

ALLIED CAPITAL CORP  
Form 10-Q  
July 31, 2003

**FORM 10-Q**

**SECURITIES AND EXCHANGE COMMISSION**

**WASHINGTON, DC 20549**

**QUARTERLY REPORT PURSUANT TO**

**SECTION 13 OR 15(d) OF  
THE SECURITIES EXCHANGE ACT OF 1934**

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**For The Quarterly Period  
Ended June 30, 2003**

**Commission File Number:  
0-22832**

**ALLIED CAPITAL CORPORATION**

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

**Maryland**  
*(State or Jurisdiction of  
Incorporation or Organization)*

**52-1081052**  
*(IRS Employer  
Identification No.)*

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

**Washington, DC 20006**  
*(Address of Principal Executive Offices)*

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

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Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter periods as the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.  
YES  NO

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

On July 30, 2003, there were 116,495,473 shares outstanding of the Registrant's common stock, \$0.0001 par value.

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**ALLIED CAPITAL CORPORATION**

**FORM 10-Q INDEX**

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## PART I: FINANCIAL INFORMATION

## Item 1. Financial Statements

## ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

## CONSOLIDATED BALANCE SHEET

(in thousands, except share and per share amounts)	June 30, 2003	December 31, 2002
	(unaudited)	
<b>ASSETS</b>		
Portfolio at value:		
Private finance		
Companies more than 25% owned (cost: 2003-\$694,891; 2002-\$628,535)	\$ 803,794	\$ 710,587
Companies 5% to 25% owned (cost: 2003-\$202,942; 2002-\$219,124)	222,143	255,677
Companies less than 5% owned (cost: 2003-\$946,750; 2002-\$863,243)	813,307	776,951
Total private finance	1,839,244	1,743,215
Commercial real estate finance (cost: 2003-\$702,887; 2002-\$718,312)	706,896	744,952
Total portfolio at value	2,546,140	2,488,167
Other assets	118,698	100,221
Deposits of proceeds from sales of borrowed Treasury securities	157,262	194,745
Cash and cash equivalents	7,484	11,186
Total assets	\$2,829,584	\$2,794,319
<b>LIABILITIES AND SHAREHOLDERS EQUITY</b>		
Liabilities:		
Notes payable and debentures	\$ 954,200	\$ 794,200
Revolving line of credit	25,500	204,250
Obligations to replenish borrowed Treasury securities	156,986	197,027
Accounts payable and other liabilities	34,755	45,771
Total liabilities	1,171,441	1,241,248
Commitments and contingencies		
Preferred stock	7,000	7,000
Shareholders equity:		
Common stock, \$0.0001 par value, 200,000,000 shares authorized; 116,034,030 and 108,698,409 shares issued and outstanding at June 30, 2003, and December 31, 2002, respectively	12	11
Additional paid-in capital	1,698,307	1,547,183
Notes receivable from sale of common stock	(22,985)	(24,704)
Net unrealized appreciation (depreciation) on portfolio	(24,923)	39,411
Undistributed (distributions in excess of) earnings	732	(15,830)

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Total shareholders' equity	<u>1,651,143</u>	<u>1,546,071</u>
Total liabilities and shareholders' equity	<u>\$2,829,584</u>	<u>\$2,794,319</u>
Net asset value per common share	<u>\$ 14.23</u>	<u>\$ 14.22</u>

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

## ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

## CONSOLIDATED STATEMENT OF OPERATIONS

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2003	2002	2003	2002
(in thousands, except per share amounts)				
	(unaudited)		(unaudited)	
<b>Interest and Related Portfolio Income:</b>				
Interest and dividends				
Companies more than 25% owned	\$ 12,728	\$ 9,374	\$ 27,931	\$ 18,847
Companies 5% to 25% owned	6,480	7,581	12,973	15,021
Companies less than 5% owned	47,929	45,737	91,754	93,797
	67,137	62,692	132,658	127,665
Total interest and dividends				
Premiums from loan dispositions				
Companies more than 25% owned			108	
Companies 5% to 25% owned	140		625	
Companies less than 5% owned	1,497	46	2,025	1,659
	1,637	46	2,758	1,659
Total premiums from loan dispositions				
Fees and other income				
Companies more than 25% owned	4,304	6,954	10,013	13,929
Companies 5% to 25% owned	177	415	230	415
Companies less than 5% owned	3,959	3,086	4,685	11,916
	8,440	10,455	14,928	26,260
Total fees and other income				
Total interest and related portfolio income				
	77,214	73,193	150,344	155,584
<b>Expenses:</b>				
Interest	19,358	17,515	37,280	34,984
Employee	9,258	8,274	17,379	16,309
Administrative	5,081	4,843	9,498	7,861
	33,697	30,632	64,157	59,154
Total operating expenses				
Net investment income before income taxes	43,517	42,561	86,187	96,430
Income tax benefit	(1,081)		(1,081)	
	44,598	42,561	87,268	96,430
Net investment income				
<b>Net Realized and Unrealized Gains (Losses):</b>				
Net realized gains (losses)				
Companies more than 25% owned	1,314	(630)	1,314	(630)
Companies 5% to 25% owned			16,688	718
Companies less than 5% owned	7,226	(125)	38,877	8,762
	8,540	(755)	56,879	8,850
Total net realized gains (losses)				
Net change in unrealized appreciation or depreciation	6,802	31,648	(64,334)	24,135

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Total net gains (losses)	<u>15,342</u>	<u>30,893</u>	<u>(7,455)</u>	<u>32,985</u>
Net increase in net assets resulting from operations	\$ 59,940	\$ 73,454	\$ 79,813	\$ 129,415
Basic earnings per common share	\$ 0.53	\$ 0.72	\$ 0.71	\$ 1.28
Diluted earnings per common share	\$ 0.52	\$ 0.71	\$ 0.71	\$ 1.26
Weighted average common shares outstanding basic	<u>113,539</u>	<u>101,660</u>	<u>111,510</u>	<u>100,822</u>
Weighted average common shares outstanding diluted	<u>114,552</u>	<u>103,440</u>	<u>112,291</u>	<u>102,900</u>

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

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

(in thousands, except per share amounts)	For the Six Months Ended June 30,	
	2003	2002
	(unaudited)	
Operations:		
Net investment income	\$ 87,268	\$ 96,430
Net realized gains	56,879	8,850
Net change in unrealized appreciation or depreciation	(64,334)	24,135
	79,813	129,415
Shareholder distributions:		
Common stock dividends	(127,474)	(109,482)
Preferred stock dividends	(110)	(110)
	(127,584)	(109,592)
Capital share transactions:		
Sale of common stock	145,126	49,920
Issuance of common stock upon the exercise of stock options	2,657	11,626
Issuance of common stock in lieu of cash distributions	3,327	3,123
Net decrease (increase) in notes receivable from sale of common stock	1,719	(2,162)
Other	14	
	152,843	62,507
Net increase in net assets resulting from capital share transactions	152,843	62,507
Total increase in net assets	105,072	82,330
Net assets at beginning of period	1,546,071	1,352,123
Net assets at end of period	\$ 1,651,143	\$ 1,434,453
Net asset value per common share	\$ 14.23	\$ 14.02
Common shares outstanding at end of period	116,034	102,296

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## ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

## CONSOLIDATED STATEMENT OF CASH FLOWS

	For the Six Months Ended June 30,	
	2003	2002
	(unaudited)	
(in thousands)		
Cash flows from operating activities:		
Net increase in net assets resulting from operations	\$ 79,813	\$ 129,415
Adjustments		
Portfolio investments	(526,399)	(195,455)
Repayments of investment principal	150,277	67,017
Proceeds from investment sales	276,708	126,280
Change in accrued or reinvested interest and dividends	(20,405)	(19,463)
Amortization of loan discounts and fees	(7,233)	(6,478)
Changes in other assets and liabilities	(23,172)	(21,788)
Depreciation and amortization	826	657
Gain on cashless exercise of warrants	(3,876)	
Realized losses	4,347	6,579
Net change in unrealized appreciation or depreciation	64,334	(24,135)
Net cash provided by (used in) operating activities	(4,780)	62,629
Cash flows from financing activities:		
Sale of common stock	145,126	49,920
Sale of common stock upon the exercise of stock options	2,657	9,245
Collections of notes receivable from sale of common stock	1,719	220
Common dividends and distributions paid	(127,329)	(106,359)
Preferred stock dividends paid	(110)	(110)
Borrowings under notes payable and debentures	300,000	
Repayments on notes payable and debentures	(140,000)	(6,856)
Net repayments on revolving line of credit	(178,750)	(5,000)
Other financing activities	(2,235)	(259)
Net cash provided by (used in) financing activities	1,078	(59,199)
Net increase (decrease) in cash and cash equivalents	(3,702)	3,430
Cash and cash equivalents at beginning of period	11,186	889
Cash and cash equivalents at end of period	\$ 7,484	\$ 4,319

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## ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

## CONSOLIDATED STATEMENT OF INVESTMENTS

Private Finance Portfolio Company (in thousands, except number of shares)	Investment <sup>(2)</sup>	June 30, 2003	
		Cost	(unaudited) Value
<b>Companies More Than 25% Owned</b>			
Acme Paging, L.P. (Telecommunications)	Loan Equity Interests Common Stock (940 shares)	\$ 4,265 13,274 27	\$ 4,265 6,525
Alaris Consulting, LLC (Business Services)	Loan Equity Interests Guaranty (\$1,100)	18,635 5,165	17,300
American Healthcare Services, Inc. (Healthcare)	Loan Debt Securities Common Stock (7,956,704 shares) Guaranty (\$1,590)	24,851 17,311 1,000	24,851 11,388
Avborne, Inc. (Business Services)	Loan Preferred Stock (12,500 shares) Common Stock (27,500 shares) Standby Letter of Credit (\$7,006)	2,770 14,138	2,770 2,300
Business Loan Express, LLC (Financial Services)	Loans Debt Securities Class A Equity Interests Class B Equity Interests Class C Equity Interests Guaranty (\$53,591 See Note 3) Standby Letters of Credit (\$25,550 See Note 3)	20,000 39,267 45,044 52,111 108,241	20,000 39,267 45,044 95,986 156,461
The Color Factory, Inc. (Consumer Products)	Loan Preferred Stock (1,000 shares) Common Stock (980,000 shares)	13,389 1,002 6,535	9,854
Foresite Towers, LLC (Tower Leasing)	Equity Interests	15,522	14,170
Gordian Group, Inc. (Business Services)	Loan Common Stock (1,000 shares)	8,935 2,385	8,935 3,500
HealthASPex, Inc. (Business Services)	Preferred Stock (1,000,000 shares) Preferred Stock (1,451,380 shares) Common Stock (1,451,380 shares)	700 4,900 4	700 2,601
The Hillman Companies, Inc. <sup>(1)</sup> (Consumer Products)	Debt Securities Common Stock (6,890,937 shares)	42,953 50,645	42,953 138,863

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HMT, Inc.	Debt Securities	9,129	9,129
(Business Services)	Preferred Stock (554,052 shares)	2,303	2,303
	Common Stock (300,000 shares)	3,000	3,000
	Warrants	1,155	1,155

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- (1) Public company.
- (2) Common stock, preferred stock, warrants, options, and equity interests are generally non-income producing and restricted.
- (3) Non-U.S. company.
- (4) Non-registered investment company.

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		June 30, 2003	
Private Finance Portfolio Company (in thousands, except number of shares)	Investment <sup>(2)</sup>	(unaudited)	
		Cost	Value
Housecall Medical Resources, Inc. (Healthcare)	Loan Preferred Stock (3,890,344 shares) Common Stock (864,000 shares)	\$ 15,062 3,889 86	\$ 15,062 3,889 3,687
Jakel, Inc. (Industrial Products)	Loan Debt Securities Preferred Stock (6,460 shares) Common Stock (158,061 shares) Standby Letter of Credit (\$4,500)	500 7,500 6,460 9,347	500 7,500 3,467
Litterer Beteiligungs-GmbH <sup>(3)</sup> (Business Services)	Debt Securities Equity Interest	1,404 295	1,032
MVL Group, Inc. (Business Services)	Loan Debt Securities Common Stock (648,661 shares)	18,765 16,525 810	18,570 15,132
Powell Plant Farms, Inc. (Consumer Products)	Loan Debt Securities Preferred Stock (1,483 shares) Warrants	18,697 19,224	18,697 9,709
Redox Brands, Inc. (Consumer Products)	Loan Debt Securities Preferred Stock (2,404,086 shares) Warrants Guaranty (\$125)	3,031 10,039 6,965 584	3,031 10,039 6,965 584
Staffing Partners Holding Company, Inc. (Business Services)	Debt Securities Preferred Stock (414,600 shares) Common Stock (50,200 shares) Warrants	6,304 4,968 50 10	6,304 4,074
STS Operating, Inc. (Industrial Products)	Preferred Stock (5,769,424 shares) Common Stock (3,000,000 shares)	6,525 3,177	6,525 3,177
Sure-Tel, Inc. (Consumer Services)	Preferred Stock (1,000,000 shares) Common Stock (37,000 shares)	1,000 5,018	1,000 1,530
Total companies more than 25% owned		\$ 694,891	\$ 803,794
<b>Companies 5% to 25% Owned</b>			
Allied Office Products, Inc. (Business Services)	Common Stock (31,333 shares)	\$ 7,695	\$ 50
Aspen Pet Products, Inc. (Consumer Products)	Loans Preferred Stock (2,112 shares)	17,145 2,024	17,145 1,348

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Common Stock (1,400 shares) 140  
Warrants

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Autania AG <sup>(1,3)</sup> (Industrial Products)	Common Stock (250,000 shares)	2,169	2,900
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		June 30, 2003	
Private Finance Portfolio Company (in thousands, except number of shares)	Investment <sup>(2)</sup>	(unaudited)	
		Cost	Value
Blue Rhino Corporation <sup>(1)</sup> (Consumer Products)	Debt Securities Common Stock (1,070,179 shares)	\$ 5,094 5,076	\$ 5,094 12,842
Border Foods, Inc. (Consumer Products)	Debt Securities Preferred Stock (50,919 shares) Common Stock (1,810 shares) Warrants	9,421 2,000 45 665	9,421 2,000 45 665
CBA-Mezzanine Capital Finance, LLC (Financial Services)	Loan	8,337	8,337
CorrFlex Graphics, LLC (Business Services)	Debt Securities Warrants Options	12,318	12,318 19,332 1,669
The Debt Exchange Inc. (Business Services)	Preferred Stock (921,875 shares)	1,250	1,250
EDM Consulting, LLC (Business Services)	Debt Securities Equity Interests	1,802 250	236
International Fiber Corporation (Industrial Products)	Debt Securities Common Stock (1,029,069 shares) Warrants	22,715 5,483 550	22,715 6,816 684
Liberty-Pittsburgh Systems, Inc. (Business Services)	Debt Securities Common Stock (123,929 shares)	3,384 142	3,384
Logic Bay Corporation (Business Services)	Common Stock (1,437,420 shares)	5,000	
Magna Card, Inc. (Consumer Products)	Debt Securities Preferred Stock (1,875 shares) Common Stock (4,687 shares)	154 94	154 28
Master Plan, Inc. (Business Services)	Loan Common Stock (156 shares)	959 42	959
MortgageRamp, Inc. (Business Services)	Common Stock (772,000 shares)	3,860	2,084
Nobel Learning Communities, Inc. <sup>(1)</sup> (Education)	Debt Securities Preferred Stock (1,063,830 shares) Warrants	9,809 2,000 575	9,809 2,000 191
Packaging Advantage Corporation (Business Services)	Debt Securities Common Stock (232,168 shares) Warrants	14,290 2,386 963	14,290 2,386 963

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Professional Paint, Inc.	Debt Securities	23,507	23,507
(Consumer Products)	Preferred Stock (15,000 shares)	20,803	20,803
	Common Stock (110,000 shares)	69	5,995

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		June 30, 2003	
Private Finance Portfolio Company (in thousands, except number of shares)	Investment <sup>(2)</sup>	(unaudited)	
		Cost	Value
Progressive International Corporation (Consumer Products)	Debt Securities Preferred Stock (500 shares) Common Stock (197 shares) Warrants	\$ 3,973 500 13	\$ 3,973 500 150
Sidarus Holdings, Inc. (Business Services)	Debt Securities Preferred Stock (98,000 shares) Common Stock (492,941 shares) Warrants	4,976 980 20	4,976 980 20
Total Foam, Inc. (Industrial Products)	Debt Securities Common Stock (164 shares)	254 10	124
Total companies 5% to 25% owned		\$202,942	\$222,143
<b>Companies Less Than 5% Owned</b>			
ACE Products, Inc. (Industrial Products)	Loan	\$ 17,164	\$ 50
Advantage Sales and Marketing, Inc. (Business Services)	Debt Securities Warrants	10,625 382	10,625 1,556
Alderwoods Group, Inc. <sup>(1)</sup> (Consumer Services)	Common Stock (357,568 shares)	5,006	1,913
American Barbecue & Grill, Inc. (Retail)	Warrants	125	
ASW Holding Corporation (Industrial Products)	Warrants	25	
Aviation Technologies, Inc. (Industrial Products)	Loan	19,901	19,901
Bakery Chef, Inc. (Consumer Products)	Loans	18,838	18,838
Benchmark Medical, Inc. (Healthcare)	Debt Securities Warrants	13,414 18	13,414 18
Camden Partners Strategic Fund II, L.P. <sup>(4)</sup> (Private Equity Fund)	Limited Partnership Interest	3,247	3,095
Candlewood Hotel Company <sup>(1)</sup> (Hospitality)	Preferred Stock (3,250 shares)	3,250	635



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Clif Bar, Inc. (Consumer Products)	Loan	24,906	24,906
Colibri Holding Corporation (Consumer Products)	Debt Securities	3,495	3,495
	Preferred Stock (237 shares)	300	300
	Common Stock (3,362 shares)	1,250	1,088
	Warrants	290	252

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		June 30, 2003	
Private Finance Portfolio Company (in thousands, except number of shares)	Investment <sup>(2)</sup>	(unaudited)	
		Cost	Value
Component Hardware Group, Inc. (Industrial Products)	Debt Securities	\$11,544	\$11,544
	Preferred Stock (18,000 shares)	2,312	2,312
	Common Stock (2,000 shares)	200	700
Cooper Natural Resources, Inc. (Industrial Products)	Loan	299	299
	Debt Securities	1,955	1,955
	Preferred Stock (6,316 shares)	1,427	1,427
	Warrants	832	832
Coverall North America, Inc. (Business Services)	Loan	12,410	12,410
	Debt Securities	6,426	6,426
CTT Holdings (Consumer Products)	Loan	1,250	1,250
Drilltec Patents & Technologies Company, Inc. (Industrial Products)	Loan	10,918	
	Debt Securities	1,500	
eCentury Capital Partners, L.P. <sup>(4)</sup> (Private Equity Fund)	Limited Partnership Interest	3,125	735
Elexis Beta GmbH <sup>(3)</sup> (Industrial Products)	Options	426	289
Eparfin S.A. <sup>(3)</sup> (Consumer Products)	Loan	29	29
E-Talk Corporation (Business Services)	Debt Securities	8,852	
	Warrants	1,157	
Executive Greetings, Inc. (Business Services)	Debt Securities	18,830	50
	Warrants	360	
Fairchild Industrial Products Company (Industrial Products)	Debt Securities	5,954	5,426
	Warrants	280	
Frozen Specialties, Inc. (Consumer Products)	Debt Securities	10,050	10,050
	Warrants	435	435
Galaxy American Communications, LLC (Broadcasting & Cable)	Debt Securities	49,704	12,712
	Options		
	Standby Letter of Credit (\$37)		
Garden Ridge Corporation (Retail)	Debt Securities	27,271	25,000
	Preferred Stock (1,130 shares)	1,130	
	Common Stock (847,800 shares)	613	

