increased the value of our equity investment in Business Loan Express by $15.5 million and recorded unrealized appreciation. We also increased the value of our investment in WyoTech Acquisition Corporation and recorded unrealized appreciation of $37.0 million. In addition to Business Loan Express and WyoTech, we increased the value of other portfolio investments and recorded unrealized appreciation of a total of $32.9 million for the year ended December 31, 2001. These companies increased in value because of their continued positive performance and valuation data that would indicate that a valuation increase was necessary.

During the year ended December 31, 2001, we decreased the value of and recorded unrealized depreciation on our investments in Startec Global Communications Corporation by $14.9 million, Galaxy American Communications, LLC by $10.4 million, Schwinn Holdings Corporation by $8.8 million, Avborne, Inc. by $8.4 million and NETtel Communications, Inc. by $7.0 million. In addition, we recorded a net decrease in the value of other portfolio investments by a total of $18.9 million for the year ended December 31, 2001.

All per share amounts included in Management s Discussion and Analysis of Financial Condition and Results of Operations have been computed using the weighted average shares used to compute diluted earnings per share, which were 93.0 million, 73.5 million and 60.0 million for the years ended December 31, 2001, 2000 and 1999, respectively. The increases in the weighted average shares reflect the issuance of new shares.

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

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

90% of our investment company taxable income as defined in the Internal Revenue Code. We intend to take all steps necessary to continue to qualify as a regulated investment company. However, there can be no assurance that we will continue to qualify for such treatment in future years.

FINANCIAL CONDITION, LIQUIDITY AND CAPITAL RESOURCES

Cash and Cash Equivalents

At June 30, 2002, and December 31, 2001, we had $4.3 million and $0.9 million, respectively, in cash and cash equivalents. We invest otherwise uninvested cash in U.S. government- or agency-issued or guaranteed securities that are backed by the full faith and credit of the United States, or in high quality, short-term repurchase agreements fully collateralized by such securities. Our objective is to manage to a low cash balance and fund new originations with our revolving line of credit.

Debt and Other Commitments

We had outstanding debt at June 30, 2002 and December 31, 2001, as follows:

($ in millions)	Facility Amount	Amount Outstanding	Annual Interest Cost(1)	Annual Portfolio Return to Cover Interest Payments(2)
At June 30, 2002				
Notes payable and debentures:				
Unsecured long-term notes	$694.0	$694.0	7.8%	2.1%
Small Business Administration debentures	101.8	94.5	8.2%	0.3%
Auction rate reset note	75.0	75.0	3.7%	0.1%
Overseas Private Investment Corporation loan	5.7	5.7	6.6%	0.0%
Total notes payable and debentures	$876.5	$869.2	7.4%	2.5%

Revolving line of credit	527.5	139.8	4.1%(3)	0.3%
Total debt	$1,404.0	$1,009.0	7.2%	2.8%

At December 31, 2001

Notes payable and debentures:				
Unsecured long-term notes	$694.0	$694.0	7.8%	2.2%
Small Business Administration debentures	101.8	94.5	7.7%	0.3%
Auction rate reset note	81.9	81.9	3.9%	0.1%
Overseas Private Investment Corporation loan	5.7	5.7	6.6%	0.0%
Total notes payable and debentures	$883.4	$876.1	7.4%	2.6%
Revolving line of credit	497.5	144.7	3.2%(3)	0.3%

Total debt	$1,380.9	$1,020.8	7.0%	2.9%

(1) The annual interest cost includes the cost of commitment fees and other facility fees that are recognized into interest expense over the contractual life of the respective borrowings.

(2) The annual portfolio return to cover interest payments is calculated as the June 30, 2002, annualized cost of debt per class of financing divided by total assets at June 30, 2002.

(3) The current interest rate payable on the revolving line of credit was 4.1% and 3.2% at June 30, 2002 and December 31, 2001, respectively, which excludes the annual cost of commitment fees and other facility fees of $2.0 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 2003. The notes require payment of interest only semi-annually, and all principal is due upon maturity.

Small Business Administration Debentures. We, through our small business investment company subsidiary, have debentures payable to the Small Business Administration with terms 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 $111.7 million from the Small Business Administration. At June 30, 2002, the Small Business Administration has a commitment to lend up to an additional $7.3 million above the amount outstanding. The commitment expires on September 30, 2005.

Auction Rate Reset Note. We have an Auction Rate Reset Senior Note Series A that matures on December 2, 2002 and bears interest at the three-month London Inter-Bank Offered Rate (LIBOR) plus 1.75%, which adjusts quarterly. Interest is due quarterly, and we, at our option, may pay or defer such interest payments. The amount outstanding on the note will increase as interest due is deferred. As a means to repay the note, we have entered into an agreement with the placement agent of this note to serve as the placement agent on a future issuance of $75.0 million of debt, equity or other securities in one or more public or private transactions. Alternatively, we may repay the note in cash without conducting a capital raise. If we choose to pay in cash without conducting a capital raise, we will incur additional expense of approximately $2.1 million.

Revolving Line of Credit. As of June 30, 2002, we have a $527.5 million unsecured revolving line of credit that expires in August 2003, with the right to extend maturity for one additional year at our sole option under substantially similar terms. This facility was increased by $30.0 million during the first quarter of 2002 from $497.5 million at December 31, 2001, and may be further expanded up to $600 million. As of June 30, 2002, $382.4 million remains unused and available, net of amounts committed for standby letters of credit of $5.3 million issued under the line of credit facility. The credit facility bears interest at a rate equal to (i) the one-month LIBOR plus 1.25% or (ii) the higher of (a) the Bank of America, N.A. prime rate or (b) the Federal Funds rate plus 0.50%. The credit facility 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 the notes payable and debentures. These covenants require us to maintain certain financial ratios, including debt to equity and interest coverage, and a minimum net worth. Our credit facilities limit our ability to declare dividends if we default under certain provisions. As of June 30, 2002, we were in compliance with these covenants.

The following table shows our significant contractual obligations as of June 30, 2002.

($ in millions) Contractual Obligations	Total	Payments Due By Year 2002	2003	2004	2005	2006	After 2006
Notes payable and debentures:							
Unsecured long-term notes	$694.0	$	$140.0	$214.0	$165.0	$175.0	$
Small Business Administration debentures	94.5			7.0	14.0		73.5
Auction rate reset note	75.0	75.0					
Overseas Private Investment Corporation loan	5.7					5.7	
Revolving line of credit(1)	139.8			139.8			
Operating leases	22.3	1.3	2.6	2.7	2.7	2.6	10.4
Total contractual cash obligations	$1,031.3	$76.3	$142.6	$363.5	$181.7	$183.3	$83.9

(1) The revolving line of credit expires in August 2003, and may be extended under substantially similar terms for one additional year at our sole option. We assume that we would exercise our option to extend the revolving line of credit, resulting in an assumed maturity of August 2004.

