

ALLIED CAPITAL CORP  
Form 10-Q  
May 11, 2009

**FORM 10-Q**

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, DC 20549**

**Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**

**For The Quarterly Period  
Ended March 31, 2009**

**Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**

**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) 721-6100**

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 period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. YES  NO

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). YES  NO

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.

Large accelerated filer  Accelerated filer  Non-accelerated filer  Smaller reporting company

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(Do not check if a smaller reporting company)

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). YES  NO

On May 8, 2009, there were 178,691,875 shares outstanding of the Registrant's common stock, \$0.0001 par value.

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**ALLIED CAPITAL CORPORATION**

**FORM 10-Q TABLE OF CONTENTS**

**PART I. FINANCIAL INFORMATION**

**Item 1. Financial Statements**

**Consolidated Balance Sheet as of March 31, 2009 (unaudited) and  
December 31, 2008**

1

**Consolidated Statement of Operations (unaudited) For the Three Months Ended March 31, 2009 and 2008**

2

**Consolidated Statement of Changes in Net Assets (unaudited) For the Three Months Ended March 31, 2009  
and 2008**

3

**Consolidated Statement of Cash Flows (unaudited) For the Three Months Ended March 31, 2009 and 2008**

4

**Consolidated Statement of Investments as of March 31, 2009  
(unaudited)**

5

**Consolidated Statement of Investments as of December 31, 2008**

19

**Notes to Consolidated Financial Statements**

33

**Report of Independent Registered Public Accounting Firm**

65

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

69

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

101

**Item 4. Controls and Procedures**

102

**PART II. OTHER INFORMATION**

**Item 1. Legal Proceedings**

103

**Item 1A. Risk Factors**

104

**Item 2. Unregistered Sales of Equity Securities and Use of Proceeds**

113

**Item 3. Defaults Upon Senior Securities**

113

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

113

**Item 5. Other Information**

113

**Item 6. Exhibits**

114

**Signatures**

119

**PART I: FINANCIAL INFORMATION****Item 1. Financial Statements****ALLIED CAPITAL CORPORATION AND SUBSIDIARIES****CONSOLIDATED BALANCE SHEET**

<b>(in thousands, except per share amounts)</b>	<b>March 31, 2009 (unaudited)</b>	<b>December 31, 2008</b>
<b>ASSETS</b>		
Portfolio at value:		
Private finance		
Companies more than 25% owned (cost: 2009-\$2,147,724; 2008-\$2,167,020)	\$ 1,039,191	\$ 1,187,722
Companies 5% to 25% owned (cost: 2009-\$267,235; 2008-\$392,516)	196,460	352,760
Companies less than 5% owned (cost: 2009-\$2,234,718; 2008-\$2,317,856)	1,594,387	1,858,581
Total private finance (cost: 2009-\$4,649,677; 2008-\$4,877,392)	2,830,038	3,399,063
Commercial real estate finance (cost: 2009-\$82,341; 2008-\$85,503)	79,030	93,887
Total portfolio at value (cost: 2009-\$4,732,018; 2008-\$4,962,895)	2,909,068	3,492,950
Accrued interest and dividends receivable	52,347	55,638
Other assets	135,939	122,909
Investments in money market and other securities	5	287
Cash	290,227	50,402
Total assets	\$ 3,387,586	\$ 3,722,186
<b>LIABILITIES AND SHAREHOLDERS EQUITY</b>		
Liabilities:		
Notes payable (maturing within one year: 2009-\$1,015,000; 2008-\$1,015,000)	\$ 1,892,500	\$ 1,895,000
Revolving line of credit	50,000	50,000
Accounts payable and other liabilities	75,333	58,786
Total liabilities	2,017,833	2,003,786
Commitments and contingencies		
Shareholders' equity:		
Common stock, \$0.0001 par value, 400,000 shares authorized; 178,692 shares issued and outstanding at March 31, 2009, and December 31, 2008	18	18
Additional paid-in capital	3,036,236	3,037,845
Notes receivable from sale of common stock	(457)	(1,089)
Net unrealized appreciation (depreciation)	(1,853,159)	(1,503,089)
Undistributed earnings	187,115	184,715

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Total shareholders' equity	1,369,753	1,718,400
Total liabilities and shareholders' equity	\$ 3,387,586	\$ 3,722,186
Net asset value per common share	\$ 7.67	\$ 9.62

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

## ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

## CONSOLIDATED STATEMENT OF OPERATIONS

(in thousands, except per share amounts)	<b>For the Three Months Ended March 31, 2009                      2008 (unaudited)</b>	
Interest and Related Portfolio Income:		
Interest and dividends		
Companies more than 25% owned	\$ 25,353	\$ 28,624
Companies 5% to 25% owned	11,136	12,674
Companies less than 5% owned	52,241	93,362
Total interest and dividends	88,730	134,660
Fees and other income		
Companies more than 25% owned	5,276	5,465
Companies 5% to 25% owned	17	53
Companies less than 5% owned	1,159	4,766
Total fees and other income	6,452	10,284
Total interest and related portfolio income	95,182	144,944
Expenses:		
Interest	43,485	37,560
Employee	11,070	22,652
Employee stock options	773	4,195
Administrative	9,845	9,019
Impairment of long-lived asset	2,873	
Total operating expenses	68,046	73,426
Gain on repurchase of debt	1,995	
Net investment income before income taxes	29,131	71,518
Income tax expense (benefit), including excise tax	(378)	1,969
Net investment income	29,509	69,549
Net Realized and Unrealized Gains (Losses):		
Net realized gains (losses)		
Companies more than 25% owned	(4,050)	(303)
Companies 5% to 25% owned	(30,095)	1,243

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Companies less than 5% owned	7,036	2,203
Total net realized gains (losses)	(27,109)	3,143
Net change in unrealized appreciation or depreciation	(350,070)	(113,404)
Total net gains (losses)	(377,179)	(110,261)
Net increase (decrease) in net assets resulting from operations	\$ (347,670)	\$ (40,712)
Basic earnings (loss) per common share	\$ (1.95)	\$ (0.25)
Diluted earnings (loss) per common share	\$ (1.95)	\$ (0.25)
Weighted average common shares outstanding basic	178,692	161,507
Weighted average common shares outstanding diluted	178,692	161,507

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)	<b>For the Three Months Ended March 31, 2009                      2008 (unaudited)</b>	
Operations:		
Net investment income	\$ 29,509	\$ 69,549
Net realized gains (losses)	(27,109)	3,143
Net change in unrealized appreciation or depreciation	(350,070)	(113,404)
Net increase (decrease) in net assets resulting from operations	(347,670)	(40,712)
Shareholder distributions:		
Common stock dividends		(108,081)
Net decrease in net assets resulting from shareholder distributions		(108,081)
Capital share transactions:		
Sale of common stock		170,883
Issuance of common stock in lieu of cash distributions		3,751
Stock option expense	773	4,195
Net decrease in notes receivable from sale of common stock	632	143
Purchase of common stock held in deferred compensation trusts		(943)
Distribution of common stock held in deferred compensation trusts		27,335
Other	(2,382)	
Net increase (decrease) in net assets resulting from capital share transactions	(977)	205,364
Total increase (decrease) in net assets	(348,647)	56,571
Net assets at beginning of period	1,718,400	2,771,847
Net assets at end of period	\$ 1,369,753	\$ 2,828,418
Net asset value per common share	\$ 7.67	\$ 16.99
Common shares outstanding at end of period	178,692	166,472

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



## ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

## CONSOLIDATED STATEMENT OF CASH FLOWS

(in thousands)	<b>For the Three Months Ended March 31, 2009                      2008 (unaudited)</b>	
Cash flows from operating activities:		
Net increase (decrease) in net assets resulting from operations	\$ (347,670)	\$ (40,712)
Adjustments:		
Portfolio investments	(39,917)	(275,130)
Principal collections related to investment repayments or sales	109,524	264,777
Collections of notes and other consideration received from sale of investments	132,246	4,901
Realized gains from the receipt of notes and other consideration from sale of investments	(4,058)	(5,466)
Realized losses	39,874	29,597
Payment-in-kind interest and dividends, net of cash collections	(7,659)	(13,392)
Change in accrued interest and dividends	1,554	(2,280)
Net collection (amortization) of discounts and fees	(4,697)	(3,748)
Redemption of (investments in) U.S. Treasury bills, money market and other securities	282	80,834
Stock option expense	773	4,195
Impairment of long-lived asset	2,873	
Changes in other assets and liabilities	8,498	(46,218)
Depreciation and amortization	398	528
Gain on repurchase of debt	(1,995)	
Net change in unrealized (appreciation) or depreciation	350,070	113,404
Net cash provided by operating activities	240,096	111,290
Cash flows from financing activities:		
Sale of common stock		170,883
Collections of notes receivable from sale of common stock	258	143
Repurchase of notes payable	(529)	
Net borrowings under (repayments on) revolving line of credit		(98,500)
Purchase of common stock held in deferred compensation trusts		(943)
Other financing activities		(916)
Common stock dividends and distributions paid		(104,330)
Net cash provided by (used in) financing activities	(271)	(33,663)
Net increase (decrease) in cash	239,825	77,627
Cash at beginning of period	50,402	3,540
Cash at end of period	\$ 290,227	\$ 81,167

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

## ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

## CONSOLIDATED STATEMENT OF INVESTMENTS

Private Finance Portfolio Company (in thousands, except number of shares) Companies More Than 25% Owned	Investment <sup>(1)(2)</sup>	March 31, 2009 (unaudited)		
		Principal	Cost	Value
AGILE Fund I, LLC <sup>(5)</sup>	Equity Interests		\$ 679	\$ 416
(Private Equity Fund)	<b>Total Investment</b>		<b>679</b>	<b>416</b>
AllBridge Financial, LLC	Equity Interests		34,967	11,071
(Asset Management)	<b>Total Investment</b>		<b>34,967</b>	<b>11,071</b>
	Standby Letter of Credit (\$15,000)			
Allied Capital Senior Debt Fund, L.P. <sup>(5)</sup>	Equity Interests (See Note 3)		31,800	32,877
(Private Debt Fund)	<b>Total Investment</b>		<b>31,800</b>	<b>32,877</b>
Avborne, Inc. <sup>(7)</sup>	Preferred Stock (12,500 shares)			938
(Business Services)	Common Stock (27,500 shares)			
	<b>Total Investment</b>			<b>938</b>
Avborne Heavy Maintenance, Inc. <sup>(7)</sup>	Common Stock (2,750 shares)			660
(Business Services)	<b>Total Investment</b>			<b>660</b>
Aviation Properties Corporation	Common Stock (100 shares)		93	
(Business Services)	<b>Total Investment</b>		<b>93</b>	
	Standby Letters of Credit (\$1,000)			
Border Foods, Inc.	Senior Loan (12.8%, Due 3/12)	\$ 33,900	27,962	33,900
(Consumer Products)	Preferred Stock (100,000 shares)		12,721	9,215

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	Common Stock (260,467 shares)		3,847	
	<b>Total Investment</b>		<b>44,530</b>	<b>43,115</b>
Calder Capital Partners, LLC <sup>(5)</sup> (Asset Management)	Senior Loan (10.5%, Due 5/09) <sup>(6)</sup>	4,496	4,496	881
	Equity Interests		2,453	
	<b>Total Investment</b>		<b>6,949</b>	<b>881</b>
Callidus Capital Corporation (Asset Management)	Subordinated Debt (18.0%, Due 8/13)	16,203	16,203	16,203
	Common Stock (100 shares)			27,705
	<b>Total Investment</b>		<b>16,203</b>	<b>43,908</b>
	Guaranty (\$6,447)			

- (1) Interest rates represent the weighted average annual stated interest rate on loans and debt securities, which are presented by nature of indebtedness for a single issuer. The maturity dates represent the earliest and the latest maturity dates.
- (2) Common stock, preferred stock, warrants, options, and equity interests are generally non-income producing and restricted.
- (5) Non-registered investment company.
- (6) Loan or debt security is on non-accrual status and therefore is considered non-income producing.
- (7) Avborne, Inc. and Avborne Heavy Maintenance, Inc. are affiliated companies.

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

## ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

## CONSOLIDATED STATEMENT OF INVESTMENTS (Continued)

Private Finance Portfolio Company (in thousands, except number of shares)	Investment <sup>(1)(2)</sup>	March 31, 2009 (unaudited)		
		Principal	Cost	Value
Ciena Capital LLC (Financial Services)	Senior Loan (5.5%, Due 3/09) <sup>(6)</sup> Class B Equity Interests Class C Equity Interests	\$ 319,031	\$ 319,031 119,436 112,601	\$ 64,088
	<b>Total Investment</b>		<b>551,068</b>	<b>64,088</b>
	Guaranty (\$5,000 See Note 3) Standby Letters of Credit (\$94,100 See Note 3)			
CitiPostal Inc. (Business Services)	Senior Loan (4.0%, Due 12/13) Unitranche Debt (12.0%, Due 12/13) Subordinated Debt (16.0%, Due 12/15) Common Stock (37,024 shares)	692 51,892 9,491	682 51,692 9,491 12,726	682 51,692 9,491
	<b>Total Investment</b>		<b>74,591</b>	<b>61,865</b>
Coverall North America, Inc. (Business Services)	Unitranche Debt (12.0%, Due 7/11) Subordinated Debt (15.0%, Due 7/11) Common Stock (763,333 shares)	32,035 5,563	31,956 5,550 14,362	31,956 5,550 19,011
	<b>Total Investment</b>		<b>51,868</b>	<b>56,517</b>
CR Holding, Inc. (Consumer Products)	Subordinated Debt (16.6%, Due 2/13) <sup>(6)</sup> Common Stock (32,090,696 shares)	39,307	39,193 28,744	9,992
	<b>Total Investment</b>		<b>67,937</b>	<b>9,992</b>

Crescent Equity Corp. <sup>(8)</sup>	Senior Loan (10.0%, Due 1/09)	433	433	433
(Business Services)	Subordinated Debt (11.0%, Due 6/17)	2,092	2,084	
	Subordinated Debt (12.0%, Due 12/10 6/17 <sup>9</sup> )	30,276	30,194	6,213
	Common Stock (174 shares)		82,596	39
	<b>Total Investment</b>		<b>115,307</b>	<b>6,685</b>
	Guaranty (\$900)			
Direct Capital Corporation	Senior Loan (8.0%, Due 1/14) <sup>(6)</sup>	8,175	8,175	8,240
(Financial Services)	Subordinated Debt (16.0%, Due 3/13) <sup>(6)</sup>	55,671	55,496	12,390
	Common Stock (2,317,020 shares)		25,732	
	<b>Total Investment</b>		<b>89,403</b>	<b>20,630</b>
Financial Pacific Company	Subordinated Debt (17.4%, Due 2/12 8/12)	68,967	68,850	57,562
(Financial Services)	Preferred Stock (9,458 shares)		8,865	
	Common Stock (12,711 shares)		12,783	
	<b>Total Investment</b>		<b>90,498</b>	<b>57,562</b>

- (1) Interest rates represent the weighted average annual stated interest rate on loans and debt securities, which are presented by nature of indebtedness for a single issuer. The maturity dates represent the earliest and the latest maturity dates.
- (2) Common stock, preferred stock, warrants, options, and equity interests are generally non-income producing and restricted.
- (6) Loan or debt security is on non-accrual status and therefore is considered non-income producing.
- (8) Crescent Equity Corp. holds investments in Crescent Hotels & Resorts, LLC and affiliates.

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

## ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

## CONSOLIDATED STATEMENT OF INVESTMENTS (Continued)

<b>Private Finance Portfolio Company (in thousands, except number of shares)</b>	<b>Investment<sup>(1)(2)</sup></b>	<b>Principal</b>	<b>March 31, 2009 (unaudited)</b>	
			<b>Cost</b>	<b>Value</b>
ForeSite Towers, LLC	Equity Interest		\$	\$ 895
(Tower Leasing)	<b>Total Investment</b>			<b>895</b>
Global Communications, LLC	Senior Loan (10.0%, Due 9/02) <sup>(6)</sup>	\$ 1,335	1,335	1,335
(Business Services)	<b>Total Investment</b>		<b>1,335</b>	<b>1,335</b>
Hot Light Brands, Inc. (Retail)	Senior Loan (9.0%, Due 2/11) <sup>(6)</sup> Common Stock (93,500 shares)	30,572	30,572 5,151	13,443
	<b>Total Investment</b>		<b>35,723</b>	<b>13,443</b>
	Standby Letter of Credit (\$70)			
Hot Stuff Foods, LLC (Consumer Products)	Senior Loan (4.0%, Due 2/11-2/12) Subordinated Debt (12.5%, Due 8/12-2/13) <sup>(6)</sup> Common Stock (1,147,453 shares)	52,387 83,692	52,257 83,387 56,187	50,112
	<b>Total Investment</b>		<b>191,831</b>	<b>50,112</b>
Huddle House, Inc. (Retail)	Subordinated Debt (15.0%, Due 12/12) Common Stock (358,428 shares)	57,683	57,517 35,828	57,517 17,455
	<b>Total Investment</b>		<b>93,345</b>	<b>74,972</b>
IAT Equity, LLC and Affiliates d/b/a Industrial Air Tool (Industrial Products)	Subordinated Debt (9.0%, Due 6/14) Equity Interests	6,000	6,000 7,500	6,000 9,078
	<b>Total Investment</b>		<b>13,500</b>	<b>15,078</b>

Impact Innovations Group, LLC	Equity Interests in Affiliate			322
(Business Services)	<b>Total Investment</b>			<b>322</b>
Insight Pharmaceuticals Corporation	Subordinated Debt (15.0%, Due 9/12)	46,064	45,982	46,064
(Consumer Products)	Subordinated Debt (19.0%, Due 9/12) <sup>(6)</sup>	16,775	16,724	17,532
	Preferred Stock (25,000 shares)		25,000	5,458
	Common Stock (620,000 shares)		6,325	
	<b>Total Investment</b>		<b>94,031</b>	<b>69,054</b>
Jakel, Inc.	Subordinated Debt (15.5%, Due 3/08) <sup>(6)</sup>	748	748	374
(Industrial Products)	<b>Total Investment</b>		<b>748</b>	<b>374</b>
Knightsbridge CLO 2007-1 Ltd. <sup>(4)</sup>	Class E Notes (10.4%, Due 1/22)	18,700	18,700	14,984
(CLO)	Income Notes (0.0%) <sup>(11)</sup>		41,747	20,431
	<b>Total Investment</b>		<b>60,447</b>	<b>35,415</b>

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- (2) Common stock, preferred stock, warrants, options, and equity interests are generally non-income producing and restricted.
- (4) Non-U.S. company or principal place of business outside the U.S.
- (6) Loan or debt security is on non-accrual status and therefore is considered non-income producing.
- (11) Represents the effective interest yield earned on the cost basis of these preferred equity investments and income notes. The yield is included in interest income in the consolidated statement of operations.

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



## ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

## CONSOLIDATED STATEMENT OF INVESTMENTS (Continued)

Private Finance Portfolio Company (in thousands, except number of shares)	Investment <sup>(1)(2)</sup>	Principal	March 31, 2009 (unaudited) Cost	Value
Knightsbridge CLO 2008-1 Ltd. <sup>(4)</sup> (CLO)	Class C Notes (8.8%, Due 6/18)	\$ 12,800	\$ 12,800	\$ 12,181
	Class D Notes (9.8%, Due 6/18)	8,000	8,000	7,046
	Class E Notes (6.3%, Due 6/18)	13,200	10,635	9,195
	Income Notes (20.6%) <sup>(11)</sup>		20,876	19,468
	<b>Total Investment</b>		<b>52,311</b>	<b>47,890</b>
MHF Logistical Solutions, Inc. (Business Services)	Subordinated Debt (13.0%, Due 6/12 6/13) <sup>(9)</sup>	49,841	49,633	
	Preferred Stock (10,000 shares)			
	Common Stock (20,934 shares)		20,942	
	<b>Total Investment</b>		<b>70,575</b>	
MVL Group, Inc. (Business Services)	Senior Loan (12.0%, Due 6/09 7/09)	30,170	30,164	30,164
	Subordinated Debt (14.5%, Due 6/09 7/09)	41,337	41,296	31,956
	Subordinated Debt (3.0%, Due 6/09) <sup>(6)</sup>	144	139	
	Common Stock (560,716 shares)		555	
	<b>Total Investment</b>		<b>72,154</b>	<b>62,120</b>
Penn Detroit Diesel Allison, LLC (Business Services)	Subordinated Debt (15.5%, Due 8/13)	38,269	38,160	38,160
	Equity Interests		18,873	20,191
	<b>Total Investment</b>		<b>57,033</b>	<b>58,351</b>
Service Champ, Inc.		27,223	27,162	27,162

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(Business Services)	Subordinated Debt (15.5%, Due 4/12) Common Stock (55,112 shares)		11,785	22,829
	<b>Total Investment</b>		<b>38,947</b>	<b>49,991</b>
Stag-Parkway, Inc. (Business Services)	Subordinated Debt (10.0%, Due 7/12) Common Stock (25,000 shares)	18,574	18,524	18,524
	<b>Total Investment</b>		<b>51,210</b>	<b>24,105</b>
Startec Equity, LLC (Telecommunications)	Equity Interests		211	7
	<b>Total Investment</b>		<b>211</b>	<b>7</b>
Unitranche Fund LLC (Private Debt Fund)	Subordinated Certificates (9.1%) Equity Interests		124,521	124,521
	<b>Total Investment</b>		<b>124,522</b>	<b>124,522</b>
Worldwide Express Operations, LLC (Business Services)	Subordinated Debt (14.0%, Due 2/14) <sup>(6)</sup> Equity Interests Warrants	2,823	2,680	11,084
	<b>Total Investment</b>		<b>13,908</b>	
<b>Total companies more than 25% owned</b>			<b>\$ 2,147,724</b>	<b>\$ 1,039,191</b>

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- (4) Non-U.S. company or principal place of business outside the U.S.
- (6) Loan or debt security is on non-accrual status and therefore is considered non-income producing.
- (11) Represents the effective interest yield earned on the cost basis of these preferred equity investments and income notes. The yield is included in interest income in the consolidated statement of operations.