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Gibson Guitar Corporation (Consumer Products)	Debt Securities Warrants	18,354 525	18,354 2,325
Ginsey Industries, Inc. (Consumer Products)	Loans Convertible Debentures Warrants	5,000 500	5,000 500 2,250

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		June 30, 2003	
Private Finance Portfolio Company (in thousands, except number of shares)	Investment <sup>(2)</sup>	(unaudited)	
		Cost	Value
Global Communications, LLC (Business Services)	Loan Debt Securities Preferred Equity Interest Options	\$ 2,348 16,711 14,067 1,639	\$ 2,348 16,711 14,193 3,551
Grant Broadcasting Systems II (Broadcasting & Cable)	Warrants	87	3,000
Grotech Partners, VI, L.P. <sup>(4)</sup> (Private Equity Fund)	Limited Partnership Interest	3,520	2,591
The Hartz Mountain Corporation (Consumer Products)	Debt Securities Common Stock (200,000 shares) Warrants	27,845 2,000 2,613	27,845 1,821 2,379
Haven Eldercare of New England, LLC (Healthcare)	Loan	35,903	35,903
Headwaters Incorporated <sup>(1)</sup> (Industrial Products)	Loan	9,958	9,958
Healthmarket, Inc. (Health Insurance)	Debt Securities Warrants	9,583 440	9,583 440
Hotelevision, Inc. (Broadcasting & Cable)	Common Stock (315,100 shares)	315	
Icon International, Inc. (Business Services)	Common Stock (25,707 shares)	1,219	1,740
Impact Innovations Group, LLC (Business Services)	Debt Securities Warrants	6,797 1,674	3,541
Insight Pharmaceuticals Corporation (Consumer Products)	Loan	9,952	9,952
Intellirisk Management Corporation (Business Services)	Loan	23,757	23,757
Interline Brands, Inc. (Business Services)	Preferred Stock (199,313 shares) Common Stock (15,615 shares) Warrants	1,849 139 1,181	1,849
JRI Industries, Inc. (Industrial Products)	Debt Securities Warrants	1,548 74	1,548 39
Julius Koch USA, Inc. (Industrial Products)	Warrants	259	4,750

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Kirker Enterprises, Inc. (Industrial Products)	Equity Interest Warrants	4 348	4 3,501
Kyrus Corporation (Business Services)	Debt Securities Warrants	6,431 348	6,431 450

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		June 30, 2003	
Private Finance Portfolio Company (in thousands, except number of shares)	Investment <sup>(2)</sup>	(unaudited)	
		Cost	Value
Love Funding Corporation (Financial Services)	Preferred Stock (26,000 shares)	\$ 359	\$ 359
Matrics, Inc. (Business Services)	Preferred Stock (511,876 shares) Warrants	500	938
MedAssets, Inc. (Business Services)	Debt Securities Preferred Stock (229,806 shares) Warrants	16,412 2,049 136	16,412 2,049 136
Mid-Atlantic Venture Fund IV, L.P. <sup>(4)</sup> (Private Equity Fund)	Limited Partnership Interest	4,725	2,674
Midview Associates, L.P. (Housing)	Warrants		
Mogas Energy, LLC (Natural Gas Pipelines)	Debt Securities Warrants	18,226 1,774	18,226 1,774
Norstan Apparel Shops, Inc. (Retail)	Debt Securities Common Stock (29,622 shares) Warrants	11,850 4,750 655	11,850 4,750 655
Northeast Broadcasting Group, L.P. (Broadcasting & Cable)	Debt Securities	235	235
Novak Biddle Venture Partners III, L.P. <sup>(4)</sup> (Private Equity Fund)	Limited Partnership Interest	870	694
Nursefinders, Inc. (Business Services)	Debt Securities Warrants	11,262 900	11,262 900
Oahu Waste Services, Inc. (Business Services)	Debt Securities Stock Appreciation Rights	8,178 239	8,178 239
Onyx Television GmbH <sup>(3)</sup> (Broadcasting & Cable)	Preferred Units	201	
Opinion Research Corporation <sup>(1)</sup> (Business Services)	Debt Securities Warrants	14,401 996	14,401 996
Oriental Trading Company, Inc. (Consumer Products)	Preferred Equity Interest Common Equity Interest	1,751	1,751 3,500
Pico Products, Inc. (Industrial Products)	Loan	1,406	1,406
Polaris Pool Systems, Inc.	Debt Securities	10,880	10,880

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(Consumer Products)	Warrants	1,145	1,145
Prosperco Finanz Holding AG <sup>(3)</sup> (Financial Services)	Convertible Debentures	7,738	5,000
	Common Stock (1,528 shares)	1,059	
	Warrants		

- (1) Public company.
- (2) Common stock, preferred stock, warrants, options, and equity interests are generally non-income producing and restricted.
- (3) Non-U.S. company.
- (4) Non-registered investment company.

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

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		June 30, 2003	
Private Finance Portfolio Company (in thousands, except number of shares)	Investment <sup>(2)</sup>	(unaudited)	
		Cost	Value
Resun Leasing, Inc. (Business Services)	Loan	\$30,000	\$30,000
Scitor Corporation (Business Services)	Loan	22,511	22,511
Simula, Inc. <sup>(1)</sup> (Industrial Products)	Loan	21,853	21,853
SmartMail, LLC (Business Services)	Loan Debt Securities Equity Interests Warrants	3,731 4,400 1,070 3	3,731 4,400 1,070 3
Soff-Cut Holdings, Inc. (Industrial Products)	Debt Securities Preferred Stock (300 shares) Common Stock (2,000 shares)	9,599 300 200	9,599 300 200
Southwest PCS, LLC (Telecommunications)	Loan	500	500
Spa Lending Corporation (Recreation)	Preferred Stock (28,672 shares)	424	306
Startec Global Communications Corporation <sup>(1)</sup> (Telecommunications)	Loan Debt Securities	25,715 20,670	25,715
SunStates Refrigerated Services, Inc. (Warehouse Facilities)	Loans Debt Securities	4,566 2,445	1,424
Sydran Food Services II, L.P. (Retail)	Debt Securities Equity Interests Warrants	12,973 3,747 162	6,646
Tubbs Snowshoe Company, LLC (Consumer Products)	Debt Securities Equity Interests Warrants	4,036 500 54	4,036 500 20
United Pet Group, Inc. (Consumer Products)	Debt Securities Warrants	9,125 85	9,125 350
United Site Services, Inc. (Business Services)	Loan	14,925	14,925
Udata Venture Partners II, L.P. <sup>(4)</sup> (Private Equity Fund)	Limited Partnership Interest	1,705	2,036



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U.S. Security Holdings, Inc. (Business Services)	Debt Securities Warrants	24,164 826	24,164 1,200
Venturehouse-Cibernet Investors, LLC (Business Services)	Equity Interest	34	34

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		June 30, 2003	
Private Finance Portfolio Company (in thousands, except number of shares)	Investment <sup>(2)</sup>	(unaudited)	
		Cost	Value
Venturehouse Group, LLC <sup>(4)</sup> (Private Equity Fund)	Equity Interest	\$ 1,000	\$ 236
Vertex Aerospace, LLC (Business Services)	Debt Securities Equity Interest	5,290	5,290 400
VICORP Restaurants, Inc. (Retail)	Debt Securities Warrants	23,849 33	23,849 33
Walker Investment Fund II, LLLP <sup>(4)</sup> (Private Equity Fund)	Limited Partnership Interest	1,246	518
Warn Industries, Inc. (Consumer Products)	Debt Securities Warrants	4,439 1,429	4,439 5,352
Weston Solutions, Inc. (Business Services)	Loan	12,189	12,189
Wilshire Restaurant Group, Inc. (Retail)	Debt Securities Warrants	16,691 735	16,691 855
Wilton Industries, Inc. (Consumer Products)	Loan	9,600	9,600
Woodstream Corporation (Consumer Products)	Debt Securities Common Stock (180 shares) Warrants	16,329 1,800 587	16,329 1,800 587
Total companies less than 5% owned		\$ 946,750	\$ 813,307
Total private finance (128 portfolio companies)		\$ 1,844,583	\$ 1,839,244

(1) Public company.

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(in Thousands)	Stated Interest	Face	June 30, 2003	
			Cost	(unaudited) Value
<b>Commercial Real Estate Finance</b>				
<b>Commercial Mortgage-Backed Securities</b>				
Mortgage Capital Funding, Series 1998-MC3	5.5%	\$ 47,103	\$ 25,867	\$ 25,543
Morgan Stanley Capital I, Series 1999-RM1	6.4%	29,629	9,685	9,999
COMM 1999-1	5.7%	57,163	26,336	27,489
Morgan Stanley Capital I, Series 1999-FNV1	6.1%	28,595	14,150	12,985
DLJ Commercial Mortgage Trust 1999-CG2	6.1%	44,635	13,913	14,446
Commercial Mortgage Acceptance Corp., Series 1999-C1	6.8%	18,346	5,146	5,911
LB Commercial Mortgage Trust, Series 1999-C2	6.7%	11,603	1,771	1,743
Chase Commercial Mortgage Securities Corp., Series 1999-2	6.5%	20,545	5,481	6,148
FUNB CMT, Series 1999-C4	6.5%	22,887	7,868	7,709
Heller Financial, HFCMC Series 2000 PH-1	6.6%	25,767	8,803	9,110
SBMS VII, Inc., Series 2000-NL1	7.2%	9,214	4,572	4,551
DLJ Commercial Mortgage Trust, Series 2000-CF1	7.0%	24,328	9,459	9,834
Deutsche Bank Alex. Brown, Series Comm 2000-C1	6.9%	17,922	5,127	3,975
LB-UBS Commercial Mortgage Trust, Series 2000-C4	6.9%	17,484	3,971	4,562
Credit Suisse First Boston Mortgage Securities Corp., Series 2001-CK1	5.9%	21,805	8,497	8,536
JP Morgan-CIBC-Deutsche 2001	5.8%	25,370	6,855	6,815
Lehman Brothers-UBS Warburg 2001-C2	6.4%	22,756	6,598	6,649
SBMS VII, Inc., Series 2001-C1	6.1%	23,049	5,648	4,988
GE Capital Commercial Mortgage Securities Corp., Series 2001-2	6.1%	21,228	6,355	5,985
Credit Suisse First Boston Mortgage Securities Corp., Series 2001-CKN5	5.2%	21,456	5,209	5,343
JP Morgan Chase Commercial Mortgage Securities Corp., Series 2001-C1	5.6%	24,493	5,855	5,575
SBMS VII, Inc., Series 2001-C2	6.2%	21,619	5,887	5,711
FUNB CMT, Series 2002-C1	6.0%	28,303	11,624	12,099
GE Capital Commercial Mortgage Corp., Series 2002-1	6.2%	50,631	24,998	30,182
GMAC Commercial Mortgage Securities, Inc., Series 2002-C2	5.8%	40,573	20,125	22,889
GE Capital Commercial Mortgage Corp., Series 2002-3	5.1%	50,047	22,604	24,218
Morgan Stanley Dean Witter Capital I Trust 2002-IQ3	6.0%	27,858	13,163	14,097
LB-UBS Commercial Mortgage Trust 2003-C1	4.6%	50,896	22,122	23,349
GS Mortgage Securities Corporation II Series 2003-C1	4.7%	39,543	19,148	19,570
J.P. Morgan Chase Commercial Mortgage Securities Corp., Series 2003-ML1	4.9%	15,946	12,315	12,738
Credit Suisse First Boston Mortgage Securities Corp., Series 2003-CK2	4.9%	69,680	37,674	39,150
GE Commercial Mortgage Corporation 2003-C1	5.1%	20,389	16,006	16,873
COMM 2003-LNB1	4.4%	36,803	14,668	14,865
Total commercial mortgage-backed securities		\$987,666	\$407,500	\$423,637

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(in Thousands)	June 30, 2003			
	Cost	Value		
<b>Collateralized Debt Obligations</b>				
Crest 2001-1, Ltd. <sup>(3)</sup>	\$ 23,126	\$ 23,126		
Crest 2002-1, Ltd. <sup>(3)</sup>	23,811	23,811		
Crest 2002-IG, Ltd. <sup>(3)</sup>	4,731	4,731		
Crest Clarendon Street 2002-1, Ltd. <sup>(3)</sup>	1,023	1,023		
Crest 2003-1, Ltd. <sup>(3)</sup>	114,139	114,684		
<b>Total collateralized debt obligations</b>	<b>\$ 166,830</b>	<b>\$ 167,375</b>		
	Interest Rate Ranges	Number of Loans	Cost	Value
<b>Commercial Mortgage Loans</b>				
	Up to 6.99%	11	\$ 10,655	\$ 11,485
	7.00% 8.99%	17	37,178	34,541
	9.00% 10.99%	9	43,972	43,901
	11.00% 12.99%	13	18,211	11,301
	13.00% 14.99%	4	4,824	3,275
	15.00% and above	1	876	876
<b>Total commercial mortgage loans</b>		<b>55</b>	<b>\$ 115,716</b>	<b>\$ 105,379</b>
<b>Real Estate Owned</b>			<b>12,841</b>	<b>10,505</b>
<b>Total commercial real estate finance</b>			<b>702,887</b>	<b>706,896</b>
<b>Total portfolio</b>			<b>\$ 2,547,470</b>	<b>\$ 2,546,140</b>

(1) Public company.

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

**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**(Information at and for the six months ended June 30, 2003 and 2002 is unaudited)**

**Note 1. Organization**

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

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

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

The investment objective of the Company is to achieve current income and capital gains. In order to achieve this objective, the Company invests in companies in a variety of industries, non-investment grade commercial mortgage-backed securities ( CMBS ) and collateralized debt obligation bonds and preferred shares ( CDOs ).

**Note 2. Summary of Significant Accounting Policies**

***Basis of Presentation***

The consolidated financial statements include the accounts of ACC and its subsidiaries. All intercompany accounts and transactions have been eliminated in consolidation. Certain reclassifications have been made to the 2002 balances to conform with the 2003 financial statement presentation.

The accompanying unaudited consolidated financial statements of the Company have been prepared in accordance with accounting principles generally accepted in the United States of America ( GAAP ) for interim financial information. Accordingly, they do not include all of the information and footnotes required by GAAP for complete consolidated financial statements. In the opinion of management, the unaudited consolidated financial results of the Company included herein contain all adjustments (consisting of only normal recurring accruals) necessary to present fairly the financial position of the Company as of June 30, 2003, and the results of operations for the three and six months ended June 30, 2003 and 2002, and changes in net assets and cash flows for the six months ended June 30, 2003 and 2002. The results of operations for the three and six months ended June 30, 2003, are not necessarily indicative of the operating results to be expected for the full year.

The private finance portfolio, the interest and related portfolio income and net realized gains (losses) earned on the private finance portfolio are presented in three categories: companies more than 25% owned, which represent portfolio companies where the Company directly or indirectly owns

**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**Note 2. Summary of Significant Accounting Policies, continued**

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

***Valuation Of Portfolio Investments***

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

***Loans and Debt Securities***

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

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

Interest income is recorded on an accrual basis to the extent that such amounts are expected to be collected. For loans and debt securities with contractual payment-in-kind interest, which represents

**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**Note 2. Summary of Significant Accounting Policies, continued**

contractual interest accrued and added to the loan balance that generally becomes due at maturity, the Company will not accrue payment-in-kind interest if the portfolio company valuation indicates that the payment-in-kind interest is not collectible. Interest on loans and debt securities is not accrued if the Company has doubt about interest collection. Loans in workout status classified as Grade 4 or 5 assets do not accrue interest. In addition, interest may not accrue on loans or debt securities to portfolio companies that are more than 50% owned by the Company if such companies are in need of additional working capital. Loan origination fees, original issue discount, and market discount are capitalized and then amortized into interest income using the effective interest method. Prepayment premiums are recorded on loans when received.

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.

***Equity Securities***

The Company's 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 or other liquidation events. The determined fair values are generally discounted to account for restrictions on resale and minority ownership positions.

The value of the Company's 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 preferred equity securities on an accrual basis to the extent that such amounts are expected to be collected, and on common equity securities on the record date for private companies or on the ex-dividend date for publicly traded companies.

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

CMBS bonds and CDO bonds and preferred shares are carried at fair value, which is based on a discounted cash flow model that utilizes prepayment and loss assumptions based on historical experience and projected performance, economic factors, the characteristics of the underlying cash flow, and comparable market yields for similar CMBS bonds and CDO bonds and preferred shares. The Company recognizes income from the amortization of original issue discount using the effective interest method, using the anticipated yield over the projected life of the investment. Yields are revised when there are changes in 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 and CDO bonds and preferred shares from the date the estimated yield is changed. The Company recognizes unrealized appreciation or depreciation on its CMBS bonds and CDO bonds and preferred shares as comparable yields in the



ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

**Note 2. Summary of Significant Accounting Policies, continued**

market change and based on changes in estimated cash flows resulting from changes in prepayment or loss assumptions in the underlying collateral pool.

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

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

***Fee Income***

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

***Deferred Financing Costs***

Financing costs are based on actual costs incurred in obtaining debt financing and are deferred and amortized as part of interest expense over the term of the related debt instrument.

***Cash and Cash Equivalents***

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

***Guarantees***

The Company accounts for guarantees under FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others* (the Interpretation). In accordance with the Interpretation, guarantees meeting the characteristics described in the Interpretation, and issued or modified after December 31, 2002, are recognized at fair value. However, certain guarantees are excluded from the initial recognition provisions of the Interpretation. See Note 5 for disclosures related to the Company's guarantees.

***Dividends to Shareholders***

Dividends to shareholders are recorded on the record date.

***Stock Compensation Plans***

At June 30, 2003 and 2002, the Company had a stock-based employee compensation plan. The Company accounts for this plan under the recognition and measurement principles of APB Opinion No. 25, *Accounting for Stock Issued to Employees*, and related Interpretations. No stock-based employee compensation cost is reflected in net increase in net assets resulting from operations, as all



## ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

## Note 2. Summary of Significant Accounting Policies, continued

options granted under this plan had an exercise price equal to the market value of the underlying common stock on the date of grant. The following table illustrates the effect on net increase in net assets resulting from operations and earnings per share if the Company had applied the fair value recognition provisions of FASB Statement No. 123, *Accounting for Stock-Based Compensation*, to stock-based employee compensation.