The following table shows, as of June 30, 2002, our contractual commitments that may have the effect of creating, increasing or accelerating our liabilities.

($ in millions) Commitments	Total	Amount of Commitment Expiration Per Year 2002	2003	2004	2005	2006	After 2006
Standby letters of credit	$11.3	$	$	$5.3	$	$	$6.0
Guarantees	52.2	1.0		50.3	0.2		0.7
Total commitments	$63.5	$1.0	$	$55.6	$0.2	$	$6.7

Equity Capital and Dividends

Because we are a regulated investment company, we distribute income and require external capital for growth. Because we are a business development company, we are limited in the amount of debt capital we may use to fund our growth, since we are generally required to maintain a minimum ratio of 200% of total assets to total borrowings, or approximately a 1 to 1 debt to equity capital ratio.

To support our growth during the three and six months ended June 30, 2002 and for the year ended December 31, 2001, we raised $30.0 million, $49.9 million and $286.9 million, respectively, in new equity capital through the sale of shares from our shelf registration statement. We issue equity from time to time when we have attractive investment opportunities. In addition, during the three and six months ended June 30, 2002 and for the year ended December 31, 2001, we raised $1.5 million, $3.1 million and $6.3 million, respectively, in new equity capital through the issuance of shares through our dividend reinvestment plan. At June 30, 2002, total shareholders equity had increased to $1,434.5 million.

Our board of directors reviews the dividend rate quarterly, and may adjust the quarterly dividend throughout the year. For the first and second quarters of 2002, the board of directors declared a dividend of $0.53 and $0.55 per common share, respectively.

The board of directors has recently declared a dividend of $0.56 per common share for the third quarter of 2002, which will be paid on September 27, 2002 to shareholders of record on September 13, 2002. Dividends are paid based on our taxable income, which includes our taxable interest and fee income as well as taxable net realized capital gains. Our board of directors evaluates whether to retain or distribute capital gains on an annual basis. Our dividend policy allows us to continue to distribute capital gains, but will also allow us to retain gains that exceed a normal capital gains distribution level, and therefore avoid any unusual spike in dividends in any one year. The dividend policy also enables the board of directors to selectively retain gains to support future growth.

We plan to maintain a strategy of financing our business with cash from operations, through borrowings under short- or long-term credit facilities or other debt securities, through asset sales, or through the sale or issuance of new equity capital. Cash flow from operations before new investments was $258.1 million for the six months ended June 30, 2002, and $330.8 million, $494.6 million, and $420.2 million for the years ended December 31, 2001, 2000 and 1999, respectively. Cash flow from operations before new investments has historically been sufficient to finance our operations.

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

At June 30, 2002, our debt to equity ratio was 0.70 to 1 and our weighted average cost of funds was 7.2%. We had $382.4 million available under our revolving line of credit. As a result of the receipt of $77.0 million from the sale of WyoTech on July 1, 2002 and the receipt of $94.7 million from the sale of CMBS bonds on July 31, 2002, there were no amounts drawn on the revolving line of credit as of August 1, 2002. Availability on the revolving line of credit, net of amounts committed for standby letters of credit issued under the line of credit facility, was $522.2 million on August 1, 2002. We believe that we have access to capital sufficient to fund our ongoing investment and operating activities.

CRITICAL ACCOUNTING POLICIES

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 primarily in illiquid securities including debt and equity securities of private companies and non-investment grade CMBS. 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 establishing 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. Conversely, we will record unrealized appreciation if we believe that the underlying portfolio company has appreciated in value and our equity security has also appreciated in value, where appropriate. The value of investments in public securities are determined using quoted market prices discounted for restrictions on resale.

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

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

Interest income is recorded on an accrual basis to the extent that such amounts are expected to be collected. For loans and debt securities with contractual payment-in-kind interest, which represents contractual interest accrued and added to the loan balance that generally becomes due at maturity, we will not accrue payment-in-kind interest if the portfolio company valuation indicates that the payment-in-kind interest is not collectible. Loans classified as Grade 4 or Grade 5 assets do not accrue interest. Loan origination fees, original issue discount and market discount are capitalized and then amortized into interest income using the effective interest method. 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. Prepayment premiums are recorded on loans 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 s securities or other liquidation events. The determined fair values are generally discounted to account for restrictions on resale and minority control positions.

The value of our equity interests in public companies for which market quotations are readily available is based upon 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 cumulative 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). CMBS are carried at fair value, which is based upon a discounted cash flow model that utilizes prepayment and loss assumptions based upon historical experience and projected performance, economic factors and the characteristics of the underlying cash flow. Our assumption with regard to discount rate is based upon the yield of comparable securities. We recognize income from the amortization of original issue discount using the effective interest method, using the anticipated yield over the projected life of the investment. Yields are revised when there are changes in estimates of future credit losses, actual losses incurred, or actual and estimated prepayment speeds. Changes in estimated yield are recognized as an adjustment to the estimated yield over the remaining life of the CMBS from the date the estimated yield is changed. We recognize unrealized appreciation or depreciation on our CMBS as comparable yields in the market change and/or whenever we determine that the value of our CMBS is less than the cost basis due to impairment in the underlying collateral pool.

Residual Interest. We value our residual interest from a previous securitization and recognize income using the same accounting policies used for the CMBS. The residual interest is carried at fair value based on discounted estimated future cash flows. We recognize income from the residual interest using the effective interest method. At each reporting date, the effective yield is recalculated and used to recognize income until the next reporting date.

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

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

Recent Developments

During the third quarter ended September 30, 2002, private finance new investment activity totaled approximately $148 million, including loans, debt securities, and equity interests.

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 indicates information which the SEC expressly does not require to be disclosed for certain types of senior securities.

Class and Year	Total Amount Outstanding Exclusive of Treasury Securities(1)	Asset Coverage Per Unit(2)	Involuntary Liquidating Preference Per Unit(3)	Average Market Value Per Unit(4)
Unsecured Long-term Notes Payable				
1992	$0	$0	$	N/A
1993	0	0		N/A
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 (as of June 30, unaudited)	694,000,000	2,562		N/A
Small Business Administration Debentures(5)				
1992	$49,800,000	$5,789	$	N/A
1993	49,800,000	6,013		N/A
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 (as of June 30, unaudited)				

94,500,000 2,562 N/A **Auction Rate Reset Note**

1992			
$0	$0	$	N/A
1993			
0	0		N/A
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 (as of June 30, unaudited)			
75,000,000	2,562		N/A

Class and Year	Total Amount Outstanding Exclusive of Treasury Securities(1)	Asset Coverage Per Unit(2)	Involuntary Liquidating Preference Per Unit(3)	Average Market Value Per Unit(4)
Overseas Private Investment Corporation Loan				
1992	$0	$0	$	N/A
1993	0	0		N/A
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 (as of June 30, unaudited)	5,700,000	2,562		N/A
Revolving Lines of Credit				
1992	$0	$0	$	N/A
1993	0	0		N/A
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 (as of June 30, unaudited)	139,750,000	2,562		N/A
Master Repurchase Agreement and Master Loan and Security Agreement				
1992				