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



**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENT OF INVESTMENTS (Continued)**

Private Finance Portfolio Company (in thousands, except number of shares) Companies 5% to 25% Owned	Investment <sup>(1)(2)</sup>	March 31, 2009 (unaudited)		
		Principal	Cost	Value
10 <sup>th</sup> Street, LLC	Subordinated Debt (13.0%, Due 11/14)	\$ 21,657	\$ 21,552	\$ 21,657
(Business Services)	Equity Interests		422	511
	Option		25	25
	<b>Total Investment</b>		<b>21,999</b>	<b>22,193</b>
Air Medical Group Holdings LLC	Senior Loan (4.5%, Due 3/11)	2,220	2,190	2,078
(Healthcare Services)	Equity Interests		2,993	12,100
	<b>Total Investment</b>		<b>5,183</b>	<b>14,178</b>
Alpine ESP Holdings, Inc.	Preferred Stock (701 shares)		701	
(Business Services)	Common Stock (11,657 shares)		13	
	<b>Total Investment</b>		<b>714</b>	
Amerex Group, LLC	Subordinated Debt (12.3%, Due 1/13)	8,789	8,785	8,785
(Consumer Products)	Equity Interests		3,508	10,505
	<b>Total Investment</b>		<b>12,293</b>	<b>19,290</b>
BB&T Capital Partners/Windsor Mezzanine Fund, LLC <sup>(5)</sup>	Equity Interests		11,789	10,832
(Private Equity Fund)	<b>Total Investment</b>		<b>11,789</b>	<b>10,832</b>
Drew Foam Companies, Inc.	Preferred Stock (622,555 shares)		623	434
(Business Services)	Common Stock (6,286 shares)		6	
	<b>Total Investment</b>		<b>629</b>	<b>434</b>
Driven Brands, Inc.		85,872	85,480	83,568

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(Consumer Services)	Subordinated Debt (16.5%, Due 7/15) Common Stock (3,772,098 shares)		9,516	2,500
	<b>Total Investment</b>		<b>94,996</b>	<b>86,068</b>
Hilden America, Inc. (Consumer Products)	Common Stock (19 shares)		454	
	<b>Total Investment</b>		<b>454</b>	
Lydall Transport, Ltd. (Business Services)	Equity Interests		432	364
	<b>Total Investment</b>		<b>432</b>	<b>364</b>
Multi-Ad Services, Inc. (Business Services)	Unitranche Debt (11.3%, Due 11/11) Equity Interests	2,524	2,503 1,737	2,471 2,185
	<b>Total Investment</b>		<b>4,240</b>	<b>4,656</b>
Pendum Acquisition, Inc. (Business Services)	Common Stock (8,872 shares)			
	<b>Total Investment</b>			

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## ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

## CONSOLIDATED STATEMENT OF INVESTMENTS (Continued)

<b>Private Finance Portfolio Company (in thousands, except number of shares)</b>		<b>March 31, 2009 (unaudited)</b>		
	<b>Investment<sup>(1)(2)</sup></b>	<b>Principal</b>	<b>Cost</b>	<b>Value</b>
Postle Aluminum Company, LLC	Senior Loan (6.0%, Due 10/12) <sup>(6)</sup>	\$ 35,000	\$ 34,876	\$ 13,634
(Industrial Products)	Subordinated Debt (3.0%, Due 10/12) <sup>(6)</sup>	23,953	23,868	
	Equity Interests		2,174	
	<b>Total Investment</b>		<b>60,918</b>	<b>13,634</b>
Progressive International Corporation	Preferred Stock (500 shares)		500	1,147
(Consumer Products)	Common Stock (197 shares)		13	3,700
	Warrants			
	<b>Total Investment</b>		<b>513</b>	<b>4,847</b>
Regency Healthcare Group, LLC	Senior Loan (11.1%, Due 6/12)	2,000	1,989	1,906
(Healthcare Services)	Unitranche Debt (11.1%, Due 6/12)	10,901	10,869	10,522
	Equity Interests		1,302	1,955
	<b>Total Investment</b>		<b>14,160</b>	<b>14,383</b>
SGT India Private Limited <sup>(4)</sup>	Common Stock (150,596 shares)		4,140	
(Business Services)	<b>Total Investment</b>		<b>4,140</b>	
Soteria Imaging Services, LLC	Subordinated Debt (11.3%, Due 11/10)	4,250	4,180	4,071
(Healthcare Services)	Equity Interests		1,881	1,510
	<b>Total Investment</b>		<b>6,061</b>	<b>5,581</b>
Triax Holdings, LLC	Subordinated Debt (21.0%, Due 2/12) <sup>(6)</sup>	10,625	10,587	
(Consumer Products)	Equity Interests		16,528	

	<b>Total Investment</b>		<b>27,115</b>	
Universal Environmental Services, LLC	Equity Interests		1,599	
(Business Services)	<b>Total Investment</b>		<b>1,599</b>	
<b>Total companies 5% to 25% owned</b>			<b>\$ 267,235</b>	<b>\$ 196,460</b>
<b>Companies Less Than 5% Owned</b>				
3SI Security Systems, Inc.	Subordinated Debt (14.0%, Due 8/13)	\$ 20,500	\$ 20,440	\$ 18,442
	Subordinated Debt (16.0%, Due 8/13) <sup>(6)</sup>	9,048	9,030	3,189
(Consumer Products)	<b>Total Investment</b>		<b>29,470</b>	<b>21,631</b>
Abraxas Corporation	Subordinated Debt (14.6%, Due 4/13)	36,644	36,493	35,323
(Business Services)	<b>Total Investment</b>		<b>36,493</b>	<b>35,323</b>
Advantage Sales & Marketing, Inc.	Equity Interests			9,300
(Business Services)	<b>Total Investment</b>			<b>9,300</b>
Augusta Sportswear Group, Inc.	Subordinated Debt (13.0%, Due 1/15)	53,000	52,833	51,638
(Consumer Products)	Common Stock (2,500 shares)		2,500	1,500
	<b>Total Investment</b>		<b>55,333</b>	<b>53,138</b>
Axium Healthcare Pharmacy, Inc.	Senior Loan (14.0%, Due 12/12)	3,750	3,726	3,749
(Healthcare Services)	Unitranche Debt (14.0%, Due 12/12)	8,500	8,472	8,477
	Common Stock (22,860 shares)		2,286	155
	<b>Total Investment</b>		<b>14,484</b>	<b>12,381</b>

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## ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

## CONSOLIDATED STATEMENT OF INVESTMENTS (Continued)

<b>Private Finance Portfolio Company (in thousands, except number of shares)</b>	<b>Investment<sup>(1)(2)</sup></b>	<b>Principal</b>	<b>March 31, 2009 (unaudited) Cost</b>	<b>Value</b>
Baird Capital Partners IV Limited <sup>(5)</sup>	Limited Partnership Interest		\$ 3,636	\$ 2,828
(Private Equity Fund)	<b>Total Investment</b>		<b>3,636</b>	<b>2,828</b>
BenefitMall Holdings Inc.	Subordinated Debt (18.0%, Due 6/14)	\$ 40,326	40,242	40,242
(Business Services)	Common Stock (39,274,290 shares) <sup>(12)</sup>		39,274	79,523
	Warrants <sup>(12)</sup>			
	<b>Total Investment</b>		<b>79,516</b>	<b>119,765</b>
Broadcast Electronics, Inc.	Senior Loan (8.8%, Due 11/11) <sup>(6)</sup>	4,890	4,862	625
(Business Services)	Preferred Stock (2,044 shares)			
	<b>Total Investment</b>		<b>4,862</b>	<b>625</b>
Bushnell, Inc.	Subordinated Debt (7.7%, Due 2/14)	41,325	40,053	33,836
(Consumer Products)	<b>Total Investment</b>		<b>40,053</b>	<b>33,836</b>
Callidus Debt Partners	Class C Notes (12.9%, Due 12/13) <sup>(6)</sup>	18,800	18,907	11,108
CDO Fund I, Ltd. <sup>(4)(10)</sup>	Class D Notes (17.0%, Due 12/13) <sup>(6)</sup>	9,400	9,454	
(CDO)	<b>Total Investment</b>		<b>28,361</b>	<b>11,108</b>
Callidus Debt Partners	Preferred Shares (23,600,000 shares)		20,138	6,360
CLO Fund III, Ltd. <sup>(4)(10)</sup>	<b>Total Investment</b>		<b>20,138</b>	<b>6,360</b>
(CLO)				

Callidus Debt Partners	Class D Notes (5.7%, Due 4/20)	3,000	2,074	1,607
CLO Fund IV, Ltd. <sup>(4)(10)</sup> (CLO)	Income Notes (0.0%) <sup>(11)</sup>		15,040	5,487
	<b>Total Investment</b>		<b>17,114</b>	<b>7,094</b>
Callidus Debt Partners	Income Notes (6.2%) <sup>(11)</sup>		13,631	6,924
CLO Fund V, Ltd. <sup>(4)(10)</sup> (CLO)				
	<b>Total Investment</b>		<b>13,631</b>	<b>6,924</b>
Callidus Debt Partners	Class D Notes (7.1%, Due 10/21)	9,000	7,180	4,004
CLO Fund VI, Ltd. <sup>(4)(10)</sup> (CLO)	Income Notes (2.6%) <sup>(11)</sup>		28,954	8,708
	<b>Total Investment</b>		<b>36,134</b>	<b>12,712</b>
Callidus Debt Partners	Income Notes (2.2%) <sup>(11)</sup>		24,688	10,520
CLO Fund VII, Ltd. <sup>(4)(10)</sup> (CLO)				
	<b>Total Investment</b>		<b>24,688</b>	<b>10,520</b>

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## ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

## CONSOLIDATED STATEMENT OF INVESTMENTS (Continued)

Private Finance Portfolio Company (in thousands, except number of shares)	Investment <sup>(1)(2)</sup>	Principal	March 31, 2009 (unaudited)	
			Cost	Value
Callidus MAPS CLO Fund I LLC <sup>(10)</sup> (CLO)	Class E Notes (6.7%, Due 12/17)	\$ 17,000	\$ 17,000	\$ 11,120
	Income Notes (0.0%) <sup>(11)</sup>		43,814	13,428
	<b>Total Investment</b>		<b>60,814</b>	<b>24,548</b>
Callidus MAPS CLO Fund II, Ltd. <sup>(4)(10)</sup>  (CLO)	Class D Notes (5.4%, Due 7/22)	7,700	3,615	3,005
	Income Notes (0.0%) <sup>(11)</sup>		18,804	4,401
	<b>Total Investment</b>		<b>22,419</b>	<b>7,406</b>
Carlisle Wide Plank Floors, Inc. (Consumer Products)	Senior Loan (6.1%, Due 6/11)	500	498	454
	Unitranche Debt (12.8%, Due 6/11)	3,161	3,141	2,894
	Preferred Stock (345,056 Shares)		345	93
	<b>Total Investment</b>		<b>3,984</b>	<b>3,441</b>
Catterton Partners VI, L.P. <sup>(5)</sup>  (Private Equity Fund)	Limited Partnership Interest		2,951	1,773
	<b>Total Investment</b>		<b>2,951</b>	<b>1,773</b>
Centre Capital Investors V, L.P. <sup>(5)</sup>  (Private Equity Fund)	Limited Partnership Interest		2,767	1,934
	<b>Total Investment</b>		<b>2,767</b>	<b>1,934</b>
CK Franchising, Inc. (Consumer Services)	Senior Loan (5.5%, Due 7/12)	1,600	1,585	1,585
	Subordinated Debt (12.3%, Due 7/12 7/17)	21,115	21,048	21,048
	Preferred Stock (1,281,887 shares)		1,282	1,651
	Common Stock (7,585,549 shares)		7,586	11,100
	<b>Total Investment</b>		<b>31,501</b>	<b>35,384</b>

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Commercial Credit Group, Inc.	Subordinated Debt (15.0%, Due 6/15)	19,000	18,970	18,970
(Financial Services)	Preferred Stock (64,679 shares) Warrants		15,543	9,074
	<b>Total Investment</b>		<b>34,513</b>	<b>28,044</b>
Community Education Centers, Inc.	Subordinated Debt (14.5%, Due 11/13)	35,749	35,690	33,260
(Education Services)	<b>Total Investment</b>		<b>35,690</b>	<b>33,260</b>
Component Hardware Group, Inc.	Subordinated Debt (13.5%, Due 1/13)	18,780	18,728	17,919
(Industrial Products)	<b>Total Investment</b>		<b>18,728</b>	<b>17,919</b>
Cook Inlet Alternative Risk, LLC	Unitranche Debt (10.8%, Due 4/13)	87,800	87,442	69,000
(Business Services)	Equity Interests		552	
	<b>Total Investment</b>		<b>87,994</b>	<b>69,000</b>
Cortec Group Fund IV, L.P. <sup>(5)</sup>	Limited Partnership Interest		4,727	2,941
(Private Equity)	<b>Total Investment</b>		<b>4,727</b>	<b>2,941</b>

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## ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

## CONSOLIDATED STATEMENT OF INVESTMENTS (Continued)

Private Finance Portfolio Company (in thousands, except number of shares)	Investment <sup>(1)(2)</sup>	March 31, 2009 (unaudited)		
		Principal	Cost	Value
Diversified Mercury	Senior Loan (4.5%, Due 3/13)	\$ 2,966	\$ 2,953	\$ 2,688
Communications, LLC  (Business Services)	<b>Total Investment</b>		<b>2,953</b>	<b>2,688</b>
Digital VideoStream, LLC  (Business Services)	Unitranche Debt (11.0%, Due 2/12)	14,133	14,073	13,934
	Convertible Subordinated Debt (10.0%, Due 2/16)	4,659	4,647	4,647
	<b>Total Investment</b>		<b>18,720</b>	<b>18,581</b>
DirectBuy Holdings, Inc.  (Consumer Products)	Subordinated Debt (14.5%, Due 5/13)	76,384	76,100	65,015
	Equity Interests		8,000	560
	<b>Total Investment</b>		<b>84,100</b>	<b>65,575</b>
Distant Lands Trading Co. (Consumer Products)	Senior Loan (7.5%, Due 11/11)	10,000	9,977	9,437
	Unitranche Debt (12.3%, Due 11/11)	43,337	43,236	42,361
	Common Stock (3,451 shares)		3,451	623
	<b>Total Investment</b>		<b>56,664</b>	<b>52,421</b>
Dryden XVIII Leveraged Loan 2007 Limited <sup>(4)</sup>  (CLO)	Class B Notes (5.7%, Due 10/19)	9,000	7,780	3,093
	Income Notes (8.2%) <sup>(11)</sup>		22,694	8,671
	<b>Total Investment</b>		<b>30,474</b>	<b>11,764</b>
Dynamic India Fund IV <sup>(4)(5)</sup>  (Private Equity Fund)	Equity Interests		9,350	8,842
	<b>Total Investment</b>		<b>9,350</b>	<b>8,842</b>

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EarthColor, Inc.	Subordinated Debt (15.0%, Due 11/13) <sup>(6)</sup>	123,819	123,385	
(Business Services)	Common Stock (63,438 shares) <sup>(12)</sup> Warrants <sup>(12)</sup>		63,438	
	<b>Total Investment</b>		<b>186,823</b>	
eCentury Capital Partners, L.P. <sup>(5)</sup>	Limited Partnership Interest		7,274	308
(Private Equity Fund)	<b>Total Investment</b>		<b>7,274</b>	<b>308</b>
eInstruction Corporation	Subordinated Debt (12.7%, Due 7/14-1/15)	34,631	34,500	31,799
(Education Services)	Common Stock (2,406 shares)		2,500	1,100
	<b>Total Investment</b>		<b>37,000</b>	<b>32,899</b>
Farley s & Sathers Candy Company, Inc.	Subordinated Debt (8.5%, Due 3/11)	2,500	2,494	2,374
(Consumer Products)	<b>Total Investment</b>		<b>2,494</b>	<b>2,374</b>

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**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENT OF INVESTMENTS (Continued)**

<b>Private Finance Portfolio Company (in thousands, except number of shares)</b>	<b>Investment<sup>(1)(2)</sup></b>	<b>March 31, 2009 (unaudited)</b>		
		<b>Principal</b>	<b>Cost</b>	<b>Value</b>
FCP-BHI Holdings, LLC	Subordinated Debt (12.0%, Due 9/13)	\$ 28,116	\$ 28,028	\$ 26,081
d/b/a Bojangles (Retail)	Equity Interests		1,029	1,800
	<b>Total Investment</b>		<b>29,057</b>	<b>27,881</b>
Fidus Mezzanine Capital, L.P. <sup>(5)</sup> (Private Equity Fund)	Limited Partnership Interest		12,828	7,653
	<b>Total Investment</b>		<b>12,828</b>	<b>7,653</b>
Freedom Financial Network, LLC (Financial Services)	Subordinated Debt (13.5%, Due 2/14)	13,000	12,947	13,168
	<b>Total Investment</b>		<b>12,947</b>	<b>13,168</b>
Geotrace Technologies, Inc. (Energy Services)	Warrants		2,027	3,000
	<b>Total Investment</b>		<b>2,027</b>	<b>3,000</b>
Gilchrist & Soames, Inc. (Consumer Products)	Subordinated Debt (13.4%, Due 10/13)	25,800	25,667	23,807
	<b>Total Investment</b>		<b>25,667</b>	<b>23,807</b>
Havco Wood Products LLC (Industrial Products)	Equity Interests		910	
	<b>Total Investment</b>		<b>910</b>	
Higginbotham Insurance Agency, Inc. (Business Services)	Subordinated Debt (13.7%, Due 8/13 8/14) Common Stock (23,695 shares) <sup>(12)</sup> Warrant <sup>(12)</sup>	53,305	53,098	53,098
			23,695	15,881
	<b>Total Investment</b>		<b>76,793</b>	<b>68,979</b>

The Hillman Companies, Inc. <sup>(3)</sup>	Subordinated Debt (10.0%, Due 9/11)	44,580	44,499	43,867
(Consumer Products)	<b>Total Investment</b>		<b>44,499</b>	<b>43,867</b>
The Homax Group, Inc.	Senior Loan (6.7%, Due 10/12)	11,203	11,159	10,013
(Consumer Products)	Subordinated Debt (14.5%, Due 4/14)	14,158	13,558	9,282
	Preferred Stock (76 shares)		76	
	Common Stock (24 shares)		5	
	Warrants		954	
	<b>Total Investment</b>		<b>25,752</b>	<b>19,295</b>
Ideal Snacks Corporation	Senior Loan (7.3%, Due 6/10)	1,333	1,333	1,286
(Consumer Products)	<b>Total Investment</b>		<b>1,333</b>	<b>1,286</b>

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## ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

## CONSOLIDATED STATEMENT OF INVESTMENTS (Continued)

Private Finance Portfolio Company (in thousands, except number of shares)	Investment <sup>(1)(2)</sup>	March 31, 2009 (unaudited)		
		Principal	Cost	Value
Kodiak Fund LP <sup>(5)</sup>	Equity Interests		\$ 9,368	\$ 900
(Private Equity Fund)	<b>Total Investment</b>		<b>9,368</b>	<b>900</b>
Market Track Holdings, LLC (Business Services)	Senior Loan (8.0%, Due 6/14)	\$ 2,500	2,450	2,352
	Subordinated Debt (15.9%, Due 6/14)	24,600	24,493	23,287
	<b>Total Investment</b>		<b>26,943</b>	<b>25,639</b>
NetShape Technologies, Inc.	Senior Loan (5.3%, Due 2/13)	441	441	375
(Industrial Products)	<b>Total Investment</b>		<b>441</b>	<b>375</b>
Network Hardware Resale, Inc. (Business Services)	Unitranche Debt (12.0%, Due 12/11)	16,618	16,682	16,632
	Convertible Subordinated Debt (9.8%, Due 12/15)	15,953	16,004	16,004
	<b>Total Investment</b>		<b>32,686</b>	<b>32,636</b>
Novak Biddle Venture Partners III, L.P. <sup>(5)</sup>	Limited Partnership Interest		2,018	1,227
(Private Equity Fund)	<b>Total Investment</b>		<b>2,018</b>	<b>1,227</b>
Oahu Waste Services, Inc. (Business Services)	Stock Appreciation Rights		206	375
	<b>Total Investment</b>		<b>206</b>	<b>375</b>
Pangaea CLO 2007-1 Ltd. <sup>(4)</sup>	Class D Notes (5.9%, Due 4/09)	15,000	11,864	4,554
(CLO)	<b>Total Investment</b>		<b>11,864</b>	<b>4,554</b>
PC Helps Support, LLC	Senior Loan (4.3%, Due 12/13)	8,610	8,520	8,573

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(Business Services)	Subordinated Debt (12.8%, Due 12/13)	28,136	28,016	28,934
	<b>Total Investment</b>		<b>36,536</b>	<b>37,507</b>
Performant Financial Corporation	Common Stock (478,816 shares)		734	400
(Business Services)	<b>Total Investment</b>		<b>734</b>	<b>400</b>

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## ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

## CONSOLIDATED STATEMENT OF INVESTMENTS (Continued)

Private Finance Portfolio Company (in thousands, except number of shares)	Investment <sup>(1)(2)</sup>	March 31, 2009 (unaudited)		
		Principal	Cost	Value
PharMEDium Healthcare Corporation	Senior Loan (3.8%, Due 10/13)	\$ 1,910	\$ 1,910	\$ 1,747
(Healthcare Services)	<b>Total Investment</b>		<b>1,910</b>	<b>1,747</b>
Promo Works, LLC	Unitranche Debt (12.3%, Due 12/11)	23,111	22,967	21,030
(Business Services)	<b>Total Investment</b>		<b>22,967</b>	<b>21,030</b>
Reed Group, Ltd.	Senior Loan (7.2%, Due 12/13)	12,865	12,732	11,429
(Healthcare Services)	Subordinated Debt (15.8%, Due 12/13)	18,723	18,652	16,408
	Equity Interests		1,800	226
	<b>Total Investment</b>		<b>33,184</b>	<b>28,063</b>
S.B. Restaurant Company	Unitranche Debt (9.8%, Due 4/11)	37,327	37,142	35,682
(Retail)	Preferred Stock (46,690 shares)		117	117
	Warrants		534	
	<b>Total Investment</b>		<b>37,793</b>	<b>35,799</b>
	Standby Letters of Credit (\$2,465)			
Snow Phipps Group, L.P. <sup>(5)</sup>	Limited Partnership Interest		4,962	4,256
(Private Equity Fund)	<b>Total Investment</b>		<b>4,962</b>	<b>4,256</b>
SPP Mezzanine Funding II, L.P. <sup>(5)</sup>	Limited Partnership Interest		9,118	9,018
(Private Equity Fund)	<b>Total Investment</b>		<b>9,118</b>	<b>9,018</b>

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STS Operating, Inc.	Subordinated Debt (11.0%, Due 1/13)	30,386	30,301	28,829
(Industrial Products)	<b>Total Investment</b>		<b>30,301</b>	<b>28,829</b>
Summit Energy Services, Inc. (Business Services)	Subordinated Debt (11.6%, Due 8/13)	35,130	34,954	34,115
	Common Stock (415,982 shares)		1,861	2,000
	<b>Total Investment</b>		<b>36,815</b>	<b>36,115</b>
Tank Intermediate Holding Corp. (Industrial Products)	Senior Loan (6.8%, Due 9/14)	16,552	16,000	13,946
	<b>Total Investment</b>		<b>16,000</b>	<b>13,946</b>

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- (2) Common stock, preferred stock, warrants, options, and equity interests are generally non-income producing and restricted.
- (5) Non-registered investment company.
- (6) Loan or debt security is on non-accrual status and therefore is considered non-income producing.

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

## ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

## CONSOLIDATED STATEMENT OF INVESTMENTS (Continued)

Private Finance Portfolio Company (in thousands, except number of shares)	Investment <sup>(1)(2)</sup>	Principal	March 31, 2009 (unaudited) Cost	Value
Tappan Wire & Cable Inc. (Business Services)	Unitranche Debt (15.0%, Due 8/14) <sup>(6)</sup> Common Stock (12,940 shares) <sup>(12)</sup> Warrant <sup>(12)</sup>	\$ 22,346	\$ 22,247	\$ 7,464
	<b>Total Investment</b>		<b>24,290</b>	<b>7,464</b>
The Step2 Company, LLC (Consumer Products)	Unitranche Debt (11.0%, Due 4/12) Equity Interests	95,083	94,836 2,156	89,671 1,065
	<b>Total Investment</b>		<b>96,992</b>	<b>90,736</b>
Tradesmen International, Inc. (Business Services)	Subordinated Debt (12.0%, Due 12/12)	40,000	39,654	35,479
	<b>Total Investment</b>		<b>39,654</b>	<b>35,479</b>
TransAmerican Auto Parts, LLC (Consumer Products)	Subordinated Debt (16.3%, Due 11/12) <sup>(6)</sup> Equity Interests	24,561	24,409 1,034	
	<b>Total Investment</b>		<b>25,443</b>	
Trover Solutions, Inc. (Business Services)	Subordinated Debt (12.0%, Due 11/12)	60,286	60,093	56,474
	<b>Total Investment</b>		<b>60,093</b>	<b>56,474</b>
United Road Towing, Inc. (Consumer Services)	Subordinated Debt (11.8%, Due 1/14)	20,000	19,920	19,772
	<b>Total Investment</b>		<b>19,920</b>	<b>19,772</b>

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Venturehouse-Cibernet Investors, LLC (Business Services)	Equity Interest  <b>Total Investment</b>			
WMA Equity Corporation and Affiliates  d/b/a Wear Me Apparel (Consumer Products)	Subordinated Debt (16.8%, Due 4/13-4/14) <sup>(6)</sup> Common Stock (86 shares)  <b>Total Investment</b>	139,455	138,559  39,635  <b>178,194</b>	46,932    <b>46,932</b>
Webster Capital II, L.P. <sup>(5)</sup> (Private Equity Fund)	Limited Partnership Interest  <b>Total Investment</b>		1,899  <b>1,899</b>	1,466  <b>1,466</b>
Woodstream Corporation (Consumer Products)	Subordinated Debt (12.0%, Due 2/15) Common Stock (6,960 shares)  <b>Total Investment</b>	90,000	89,648  6,961  <b>96,609</b>	78,683  1,300  <b>79,983</b>
Other companies	Other debt investments Other equity investments  <b>Total Investment</b>	155	81  31  <b>112</b>	74  8  <b>82</b>
	Standby Letters of Credit (\$200)			
<b>Total companies less than 5% owned</b>			<b>\$ 2,234,718</b>	<b>\$ 1,594,387</b>
<b>Total private finance (132 portfolio investments)</b>			<b>\$ 4,649,677</b>	<b>\$ 2,830,038</b>

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- (2) Common stock, preferred stock, warrants, options, and equity interests are generally non-income producing and restricted.
- (5) Non-registered investment company.
- (6) Loan or debt security is on non-accrual status and therefore is considered non-income producing.
- (12) Common stock is non-voting. In addition to non-voting stock ownership, the Company has an option to acquire a majority of the voting securities of the portfolio company at fair market value.

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

## ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

## CONSOLIDATED STATEMENT OF INVESTMENTS (Continued)

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

			March 31, 2009 (unaudited)	
	Stated Interest Rate Ranges	Number of Loans	Cost	Value
<b>Commercial Mortgage Loans</b>				
	Up to 6.99%	4	\$ 30,680	\$ 29,538
	7.00% 8.99%	2	2,003	1,940
	9.00% 10.99%	1	6,469	6,469
	11.00% 12.99%	1	10,472	9,316
	15.00% and above	2	3,970	6,670
<b>Total commercial mortgage loans<sup>(13)</sup></b>			<b>\$ 53,594</b>	<b>\$ 53,933</b>
<b>Real Estate Owned</b>			<b>\$ 15,042</b>	<b>\$ 7,801</b>
<b>Equity Interests<sup>(2)</sup> Companies more than 25% owned</b>			<b>\$ 13,705</b>	<b>\$ 17,296</b>
Guarantees (\$6,871)				
Standby Letter of Credit (\$650)				
<b>Total commercial real estate finance</b>			<b>\$ 82,341</b>	<b>\$ 79,030</b>
<b>Total portfolio</b>			<b>\$ 4,732,018</b>	<b>\$ 2,909,068</b>

	Yield	Cost	Value
<b>Investments in Money Market and Other Securities</b>			
SEI Daily Income Tr Prime Obligation Money Market Fund	0.2 %	\$ 5	\$ 5
Total		\$ 5	\$ 5

(2) Common stock, preferred stock, warrants, options, and equity interests are generally non-income producing and restricted.