	For the Six Months Ended June 30,	
	2003	2002
(in thousands, except per share amounts)		
Net increase in net assets resulting from operations as reported	\$79,813	\$129,415
Less total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	(8,078)	(3,632)
Pro forma net increase in net assets resulting from operations	71,735	125,783
Less preferred stock dividends	(110)	(110)
Pro forma income available to common shareholders	\$71,625	\$125,673
Basic earnings per common share:		
As reported	\$ 0.71	\$ 1.28
Pro forma	\$ 0.64	\$ 1.25
Diluted earnings per common share:		
As reported	\$ 0.71	\$ 1.26
Pro forma	\$ 0.64	\$ 1.22

Pro forma expenses are based on the underlying value of the options granted by the Company. The fair value of each option grant is estimated on the date of grant using the Black-Scholes option pricing model, with the following weighted average assumptions for options granted during the six months ended June 30, 2003 and 2002:

	For the Six Months Ended June 30,	
	2003	2002
Risk-free interest rate	2.6%	4.5%
Expected life	5.0	5.0
Expected volatility	38.8%	39.7%
Dividend yield	8.9%	8.5%
Weighted average fair value per option	\$3.31	\$4.82

*Federal and State Income Taxes*

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The Company intends to comply with the requirements of the Internal Revenue Code ( Code ) that are applicable to regulated investment companies ( RIC ) and real estate investment trusts ( REIT ). The Company and its subsidiaries that qualify as a RIC or a REIT intend to annually distribute or retain through a deemed distribution all of their taxable income to shareholders; therefore, the Company has made no provision for income taxes for these entities. AC Corp is a corporation subject to federal and state income taxes and records a benefit or expense for income taxes as appropriate.

## ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

**Note 2. Summary of Significant Accounting Policies, continued*****Per Share Information***

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

***Use of Estimates in the Preparation of Financial Statements***

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

The consolidated financial statements include portfolio investments at value of \$2.5 billion as of June 30, 2003, and December 31, 2002. At June 30, 2003, and December 31, 2002, 89% and 88%, respectively, of our total assets represented investments whose fair values have been determined by the board of directors in good faith in the absence of readily available market values. Because of the inherent uncertainty of valuation, the board of directors determined values may differ significantly from the values that would have been used had a ready market existed for the investments, and the differences could be material.

***New Accounting Pronouncements***

In May 2003, the FASB issued Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity* which provides guidance on how an entity classifies and measures certain financial instruments with characteristics of both liabilities and equity. This statement is effective for financial instruments entered into or modified after May 31, 2003, and otherwise is effective at the beginning of the first interim period beginning after June 15, 2003. The statement requires cumulative effect transition for financial instruments existing at adoption date. The Company does not expect the adoption of this statement to have a significant effect on the Company's financial position or its results of operations.

**Note 3. Portfolio*****Private Finance***

At June 30, 2003, and December 31, 2002, the private finance portfolio consisted of the following:

	2003			2002		
	Cost	Value	Yield	Cost	Value	Yield
(\$ in thousands)						
Loans and debt securities	\$ 1,351,947	\$ 1,192,452	14.4% <sup>(1)</sup>	\$ 1,272,401	\$ 1,151,256	14.4% <sup>(1)</sup>
Equity interests	492,636	646,792		438,501	591,959	
Total	\$ 1,844,583	\$ 1,839,244		\$ 1,710,902	\$ 1,743,215	

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- (1) The weighted average yield on loans and debt securities is computed as the (a) annual stated interest rate earned plus the annual amortization of loan origination fees, original issue discount, and market discount earned on accruing loans and debt securities, divided by (b) total loans and debt securities at value. At June 30, 2003, the cost and value of loans and debt securities include the Class A equity interests in BLX and the yield includes dividends earned on these equity interests. The weighted average yield is computed as of the balance sheet date.

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

**Note 3. Portfolio, continued**

Private finance investment activity principally involves providing financing through privately negotiated long-term debt and equity investments. Private finance investments are generally structured as loans and debt securities that carry a relatively high fixed rate of interest, which may be combined with equity features, such as conversion privileges, or warrants or options to purchase a portion of the portfolio company's equity at a pre-determined strike price, which is generally a nominal price for warrants or options in a private company. Private finance investments are generally issued by privately owned companies and are generally illiquid and subject to restrictions on resale or transferability.

Loans and debt securities generally have a maturity of five to ten years, with interest-only payments in the early years and payments of both principal and interest in the later years, although debt maturities and principal amortization schedules vary. At June 30, 2003, and December 31, 2002, approximately 96% and 95%, respectively, of the Company's loans and debt securities had fixed interest rates.

Equity interests consist primarily of securities issued by privately owned companies and may be subject to restrictions on their resale or may be otherwise illiquid. Equity securities generally do not produce a current return, but are held in anticipation of investment appreciation and ultimate realized gain on sale.

The Company may acquire more than 50% of the common stock of a portfolio company in a control buyout transaction. The Company's most significant investments acquired through control buyout transactions both at June 30, 2003, and December 31, 2002, were Business Loan Express, LLC and The Hillman Companies, Inc.

At June 30, 2003, and December 31, 2002, the Company had an investment at value totaling \$356.8 million and \$256.8 million, respectively, in Business Loan Express, LLC (BLX), a small business lender that participates in the U.S. Small Business Administration's 7(a) Guaranteed Loan Program. During the first quarter of 2003, the Company invested \$50 million in BLX in the form of a \$25 million short-term line of credit and \$25 million of preferred equity in connection with BLX's acquisition of \$128 million in assets from Amresco Independence Funding, Inc. BLX also completed its corporate reorganization to a limited liability company during the first quarter by merging BLX, Inc. into BLX, LLC. Prior to this transaction, BLX converted \$43 million of the Company's subordinated debt to preferred stock in BLX, Inc., which was exchanged upon the merger for Class A equity interests of BLX, LLC. In addition, as part of the merger, the Company exchanged its existing preferred stock and common equity investments in BLX, Inc. for similar classes of members' equity in BLX, LLC represented by Class B and Class C equity interests, respectively. At June 30, 2003, the Company owned 94.9% of the voting Class C equity interests. BLX has an equity appreciation rights plan for management which will dilute the value available to the Class C equity interest holders.

At the time of the corporate reorganization of BLX, Inc. from a C corporation to a limited liability company, for tax purposes BLX had a built-in gain representing the aggregate fair market value of its assets in excess of the tax basis of its assets. As a regulated investment company, the Company will be subject to the built-in gain rules on the assets of BLX. Under these rules, taxes will be payable by the Company at the time and to the extent that the built-in gains on BLX's assets at the date of reorganization are recognized in a taxable disposition of such assets in the 10-year period following the date of the reorganization. At such time, the built-in gains realized upon the disposition

**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**Note 3. Portfolio, continued**

of these assets will be included in the Company's taxable income, net of the corporate level taxes paid by the Company on the built-in gains. However, if these assets are disposed of after the 10-year period, there will be no corporate level taxes on these built-in gains.

While the Company has no obligation to pay the built-in gains tax until these assets are disposed of in the future, it may be necessary to record a liability for these taxes in the future should the Company intend to sell the assets of BLX within the 10-year period. The Company estimates its future tax liability resulting from the built-in gains at the date of BLX's reorganization may total up to \$42 million. At June 30, 2003, the Company has considered the increase in fair value of its investment in BLX due to BLX's tax attributes as an LLC and has also considered the corresponding reduction in fair value of its investment due to these estimated built-in gain taxes in determining the fair value of its investment in BLX.

As the controlling equity owner of BLX, the Company has provided an unconditional guaranty to the BLX credit facility lenders in an amount up to 50% of the total obligations (consisting of principal, accrued interest, and other fees) on BLX's three-year unsecured \$164.0 million revolving credit facility that matures in March 2004. The amount guaranteed by the Company at June 30, 2003, was \$53.6 million. This guaranty can be called by the lenders only in the event of a default by BLX. BLX was in compliance with the terms of its credit facility at June 30, 2003. The Company has also provided three standby letters of credit in connection with three term securitization transactions completed by BLX totaling \$25.6 million. In consideration for providing this guaranty and the three standby letters of credit, BLX paid the Company fees of \$1.9 million and \$1.6 million for the six months ended June 30, 2003 and 2002, respectively. BLX is headquartered in New York, NY.

At June 30, 2003, and December 31, 2002, the Company had an investment in The Hillman Companies, Inc. ( Hillman ) totaling \$181.8 million and \$180.5 million at value, respectively. At June 30, 2003, the Company owned 96.8% of Hillman's common stock. The Company's common stock ownership is subject to dilution by management options. 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.

Total interest and portfolio related income earned from the Company's investments in BLX and Hillman for the six months ended June 30, 2003 and 2002, was \$27.5 million and \$24.5 million, respectively.



## ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

**Note 3. Portfolio, continued**

At June 30, 2003, and December 31, 2002, loans and debt securities in workout status (classified as Grades 4 and 5 under the Company's internal grading system) that were not accruing interest were as follows at value:

(in thousands)	2003	2002
Companies more than 25% owned	\$23,828	\$ 9,709
Companies 5% to 25% owned	360	411
Companies less than 5% owned	33,801	65,931
	<u>          </u>	<u>          </u>
Total	\$57,989	\$76,051
	<u>          </u>	<u>          </u>

In addition to Grade 4 and 5 assets that are in workout, the Company may not accrue interest on loans and debt securities to companies that are more than 50% owned by the Company if such companies are in need of additional working capital and, therefore, the Company may defer current debt service. Loans and debt securities to such companies totaled \$72.2 million and \$63.6 million at value at June 30, 2003, and December 31, 2002, respectively. In addition, loans to companies that are less than 50% owned by the Company and were not in workout but were not accruing interest totaled \$1.0 million and \$7.2 million at value at June 30, 2003, and December 31, 2002, respectively.

The industry and geographic compositions of the private finance portfolio at value at June 30, 2003, and December 31, 2002, were as follows:

	2003	2002
<b>Industry</b>		
Consumer products	30%	34%
Business services	24	26
Financial services	20	16
Industrial products	8	9
Healthcare	6	5
Retail	5	4
Telecommunications	2	2
Education	1	1
Broadcasting & cable	1	1
Other	3	2
	<u>          </u>	<u>          </u>
Total	100%	100%
	<u>          </u>	<u>          </u>

## ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

## Note 3. Portfolio, continued

	2003	2002
<b>Geographic Region</b>		
Mid-Atlantic	51%	45%
West	17	15
Southeast	14	16
Midwest	11	16
Northeast	6	7
International	1	1
	—	—
Total	100%	100%

*Commercial Real Estate Finance*

At June 30, 2003, and December 31, 2002, the commercial real estate finance portfolio consisted of the following:

	2003			2002		
	Cost	Value	Yield <sup>(1)</sup>	Cost	Value	Yield <sup>(1)</sup>
<b>(\$ in thousands)</b>						
CMBS bonds	\$407,500	\$423,637	13.9%	\$523,671	\$555,519	14.2%
Collateralized debt obligation bonds and preferred shares	166,830	167,375	16.6%	52,818	52,818	17.2%
Loans	115,716	105,379	7.8%	66,546	63,707	7.5%
Residual interest				69,335	69,035	9.4%
Real estate owned	12,841	10,505		5,942	3,873	
	—	—		—	—	
Total	\$702,887	\$706,896		\$718,312	\$744,952	

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

**CMBS Bonds.** At June 30, 2003, and December 31, 2002, CMBS bonds consisted of the following:

	2003	2002
<b>(\$ in thousands)</b>		
Face	\$ 987,666	\$1,173,194
Original issue discount	(580,166)	(649,523)
	—	—
Cost	\$ 407,500	\$ 523,671

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Value

\$ 423,637

\$ 555,519

The non-investment grade and unrated tranches of the CMBS bonds in which the Company invests 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

## ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

**Note 3. Portfolio, continued**

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 or the properties securing those mortgages resulting in reduced cash flows, the most subordinate tranche will bear this loss first. At June 30, 2003, the Company's CMBS bonds were subordinate to 91% to 99% of the tranches of bonds issued in various CMBS transactions. Given that the non-investment grade CMBS bonds in which the Company invests are junior in priority for payment of principal and interest, the Company invests in these CMBS bonds at a significant discount from the face amount of the bonds.

The underlying rating classes of the CMBS bonds at value at June 30, 2003, and December 31, 2002, were as follows:

(\$ in thousands)	2003		2002	
	Value	Percentage of Total	Value	Percentage of Total
BB+	\$ 68,699	16.2%	\$ 49,811	9.0%
BB	51,011	12.0	39,011	7.0
BB-	28,015	6.6	22,030	4.0
B+	35,915	8.5	121,038	21.8
B	31,476	7.4	141,998	25.6
B-	79,245	18.7	83,493	15.0
CCC+	12,778	3.0		
CCC	18,398	4.4	8,634	1.5
Unrated	98,100	23.2	89,504	16.1
Total	\$423,637	100.0%	\$555,519	100.0%

At June 30, 2003, and December 31, 2002, the underlying collateral for the Company's CMBS bonds consisted of approximately 5,100 and 4,500 commercial mortgage loans and real estate properties owned with a total outstanding principal balance of \$32.0 billion and \$25.0 billion, respectively. At June 30, 2003, and December 31, 2002, 1.2% and 1.0%, respectively, of the mortgage loans in the underlying collateral pool for the Company's CMBS bonds were over 30 days delinquent or were classified as real estate owned.

## ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

## Note 3. Portfolio, continued

The property types and the geographic composition of the underlying mortgage loans and real estate properties owned in the underlying collateral pool calculated using the outstanding principal balance at June 30, 2003, and December 31, 2002, were as follows:

	2003	2002
	_____	_____
<b>Property Type</b>		
Retail	34%	32%
Housing	25	27
Office	23	21
Industrial Real Estate	6	7
Hospitality	5	6
Other	7	7
	_____	_____
Total	100%	100%
	_____	_____
<b>Geographic Region</b>		
West	31%	31%
Mid-Atlantic	27	25
Midwest	22	22
Southeast	16	17
Northeast	4	5
	_____	_____
Total	100%	100%
	_____	_____

The Company's yield on its CMBS bonds is based upon a number of assumptions that are subject to certain business and economic uncertainties and contingencies. Examples include the timing and magnitude of credit losses on the mortgage loans underlying the CMBS bonds that are a result of the general condition of the real estate market (including vacancies, rental rates and tenant credit quality) and changes in market rental rates. The initial yield on each CMBS bond has been computed assuming an approximate 1% loss rate on its entire underlying collateral mortgage pool, with the estimated losses being assumed to occur in three equal installments in years three, six, and nine. As each CMBS bond ages, the amount of losses and the expected timing of recognition of such losses will be updated, and the respective yield will be adjusted as necessary. As these uncertainties and contingencies are difficult to predict and are subject to future events which may alter these assumptions, no assurance can be given that the anticipated yields to maturity will be achieved.

**Collateralized Debt Obligation Bonds and Preferred Shares ( CDOs ).** At June 30, 2003, the Company owned BBB rated bonds in one CDO totaling \$24.3 million at value and preferred shares in five CDOs totaling \$143.1 million at value secured by investment grade unsecured debt issued by various real estate investment trusts ( REITs ) and investment and non-investment grade CMBS bonds. The investment grade REIT collateral consists of debt with a cut-off balance of \$1.2 billion and was issued by 39 REITs. The investment grade CMBS collateral consists of CMBS bonds with a face amount of \$496.0 million issued in 41 separate CMBS transactions and the non-investment grade CMBS collateral consists of BB+, BB, BB-, B+, and B rated CMBS bonds with a face amount of \$873.7 million issued in 42 separate CMBS transactions ( CMBS Collateral ). Included in the CMBS Collateral for the CDOs are \$793.7 million of CMBS bonds that are senior in priority of repayment to certain lower rated CMBS bonds held by the Company, which were issued in 27 separate CMBS transactions.

## ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

**Note 3. Portfolio, continued**

The BBB rated bonds and the preferred shares owned by the Company are junior in priority for payment of principal and interest 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 and then the BBB rated bonds would bear any loss after the preferred shares. At June 30, 2003, the Company's BBB bonds and preferred shares in the CDOs were subordinate to 61% to 98% of the more senior tranches of debt issued in various CDO transactions.

As of June 30, 2003, the Company acted as the disposition consultant with respect to four of the CDOs, which allows the Company to approve disposition plans for individual collateral securities. As of June 30, 2002, the Company acted as the disposition consultant with respect to two of the CDOs. For these services, the Company collects annual fees based on the outstanding collateral pool balance, and for the six months ended June 30, 2003 and 2002, these fees totaled \$515 thousand and \$160 thousand, respectively.

**Loans.** The commercial mortgage loan portfolio contains loans that were originated by the Company or were purchased from third-party sellers. At June 30, 2003, approximately 92% and 8% of the Company's commercial mortgage loan portfolio was composed of fixed and adjustable interest rate loans, respectively. As of December 31, 2002, approximately 84% and 16% of the Company's commercial mortgage loan portfolio was composed of fixed and adjustable interest rate loans, respectively. As of June 30, 2003, and December 31, 2002, loans with a value of \$19.9 million and \$13.0 million, respectively, were not accruing interest. Loans greater than 120 days delinquent generally do not accrue interest.

The property types and the geographic composition securing the commercial mortgage loan portfolio at value at June 30, 2003, and December 31, 2002, were as follows:

	<u>2003</u>	<u>2002</u>
<b>Property Type</b>		
Hospitality	31%	23%
Office	29	20
Retail	22	21
Healthcare	8	15
Recreation	2	3
Other	8	18
	<u>        </u>	<u>        </u>
Total	100%	100%
	<u>        </u>	<u>        </u>
<b>Geographic Region</b>		
Southeast	34%	40%
Midwest	24	12
West	19	20
Mid-Atlantic	17	17
Northeast	6	11
	<u>        </u>	<u>        </u>
Total	100%	100%
	<u>        </u>	<u>        </u>

## ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

## Note 3. Portfolio, continued

**Residual Interest.** At June 30, 2003, and December 31, 2002, the residual interest consisted of the following:

	2003		2002	
	Cost	Value	Cost	Value
(in thousands)				
Residual interest	\$	\$	\$68,853	\$68,853
Residual interest spread			482	182
Total	\$	\$	\$69,335	\$69,035

The residual interest primarily consisted of a retained interest from a 1998 asset securitization. At March 31, 2003, one class of bonds rated AAA was outstanding, totaling \$6.0 million. During April 2003, the call provision was exercised and, accordingly, the bondholders were repaid in full and the remaining available cash, loans, and real estate owned of the trust were subsequently returned to the Company as payment on the residual interest.