	$0	$0	$ N/A
1993	0	0	N/A
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 (as of June 30, unaudited)	0	0	N/A

Class and Year	Total Amount Outstanding Exclusive of Treasury Securities(1)	Asset Coverage Per Unit(2)	Involuntary Liquidating Preference Per Unit(3)	Average Market Value Per Unit(4)
Senior Note Payable(6)				
1992	$20,000,000	$5,789	$	N/A
1993	20,000,000	6,013		N/A
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 (as of June 30, unaudited)	0	0		N/A
Bonds Payable				
1992	$0	$0	$	N/A
1993	0	0		N/A
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 (as of June 30, unaudited)	0	0		N/A
Redeemable Cumulative Preferred Stock(5)				
1992	$1,000,000	$526	$100	N/A
1993	1,000,000	546	100	N/A
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 (as of June 30, unaudited)				
	1,000,000	254	100	N/A

Class and Year	Total Amount Outstanding Exclusive of Treasury Securities(1)	Asset Coverage Per Unit(2)	Involuntary Liquidating Preference Per Unit(3)	Average Market Value Per Unit(4)
Non-Redeemable Cumulative Preferred Stock(5)				
1992	$6,000,000	$526	$100	N/A
1993	6,000,000	546	100	N/A
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 (as of June 30, unaudited)	6,000,000	254	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.

BUSINESS

General

As a business development company, we generally provide long-term debt and equity investment capital to support the expansion of primarily private companies in a variety of industries. We generally invest in illiquid securities through privately negotiated transactions. We have been investing in businesses for over 40 years and have financed thousands of private companies nationwide. Today, our investment and lending activity is generally focused in two areas:

- Private finance and
- Commercial real estate finance, primarily the investment in non-investment grade commercial mortgage-backed securities.

Our investment portfolio consists primarily of long-term unsecured loans with or without equity features, equity investments in middle market companies, which may or may not constitute a controlling equity interest, non-investment grade commercial mortgage-backed securities, and commercial mortgage loans. At June 30, 2002, our investment portfolio totaled $2.4 billion. Our investment objective is to achieve current income and capital gains.

Corporate History and Offices

Allied Capital Corporation was formed in 1958. On December 31, 1997, Allied Capital Corporation, Allied Capital Corporation II, Allied Capital Commercial Corporation and Allied Capital Advisers, Inc. merged with and into Allied Capital Lending Corporation in a tax-free stock-for-stock exchange. Immediately following the merger, Allied Capital Lending changed its name to Allied Capital Corporation.

We are a Maryland corporation and a closed-end management investment company that has elected to be regulated as a business development company under the Investment Company Act of 1940. We are a registered investment adviser. We have a subsidiary that has also elected to be regulated as a BDC, Allied Investment Corporation, which 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 which are single-member limited liability companies established primarily to hold real estate properties. In April 2001, we established a subsidiary, A.C. Corporation (AC Corp), which 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, its 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 and we also have an office in Frankfurt, Germany.

Private Finance

We participate in the private equity business generally by providing privately negotiated long-term debt and equity investment capital. Our private finance investment activity is generally focused on providing junior capital, generally in the form of subordinated debt with or without equity features, such as warrants or options, often referred to as mezzanine financing. In certain situations, we may also take a controlling equity position in a company. Our private financing is generally used to fund growth, buyouts, acquisitions, recapitalizations, note purchases, and bridge financings. We generally invest in private companies though, from time to time, we may invest in public companies that lack access to public capital or whose securities may not be marginable.

At June 30, 2002, 64% of the private finance portfolio consisted of loans and debt securities and 36% consisted of equity securities. In addition, at June 30, 2002, 90% of the private finance portfolio consists of junior securities including mezzanine debt, preferred equity, common equity or warrants or options to purchase preferred or common equity as shown in the table below.

	Senior Notes	Bonds	Mezzanine Debt	Preferred Stock	Warrants/ Options	Public Common Equity	Private Common Equity	Total
Dollars at Value ($ in millions)	$168.8	$ 0	$882.0	$124.7	$94.3	$ 5.1	$360.4	$1,635.3

Our private finance portfolio includes investments in a wide variety of industries, including non-durable consumer products, business services, financial services, light industrial products, retail, education, telecommunications and broadcasting and cable. The industry and geographic compositions of the private finance portfolio at value at June 30, 2002 and December 31, 2001 and 2000 were as follows:

	2002	2001	2000
Industry			
Consumer products	30%	28%	26%
Business services	24	22	24
Financial services	16	15	16
Industrial products	10	10	9
Retail	5	5	5
Education	5	5	3
Telecommunications	3	4	6
Broadcasting & cable	2	4	5
Other	5	7	6

Total	100%	100%	100%

Geographic Region

Mid-Atlantic	42%	43%	43%
West	20	19	17
Midwest	17	17	18
Southeast	14	14	12
Northeast	6	5	8
International	1	2	2
Total	100%	100%	100%

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

Capital Provider
Banks Commercial Finance Companies Private Placement/ High Yield
Private Mezzanine Funds
Allied Capital Private Equity Funds

Primary Business Focus Senior, short- term debt Asset-based lending Large credits (private > $50 mm) (public > $150 mm) Unsecured long- term debt with warrants

Preferred and common equity Unsecured long- term debt with warrants

Preferred and common equity Equity

Typical Pricing Spectrum* LIBOR+
[graphic of arrow stretching between LIBOR+ and 30%+]
30%+

* Based on our market experience.

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 placement 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 private placement/high yield market. Instead, we compete directly with the private mezzanine sector of the private capital 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.

Many private mezzanine 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 gives us a lower cost of capital than that of private 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 mezzanine fund, which typically has a limited life.

Over our 40-year history, we have developed and maintained relationships with intermediaries including investment banks, financial services companies and private mezzanine and equity sponsors, through which we source investment opportunities. Through these relationships, especially those with equity sponsors, we have been able to strengthen our position as a long-term investor. For the transactions in which we have provided debt capital, an equity sponsor provides a reliable source of additional equity capital if the portfolio company requires additional financing. Private equity sponsors also assist us in confirming our own due diligence findings when assessing a new investment opportunity, and they provide assistance and leadership to the portfolio company s management team throughout our investment period.

Investment Criteria. When assessing a prospective 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 characteristics generally include the following:

Management teams with meaningful equity ownership

Dominant or defensible market position

High return on invested capital

Revenues of $50 million to $500 million

Stable operating margins

EBITDA of at least $5 million

Solid cash flow margins

Sound balance sheets

We generally target and do not target the following industries, though we will consider investments in any industry if the prospective company demonstrates unique characteristics that make it an attractive investment opportunity:

Industries Targeted *Less Cyclical/Cash Flow Intensive/ High Return on Capital*	**Industries Not Targeted** *Cyclical/Capital Intensive/ Low Return on Capital*
Consumer products	Heavy equipment
Business services	Natural resources
Financial services	Commodity retail
Light industrial products	Low value-add distribution
Broadcasting/Cable	Agriculture
	Transportation

Investment Structure. 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 relate relative to the other capital in the portfolio company s capital structure. Generally, our private finance portfolio companies seek a component of senior capital above us and an equity piece below us.