(13) Commercial mortgage loans totaling \$11.0 million at value were on non-accrual status and therefore were considered non-income producing.

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





## ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

## CONSOLIDATED STATEMENT OF INVESTMENTS

Private Finance Portfolio Company (in thousands, except number of shares) Companies More Than 25% Owned	Investment <sup>(1)(2)</sup>	December 31, 2008		
		Principal	Cost	Value
AGILE Fund I, LLC <sup>(5)</sup>	Equity Interests		\$ 694	\$ 497
(Private Equity Fund)	<b>Total Investment</b>		<b>694</b>	<b>497</b>
AllBridge Financial, LLC	Equity Interests		33,294	10,960
(Asset Management)	<b>Total Investment</b>		<b>33,294</b>	<b>10,960</b>
	Standby Letter of Credit (\$15,000)			
Allied Capital Senior Debt Fund, L.P. <sup>(5)</sup>	Equity Interests (See Note 3)		31,800	31,800
(Private Debt Fund)	<b>Total Investment</b>		<b>31,800</b>	<b>31,800</b>
Avborne, Inc. <sup>(7)</sup>	Preferred Stock (12,500 shares)			942
(Business Services)	Common Stock (27,500 shares)			
	<b>Total Investment</b>			<b>942</b>
Avborne Heavy Maintenance, Inc. <sup>(7)</sup>	Common Stock (2,750 shares)			
(Business Services)	<b>Total Investment</b>			
Aviation Properties Corporation	Common Stock (100 shares)		93	
(Business Services)	<b>Total Investment</b>		<b>93</b>	
	Standby Letters of Credit (\$1,000)			
Border Foods, Inc.	Senior Loan (12.6%, Due 12/09 3/12)	\$ 33,027	26,860	33,027
(Consumer Products)	Preferred Stock (100,000 shares)		12,721	11,851
	Common Stock (260,467 shares)		3,847	

	<b>Total Investment</b>		<b>43,428</b>	<b>44,878</b>
Calder Capital Partners, LLC <sup>(5)</sup> (Asset Management)	Senior Loan (10.5%, Due 5/09) <sup>(6)</sup> Equity Interests	4,496	4,496 2,453	953
	<b>Total Investment</b>		<b>6,949</b>	<b>953</b>
Callidus Capital Corporation (Asset Management)	Subordinated Debt (18.0%, Due 8/13 2/14) Common Stock (100 shares)	16,068	16,068	16,068 34,377
	<b>Total Investment</b>		<b>16,068</b>	<b>50,445</b>
	Guaranty (\$6,447)			

- (1) Interest rates represent the weighted average annual stated interest rate on loans and debt securities, which are presented by nature of indebtedness for a single issuer. The maturity dates represent the earliest and the latest maturity dates.
- (2) Common stock, preferred stock, warrants, options, and equity interests are generally non-income producing and restricted.
- (5) Non-registered investment company.
- (6) Loan or debt security is on non-accrual status and therefore is considered non-income producing.
- (7) Avborne, Inc. and Avborne Heavy Maintenance, Inc. are affiliated companies.

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

## ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

## CONSOLIDATED STATEMENT OF INVESTMENTS (Continued)

## Private Finance

## Portfolio Company

(in thousands, except number of shares)

	Investment <sup>(1)(2)</sup>	December 31, 2008		
		Principal	Cost	Value
Ciena Capital LLC	Senior Loan (5.5%, Due 3/09) <sup>(6)</sup>	\$ 319,031	\$ 319,031	\$ 104,883
(Financial Services)	Class B Equity Interests		119,436	
	Class C Equity Interests		109,301	
	<b>Total Investment</b>		<b>547,768</b>	<b>104,883</b>
	Guaranty (\$5,000 See Note 3)			
	Standby Letters of Credit (\$102,600 See Note 3)			
CitiPostal Inc.	Senior Loan (4.0%, Due 12/13)	692	681	681
(Business Services)	Unitranche Debt (12.0%, Due 12/13)	51,758	51,548	51,548
	Subordinated Debt (16.0%, Due 12/15)	9,114	9,114	9,114
	Common Stock (37,024 shares)		12,726	8,616
	<b>Total Investment</b>		<b>74,069</b>	<b>69,959</b>
Coverall North America, Inc.	Unitranche Debt (12.0%, Due 7/11)	32,035	31,948	31,948
(Business Services)	Subordinated Debt (15.0%, Due 7/11)	5,563	5,549	5,549
	Common Stock (763,333 shares)		14,361	17,968
	<b>Total Investment</b>		<b>51,858</b>	<b>55,465</b>
CR Holding, Inc.	Subordinated Debt (16.6%, Due 2/13) <sup>(6)</sup>	39,307	39,193	17,360
(Consumer Products)	Common Stock (32,090,696 shares)		28,744	
	<b>Total Investment</b>		<b>67,937</b>	<b>17,360</b>

Crescent Equity Corp. <sup>(8)</sup>	Senior Loan (10.0%, Due 1/09)	433	433	433
(Business Services)	Subordinated Debt (11.0%, Due 9/11 6/17)	22,312	22,247	14,283
	Subordinated Debt (11.0%, Due 1/12 9/12) <sup>(6)</sup>	10,097	10,072	4,331
	Common Stock (174 shares)		81,255	4,580
	<b>Total Investment</b>		<b>114,007</b>	<b>23,627</b>
	Guaranty (\$900)			
	Standby Letters of Credit (\$200)			
Direct Capital Corporation	Subordinated Debt (16.0%, Due 3/13) <sup>(6)</sup>	55,671	55,496	13,530
(Financial Services)	Common Stock (2,317,020 shares)		25,732	
	<b>Total Investment</b>		<b>81,228</b>	<b>13,530</b>
Financial Pacific Company	Subordinated Debt (17.4%, Due 2/12 8/12)	68,967	68,840	62,189
(Financial Services)	Preferred Stock (9,458 shares)		8,865	
	Common Stock (12,711 shares)		12,783	
	<b>Total Investment</b>		<b>90,488</b>	<b>62,189</b>

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- (2) Common stock, preferred stock, warrants, options, and equity interests are generally non-income producing and restricted.
- (6) Loan or debt security is on non-accrual status and therefore is considered non-income producing.
- (8) Crescent Equity Corp. holds investments in Crescent Hotels & Resorts, LLC and affiliates.

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

## ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

## CONSOLIDATED STATEMENT OF INVESTMENTS (Continued)

## Private Finance

## Portfolio Company

(in thousands, except number of shares)

		December 31, 2008		
	Investment <sup>(1)(2)</sup>	Principal	Cost	Value
ForeSite Towers, LLC	Equity Interest		\$	\$ 889
(Tower Leasing)	<b>Total Investment</b>			<b>889</b>
Global Communications, LLC	Senior Loan (10.0%, Due 9/02) <sup>(6)</sup>	\$ 1,335	1,335	1,335
(Business Services)	<b>Total Investment</b>		<b>1,335</b>	<b>1,335</b>
Hot Light Brands, Inc. (Retail)	Senior Loan (9.0%, Due 2/11) <sup>(6)</sup> Common Stock (93,500 shares)	30,522	30,522 5,151	13,678
	<b>Total Investment</b>		<b>35,673</b>	<b>13,678</b>
	Standby Letter of Credit (\$105)			
Hot Stuff Foods, LLC (Consumer Products)	Senior Loan (4.0%, Due 2/11-2/12) Subordinated Debt (12.4%, Due 8/12-2/13) <sup>(6)</sup> Common Stock (1,147,453 shares)	53,597 83,692	53,456 83,387 56,187	42,378
	<b>Total Investment</b>		<b>193,030</b>	<b>42,378</b>
Huddle House, Inc. (Retail)	Subordinated Debt (15.0%, Due 12/12) Common Stock (358,428 shares)	57,244	57,067 35,828	57,067 20,922
	<b>Total Investment</b>		<b>92,895</b>	<b>77,989</b>
IAT Equity, LLC and Affiliates d/b/a Industrial Air Tool (Industrial Products)	Subordinated Debt (9.0%, Due 6/14) Equity Interests	6,000	6,000 7,500	6,000 8,860
	<b>Total Investment</b>		<b>13,500</b>	<b>14,860</b>

Impact Innovations Group, LLC	Equity Interests in Affiliate			321
(Business Services)	<b>Total Investment</b>			<b>321</b>
Insight Pharmaceuticals Corporation	Subordinated Debt (15.0%, Due 9/12)	45,827	45,738	45,827
(Consumer Products)	Subordinated Debt (19.0%, Due 9/12) <sup>(6)</sup>	16,177	16,126	17,532
	Preferred Stock (25,000 shares)		25,000	4,068
	Common Stock (620,000 shares)		6,325	
	<b>Total Investment</b>		<b>93,189</b>	<b>67,427</b>
Jakel, Inc.	Subordinated Debt (15.5%, Due 3/08) <sup>(6)</sup>	748	748	374
(Industrial Products)	<b>Total Investment</b>		<b>748</b>	<b>374</b>
Knightsbridge CLO 2007-1 Ltd. <sup>(4)</sup>	Class E Notes (13.8%, Due 1/22)	18,700	18,700	14,866
(CLO)	Income Notes (14.9%) <sup>(11)</sup>		40,914	35,214
	<b>Total Investment</b>		<b>59,614</b>	<b>50,080</b>

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- (2) Common stock, preferred stock, warrants, options, and equity interests are generally non-income producing and restricted.
- (4) Non-U.S. company or principal place of business outside the U.S.
- (6) Loan or debt security is on non-accrual status and therefore is considered non-income producing.
- (11) Represents the effective interest yield earned on the cost basis of these preferred equity investments and income notes. The yield is included in interest income in the consolidated statement of operations.

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

## ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

## CONSOLIDATED STATEMENT OF INVESTMENTS (Continued)

## Private Finance

## Portfolio Company

(in thousands, except number of shares)

Knightsbridge CLO 2008-1 Ltd.<sup>(4)</sup>

(CLO)

Investment<sup>(1)(2)</sup>Class C Notes (9.3%, Due  
6/18)Class D Notes (10.3%, Due  
6/18)Class E Notes (6.8%, Due  
6/18)Income Notes (16.6%)<sup>(11)</sup>**Total Investment**

December 31, 2008

Principal

Cost

Value

\$ 12,800

\$ 12,800

\$ 12,800

8,000

8,000

8,000

13,200

10,573

10,573

21,315

21,315

**52,688****52,688**

MHF Logistical Solutions, Inc.

(Business Services)

Subordinated Debt (13.0%,  
Due 6/12 6/13<sup>9</sup>)Preferred Stock  
(10,000 shares)Common Stock (20,934  
shares)**Total Investment**

49,841

49,633

20,942

**70,575**

MVL Group, Inc.

(Business Services)

Senior Loan (12.0%, Due  
6/09 7/09)Subordinated Debt (14.5%,  
Due 6/09 7/09)Subordinated Debt (3.0%,  
Due 6/09)<sup>(6)</sup>Common Stock  
(560,716 shares)**Total Investment**

30,674

30,663

30,663

41,074

40,994

40,994

144

139

86

555

**72,351****71,743**

Old Orchard Brands, LLC

(Consumer Products)

Subordinated Debt (18.0%,  
Due 7/14)

Equity Interests

18,951

18,882

18,882

16,857

27,763

**Total Investment****35,739****46,645**

Penn Detroit Diesel Allison, LLC

37,984

37,869

37,869



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(Business Services)	Subordinated Debt (15.5%, Due 8/13) Equity Interests		18,873	21,100
	<b>Total Investment</b>		<b>56,742</b>	<b>58,969</b>
Service Champ, Inc. (Business Services)	Subordinated Debt (15.5%, Due 4/12) Common Stock (55,112 shares)	27,050	26,984	26,984
			11,785	21,156
	<b>Total Investment</b>		<b>38,769</b>	<b>48,140</b>
Stag-Parkway, Inc. (Business Services)	Unitranche Debt (14.0%, Due 7/12) Common Stock (25,000 shares)	17,975	17,920	17,962
			32,686	6,968
	<b>Total Investment</b>		<b>50,606</b>	<b>24,930</b>
Startec Equity, LLC (Telecommunications)	Equity Interests		211	332
	<b>Total Investment</b>		<b>211</b>	<b>332</b>
Unitranche Fund LLC (Private Debt Fund)	Subordinated Certificates (12.0%) Equity Interests		125,423	125,423
			1	1
	<b>Total Investment</b>		<b>125,424</b>	<b>125,424</b>
Worldwide Express Operations, LLC (Business Services)	Subordinated Debt (14.0%, Due 2/14) <sup>(6)</sup> Equity Interests Warrants	2,865	2,722	2,032
			11,384	
			144	
	<b>Total Investment</b>		<b>14,250</b>	<b>2,032</b>
<b>Total companies more than 25% owned</b>			<b>\$ 2,167,020</b>	<b>\$ 1,187,722</b>

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- (2) Common stock, preferred stock, warrants, options, and equity interests are generally non-income producing and restricted.

- (4) Non-U.S. company or principal place of business outside the U.S.
- (6) Loan or debt security is on non-accrual status and therefore is considered non-income producing.
- (11) Represents the effective interest yield earned on the cost basis of these preferred equity investments and income notes. The yield is included in interest income in the consolidated statement of operations.

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

**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENT OF INVESTMENTS (Continued)**

<b>Private Finance Portfolio Company (in thousands, except number of shares) Companies 5% to 25% Owned</b>	<b>Investment<sup>(1)(2)</sup></b>	<b>December 31, 2008</b>		
		<b>Principal</b>	<b>Cost</b>	<b>Value</b>
10 <sup>th</sup> Street, LLC  (Business Services)	Subordinated Debt (13.0%, Due 11/14) Equity Interests Option	\$ 21,439	\$ 21,329 422 25	\$ 21,439 975 25
	<b>Total Investment</b>		<b>21,776</b>	<b>22,439</b>
Advantage Sales & Marketing, Inc.  (Business Services)	Subordinated Debt (12.0%, Due 3/14) Equity Interests	158,617	158,132	135,000 5,000
	<b>Total Investment</b>		<b>158,132</b>	<b>140,000</b>
Air Medical Group Holdings LLC (Healthcare Services)	Senior Loan (3.3%, Due 3/11) Equity Interests	3,360	3,326 2,993	3,139 10,800
	<b>Total Investment</b>		<b>6,319</b>	<b>13,939</b>
Alpine ESP Holdings, Inc. (Business Services)	Preferred Stock (701 shares) Common Stock (11,657 shares)		701 13	
	<b>Total Investment</b>		<b>714</b>	
Amerex Group, LLC  (Consumer Products)	Subordinated Debt (12.3%, Due 1/13) Equity Interests	8,789	8,784 3,508	8,784 9,932
	<b>Total Investment</b>		<b>12,292</b>	<b>18,716</b>
BB&T Capital Partners/Windsor Mezzanine Fund, LLC <sup>(5)</sup> (Private Equity Fund)	Equity Interests		11,789	11,063
	<b>Total Investment</b>		<b>11,789</b>	<b>11,063</b>

Becker Underwood, Inc. (Industrial Products)	Subordinated Debt (14.5%, Due 8/12) Common Stock (4,376 shares)	25,503	25,450 5,014	25,502 2,267
	<b>Total Investment</b>		<b>30,464</b>	<b>27,769</b>
Drew Foam Companies, Inc. (Business Services)	Preferred Stock (622,555 shares) Common Stock (6,286 shares)		623 6	512
	<b>Total Investment</b>		<b>629</b>	<b>512</b>
Driven Brands, Inc. (Consumer Services)	Subordinated Debt (16.5%, Due 7/15) Common Stock (3,772,098 shares)	84,106	83,698 9,516	83,698 4,855
	<b>Total Investment</b>		<b>93,214</b>	<b>88,553</b>
Hilden America, Inc. (Consumer Products)	Common Stock (19 shares)		454	76
	<b>Total Investment</b>		<b>454</b>	<b>76</b>
Lydall Transport, Ltd. (Business Services)	Equity Interests		432	345
	<b>Total Investment</b>		<b>432</b>	<b>345</b>
Multi-Ad Services, Inc. (Business Services)	Unitranche Debt (11.3%, Due 11/11) Equity Interests	3,018	2,995 1,737	2,941 1,782
	<b>Total Investment</b>		<b>4,732</b>	<b>4,723</b>

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- (2) Common stock, preferred stock, warrants, options, and equity interests are generally non-income producing and restricted.
- (5) Non-registered investment company.

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## ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

## CONSOLIDATED STATEMENT OF INVESTMENTS (Continued)

## Private Finance

## Portfolio Company

(in thousands, except number of shares)	Investment <sup>(1)(2)</sup>	December 31, 2008		
		Principal	Cost	Value
Progressive International Corporation (Consumer Products)	Preferred Stock (500 shares)		\$ 500	\$ 1,125
	Common Stock (197 shares)		13	4,600
	Warrants			
	<b>Total Investment</b>		<b>513</b>	<b>5,725</b>
Regency Healthcare Group, LLC (Healthcare Services)	Unitranche Debt (11.1%, Due 6/12)	\$ 10,901	10,855	10,825
	Equity Interests		1,302	2,050
	<b>Total Investment</b>		<b>12,157</b>	<b>12,875</b>
SGT India Private Limited <sup>(4)</sup> (Business Services)	Common Stock (150,596 shares)		4,137	
	<b>Total Investment</b>		<b>4,137</b>	
Soteria Imaging Services, LLC (Healthcare Services)	Subordinated Debt (11.3%, Due 11/10)	4,250	4,167	4,054
	Equity Interests		1,881	1,971
	<b>Total Investment</b>		<b>6,048</b>	<b>6,025</b>
Triax Holdings, LLC (Consumer Products)	Subordinated Debt (21.0%, Due 2/12) <sup>(6)</sup>	10,625	10,587	
	Equity Interests		16,528	
	<b>Total Investment</b>		<b>27,115</b>	
Universal Environmental Services, LLC (Business Services)	Equity Interests		1,599	
	<b>Total Investment</b>		<b>1,599</b>	
<b>Total companies 5% to 25% owned</b>			<b>\$ 392,516</b>	<b>\$ 352,760</b>

**Companies Less Than 5% Owned**

3SI Security Systems, Inc.	Subordinated Debt (14.6%, Due 8/13)	\$ 29,200	\$ 29,118	\$ 28,170
(Consumer Products)	<b>Total Investment</b>		<b>29,118</b>	<b>28,170</b>
Abraxas Corporation	Subordinated Debt (14.6%, Due 4/13)	36,822	36,662	36,170
(Business Services)	<b>Total Investment</b>		<b>36,662</b>	<b>36,170</b>
Augusta Sportswear Group, Inc.	Subordinated Debt (13.0%, Due 1/15)	53,000	52,825	52,406
(Consumer Products)	Common Stock (2,500 shares)		2,500	1,400
	<b>Total Investment</b>		<b>55,325</b>	<b>53,806</b>
Axiom Healthcare Pharmacy, Inc.	Senior Loan (14.0%, Due 12/12)	3,750	3,724	3,654
(Healthcare Services)	Unitranche Debt (14.0%, Due 12/12)	8,500	8,471	7,908
	Common Stock (22,860 shares)		2,286	100
	<b>Total Investment</b>		<b>14,481</b>	<b>11,662</b>

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## ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

## CONSOLIDATED STATEMENT OF INVESTMENTS (Continued)

## Private Finance

## Portfolio Company

(in thousands, except number of shares)

	Investment <sup>(1)(2)</sup>	December 31, 2008		
		Principal	Cost	Value
Baird Capital Partners IV Limited <sup>(5)</sup>	Limited Partnership Interest		\$ 3,636	\$ 2,978
(Private Equity Fund)	<b>Total Investment</b>		<b>3,636</b>	<b>2,978</b>
BenefitMall Holdings Inc.	Subordinated Debt (18.0%, Due 6/14)	\$ 40,326	40,238	40,238
(Business Services)	Common Stock (39,274,290 shares) <sup>(12)</sup>		39,274	91,149
	Warrants <sup>(12)</sup>			
	<b>Total Investment</b>		<b>79,512</b>	<b>131,387</b>
Broadcast Electronics, Inc.	Senior Loan (8.8%, Due 11/11) <sup>(6)</sup>	4,912	4,884	773
(Business Services)	Preferred Stock (2,044 shares)			
	<b>Total Investment</b>		<b>4,884</b>	<b>773</b>
Bushnell, Inc.	Subordinated Debt (8.0%, Due 2/14)	41,325	40,003	35,794
(Consumer Products)	<b>Total Investment</b>		<b>40,003</b>	<b>35,794</b>
Callidus Debt Partners	Class C Notes (12.9%, Due 12/13)	18,800	18,907	10,116
CDO Fund I, Ltd. <sup>(4)(10)</sup>	Class D Notes (17.0%, Due 12/13)	9,400	9,454	
(CDO)	<b>Total Investment</b>		<b>28,361</b>	<b>10,116</b>
Callidus Debt Partners	Preferred Shares (23,600,000 shares)		20,138	5,402
CLO Fund III, Ltd. <sup>(4)(10)</sup>	<b>Total Investment</b>		<b>20,138</b>	<b>5,402</b>
(CLO)				



Callidus Debt Partners	Class D Notes (9.1%, Due 4/20)	3,000	2,045	1,445
CLO Fund IV, Ltd. <sup>(4)(10)</sup> (CLO)	Income Notes (13.2%) <sup>(11)</sup>		14,591	10,628
	<b>Total Investment</b>		<b>16,636</b>	<b>12,073</b>
Callidus Debt Partners	Income Notes (16.4%) <sup>(11)</sup>		13,388	10,331
CLO Fund V, Ltd. <sup>(4)(10)</sup> (CLO)				
	<b>Total Investment</b>		<b>13,388</b>	<b>10,331</b>
Callidus Debt Partners	Class D Notes (9.8%, Due 10/21)	9,000	7,144	3,929
CLO Fund VI, Ltd. <sup>(4)(10)</sup> (CLO)	Income Notes (17.8%) <sup>(11)</sup>		28,314	23,090
	<b>Total Investment</b>		<b>35,458</b>	<b>27,019</b>
Callidus Debt Partners	Income Notes (11.4%) <sup>(11)</sup>		24,026	15,361
CLO Fund VII, Ltd. <sup>(4)(10)</sup> (CLO)				
	<b>Total Investment</b>		<b>24,026</b>	<b>15,361</b>

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- (10) The fund is managed by Callidus Capital, a portfolio company of Allied Capital.
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## ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

## CONSOLIDATED STATEMENT OF INVESTMENTS (Continued)

## Private Finance

## Portfolio Company

(in thousands, except number of shares)

	Investment <sup>(1)(2)</sup>	December 31, 2008		
		Principal	Cost	Value
Callidus MAPS CLO Fund I LLC <sup>(10)</sup> (CLO)	Class E Notes (7.0%, Due 12/17)	\$ 17,000	\$ 17,000	\$ 9,813
	Income Notes (4.0%) <sup>(11)</sup>		45,053	27,678
	<b>Total Investment</b>		<b>62,053</b>	<b>37,491</b>
Callidus MAPS CLO Fund II, Ltd. <sup>(4)(10)</sup> (CLO)	Class D Notes (8.8%, Due 7/22)	7,700	3,555	2,948
	Income Notes (13.3%) <sup>(11)</sup>		18,393	12,626
	<b>Total Investment</b>		<b>21,948</b>	<b>15,574</b>
Carlisle Wide Plank Floors, Inc. (Consumer Products)	Senior Loan (6.1%, Due 6/11)	1,000	998	953
	Unitranche Debt (14.5%, Due 6/11)	3,161	3,139	3,047
	Preferred Stock (345,056 Shares)		345	82
	<b>Total Investment</b>		<b>4,482</b>	<b>4,082</b>
Catterton Partners VI, L.P. <sup>(5)</sup> (Private Equity Fund)	Limited Partnership Interest		2,812	2,356
	<b>Total Investment</b>		<b>2,812</b>	<b>2,356</b>
Centre Capital Investors V, L.P. <sup>(5)</sup> (Private Equity Fund)	Limited Partnership Interest		3,049	2,344
	<b>Total Investment</b>		<b>3,049</b>	<b>2,344</b>
CK Franchising, Inc. (Consumer Services)	Subordinated Debt (12.3%, Due 7/12 7/17)	21,000	20,912	20,912
	Preferred Stock (1,281,887 shares)		1,282	1,592
	Common Stock (7,585,549 shares)		7,586	10,600
	<b>Total Investment</b>		<b>29,780</b>	<b>33,104</b>
Commercial Credit Group, Inc.		19,000	18,970	18,970