At December 31, 2002, the Company used a discounted cash flow methodology for determining the fair value of its retained residual interest and residual interest spread (Residual). In determining the cash flow of the Residual, the Company assumed a prepayment speed of 15% after the applicable prepayment lockout period and credit losses of 1% or approximately \$0.8 million of the total principal balance of the underlying collateral throughout the life of the collateral. These assumptions resulted in an expected weighted average life of the bonds of four months. The value of the resulting Residual cash flows at December 31, 2002, was then determined by applying a discount rate of 9% which, in the Company's view, was commensurate with the market risk of comparable assets.

## Note 4. Debt

At June 30, 2003, and December 31, 2002, the Company had the following debt:

	2003			2002		
	Facility Amount	Amount Drawn	Annual Interest Cost <sup>(1)</sup>	Facility Amount	Amount Drawn	Annual Interest Cost <sup>(1)</sup>
(in thousands)						
Notes payable and debentures:						
Unsecured long-term notes payable	\$ 854,000	\$854,000	7.2%	\$ 694,000	\$694,000	7.7%
SBA debentures	101,800	94,500	8.1%	101,800	94,500	8.2%
OPIC loan	5,700	5,700	6.6%	5,700	5,700	6.6%
Total notes payable and debentures	961,500	954,200	7.3%	801,500	794,200	7.8%
Revolving line of credit	462,500	25,500	11.7% <sup>(2)</sup>	527,500	204,250	3.7% <sup>(2)</sup>
Total	\$1,424,000	\$979,700	7.4%	\$1,329,000	\$998,450	6.9%

- 
- (1) The weighted average annual interest cost is computed as the (a) annual stated interest rate on the debt plus the annual amortization of commitment fees and other facility fees that are recognized into interest expense over the contractual life of the respective borrowings, divided by (b) debt outstanding.
- (2) The current interest rate payable on the revolving line of credit was 2.6% and 2.7% at June 30, 2003, and December 31, 2002, respectively, which excludes the annual cost of commitment fees and other facility fees of \$2.3 million and \$2.0 million, respectively.



## ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

## Note 4. Debt, continued

*Notes Payable and Debentures*

**Unsecured Long-Term Notes Payable.** The Company has issued unsecured long-term notes to private institutional investors. The notes require semi-annual interest payments until maturity and have original terms of five or seven years. At June 30, 2003, the notes had remaining maturities of one year to seven years. The notes may be prepaid in whole or in part, together with an interest premium, as stipulated in the note agreement.

On May 14, 2003, the Company issued \$153 million of five-year and \$147 million of seven-year unsecured long-term notes, primarily to insurance companies. The five- and seven-year notes have fixed interest rates of 5.45% and 6.05%, respectively, and have substantially the same terms as the Company's existing unsecured long-term notes. On May 30, 2003, \$140 million of the Company's existing unsecured long-term notes matured and the Company used the proceeds from the new long-term note issuance to repay this amount.

**SBA Debentures.** At June 30, 2003, and December 31, 2002, the Company had debentures payable to the SBA with original terms of ten years and at fixed interest rates ranging from 5.9% to 8.2%. At June 30, 2003, the debentures had remaining maturities of one to nine years. The debentures require semi-annual interest-only payments with all principal due upon maturity. The SBA debentures are subject to prepayment penalties if paid prior to the fifth anniversary date of the notes. At June 30, 2003, the Company had a commitment from the SBA to borrow up to an additional \$7.3 million above the current amount outstanding. The commitment expires on September 30, 2005.

Scheduled future maturities of notes payable and debentures at June 30, 2003, were as follows:

Year	Amount Maturing (in thousands)
2003	\$
2004	221,000
2005	179,000
2006	180,700
2007	
Thereafter	373,500
	<hr/>
Total	\$954,200
	<hr/>

**Revolving Line of Credit**

On April 18, 2003, the Company renewed its unsecured revolving line of credit. The committed amount under the renewed facility is \$462.5 million and may be expanded through new or additional commitments up to \$600 million at the Company's option. The renewed line of credit expires in April 2005 and may be extended under substantially similar terms for one additional year at the Company's option. The facility bears interest at a rate equal to (i) the one-month LIBOR plus 1.25%, (ii) the Bank of America, N.A. prime rate, or (iii) the Federal Funds rate plus 0.50% at the Company's option. The interest rate adjusts at the beginning of each new interest period, usually every 30 days. The interest rates were 2.6% and 2.7% at June 30, 2003, and December 31, 2002, respectively, and the facility requires an annual commitment fee equal to 0.25% of the committed amount. The annual cost of commitment fees and other facility fees is \$2.3 million. The line of credit generally requires monthly payments of interest, and all principal is due upon maturity.

## ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

**Note 4. Debt, continued**

The average debt outstanding on the revolving line of credit was \$78.0 million and \$68.3 million for the six months ended June 30, 2003, and the year ended December 31, 2002, respectively. The maximum amount borrowed under this facility and the weighted average interest rate for the six months ended June 30, 2003, and the year ended December 31, 2002, were \$208.8 million and \$216.5 million, and 2.7% and 3.2%, respectively. As of June 30, 2003, the amount available under the revolving line of credit was \$399.9 million, net of amounts committed for standby letters of credit of \$37.1 million issued under the credit facility.

The Company has various financial and operating covenants required by the revolving line of credit and the notes payable and debentures. These covenants require the Company to maintain certain financial ratios, including debt to equity and interest coverage, and a minimum net worth. The Company's credit facilities limit its ability to declare dividends if the Company defaults under certain provisions. As of June 30, 2003, the Company was in compliance with these covenants.

**Note 5. Guarantees**

In the ordinary course of business, the Company has issued guarantees and has extended standby letters of credit through financial intermediaries on behalf of certain portfolio companies. As of June 30, 2003, and December 31, 2002, the Company had issued guarantees of debt, rental obligations, lease obligations and severance obligations aggregating \$58.9 million and \$54.6 million, respectively, and had extended standby letters of credit aggregating \$37.1 million and \$11.3 million, respectively. Under these arrangements, the Company would be required to make payments to third-party beneficiaries if the portfolio companies were to default on their related payment obligations. The maximum amount of future payments was \$96.0 million and \$65.9 million at June 30, 2003, and December 31, 2002, respectively. At June 30, 2003, and December 31, 2002, no amounts had been recorded as a liability for the Company's guarantees or standby letters of credit.

As of June 30, 2003, the guarantees and standby letters of credit expire as follows:

(in thousands)	Total	2003	2004	2005	2006	2007	After 2007
Guarantees	\$58,904	\$351	\$54,302	\$395	\$142	\$114	\$3,600
Standby letters of credit	37,093	37	—	4,500	32,556	—	—
Total	\$95,997	\$388	\$54,302	\$4,895	\$32,698	\$114	\$3,600

**Note 6. Preferred Stock**

Allied Investment has outstanding a total of 60,000 shares of \$100 par value, 3% cumulative preferred stock and 10,000 shares of \$100 par value, 4% redeemable cumulative preferred stock issued to the SBA pursuant to Section 303(c) of the Small Business Investment Act of 1958, as amended. The 3% cumulative preferred stock does not have a required redemption date. Allied Investment has the option to redeem in whole or in part the preferred stock by paying the SBA the par value of such securities and any dividends accumulated and unpaid to the date of redemption. The 4% redeemable cumulative preferred stock has a required redemption date in June 2005.

## ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

## Note 7. Shareholders Equity

Sales of common stock for the six months ended June 30, 2003 and 2002, were as follows:

	For the Six Months Ended June 30,	
	2003	2002
(in thousands)		
Number of common shares	7,050	1,946
Gross proceeds	\$ 152,632	\$ 51,800
Less costs including underwriting fees	(7,506)	(1,880)
Net proceeds	\$ 145,126	\$ 49,920

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

Dividend reinvestment plan activity for the six months ended June 30, 2003 and 2002, was as follows:

	For the Six Months Ended June 30,	
	2003	2002
(in thousands, except per share amounts)		
Shares issued	154	128
Average price per share	\$ 21.50	\$ 24.34

## Note 8. Earnings Per Common Share

Earnings per common share for the three and six months ended June 30, 2003 and 2002, were as follows:

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2003	2002	2003	2002
(in thousands, except per share amounts)				
Net increase in net assets resulting from operations	\$ 59,940	\$ 73,454	\$ 79,813	\$ 129,415
Less preferred stock dividends	(55)	(55)	(110)	(110)
Income available to common shareholders	\$ 59,885	\$ 73,399	\$ 79,703	\$ 129,305
Weighted average common shares outstanding basic	113,539	101,660	111,510	100,822

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Dilutive options outstanding to officers	1,013	1,780	781	2,078
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
Weighted average common shares outstanding diluted	114,552	103,440	112,291	102,900
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
Basic earnings per common share	\$ 0.53	\$ 0.72	\$ 0.71	\$ 1.28
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
Diluted earnings per common share	\$ 0.52	\$ 0.71	\$ 0.71	\$ 1.26
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>

**Note 9. Dividends and Distributions**

The Company's Board of Directors declared and the Company paid dividends of \$0.57 per common share for each of the first and second quarters of 2003. The dividends totaled \$64.5 million

## ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

**Note 9. Dividends and Distributions, continued**

and \$127.5 million for the three and six months ended June 30, 2003, respectively. The Company paid dividends to common shareholders of \$56.2 million and \$109.5 million for the three and six months ended June 30, 2002, respectively.

The Company's Board of Directors also declared a dividend of \$0.57 per common share for the third quarter of 2003.

**Note 10. Supplemental Disclosure of Cash Flow Information**

For the six months ended June 30, 2003 and 2002, the Company paid \$35.2 million and \$34.1 million, respectively, for interest. For the six months ended June 30, 2003, the Company's non-cash financing activities totaled \$3.3 million related to dividend reinvestment. For the six months ended June 30, 2002, the Company's non-cash financing activities totaled \$5.5 million related to stock option exercises and dividend reinvestment.

Non-cash operating activities for the six months ended June 30, 2003, included transfers of commercial mortgage loans and real estate owned in the repayment of the Company's Residual Interest totaling \$69.3 million, real estate owned received in connection with foreclosure on commercial mortgage loans of \$2.2 million, and receipt of commercial mortgage loans in satisfaction of private finance loans and debt securities of \$9.9 million. Non-cash operating activities for the six months ended June 30, 2002, included real estate owned received in connection with foreclosure on commercial mortgage loans of \$2.5 million.

**Note 11. Hedging Activities**

The Company invests in CMBS bonds, which are purchased at prices that are based in part on comparable Treasury rates. The Company has entered into transactions with one or more financial institutions to hedge against movement in Treasury rates on certain of the BB+ through B rated CMBS bonds and CDO bonds. These transactions, referred to as short sales, involved the Company receiving the proceeds from the short sales of borrowed Treasury securities, with the obligation to replenish the borrowed Treasury securities at a later date based on the then current market price. Borrowed Treasury securities and the related obligations to replenish the borrowed Treasury securities at value, including accrued interest payable on the obligations, as of June 30, 2003, and December 31, 2002, consisted of the following:

(in thousands) Description of Issue	2003	2002
10-year Treasury securities, due February 2012	\$	\$ 52,053
10-year Treasury securities, due November 2012	45,064	107,327
10-year Treasury securities, due February 2013	85,800	
10-year Treasury securities, due May 2013	8,671	
5-year Treasury securities, due November 2007	9,959	37,647
5-year Treasury securities, due February 2008	7,492	
	_____	_____
Total	\$ 156,986	\$ 197,027
	_____	_____

As of June 30, 2003, and December 31, 2002, the total obligations to replenish borrowed Treasury securities had increased since the related original sale dates due to changes in the yield on the borrowed Treasury securities, resulting in unrealized depreciation on the obligations of \$3.9 million and \$7.1 million, respectively. The net proceeds related to the sales of the borrowed Treasury securities were \$152.2 million and \$189.3 million at June 30, 2003, and December 31, 2002,

## ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

**Note 11. Hedging Activities, continued**

respectively. Under the terms of the transactions, the Company has provided additional cash collateral of \$5.1 million and \$5.4 million at June 30, 2003, and December 31, 2002, respectively, for the difference between the net proceeds related to the sales of the borrowed Treasury securities and the obligations to replenish the securities. The Company has deposited the proceeds related to the sales of the borrowed Treasury securities and the additional cash collateral with the financial institutions under repurchase agreements. The repurchase agreements are collateralized by U.S. Treasury securities and are settled weekly. As of June 30, 2003, the repurchase agreements were due on July 9, 2003, and had a weighted average interest rate of 0.6%. The weighted average interest rate on the repurchase agreements as of December 31, 2002, was 0.8%.

**Note 12. Financial Highlights**

	At and for the Six Months Ended June 30,		At and for the Year Ended December 31,
	2003 <sup>(3)</sup>	2002 <sup>(3)</sup>	2002
<b>Per Common Share Data</b>			
Net asset value, beginning of period	\$ 14.22	\$ 13.57	\$ 13.57
Net investment income <sup>(1)</sup>	0.78	0.94	1.77
Net gains (losses) <sup>(1)</sup>	(0.07)	0.32	0.43
Net increase in net assets resulting from operations	0.71	1.26	2.20
Net decrease in net assets from shareholder distributions	(1.14)	(1.08)	(2.23)
Net increase in net assets from capital share transactions	0.44	0.27	0.68
Net asset value, end of period	\$ 14.23	\$ 14.02	\$ 14.22
Market value, end of period	\$ 23.10	\$ 22.65	\$ 21.83
Total return	12%	(9)%	(7)%

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

## ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

## Note 12. Financial Highlights, continued

	At and for the Six Months Ended June 30,		At and for the Year Ended December 31,
	2003 <sup>(3)</sup>	2002 <sup>(3)</sup>	2002
<b>Ratios and Supplemental Data</b>			
Ending net assets	\$ 1,651,143	\$ 1,434,453	\$ 1,546,071
Common shares outstanding at end of period	116,034	102,296	108,698
Diluted weighted average common shares outstanding	112,291	102,900	103,574
Employee and administrative expenses/ average net assets	1.68%	1.74%	3.82%
Total expenses/average net assets	4.02%	4.26%	8.75%
Net investment income/average net assets	5.47%	6.94%	12.94%
Net increase in net assets resulting from operations <sup>(2)</sup> /average net assets	5.00%	9.32%	15.98%
Portfolio turnover rate	17.26%	8.33%	15.12%
Average debt outstanding	\$ 927,009	\$ 940,357	\$ 938,148
Average debt per share	\$ 8.26	\$ 9.14	\$ 9.06

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

(3) The results for the six months ended June 30, 2003 and 2002, are not necessarily indicative of the operating results to be expected for the full year.

**Note 13. Litigation**

During April 2003, the U.S. District Court for the Southern District of New York dismissed a consolidated securities class action lawsuit alleging violations of the federal securities laws filed against the Company and certain of its officers. In its ruling, the court found that the plaintiffs had failed to allege sufficient facts to support their claim and, therefore, dismissed the lawsuit in its entirety.

The Company is a party to certain other legal proceedings incidental to the normal course of its business, including enforcement of its rights under contracts with its portfolio companies. While the outcome of these legal proceedings cannot at this time be predicted with certainty, the Company does not expect that these proceedings will have a material effect upon its financial condition or results of operations.

**Independent Accountants Review Report**

The Board of Directors and Shareholders

Allied Capital Corporation and Subsidiaries:

We have reviewed the accompanying consolidated balance sheet of Allied Capital Corporation and subsidiaries, including the consolidated statement of investments, as of June 30, 2003, and the related consolidated statements of operations for the three- and six-month periods ended June 30, 2003 and 2002, changes in net assets and cash flows and the financial highlights (included in Note 12) for the six-month periods ended June 30, 2003 and 2002. These consolidated financial statements and financial highlights are the responsibility of the Company's management.

We conducted our reviews in accordance with standards established by the American Institute of Certified Public Accountants. A review of interim financial information consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with auditing standards generally accepted in the United States of America, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

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

We have previously audited, in accordance with auditing standards generally accepted in the United States of America, the consolidated balance sheet of Allied Capital Corporation and subsidiaries as of December 31, 2002, and the related consolidated statements of operations, changes in net assets and cash flows (not presented herein), and the financial highlights (included in Note 12), for the year then ended; and in our report dated February 11, 2003, we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying condensed consolidated balance sheet as of December 31, 2002, is fairly stated, in all material respects, in relation to the consolidated balance sheet from which it has been derived.

/s/ KPMG LLP

Washington, D.C.

July 28, 2003



**Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**

*The following analysis of the financial condition and results of operations of the Company should be read in conjunction with the Company's Consolidated Financial Statements and the Notes thereto included herein and in the Company's annual report on Form 10-K for the year ended December 31, 2002. This quarterly report on Form 10-Q contains certain forward-looking statements. These statements include the plans and objectives of management for future operations and financial objectives and can be identified by the use of forward-looking terminology such as may, will, expect, intend, anticipate, estimate, or continue or the negative thereof or other variations thereon or other terminology. These forward-looking statements are subject to the inherent uncertainties in predicting future results and conditions. Certain factors that could cause actual results and conditions to differ materially from those projected in these forward-looking statements are set forth below in the Risk Factors section. Other factors that could cause actual results to differ materially include:*

*the ongoing global economic downturn;*

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

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

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

*Financial or other information presented for private finance portfolio companies has been obtained from the portfolio 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 companies in a variety of industries. Our lending and investment activity is generally focused on private finance and commercial real estate finance, primarily the investment in non-investment grade commercial mortgage-backed securities, which we refer to as CMBS, and collateralized debt obligation bonds and preferred shares, which we refer to as CDOs. Our private finance activity principally involves providing financing through privately negotiated long-term debt and equity investment capital. Our private financing is generally used to fund growth, 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.