Our private finance mezzanine investments are generally structured as an unsecured, subordinated loan that carries a relatively high contractual fixed interest rate generally in excess of 12%, to provide interest income. Approximately 97% of the loans and debt securities in the private finance portfolio have fixed rates of interest. The 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 debt maturities and principal amortization schedules vary. Such payments are generally made to us quarterly.

Our mezzanine debt instruments are tailored to the facts and circumstances of the deal. The specific structure is negotiated over a period of several weeks 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, take control provisions and board observation. Our private finance 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. We seek to achieve additional investment return from the appreciation and sale of our warrants. We generally target a total return of 16% to 25% for our private finance mezzanine investments. The typical private finance structure focuses, first, on the protection of our investment principal and then on investment return.

We exit our private finance investments generally when a liquidity event takes place, such as the sale, recapitalization or initial public offering of such portfolio company. 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. 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.

We may also acquire preferred or common equity in a company as a part of our private finance investing activities, particularly when we see a unique opportunity to profit from the growth of a company. Preferred equity investments may be structured with a dividend yield, which would provide us with a current return. With respect to preferred or common equity investments, we generally target an investment return of 25% to 40%.

In addition to our private finance mezzanine investment activities, we may acquire more than 50% of the common stock of a company in a control buyout transaction. In addition to our common equity investment, we may also provide additional capital to the controlled portfolio company in the form of senior loans, subordinated debt or preferred stock. The types of companies that we would acquire through a control buyout transaction are generally the same types of companies that we would invest in through our other private finance investing activities. In particular, we may see opportunities to acquire illiquid public companies and take them private. We intend to be selective about the companies in which we would acquire a controlling interest to ensure that we maintain a diversified portfolio with respect to industry types.

We generally structure our control 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 stock, and management or transaction services fees to compensate us for the managerial assistance that we provide to a controlled portfolio company. For these types of investments, we generally target an overall investment return on control investments of 25% to 40%.

We fund new investments using cash, through the issuance of common equity, the reinvestment of previously accrued interest and dividends in debt and 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 also opt to reinvest accrued interest receivable in a new debt or equity security, in lieu of receiving such interest in cash and funding a subsequent growth investment. When we acquire a controlling interest in a company, we may have the opportunity to acquire the company s equity with our common stock. The issuance of our stock as consideration may provide us with the benefit of raising equity without having to access the public markets in an underwritten offering, including the added benefit of the elimination of any underwriter commissions.

As a business development company, we are required to make significant managerial assistance available to the companies in our investment portfolio. In addition to the interest and dividends received from our private finance investments, we will often generate additional fee income for the structuring, diligence, transaction and management services and guarantees we provide to our portfolio companies.

Commercial Real Estate Finance

Our commercial real estate investment activity is primarily focused on the investment in non-investment grade commercial mortgage-backed securities, which we refer to as CMBS. As an investor, we believe that CMBS has attractive risk/return characteristics. The CMBS bonds 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 typicall unsecured debt instruments, the non-investment grade CMBS 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 consists 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 invest in CMBS bonds on the initial issuance of the CMBS bond offering, and are able to underwrite and negotiate to acquire the securities at a significant discount from their face amount, generally resulting in an estimated yield to maturity ranging from 13% to 16%. We find the yields for CMBS bonds attractive given their collateral protection.

We believe this risk/return dynamic exists in the market 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 bonds in an initial issuance, we re-underwrite the mortgage loans in the underlying collateral pool, and we meet with issuers 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 bonds 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 bonds represented by the BB+ to non-rated tranches of a CMBS issuance. The non-investment grade CMBS bonds in which we invest are junior in priority for payment of principal and interest 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 tranch will bear this loss first. At June 30, 2002, our CMBS bonds were subordinate to 92% to 97% of the tranches of bonds issued in various CMBS transactions.

To mitigate the risks associated with a CMBS investment discussed above, we perform extensive due diligence prior to each investment in CMBS. The underwriting procedures and criteria used to underwrite each of the commercial mortgage loans in each collateral pool 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. At June 30, 2002, the underlying pools of mortgage loans that are collateral for our CMBS bonds consisted of approximately 4,100 commercial mortgage loans with a total outstanding principal balance of $22.9 billion. These mortgage loans are secured by properties located in diverse geographic locations across the United States, and include a variety of property types such as retail, multi-family housing, office, and hospitality.

The property types and the geographic composition of the underlying mortgage loans securing the CMBS bonds calculated using the outstanding principal balance at June 30, 2002 and December 31, 2001 and using the underwritten principal balance at December 31, 2000 were as follows:

	2002	**2001**	**2000**
Property Type			
Retail	31%	31%	32%
Housing	27	27	30
Office	21	22	21
Hospitality	7	7	8
Other	14	13	9
Total	100%	100%	100%
Geographic Region			
West	31%	32%	31%
Mid-Atlantic	25	24	23
Midwest	22	21	22

Southeast	17	17	19
Northeast	5	6	5
Total	100%	100%	100%

In addition to our CMBS bond investments, we have invested in the preferred shares of three collateralized debt obligations, or CDOs, secured by investment grade unsecured debt issued by various real estate investment trusts, or REITs, and non-investment grade CMBS bonds. The preferred shares are junior in priority for payment of 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 resulting in reduced cash flows, the preferred shares will bear this loss first. At June 30, 2002, our preferred shares in the CDOs were subordinate to approximately 95% of the more senior tranches of debt issued by the CDOs. The yield on the CDOs at June 30, 2002 was 17.2%.

Our CMBS investing activity complements our private finance activity because it provides a steady stream of recurring interest income. In addition, given the depth of our commercial real estate experience and the due diligence that we perform prior to an investment in CMBS, we have from time to time received structuring and diligence fees upon the investment in CMBS bonds. These fees are separately negotiated for each transaction. In order to maintain a balanced investment portfolio, we expect to limit our investment in CMBS to approximately 20% to 25% of total assets.

Investment Advisory Services

We are a registered investment adviser, pursuant to the Investment Advisers Act of 1940, and have a wholly owned subsidiary that has an investment advisory agreement to manage a private investment fund. The revenue generated from this agreement is not material to our operations.

Investment Sourcing

We maintain a network of relationships with investors, lenders and intermediaries including:

- private mezzanine and equity investors;
- boutique investment banks;
- business brokers;
- merger and acquisition advisors;
- 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.

Investment Approval and Underwriting Procedures

In assessing new investment opportunities, we follow an institutionalized process which includes a due diligence process and a centralized credit and investment approval process requiring committee review, all of which are described below.