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(Financial Services)	Subordinated Debt (15.0%, Due 6/15) Preferred Stock (64,679 shares) Warrants		15,543	9,073
	<b>Total Investment</b>		<b>34,513</b>	<b>28,043</b>
Community Education Centers, Inc.	Subordinated Debt (14.5%, Due 11/13)	35,548	35,486	34,056
(Education Services)	<b>Total Investment</b>		<b>35,486</b>	<b>34,056</b>
Component Hardware Group, Inc.	Subordinated Debt (13.5%, Due 1/13)	18,710	18,654	18,261
(Industrial Products)	<b>Total Investment</b>		<b>18,654</b>	<b>18,261</b>
Cook Inlet Alternative Risk, LLC	Unitranche Debt (10.8%, Due 4/13)	90,000	89,619	82,839
(Business Services)	Equity Interests		552	
	<b>Total Investment</b>		<b>90,171</b>	<b>82,839</b>
Cortec Group Fund IV, L.P. <sup>(5)</sup>	Limited Partnership Interest		4,647	3,445
(Private Equity)	<b>Total Investment</b>		<b>4,647</b>	<b>3,445</b>

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## ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

## CONSOLIDATED STATEMENT OF INVESTMENTS (Continued)

## Private Finance

## Portfolio Company

(in thousands, except number of shares)	Investment <sup>(1)(2)</sup>	December 31, 2008		
		Principal	Cost	Value
Diversified Mercury Communications, LLC	Senior Loan (4.5%, Due 3/13)	\$ 2,972	\$ 2,958	\$ 2,692
(Business Services)	<b>Total Investment</b>		<b>2,958</b>	<b>2,692</b>
Digital VideoStream, LLC	Unitranche Debt (11.0%, Due 2/12)	14,097	14,032	14,003
(Business Services)	Convertible Subordinated Debt (10.0%, Due 2/16)	4,545	4,533	4,700
	<b>Total Investment</b>		<b>18,565</b>	<b>18,703</b>
DirectBuy Holdings, Inc.	Subordinated Debt (14.5%, Due 5/13)	75,909	75,609	71,703
(Consumer Products)	Equity Interests		8,000	3,200
	<b>Total Investment</b>		<b>83,609</b>	<b>74,903</b>
Distant Lands Trading Co.	Senior Loan (7.5%, Due 11/11)	4,825	4,800	4,501
(Consumer Products)	Unitranche Debt (12.3%, Due 11/11)	43,133	43,022	42,340
	Common Stock (3,451 shares)		3,451	984
	<b>Total Investment</b>		<b>51,273</b>	<b>47,825</b>
Dryden XVIII Leveraged Loan 2007 Limited <sup>(4)</sup>	Class B Notes (8.0%, Due 10/19)	9,000	7,728	4,535
	Income Notes (16.0%) <sup>(11)</sup>		22,080	17,477
(CLO)	<b>Total Investment</b>		<b>29,808</b>	<b>22,012</b>
Dynamic India Fund IV <sup>(4)(5)</sup>	Equity Interests		9,350	8,966
(Private Equity Fund)	<b>Total Investment</b>		<b>9,350</b>	<b>8,966</b>

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EarthColor, Inc.	Subordinated Debt (15.0%, Due 11/13) <sup>(6)</sup>	123,819	123,385	77,243
(Business Services)	Common Stock (63,438 shares) <sup>(12)</sup> Warrants <sup>(12)</sup>		63,438	
	<b>Total Investment</b>		<b>186,823</b>	<b>77,243</b>
eCentury Capital Partners, L.P. <sup>(5)</sup>	Limited Partnership Interest		7,274	1,431
(Private Equity Fund)	<b>Total Investment</b>		<b>7,274</b>	<b>1,431</b>
eInstruction Corporation	Subordinated Debt (12.6%, Due 7/14-1/15)	33,931	33,795	31,670
(Education Services)	Common Stock (2,406 shares)		2,500	1,700
	<b>Total Investment</b>		<b>36,295</b>	<b>33,370</b>
Farley s & Sathers Candy Company, Inc.	Subordinated Debt (10.1%, Due 3/11)	2,500	2,493	2,365
(Consumer Products)	<b>Total Investment</b>		<b>2,493</b>	<b>2,365</b>

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## ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

## CONSOLIDATED STATEMENT OF INVESTMENTS (Continued)

## Private Finance

## Portfolio Company

(in thousands, except number of shares)

	Investment <sup>(1)(2)</sup>	December 31, 2008		
		Principal	Cost	Value
FCP-BHI Holdings, LLC	Subordinated Debt (12.0%, Due 9/13)	\$ 27,284	\$ 27,191	\$ 25,640
d/b/a Bojangles	Equity Interests		1,029	1,700
(Retail)	<b>Total Investment</b>		<b>28,220</b>	<b>27,340</b>
Fidus Mezzanine Capital, L.P. <sup>(5)</sup>	Limited Partnership Interest		9,597	6,754
(Private Equity Fund)	<b>Total Investment</b>		<b>9,597</b>	<b>6,754</b>
Freedom Financial Network, LLC	Subordinated Debt (13.5%, Due 2/14)	13,000	12,945	12,811
(Financial Services)	<b>Total Investment</b>		<b>12,945</b>	<b>12,811</b>
Geotrace Technologies, Inc.	Warrants		2,027	3,000
(Energy Services)	<b>Total Investment</b>		<b>2,027</b>	<b>3,000</b>
Gilchrist & Soames, Inc. (Consumer Products)	Subordinated Debt (13.4%, Due 10/13)	25,800	25,660	24,692
	<b>Total Investment</b>		<b>25,660</b>	<b>24,692</b>
Havco Wood Products LLC	Equity Interests		910	400
(Industrial Products)	<b>Total Investment</b>		<b>910</b>	<b>400</b>
Higginbotham Insurance Agency, Inc.	Subordinated Debt (13.7%, Due 8/13 8/14)	53,305	53,088	53,088
(Business Services)	Common Stock (23,695 shares) <sup>(12)</sup> Warrant <sup>(12)</sup>		23,695	27,335
	<b>Total Investment</b>		<b>76,783</b>	<b>80,423</b>

The Hillman Companies, Inc. <sup>(3)</sup>	Subordinated Debt (10.0%, Due 9/11)	44,580	44,491	44,345
(Consumer Products)	<b>Total Investment</b>		<b>44,491</b>	<b>44,345</b>
The Homax Group, Inc.	Senior Loan (7.2%, Due 10/12)	11,785	11,742	10,689
(Consumer Products)	Subordinated Debt (14.5%, Due 4/14)	14,000	13,371	12,859
	Preferred Stock (76 shares)		76	
	Common Stock (24 shares)		5	
	Warrants		954	
	<b>Total Investment</b>		<b>26,148</b>	<b>23,548</b>
Ideal Snacks Corporation	Senior Loan (5.3%, Due 6/10)	1,496	1,496	1,438
(Consumer Products)	<b>Total Investment</b>		<b>1,496</b>	<b>1,438</b>

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## ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

## CONSOLIDATED STATEMENT OF INVESTMENTS (Continued)

## Private Finance

## Portfolio Company

(in thousands, except number of shares)

	Investment <sup>(1)(2)</sup>	December 31, 2008		
		Principal	Cost	Value
Kodiak Fund LP <sup>(5)</sup>	Equity Interests		\$ 9,422	\$ 900
(Private Equity Fund)	<b>Total Investment</b>		<b>9,422</b>	<b>900</b>
Market Track Holdings, LLC (Business Services)	Senior Loan (8.0%, Due 6/14)	\$ 2,500	2,450	2,352
	Subordinated Debt (15.9%, Due 6/14)	24,600	24,488	23,785
	<b>Total Investment</b>		<b>26,938</b>	<b>26,137</b>
NetShape Technologies, Inc.	Senior Loan (5.3%, Due 2/13)	382	382	346
(Industrial Products)	<b>Total Investment</b>		<b>382</b>	<b>346</b>
Network Hardware Resale, Inc. (Business Services)	Unitranche Debt (12.5%, Due 12/11)	18,734	18,809	18,703
	Convertible Subordinated Debt (9.8%, Due 12/15)	14,533	14,585	14,585
	<b>Total Investment</b>		<b>33,394</b>	<b>33,288</b>
Novak Biddle Venture Partners III, L.P. <sup>(5)</sup>	Limited Partnership Interest		2,018	1,349
(Private Equity Fund)	<b>Total Investment</b>		<b>2,018</b>	<b>1,349</b>
Oahu Waste Services, Inc. (Business Services)	Stock Appreciation Rights		206	750
	<b>Total Investment</b>		<b>206</b>	<b>750</b>
Pangaea CLO 2007-1 Ltd. <sup>(4)</sup>	Class D Notes (9.2%, Due 10/21)	15,000	11,761	7,114
(CLO)	<b>Total Investment</b>		<b>11,761</b>	<b>7,114</b>



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PC Helps Support, LLC (Business Services)	Senior Loan (4.8%, Due 12/13)	8,610	8,520	8,587
	Subordinated Debt (13.3%, Due 12/13)	28,136	28,009	28,974
	<b>Total Investment</b>		<b>36,529</b>	<b>37,561</b>
Performant Financial Corporation (Business Services)	Common Stock (478,816 shares)		734	200
	<b>Total Investment</b>		<b>734</b>	<b>200</b>

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**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENT OF INVESTMENTS (Continued)**

<b>Private Finance</b>		<b>December 31, 2008</b>		
<b>Portfolio Company</b>	<b>Investment<sup>(1)(2)</sup></b>	<b>Principal</b>	<b>Cost</b>	<b>Value</b>
<b>(in thousands, except number of shares)</b>			<b>\$</b>	<b>\$</b>
Peter Brasseler Holdings, LLC	Equity Interests		\$ 3,451	\$ 2,900
(Business Services)	<b>Total Investment</b>		<b>3,451</b>	<b>2,900</b>
PharMEDium Healthcare Corporation	Senior Loan (4.3%, Due 10/13)	\$ 1,910	1,910	1,747
(Healthcare Services)	<b>Total Investment</b>		<b>1,910</b>	<b>1,747</b>
Postle Aluminum Company, LLC	Unitranche Debt (13.0%, Due 10/12) <sup>(6)</sup>	58,953	58,744	9,978
(Industrial Products)	Equity Interests		2,174	
	<b>Total Investment</b>		<b>60,918</b>	<b>9,978</b>
Pro Mach, Inc.	Subordinated Debt (12.5%, Due 6/12)	14,616	14,573	14,089
(Industrial Products)	Equity Interests		1,294	1,900
	<b>Total Investment</b>		<b>15,867</b>	<b>15,989</b>
Promo Works, LLC	Unitranche Debt (12.3%, Due 12/11)	23,111	22,954	21,266
(Business Services)	<b>Total Investment</b>		<b>22,954</b>	<b>21,266</b>
Reed Group, Ltd.	Senior Loan (7.6%, Due 12/13)	12,893	12,758	11,502
(Healthcare Services)	Subordinated Debt (13.8%, Due 12/13)	18,543	18,469	16,683
	Equity Interests		1,800	300
	<b>Total Investment</b>		<b>33,027</b>	<b>28,485</b>
S.B. Restaurant Company	Unitranche Debt (9.8%, Due 4/11)	36,501	36,295	34,914
(Retail)	Preferred Stock (46,690 shares)		117	117

	Warrants		534	
	<b>Total Investment</b>		<b>36,946</b>	<b>35,031</b>
	Standby Letters of Credit (\$2,465)			
Snow Phipps Group, L.P. <sup>(5)</sup>	Limited Partnership Interest		4,785	4,374
(Private Equity Fund)	<b>Total Investment</b>		<b>4,785</b>	<b>4,374</b>
SPP Mezzanine Funding II, L.P. <sup>(5)</sup>	Limited Partnership Interest		9,362	9,269
(Private Equity Fund)	<b>Total Investment</b>		<b>9,362</b>	<b>9,269</b>
STS Operating, Inc.	Subordinated Debt (11.0%, Due 1/13)	30,386	30,296	29,745
(Industrial Products)	<b>Total Investment</b>		<b>30,296</b>	<b>29,745</b>
Summit Energy Services, Inc. (Business Services)	Subordinated Debt (11.6%, Due 8/13) Common Stock (415,982 shares)	35,730	35,547 1,861	32,113 1,900
	<b>Total Investment</b>		<b>37,408</b>	<b>34,013</b>
Tank Intermediate Holding Corp. (Industrial Products)	Senior Loan (7.1%, Due 9/14)	30,514	29,539	25,937
	<b>Total Investment</b>		<b>29,539</b>	<b>25,937</b>

- (1) Interest rates represent the weighted average annual stated interest rate on loans and debt securities, which are presented by nature of indebtedness for a single issuer. The maturity dates represent the earliest and the latest maturity dates.
- (2) Common stock, preferred stock, warrants, options, and equity interests are generally non-income producing and restricted.
- (5) Non-registered investment company.
- (6) Loan or debt security is on non-accrual status and therefore is considered non-income producing.

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

## ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

## CONSOLIDATED STATEMENT OF INVESTMENTS (Continued)

## Private Finance

## Portfolio Company

(in thousands, except number of shares)

	Investment <sup>(1)(2)</sup>	Principal	December 31, 2008		Value
			Cost		
Tappan Wire & Cable Inc.	Unitranche Debt (15.0%, Due 8/14)	\$ 22,346	\$ 22,248	\$	15,625
(Business Services)	Common Stock (12,940 shares) <sup>(12)</sup>		2,043		
	Warrant <sup>(12)</sup>				
	<b>Total Investment</b>		<b>24,291</b>		<b>15,625</b>
The Step2 Company, LLC	Unitranche Debt (11.0%, Due 4/12)	95,083	94,816		90,474
(Consumer Products)	Equity Interests		2,156		1,161
	<b>Total Investment</b>		<b>96,972</b>		<b>91,635</b>
Tradesmen International, Inc.	Subordinated Debt (12.0%, Due 12/12)	40,000	39,586		37,840
(Business Services)	<b>Total Investment</b>		<b>39,586</b>		<b>37,840</b>
TransAmerican Auto Parts, LLC	Subordinated Debt (16.3%, Due 11/12) <sup>(6)</sup>	24,561	24,409		
(Consumer Products)	Equity Interests		1,034		
	<b>Total Investment</b>		<b>25,443</b>		
Trover Solutions, Inc.	Subordinated Debt (12.0%, Due 11/12)	60,054	59,847		57,362
(Business Services)	<b>Total Investment</b>		<b>59,847</b>		<b>57,362</b>
United Road Towing, Inc.	Subordinated Debt (12.1%, Due 1/14)	20,000	19,915		20,000
(Consumer Services)	<b>Total Investment</b>		<b>19,915</b>		<b>20,000</b>

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Venturehouse-Cibernet Investors, LLC	Equity Interest			
(Business Services)	<b>Total Investment</b>			
VICORP Restaurants, Inc.	Warrants		33	
(Retail)	<b>Total Investment</b>		<b>33</b>	
WMA Equity Corporation and Affiliates	Subordinated Debt (16.8%, Due 4/13-4/14) <sup>(6)</sup>	139,455	138,559	63,823
d/b/a Wear Me Apparel	Common Stock (86 shares)		39,721	
(Consumer Products)	<b>Total Investment</b>		<b>178,280</b>	<b>63,823</b>
Webster Capital II, L.P. <sup>(5)</sup>	Limited Partnership Interest		1,702	1,481
(Private Equity Fund)	<b>Total Investment</b>		<b>1,702</b>	<b>1,481</b>
Woodstream Corporation	Subordinated Debt (12.0%, Due 2/15)	90,000	89,633	83,258
(Consumer Products)	Common Stock (6,960 shares)		6,961	2,500
	<b>Total Investment</b>		<b>96,594</b>	<b>85,758</b>
York Insurance Services Group, Inc.	Common Stock (12,939 shares)		1,294	1,700
(Business Services)	<b>Total Investment</b>		<b>1,294</b>	<b>1,700</b>
Other companies	Other debt investments	155	74	72
	Other equity investments		30	8
	<b>Total Investment</b>		<b>104</b>	<b>80</b>
<b>Total companies less than 5% owned</b>			<b>\$ 2,317,856</b>	<b>\$ 1,858,581</b>
<b>Total private finance (138 portfolio investments)</b>			<b>\$ 4,877,392</b>	<b>\$ 3,399,063</b>

- (1) Interest rates represent the weighted average annual stated interest rate on loans and debt securities, which are presented by nature of indebtedness for a single issuer. The maturity dates represent the earliest and the latest maturity dates.
- (2) Common stock, preferred stock, warrants, options, and equity interests are generally non-income producing and restricted.
- (5) Non-registered investment company.
- (6) Loan or debt security is on non-accrual status and therefore is considered non-income producing.
- (12) Common stock is non-voting. In addition to non-voting stock ownership, the Company has an option to acquire a majority of the voting securities of the portfolio company at fair market value.

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

## ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

## CONSOLIDATED STATEMENT OF INVESTMENTS (Continued)

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

			December 31, 2008 (unaudited)	
	Stated Interest Rate Ranges	Number of Loans	Cost	Value
<b>Commercial Mortgage Loans</b>				
	Up to 6.99%	4	\$ 30,999	\$ 30,537
	7.00% 8.99%	1	644	580
	9.00% 10.99%	1	6,465	6,465
	11.00% 12.99%	1	10,469	9,391
	15.00% and above	2	3,970	6,529
<b>Total commercial mortgage loans<sup>(13)</sup></b>			<b>\$ 52,547</b>	<b>\$ 53,502</b>
<b>Real Estate Owned</b>			<b>\$ 18,201</b>	<b>\$ 20,823</b>
<b>Equity Interests<sup>(2)</sup> Companies more than 25% owned</b>			<b>\$ 14,755</b>	<b>\$ 19,562</b>
Guarantees (\$6,871)				
Standby Letter of Credit (\$650)				
<b>Total commercial real estate finance</b>			<b>\$ 85,503</b>	<b>\$ 93,887</b>
<b>Total portfolio</b>			<b>\$ 4,962,895</b>	<b>\$ 3,492,950</b>

	Yield	Cost	Value
<b>Investments in Money Market and Other Securities</b>			
SEI Daily Income Tr Prime Obligation Money Market Fund	0.9%	\$ 5	\$ 5
Columbia Treasury Reserves Fund		12	12
Other Money Market Funds		270	270
<b>Total</b>		<b>\$ 287</b>	<b>\$ 287</b>

(2) Common stock, preferred stock, warrants, options, and equity interests are generally non-income producing and restricted.

(13) Commercial mortgage loans totaling \$7.7 million at value were on non-accrual status and therefore were considered non-income producing.

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 three months ended March 31, 2009 and 2008 is unaudited)

#### Note 1. Organization

Allied Capital Corporation, a Maryland corporation, is a closed-end, non-diversified 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 real estate investment trust subsidiary, Allied Capital REIT, Inc. ( Allied REIT ), and several subsidiaries that are single member limited liability companies established for specific purposes including holding real estate properties. ACC also has a subsidiary, A.C. Corporation ( AC Corp ), that generally provides diligence and structuring services, as well as transaction, management, consulting, and other services, including underwriting and arranging senior loans, to the Company, its portfolio companies and its managed funds.

ACC and its subsidiaries, collectively, are referred to as the Company. The Company consolidates the results of its subsidiaries for financial reporting purposes.

Pursuant to Article 6 of Regulation S-X, the financial results of the Company's portfolio investments are not consolidated in the Company's financial statements. Portfolio investments are held for purposes of deriving investment income and future capital gains.

The investment objective of the Company is to achieve current income and capital gains. In order to achieve this objective, the Company has primarily invested in debt and equity securities of private companies in a variety of industries.

#### *Events of Default, Liquidity and Operations*

The Company experienced a significant reduction in its net worth during the second half of 2008, primarily resulting from net unrealized depreciation on its portfolio, which reflected market conditions. As a result, on December 30, 2008, the Company entered into amendments relating to its private notes and revolving line of credit, including amendments which added new covenants. The amendments are more fully described in Note 4 to the consolidated financial statements.

In January 2009 the Company re-opened discussions with the revolving line of credit lenders (the Lenders ) and the private noteholders (the Noteholders ) to seek relief under certain terms of both the revolving credit facility and the private notes due to a then-expected covenant default. As of December 31, 2008, the Company's asset coverage was less than the 200% required by the revolving credit facility and the private notes. The Company continued to experience additional net unrealized depreciation on its portfolio in the first quarter of 2009 and as a result, as of March 31, 2009, the Company's asset coverage remained less than 200%. Asset coverage generally refers to the percentage resulting from assets less accounts payable and other liabilities, divided by total debt. In addition, the Company has not completed the documents contemplated by the December 30, 2008 amendments to the revolving credit facility and private notes, which were to include a grant of a first lien security interest on substantially all of the Company's assets. Under these debt agreements, events of default have occurred and are continuing related to these covenants and certain financial and other covenants. Discussions with the Lenders and the Noteholders are continuing and the discussions encompass a more comprehensive restructuring of these debt agreements to provide long-term operational flexibility.

Pursuant to the 1940 Act, the Company is not permitted to issue indebtedness unless immediately after such issuance the Company has asset coverage of all outstanding indebtedness of at least 200%. The Company's publicly issued unsecured notes payable require the Company to comply with this provision of the 1940 Act. At March 31, 2009, the Company's asset coverage ratio was 171%, which is

**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**

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

less than the 200% requirement. As a result under the publicly issued unsecured notes payable, the Company will not be able to issue additional indebtedness until such time as its asset coverage returns to at least 200%. The Company has not experienced any default or cross default with respect to the publicly issued unsecured notes payable.

The existence of an event of default under the revolving credit facility and private notes restricts the Company from additional borrowing or obtaining letters of credit under its revolving credit facility, and from declaring dividends or other distributions to the Company's shareholders. Pursuant to the terms of the revolving credit facility, during the continuance of an event of default, the applicable spread on any borrowings outstanding and fees on any letters of credit outstanding under the revolving credit facility increase by up to 200 basis points. Pursuant to the terms of the private notes, during the continuance of an event of default, the rate of interest borne by the private notes increases by 200 basis points.

On March 27, 2009, pursuant to the terms of the revolving line of credit, the administrative agent for the lenders terminated substantially all of the unused commitments under the revolving line of credit. As a result, the aggregate commitments under the Company's revolving line of credit have been reduced to \$165.0 million. As of March 31, 2009, the Company had \$50 million in outstanding borrowings and \$113.5 million in outstanding letters of credit issued under the revolving line of credit.

Neither the Lenders nor the Noteholders have accelerated repayment of the Company's obligations; however, the occurrence of an event of default permits the administrative agent for the Lenders, or the holders of more than 51% of the commitments under the revolving credit facility, to accelerate repayment of all amounts due, to terminate commitments thereunder, and to require the Company to provide cash collateral equal to the face amount of all outstanding letters of credit. Pursuant to the terms of the private notes, the occurrence of an event of default permits the holders of 51% or more of any issue of outstanding private notes to accelerate repayment of all amounts due thereunder.

The Company's consolidated financial statements have been prepared assuming that the Company will continue as a going concern. The Company does not have available cash resources sufficient to satisfy all of the obligations under these debt agreements should the lenders accelerate these obligations. These factors raise substantial doubt about the Company's ability to continue as a going concern. The Company continues to seek a comprehensive restructuring of these debt agreements to provide long-term operational flexibility. In addition, the Company continues to sell assets to generate capital to repay debt. There can be no assurance that the Company's plans will be successful in addressing the liquidity uncertainties discussed above. In the event there is an acceleration of the amounts outstanding under the revolving credit facility or any issue of the private notes, it would cause the Company to evaluate other alternatives and would have a material adverse effect on the Company's operations. The accompanying consolidated financial statements do not include any adjustments that might result from these uncertainties.

**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 2008 balances to conform with the 2009 financial statement presentation.

The accompanying unaudited consolidated financial statements of the Company have been prepared in accordance with U.S. generally accepted accounting principles ( GAAP ) for interim financial information. Accordingly, they do not include all of the information and footnotes required by GAAP for complete consolidated financial statements. In the opinion of management, the unaudited consolidated financial results of the Company included herein contain all adjustments (consisting of only normal recurring accruals)

**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**

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

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

necessary to present fairly the financial position of the Company as of March 31, 2009, the results of operations, and changes in net assets and cash flows for the three months ended March 31, 2009 and 2008. The results of operations for the three months ended March 31, 2009, are not necessarily indicative of the operating results to be expected for the full year.

The private finance portfolio and the interest and related portfolio income and net realized gains (losses) on the private finance portfolio are presented in three categories: companies more than 25% owned, which represent portfolio companies where the Company directly or indirectly owns more than 25% of the outstanding voting securities of such portfolio company or where the Company controls the portfolio company's board of directors 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, including investments in money market and other securities, are included in the companies less than 5% owned category on the consolidated statement of operations.

In the ordinary course of business, the Company enters into transactions with portfolio companies that may be considered related party transactions.