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Our portfolio composition at June 30, 2003, and December 31, 2002, was as follows:

	<u>2003</u>	<u>2002</u>
Private Finance	72%	70%
Commercial Real Estate Finance	28%	30%

Our earnings depend primarily on the level of interest and dividend income, fee income, and net 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 and debt securities 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 three and six months ended June 30, 2003 and 2002, and at and for the year ended December 31, 2002, were as follows:

(\$ in millions)	At and for the Three Months Ended June 30,		At and for the Six Months Ended June 30,		At and for the Year Ended December 31,
	2003	2002	2003	2002	2002
	(unaudited)		(unaudited)		
Portfolio at value	\$2,546.1	\$2,381.0	\$2,546.1	\$2,381.0	\$2,488.2
Investments funded	\$ 257.4	\$ 115.5	\$ 526.4	\$ 195.5	\$ 506.4
Change in accrued or reinvested interest and dividends	\$ 9.3	\$ 6.2	\$ 20.4	\$ 19.5	\$ 44.7
Principal repayments	\$ 74.3	\$ 36.0	\$ 150.3	\$ 67.0	\$ 143.2
Sales	\$ 32.6	\$ 1.2	\$ 276.7	\$ 126.3	\$ 213.5
Yield <sup>(1)</sup>	14.1%	13.8%	14.1%	13.8%	14.0%

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

**Private Finance**

The private finance portfolio, investment activity, and yields at and for the three and six months ended June 30, 2003 and 2002, and at and for the year ended December 31, 2002, were as follows:

(\$ in millions)	At and for the Three Months Ended June 30,		At and for the Six Months Ended June 30,		At and for the Year Ended December 31,
	2003	2002	2003	2002	2002
	(unaudited)		(unaudited)		
Portfolio at value:					
Loans and debt securities	\$1,192.4	\$1,050.8	\$1,192.4	\$1,050.8	\$1,151.2
Equity interests	646.8	584.5	646.8	584.5	592.0
Total portfolio	\$1,839.2	\$1,635.3	\$1,839.2	\$1,635.3	\$1,743.2
Investments funded	\$ 163.8	\$ 32.2	\$ 273.9	\$ 69.8	\$ 297.2
Change in accrued or reinvested interest and dividends	\$ 8.1	\$ 7.0	\$ 19.4	\$ 19.1	\$ 42.6
Principal repayments	\$ 70.9	\$ 27.2	\$ 146.0	\$ 56.0	\$ 129.3
Yield <sup>(1)</sup>	14.4%	13.9%	14.4%	13.9%	14.4%

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

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Investments funded for the six months ended June 30, 2003 and 2002, and for the year ended December 31, 2002, consisted of the following:

(\$ in millions)	Loans and Debt Securities	Equity Interests	Total
<b><i>For the Six Months Ended June 30, 2003<sup>(1)</sup></i></b>			
Companies more than 25% owned	\$ 42.2	\$ 25.2	\$ 67.4
Companies 5% to 25% owned	9.5	1.0	10.5
Companies less than 5% owned	190.6	5.4	196.0
<b>Total</b>	<b>\$242.3</b>	<b>\$31.6</b>	<b>\$273.9</b>
<b><i>For the Six Months Ended June 30, 2002<sup>(1)</sup></i></b>			
Companies more than 25% owned	\$ 16.0	\$ 3.8	\$ 19.8
Companies 5% to 25% owned	7.5	7.0	14.5
Companies less than 5% owned	34.0	1.5	35.5
<b>Total</b>	<b>\$ 57.5</b>	<b>\$12.3</b>	<b>\$ 69.8</b>
<b><i>For the Year Ended December 31, 2002<sup>(1)</sup></i></b>			
Companies more than 25% owned	\$ 86.1	\$ 18.7	\$ 104.8
Companies 5% to 25% owned	22.3	0.4	22.7
Companies less than 5% owned	154.6	15.1	169.7
<b>Total</b>	<b>\$263.0</b>	<b>\$34.2</b>	<b>\$297.2</b>

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

At June 30, 2003, we had outstanding funding commitments of \$103.9 million to portfolio companies, including \$27.4 million committed to private venture capital funds. At June 30, 2003, we also had total commitments to portfolio companies in the form of standby letters of credit and guarantees of \$96.0 million.

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 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. We plan to continue to seek attractive control investments. Control investments provide the opportunity to invest meaningful amounts of

capital with the potential for attractive current income returns as well as the potential for future capital gains. Control transactions are typically larger than our mezzanine investments. 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 working capital. In such cases, we may defer current debt service. Our most significant investments acquired through control buyout transactions at June 30, 2003, were Business Loan Express, LLC (BLX), acquired in 2000, and The Hillman Companies, Inc., acquired in 2001.

**Business Loan Express, LLC.** At June 30, 2003, our investment in BLX totaled \$264.7 million at cost and \$356.8 million at value, or 12.6% of our total assets, which includes unrealized appreciation of \$92.1 million.

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

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

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

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

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

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Summary financial data for BLX at and for the twelve months ended June 30, 2003 and 2002, is presented below.

(\$ in millions)	For the Twelve Months Ended June 30, 2003 <sup>(1)</sup>	For the Twelve Months Ended June 30, 2002
<b>Operating Data</b>		
Total revenue	\$ 109.1	\$ 84.6
Net income <sup>(4)</sup>	\$ 7.5	\$ 2.3
Earnings before interest, taxes and management fees (EBITM) <sup>(4)</sup>	\$ 44.4	\$ 43.0
<b>Balance Sheet Data</b>		
Total assets <sup>(2)</sup>	\$ 340.0	\$ 277.1
Total debt	\$ 166.0	\$ 183.0
Total owners' equity	\$ 137.0	\$ 59.9
<b>Other Data</b>		
Total loan originations	\$ 718.1	\$ 565.1
Serviced loan portfolio	\$2,165.5	\$1,372.6
Number of loans	3,048	2,083
Loan delinquencies <sup>(3)</sup>	8.1%	9.4%
<b>Serviced Loan Portfolio by Industry</b>		
Hotels	24%	27%
Gas stations/convenience stores	18	16
Professional and retail services	12	10
Restaurants	9	10
Manufacturing and industrial	9	10
Car wash/auto repair services	7	3
Child care and health care services	6	4
Shrimp/fishing vessels	5	7
Recreation	5	5
Other	5	8
Total	100%	100%

- (1) Post reorganization BLX's fiscal year end changed to September 30. The results of operations and loan originations for the twelve months ended June 30, 2003, are not necessarily indicative of the operating results to be expected for the fiscal twelve months ending September 30, 2003.
- (2) Included in total assets is \$6 million of goodwill at June 30, 2003 and 2002. 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 total serviced loan portfolio that are greater than 30 days delinquent, which includes loans in workout status. Loans greater than 30 days delinquent for the SBA 7(a) loan portfolio only, which are included in the total serviced loan portfolio, were 8.2% at June 30, 2003. SBA 7(a) loans greater than one year old at June 30, 2003, had a delinquency rate of 10.5%. BLX will from time to time grant a 90-day deferment to borrowers experiencing short-term cash flow shortfalls. Loans that have been granted a deferment that perform as required are not considered delinquent consistent with SBA practice.

The ability of small businesses to repay their loans may be adversely affected by numerous factors, including a downturn in their industry or negative economic conditions. Small businesses are also more vulnerable to customer preferences, competition, rising fuel prices and market conditions and, as a result, delinquencies in BLX's portfolio may increase. For instance, the shrimp and fishing industry has been affected by rising fuel costs and competition from imported shrimp. For these reasons, BLX focuses on collateral protection for each loan in addition to the cash flow of the small business and receives personal guarantees from the principal owners of the small business.

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(4) As an LLC, BLX is generally not subject to a corporate income tax.

For the twelve months ended June 30, 2003, BLX earned revenue of \$109.1 million and EBITM of \$44.4 million. EBITM was reduced by \$2.3 million due to costs associated with the AIF acquisition and the LLC reorganization, as well as by \$1.3 million because of the increased value of issued and outstanding equity appreciation rights to employees. Adding back these acquisition and

reorganization costs, and expenses due to equity appreciation rights, BLX's EBITM increased by 11.6% on a comparative twelve month basis. BLX's revenues consist of cash premiums from guaranteed loan sales, gain on sale income arising from loans sold at par or securitized where BLX will receive future cash flows representing the spread between loan interest and the interest paid on bonds issued including service fee income, interest income on loans remaining in BLX's portfolio, and other income. Gain on sale income is a non-cash source of income when recognized, and as future cash flows are received, the resulting cash reduces the receivable or residual interest that is recognized when the loan is sold. The total of cash loan sale premiums, cash interest income and cash received from residual interests and other cash income is equal to approximately 77% of BLX's revenue of \$109.1 million during the twelve months ended June 30, 2003.

BLX's business is to originate small business loans and then sell substantially all of the loans originated for cash proceeds. Loans originated during the twelve months ended June 30, 2003, totaled \$718.1 million, including loans purchased from AIF. Proceeds from loan sales during the twelve months ended June 30, 2003, totaled approximately \$699.4 million. BLX funds the construction of commercial real estate projects, and as a result is unable to sell a construction loan until the loan is fully-funded and the construction is complete. In addition, BLX typically does not immediately receive the proceeds from the sale of its SBA 7(a) guaranteed and unguaranteed loan strips sold, but receives the cash upon settlement. Therefore until BLX sells construction loans or fully funded loans held for sale, it will finance the origination of the loans through funding on its revolving line of credit, or through financing provided by us.

BLX has a three-year \$164.0 million revolving credit facility that matures in March 2004. As the controlling equity owner in BLX, we have provided an unconditional guaranty to the revolving credit facility lenders in an amount of up to 50% of the total obligations (consisting of principal, accrued interest, and other fees) of BLX under the revolving credit facility. The amount guaranteed by us at June 30, 2003, was \$53.6 million. This guaranty can be called by the lenders only in the event of a default by BLX. BLX was in compliance with the terms of the revolving credit facility at June 30, 2003. We have provided three standby letters of credit in connection with three term securitization transactions completed by BLX totaling \$25.6 million.

BLX sells the guaranteed piece of guaranteed loans for cash premiums of up to 10% of the guaranteed loan amount plus a retained annual servicing fee generally between 1.0% and 2.0% of the guaranteed loan amount. Cash premiums received from guaranteed loan sales during the twelve months ended June 30, 2003, were approximately \$30.3 million in total.

Alternatively, BLX may sell the guaranteed pieces of SBA 7(a) guaranteed loans at par and receive cash only for the face amount of the loan sold, and instead of receiving a cash premium, BLX will receive an annual servicing spread on the loans sold of between 4.0% and 4.8%. In addition, BLX will sell the unguaranteed pieces of the SBA 7(a) loans and conventional loans it originates into a conduit facility. The conduit loans are securitized and BLX retains an interest of up to 2.7% of the loan pool. BLX then receives the excess of loan interest payments on the loans sold over the interest cost on the securities issued in the securitization over the life of the loan pool. BLX generally receives between 4.3% and 4.9% annually on the loans sold into the securitization pools. For the twelve months ended June 30, 2003, BLX received cash payments from securitization pools of approximately \$43.2 million.

When BLX sells a guaranteed piece of an SBA 7(a) loan at par, or when BLX securitizes a loan, it will record a residual interest and servicing asset together referred to as Residual Interest in order to account for the retained interest in the loans sold and the net present value of the future cash flows it will receive from the loans sold or securitized. In computing the Residual Interest, BLX



discounts for the present value of future cash flows, and also makes assumptions as to future loan losses and loan prepayments which may reduce future cash flows.

At June 30, 2003, BLX's Residual Interest totaled \$162 million, representing BLX's estimate of the net present value of future cash flows of scheduled loan payments, after estimated future loan losses and loan prepayments. If scheduled loan payments were to be received as stated in the loan agreements with no future losses or prepayments, BLX would receive future cash flows of \$709 million over time, with approximately \$52.3 million, \$51.7 million, \$50.4 million, and \$49.0 million (or \$203.4 million in the aggregate) scheduled to be received in the next four years ending on June 30, 2004, 2005, 2006, and 2007, respectively.

***The Hillman Companies, Inc.*** At June 30, 2003, our investment in Hillman totaled \$93.6 million at cost and \$181.8 million at value, or 6.4% of total assets, which includes unrealized appreciation of \$88.2 million.

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

For the year ended December 31, 2002, Hillman had total revenue of \$286.8 million, earnings before interest, taxes, depreciation, amortization, and management fees, or EBITDAM, of \$50.2 million, and profits before taxes of \$10.0 million. For the three months ended March 31, 2003, Hillman had total revenue of \$70.0 million and EBITDAM of \$10.2 million. This EBITDAM is before the write-down of \$5.7 million of a note receivable related to an investment made by Hillman. For the three months ended March 31, 2003, Hillman had a loss before taxes of \$6.5 million, which includes the write-down of the note receivable. The total revenue, EBITDAM, and loss before taxes for the three months ended March 31, 2003, are not necessarily indicative of the operating results to be expected for the full year. Hillman had total assets of \$371.0 million and total debt of \$158.6 million at March 31, 2003.

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**Commercial Real Estate Finance**

The commercial real estate finance portfolio, investment activity, and yields at and for the three and six months ended June 30, 2003 and 2002, and at and for the year ended December 31, 2002, were as follows:

(\$ in millions)	At and for the Three Months Ended June 30,				At and for the Six Months Ended June 30,				At and for the Year Ended December 31, 2002	
	2003		2002		2003		2002		Value	Yield*
	Value	(unaudited) Yield*	Value	Yield*	Value	(unaudited) Yield*	Value	Yield*		
CMBS bonds	\$ 423.6	13.9%	\$ 560.9	14.6%	\$ 423.6	13.9%	\$ 560.9	14.6%	\$ 555.5	14.2%
CDO bonds and preferred shares	167.4	16.6%	52.5	17.2%	167.4	16.6%	52.5	17.2%	52.8	17.2%
Commercial mortgage loans	105.4	7.8%	62.0	7.9%	105.4	7.8%	62.0	7.9%	63.7	7.5%
Residual interest			69.0	9.3%			69.0	9.3%	69.0	9.4%
Real estate owned	10.5		1.3		10.5		1.3		4.0	
<b>Total portfolio</b>	<b>\$ 706.9</b>		<b>\$ 745.7</b>		<b>\$ 706.9</b>		<b>\$ 745.7</b>		<b>\$ 745.0</b>	
Investments funded	\$ 93.6		\$ 83.3		\$ 252.5		\$ 125.7		\$ 209.2	
Change in accrued or reinvested interest	\$ 1.2		\$ (0.8)		\$ 1.0		\$ 0.4		\$ 2.1	
Principal repayments	\$ 3.4		\$ 8.8		\$ 4.3		\$ 11.0		\$ 13.9	
CMBS, CDO, and commercial real estate loan sales	\$ 32.6		\$ 1.2		\$ 276.7		\$ 126.3		\$ 213.5	

\* 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 commercial real estate investment activity for the six months ended June 30, 2003 and 2002, and for the year ended December 31, 2002, was as follows:

(\$ in millions)	Face Amount	Discount	Amount Funded
<b>For the Six Months Ended June 30, 2003</b>			
CMBS bonds	\$ 250.1	\$ (115.7)	\$ 134.4
CDO bonds and preferred shares	118.4	(0.3)	118.1
<b>Total</b>	<b>\$ 368.5</b>	<b>\$ (116.0)</b>	<b>\$ 252.5</b>
<b>For the Six Months Ended June 30, 2002</b>			
CMBS bonds	\$ 181.4	\$ (83.8)	\$ 97.6
CDO preferred shares	28.0		28.0
Commercial mortgage loans	0.1		0.1
<b>Total</b>	<b>\$ 209.5</b>	<b>\$ (83.8)</b>	<b>\$ 125.7</b>

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*For the Year Ended December 31, 2002*

CMBS bonds	\$302.5	\$(140.2)	\$162.3
CDO preferred shares	29.0		29.0
Commercial mortgage loans	11.7	(1.7)	10.0
Real estate owned	7.9		7.9
	<u>          </u>	<u>          </u>	<u>          </u>
Total	\$351.1	\$(141.9)	\$209.2
	<u>          </u>	<u>          </u>	<u>          </u>

**CMBS Bonds.** During the six months ended June 30, 2003 and 2002, we invested \$134.4 million in seven CMBS bond issuances and \$97.6 million in three CMBS bond issuances, respectively. During the year ended December 31, 2002, we invested \$162.3 million in five CMBS bond issuances.

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The underlying pools of mortgage loans that are collateral for our new investments in CMBS bonds for the six months ended June 30, 2003 and 2002, and for the year ended December 31, 2002, had respective underwritten loan to value and underwritten debt service coverage ratios as follows:

Loan to Value Ranges (\$ in millions)	For the Six Months Ended June 30,				For the Year Ended December 31, 2002	
	2003		2002		Amount	Percentage
	Amount	Percentage	Amount	Percentage		
Less than 60%	\$ 1,971.8	28%	\$ 401.9	16%	\$ 909.3	20%
60-65%	527.2	8	178.7	7	287.3	6
65-70%	776.5	11	264.1	11	587.9	13
70-75%	1,217.3	18	799.5	32	1,214.5	27
75-80%	2,364.9	34	812.7	33	1,477.5	33
Greater than 80%	25.2	1	12.0	1	47.8	1
<b>Total</b>	<b>\$6,882.9</b>	<b>100%</b>	<b>\$2,468.9</b>	<b>100%</b>	<b>\$4,524.3</b>	<b>100%</b>
Weighted average loan to value	67.1%		70.4%		68.5%	

Debt Service Coverage Ratio <sup>(1)</sup> Ranges (\$ in millions)	For the Six Months Ended June 30,				For the Year Ended December 31, 2002	
	2003		2002		Amount	Percentage
	Amount	Percentage	Amount	Percentage		
Greater than 2.00	\$ 2,042.6	30%	\$ 103.3	4%	\$ 366.9	8%
1.76-2.00	697.1	10	84.2	3	229.6	5
1.51-1.75	1,264.4	18	240.3	10	477.4	11
1.26-1.50	2,478.3	36	1,631.8	66	2,739.6	60
Less than 1.25	400.5	6	409.3	17	710.8	16
<b>Total</b>	<b>\$6,882.9</b>	<b>100%</b>	<b>\$2,468.9</b>	<b>100%</b>	<b>\$4,524.3</b>	<b>100%</b>
Weighted average debt service coverage ratio	1.75		1.41		1.41	

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

From time to time, we may sell lower yielding CMBS bonds rated BB+ through B in order to maximize the return on our CMBS bond portfolio. The cost basis of and proceeds from CMBS bonds sold, the related net realized gains from these sales, and the weighted average yield on the CMBS bonds sold for the six months ended June 30, 2003 and 2002, and for the year ended December 31, 2002, were as follows:

(\$ in millions)	For the Six Months Ended June 30,		For the Year Ended December 31, 2002
	2003	2002	

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Cost basis	\$253.5	\$123.3	\$205.9
Sales proceeds	\$284.8	\$128.8	\$225.6
Net realized gains (net of related hedge gains or losses)	\$ 24.6	\$ 7.1	\$ 19.1
Weighted average yield	11.8%	11.2%	11.5%

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, 2003, our CMBS bonds were subordinate to 91% to 99% 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 and interest, we invest in these CMBS bonds at a discount from the face amount of the bonds. The discount increases with the decrease in the seniority of the CMBS bonds. For the six months ended June 30, 2003 and 2002, and for the year ended December 31, 2002, the average discount for the CMBS bonds in which we invested was 46%.

At June 30, 2003, and December 31, 2002, the unamortized discount related to the CMBS bond portfolio was \$580.2 million and \$649.5 million, respectively. At June 30, 2003, we have set aside \$261.2 million of this unamortized discount to absorb potential future losses, and therefore, the yield on the CMBS bonds of 13.9% assumes that this amount will not be amortized. At June 30, 2003, the CMBS bond portfolio had a fair value of \$423.6 million, which included net unrealized appreciation on the CMBS bonds of \$16.1 million.

The yield on our CMBS bond portfolio at June 30, 2003, and December 31, 2002, was 13.9% and 14.2%, respectively. The yield on the CMBS bond portfolio at any point in time will vary depending on the concentration of lower yielding BB+, BB, and BB- CMBS bonds held in the portfolio. The BB+, BB and BB- CMBS bonds totaled \$147.7 million and \$110.9 million and had a yield of 8.0% and 8.8% at June 30, 2003, and December 31, 2002, respectively.