Private Finance. The typical private finance transaction requires two to four months of diligence and structuring before funding occurs. The due diligence process is significantly longer for those transactions in which we take a control position or substantial equity stake in the company. The key steps in our private finance investment process are as follows:

- Initial investment screening
- Presentation of investment to investment professionals at weekly meeting
- Initial approval of the investment by the investment committee
- Due diligence completed and investment structured
- Independent internal peer review of the investment completed
- Final approval of the investment by the investment committee

Approval of the investment by the executive committee of the board of directors (for all investments greater than $10 million)

Investment is funded

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.

Private finance transactions are approved by an investment committee consisting of our most senior officers and chaired by our Chairman and Chief Executive Officer, William L. Walton. The private finance approval process benefits from the experience of the investment committee members and from the experience of our other investment professionals who have significant 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 portfolio company.

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 investment. The typical CMBS investment takes between two to three months to complete because of the breadth and depth of our diligence procedures. The key steps in our CMBS investment process are as follows:

Review initial loan collateral pool data

Prepare and submit a preliminary bid letter to purchase non-investment grade bonds

Commence underwriting process for loans in collateral pool including physical site inspection

Review re-underwriting data for the entire pool

Submit bond purchase to investment committee for approval

Submit bond purchase to executive committee of the board of directors for approval

Complete final pricing and structuring of investment

Fund investment

We re-underwrite the underlying commercial mortgage loans securing the CMBS. We challenge the estimate of underwriteable 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 and consultants physically inspect the collateral properties, and assess appraised values based on our own opinion of comparable market values.

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

CMBS transactions are approved by an investment committee consisting of our most senior officers and chaired by our Chairman and Chief Executive Officer, William L. Walton. CMBS transactions over $10 million are reviewed and approved by the executive committee of the board of directors.

Portfolio Management

Portfolio Diversity. We monitor the portfolio to maintain industry diversity. We currently do not have a policy with respect to concentrating (i.e., investing 25% or 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.

Grading System. The grading system assigns grades to investments from 1 to 5, and the portfolio was graded at June 30, 2002 as follows:

Grade	Description	Portfolio at Value	Percentage of Total Portfolio
		(in millions)	
1	Probable capital gain	$ 793.6	33.3%
2	Performing security	1,400.0	58.8
3	Close monitoring no loss of principal or interest expected	46.7	2.0
4	Workout Some loss of current interest expected	43.6	1.8
5	Workout Some loss of principal expected	97.1	4.1
		$2,381.0	100.0%

Valuation Methodology. We determine the fair value of each investment in our portfolio on a quarterly basis. At June 30, 2002, approximately 93% of our total assets represented investments recorded at fair value. Value, as defined in Section 2(a)(41) of the Investment Company Act of 1940, is (i) the market price for those securities for which a market quotation is readily available and (ii) for all other securities and assets, fair value is as determined in good faith by the board of directors. Since there is typically no readily ascertainable market value for the investments in our portfolio, we value substantially all of our 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 ascertainable 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 must determine the fair value of 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. Conversely, we will record unrealized appreciation if we have an indication that the underlying portfolio company has appreciated in value and, therefore, our equity security has also appreciated in value, where appropriate. Changes in fair value are recorded in the statement of operations as unrealized gains and losses.

As a business development company, we invest primarily in illiquid securities including debt and equity securities of private companies and non-investment grade CMBS. The structure of each debt and equity security is specifically negotiated to enable us to protect our investment and maximize our returns. We include many terms governing interest rate, repayment terms, prepayment penalties, financial covenants, operating covenants, ownership parameters, dilution parameters, liquidation preferences, voting rights, and put or call rights. Our investments 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 upon 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, 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 of the portfolio company. We generally require portfolio companies to provide annual audited and monthly unaudited financial statements, as well as annual projections for the upcoming fiscal year. Typically in the private equity business, companies are bought and sold based upon multiples of EBITDA, cash flow, net income, revenues or in limited instances book value. 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, or acquisition, recapitalization or restructuring related 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 private relative to a peer group, but 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 upon future projections. If a portfolio company is distressed, a liquidation analysis may provide the best indication of enterprise value.

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

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

Valuation Process. The following is a description of the steps we take each quarter to determine the fair value of our portfolio.

Our quarterly valuation process begins with each portfolio company or investment being initially valued by the investment professionals responsible for the portfolio investment, led by the Managing Director who is responsible for the relationship.

Preliminary valuation conclusions are then discussed and documented in a valuation write-up and/ or worksheet and then discussed with our portfolio management team under the supervision of the Chief Financial Officer.

The investment committee, consisting of our most senior officers and chaired by our Chairman and Chief Executive Officer, William L. Walton, meets to discuss valuations as preliminarily determined and documented by each deal team, questions the valuation data and conclusions, and arrives at an investment committee view of valuation.

The investment committee provides comments on the preliminary valuation and the deal team and portfolio management team respond and supplement the documentation based upon those comments.

The valuation documentation is updated and distributed to our board of directors and the audit committee of the board of directors.

The audit committee meets in advance of the board of directors to discuss the valuations and supporting documentation.

The board of directors meets to discuss valuations and review the input of the audit committee and management.

To the extent changes or additional information is deemed necessary, a follow-up board meeting, executive committee meeting or audit committee meeting may take place.

The board of directors determines the final fair value of the portfolio in good faith.

Portfolio Monitoring. 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. This portfolio company monitoring process includes discussions with the senior management team of the company s financial performance, the review of current financial statements and generally includes attendance at portfolio company board meetings. 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 at any one time may vary. The nature of our private finance portfolio relationships frequently provide an opportunity for us to restructure the debt and equity capital of the portfolio company. During such restructuring, we may not 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.

The investment portfolio is priced to provide current returns for shareholders assuming that a portion of the portfolio at any time may not be accruing interest currently. We also price our investments for a total return including 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. Our portfolio grading system is used as a means to assess loss of current interest (Grade 4 assets) or loss of investment principal (Grade 5 assets). We expect that a certain number of portfolio companies will be in the Grade 4 or 5 categories from time to time. Part of the business of private finance is working with troubled portfolio companies to improve their businesses and protect our investment. The number of portfolio companies and related investment amount included in Grades 4 and 5 may fluctuate significantly from quarter to quarter. We continue to follow our historical practice of working with a troubled portfolio company in order to recover the maximum amount of our investment, but record unrealized depreciation for the full amount of the expected loss when such exposure is identified.

With respect to our CMBS portfolio, we monitor the performance of the individual loans in the underlying collateral pool through market data and discussions with the pool master servicers and special servicers. The 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. The special servicers are responsible for collections on loans greater than 60 days past due, including workout administration and management of foreclosed properties. We discuss the status of past due or underperforming loans with the master servicers on a monthly basis. When a loan moves to a special servicer, a workout plan is formulated by the special servicer and generally reviewed by us as the directing certificate holder. Once reviewed by us, the special servicer carries out the workout plan, updating us on the status. We have the ability to replace the named special servicer at any time. With respect to our collateralized debt obligation, or CDO investments, we act as the disposition consultant with respect to two of the CDOs, which allows us to approve disposition plans for individual collateral securities. For these services, we collect annual fees based on the outstanding collateral pool balance.