The Company, as a BDC, has invested in illiquid securities including debt and equity securities of portfolio companies, CLO bonds and preferred shares/income notes, CDO bonds and investment funds. The Company's investments may be subject to certain restrictions on resale and generally have no established trading market. The Company values substantially all of its investments at fair value as determined in good faith by the Board of Directors in accordance with the Company's valuation policy and the provisions of the 1940 Act and FASB Statement No. 157, *Fair Value Measurements* (SFAS 157 or the Statement) and related interpretations. The Company determines fair value to be the price that would be received for an investment in a current sale, which assumes an orderly transaction between market participants on the measurement date. The Company's valuation policy considers the fact that no ready market exists for substantially all of the securities in which it invests and that fair value for its investments must typically be determined using unobservable inputs. The Company's valuation policy is intended to provide a consistent basis for determining the fair value of the portfolio.

The Company adopted SFAS 157 on a prospective basis in the first quarter of 2008. SFAS 157 requires the Company to assume that the portfolio investment is assumed to be sold in the principal market to market participants, or in the absence of a principal market, the most advantageous market, which may be a hypothetical market. Market participants are defined as buyers and sellers in the principal or most advantageous market that are independent, knowledgeable, and willing and able to transact. In accordance with the Statement, the Company has considered its principal market, or the market in which the Company exits its portfolio investments with the greatest volume and level of activity.

The Company has determined that for its buyout investments, where the Company has control or could gain control through an option or warrant security, both the debt and equity securities of the portfolio investment would exit in the merger and acquisition ( M&A ) market as the principal market

**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**

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

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

generally through a sale or recapitalization of the portfolio company. The Company believes that the in-use premise of value (as defined in SFAS 157), which assumes the debt and equity securities are sold together, is appropriate as this would provide maximum proceeds to the seller. As a result, the Company uses the enterprise value methodology to determine the fair value of these investments under SFAS 157. Enterprise value means the entire value of the company to a market participant, including the sum of the values of debt and equity securities used to capitalize the enterprise at a point in time. Enterprise value is determined using various factors, including cash flow from operations of the portfolio company, multiples at which private companies are bought and sold, and other pertinent factors, such as recent offers to purchase a portfolio company, recent transactions involving the purchase or sale of the portfolio company's equity securities, liquidation events, or other events. The Company allocates the enterprise value to these securities in order of the legal priority of the securities.

While the Company typically exits its securities upon the sale or recapitalization of the portfolio company in the M&A market, for investments in portfolio companies where the Company does not have control or the ability to gain control through an option or warrant security, the Company cannot typically control the exit of its investment into its principal market (the M&A market). As a result, in accordance with SFAS 157, the Company is required to determine the fair value of these investments assuming a sale of the individual investment (the in-exchange premise of value) in a hypothetical market to a hypothetical market participant. The Company continues to perform an enterprise value analysis for the investments in this category to assess the credit risk of the loan or debt security and to determine the fair value of its equity investment in these portfolio companies. The determined equity values are generally discounted when the Company has a minority ownership position, restrictions on resale, specific concerns about the receptivity of the capital markets to a specific company at a certain time, or other factors. For loan and debt securities, the Company performs a yield analysis assuming a hypothetical current sale of the investment. The yield analysis requires the Company to estimate the expected repayment date of the instrument and a market participant's required yield. The Company's estimate of the expected repayment date of a loan or debt security is generally shorter than the legal maturity of the instruments as the Company's loans have historically been repaid prior to the maturity date. The yield analysis considers changes in interest rates and changes in leverage levels of the loan or debt security as compared to market interest rates and leverage levels. Assuming the credit quality of the loan or debt security remains stable, the Company will use the value determined by the yield analysis as the fair value for that security. A change in the assumptions that the Company uses to estimate the fair value of its loans and debt securities using the yield analysis could have a material impact on the determination of fair value. If there is deterioration in credit quality or a loan or debt security is in workout status, the Company may consider other factors in determining the fair value of a loan or debt security, including the value attributable to the loan or debt security from the enterprise value of the portfolio company or the proceeds that would be received in a liquidation analysis.

The Company's equity investments in private debt and equity funds generally are valued at the fund's net asset value, unless other factors lead to a determination of fair value at a different amount. The value of the Company's equity securities in public companies for which quoted prices in an active market are readily available is based on the closing public market price on the measurement date.

The fair value of the Company's CLO bonds and preferred shares/income notes and CDO bonds (CLO/CDO Assets) is generally based on a discounted cash flow model that utilizes prepayment, re-investment and loss assumptions based on historical experience and projected performance, economic factors, the characteristics of the underlying cash flow, and comparable yields for similar bonds and





**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**

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

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

preferred shares/ income notes, when available. The Company recognizes unrealized appreciation or depreciation on its CLO/CDO Assets as comparable yields in the market change and/or based on changes in estimated cash flows resulting from changes in prepayment, re-investment or loss assumptions in the underlying collateral pool or changes in redemption assumptions for the CLO/CDO Assets, if applicable. The Company determines the fair value of its CLO/CDO Assets on an individual security-by-security basis.

The Company will record unrealized depreciation on investments when it determines that the fair value of a security is less than its cost basis, and will record unrealized appreciation when it determines that the fair value is greater than its cost basis. Because of the inherent uncertainty of valuation, the values determined at the measurement date 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. Additionally, changes in the market environment and other events that may occur over the life of the investments may cause the gains or losses ultimately realized on these investments to be different than the values determined at the measurement date. In accordance with FSP 157-4 (discussed below), the Company does not consider a transaction price that is associated with a transaction that is not orderly to be indicative of fair value or market participant risk premiums, and accordingly would place little, if any, weight on transactions that are not orderly in determining fair value. When considering recent potential or completed transactions, the Company uses judgment in determining if such offers or transactions were pursuant to an orderly process for purposes of determining how much weight is placed on these data points in accordance with the applicable guidelines in SFAS 157 and FSP 157-4.

***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 period, net of recoveries. Net change in unrealized appreciation or depreciation primarily reflects the change in portfolio investment values during the reporting period, including the reversal of previously recorded unrealized appreciation or depreciation when gains or losses are realized. Net change in unrealized appreciation or depreciation also reflects the change in the value of U.S. Treasury bills, when applicable, and depreciation on accrued interest and dividends receivable and other assets where collection is doubtful.

***Interest and Dividend Income***

Interest income is recorded on an accrual basis to the extent that such amounts are expected to be collected. For loans and debt securities with contractual payment-in-kind interest, which represents contractual interest accrued and added to the loan balance that generally becomes due at maturity, the Company will not accrue payment-in-kind interest if the portfolio company valuation indicates that the payment-in-kind interest is not collectible. In general, interest is not accrued on loans and debt securities if the Company has doubt about interest collection or where the enterprise value of the portfolio company may not support further accrual. Loans in workout status generally do not accrue interest. In addition, interest may not accrue on loans or debt securities to portfolio companies that are more than 50% owned by the Company depending on such company's capital requirements.

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



**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**

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

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

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. Loan origination fees, original issue discount, and market discount are capitalized and then amortized into interest income using a method that approximates the effective interest method. Upon the prepayment of a loan or debt security, any unamortized loan origination fees are recorded as interest income and any unamortized original issue discount or market discount is recorded as a realized gain.

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

The Company recognizes interest income on the CLO preferred shares/income notes using the effective interest method, based on the anticipated yield that is determined using the estimated cash flows over the projected life of the investment. Yields are revised when there are changes in actual or estimated cash flows due to changes in prepayments and/or re-investments, credit losses or asset pricing. Changes in estimated yield are recognized as an adjustment to the estimated yield over the remaining life of the preferred shares/income notes from the date the estimated yield was changed. CLO and CDO bonds have stated interest rates. The weighted average yield on the CLO/CDO Assets is calculated as the (a) annual stated interest or the effective interest yield on the accruing bonds or the effective yield on the preferred shares/income notes, divided by (b) CLO/CDO Assets at value. The weighted average yields are computed as of the balance sheet date.

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

***Fee Income***

Fee income includes fees for loan prepayment premiums, guarantees, commitments, and services rendered by the Company to portfolio companies and other third parties such as diligence, structuring, transaction services, management and consulting services, and other services. Loan prepayment premiums are recognized at the time of prepayment. Guaranty and commitment fees are generally recognized as income over the related period of the guaranty or commitment, respectively. Diligence, structuring, and transaction services fees are generally recognized as income when services are rendered or when the related transactions are completed. Management, consulting and other services fees generally are recognized as income as the services are rendered. Fees are not accrued if the Company has doubt about collection of those fees.

***Guarantees***

Guarantees meeting the characteristics described in FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others* and issued or modified after December 31, 2002, are recognized at fair value at inception.



**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**

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

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

Guarantees made on behalf of portfolio companies are considered in determining the fair value of the Company's investments. See Note 5.

***Financing Costs***

Debt financing costs are based on actual costs incurred in obtaining debt financing and are deferred and amortized as part of interest expense over the term of the related debt instrument using a method that approximates the effective interest method. Costs associated with the issuance of common stock are recorded as a reduction to the proceeds from the sale of common stock. Financing costs generally include underwriting, accounting and legal fees, and printing costs.

***Dividends to Shareholders***

Dividends to shareholders are recorded on the ex-dividend date.

***Stock Compensation Plans***

The Company has a stock-based employee compensation plan. See Note 9. Effective January 1, 2006, the Company adopted the provisions of FASB Statement No. 123 (Revised 2004), *Share-Based Payment* (SFAS 123R). SFAS 123R was adopted using the modified prospective method of application, which required the Company to recognize compensation costs on a prospective basis beginning January 1, 2006. Accordingly, the Company did not restate prior year financial statements. Under this method, the unamortized cost of previously awarded options that were unvested as of January 1, 2006, is recognized over the remaining service period in the statement of operations beginning in 2006, using the fair value amounts determined for pro forma disclosure under SFAS 123R. With respect to options granted on or after January 1, 2006, compensation cost based on estimated grant date fair value is recognized over the related service period in the statement of operations. The stock option expense for the three months ended March 31, 2009 and 2008, was as follows:

<b>(\$ in millions, except per share amounts)</b>	<b>2009</b>	<b>2008</b>
Employee Stock Option Expense:		
Previously awarded, unvested options as of January 1, 2006	\$	\$ 1.7
Options granted on or after January 1, 2006	0.8	2.5
Total employee stock option expense	\$ 0.8	\$ 4.2
Per basic share	\$ 0.00	\$ 0.03
Per diluted share	\$ 0.00	\$ 0.03

## ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

**Options Granted.** The stock option expense shown in the table above was based on the underlying value of the options granted by the Company. The fair value of each option grant was estimated on the date of grant using the Black-Scholes option pricing model and expensed over the vesting period. The following weighted average assumptions were used to calculate the fair value of options granted during the three months ended March 31, 2009 and 2008:

	2009	2008
Expected term (in years)	3.0	5.0
Risk-free interest rate	1.3%	2.7%
Expected volatility	103.8%	27.6%
Dividend yield	34.4%	8.5%
Weighted average fair value per option	\$ 0.12	\$ 2.19

The expected term of the options granted represents the period of time that such options are expected to be outstanding. To determine the expected term of the options, the Company used historical and other data to estimate option exercise time frames, including considering employee terminations. The risk free rate was based on the U.S. Treasury bond yield curve at the date of grant consistent with the expected term. Expected volatilities were determined based on the historical volatility of the Company's common stock over a historical time period consistent with the expected term. The dividend yield was determined based on an estimate of the Company's future dividends over the expected term, relative to the option price. The estimate of future dividends takes into consideration the Company's estimate of future taxable income required to be distributed in order to maintain its status as a registered investment company (see Federal and State Income Taxes and Excise Tax below). The Company currently is not paying a dividend and may or may not be able to pay a dividend during the expected term. In addition, actual future taxable income and dividends may significantly differ from these estimates.

To determine the stock options expense for options granted, the calculated fair value of the options granted is applied to the options granted, net of assumed future option forfeitures. The Company estimates that the employee-related stock option expense for outstanding unvested options as of March 31, 2009, will be \$3.7 million, \$4.1 million, and \$3.7 million for the years ended December 31, 2009, 2010, and 2011, respectively. This estimate may change if the Company's assumptions related to future option forfeitures change. This estimate does not include any expense related to stock option grants after March 31, 2009, as the fair value of those stock options will be determined at the time of grant. The aggregate total stock option expense remaining as of March 31, 2009, is expected to be recognized over an estimated weighted-average period of 1.55 years.

**Federal and State Income Taxes and Excise Tax**

The Company has complied with the requirements of the Code that are applicable to regulated investment companies (RIC) and real estate investment trusts (REIT). ACC and any subsidiaries that qualify as a RIC or a REIT intend to distribute or retain through a deemed distribution all of their annual taxable income to shareholders; therefore, the Company has made no provision for income taxes exclusive of excise taxes for these entities.

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

**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**

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

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

accrues excise taxes on estimated excess taxable income as taxable income is earned using an annual effective excise tax rate. The annual effective excise tax rate is determined by dividing the estimated annual excise tax by the estimated annual taxable income.

Income taxes for AC Corp are accounted for under the asset and liability method. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases as well as operating loss and tax credit carryforwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled.

***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. Common stock equivalents of 1,268,614 and 6,305 were not included in the calculation of diluted earnings (loss) per common share for the three months ended March 31, 2009 and 2008, respectively, as the effect would have been antidilutive.

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

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

The consolidated financial statements include portfolio investments at value of \$2.9 billion and \$3.5 billion at March 31, 2009, and December 31, 2008, respectively. At March 31, 2009, and December 31, 2008, 86% and 94%, respectively, of the Company's total assets represented portfolio investments whose fair values have been determined by the Board of Directors in good faith in the absence of readily available market values. Because of the inherent uncertainty of valuation, the Board of Directors' determined values may differ significantly from the values that would have been used had a ready market existed for the investments, and the differences could be material.

***Recent Accounting Pronouncements***

***Fair Value Measurements.*** In September 2006, the FASB issued Statement No. 157, which defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. This statement was effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years.

The Company adopted this statement on a prospective basis beginning in the quarter ended March 31, 2008. The initial adoption of this statement did not have a material effect on the Company's consolidated financial statements.





**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**

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

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

*The Fair Value Option for Financial Assets and Financial Liabilities – Including an Amendment of FASB Statement No. 115.* In February 2007, the FASB issued Statement No. 159, which permits an entity to choose to measure many financial instruments and certain other items at fair value. This statement applies to all reporting entities, and contains financial statement presentation and disclosure requirements for assets and liabilities reported at fair value as a consequence of the election. This statement was effective for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years.

The Company did not elect fair value measurement for assets or liabilities other than portfolio investments, which already were required to be measured at fair value, therefore, the adoption of this statement did not impact the Company's consolidated financial position or its results of operations.

*Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active ( FSP 157-3 ).* In October 2008, the FASB issued FSP 157-3, which applies to financial assets within the scope of accounting pronouncements that require or permit fair value measurements in accordance with Statement 157. FSP 157-3 clarifies the application of Statement 157 in a market that is not active and provides an example to illustrate key considerations in determining the fair value.

The Company has applied the provisions of FSP 157-3 in determining the fair value of its portfolio investments at December 31, 2008. The application of FSP 157-3 did not have a material impact on the Company's consolidated financial position or its results of operations.

*Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly ( FSP 157-4 ).* In April 2009, the FASB issued FSP 157-4, which provides guidance on how to determine the fair value of assets under SFAS 157 in the current economic environment and reemphasizes that the objective of a fair value measurement remains an orderly transaction (that is, not a forced liquidation or distressed sale) between market participants at the measurement date under current market conditions. FSP 157-4 states that a transaction price that is associated with a transaction that is not orderly is not determinative of fair value or market-participant risk premiums and companies should place little, if any, weight (compared with other indications of fair value) on transactions that are not orderly when estimating fair value or market risk premiums.

The Company adopted the provisions of FSP 157-4 on a prospective basis beginning in the quarter ending March 31, 2009. The adoption of the provisions of FSP 157-4 did not have a material effect on the Company's consolidated financial statements.

## ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

## Note 3. Portfolio

*Private Finance*

At March 31, 2009, and December 31, 2008, the private finance portfolio consisted of the following:

(\$ in millions)	Cost	2009 Value	Yield <sup>(1)</sup>	Cost	2008 Value	Yield <sup>(1)</sup>
Loans and debt securities:						
Senior loans	\$ 592.3	\$ 289.1	5.9%	\$ 556.9	\$ 306.3	5.6%
Unitranche debt <sup>(2)</sup>	447.3	403.8	12.1%	527.5	456.4	12.0%
Subordinated debt <sup>(3)</sup>	2,134.7	1,492.7	13.5%	2,300.1	1,829.1	12.9%
Total loans and debt securities <sup>(4)</sup>	3,174.3	2,185.6	12.3%	3,384.5	2,591.8	11.9%
Equity securities:						
Preferred shares/income notes of CLOs <sup>(5)</sup>	250.4	104.4	8.0%	248.2	179.2	16.4%
Subordinated certificates in Unitranche Fund LLC <sup>(5)</sup>	124.5	124.5	9.2%	125.4	125.4	12.0%
Other equity securities	1,100.5	415.5		1,119.3	502.7	
Total equity securities	1,475.4	644.4		1,492.9	807.3	
Total	\$ 4,649.7	\$ 2,830.0		\$ 4,877.4	\$ 3,399.1	

<sup>(1)</sup> The weighted average yield on loans and debt securities is computed as the (a) annual stated interest on accruing loans and debt securities plus the annual amortization of loan origination fees, original issue discount, and market discount on accruing loans and debt securities less the annual amortization of loan origination costs, divided by (b) total loans and debt securities at value. At March 31, 2009, senior loans included the senior secured loan to Ciena totaling \$319.0 million at cost and \$64.1 million at value, which was placed on non-accrual status on the purchase date.

The weighted average yield on the preferred shares/income notes of CLOs is calculated as the (a) effective interest yield on the preferred shares/income notes of CLOs, divided by (b) total preferred shares/income notes of CLOs at value. The weighted average yields are computed as of the balance sheet date. The yield on the CLO assets represents the yield used for recording interest income. The market yield used in the valuation of the CLO assets may be different than the interest yields.

The weighted average yield on the subordinated certificates in the Unitranche Fund LLC is computed as the (a) annual stated interest divided by (b) total investment at value.

- (2) Unitranche debt is an investment that combines both senior and subordinated financing, generally in a first lien position.
- (3) Subordinated debt includes bonds in CLOs and in a CDO.
- (4) The total principal balance outstanding on loans and debt securities was \$3,205.6 million and \$3,418.0 million at March 31, 2009, and December 31, 2008, respectively. The difference between principal and cost is represented by unamortized loan origination fees and costs, original issue discounts, and market discounts totaling \$31.3 million and \$33.5 million at March 31, 2009, and December 31, 2008, respectively.
- (5) Investments in the preferred shares/income notes of CLOs and the subordinated certificates in Unitranche Fund LLC earn a current return that is included in interest income in the accompanying consolidated statement of operations.

The Company's private finance investment activity principally involves providing financing through privately negotiated long-term debt and equity investments. The Company's private finance debt and equity investments generally are issued by private companies and generally are illiquid and may be subject to certain restrictions on resale.

The Company's private finance debt investments are generally structured as loans and debt securities that carry a relatively high fixed rate of interest, which may be combined with equity features, such as conversion privileges, or warrants or options to purchase a portion of the portfolio company's equity at a pre-determined strike price, which is generally a nominal price for warrants or options in a private company. The annual stated interest rate is only one factor in pricing the investment relative to the Company's rights and priority in the portfolio company's capital structure, and will vary depending on many factors, including if the Company has received nominal cost equity or other components of investment return, such as loan origination fees or market

**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**

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

**Note 3. Portfolio, continued**

discount. The stated interest rate may include some component of contractual payment-in-kind interest, which represents contractual interest accrued and added to the loan balance that generally becomes due at maturity.

At March 31, 2009, 84% of the private finance loans and debt securities had a fixed rate of interest and 16% had a floating rate of interest. At December 31, 2008, 85% of the private finance loans and debt securities had a fixed rate of interest and 15% had a floating rate of interest. Senior loans may carry a fixed rate of interest or a floating rate of interest, usually set as a spread over prime or LIBOR, and may require payments of both principal and interest throughout the life of the loan. Senior loans generally have contractual maturities of three to six years and interest is generally paid to the Company monthly or quarterly. Unitranche debt generally carries a fixed rate of interest and generally requires payments of both principal and interest throughout the life of the loan. Unitranche debt generally has contractual maturities of five to six years and interest generally is paid to the Company quarterly. Subordinated debt generally carries a fixed rate of interest generally with contractual maturities of five to ten years and generally has interest-only payments in the early years and payments of both principal and interest in the later years, although maturities and principal amortization schedules may vary. Interest on subordinated debt generally is paid to the Company quarterly.

Equity securities primarily consist of securities issued by private companies and may be subject to certain restrictions on their resale and are generally illiquid. The Company may make equity investments for minority stakes in portfolio companies or may receive equity features, such as nominal cost warrants. The Company also may invest in the equity (preferred and/or voting or non-voting common) of a portfolio company where the Company's equity ownership may represent a significant portion of the equity, but may or may not represent a controlling interest. If the Company invests in non-voting equity in a buyout investment, the Company generally has the option to acquire a controlling stake in the voting securities of the portfolio company at fair market value. The Company may incur costs associated with making buyout investments that will be included in the cost basis of the Company's equity investment. These include costs such as legal, accounting and other professional fees associated with diligence, referral and investment banking fees, and other costs. Equity securities generally do not produce a current return, but are held with the potential for investment appreciation and ultimate gain on sale.

**Ciena Capital LLC.** Ciena Capital LLC (f/k/a Business Loan Express, LLC) (Ciena) has provided loans to commercial real estate owners and operators. Ciena has been a participant in the Small Business Administration's 7(a) Guaranteed Loan Program and its wholly-owned subsidiary is licensed by the SBA as a Small Business Lending Company (SBLC). Ciena is headquartered in New York, NY.

On September 30, 2008, Ciena voluntarily filed for bankruptcy protection under Chapter 11 of Title 11 of the United States Code (the Bankruptcy Code) in the United States Bankruptcy Court for the Southern District of New York (the Court). Ciena continues to operate its servicing business and manage its assets as a debtor-in-possession under the jurisdiction of the Court and in accordance with the applicable provisions of the Bankruptcy Code and the orders of the Court.

At March 31, 2009 and December 31, 2008, the Company's investment in Ciena was as follows:

**March 31, 2009**

**December 31, 2008**

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<b>(\$ in millions)</b>	<b>Cost</b>	<b>Value</b>	<b>Cost</b>	<b>Value</b>
Senior Loan	\$ 319.0	\$ 64.1	\$ 319.0	\$ 104.9
Class B Equity Interests <sup>(1)</sup>	119.5		119.5	
Class C Equity Interests <sup>(1)</sup>	112.6		109.3	
<b>Total</b>	<b>\$ 551.1</b>	<b>\$ 64.1</b>	<b>\$ 547.8</b>	<b>\$ 104.9</b>

<sup>(1)</sup> At March 31, 2009 and December 31, 2008, the Company held 100% of the Class B equity interests and 94.9% of the Class C equity interests.

**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**

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

**Note 3. Portfolio, continued**

At March 31, 2009 and December 31, 2008, other assets includes amounts receivable from or related to Ciena totaling \$15.5 million and \$15.4 million at cost and \$2.1 million and \$2.1 million at value, respectively. Net change in unrealized appreciation or depreciation included a net decrease in the Company's investment in Ciena of \$44.1 million and \$39.3 million for the three months ended March 31, 2009 and 2008, respectively.

In addition, at March 31, 2009, the Company had standby letters of credit issued under the Company's line of credit of \$94.1 million in connection with term securitization transactions completed by Ciena. The term securitizations have experienced increasing defaults as a result of the economic environment, which may require the Company to fund a portion of the standby letters of credit in 2009. The Company's asset coverage ratio is currently less than 200% and the Company currently is in default under its revolving line of credit. In addition, the financial institution that has issued these letters of credit has experienced a ratings downgrade. As a result of these factors, the Company may need to use cash to provide credit enhancement to these term securitizations if these letters of credit cannot be maintained through the revolving credit facility or if the issuer of these letters of credit is further downgraded. During the three months ended March 31, 2009, the Company contributed \$3.3 million to Ciena in exchange for additional Class C equity interests, which was used to support Ciena's term securitizations in lieu of a draw under the letters of credit. This investment was required as a result of the downgrade of the issuer of the letters of credit. The Company has considered any funding under the letters of credit in the valuation of Ciena at March 31, 2009 and December 31, 2008.

As a result of Ciena's decision to file for bankruptcy protection, the Company's unconditional guaranty of the obligations outstanding under Ciena's revolving credit facility became due. As of March 31, 2009, the senior secured loan to Ciena had a cost basis of \$319.0 million and a value of \$64.1 million. The Company continues to guarantee the remaining principal balance of \$5 million, plus related interest, fees and expenses payable to a third party bank. In connection with the Company's continuing guaranty of the amounts held by this bank, the Company has agreed that the amounts owing to the bank under the Ciena revolving credit facility will be paid before any of the secured obligations of Ciena now owed to the Company.

The Company's investment in Ciena was on non-accrual status, therefore the Company did not earn any interest and related portfolio income from its investment in Ciena for each of the three months ended March 31, 2009 and 2008.