At June 30, 2003, and December 31, 2002, the underlying collateral for our CMBS bonds consisted of approximately 5,100 and 4,500 commercial mortgage loans and real estate properties owned with a total outstanding principal balance of \$32.0 billion and \$25.0 billion, respectively. At June 30, 2003, and December 31, 2002, 1.2% and 1.0%, 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.

***Collateralized Debt Obligation Bonds and Preferred Shares.*** The yield on our CDO bonds and preferred shares at June 30, 2003, and December 31, 2002, was 16.6% and 17.2%, respectively. The yield on the CDO portfolio at any point in time will vary depending on the amount of lower yielding BBB rated CDO bonds held in the portfolio.

During the six months ended June 30, 2003 and 2002, and the year ended December 31, 2002, we invested in the BBB bonds and preferred shares of one, two, and three collateralized debt obligations, respectively, 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 collateral consists of debt with a cut-off balance of \$1.2 billion and was issued by 39 REITs. The investment grade CMBS collateral consists of CMBS bonds with a face amount of \$496.0 million issued in 41 separate CMBS transactions and the non-investment grade CMBS collateral consists of BB+, BB, BB-, B+, and B rated CMBS bonds with a face amount of \$873.7 million issued in 42 separate CMBS transactions. Included in the CMBS collateral for the CDOs are \$793.7 million of CMBS bonds that are senior in priority of repayment to certain lower rated CMBS bonds held by us, which were issued in 27 separate CMBS transactions.

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During the three months ended June 30, 2003, we sold \$6.4 million of CDO bonds and preferred shares for a net realized loss of \$85 thousand, net of the related hedge loss.

The BBB rated bonds and the preferred shares that we own are junior in priority for payment of principal and interest 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 and then the BBB rated bonds would bear any loss after the preferred shares. At June 30, 2003, our BBB bonds and preferred shares in the CDOs were subordinate to 61% to 98% of the more senior tranches of debt issued in various CDO transactions.

### Portfolio Asset Quality

**Portfolio by Grade.** 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 investment return or principal is expected. Grade 4 is used for investments that are in workout and for which some loss of current investment return is expected, but no loss of principal is expected. Grade 5 is used for investments that are in workout and for which some loss of principal is expected.

At June 30, 2003, and December 31, 2002, our portfolio was graded as follows:

Grade	At June 30, 2003		At December 31, 2002	
	Portfolio at Value	Percentage of Total Portfolio	Portfolio at Value	Percentage of Total Portfolio
(\$ in millions)				
1	\$ 839.0	32.9%	\$ 801.0	32.1%
2	1,460.9	57.4	1,400.8	56.3
3	124.8	4.9	166.0	6.7
4	20.2	0.8	23.6	1.0
5	101.2	4.0	96.8	3.9
	\$2,546.1	100.0%	\$2,488.2	100.0%

Total Grade 4 and 5 assets as a percentage of the total portfolio at value at June 30, 2003, and December 31, 2002, were 4.8% and 4.9%, respectively. Included in Grade 4 and 5 assets at June 30, 2003, and December 31, 2002, were assets totaling \$32.3 million and \$24.1 million, respectively, that are secured by commercial real estate. Grade 4 and 5 assets include loans, debt securities, and equity securities. We expect that a number of portfolio companies will be in the 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 Grade 4 and 5 may fluctuate 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 amount of the loss when such exposure is identified.

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

For the total investment portfolio, workout loans and debt securities (which excludes equity securities that are included in the total Grade 4 and 5 assets above) not accruing interest that were classified in Grade 4 and 5 were \$75.0 million and \$89.1 million at value at June 30, 2003, and December 31, 2002, respectively. Included in this category were loans of \$17.0 million and \$13.0 million, respectively, that were secured by commercial real estate. In addition to Grade 4 and 5 assets that are in workout, loans and debt securities to companies that are more than 50% owned by us that were not accruing interest totaled \$72.2 million and \$63.6 million at value at June 30, 2003, and December 31, 2002, respectively, and loans and debt securities to companies that are less than 50% owned by us and were not in workout but were not accruing interest totaled \$3.9 million and \$7.2 million at value at June 30, 2003, and December 31, 2002, respectively.

***Loans and Debt Securities Over 90 Days Delinquent.*** Loans and debt securities greater than 90 days delinquent were \$119.2 million and \$103.1 million at value at June 30, 2003, and December 31, 2002, respectively, or 4.7% and 4.1% of the total portfolio. Included in this category were loans valued at \$43.5 million and \$26.0 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 return or investment principal.

#### **Hedging Activities**

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

The total obligations to replenish borrowed Treasury securities, including accrued interest payable on the obligations, were \$157.0 million and \$197.0 million at June 30, 2003, and December 31, 2002, respectively, which included unrealized depreciation on the obligations of \$3.9 million and



\$7.1 million, respectively, due to changes in the yield on the borrowed Treasury securities. The net proceeds related to the sales of the borrowed Treasury securities were \$152.2 million and \$189.3 million at June 30, 2003, and December 31, 2002, respectively. Under the terms of the transactions, we have provided additional cash collateral of \$5.1 million and \$5.4 million at June 30, 2003, and December 31, 2002, respectively, for the difference between the net proceeds related to the sales of the borrowed Treasury securities and the obligations to replenish the securities on the weekly settlement date, which is included in deposits of proceeds from sales of borrowed Treasury securities in the accompanying financial statements. The amount of the hedge will vary from period to period depending upon the amount of BB+ through B rated CMBS bonds and BBB rated CDO bonds that we own and have hedged on the balance sheet date.

**RESULTS OF OPERATIONS****Comparison of Three Months Ended June 30, 2003 and 2002**

The following table summarizes the Company's operating results for the three months ended June 30, 2003 and 2002.

(\$ in thousands, except per share amounts)	For the Three Months Ended June 30,		Change	Percentage Change
	2003	2002		
	(unaudited)			
<b>Interest and Related Portfolio Income</b>				
Interest and dividends	\$ 67,137	\$ 62,692	\$ 4,445	7%
Premiums from loan dispositions	1,637	46	1,591	**
Fees and other income	8,440	10,455	(2,015)	(19)%
<b>Total interest and related portfolio income</b>	<b>77,214</b>	<b>73,193</b>	<b>4,021</b>	<b>5%</b>
<b>Expenses</b>				
Interest	19,358	17,515	1,843	11%
Employee	9,258	8,274	984	12%
Administrative	5,081	4,843	238	5%
<b>Total operating expenses</b>	<b>33,697</b>	<b>30,632</b>	<b>3,065</b>	<b>10%</b>
Net investment income before income taxes	43,517	42,561	956	2%
Income tax benefit	(1,081)		(1,081)	**
<b>Net investment income</b>	<b>44,598</b>	<b>42,561</b>	<b>2,037</b>	<b>5%</b>
<b>Net Realized and Unrealized Gains (Losses)</b>				
Net realized gains (losses)	8,540	(755)	9,295	*
Net change in unrealized appreciation or depreciation	6,802	31,648	(24,846)	*
<b>Total net gains (losses)</b>	<b>15,342</b>	<b>30,893</b>	<b>(15,551)</b>	<b>*</b>
<b>Net income</b>	<b>\$ 59,940</b>	<b>\$ 73,454</b>	<b>\$ (13,514)</b>	<b>(18)%</b>
<b>Diluted earnings per common share</b>	<b>\$ 0.52</b>	<b>\$ 0.71</b>	<b>\$ (0.19)</b>	<b>(27)%</b>
<b>Weighted average common shares outstanding - diluted</b>	<b>114,552</b>	<b>103,440</b>	<b>11,112</b>	<b>11%</b>

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

\*\* Percentage change is not meaningful.

Net income results from total interest and related portfolio income earned, less total expenses incurred in our operations, plus or minus net gains or losses.

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

The level of interest income is directly related to the balance of the interest-bearing investment portfolio multiplied by the weighted average yield. The weighted average yield varies from period to period based on the current stated interest rate earned on interest-bearing investments and the amount of loans and debt securities for which interest is not accruing. Our interest-bearing investments in the portfolio increased by 5.7% to \$1,899.3 million at June 30, 2003, from \$1,796.5 million at June 30, 2002. The weighted average yield on the interest-bearing investments in the portfolio at June 30, 2003 and 2002, was as follows:

(\$ in millions)	2003	2002
Interest-bearing portfolio	\$1,899.3	\$1,796.5
Portfolio yield	14.1%	13.8%

Included in premiums from loan dispositions are prepayment premiums of \$1.6 million and \$46 thousand for the three months ended June 30, 2003 and 2002, 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, or a company may enter into a transaction that results in the early repayment of their debt to us. Therefore, we generally structure our loans to require a prepayment premium for the first three to five years of the loan.

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

Fees and other income for the quarters ended June 30, 2003 and 2002, primarily included fees of \$3.1 million and \$2.6 million, respectively, related to structuring and diligence; fees of \$0.8 million and \$1.8 million, respectively, related to transaction and other services provided to portfolio companies; and fees of \$4.3 million and \$6.0 million, respectively, 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 depending on the level and types of services provided. 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 and Hillman are our most significant portfolio investments and together represented 19.0% of our total assets at June 30, 2003. Total interest and related portfolio income earned from these investments for the three months ended June 30, 2003 and 2002, were \$12.1 million and \$12.2 million, respectively. In July 2002, we sold WyoTech Acquisition Corporation, which was a significant portfolio investment during 2002. Total interest and related portfolio income earned on this investment for the three months ended June 30, 2002, was \$1.8 million.

**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 three months ended June 30, 2003 and 2002, were attributable to changes in the level of our borrowings under various notes payable and debentures and our revolving line of credit.

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Our borrowing activity and weighted average interest cost, including fees and closing costs, were as follows:

	At and for the Three Months Ended June 30,	
	2003	2002
(\$ in millions)		
Total Outstanding Debt	\$ 979.7	\$ 1,009.0
Average Outstanding Debt	\$ 962.3	\$ 942.3
Weighted Average Cost	7.4%	7.2%
BDC Asset Coverage*	286%	256%

\* As a BDC, the Company is generally required to maintain a minimum ratio of 200% of total assets to total borrowings.

Employee expenses include salaries and employee benefits. The change in employee expenses reflects the effect of wage increases, increased staffing, and the change in mix of employees given their area of responsibility and relevant experience level. Total employees were 116 and 103 at June 30, 2003 and 2002, respectively. We no longer provide loans to our employees to exercise stock options because of recent legislation. This was an important benefit to our employees and as a result, we are considering compensation alternatives and expect to have a new program in place by the end of 2003.

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.

**Income Tax Benefit.** The Company's wholly owned subsidiary, AC Corp, is a corporation subject to federal and state income taxes and records a benefit or expense for income taxes as appropriate. For the three months ended June 30, 2003, we recorded a tax benefit of \$1.1 million as a result of AC Corp's operating loss for the period.

**Realized Gains and Losses.** Net realized gains result from the sale of equity securities associated with certain private finance investments, the sale of CMBS bonds, and the realization of unamortized discount resulting from the sale and early repayment of private finance loans and commercial mortgage loans, offset by losses on investments. Net realized gains and losses for the three months ended June 30, 2003 and 2002, were as follows:

	For the Three Months Ended June 30,	
	2003	2002
(\$ in millions)		
Realized gains	\$ 12.7	\$ 2.5
Realized losses	(4.2)	(3.3)
Net realized gains (losses)	\$ 8.5	\$(0.8)

Realized gains and losses for the three months ended June 30, 2003, resulted from various private finance and commercial real estate finance transactions. Realized gains for the three months ended June 30, 2003, primarily resulted from transactions involving three private finance portfolio companies, including Woodstream Corporation (\$6.6 million), Kirkland's Inc. (\$1.8 million), and

Interline Brands, Inc. (\$1.7 million). For the three months ended June 30, 2003 and 2002, we reversed previously recorded unrealized appreciation totaling \$7.9 million and \$2.1 million, respectively, when gains were realized. When we exit an investment and realize a gain, we make an accounting entry to reverse any unrealized appreciation we had previously recorded to reflect the appreciated value of the investment.

Realized losses for the three months ended June 30, 2003, primarily resulted from one transaction involving North American Archery, LLC (\$2.1 million), and two transactions involving commercial mortgage loans (\$2.0 million). For the three months ended June 30, 2003 and 2002, we reversed previously recorded unrealized depreciation totaling \$4.7 million and \$2.0 million, respectively, when losses were realized. When we exit an investment and realize a loss, we make an accounting entry to reverse any unrealized depreciation we had previously recorded to reflect the depreciated value of the investment.

***Change in Unrealized Appreciation or Depreciation.*** We determine the value of each investment in our portfolio on a quarterly basis, and changes in value result in unrealized appreciation or depreciation being recognized. At June 30, 2003, approximately 89% of our total assets represented portfolio 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 available market value for the investments in our portfolio, we value substantially all of our portfolio investments at fair value as determined in good faith by the board of directors pursuant to a valuation policy and a consistently applied valuation process. Because of the inherent uncertainty of determining the fair value of investments that do not have a readily available market value, the fair value of our investments determined in good faith by the board of directors may differ significantly from the values that would have been used had a ready market existed for the investments, and the differences could be material.

There is no single standard for determining fair value in good faith. As a result, determining fair value requires that judgment be applied to the specific facts and circumstances of each portfolio investment while employing a consistently applied valuation process for the types of investments we make. Unlike banks, we are not permitted to provide a general reserve for anticipated loan losses. Instead, we are required to specifically value each individual investment on a quarterly basis. We will record unrealized depreciation on investments when we believe that an investment has become impaired, including where collection of a loan or realization of an equity security is doubtful, or when the enterprise value of the company does not currently support the cost of our debt or equity investment. Enterprise value means the entire value of the company to a potential buyer, including the sum of the values of debt and equity securities used to capitalize the enterprise at a point in time. We will record unrealized appreciation if we believe that the underlying portfolio company has appreciated in value and, therefore, our equity security has also appreciated in value. Changes in fair value are recorded in the statement of operations as net change in unrealized appreciation or depreciation.

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

of, among other things, the underlying investment performance, financial condition, and market changing events that impact valuation.

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

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

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

If there is adequate enterprise value to support the repayment of our debt, the fair value of our loan or debt security normally corresponds to cost unless the borrower's condition or other factors lead to a determination of fair value at a different amount. The fair value of equity interests in portfolio companies are determined based on 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 and CDO Bonds and Preferred Shares* CMBS bonds and CDO bonds and preferred shares are carried at fair value, which is based on a discounted cash flow model, which utilizes prepayment and loss assumptions based on historical experience and projected performance, economic factors, the characteristics of the underlying cash flow and comparable market yields for similar CMBS bonds and CDO bonds and preferred shares. Our

assumption with regard to discount rate is based on the yield of comparable securities. We recognize 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 and CDO bonds and preferred shares from the date the estimated yield is changed. We recognize unrealized appreciation or depreciation on our CMBS and CDO bonds and preferred shares as comparable yields in the market change and based on changes in estimated cash flows resulting from changes in prepayment or loss assumptions in the underlying collateral pool.

For the portfolio, net change in unrealized appreciation or depreciation for the three months ended June 30, 2003 and 2002, consisted of the following:

(\$ in millions)	2003 <sup>(1)</sup>	2002 <sup>(1)</sup>
Net unrealized appreciation or depreciation	\$10.0	\$31.7
Reversal of previously recorded unrealized appreciation associated with realized gains	(7.9)	(2.1)
Reversal of previously recorded unrealized depreciation associated with realized losses	4.7	2.0
	\$6.8	\$31.6

(1) The net change in unrealized appreciation or depreciation can fluctuate significantly from period to period. As a result quarterly comparisons may not be meaningful.

Our two most significant portfolio investments are in BLX and Hillman. The following is a simplified summary of the methodology that we used to determine the fair value of these investments.

**Business Loan Express, LLC.** The most significant change in the value of our portfolio this quarter was in our investment in BLX, which increased in value by \$50.5 million. BLX continues to make solid progress in its business. EBITM increased by 11.6% for the twelve months ended June 30, 2003, as compared to the twelve months ended June 30, 2002, adjusted for certain non-recurring expenses and the expense of equity appreciation rights. In addition, BLX has significantly strengthened its loan origination platform by increasing its preferred lender designation to 74 out of 79 SBA markets and as a result of the AIF acquisition.

To determine the value of our investment in BLX at June 30, 2003, we performed four separate valuation analyses to determine its enterprise value: (1) analysis of comparable public company trading multiples, (2) analysis of BLX's value assuming an initial public offering, (3) analysis of merger and acquisition transactions for financial services companies, and (4) a discounted dividend analysis. In arriving at the value of our investment, we estimated that the total enterprise value of BLX increased from \$407 million at March 31, 2003, to \$465 million at June 30, 2003. This results in a total value of the Class B and Class C equity interests of \$262.7 million at June 30, 2003, as compared to a total value for the Class B and Class C equity interests of \$207.2 million at March 31, 2003, or an increase of 27%.

The 27% increase in the value of the Class B and Class C equity interests is a result of BLX's continued progress as well as the fact that there has been an overall increase in the market valuations for financial services companies during the quarter. We benchmarked the valuation of BLX against a public comparable group consisting of six public financial services companies, and during this quarter the median trailing price to earnings ratio for this comparable group increased by 29% and the median forward price to earnings ratio for this comparable group increased by 52%. The increases in the comparable group market valuations indicate that the fair value of BLX has increased by current market standards.



At a value of \$262.7 million for the Class B and Class C equity interests, we are valuing BLX at a trailing price to pro-forma earnings ratio of approximately 10.5 times and on a forward projected price to pro-forma earnings ratio of approximately 9.4 times. The fair value of BLX's Class B and Class C equity interests is at a multiple of investor cost basis of 1.6 times.

**The Hillman Companies, Inc.** In performing our valuation analysis of Hillman at June 30, 2003, we determined normalized 2003 EBITDAM to be approximately \$61.5 million. We believe the current enterprise value for Hillman is approximately \$430.5 million, or 7.0 times 2003 normalized EBITDAM of \$61.5 million. The multiple was determined by obtaining a range of multiples representing the multiple of enterprise value to EBITDA for comparable public companies and the multiple of enterprise value to EBITDA for acquisition transactions involving companies in Hillman's peer group. From this market comparable analysis, we selected a 7.0 times multiple for our valuation. Using an enterprise value of \$430.5 million, the value of our equity investment in Hillman is approximately \$138.8 million, or \$88.2 million greater than our cost basis of \$50.6 million at June 30, 2003.

**Per Share Amounts.** All per share amounts included in the Management's Discussion and Analysis of Financial Condition and Results of Operations section have been computed using the weighted average common shares used to compute diluted earnings per common share, which were 114.6 million and 103.4 million for the three months ended June 30, 2003 and 2002, respectively.