Employees

At June 30, 2002, we employed 103 individuals including investment and portfolio management professionals, operations professionals and administrative staff. The majority of these individuals are located in the Washington, DC office. We believe that our relations with our employees are excellent.

Legal Proceedings

A series of class action lawsuits have been filed in the United States District Court for the Southern District of New York against us, certain of our directors and officers and our former independent auditors, Arthur Andersen LLP, with respect to alleged violations of the securities laws. These lawsuits allege violations of Sections 10(b) and 20(a) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder, specifically they allege, among other things, that we purportedly misstated the value of certain portfolio investments in our financial statements, which allegedly resulted in the purchase of our common stock by purported class members at artificially inflated prices. Several of the complaints also allege state law claims for common law fraud. The complaints seek compensatory and other damages, and costs and expenses associated with the litigation. The lawsuits have been consolidated into a single proceeding captioned In re Allied Capital Corp. Securities Litigation, 02 CV 3812. We believe the lawsuit is without merit, and we intend to defend the lawsuit vigorously. While we do not expect these matters to materially affect our financial condition or results of operations, there can be no assurance as to whether any such pending litigation will have a material adverse effect on our financial condition or results of operations in any future reporting period.

We are also a party to certain other 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 our portfolio companies in which we had an equity investment at June 30, 2002. 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 June 30, 2002 at pages F-6 to F-14.

Name and Address of Portfolio Company	Nature of its Principal Business	Title of Securities Held by the Company	Percentage of Class Held(1)

Companies More Than 25% Owned

Acme Paging, L.P.(2)(3)
Paging Services Equity
Interests 1.8%
6080 SW 40th Street,
Suite 3
Equity Interests
Miami, FL 33155
in Affiliate 76.9%
American Healthcare
Services, Inc.
Consumer Health
Common Stock 80.3%
(formerly Physicians
Specialty
Services Provider
Corporation)(2)(3)

1150 Lake Hearn Drive

Atlanta, GA 30342

Business Loan Express,
Inc.(2)(3)
Small Business Lender
Preferred Stock 100.0%
645 Madison Ave.
Common Stock 94.9%
19th Floor

New York, NY 10022

The Color Factory
Inc.(2)(3)
Cosmetic Manufacturer
Preferred Stock 100.0%
11312 Penrose Street
Common
Stock 100.0%
Sun Valley, CA 91352

Directory Investment
Corporation(2)(3)
Telephone Directories
Common Stock 50.0%
1919 Pennsylvania Avenue,
N.W.

Washington, DC 20006

Directory Lending
Corporation(2)(3)
Telephone Directories
Common Stock 50.0%
1919 Pennsylvania Avenue,
N.W.

Washington, DC 20006

EDM Consulting, LLC
Environmental Equity
Interest 25.0%
14 Macopin Avenue
Consulting
Montclair, NJ 07043

Elmhurst Consulting,
LLC(2)(3)
Consulting Firm Equity
Interest 100% 360 W.
Butterfield Road,
Common Stock in Suite
400 Controlled
Company 95.0%
Elmhurst, IL 60126

Foresite Towers, LLC(2)(3)
Tower Common Equity
Interest 70.0%
22 Iverness Center Parkway
Leasing Series A
Preferred
Suite 50
Equity Interest 100.0%
Birmingham, AL 35242
Series B Preferred
Equity Interest 100.0%

Name and Address of Portfolio Company	Nature of its Principal Business	Title of Securities Held by the Company	Percentage of Class Held(1)
Gordian Group, Inc.(2)(3) 499 Park Avenue 5th Floor New York, NY 10022	Financial Advisory Services	Common Stock	100.0%

HealthASPex, Inc.(2)(3)
Third Party Class A Convertible
2812 Trinity Square Drive
Administrator
Preferred Stock 69.9%
Carrollton, TX 75006
Class B Convertible
Preferred Stock 67.3%
Common Stock 45.8%
The Hillman Companies, Inc. (formerly SunSource Inc.)(2)(3)
Merchandiser of
Retail Common Stock 93.2%
One Logan Square
Hardware Supplies
Philadelphia, PA 19013

HMT, Inc.
Storage Tank
Convertible Preferred
1422 FM 1960 W.
Maintenance &
Stock 36.4%
Suite 350
Repair Common Stock 26.1%
Houston, TX 77068
Warrants to Purchase
Common Stock 10.0%
Monitoring Solutions, Inc.

Air Emissions
Common
Stock 25.0%
4303 South High
School Road
Monitoring
Warrants to
Purchase
Indianapolis, IN
46241
Common
Stock 50.0%
MVL Group,
Inc.(2)(3)
Market Research
Common
Stock 63.7%
1061 E. Indiantown
Road
Services
Suite 300

Jupiter, FL 33477

Spa Lending
Corporation(2)(3)
Health Spas
Series A Preferred
Stock 100.0%
1919 Pennsylvania
Avenue, N.W.
Series B Preferred
Stock 68.4%
Washington, DC
20006
Series C Preferred
Stock 46.3%
Common
Stock 62.1%
STS Operating, Inc.
(d/b/a SunSource
Technology
Services, Inc.)(3)
Engineering Design
and Common
Stock 42.2%
2301 Windsor Court
Services
Addison, IL 60101

Sure-Tel, Inc.(3)
Prepaid Telephone
Preferred
Stock 50.0%
5 North McCormick
Services Company
Common
Stock 37.0%

Oklahoma City, OK
73127

Total Foam, Inc.
Packaging Systems
Common
Stock 49.0%
P.O. Box 688

Ridgefield, CT 06877

WyoTech Acquisition
Corporation(2)(3)(4)
Vocational School
Preferred
Stock 100.0%
4373 N. 3rd Street
Common
Stock 99.0%
Laramie, WY 82072

**Companies 5% to
25% Owned**

Aspen Pet Products,
Inc.
Pet Product Series B
Preferred
Stock 40.8%
11701 East 53rd Ave.
Provider Series A
Common
Stock 4.7%
Denver, CO 80239

Autania AG
Machine and Tool
Common
Stock 6.2%
Industriestrasse 7
Manufacturer
65779 Kelkheim

Germany

Colibri Holding
Corporation
Outdoor Living
Products Preferred
Stock 5.9%
2201 S. Walbash
Street
Common
Stock 4.2%
Denver, CO 80231
Warrants to
Purchase
Common Stock 2.4%

CorrFlex Graphics, LLC(3)
Packaging Manufacturer
Warrants to Purchase 4.8%
P.O. Box 1337
Common Stock
Monroe, NC 28110
Options to Purchase 7.0%
Common Stock