At March 31, 2009, Ciena had two non-recourse securitization warehouse facilities, both of which have matured. In order to pay down debt under the conventional loan warehouse facility, Ciena is in the process of selling loans on behalf of the conventional loan warehouse facility providers. Ciena is also working with the providers of the SBA loan warehouse facility with regard to the repayment of that facility. The Company has issued performance guaranties whereby the Company agreed to indemnify the warehouse providers for any damages, losses, liabilities and related costs and expenses that they may incur as a result of Ciena's failure to perform any of its obligations as loan originator, loan seller or loan servicer under the warehouse securitizations.

The Office of the Inspector General of the SBA (OIG) and the United States Secret Service are conducting ongoing investigations of allegedly fraudulently obtained SBA-guaranteed loans issued by Ciena. Ciena also is subject to other SBA and OIG audits, investigations, and reviews. In addition, the Office of the Inspector General of the U.S. Department of Agriculture is conducting an investigation of Ciena's lending practices under the Business and Industry Loan (B&I) program. The OIG and the





## ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

## Note 3. Portfolio, continued

U.S. Department of Justice are also conducting a civil investigation of Ciena's lending practices in various jurisdictions. The Company is unable to predict the outcome of these inquiries, and it is possible that third parties could try to seek to impose liability against the Company in connection with certain defaulted loans in Ciena's portfolio. These investigations, audits and reviews are ongoing.

These investigations, audits, reviews, and litigation have had and may continue to have a material adverse impact on Ciena and, as a result, could continue to negatively affect the Company's financial results. The Company has considered Ciena's voluntary filing for bankruptcy protection, any funding under the letters of credit, current regulatory issues, ongoing investigations and litigation in performing the valuation of Ciena at March 31, 2009 and at December 31, 2008.

*Collateralized Loan Obligations ( CLOs ) and Collateralized Debt Obligations ( CDOs ).* At March 31, 2009, and December 31, 2008, the Company owned bonds and preferred shares/income notes in CLOs and bonds in a CDO as follows:

(\$ in millions)	Cost	2009 Value	Yield <sup>(1)</sup>	Cost	2008 Value	Yield <sup>(1)</sup>
<i>Bonds<sup>(2)</sup>:</i>						
Callidus Debt Partners CDO Fund I, Ltd.	\$ 28.4	\$ 11.1	%	\$ 28.4	\$ 10.1	39.4%
Callidus Debt Partners CLO Fund IV, Ltd.	2.0	1.6	21.6%	2.0	1.4	26.9%
Callidus Debt Partners CLO Fund VI, Ltd.	7.2	4.0	20.9%	7.1	3.9	26.1%
Callidus MAPS CLO Fund I LLC	17.0	11.1	10.3%	17.0	9.8	12.2%
Callidus MAPS CLO Fund II LLC	3.6	3.0	25.6%	3.6	3.0	30.2%
Dryden XVIII Leveraged Loan 2007 Limited	7.8	3.1	19.3%	7.7	4.5	20.5%
Knightsbridge CLO 2007-1 Ltd. <sup>(3)</sup>	18.7	15.0	12.9%	18.7	14.9	17.4%
Knightsbridge CLO 2008-1 Ltd. <sup>(3)</sup>	31.4	28.4	13.3%	31.4	31.4	10.2%
Pangaea CLO 2007-1 Ltd.	11.9	4.6	24.4%	11.8	7.1	25.0%
Total bonds	128.0	81.9	12.9%	127.7	86.1	18.5%
<i>Preferred Shares/Income Notes:</i>						
Callidus Debt Partners CLO Fund III, Ltd.	20.1	6.4	%	20.1	5.4	%
Callidus Debt Partners CLO Fund IV, Ltd.	15.0	5.5	%	14.6	10.6	18.1%
Callidus Debt Partners CLO Fund V, Ltd.	13.6	6.9	12.1%	13.4	10.3	21.3%
Callidus Debt Partners CLO Fund VI, Ltd.	29.0	8.7	8.7%	28.3	23.1	21.8%
Callidus Debt Partners CLO Fund VII, Ltd.	24.7	10.5	5.1%	24.0	15.4	17.9%
Callidus MAPS CLO Fund I LLC	43.8	13.4	%	45.1	27.8	6.5%
Callidus MAPS CLO Fund II, Ltd.	18.8	4.4	%	18.4	12.6	19.3%
Dryden XVIII Leveraged Loan 2007 Limited	22.7	8.7	21.5%	22.1	17.5	20.2%
Knightsbridge CLO 2007-1 Ltd. <sup>(3)</sup>	41.8	20.4	%	40.9	35.2	17.4%
Knightsbridge CLO 2008-1 Ltd. <sup>(3)</sup>	20.9	19.5	22.1%	21.3	21.3	16.6%

Total preferred shares/income notes	250.4	104.4	7.9%	248.2	179.2	16.4%
Total	\$ 378.4	\$ 186.3		\$ 375.9	\$ 265.3	

(1) The weighted average yield is calculated as the (a) annual stated interest or the effective interest yield on the accruing bonds or the effective interest yield on the preferred shares/income notes, divided by (b) CLO and CDO assets at value. The yield on these debt and equity securities is included in interest income in the accompanying consolidated statement of operations.

The market yield used in the valuation of the CLO and CDO assets may be different than the interest yields shown above.

(2) These securities are included in private finance subordinated debt.

(3) These funds are managed by the Company through a wholly-owned subsidiary.

## ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

**Note 3. Portfolio, continued**

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

The bonds, preferred shares and income notes of the CLOs and CDO in which the Company has invested are junior in priority for payment of interest and principal to the more senior notes issued by the CLOs and CDO. Cash flow from the underlying collateral assets in the CLOs and CDO is generally allocated first to the senior bonds in order of priority, then any remaining cash flow is generally distributed to the preferred shareholders and income note holders. To the extent there are ratings downgrades, defaults and unrecoverable losses on the underlying collateral assets that result in reduced cash flows, the preferred shares/income notes will bear this loss first and then the subordinated bonds would bear any loss after the preferred shares/income notes. At both March 31, 2009, and December 31, 2008, the face value of the CLO and CDO assets held by the Company was subordinate to as much as 94% of the face value of the securities outstanding in these CLOs and CDO.

At March 31, 2009, and December 31, 2008, the underlying collateral assets of these CLO and CDO issuances, consisting primarily of senior corporate loans, were issued by 646 issuers and 658 issuers, respectively, and had balances as follows:

(\$ in millions)	2009	2008
Bonds	\$ 240.7	\$ 268.3
Syndicated loans	4,428.8	4,477.3
Cash <sup>(1)</sup>	130.6	89.6
Total underlying collateral assets at cost <sup>(2)</sup>	\$ 4,800.1	\$ 4,835.2

(1) Includes undrawn liability amounts.

(2) At March 31, 2009, and December 31, 2008, the total cost basis of defaulted obligations was \$134.0 million and \$95.0 million, respectively, or approximately 2.8% and 2.0% respectively, of the total underlying collateral assets.

**Loans and Debt Securities on Non-Accrual Status.** At March 31, 2009, and December 31, 2008, private finance loans and debt securities at value not accruing interest were as follows:

(\$ in millions)	2009	2008
Loans and debt securities		
Companies more than 25% owned	\$ 134.5	\$ 176.1
Companies 5% to 25% owned	13.6	

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Companies less than 5% owned	69.3	151.8
Total	\$ 217.4	\$ 327.9

## ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

## Note 3. Portfolio, continued

**Industry and Geographic Compositions.** The industry and geographic compositions of the private finance portfolio at value at March 31, 2009, and December 31, 2008, were as follows:

	2009	2008
<b>Industry</b>		
Business services	33%	36%
Consumer products	26	24
CLO/CDO <sup>(1)</sup>	7	8
Financial services	6	6
Private debt funds	5	5
Consumer services	5	5
Retail	5	5
Industrial products	4	5
Healthcare services	3	2
Other	6	4
Total	100%	100%
<b>Geographic Region<sup>(2)</sup></b>		
Mid-Atlantic	39%	41%
Midwest	29	28
Southeast	20	17
West	11	13
Northeast	1	1
Total	100%	100%

(1) These funds primarily invest in senior corporate loans. Certain of these funds are managed by Callidus Capital, a portfolio company of Allied Capital.

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

**Commercial Real Estate Finance**

At March 31, 2009, and December 31, 2008, the commercial real estate finance portfolio consisted of the following:

(\$ in millions)	2009			2008		
	Cost	Value	Yield <sup>(1)</sup>	Cost	Value	Yield <sup>(1)</sup>
Commercial mortgage loans	\$ 53.6	\$ 53.9	6.7%	\$ 52.5	\$ 53.5	7.4%
Real estate owned	15.0	7.8		18.2	20.8	

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Equity interests	13.7	17.3	14.8	19.6
Total	\$ 82.3	\$ 79.0	\$ 85.5	\$ 93.9

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

**Commercial Mortgage Loans and Equity Interests.** The commercial mortgage loan portfolio contains loans that were originated by the Company or were purchased from third-party sellers. At March 31,

**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****Note 3. Portfolio, continued**

2009, and December 31, 2008, approximately 68% and 69% of the Company's commercial mortgage loan portfolio was composed of fixed interest rate loans, respectively, and 32% and 31% of the Company's commercial loan portfolio was composed of adjustable interest rate loans, respectively. At March 31, 2009, and December 31, 2008, loans with a value of \$11.0 million and \$7.7 million, respectively, were not accruing interest. Loans greater than 120 days delinquent generally do not accrue interest.

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

The property types and the geographic composition securing the commercial real estate finance portfolio at value at March 31, 2009, and December 31, 2008, were as follows:

	<b>2009</b>	<b>2008</b>
<b>Property Type</b>		
Hospitality	57%	52%
Recreation	28	22
Office	13	15
Retail		9
Other	2	2
Total	100%	100%
<b>Geographic Region</b>		
Southeast	42%	43%
West	30	26
Midwest	19	22
Northeast	9	9
Mid-Atlantic		
Total	100%	100%

***Fair Value Measurements***

The Company, as a BDC, has invested in illiquid securities including debt and equity securities of portfolio companies, CLO bonds and preferred shares/income notes, CDO bonds and investment funds. The Company's investments may be subject to certain restrictions on resale and generally have no established trading market. The Company values substantially all of its investments at fair value as determined in good faith by the Board of Directors in accordance with the Company's valuation policy and the provisions of the 1940 Act and SFAS 157. The Company determines fair value to be the price that would be received for an investment in a current sale, which assumes an

orderly transaction between market participants on the measurement date. The Company's valuation policy considers the fact that no ready market exists for substantially all of the securities in which it invests and that fair value for its investments must typically be determined using unobservable inputs.

SFAS 157 establishes a fair value hierarchy that encourages the use of observable inputs, but allows for unobservable inputs when observable inputs do not exist. Inputs are classified into one of three categories:

Level 1 Quoted prices (unadjusted) in active markets for identical assets



## ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

## Note 3. Portfolio, continued

Level 2 Inputs other than quoted prices that are observable to the market participant for the asset or quoted prices in a market that is not active

Level 3 Unobservable inputs

When there are multiple inputs for determining the fair value of an investment, the Company classifies the investment in total based on the lowest level input that is significant to the fair value measurement.

Assets measured at fair value on a recurring basis by level within the fair value hierarchy at March 31, 2009, were as follows:

(\$ in millions)	Fair Value Measurement as of March 31, 2009	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets at Fair Value:				
Portfolio				
Private finance:				
Loans and debt securities	\$ 2,185.6	\$	\$	\$ 2,185.6
Preferred shares/income notes of CLOs	104.4			104.4
Subordinated certificates in Unitranche Fund LLC	124.5			124.5
Other equity securities	415.5			415.5
Commercial real estate finance	79.0			79.0
Total portfolio	\$ 2,909.0	\$	\$	\$ 2,909.0

The table below sets forth a summary of changes in the Company's assets measured at fair value using level 3 inputs.

	Private Finance		Other Equity	Commercial Real Estate
	Preferred	Subordinated		
Loans and Debt	Shares/ Income Notes	Certificates in Unitranche		

(\$ in millions)	Securities	of CLOs	Fund LLC	Securities	Finance	Total
Balance at December 31, 2008	\$ 2,591.8	\$ 179.2	\$ 125.4	\$ 502.7	\$ 93.9	\$ 3,493.0
Total gains or losses						
Net realized gains (losses) <sup>(1)</sup>	(30.4)	7.3		(6.8)	4.1	(25.8)
Net change in unrealized appreciation or depreciation <sup>(2)</sup>	(196.0)	(76.9)		(68.4)	(11.7)	(353.0)
Purchases, issuances, repayments and exits, net <sup>(3)</sup>	(179.8)	(5.2)	(0.9)	(12.0)	(7.3)	(205.2)
Transfers in and/or out of level 3						
Balance at March 31, 2009	\$ 2,185.6	\$ 104.4	\$ 124.5	\$ 415.5	\$ 79.0	\$ 2,909.0
Net unrealized appreciation (depreciation) during the period relating to assets still held at the reporting date <sup>(2)</sup>	\$ (221.1)	\$ (76.9)	\$	\$ (57.7)	\$ (5.2)	\$ (360.9)

(1) Includes net realized gains (losses) (recorded as realized gains or losses in the accompanying consolidated statement of operations), and amortization of discounts and closing points (recorded as interest income in the accompanying consolidated statement of operations).

(2) Included in change in net unrealized appreciation or depreciation in the accompanying consolidated statement of operations.

Net change in unrealized appreciation or depreciation includes net unrealized appreciation (depreciation) resulting from changes in portfolio investment values during the reporting period and the reversal of previously recorded unrealized appreciation or depreciation when gains or losses are realized.

(3) Includes interest and dividend income reinvested through the receipt of a debt or equity security (payment-in-kind income) (recorded as interest and dividend income in the accompanying consolidated statement of operations).

## ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

## Note 3. Portfolio, continued

*Managed Funds*

In addition to managing its own assets, the Company manages certain funds that also invest in the debt and equity securities of primarily private middle market companies in a variety of industries. At March 31, 2009, the Company had eight separate funds under its management (together, the Managed Funds ) for which the Company may earn management or other fees for its services. The Company may invest in the equity of these funds, along with other third parties, from which the Company may earn a current return and/or a future incentive allocation.

On March 3, 2009, the Company announced the completion of the acquisition of the management contracts of three middle market senior debt CLOs (together, the Emporia Funds ) and certain other related assets for approximately \$11 million (subject to post-closing adjustments). The acquired assets are included in other assets in the accompanying consolidated balance sheet and the cost will be amortized over the life of the contracts. The Emporia Funds primarily invest in middle market and broadly syndicated senior secured loans. The Company is not an investor in the Emporia Funds.

The assets of the Managed Funds at March 31, 2009 and December 31, 2008, and the Company's management fees as of March 31, 2009 were as follows:

(\$ in millions) Name of Fund	Assets of Managed Funds		Management Fee <sup>(2)</sup>
	March 31, 2009	December 31, 2008	
Unitranche Fund LLC	\$ 781.3	\$ 789.8	0.375%
Allied Capital Senior Debt Fund, L.P.	397.7	412.9	1.625% <sup>(1)(2)</sup>
Knightsbridge CLO 2007-1 Ltd.	502.0	500.6	0.600%
Knightsbridge CLO 2008-1 Ltd.	304.6	304.8	0.600%
AGILE Fund I, LLC	83.2	99.3	(1)
Emporia Preferred Funding I, Ltd.	414.2		0.625% <sup>(1)</sup>
Emporia Preferred Funding II, Ltd.	352.5		0.650% <sup>(1)</sup>
Emporia Preferred Funding III, Ltd.	406.2		0.650% <sup>(1)</sup>
Total Assets	\$ 3,241.7	\$ 2,107.4	

(1) The Company is entitled to an incentive allocation subject to certain performance benchmarks. There can be no assurance that the incentive allocation will be earned.

(2) Management fees are stated as a percent of assets except for the Allied Capital Senior Debt Fund, L.P. ( ACSDF ) which is stated as a percent of equity capital. The management fee paid by ACSDF was 2.000% at December 31, 2008 and reduced to 1.625% effective January 1, 2009.

A portion of the management fees earned by the Company may be deferred under certain circumstances. Collection of the fees earned may be dependent in part on the performance of the Managed Fund. The Company may pay a portion of management fees it receives to Callidus Capital Corporation, a portfolio investment controlled by the Company, for services provided as special manager to the Allied Capital Senior Debt Fund, L.P., Knightsbridge CLO 2007-1 Ltd., Knightsbridge CLO 2008-1 Ltd. and the Emporia Funds.

The Company's responsibilities to the Managed Funds may include investment origination, underwriting, and portfolio monitoring services. Each of the Managed Funds may separately invest in the debt or equity of companies in the Company's portfolio, and these investments may be senior, pari passu or

**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**

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

**Note 3. Portfolio, continued**

junior to the debt and equity investments held by the Company. The Company may or may not participate in investments made by the Managed Funds.

No assets were sold to any of the Managed Funds during the three months ended March 31, 2009. During the three months ended March 31, 2008, the Company sold \$166.7 million of assets to the AGILE Fund I, LLC, for which the Company recognized a realized gain of \$8.8 million and dividend income of \$5.4 million.

The Company accounts for the sale of securities to funds with which it has continuing involvement as sales pursuant to SFAS No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities, a replacement of FASB Statement 125, when the securities have been legally isolated from the Company, the Company has no ability to restrict or constrain the ability of the Managed Funds to pledge or exchange the transferred securities, and the Company does not have either the entitlement and the obligation to repurchase the securities or the ability to unilaterally cause the Managed Fund to put the securities back to the Company.

In addition to managing these funds, the Company holds certain investments in the Managed Funds as follows:

(\$ in millions)		March 31, 2009		December 31, 2008	
Name of Fund	Investment Description	Cost	Value	Cost	Value
Unitranche Fund LLC <sup>(1)</sup>	Subordinated Certificates and Equity Interests	\$ 124.5	\$ 124.5	\$ 125.4	\$ 125.4
Allied Capital Senior Debt Fund, L.P.	Equity interests	31.8	32.9	31.8	31.8
Knightsbridge CLO 2007-1 Ltd.	Class E Notes and Income Notes	60.4	35.4	59.6	50.1
Knightsbridge CLO 2008-1 Ltd.	Class C Notes, Class D Notes, Class E Notes and Income Notes	52.3	47.9	52.7	52.7
AGILE Fund I, LLC	Equity Interests	0.7	0.4	0.7	0.5
Total		\$ 269.7	\$ 241.1	\$ 270.2	\$ 260.5

<sup>(1)</sup> The Company has committed up to \$525.0 million of subordinated certificates to the Unitranche Fund. The Unitranche Fund will be capitalized as investment transactions are completed. Investments made by the Unitranche Fund must be approved by the investment committee of the Unitranche Fund, which includes a representative from the Company. Therefore, this commitment to the Unitranche Fund cannot be drawn without the Company's approval.

## ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

## Note 4. Debt

At March 31, 2009, and December 31, 2008, the Company had the following debt:

	2009			2008		
	Facility Amount	Amount Drawn	Annual Interest Cost <sup>(1)</sup>	Facility Amount	Amount Drawn	Annual Interest Cost <sup>(1)</sup>
(\$ in millions)						
Notes payable:						
Privately issued unsecured notes payable	\$1,015.0	\$1,015.0	9.8% <sup>(5)</sup>	\$1,015.0	\$1,015.0	7.8%
Publicly issued unsecured notes payable	877.5	877.5	6.7%	880.0	880.0	6.7%
Total notes payable	1,892.5	1,892.5	8.3%	1,895.0	1,895.0	7.3%
Revolving line of credit <sup>(4)</sup>	165.0	50.0	6.3% <sup>(2)(5)</sup>	632.5	50.0	4.3% <sup>(2)</sup>
Total debt	\$2,057.5	\$1,942.5	8.6% <sup>(3)(5)</sup>	\$2,527.5	\$1,945.0	7.7% <sup>(3)</sup>

- (1) The weighted average annual interest cost is computed as the (a) annual stated interest on the debt plus any applicable default interest, plus the annual amortization of commitment fees, other facility fees and amortization of debt financing costs that are recognized into interest expense over the contractual life of the respective borrowings, divided by (b) debt outstanding on the balance sheet date.
- (2) The annual interest cost reflects the interest rate payable for borrowings under the revolving line of credit in effect at the balance sheet date. In addition to the current interest payable, there were annual costs of commitment fees, other facility fees and amortization of debt financing costs of \$6.0 million at March 31, 2009, and \$8.5 million at December 31, 2008.
- (3) The annual interest cost for total debt includes the annual cost of commitment fees, other facility fees and amortization of debt financing costs on the revolving line of credit regardless of the amount outstanding on the facility as of the balance sheet date. The annual interest cost reflects the facilities in place on the balance sheet date.
- (4) At March 31, 2009, \$1.5 million remained unused on the revolving line of credit, net of amounts committed for standby letters of credit of \$113.5 million issued under the credit facility. See discussion below.
- (5) Events of default have occurred and are continuing under the Revolving Line of Credit and Private Notes which have increased the interest rates by 2.00% during the continuance of such events of default. Excluding this default interest, the annual interest cost on total debt would have been 7.5%.

*Notes Payable*

**Revolving Line of Credit.** The Company has a three-year unsecured revolving line of credit with total commitments of \$165.0 million that expires on April 11, 2011 (the Revolving Line of Credit). At March 31, 2009, there was \$50.0 million outstanding under the Company's Revolving Line of Credit and standby letters of credit of \$113.5 million were issued under the credit facility.

Borrowings under the Revolving Line of Credit generally bear interest at a rate per annum equal to (i) LIBOR (for the period selected by the Company) plus 3.00% or (ii) the higher of (a) the Federal Funds rate plus 1.50% or (b) the Bank of America N.A. prime rate plus 1.00%. The Revolving Line of Credit requires the payment of an annual commitment fee equal to 0.50% of the committed amount (whether used or unused). The Revolving Line of Credit generally requires payments of interest at the end of each LIBOR interest period, but no less frequently than quarterly, on LIBOR-based loans, and monthly payments of interest on other loans. All principal is due upon maturity.

The Revolving Line of Credit provides for a swingline sub-facility. The swingline sub-facility bears interest at the Bank of America N.A. cost of funds plus 2.00%. The Revolving Line of Credit also provides for a sub-facility for the issuance of letters of credit for up to an aggregate amount of \$115.0 million. The letter of credit fee is 3.00% per annum on letters of credit issued, which is payable quarterly. Events of default have increased the interest rate and fees on letters of credit by up to 2.00% during the continuance of such events of default. See Note 1.

***Privately Issued Unsecured Notes Payable.*** The Company has privately issued notes (the Private Notes ) to institutional investors, primarily insurance companies. The Private Notes have five- or seven-year maturities and stated fixed rates of interest ranging from 6.53% to 9.14% at March 31, 2009. Events of default have occurred which have increased these interest rates by 2.00% during the continuance of such events of default. See Note 1. The Private Notes generally require payment of interest only semi-annually, and all principal is due upon maturity. At March 31, 2009, the Private Notes had maturities from November 2009 to June 2015. The Private Notes may be prepaid in whole or in part, together with an interest premium, if any, as stipulated in the private note agreements.

**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**

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

**Note 4. Debt, continued**

The Revolving Line of Credit and the Private Notes have similar financial and operating covenants. These covenants require the Company to maintain certain financial ratios, including asset coverage, debt to equity and interest coverage, and a minimum net worth. These debt agreements provide for customary events of default, including, but not limited to, payment defaults, breach of representations or covenants, cross-defaults, bankruptcy events, failure to pay judgments, attachment of its assets, change of control and the issuance of an order of dissolution. Certain of these events of default are subject to notice and cure periods or materiality thresholds. These debt agreements limit the Company's ability to declare dividends or repurchase its common stock during the existence of certain defaults and events of default.

***Amendments to Revolving Line of Credit and Privately Issued Unsecured Notes Payable.*** On December 30, 2008, the Company entered into amendments relating to the Company's Private Notes and Revolving Line of Credit. The amendments reduced the Company's capital maintenance covenant to the greater of \$1.5 billion and 85% of consolidated adjusted debt, and reduced the Company's interest charges coverage ratio covenant, determined as of the last day of each fiscal quarter for the period of four consecutive fiscal quarters ending on such day, to 1.4 to 1 for the fiscal quarter ending December 31, 2008 and each fiscal quarter thereafter to and including the fiscal quarter ending December 31, 2009, to 1.6 to 1 for the fiscal quarter ending March 31, 2010 and each fiscal quarter thereafter to and including the fiscal quarter ending December 31, 2010, and to 1.7 to 1 for the fiscal quarter ending March 31, 2011 and each fiscal quarter thereafter. The amendments did not modify the Company's obligation to maintain a minimum 200% asset coverage ratio.