#### OTHER MATTERS

**Regulated Investment Company Status.** We have elected to be taxed as a regulated investment company under Subchapter M of the Internal Revenue Code of 1986. As long as we qualify as a regulated investment company, we are not taxed on our investment company taxable income or realized capital gains, to the extent that such taxable income or gains are distributed, or deemed to be distributed, to shareholders on a timely basis. Annual tax distributions generally differ from net income for the fiscal year due to temporary and permanent 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.

**RESULTS OF OPERATIONS****Comparison of Six Months Ended June 30, 2003 and 2002**

The following table summarizes our condensed operating results for the six months ended June 30, 2003 and 2002.

(\$ in thousands, except per share amounts)	For the Six Months Ended June 30,		Change	Percentage Change
	2003	2002		
	(unaudited)			
<b>Interest and Related Portfolio Income</b>				
Interest and dividends	\$ 132,658	\$ 127,665	\$ 4,993	4%
Premiums from loan dispositions	2,758	1,659	1,099	66%
Fees and other income	14,928	26,260	(11,332)	(43)%
<b>Total interest and related portfolio income</b>	<b>150,344</b>	<b>155,584</b>	<b>(5,240)</b>	<b>(3)%</b>
<b>Expenses</b>				
Interest	37,280	34,984	2,296	7%
Employee	17,379	16,309	1,070	7%
Administrative	9,498	7,861	1,637	21%
<b>Total operating expenses</b>	<b>64,157</b>	<b>59,154</b>	<b>5,003</b>	<b>8%</b>
<b>Net investment income before income taxes</b>	<b>86,187</b>	<b>96,430</b>	<b>(10,243)</b>	<b>(11)%</b>
Income tax benefit	(1,081)		(1,081)	**
<b>Net investment income</b>	<b>87,268</b>	<b>96,430</b>	<b>(9,162)</b>	<b>(10)%</b>
<b>Net Realized and Unrealized Gains (Losses)</b>				
Net realized gains (losses)	56,879	8,850	48,029	*
Net change in unrealized appreciation or depreciation	(64,334)	24,135	(88,469)	*
<b>Total net gains (losses)</b>	<b>(7,455)</b>	<b>32,985</b>	<b>(40,440)</b>	<b>*</b>
<b>Net income</b>	<b>\$ 79,813</b>	<b>\$ 129,415</b>	<b>\$ (49,602)</b>	<b>(38)%</b>
<b>Diluted earnings per common share</b>	<b>\$ 0.71</b>	<b>\$ 1.26</b>	<b>\$ (0.55)</b>	<b>(44)%</b>
<b>Weighted average common shares outstanding diluted</b>	<b>112,291</b>	<b>102,900</b>	<b>9,391</b>	<b>9%</b>

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

\*\* Percentage change is not meaningful.

Net income results from total interest and related portfolio income earned, less total expenses incurred in our operations, plus or minus net gains or losses.

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

The level of interest income is directly related to the balance of the interest-bearing investment portfolio multiplied by the weighted average yield. The weighted average yield varies from period to period based on the current stated interest rate earned on interest-bearing investments and the amount of loans and debt securities for which interest is not accruing. Our interest-bearing investments in the portfolio increased by 5.7% to \$1,899.3 million at June 30, 2003, from

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\$1,796.5 million at June 30, 2002. The weighted average yield on the interest-bearing investments in the portfolio at June 30, 2003 and 2002, was as follows:

(\$ in millions)	2003	2002
Interest-bearing portfolio	\$ 1,899.3	\$ 1,796.5
Portfolio yield	14.1%	13.8%

Included in premiums from loan dispositions are prepayment premiums of \$2.8 million and \$1.6 million for the six months ended June 30, 2003 and 2002, 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 or a company may enter into a transaction that results in early repayment of their debt to us. Therefore, we generally structure our loans to require a prepayment premium for the first three to five years of the loan.

Fees and other income primarily include fees related to financial structuring, diligence, transaction services, management services to portfolio companies, guarantees, and other advisory services. As a business development company, we are required to make significant managerial assistance available to the companies in our investment portfolio. Managerial assistance includes management and consulting services including, but not limited to, 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, 2003 and 2002, included fees of \$3.4 million and \$10.6 million, respectively, related to structuring and diligence, fees of \$1.2 million and \$3.8 million, respectively, related to transaction and other services provided to portfolio companies, and fees of \$9.9 million and \$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 depending on the level and types of services provided. 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 and Hillman are our most significant portfolio investments and together represented 19.0% of our total assets at June 30, 2003. Total interest and related portfolio income earned from these investments for the six months ended June 30, 2003 and 2002, was \$27.5 million and \$24.5 million, respectively. Total interest and related portfolio income earned from WyoTech for the six months ended June 30, 2002 was \$3.6 million, which no longer occurred after the sale of the investment on July 1, 2002.

**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, 2003 and 2002, were attributable to changes in the level of our borrowings under various notes payable and debentures and our revolving line of credit.

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Our borrowing activity and weighted average interest cost, including fees and closing costs, were as follows:

(\$ in millions)	At and for the Six Months Ended June 30,	
	2003	2002
Total Outstanding Debt	\$ 979.7	\$ 1,009.0
Average Outstanding Debt	\$ 927.0	\$ 940.4
Weighted Average Cost	7.4%	7.2%
BDC Asset Coverage*	286%	256%

\* 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 change in employee expenses reflects the effect of wage increases, increased staffing, and the change in mix of employees given their area of responsibility and relevant experience level. Total employees were 116 and 103 at June 30, 2003 and 2002, respectively. We no longer provide loans to our employees to exercise stock options because of recent legislation. This was an important benefit to our employees and as a result, we are considering compensation alternatives and expect to have a new program in place by the end of 2003.

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 six months ended June 30, 2002, includes approximately \$0.8 million from directors' fees, legal and accounting fees, and consulting fees, and \$0.8 million due to increased costs for corporate liability insurance.

**Income Tax Benefit.** The Company's wholly owned subsidiary, AC Corp, is a corporation subject to federal and state income taxes and records a benefit or expense for income taxes as appropriate. For the six months ended June 30, 2003, we recorded a tax benefit of \$1.1 million as a result of AC Corp's operating loss for the period.

**Realized Gains and Losses.** Net realized gains result from the sale of equity securities associated with certain private finance investments, the sale of CMBS bonds, and the realization of unamortized discount resulting from the sale and early repayment of private finance loans and commercial mortgage loans, offset by losses on investments. Net realized gains and losses for the six months ended June 30, 2003 and 2002, were as follows:

(\$ in millions)	For the Six Months Ended June 30,	
	2003	2002
Realized gains	\$ 61.3	\$ 15.4
Realized losses	(4.4)	(6.5)
Net realized gains	\$ 56.9	\$ 8.9

Realized gains and losses for the six months ended June 30, 2003, resulted from various private finance and commercial real estate finance transactions. Realized gains for the six months ended June 30, 2003, primarily resulted from transactions involving seven private finance portfolio

companies, including Morton Grove Pharmaceuticals, Inc. (\$8.4 million), CyberRep (\$8.3 million), Woodstream Corporation (\$6.6 million), Blue Rhino Corporation (\$3.9 million), Kirkland's Inc. (\$3.0 million), GC-Sun Holdings II, LP (\$2.5 million), and Interline Brands, Inc. (\$1.7 million). In addition, gains were also realized on CMBS bonds (\$24.6 million, net of a realized loss of \$6.7 million from hedges related to the CMBS bonds sold). For the six months ended June 30, 2003 and 2002, we reversed previously recorded unrealized appreciation totaling \$50.8 million and \$7.3 million, respectively, when gains were realized. When we exit an investment and realize a gain, we make an accounting entry to reverse any unrealized appreciation we had previously recorded to reflect the appreciated value of the investment.

Realized losses for the six months ended June 30, 2003, primarily resulted from one transaction involving North American Archery, LLC (\$2.1 million), and two transactions involving commercial mortgage loans (\$2.0 million). For the six months ended June 30, 2003 and 2002, we reversed previously recorded unrealized depreciation totaling \$4.9 million and \$5.2 million, respectively, when losses were realized. When we exit an investment and realize a loss, we make an accounting entry to reverse any unrealized depreciation we had previously recorded to reflect the depreciated value of the investment.

**Change in Unrealized Appreciation or Depreciation.** For a discussion of our fair value methodology and how it affects the net change in unrealized appreciation or depreciation, see *Change in Unrealized Appreciation or Depreciation* included in the *Comparison of Three Months Ended June 30, 2003 and 2002*.

For the portfolio, net change in unrealized appreciation or depreciation for the six months ended June 30, 2003 and 2002, consisted of the following:

(\$ in millions)	2003 <sup>(1)</sup>	2002 <sup>(1)</sup>
Net unrealized appreciation or depreciation	\$(18.4)	\$26.2
Reversal of previously recorded unrealized appreciation associated with realized gains	(50.8)	(7.3)
Reversal of previously recorded unrealized depreciation associated with realized losses	4.9	5.2
Net change in unrealized appreciation or depreciation	\$(64.3)	\$24.1

(1) The net change in unrealized appreciation or depreciation can fluctuate significantly from period to period. As a result year-to-date comparisons may not be meaningful.

Net change in unrealized appreciation or depreciation for the six months ended June 30, 2003 included those discussed under the caption *Change in Unrealized Appreciation or Depreciation* included in the *Comparison of Three Months Ended June 30, 2003 and 2002*.

**Per Share Amounts.** All per share amounts included in the Management's Discussion and Analysis of Financial Condition and Results of Operations section have been computed using the weighted average common shares used to compute diluted earnings per common share, which were 112.3 million and 102.9 million for the six months ended June 30, 2003 and 2002, respectively.

## FINANCIAL CONDITION, LIQUIDITY AND CAPITAL RESOURCES

## Cash and Cash Equivalents

At June 30, 2003, we had \$7.5 million in cash and cash equivalents. We invest otherwise uninvested cash in U.S. government- or agency-issued or guaranteed securities that are backed by the full faith and credit of the United States, or in high quality, short-term repurchase agreements fully collateralized by such securities. Our objective is to manage to a low cash balance and fund new originations with our revolving line of credit, and through the issuance of debt and equity securities.

## Debt

At June 30, 2003, we had outstanding debt as follows:

(\$ in millions)	Facility Amount	Amount Outstanding	Annual Interest Cost <sup>(1)</sup>
Notes payable and debentures:			
Unsecured long-term notes	\$ 854.0	\$854.0	7.2%
SBA debentures	101.8	94.5	8.1%
OPIC loan	5.7	5.7	6.6%
	-----	-----	
Total notes payable and debentures	961.5	954.2	7.3%
Revolving line of credit	462.5	25.5	11.7% <sup>(2)</sup>
	-----	-----	
Total debt	\$1,424.0	\$979.7	7.4%
	-----	-----	

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

(2) The current interest rate payable on the revolving line of credit is 2.6%, which excludes the annual cost of commitment fees and other facility fees of \$2.3 million.

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

**Small Business Administration Debentures.** We, through our small business investment company subsidiary, have debentures payable to the Small Business Administration with contractual maturities of ten years. The notes require payment of interest only semi-annually, and all principal is due upon maturity. Under the small business investment company program, we may borrow up to \$113.4 million from the Small Business Administration. At June 30, 2003, we had a commitment from the Small Business Administration to borrow up to an additional \$7.3 million above the current amount outstanding. The commitment expires on September 30, 2005.

**Revolving Line of Credit.** We have a \$462.5 million unsecured revolving line of credit that expires in April 2005, with the right to extend maturity for one additional year at our option under substantially similar terms. The revolving line of credit may be expanded through new or additional commitments up to \$600 million at our option. As of June 30, 2003, \$399.9 million remained unused and available, net of amounts committed for standby letters of credit of \$37.1 million issued under the line of credit facility. Net repayments on the revolving line of credit for the six months ended

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June 30, 2003, were \$178.8 million. The credit facility bears interest at a rate equal to (i) the one-month LIBOR plus 1.25%, (ii) the Bank of America, N.A. prime rate, or (iii) the Federal Funds rate plus 0.50% at our option. The line of credit generally requires monthly payments of interest, and all principal is due upon maturity.

We have various financial and operating covenants required by the revolving line of credit and notes payable and debentures. These covenants require us to maintain certain financial ratios, including debt to equity and interest coverage, and a minimum net worth. Our credit facilities limit our ability to declare dividends if we default under certain provisions. As of June 30, 2003, we were in compliance with these covenants.

The following table shows our significant contractual obligations as of June 30, 2003.

(\$ in millions)	Payments Due By Year						
	Total	2003	2004	2005	2006	2007	After 2007
Notes payable and debentures:							
Unsecured long-term notes	\$ 854.0	\$	\$ 214.0	\$ 165.0	\$ 175.0	\$	\$ 300.0
Small Business Administration debentures	94.5		7.0	14.0			73.5
Overseas Private Investment Corporation loan	5.7				5.7		
Revolving line of credit <sup>(1)</sup>	25.5				25.5		
Operating Leases	19.7	1.3	2.7	2.7	2.6	2.5	7.9
<b>Total contractual obligations</b>	<b>\$ 999.4</b>	<b>\$ 1.3</b>	<b>\$ 223.7</b>	<b>\$ 181.7</b>	<b>\$ 208.8</b>	<b>\$ 2.5</b>	<b>\$ 381.4</b>

(1) The revolving line of credit expires in April 2005 and may be extended under substantially similar terms for one additional year at our option. We assume that we would exercise our option to extend the revolving line of credit resulting in an assumed maturity of April 2006. At June 30, 2003, \$399.9 million remains unused and available, net of amounts committed for standby letters of credit of \$37.1 million issued under the credit facility.

The following table shows our contractual commitments that may have the effect of creating, increasing, or accelerating our liabilities as of June 30, 2003.

(\$ in millions)	Amount of Commitment Expiration Per Year						
	Total	2003	2004	2005	2006	2007	After 2007
Guarantees	\$ 58.9	\$ 0.4	\$ 54.3	\$ 0.4	\$ 0.1	\$ 0.1	\$ 3.6
Standby letters of credit	37.1			4.5	32.6		
<b>Total commitments</b>	<b>\$ 96.0</b>	<b>\$ 0.4</b>	<b>\$ 54.3</b>	<b>\$ 4.9</b>	<b>\$ 32.7</b>	<b>\$ 0.1</b>	<b>\$ 3.6</b>

### Equity Capital and Dividends

Because we are a regulated investment company, we distribute our 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 ratio. At June 30, 2003, our asset coverage for senior indebtedness was 286% and our debt to equity ratio was 0.59 to 1.00.

To support our growth during the six months ended June 30, 2003 and 2002, we raised \$145.1 million and \$49.9 million, respectively, in new equity capital. In July 2003, we raised an additional \$9.7 million in new equity capital. We issue equity from time to time when we have



attractive investment opportunities. In addition, we raised \$3.3 million and \$3.1 million in new equity capital through the issuance of shares through our dividend reinvestment plan during the six months

ended June 30, 2003 and 2002, respectively. During the six months ended June 30, 2003, total shareholder's equity had increased 6.8% to \$1.7 billion.

Our Board of Directors reviews the dividend rate quarterly, and may adjust the quarterly dividend throughout the year. For the first, second and third quarters of 2003, the Board of Directors declared a dividend of \$0.57 per common share. The third quarter dividend is payable on September 26, 2003, with a record date of September 12, 2003. 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 to support future growth.

**Liquidity and Capital Resources.** We plan to maintain a strategy of financing our business and related debt maturities 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. The need for private investment capital has increased in 2003 and we have funded new investments totaling \$526.4 million for the six months ended June 30, 2003, as compared to \$506.4 million for the year ended December 31, 2002. Although there can be no assurance that we will secure new investments, we plan to raise new debt and equity capital as appropriate to fund investment growth.

Dividends to shareholders for the six months ended June 30, 2003 and 2002, were \$127.5 million and \$109.5 million, respectively. Cash flow from operations before new investments has historically been sufficient to finance our operating expenses and pay dividends to shareholders.

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 revolving line of credit facility 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, 2003, our debt to equity ratio was 0.59 to 1.00 and our weighted average cost of funds was 7.4%. Availability on the revolving line of credit, net of amounts committed for standby letters of credit issued under the line of credit facility, was \$399.9 million on June 30, 2003. We believe that we have access to capital sufficient to fund our ongoing investment and operating activities.

## CRITICAL ACCOUNTING POLICIES

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

**Valuation of Portfolio Investments.** As a business development company, we invest in illiquid securities including debt and equity securities of companies, non-investment grade CMBS, and CDOs. Our investments are generally subject to restrictions on resale and generally have no established trading market. We value substantially all of our investments at fair value as determined in good faith by the board of directors in accordance with our valuation policy. We determine fair value to be the amount for which an investment could be exchanged in an orderly disposition over a reasonable period of time between willing parties other than in a forced or liquidation sale. Our

valuation policy considers the fact that no ready market exists for substantially all of the securities in which we invest. Our valuation policy is intended to provide a consistent basis for determining the fair value of the portfolio. We will record unrealized depreciation on investments when we believe that an investment has become impaired, including where collection of a loan or realization of an equity security is doubtful, or when the enterprise value of the company does not currently support the cost of our debt or equity investments. Enterprise value means the entire value of the company to a potential buyer, including the sum of the values of debt and equity securities used to capitalize the enterprise at a point in time. We will record unrealized appreciation if we believe that the underlying portfolio company has appreciated in value and, therefore, our equity security has also appreciated in value. The value of investments in publicly traded securities are determined using quoted market prices discounted for restrictions on resale, if any.

**Loans and Debt Securities.** For loans and debt securities, fair value generally approximates cost unless the borrower's enterprise value 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. Interest on loans and debt securities is not accrued if we have doubt about interest collection. Loans in workout status classified as Grade 4 or 5 assets do not accrue interest. In addition, interest may not accrue on loans or debt securities to portfolio companies that are more than 50% owned by us if such companies are in need of additional working capital. Loan origination fees, original issue discount, and market discount are capitalized and then amortized into interest income using the effective interest method. Prepayment premiums are recorded on loans when received.

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.

**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 or other liquidation events. The determined fair values are generally discounted to account for restrictions on resale and minority ownership positions.

The value of our equity interests in public companies for which market quotations are readily available is based 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 preferred equity securities on an accrual basis to the extent that such amounts are expected to be collected and on common equity securities on the record date for private companies or on the ex-dividend date for publicly traded companies.

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

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

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

## 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.*

**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, 2003, approximately 89% of our total assets represented portfolio 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 available market value for the investments in our portfolio, our board of directors determines in good faith the fair value of these investments pursuant to a valuation policy and a consistently applied valuation process.