70

Name and Address of Portfolio Company	Nature of its Principal Business	Title of Securities Held by the Company	Percentage of Class Held(1)
Csabai Canning Factory Rt. 5600 Békéscasba Békís: vt 52-54 Hungary	Food Processing	Hungarian Quotas	9.2%

CyberRep(4)
Operator of Call
Service Warrants to
Purchase 31.7%
8300 Greensboro Drive,
6th Floor
Centers Common
Stock
McLean, VA 22102

The Debt Exchange,
Inc.
Online Sales of
Series B
Convertible 40.0%
101 Arch Street, Suite
410
Distressed Assets
Preferred Stock
Boston, MA 02110

Gibson Guitar
Corporation(3)
Guitar Manufacturer
Warrants to
Purchase 3.0%
1818 Elm Hill Pike
Common Stock
Nashville, TN 37210

International Fiber
Corporation
Cellulose and Fiber
Common
Stock 11.7%
50 Bridge Street
Producer Warrants to
Purchase
North Tonawanda, NY
14120
Common
Stock 3.0%
Liberty-Pittsburgh
Systems, Inc.
Business Forms
Printing Common
Stock 17.2%
265 Executive Drive

Plainview, NY 11803

Litterer
Beteiligungs-GmbH
Scaffolding Company
Equity Interest 15.0%
Uhlandstrasse 1

69493 Hirschberg

Germany

Logic Bay Corporation
Computer-Based
Series C
Redeemable 29.4%
7900 International
Drive
Training Developer
Preferred Stock
Suite 750

Minneapolis, MN
55425

Magna Card, Inc.
Magnet Packager
Preferred Stock 6.3%
10315 South Dolifield
Rd.
and Distributor
Common Stock 5.4%
Owings Mills, MD
21117

Master Plan, Inc.
Healthcare
Outsourcing Common
Stock 8.5%
21540 Plummer Street

Chatsworth, CA 91311

MortgageRamp.com,
Inc.(3)
Internet Based Class
A Common 7.7%
116 Welsh Road
Loan Origination
Stock
Horsham, PA 19044
Service Platform
Morton Grove
Pharmaceuticals, Inc.
Generic Drug
Convertible 23.9%
6451 West Main Street

Manufacturer
Preferred Stock
Morton Grove, IL
60053

Nobel Learning
Communities, Inc.
Educational Services
Series D
Convertible 100.0%
1400 N. Providence
Road,
Preferred Stock
Suite 3055
Warrants to
Purchase 11.6%
Media, PA 19063
Common Stock
North American
Archery, LLC(3)
Sporting Equipment
Debentures
Convertible 26.9%
1733 Gunn Highway
Manufacturer into
LLC Equity
Odessa, FL 33556
Interest
Packaging Advantage
Corporation
Personal Care,
Common
Stock 11.4%
4633 Downey Road
Household and
Warrants to
Purchase 5.5%
Los Angeles, CA 90058
Disinfectant Product
Common Stock
Packager
Professional Paint, Inc.
Paint Manufacturer
Series A-1
Senior 100.0%
3900 Joliet Street
Exchangeable
Preferred
Denver, CO 80239
Stock Common
Stock 13.8%
Progressive
International

Corporation
Retail Kitchenware
Series A

Redeemable 6.3%
6111 S. 228th Street
Preferred Stock
P.O. Box 97045
Common
Stock 0.6%
Kent, WA 98064
Warrants to
Purchase 32.0%
Common Stock

Name and Address of Portfolio Company	Nature of its Principal Business	Title of Securities Held by the Company	Percentage of Class Held(1)
Redox Brands, Inc.(3) 9100 Centre Point Drive Suite 200 West Chester, OH 45069	Household Cleaning Products	Series A Convertible Preferred Stock Warrants to Purchase Class A Common Stock	100.0% 3.5%

Staffing Partners
Holding
Company, Inc.
Temporary
Employee
Redeemable
Preferred 48.3%
104 Church Lane
#100
Services Stock
Baltimore, MD
21208
Class A-1
Common 50.0%
Stock Class
A-2
Common 24.4%
Stock Class B
Common 24.0%
Stock

Companies Less Than 5% Owned

Advantage Mayer,
Inc.
Regional Food
Warrants to
Purchase 4.5%
3444 Memorial
Highway
Broker Common
Stock
Tampa, FL 33607

Alderwoods Group,
Inc.
Death Care
Services Common
Stock 0.9%
311 Elm Street, Suite
1000

Cincinnati, OH
45202

Allied Office
Products, Inc.

Office Products
Warrants to
Purchase 0.0%
75 Route 17 South
Common Stock
Hasbrouck Heights,
NJ 07604

American
Barbecue & Grill,
Inc.
Restaurant Chain
Warrants to
Purchase 17.3%
7300 W. 110th
Street, Suite 570
Common Stock
Overland Park, KS
66210

American HomeCare
Supply, LLC
Home Medical
Warrants to 2.5%
One First Avenue
Equipment
Purchase Class A
Suite 100
Provider Common
Units
Conshohocken, PA
19428

ASW Holding
Corporation
Steel Wool
Manufacturer
Warrants to
Purchase 5.0%
2825 W. 31st Street
Common Stock
Chicago, IL 60623

Avborne, Inc.
Aviation Services
Warrants to
Purchase 3.5%
c/o Trivest, Inc.
Common Stock
5300 NW 36th Street

Miami, FL 33152

Blue Rhino
Corporation
Propane Cylinder
Warrants to
Purchase 12.8%

104 Cambridge Plaza
Drive
Exchange
Common Stock
Winston-Salem, NC
27104

Border Foods, Inc.
Mexican Ingredient
& Series A
Convertible 9.4%
J Street
Food Product
Preferred Stock
Deming Industrial
Park
Manufacturer
Warrants to
Purchase 88.6%
Deming, NM 88030
Common Stock
Camden Partners
Strategic Fund II,
L.P.
Private Equity
Fund Limited
Partnership 4.2%
One South Street
Interest
Suite 2150

Baltimore, MD
21202

Candlewood Hotel
Company
Extended Stay
Series A
Convertible 5.0%
9342 East Central
Facilities Preferred
Stock
Wichita, KS 67206

Celebrities, Inc.
Radio Stations
Warrants to
Purchase 25.0%
408-412 W. Oakland
Park
Common
Stock
Boulevard

Ft. Lauderdale, FL
33311-1712

Component
Hardware Group,
Inc.
Designer &
Developer Class A
Preferred
Stock 9.1%
1890 Swarthmore
Ave.
of Hardware
Common
Stock 8.2%
P.O. Box 2020
Components
Lakewood, NJ 08701

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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(1)
Convenience Corporation of America 711 N. 108th Court Omaha, NE 68154	Convenience Store Chain	Series A Preferred Stock Warrants to Purchase Senior Preferred Stock	10.0% 4.0%

Cooper Natural Resources, Inc.