The amendments added new covenants that required the Company to grant to the Noteholders and the Lenders a first priority lien on substantially all of the Company's assets no later than January 30, 2009, and to maintain a ratio of consolidated total adjusted assets to secured debt of not less than 2.25 to 1. Also, prior to December 31, 2010, the Company is (i) required to limit the payment of dividends to a maximum of \$0.20 per share per fiscal quarter (or such greater amount required for the Company to maintain its regulated investment company status), and (ii) restricted from purchasing, redeeming or retiring any shares of the Company's common stock or any warrants, rights or options to purchase or acquire any shares of the Company's common stock for an aggregate consideration in excess of \$60 million. In addition, the amendments restricted the Company from prepaying, redeeming, purchasing or otherwise acquiring any of its currently outstanding public notes prior to their stated maturity. The amendments also made certain other modifications. The amendments increased the rate of interest on the instruments by 100 basis points. In addition, these amendments required a 50 basis point amendment fee.

Events of default have occurred and are continuing under the Revolving Line of Credit and Private Notes related to certain financial and other covenants. See Note 1.

***Publicly Issued Unsecured Notes Payable.*** At March 31, 2009, the Company had outstanding publicly issued unsecured notes as follows:

(\$ in millions)	Amount	Maturity Date
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6.625% Notes due 2011	\$397.5	July 15, 2011
6.000% Notes due 2012	250.0	April 1, 2012
6.875% Notes due 2047	230.0	April 15, 2047
Total	\$877.5	

**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**

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

**Note 4. Debt, continued**

The 6.625% Notes due 2011 and the 6.000% Notes due 2012 require payment of interest only semi-annually, and all principal is due upon maturity. The Company has the option to redeem these notes in whole or in part, together with a redemption premium, as stipulated in the notes. In addition, the Company may purchase these notes in the market at par or at a discount to the extent permitted by the 1940 Act. During the three months ended March 31, 2009, the Company paid \$0.5 million to repurchase certain of the 6.625% Notes due 2011 which had a face value of \$2.5 million.

The 6.875% Notes due 2047 require payment of interest only quarterly, and all principal is due upon maturity. These notes are redeemable in whole or in part at any time or from time to time on or after April 15, 2012, at par and upon the occurrence of certain tax events as stipulated in the notes.

The Company has certain financial and operating covenants that are required by the publicly issued unsecured notes payable. The Company is not permitted to issue indebtedness unless immediately after such issuance the Company has asset coverage of all outstanding indebtedness of at least 200% as required by the 1940 Act, as amended. At March 31, 2009, the Company's asset coverage ratio was 171%, which is less than the 200% requirement. As a result, under the publicly issued unsecured notes payable, the Company will not be able to issue indebtedness until such time as the Company's asset coverage returns to at least 200%. The Company has not experienced any default or cross default with respect to the publicly issued unsecured notes payable.

**Scheduled Maturities.** Scheduled future maturities of notes payable at March 31, 2009, were as follows:

(\$ in millions) Year	Amount Maturing		
	Privately Issued Unsecured Notes Payable <sup>(1)</sup>	Publicly Issued Unsecured Notes Payable	Total
2009	\$ 1,015.0	\$	\$ 1,015.0
2010			
2011		397.5	397.5
2012		250.0	250.0
2013			
Thereafter		230.0	230.0
<b>Total</b>	<b>\$ 1,015.0</b>	<b>\$ 877.5</b>	<b>\$ 1,892.5</b>

<sup>(1)</sup> The private notes have stated contractual maturities as follows: 2009 \$252.5 million, 2010 \$408.0 million, 2011 \$72.5 million, 2012 \$89.0 million, 2013 \$140.5 million, and thereafter \$52.5 million.

As discussed above and in Note 1, events of default have occurred and are continuing under the Revolving Line of Credit and Private Notes. Neither the Lenders nor Noteholders have accelerated repayment; however, if the administrative agent for the Lenders under the Revolving Line of Credit or the required percentage of Lenders under the Revolving Line of Credit or Noteholders under the Private Notes, respectively, were to accelerate repayment, these obligations would become immediately due and payable. Therefore, in the table above, the Private Notes are shown as payable in 2009.

## ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

**Note 5. Guarantees and Commitments**

In the ordinary course of business, the Company has issued guarantees and has extended standby letters of credit through financial intermediaries on behalf of certain portfolio companies. All standby letters of credit have been issued through Bank of America, N.A. As of March 31, 2009, and December 31, 2008, the Company had issued guarantees of debt and rental obligations aggregating \$19.2 million and \$19.2 million, respectively, and had extended standby letters of credit aggregating \$113.5 million and \$122.3 million, respectively. Under these arrangements, the Company would be required to make payments to third parties if the portfolio companies were to default on their related payment obligations or if the expiration dates of the letters of credit are not extended. The maximum amount of potential future payments was \$132.7 million and \$141.5 million at March 31, 2009, and December 31, 2008, respectively.

As of March 31, 2009, the guarantees and standby letters of credit expired as follows:

(in millions)	Total	2009	2010	2011	2012	2013	After 2013
Guarantees	\$ 19.2	\$ 7.5	\$ 6.4	\$ 4.4	\$ 0.1	\$	\$ 0.8
Standby letters of credit	113.5	113.5					
Total	\$ 132.7	\$ 121.0	\$ 6.4	\$ 4.4	\$ 0.1	\$	\$ 0.8

Standby letters of credit have been issued under the Revolving Line of Credit. The Company's asset coverage ratio is currently less than 200% and events of default have occurred and are continuing under the Revolving Line of Credit. Therefore, the Company is precluded from borrowing under its Revolving Line of Credit to fund these standby letters of credit and the Company may need to fund these standby letter of credit draws with cash in lieu of a borrowing. As a result, in the table above the Company has assumed that these standby letters of credit may not be able to be extended and may mature in 2009. During the existence of an event of default, the administrative agent is (i) permitted to require the Company to provide cash collateral equal to the face amount of all outstanding standby letters of credit and (ii) not required to extend the existing letters of credit beyond their maturity dates, all of which expire during the course of 2009.

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

At March 31, 2009, the Company had outstanding commitments to fund investments totaling \$651.6 million, including \$619.3 million related to private finance investments and \$32.3 million related to commercial real estate finance investments. Total outstanding commitments related to private finance investments included \$399.6 million to the Unitranche Fund LLC. Investments made by the Unitranche Fund must be approved by the investment committee of the Unitranche Fund, which includes a representative from the Company. Therefore, the Company's commitment to the Unitranche Fund cannot be drawn without the Company's approval. See Note 3.



**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**

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

**Note 6. Shareholders' Equity**

Sales of common stock for the three months ended March 31, 2009 and 2008, were as follows:

<b>(in millions)</b>	<b>2009</b>	<b>2008</b>
Number of common shares		8.3
Gross proceeds	\$	\$ 175.5
Less costs, including underwriting fees		4.6
Net proceeds	\$	\$ 170.9

There were no stock options exercised during the three months ended March 31, 2009 and 2008.

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. The Company may not issue new shares below net asset value. Dividend reinvestment plan activity for the three months ended March 31, 2009 and 2008, was as follows:

<b>(in millions, except per share amounts)</b>	<b>2009</b>	<b>2008</b>
Shares issued		0.2
Average price per share	\$	\$ 19.49
Shares purchased by plan agent for shareholders		
Average price per share		

**Note 7. Earnings Per Common Share**

Earnings per common share for the three months ended March 31, 2009 and 2008, were as follows:

<b>(in millions, except per share amounts)</b>	<b>2009</b>	<b>2008</b>
Net increase (decrease) in net assets resulting from operations	\$ (347.7)	\$ (40.7)

Weighted average common shares outstanding basic	178.7	161.5
Dilutive options outstanding		
Weighted average common shares outstanding diluted	178.7	161.5
Basic earnings (loss) per common share	\$ (1.95)	\$ (0.25)
Diluted earnings (loss) per common share	\$ (1.95)	\$ (0.25)

**Note 8. Employee Compensation Plans**

The Company has an Individual Performance Award plan ( IPA ), and an Individual Performance Bonus plan ( IPB ), each individually a Plan, or collectively, the Plans ). These Plans generally are determined annually at the beginning of each year but may be adjusted throughout the year. In 2008, the

**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES****NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)****Note 8. Employee Compensation Plans, continued**

IPA was paid in cash in two equal installments during the year. Through December 31, 2007, the IPA amounts were contributed into a trust and invested in the Company's common stock. The IPB was distributed in cash to award recipients throughout the year (beginning in February of each respective year) as long as the recipient remained employed by the Company. The Company currently has not established an IPA or IPB for 2009; however, depending upon the Company's need to retain and motivate its employees, the Company may determine in conjunction with the Compensation Committee of the Board of Directors that some form of 2009 retention compensation or additional individual performance compensation may be in the best interests of the Company.

The trusts for the IPA payments were consolidated with the Company's accounts. The common stock was classified as common stock held in deferred compensation trust in the accompanying financial statements and the deferred compensation obligation, which represented the amount owed to the employees, was included in other liabilities. Changes in the value of the Company's common stock held in the deferred compensation trust were not recognized. However, the liability was marked to market with a corresponding charge or credit to employee compensation expense.

In December 2007, the Company's Board of Directors made a determination that it was in the best interests of the Company to terminate its deferred compensation arrangements. The Board of Directors' decision primarily was in response to increased complexity resulting from recent changes in the regulation of deferred compensation arrangements. The Board of Directors resolved that the accounts under these Plans would be distributed to participants in full on March 18, 2008, the termination and distribution date, or as soon as was reasonably practicable thereafter, in accordance with the provisions of each of these Plans.

The accounts under the deferred compensation arrangements totaled \$52.5 million at December 31, 2007. The balances on the termination date were distributed to participants in March 2008 subsequent to the termination date in accordance with the transition rule for payment elections under Section 409A of the Code. Distributions from the plans were made in cash or shares of the Company's common stock, net of required withholding taxes.

The IPA and IPB expenses are included in employee expenses and for the three months ended March 31, 2009 and 2008, were as follows:

<b>(\$ in millions)</b>	<b>2009</b>	<b>2008</b>
IPA	\$	\$ 2.4
IPA mark to market expense (benefit)		(4.1)
Total IPA expense (benefit)	\$	\$ (1.7)
Total IPB expense	\$	\$ 1.7

**Note 9. Stock Option Plan**



The purpose of the stock option plan ( Option Plan ) is to provide officers and non-officer directors of the Company with additional incentives. Options are exercisable at a price equal to the fair market value of the shares on the day the option is granted. Each option states the period or periods of time within which the option may be exercised by the optionee, which may not exceed ten years from the date

**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**

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

**Note 9. Stock Option Plan, continued**

the option is granted. The options granted to officers generally vest ratably over up to a three year period. Options granted to non-officer directors vest on the grant date.

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

At March 31, 2009, and December 31, 2008, there were 37.2 million shares authorized under the Option Plan and the number of shares available to be granted under the Option Plan was 2.6 million and 9.5 million, respectively.

Information with respect to options granted, exercised and forfeited under the Option Plan for the three months ended March 31, 2009, was as follows:

(in millions, except per share amounts)	Shares	Weighted Average Exercise Price Per Share	Weighted Average Contractual Remaining Term (Years)	Aggregate Intrinsic Value at March 31, 2009 <sup>(1)</sup>
Options outstanding at January 1, 2009	19.7	\$ 26.56		
Granted	10.6	\$ 0.73		
Exercised		\$		
Forfeited	(3.6)	\$ 26.73		
Options outstanding at March 31, 2009	26.7	\$ 16.28	5.98	\$9.1
Exercisable at March 31, 2009 <sup>(2)</sup>	9.8	\$ 28.23	5.14	\$
Exercisable and expected to be exercisable at March 31, 2009 <sup>(3)</sup>	23.2	\$ 16.37	5.95	\$8.2

<sup>(1)</sup> Represents the difference between the market value of the options at March 31, 2009, and the cost for the option holders to exercise the options.

<sup>(2)</sup> Represents vested options.

<sup>(3)</sup> The amount of options expected to be exercisable at March 31, 2009, is calculated based on an estimate of expected forfeitures.

During the three months ended March 31, 2008, 7.1 million options were granted, no options were exercised and 0.3 million options were forfeited. No options vested during the three months ended March 31, 2009 and 2008.

**Note 10. Dividends and Distributions and Taxes**

At December 31, 2008, the Company estimated that it did not have excess taxable income available for distribution to shareholders in 2009, and the Company's Board of Directors did not declare a dividend for the first quarter of 2009. The Company's Board of Directors declared and the Company paid a dividend of \$0.65 per common share for the first quarter of 2008, totaling \$108.1 million.

**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**

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

**Note 10. Dividends and Distributions and Taxes, continued**

The Company generally will be required to pay an excise tax equal to 4% of the amount by which 98% of the Company's annual taxable income exceeds the distributions for the year. The Company records an excise tax based on the Company's estimated excess taxable income for the period. Such estimates may change from period to period. The Company did not record an excise tax for the three months ended March 31, 2009. The Company recorded an excise tax of \$2.3 million for the three months ended March 31, 2008.

In certain circumstances, the Company is restricted in its ability to pay dividends. Each of the Company's Private Notes and the Company's Revolving Line of Credit contain provisions that limit the amount of dividends the Company can pay, and have a covenant that requires a minimum 200% asset coverage ratio at all times. At March 31, 2009, the Company was in default of that covenant (see Note 1). During the continuance of an event of default, the Company is precluded from declaring dividends or other distributions to its shareholders. In addition, pursuant to the 1940 Act, the Company may be precluded from declaring dividends or other distributions to its shareholders unless the Company's asset coverage is at least 200%.

The Company currently estimates that it had cumulative deferred taxable income related to installment sale gains of approximately \$217.4 million as of December 31, 2008. These gains have been recognized for financial reporting purposes in the respective years they were realized, but are generally deferred for tax purposes until the notes or other amounts received from the sale of the related investments are collected in cash. The recognition of installment sales gains as of December 31, 2008 are estimates and will not be finally determined until the Company files its 2008 tax return in September 2009. Certain of these installment gains as of December 31, 2008 will be recognized for tax purposes in 2009 as certain notes received from the sale of the related investments have been sold.

The Company's undistributed book earnings of \$184.7 million as of December 31, 2008 resulted from undistributed ordinary income and long-term capital gains. The difference between undistributed book earnings at the end of the year and taxable income carried over from the current year into the next year relates to a variety of timing and permanent differences in the recognition of income and expenses for book and tax purposes.

The Company's consolidated subsidiary, AC Corp, is subject to federal and state income taxes. For the three months ended March 31, 2009 and 2008, AC Corp's income tax benefit was \$0.4 million and \$0.3 million, respectively. For the three months ended March 31, 2009, paid in capital was decreased by \$2.4 million primarily for the reduction of the deferred tax asset related to stock options that expired unexercised.

**Note 11. Supplemental Disclosure of Cash Flow Information**

The Company paid interest of \$33.2 million and \$31.1 million, respectively, for the three months ended March 31, 2009 and 2008. The Company paid income taxes, including excise taxes (net of refunds), of \$3.0 million and \$13.0 million the three months ended March 31, 2009 and 2008, respectively.

Non-cash operating activities for the three months ended March 31, 2009 and 2008, totaled \$58.7 million and \$132.0 million, respectively. Non-cash operating activities for the three months ended March 31, 2009 and 2008, included the exchange of existing debt securities and accrued interest with a



**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**

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

**Note 11. Supplemental Disclosure of Cash Flow Information, continued**

cost basis of \$58.7 million and \$99.6 million, respectively, for new debt and equity securities, and non-cash operating activities for the three months ended March 31, 2008, included consideration received in connection with the sale of securities of \$32.4 million, which was received in cash in April 2008.

Non-cash financing activities included the issuance of common stock in lieu of cash distributions totaling \$3.8 million for the three months ended March 31, 2008.

## ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

## Note 12. Financial Highlights

	At and for the Three Months Ended		At and for the
	March 31,		Year Ended
	2009 <sup>(1)</sup>	2008	December 31, 2008
<b>Per Common Share Data</b>			
Net asset value, beginning of period	\$ 9.62	\$ 17.54	\$ 17.54
Net investment income <sup>(2)</sup>	0.16	0.43	1.23
Net realized gains (losses) <sup>(2)(3)</sup>	(0.15)	0.02	(0.75)
Net investment income plus net realized gains (losses) <sup>(2)</sup>	0.01	0.45	0.48
Net change in unrealized appreciation or depreciation <sup>(2)(3)</sup>	(1.96)	(0.70)	(6.49)
Net increase (decrease) in net assets resulting from operations <sup>(2)</sup>	(1.95)	(0.25)	(6.01)
Net decrease in net assets from shareholder distributions		(0.65)	(2.60)
Net increase in net assets from capital share transactions <sup>(2)</sup>		0.35	0.69
Net asset value, end of period	\$ 7.67	\$ 16.99	\$ 9.62
Market value, end of period	\$ 1.59	\$ 18.43	\$ 2.69
Total return <sup>(4)</sup>	(40.9)%	(11.4)%	(82.5)%
<b>Ratios and Supplemental Data</b>			
(\$ and shares in millions, except per share amounts)			
Ending net assets	\$ 1,369.8	\$ 2,828.4	\$ 1,718.4
Common shares outstanding at end of period	178.7	166.5	178.7
Diluted weighted average common shares outstanding	178.7	161.5	173.0
Employee, employee stock option and administrative expenses/average net assets <sup>(5)</sup>	1.40%	1.28%	5.47%
Total operating expenses/average net assets <sup>(5)(6)</sup>	4.41%	2.62%	11.39%
Income tax expense (benefit), including excise tax/average net assets <sup>(5)</sup>	(0.02)%	0.07%	0.10%
Net investment income/average net assets <sup>(5)</sup>	1.91%	2.48%	8.47%
Net increase (decrease) in net assets resulting from operations/average net assets <sup>(5)</sup>	(22.52)%	(1.45)%	(41.34)%
Portfolio turnover rate <sup>(5)</sup>	1.25%	5.62%	24.00%
Average debt outstanding	\$ 1,945.0	\$ 2,209.5	\$ 2,091.6
Average debt per share <sup>(2)</sup>	\$ 10.88	\$ 13.68	\$ 12.09

- (1) The results for the three months ended March 31, 2009, are not necessarily indicative of the operating results to be expected for the full year.
- (2) Based on diluted weighted average number of common shares outstanding for the period.
- (3) Net realized gains (losses) and net change in unrealized appreciation or depreciation can fluctuate significantly from period to period. As a result, quarterly comparisons may not be meaningful.
- (4) Total return assumes the reinvestment of all dividends paid for the periods presented.
- (5) The ratios for the three months ended March 31, 2009 and 2008, do not represent annualized results.
- (6) Includes 0.19% for the effect of the impairment of long-lived asset during the three months ended March 31, 2009.



**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**

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

**Note 13. Litigation**

On June 23, 2004, the Company was notified by the SEC that the SEC was conducting an informal investigation of the Company. The investigation related to the valuation of securities in the Company's private finance portfolio and other matters. On June 20, 2007, the Company announced that it entered into a settlement with the SEC that resolved the SEC's informal investigation. As part of the settlement and without admitting or denying the SEC's allegations, the Company agreed to the entry of an administrative order. In the order the SEC alleged that, between June 30, 2001, and March 31, 2003, the Company did not maintain books, records and accounts which, in reasonable detail, supported or accurately and fairly reflected valuations of certain securities in the Company's private finance portfolio and, as a result, did not meet certain recordkeeping and internal controls provisions of the federal securities laws. In the administrative order, the SEC ordered the Company to continue to maintain certain of its current valuation-related controls. Specifically, for a period of two years, the Company has undertaken to: (1) continue to employ a Chief Valuation Officer, or a similarly structured officer-level employee, to oversee its quarterly valuation processes; and (2) continue to employ third-party valuation consultants to assist in its quarterly valuation processes.

On December 22, 2004, the Company received letters from the U.S. Attorney for the District of Columbia requesting the preservation and production of information regarding the Company and Business Loan Express, LLC (currently known as Ciena Capital LLC) in connection with a criminal investigation relating to matters similar to those investigated by and settled with the SEC as discussed above. The Company produced materials in response to the requests from the U.S. Attorney's office and certain current and former employees were interviewed by the U.S. Attorney's Office. The Company has voluntarily cooperated with the investigation.

In late December 2006, the Company received a subpoena from the U.S. Attorney for the District of Columbia requesting, among other things, the production of records regarding the use of private investigators by the Company or its agents. The Board established a committee, which was advised by its own counsel, to review this matter. In the course of gathering documents responsive to the subpoena, the Company became aware that an agent of the Company obtained what were represented to be telephone records of David Einhorn and which purport to be records of calls from Greenlight Capital during a period of time in 2005. Also, while the Company was gathering documents responsive to the subpoena, allegations were made that the Company's management had authorized the acquisition of these records and that management was subsequently advised that these records had been obtained. The Company's management has stated that these allegations are not true. The Company has cooperated fully with the inquiry by the U.S. Attorney's Office.

On February 26, 2007, Dana Ross filed a class action complaint in the U.S. District Court for the District of Columbia in which she alleges that Allied Capital Corporation and certain members of management violated Sections 10(b) and 20(a) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder. Thereafter, the court appointed new lead counsel and approved new lead plaintiffs. On July 30, 2007, plaintiffs served an amended complaint. Plaintiffs claim that, between November 7, 2005, and January 22, 2007, Allied Capital either failed to disclose or misrepresented information about its portfolio company, Business Loan Express, LLC. Plaintiffs seek unspecified compensatory and other damages, as well as other relief. The Company believes the lawsuit is without merit, and intends to defend the lawsuit vigorously. On September 13, 2007, the Company filed a motion to dismiss the lawsuit. The motion is pending.

**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**

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

**Note 13. Litigation, continued**

On October 6, 2008, Rena Nadoff filed a shareholder derivative action in the Superior Court of the District of Columbia, captioned Rena Nadoff v. Walton, et al., 2008 CA 007108, seeking unspecified compensatory and other damages, as well as equitable relief on behalf of Allied Capital Corporation. Ms. Nadoff's suit is substantially similar to a derivative action she filed in February 2007, which the Court dismissed in July 2007. On November 26, 2008, the Company filed a motion to dismiss the second Nadoff lawsuit. On February 3, 2009, the Court denied the motion to dismiss but ordered Ms. Nadoff to file an amended complaint that clearly identifies and sets forth the breaches of fiduciary duty, if any, that are alleged to have occurred after the filing (or dismissal) of the first Nadoff derivative lawsuit. Ms. Nadoff filed an amended complaint alleging breaches of fiduciary duty by the Board of Directors. The Company filed a motion to dismiss the amended complaint. In response, Ms. Nadoff requested that she be allowed to voluntarily dismiss the amended complaint without prejudice. The court denied her request and the motion to dismiss is pending.

In addition, the Company is party to certain lawsuits in the normal course of business. Furthermore, third parties may try to seek to impose liability on the Company in connection with the activities of its portfolio companies. For a discussion of civil investigations being conducted regarding the lending practice of Ciena Capital LLC, a portfolio company of the Company, see Note 3, Portfolio Ciena Capital LLC.

While the outcome of any of the open legal proceedings described above cannot at this time be predicted with certainty, the Company does not expect these matters will materially affect its financial condition or results of operations.

**Note 14. Subsequent Events**

Subsequent to March 31, 2009, the Company sold portfolio investments and received \$78.4 million of cash proceeds, as compared to their aggregate carrying value of \$83.1 million at March 31, 2009. The assets were sold primarily in transactions the Company does not consider orderly in accordance with FSP 157-4. The Company will record any realized gains or losses on these sales during the three months ending June 30, 2009.

Subsequent to March 31, 2009, the Company purchased publicly issued notes in the market with a total par value of \$56.8 million, which consisted of \$34.6 million of its 6.625% Notes due 2011 and \$22.2 million of its 6.000% Notes due 2012, for a total cost of \$17.7 million, resulting in a gain of \$39.1 million which will be reflected in the Company's results of operations for the three months ending June 30, 2009.

**Report of Independent Registered Public Accounting Firm**

**The Board of Directors and Shareholders**

**Allied Capital Corporation:**

We have reviewed the accompanying consolidated balance sheet of Allied Capital Corporation and subsidiaries (the Company), including the consolidated statement of investments, as of March 31, 2009, the related consolidated statements of operations, changes in net assets and cash flows and the financial highlights (included in Note 12) for the three-month periods ended March 31, 2009 and 2008. These consolidated financial statements and financial highlights are the responsibility of the Company's management.

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

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

We have previously audited, in accordance with standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheet of Allied Capital Corporation and subsidiaries, including the consolidated statement of investments, as of December 31, 2008, and the related consolidated statements of operations, changes in net assets and cash flows (not presented herein), and the financial highlights, for the year then ended; and in our report dated March 2, 2009, we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying condensed consolidated balance sheet including the consolidated statement of investments as of December 31, 2008, is fairly stated, in all material respects, in relation to the consolidated balance sheet from which it has been derived.

Note 1 of the Company's audited financial statements as of December 31, 2008, and for the year then ended, discloses that the Company was in default on provisions of certain credit agreements at December 31, 2008. Our auditors' report on those financial statements dated March 2, 2009, includes an explanatory paragraph referring to the matters in Note 1 of those financial statements, and indicating that these matters raised substantial doubt about the Company's ability to continue as a going concern. As indicated in Note 1 of the Company's unaudited interim financial statements as of March 31, 2009, and for the three-months then ended, the Company was still in default on provisions of certain credit agreements as of March 31, 2009. The accompanying interim financial information does not include any adjustments that might result from the outcome of this uncertainty.