There is no single standard for determining fair value in good faith. As a result, determining fair value requires that judgment be applied to the specific facts and circumstances of each portfolio investment while employing a consistently applied valuation process for the types of investments we make. Unlike banks, we are not permitted to provide a general reserve for anticipated loan losses; we are instead required by the 1940 Act to specifically value each individual investment on a quarterly basis and record unrealized depreciation for an investment that we believe has become impaired, including where collection of a loan or realization of an equity security is doubtful, or when the enterprise value of the company does not currently support the cost of our debt or equity investment. Enterprise value means the entire value of the company to a potential buyer, including the sum of the values of debt and equity securities used to capitalize the enterprise at a point in time. We will record unrealized appreciation if we believe that the underlying portfolio company has appreciated in value and, therefore, our equity security has also appreciated in value. Without a readily available market value and because of the inherent uncertainty of valuation, the fair value of our investments determined in good faith by the board of directors may differ significantly from the values that would have been used had a ready market existed for the investments, and the differences could be material.

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

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

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

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

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

**Our financial results could be negatively affected if Business Loan Express fails to perform as expected.** Business Loan Express, LLC (BLX) is our largest portfolio investment. Our financial results could be negatively affected if BLX, as a portfolio company, fails to perform as expected or if government funding for, or regulations related to the Small Business Administration 7(a) Guaranteed Loan Program change. At June 30, 2003, the investment totaled \$356.8 million at value, or 12.6% of total assets.

In addition, as controlling equity owner of BLX, we have provided an unconditional guaranty to BLX's senior credit facility lenders in an amount equal to 50% of BLX's total obligations on its \$164.0 million revolving credit facility. The amount we have guaranteed at June 30, 2003, was \$53.6 million. This guaranty can only be called in the event of a default by BLX. We have also provided three standby letters of credit in connection with three term securitization transactions completed by BLX totaling \$25.6 million.

**Investments in non-investment grade commercial mortgage-backed securities and collateralized debt obligations may be illiquid, may have a higher risk of default, and may not produce current returns.** The commercial mortgage-backed securities and collateralized debt obligation preferred shares in which we invest are not investment grade, which means that nationally recognized statistical

rating organizations rate them below the top four investment-grade rating categories (i.e., AAA through BBB ), and are sometimes referred to as junk bonds. Non-investment grade commercial mortgage-backed securities and collateralized debt obligation preferred shares tend to be less liquid, may have a higher risk of default and may be more difficult to value. Non-investment grade securities usually provide a higher yield than do investment grade securities, but with the higher return comes greater risk of default. 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, 2003, our asset coverage for senior indebtedness was 286%.

**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, 2003, we had \$979.7 million of outstanding indebtedness, bearing a weighted average annual interest cost of 7.4%. In order for us to cover these annual interest payments on indebtedness, we must achieve annual returns on our assets of at least 2.6%.

**Changes in interest rates may affect our cost of capital and net investment income.** Because we borrow money to make investments, our net investment income is dependent upon the difference between the rate at which we borrow funds and the rate at which we invest these funds. As a result, there can be no assurance that a significant change in market interest rates will not have a material adverse effect on our net investment income. In periods of rising interest rates, our cost of funds would increase, which would reduce our net investment income. We use a combination of long-term and short-term borrowings and equity capital to finance our investing activities. We utilize our revolving line of credit as a means to bridge to long-term financing. Our long-term fixed-rate investments are financed primarily with long-term fixed-rate debt and equity. We may use interest rate risk management techniques in an effort to limit our exposure to interest rate fluctuations. Such techniques may include various interest rate hedging activities to the extent permitted by the 1940 Act. We have analyzed the potential impact of changes in interest rates on interest income net of interest expense. Assuming that the balance sheet were to remain constant and no actions were taken to alter the existing interest rate sensitivity, a hypothetical immediate 1% change in interest rates

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

**We will continue to need additional capital to grow because we must distribute our income.** We will continue to need capital to fund growth in our investments. Historically, we have borrowed from financial institutions and have issued equity securities. A reduction in the availability of new capital could limit our ability to grow. We must distribute at least 90% of our taxable ordinary income, which excludes 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 issue additional debt and equity securities. If we fail to obtain funds from such sources or from other sources to fund our investments, it could limit our ability to grow, which could have a material adverse effect on the value of our common stock. In addition, as a business development company, we are generally required to maintain a ratio of at least 200% of total assets to total borrowings, which may restrict our ability to borrow in certain circumstances.

**Loss of 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 taxable income, we generally will be subject to a 4% excise tax.

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



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

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

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

**Results may fluctuate and may not be indicative of future performance.** Our operating results may fluctuate and, therefore, you should not rely on current or historical period results to be indicative of our performance in future reporting periods. Factors that could cause operating results to fluctuate include, among others, variations in the investment origination volume and fee income earned, variation in timing of prepayments, variations in and the timing of the recognition of net realized 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.

**Item 3. *Quantitative and Qualitative Disclosures About Market Risk***

There has been no material change in quantitative or qualitative disclosures about market risk since December 31, 2002.

**Item 4. *Controls and Procedures***

(a) As of the end of the period covered by this quarterly report on Form 10-Q, the Company's chief executive officer and chief financial officer conducted an evaluation of the Company's disclosure controls and procedures (as defined in Rules 13a-15 and 15d-15 of the Securities Exchange Act of 1934). Based upon this evaluation, the Company's chief executive officer and chief financial officer concluded that the Company's disclosure controls and procedures are effective in timely alerting them of any material information relating to the Company that is required to be disclosed by the Company in the reports it files or submits under the Securities Exchange Act of 1934.

(b) There have been no changes in the Company's internal control over financial reporting that occurred during the quarter ended June 30, 2003, that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

**PART II. OTHER INFORMATION**

**Item 1. Legal Proceedings**

On April 21, 2003, the U.S. District Court for the Southern District of New York dismissed a consolidated securities class action lawsuit alleging violations of the federal securities laws filed against us and certain of our officers. In its ruling, the court found that the plaintiffs had failed to allege sufficient facts to support their claim and, therefore, dismissed the lawsuit in its entirety.

We are party to certain other legal proceedings incidental to the normal course of our business, including enforcement of our rights under contracts with our portfolio companies. 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.

**Item 2. Changes in Securities and Use of Proceeds**

During the three months ended June 30, 2003, we issued a total of 70,485 shares of common stock under our dividend reinvestment plan pursuant to an exemption from the registration requirements of the Securities Act of 1933. The aggregate offering price for the shares of common stock sold under the dividend reinvestment plan was approximately \$1.6 million.

**Item 3. Defaults Upon Senior Securities**

Not applicable.

**Item 4. Submission of Matters to a Vote of Security Holders**

On May 13, 2003, we held our Annual Meeting of Shareholders in Washington, DC. Shareholders voted on two matters; the substance of these matters and the results of the voting of each such matter are described below. There were no broker non-votes for items 1 and 2 below.

1. Election of Directors: Shareholders elected four directors of the Company, who will serve for three years, or until their successors are elected and qualified. Votes were cast as follows:

	<u>For</u>	<u>Withheld</u>
Ann Torre Grant	101,618,275	1,165,261
John I. Leahy	101,661,594	1,121,942
Alex J. Pollock	101,752,823	1,030,713
Guy T. Steuart II	96,455,856	6,327,680

The following directors are continuing as directors of the Company for their respective terms - William L. Walton, Brooks H. Browne, John D. Firestone, Anthony T. Garcia, Lawrence I. Hebert, Laura W. van Roijen, Robert E. Long, and George C. Williams, Jr.

2. Ratification of the selection of KPMG LLP to serve as independent public accounts for the year ending December 31, 2003. Votes were cast as follows:

<u>For</u>	<u>Against</u>	<u>Abstain</u>
101,681,526	704,400	397,610

**Item 5. Other Information**

Not applicable.



**Item 6. Exhibits and Reports on Form 8-K**

## (a) List of Exhibits

Exhibit Number	Description
3.1	Restated Articles of Incorporation. (Incorporated by reference to Exhibit a.1 filed with Allied Capital's Post-Effective Amendment No. 2 to registration statement on Form N-2 (File No. 333-67336) filed on March 22, 2002).
3.2	Amended and Restated Bylaws. (Incorporated by reference to Exhibit b. filed with Allied Capital's Post-Effective Amendment No. 2 to registration statement on Form N-2 (File No. 333-67336) filed on March 22, 2002).
4.1	Specimen Certificate of Allied Capital's Common Stock, par value \$0.0001 per share. (Incorporated by reference to Exhibit d. filed with Allied Capital's registration statement on Form N-2 (File No. 333-51899) filed on May 6, 1998).
4.2	Form of debenture between certain subsidiaries of Allied Capital and the U.S. Small Business Administration. (Incorporated by reference to Exhibit 4.2 filed by a predecessor entity to Allied Capital on Form 10-K for the year ended December 31, 1996).
10.1	Dividend Reinvestment Plan, as amended. (Incorporated by reference to Exhibit e. filed with Allied Capital's registration statement on Form N-2 (File No. 333-87862) filed on May 8, 2002).
10.2	Third Amended and Restated Credit Agreement, dated April 18, 2003. (Incorporated by reference to Exhibit 10.2 filed with Allied Capital's Form 10-Q for the period ended March 31, 2003).
10.3	Note Agreement, dated as of April 30, 1998. (Incorporated by reference to Exhibit 10.2 filed with Allied Capital's Form 10-Q for the period ended June 30, 1998).
10.4	Loan Agreement between a predecessor entity to Allied Capital and Overseas Private Investment Corporation, dated April 10, 1995. (Incorporated by reference to Exhibit f.7 filed by a predecessor entity to Allied Capital to Pre-Effective Amendment No. 2 to registration statement on Form N-2 (File No. 333-64629) filed on January 24, 1996). Letter, dated December 11, 1997, evidencing assignment of Loan Agreement from the predecessor entity of Allied Capital to Allied Capital. (Incorporated by reference to Exhibit 10.3 to Allied Capital's Form 10-K for the year ended December 31, 1997).
10.5	Note Agreement, dated as of May 1, 1999. (Incorporated by reference to Exhibit 10.5 filed with Allied Capital's Form 10-Q for the period ended June 30, 1999).
10.6	Amendment and Consent Agreement, dated December 11, 2000, to the Amended and Restated Credit Agreement, dated May 17, 2000. (Incorporated by reference to Exhibit f.6 filed with Allied Capital's Post-Effective Amendment No. 2 to the registration statement on Form N-2 (File No. 333-43534) filed on March 21, 2001).
10.7	Sale and Servicing Agreement, dated as of January 1, 1998, among Allied Capital CMT, Inc., Allied Capital Commercial Mortgage Trust 1998-1, Allied Capital Corporation, LaSalle National Bank and ABN AMRO Bank N.V. (Incorporated by reference to Exhibit f.7.a filed with Allied Capital's registration statement on Form N-2 (File No. 333-51899) filed on May 6, 1998).
10.8	Indenture, dated as of January 1, 1998, between Allied Capital Commercial Mortgage Trust 1998-1 and LaSalle National Bank. (Incorporated by reference to Exhibit f.7.b filed with Allied Capital's registration statement on Form N-2 (File No. 333-51899) filed on May 6, 1998).

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Exhibit Number	Description
10.9	Amended and Restated Trust Agreement, dated January 1, 1998, between Allied Capital CMT, Inc., LaSalle National Bank Inc. and Wilmington Trust Company. (Incorporated by reference to Exhibit f.7.c filed with Allied Capital's registration statement on Form N-2 (File No. 333-51899) filed on May 6, 1998).
10.10	Guaranty, dated as of January 1, 1998, by Allied Capital. (Incorporated by reference to Exhibit f.7.d filed with Allied Capital's registration statement on Form N-2 (File No. 333-51899) filed on May 6, 1998).
10.11	Note Agreement, dated as of November 15, 1999. (Incorporated by reference to Exhibit 10.4a of Allied Capital's Form 10-K for the year ended December 31, 1999).
10.12	Note Agreement, dated as of October 15, 2000. (Incorporated by reference to Exhibit 10.4b filed with Allied Capital's Form 10-Q for the period ended September 30, 2000).
10.13	Note Agreement, dated as of October 15, 2001. (Incorporated by reference to Exhibit f.10 filed with Allied Capital's Post-Effective Amendment No. 1 to registration statement on Form N-2 (File No. 333-67336) filed on November 14, 2001).
10.15	Control Investor Guaranty Agreement, dated as of March 28, 2001, between Allied Capital and Fleet National Bank and Business Loan Express, Inc. (Incorporated by reference to Exhibit f.14 filed with Allied Capital's Post-Effective Amendment No. 3 to registration statement on Form N-2 (File No. 333-43534) filed on May 15, 2001).
10.16	Amended and Restated Deferred Compensation Plan, dated December 30, 1998. (Incorporated by reference to Exhibit 10.11 to Allied Capital's Form 10-K for the year ended December 31, 1998).
10.17	Amended to Deferred Compensation Plan, dated October 18, 2000. (Incorporated by reference to Exhibit i.2.a filed with Allied Capital's Post-Effective Amendment No. 1 to registration statement on Form N-2 (File No. 333-43534) filed on January 19, 2001).
10.18	Amended and Restated Deferred Compensation Plan, dated May 15, 2001. (Incorporated by reference to Exhibit i.2.b filed with Allied Capital's Post-Effective Amendment No. 1 to registration statement on Form N-2 (File No. 333-67336) filed on November 14, 2001).
10.19	Amended Stock Option Plan. (Incorporated by reference to Exhibit A of Allied Capital's definitive proxy statement for Allied Capital's 2002 Annual Meeting of Stockholders filed on April 3, 2002).
10.20(a)	Allied Capital Corporation 401(k) Plan, dated September 1, 1999. (Incorporated by reference to Exhibit 4.4 filed with Allied Capital's registration statement on Form S-8 (File No. 333-88681) filed on October 8, 1999).
10.20(b)	Amendment to Allied Capital Corporation 401(k) Plan, dated December 31, 2000. (Incorporated by reference to Exhibit i.5.a filed with Allied Capital's Post-Effective Amendment No. 1 to registration statement on Form N-2 (File No. 333-43534) filed on January 19, 2001).
10.21	Employment Agreement, dated June 15, 2000, between Allied Capital and William L. Walton. (Incorporated by reference to Exhibit f.9 filed with Allied Capital's registration statement on Form N-2 (File No. 333-43534) filed on August 11, 2000).
10.22	Employment Agreement, dated June 15, 2000, between Allied Capital and Joan M. Sweeney. (Incorporated by reference to Exhibit f.10 filed with Allied Capital's registration statement on Form N-2 (File No. 333-43534) filed on August 11, 2000).
10.23	Employment Agreement, dated June 15, 2000, between Allied Capital and John M. Scheurer. (Incorporated by reference to Exhibit i.8 filed with Allied Capital's Post-Effective Amendment No. 2 to registration statement on Form N-2 (File No. 333-43534) filed on March 21, 2001).

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Exhibit Number	Description
10.24	Employment Agreement, dated June 15, 2002, between Allied Capital and Thomas H. Westbrook and amended as of March 10, 2003. (Incorporated by reference to Exhibit 10.24 filed with Allied Capital's Form 10-K for the year ended December 31, 2002).
10.25	Form of Custody Agreement with Riggs Bank N.A. (Incorporated by reference to Exhibit j.1 filed with Allied Capital's registration statement on Form N-2 (File No. 333-51899) filed on May 6, 1998).
10.26	Form of Custody Agreement with LaSalle National Bank. (Incorporated by reference to Exhibit j.2 filed with Allied Capital's registration statement on Form N-2 (File No. 333- 51899) filed on May 6, 1998).
10.27	Custodian Agreement with LaSalle National Bank Association dated July 9, 2001. (Incorporated by reference to Exhibit j.3 filed with Allied Capital's registration statement on Form N-2 (File No. 333-67336) filed on August 10, 2001).
10.28	Code of Ethics. (Incorporated by reference to Exhibit r. filed with Allied Capital's Pre-Effective Amendment No. 1 to the registration statement on Form N-2 (File No. 333-43534) on September 12, 2000).
10.30	Agreement and Plan of Merger by and among Allied Capital, Allied Capital Lock Acquisition Corporation, and Sunsource, Inc dated June 18, 2001. (Incorporated by reference to Exhibit k.1 filed with Allied Capital's registration statement on Form N-2 (File No. 333-67336) filed on August 10, 2001).
10.31	Note Agreement, dated as of May 14, 2003. (Incorporated by reference to Exhibit 10.31 filed with Allied Capital's Form 10-Q for the period ended March 31, 2003).
10.32	Amendment, dated as of April 30, 2003, to Note Agreement, dated as of April 30, 1998. (Incorporated by reference to Exhibit 10.32 filed with Allied Capital's Form 10-Q for the period ended March 31, 2003).
10.33	Amendment, dated as of April 30, 2003, to Note Agreement, dated as of May 1, 1999. (Incorporated by reference to Exhibit 10.33 filed with Allied Capital's Form 10-Q for the period ended March 31, 2003).
10.34	Amendment, dated as of April 30, 2003, to Note Agreement, dated as of November 15, 1999. (Incorporated by reference to Exhibit 10.34 filed with Allied Capital's Form 10-Q for the period ended March 31, 2003).
10.35	Amendment, dated as of April 30, 2003, to Note Agreement, dated as of October 15, 2000. (Incorporated by reference to Exhibit 10.35 filed with Allied Capital's Form 10-Q for the period ended March 31, 2003).
10.36	Amendment, dated as of April 30, 2003, to Note Agreement, dated as of October 15, 2001. (Incorporated by reference to Exhibit 10.36 filed with Allied Capital's Form 10-Q for the period ended March 31, 2003).
15.*	Letter regarding Unaudited Interim Financial Information
31.1*	Certification of Chief Executive Officer Pursuant to Rule 13a-14(a) or 15d-14(a) under the Securities Act of 1934.
31.2*	Certification of Chief Financial Officer Pursuant Rule 13a-14(a) or 15d-14(a) under the Securities Act of 1934.
32.1*	Certification of Chief Executive Officer Pursuant to 18 U.S.C. 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.
32.2*	Certification of Chief Financial Officer Pursuant to 18 U.S.C. 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

\* Filed herewith.

(b) Reports on Form 8-K

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On April 18, 2003, we filed a Form 8-K pursuant to Item 12 reporting the issuance of a press release announcing that we had declared a dividend for the second quarter of 2003.

On April 22, 2003, we filed a Form 8-K pursuant to Item 12 reporting the issuance of a press release announcing our financial results for the quarter ended March 31, 2003.

On April 24, 2003, we filed a Form 8-K pursuant to Item 5 reporting the issuance of a press release announcing that the United States District Court for the Southern District of New York had dismissed a consolidated securities class action lawsuit against us and certain of our officers.

On July 21, 2003, we filed a Form 8-K pursuant to Item 9 reporting the issuance of a press release announcing that we had declared a dividend for the third quarter of 2003.

On July 29, 2003, we filed a Form 8-K pursuant to Item 12 reporting the issuance of a press release announcing our financial results for the quarter ended June 30, 2003.



**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunder duly authorized.

ALLIED CAPITAL CORPORATION  
(Registrant)

Dated: July 31, 2003

/s/ WILLIAM L. WALTON

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William L. Walton  
Chairman and Chief Executive Officer

/s/ PENNI F. ROLL

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Penni F. Roll  
Chief Financial Officer

**EXHIBIT INDEX**

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