Sodium Sulfate

Producer Series A Convertible 100.0%
P.O. Box 1477

Preferred Stock

Seagraves, TX 79360

Warrants to

Purchase 46.7%

Series A Convertible Preferred Stock
Warrants to
Purchase 2.5%

Common Stock

Cumulus Media, Inc.

Radio Stations

Common Stock 0.0%

111 Kilbourne Avenue

Suite 2700

Milwaukee, WI 53202

Drilltec Patents & Technologies Company, Inc.

Drill Pipe Packager

Warrants to
Purchase 15.0%
10875 Kempwood Drive, Suite 2

Common Stock

Houston, TX 77043

eCentury Capital Partners, L.P.

Private Equity Fund

Limited Partnership 25.0%
1101 Connecticut Ave, NW

Interest

7th Floor

Washington, DC 20036

Elexis Beta GmbH
Distance
Measurement Options
to Purchase 9.8%
Ulmenstrabe 22
Device Shares
60325 Frankfurt am
Main
Manufacturer
Germany

E-Talk Corporation
Telecommunications
Warrants to
Purchase 5.5%
4425 Cambridge Road
Software Provider
Common Stock
Fort Worth, TX
76155-2692

Executive Greetings,
Inc.
Personalized Business
Warrants to
Purchase 0.9%
120 Industrial Park
Access Road
Products Common
Stock
New Hartford, CT
06057

ExTerra Credit
Recovery, Inc.
Consumer Finance
Series A Preferred
Stock 0.9%
35 Lennon Lane, Suite
200
Receivable
Collections Common
Stock 0.7%
Walnut Creek, CA
94598
Warrants to
Purchase 0.7%
Common Stock
Fairchild Industrial
Products Company
Industrial Controls
Warrants to
Purchase 20.0%
3920 Westpoint
Boulevard
Manufacturer
Common Stock

Winston-Salem, NC
27013

Galaxy American
Communications, LLC
Cable Television
Options to
Purchase 51.0%
1220 N. Main Street
Operator Common
LLC Interest
Sikeston, MO 63801

Garden Ridge
Corporation
Home Decor Retailer
Series A Preferred
Stock 2.6%
650 Madison Avenue
Common
Stock 4.8%
New York, NY 10022

Ginsey Industries, Inc.
Bathroom
Accessories
Convertible
Debentures 8.3%
281 Benigno Boulevard
Manufacturer
Warrants to
Purchase 17.1%
Bellmawr, NJ 08031
Common Stock
Global
Communications, LLC
Muzak Franchisee
Preferred Equity
Interest 59.3%
201 East 69th Street
Options for
Common 59.3%
New York, NY 10021
Membership
Interest
Grant Broadcasting
Systems II
Television Stations
Warrants to
Purchase 25.0%
919 Middle River
Drive,
Common Stock
Suite 409
Warrants to
Purchase 25.0%
Ft. Lauderdale, FL
33304

Common Stock in
Affiliate Company

Name and Address of Portfolio Company	Nature of its Principal Business	Title of Securities Held by the Company	Percentage of Class Held(1)
Grotech Partners VI, L.P. c/o Grotech Capital Group 9690 Deereco Road Suite 800 Timonium, MD 21093	Private Equity Fund	Limited Partnership Interest	3.1%
The Hartz Mountain Corporation 400 Plaza Drive Secaucus, NJ 07094	Pet Supply Manufacturer	Common Stock	2.0%
		Warrants to Purchase Common Stock	4.3%
Hotelevision, Inc. 599 Lexington Avenue Suite 2300 New York, NY 10022	Hotel Cable-TV Network	Series 3 Preferred Stock	16.2%
Icon International, Inc. 281 Tressor Boulevard 8th Floor Stamford, CT 06901	Corporate Barter Services	Class A Common Stock	0.8%
		Class C Common Stock	0.2%
Impact Innovations Group, LLC 5825 Glenridge Drive	Information Technology	Warrants to Purchase	4.0%

Services Provider
Common Stock
Building II, Suite
107

Atlanta, GA 30328

Interline Brands,
Inc.
Repair and
Maintenance Senior
Preferred
Stock 0.9%
(also know as
Wilmar Industries,
Product Distributor
Common
Stock 0.9%
Inc.)
Warrants to
Purchase 1.3%
303 Harper Drive
Common Stock
Moorestown, NJ
08057

JRI Industries, Inc.
Machinery
Manufacturer
Warrants to
Purchase 7.5%
2958 East Division
Common Stock
Springfield, MO
65803

Julius Koch USA,
Inc.
Mini-Blind Cord
Warrants to
Purchase 39.6%
387 Church Street
Manufacturer
Common Stock
New Bedford, MA
02745

Kirker Enterprises,
Inc.
Nail Enamel
Warrants to
Purchase 22.5%
55 East 6th Street
Manufacturer
Series B Common
Stock
Paterson, NJ 07524

Equity Interest in
Affiliate
Company 22.5%
Kirkland s, Inc.
Home Furnishing
Series D Preferred
Stock 3.3%
P.O. Box 7222
Retailer Warrants
to Purchase 4.2%
Jackson, TN
38308-7222
Common Stock
Kyrus Corporation
Value-Added
Reseller, Warrants
to Purchase 13.0%
25 Westridge Market
Place
Computer Systems
Common Stock
Chandler, NC 28715

Love Funding
Corporation
Mortgage Services
Series D Preferred
Stock 26.0%
1220 19th Street,
NW, Suite 801

Washington, DC
20036

Matrics, Inc.
Radio Frequency
Series B
Convertible 5.5%
8850 Stanford
Boulevard
Identification
Technology
Preferred Stock
Suite 3000
Warrants 0.5%
Columbia, MD
21045

MedAssets.com, Inc.
Healthcare
Outsourcing
Series B
Convertible 6.4%
21540 Plummer
Street
Preferred Stock
Chatsworth, CA
91311

Warrants to
Purchase 0.2%
Common Stock
Mid-Atlantic Venture
Fund IV, L.P.
Private Equity
Fund Limited
Partnership 7.3%
128 Goodman Drive
Interest
Bethlehem, PA
18015

Midview Associates,
L.P.
Residential Land
Warrants to
Purchase 35.0%
2 Eaton Street,
Suite 1101
Development
Partnership
Interests
Hampton, VA 23669

Name and Address of Portfolio Company	Nature of its Principal Business	Title of Securities Held by the Company	Percentage of Class Held(1)
NetCare, AG Platenstrasse 46 90441 Nuremberg Germany	Equipment Maintenance Services	Common Stock	2.0%

Novak Biddle
Venture Partners III,
L.P.
Private Equity
Fund Limited
Partnership 2.9%
1750 Tysons
Boulevard
Interest
Suite 1190

McLean, VA 22102

Nursefinders, Inc.
Healthcare
Warrants to
Purchase 4.1%
1200 Copeland
Road, Suite 200
Services Common
Stock
Arlington, TX 76011

Onyx Television
GmbH
Cable Television
Preferred
Units 12.0%
Immedia Park 6b