Washington, D.C.  
May 11, 2009

## ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

## SCHEDULE OF INVESTMENTS IN AND ADVANCES TO AFFILIATES

PRIVATE FINANCE Portfolio Company  (in thousands)	Investment <sup>(1)</sup>	Amount of Interest or Dividends Credited to		December 31, 2008	Gross	Gross	March 31, 2009
		Income <sup>(6)</sup>	Other <sup>(2)</sup>	Value	Additions <sup>(3)</sup>	Reductions <sup>(4)</sup>	Value
<b>Companies More Than 25% Owned</b>							
AGILE Fund I, LLC (Private Equity Fund)	Equity Interests			\$ 497	\$	\$ (81)	\$ 416
AllBridge Financial, LLC (Asset Management)	Equity Interests			10,960	1,673	(1,562)	11,071
Allied Capital Senior Debt Fund, L.P. (Private Debt Fund)	Equity Interests			31,800	1,077		32,877
Avborne, Inc. (Business Services)	Preferred Stock Common Stock			942		(4)	938
Avborne Heavy Maintenance, Inc. (Business Services)	Common Stock				660		660
Aviation Properties Corporation (Business Services)	Common Stock						
Border Foods, Inc. (Consumer Products)	Senior Loan Preferred Stock Common Stock	\$ 1,315		33,027 11,851	1,102	(229) (2,636)	33,900 9,215
Calder Capital Partners, LLC (Asset Management)	Senior Loan <sup>(5)</sup> Equity Interests			953		(72)	881
Callidus Capital Corporation	Subordinated Debt	720		16,068	135		16,203

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(Asset Management)	Common Stock		34,377		(6,672)	27,705
Ciena Capital LLC (Financial Services)	Senior Loan <sup>(5)</sup>		104,883		(40,795)	64,088
	Class B Equity Interests					
	Class C Equity Interests			3,300	(3,300)	
CitiPostal Inc. (Business Services)	Senior Loan	8	681	1		682
	Unitranche Debt	1,567	51,548	144		51,692
	Subordinated Debt	379	9,114	377		9,491
	Common Stock		8,616		(8,616)	
Coverall North America, Inc. (Business Services)	Unitranche Debt	969	31,948	8		31,956
	Subordinated Debt	210	5,549	1		5,550
	Common Stock		17,968	1,043		19,011
CR Holding, Inc. (Consumer Products)	Subordinated Debt <sup>(5)</sup>		17,360		(7,368)	9,992
	Common Stock					
Crescent Equity Corp. (Business Services)	Senior Loan	11	433			433
	Subordinated Debt	58	1,135		(1,135)	
	Subordinated Debt <sup>(5)</sup>		17,479		(11,266)	6,213
	Common Stock		4,580	1,341	(5,882)	39
Direct Capital Corporation (Financial Services)	Senior Loan <sup>(5)</sup>			8,240		8,240
	Subordinated Debt <sup>(5)</sup>		13,530		(1,140)	12,390
	Common Stock					
Financial Pacific Company (Financial Services)	Subordinated Debt	2,683	62,189	10	(4,637)	57,562
	Preferred Stock					
	Common Stock					
ForeSite Towers, LLC (Tower Leasing)	Equity Interest		889	6		895
Global Communications, LLC (Business Services)	Senior Loan <sup>(5)</sup>		1,335			1,335
Hot Light Brands, Inc. (Retail)	Senior Loan <sup>(5)</sup>		13,678	50	(285)	13,443
	Common Stock					
Hot Stuff Foods, LLC (Consumer Products)	Senior Loan	539	42,378	8,944	(1,210)	50,112
	Subordinated Debt <sup>(5)</sup>					
	Common Stock					

See related footnotes at the end of this schedule.

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<b>PRIVATE FINANCE Portfolio Company</b>		Amount of Interest or Dividends Credited to	December 31, 2008	Gross	Gross	March 31, 2009
<b>(in thousands)</b>	<b>Investment<sup>(1)</sup></b>	Income <sup>(6)</sup> Other <sup>(2)</sup>	Value	Additions <sup>(3)</sup>	Reductions <sup>(4)</sup>	Value
Huddle House, Inc. (Retail)	Subordinated Debt Common Stock	\$ 2,168	\$ 57,067 20,922	\$ 450	\$ (3,467)	\$ 57,517 17,455
IAT Equity, LLC and Affiliates d/b/a Industrial Air Tool (Industrial Products)	Subordinated Debt Equity Interests	135	6,000 8,860	218		6,000 9,078
Impact Innovations Group, LLC (Business Services)	Equity Interests in Affiliate		321	1		322
Insight Pharmaceuticals Corporation (Consumer Products)	Subordinated Debt Subordinated Debt <sup>(5)</sup> Preferred Stock Common Stock	1,731	45,827 17,532 4,068	244 598 1,390	(7) (598)	46,064 17,532 5,458
Jakel, Inc. (Industrial Products)	Subordinated Debt <sup>(5)</sup>		374			374
Knightsbridge CLO 2007-1 Ltd. (CLO)	Class E Notes Income Notes	503 1,530	14,866 35,214	118 1,529	(16,312)	14,984 20,431
Knightsbridge CLO 2008-1 Ltd. (CLO)	Class C Notes Class D Notes Class E Notes Income Notes	296 205 286 898	12,800 8,000 10,573 21,315	63 898	(619) (954) (1,441) (2,745)	12,181 7,046 9,195 19,468
MHF Logistical Solutions, Inc. (Business Services)	Subordinated Debt <sup>(5)</sup> Preferred Stock Common Stock					
MVL Group, Inc. (Business Services)	Senior Loan Subordinated Debt Subordinated Debt <sup>(5)</sup> Common Stock	901 1,282	30,663 40,994 86	6 302	(505) (9,340) (86)	30,164 31,956
Old Orchard Brands, LLC	Subordinated Debt	917	18,882	262	(19,144)	

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(Consumer Products)	Equity Interests		27,763		(27,763)	
Penn Detroit Diesel Allison, LLC (Business Services)	Subordinated Debt	1,489	37,869	291		38,160
	Equity Interests		21,100		(909)	20,191
Service Champ, Inc. (Business Services)	Subordinated Debt	1,060	26,984	178		27,162
	Common Stock		21,156	1,673		22,829
Stag-Parkway, Inc. (Business Services)	Unitranche Debt	169	17,962	418	(18,380)	
	Subordinated Debt	395		18,524		18,524
	Common Stock		6,968		(1,387)	5,581
Startec Equity, LLC (Telecommunications)	Equity Interests		332		(325)	7
Unitranche Fund LLC (Private Debt Fund)	Subordinated Certificates	2,929	125,423		(902)	124,521
	Equity Interests		1			1
Worldwide Express Operations, LLC (Business Services)	Subordinated Debt <sup>(5)</sup>	\$ 41	2,032		(2,032)	
	Equity Interests			300	(300)	
	Warrants					
<b>Total companies more than 25% owned</b>		<b>\$ 25,353</b>	<b>\$ 1,187,722</b>			<b>\$ 1,039,191</b>
<b>Companies 5% to 25% Owned</b>						
10th Street, LLC (Business Services)	Subordinated Debt	\$ 708	\$ 21,439	\$ 223	\$ (5)	\$ 21,657
	Equity Interests		975		(464)	511
	Option		25			25
Advantage Sales & Marketing, Inc. (Business Services)	Subordinated Debt	2,286	135,000		(135,000)	
	Equity Interests		5,000		5,000	
Air Medical Group Holdings LLC (Healthcare Services)	Senior Loan	33	3,139	5,344	(6,405)	2,078
	Equity Interests		10,800	1,300		12,100
Alpine ESP Holdings, Inc. (Business Services)	Preferred Stock					
	Common Stock					
Amerex Group, LLC (Consumer Products)	Subordinated Debt	1,772	8,784	1		8,785
	Equity Interests	1,800	9,932	573		10,505
BB&T Capital Partners/Windsor Mezzanine Fund, LLC	Equity Interests		11,063		(231)	10,832



(Private Equity Fund)

Becker Underwood, Inc. (Industrial Products)	Subordinated Debt	425	25,502	216	(25,718)	
	Common Stock		2,267	2,748	(5,015)	
Drew Foam Companies, Inc. (Business Services)	Preferred Stock		512		(78)	434
	Common Stock					

See related footnotes at the end of this schedule.

<b>PRIVATE FINANCE Portfolio Company</b>		Amount of Interest or Dividends Credited to	December 31, 2008	Gross	Gross	March 31, 2009	
<b>(in thousands)</b>	<b>Investment<sup>(1)</sup></b>	<b>Income<sup>(6)</sup></b>	<b>Other<sup>(2)</sup></b>	<b>Value</b>	<b>Additions<sup>(3)</sup></b>	<b>Reductions<sup>(4)</sup></b>	<b>Value</b>
Driven Brands, Inc. (Consumer Services)	Subordinated Debt Common Stock	\$ 3,545		\$ 83,698 4,855	\$ 1,783	\$ (1,913) (2,355)	\$ 83,568 2,500
Hilden America, Inc. (Consumer Products)	Common Stock			76		76	
Lydall Transport, Ltd. (Business Services)	Equity Interests			345	19		364
Multi-Ad Services, Inc. (Business Services)	Unitranche Debt Equity Interests	86		2,941 1,782	23 403	(493)	2,471 2,185
Pendum Acquisition, Inc. (Business Services)							
Postle Aluminum Company, LLC (Industrial Products)	Senior Loan Subordinated Debt <sup>(5)</sup> Equity Interest				34,876 23,868	(21,242) (23,868)	13,634
Progressive International Corporation (Consumer Products)	Preferred Stock Common Stock  Warrants			1,125 4,600	22	(900)	1,147 3,700
Regency Healthcare Group, LLC (Healthcare Services)	Senior Loan Unitranche Debt Equity Interests	44 305		10,825 2,050	4,001 2	(2,095) (305) (95)	1,906 10,522 1,955
SGT India Private Limited (Business Services)	Common Stock				3	(3)	
Soteria Imaging Services, LLC (Healthcare Services)	Subordinated Debt Equity Interests			4,054 1,971	17	(461)	4,071 1,510
Triax Holdings, LLC (Consumer Products)	Subordinated Debt <sup>(5)</sup> Equity Interests	132					

Universal Environmental Equity Interests  
 Services, LLC  
 (Business Services)

<b>Total companies 5% to 25% owned</b>	<b>\$ 11,136</b>	<b>\$ 352,760</b>	<b>\$ 196,460</b>
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This schedule should be read in conjunction with the Company's consolidated financial statements, including the consolidated statement of investments and Note 3 to the consolidated financial statements. Note 3 includes additional information regarding activities in the private finance portfolio.

- (1) Common stock, preferred stock, warrants, options, and equity interests are generally non-income producing and restricted. The principal amount for loans and debt securities and the number of shares of common stock and preferred stock is shown in the consolidated statement of investments as of March 31, 2009.
- (2) Other includes interest, dividend, or other income which was applied to the principal of the investment and therefore reduced the total investment. These reductions are also included in the Gross Reductions for the investment, as applicable.
- (3) Gross additions include increases in the cost basis of investments resulting from new portfolio investments, paid-in-kind interest or dividends, the amortization of discounts and closing fees, the exchange of one or more existing securities for one or more new securities and the movement of an existing portfolio company into this category from a different category. Gross additions also include net increases in unrealized appreciation or net decreases in unrealized depreciation.
- (4) Gross reductions include decreases in the cost basis of investments resulting from principal collections related to investment repayments or sales, the exchange of one or more existing securities for one or more new securities and the movement of an existing portfolio company out of this category into a different category. Gross reductions also include net increases in unrealized depreciation or net decreases in unrealized appreciation.
- (5) Loan or debt security is on non-accrual status at March 31, 2009, and is therefore considered non-income producing. Loans or debt securities on non-accrual status at the end of the period may or may not have been on non-accrual status for the full period.
- (6) Represents the total amount of interest or dividends credited to income for the portion of the year an investment was included in the companies more than 25% owned or companies 5% to 25% owned categories, respectively.

## **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, 2008. In addition, this quarterly report on Form 10-Q contains certain forward-looking statements. These statements include the plans and objectives of management for future operations and financial objectives and can be identified by the use of forward-looking terminology such as may, will, expect, intend, anticipate, estimate, or continue or the negative thereof or variations thereon or comparable terminology. These forward-looking statements are subject to the inherent uncertainties in predicting future results and conditions. Certain factors that could cause actual results and conditions to differ materially from those projected in these forward-looking statements are set forth below in the Risk Factors section. Other factors that could cause actual results to differ materially include:*

*changes in the economy, including economic downturns or recessions;*

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

*future changes in laws or regulations or changes in accounting principles; and*

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

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

### **OVERVIEW**

We are a business development company, or BDC, in the private equity business and we are internally managed. Specifically, we primarily invest in private middle market companies in a variety of industries through long-term debt and equity capital instruments. Our financing generally is used to fund buyouts, acquisitions, growth, recapitalizations, note purchases, and other types of financings. Our investment objective is to achieve current income and capital gains.

The United States and the global economies continue to operate in an unprecedented economic recession and the U.S. capital markets continue to experience volatility and a severe lack of liquidity. In addition, events of default have occurred and are continuing under our revolving line of credit and private notes related to certain financial and other covenants. See Financial Condition, Liquidity and Capital Resources. Our strategy in these difficult economic times has been focused on reducing costs and streamlining our organization; building liquidity through selected asset sales; retaining capital by limiting new investment activity and suspending dividend payments; and working with portfolio companies to help them position for growth when the economy recovers.

Our portfolio composition at March 31, 2009 and 2008, and December 31, 2008, was as follows:

	<b>March 31,</b>		<b>December</b>
	<b>2009</b>	<b>2008</b>	<b>31,</b>
			<b>2008</b>
Private finance	97 %	98%	97%
Commercial real estate finance	3 %	2%	3%

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

In addition to managing our own assets, we manage certain funds that also invest in the debt and equity securities of primarily private middle market companies in a variety of industries. At March 31, 2009, we had eight separate funds under our management (together, the Managed Funds) for which we may earn management or other fees for our services. We may invest in the equity of these funds, along with other third parties, from which we may earn a current return and/or a future incentive allocation. At March 31, 2009, the Managed Funds had total assets of approximately \$3.2 billion. See **Managed Funds** below for further discussion.

In aggregate, including the total assets on our balance sheet and assets under management in our Managed Funds, we had \$6.6 billion in managed assets at March 31, 2009.

In addition to the funds we already manage or co-manage, we may pursue additional managed fund opportunities including the potential acquisition of asset managers. These potential funds are focused on all levels of a middle market company's capital structure, from senior debt through equity capital. By growing our privately managed capital base, we seek to diversify our sources of capital, leverage our core investment expertise and increase fees and other income from asset management activities. There can be no assurance that these new fund raising initiatives will result in additional funds under management.

### PORTFOLIO AND INVESTMENT ACTIVITY

The total portfolio at value, investment activity, and the yield on interest-bearing investments at and for the three months ended March 31, 2009 and 2008, and at and for the year ended December 31, 2008, were as follows:

(\$ in millions)	At and for the Three Months Ended March 31,		At and for the Year Ended December 31,
	2009	2008	2008
Portfolio at value	\$ 2,909.1	\$ 4,635.6	\$ 3,493.0
Investments funded	\$ 39.9	\$ 275.1	\$ 1,078.2
Payment-in-kind interest and dividends, net of cash collections	\$ 7.7	\$ 13.4	\$ 53.4
Principal collections related to investment repayments or sales <sup>(1)</sup>	\$ 241.8	\$ 264.8	\$ 1,037.3
Yield on interest-bearing portfolio investments <sup>(2)</sup>	11.8%	12.3%	12.1%

(1)

Principal collections related to investment repayments or sales for the three months ended March 31, 2009, included \$132.2 million of cash collections related to notes and other receivables received from the sale of investments in one portfolio company in prior periods. Principal collections related to investment repayments or sales for the three months ended March 31, 2008, and year ended December 31, 2008, included collections of \$30.0 million and \$216.3 million, respectively, related to the sale of loans to certain of our Managed Funds.

- (2) The weighted average yield on interest-bearing investments is computed as the (a) annual stated interest on accruing loans and debt securities plus the annual amortization of loan origination fees, original issue discount, and market discount on accruing loans and debt securities less the annual amortization of loan origination costs, plus the effective interest yield on the preferred shares/income notes of CLOs, plus the annual stated interest on the subordinated certificates in the Unitranche Fund LLC divided by (b) total interest-bearing investments at value. The weighted average yield is computed as of the balance sheet date.

**Private Finance**

The private finance portfolio at value, investment activity, and the yield on interest bearing investments at and for the three months ended March 31, 2009 and 2008, and at and for the year ended December 31, 2008, were as follows:

(\$ in millions)	At and for				At and for the	
	Three Months Ended March 31, 2009		2008		Year Ended December 31, 2008	
	Value	Yield <sup>(1)</sup>	Value	Yield <sup>(1)</sup>	Value	Yield <sup>(1)</sup>
Portfolio at value:						
Loans and debt securities:						
Senior loans	\$ 289.1	5.9%	\$ 325.7	7.0%	\$ 306.3	5.6%
Unitranche debt	403.8	12.1%	655.7	11.8%	456.4	12.0%
Subordinated debt	1,492.7	13.5%	2,430.4	13.0%	1,829.1	12.9%
Total loans and debt securities	2,185.6	12.3%	3,411.8	12.2%	2,591.8	11.9%
Equity securities:						
Preferred shares/income notes of CLOs <sup>(2)</sup>	104.4	8.0%	197.4	15.8%	179.2	16.4%
Subordinated certificates in Unitranche Fund LLC <sup>(2)</sup>	124.5	9.2%	31.5	12.4%	125.4	12.0%
Other equity securities	415.5		879.1		502.7	
Total equity securities	644.4		1,108.0		807.3	
Total portfolio	\$ 2,830.0		\$ 4,519.8		\$ 3,399.1	
Investments funded	\$ 38.9 <sup>(4)</sup>		\$ 274.6		\$ 1,068.1	
Payment-in-kind interest and dividends, net of cash collections	\$ 7.7		\$ 13.2		\$ 53.2	
Principal collections related to investment repayments or sales <sup>(3)</sup>	\$ 240.7		\$ 256.4		\$ 1,020.5	

<sup>(1)</sup> The weighted average yield on loans and debt securities is computed as the (a) annual stated interest on accruing loans and debt securities plus the annual amortization of loan origination fees, original issue discount, and market discount on accruing loans and debt securities less the annual amortization of loan origination costs, divided by (b) total loans and debt securities at value. The weighted average yield on the preferred shares/income notes of CLOs is calculated as the (a) effective interest yield on the preferred shares/income notes of CLOs, divided by (b) preferred shares/income notes of CLOs at value. The weighted average yield on the subordinated certificates in the Unitranche Fund LLC is computed as the (a) annual stated interest divided by (b) total investment at value. The weighted average yields are computed as of the balance sheet date.

<sup>(2)</sup> Investments in the preferred shares/income notes of CLOs and the subordinated certificates in the Unitranche Fund LLC earn a current return that is included in interest income in the consolidated statement of operations.

<sup>(3)</sup> Includes \$132.2 million of cash collections during the three months ended March 31, 2009, related to notes and other receivables received from the sale of investments in prior periods. Also includes collections from the sale or repayment of senior loans totaling \$25.2 million, \$48.6 million, and \$285.3 million for the three months ended March 31, 2009 and 2008, and for the year ended December 31, 2008, respectively.



- (4) Includes \$20.5 million funded under pre-existing commitments under revolving lines of credit. During the three months ended March 31, 2009, a total of \$15.8 million was repaid under these arrangements, which is included in principal collections related to investment repayments or sales.

Our private finance portfolio primarily is composed of debt and equity investments. Debt investments include senior loans, unitranche debt (an instrument that combines both senior and subordinated financing, generally in a first lien position), or subordinated debt (with or without equity features). The junior debt that we have in the portfolio is lower in repayment priority than senior debt and is also known as mezzanine debt. Our portfolio contains equity investments for a minority equity stake in portfolio companies and includes equity features such as nominal cost warrants received in conjunction with our debt investments. In a buyout transaction, we generally invest in senior and/or subordinated debt and equity (preferred and/or voting or non-voting common) where our equity ownership represents a significant portion of the equity, but may or may not represent a controlling interest.

**Investment Activity.** Investments funded and the weighted average yield on interest-bearing investments funded for the three months ended March 31, 2009 and 2008, and for the year ended December 31, 2008, consisted of the following:

(\$ in millions)	For the Three Months Ended March 31, 2009					
	Debt Investments		Buyout Investments		Total	
	Amount	Weighted Average Yield <sup>(1)</sup>	Amount	Weighted Average Yield <sup>(1)</sup>	Amount	Weighted Average Yield <sup>(1)</sup>
Loans and debt securities:						
Senior loans	\$ 20.4	7.0%	\$ 8.3	8.0%	\$ 28.7	7.3%
Total loans and debt securities	20.4	7.0%	8.3	8.0%	28.7	7.3%
Equity	3.9		6.3		10.2	
Total	\$ 24.3		\$ 14.6		\$ 38.9	

(\$ in millions)	For the Three Months Ended March 31, 2008					
	Debt Investments		Buyout Investments		Total	
	Amount	Weighted Average Yield <sup>(1)</sup>	Amount	Weighted Average Yield <sup>(1)</sup>	Amount	Weighted Average Yield <sup>(1)</sup>
Loans and debt securities:						
Senior loans	\$ 26.8	7.4%	\$ 10.4	6.7%	\$ 37.2	7.2%
Unitranche debt <sup>(2)</sup>	4.5	10.3%	0.5	6.6%	5.0	9.9%
Subordinated debt	129.9 <sup>(3)</sup>	12.0%	31.3	14.2%	161.2	12.4%
Total loans and debt securities	161.2	11.2%	42.2	12.3%	203.4	11.4%
Preferred shares/income notes of CLOs <sup>(4)</sup>	3.0	27.6%			3.0	27.6%
Subordinated certificates in Unitranche Fund LLC	30.7	12.4%			30.7	12.4%
Equity	13.6		23.9		37.5	
Total	\$ 208.5		\$ 66.1		\$ 274.6	

	For the Year Ended December 31, 2008		
	Debt Investments	Buyout Investments	Total
	Weighted Average	Weighted Average	Weighted Average

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(\$ in millions)	Amount	Yield <sup>(1)</sup>	Amount	Yield <sup>(1)</sup>	Amount	Yield <sup>(1)</sup>
Loans and debt securities:						
Senior loans	\$ 175.9	7.4%	\$ 13.9	5.4%	\$ 189.8	7.2%
Senior secured loan to Ciena Capital LLC			319.0	0.0% <sup>(5)</sup>	319.0	0.0% <sup>(5)</sup>
Unitranche debt <sup>(2)</sup>	15.3	10.5%	0.5	6.6%	15.8	10.4%
Subordinated debt	246.4 <sup>(3)</sup>	12.6%	54.8	15.4%	301.2	13.1%
Total loans and debt securities	437.6	10.4%	388.2	2.4%	825.8	6.6% <sup>(6)</sup>
Preferred shares/income notes of CLOs <sup>(4)</sup>	35.6	18.6%			35.6	18.6%
Subordinated certificates in Unitranche Fund LLC	124.7	10.9%			124.7	10.9%
Equity	40.5		41.5		82.0	
Total	\$ 638.4		\$ 429.7		\$ 1,068.1	

- (1) The weighted average yield on interest-bearing investments is computed as the (a) annual stated interest on accruing interest-bearing investments, divided by (b) total interest-bearing investments funded. The weighted average yield on the preferred shares/income notes of CLOs is calculated as the (a) effective interest yield on the preferred shares/income notes of CLOs, divided by (b) preferred shares/income notes of CLOs funded. The weighted average yield on the subordinated certificates in the Unitranche Fund LLC is computed as the (a) annual stated interest divided by (b) total investment at value. The weighted average yield is calculated using yields as of the date an investment is funded.
- (2) Unitranche debt is an investment that combines both senior and subordinated financing, generally in a first lien position. The yield on a unitranche investment reflects the blended yield of senior and subordinated debt.
- (3) Subordinated debt investments for the three months ended March 31, 2008, and year ended December 31, 2008, included \$2.0 million and \$43.8 million, respectively, in investments in the bonds of collateralized loan obligations (CLOs). Certain of these CLOs are managed by Callidus Capital Corporation (Callidus), a portfolio company controlled by us. These CLOs primarily invest in senior corporate loans.
- (4) CLO equity investments included preferred shares/income notes of CLOs that primarily invest in senior corporate loans. Certain of these CLOs are managed by us or by Callidus.
- (5) The senior secured loan to Ciena Capital LLC was acquired on September 30, 2008, and was placed on non-accrual status on the purchase date.
- (6) Excluding the senior secured loan to Ciena, the weighted average yield on new investments for the year ended December 31, 2008 was 10.8%.

For the three months ended March 31, 2009, we made private finance investments totaling \$38.9 million. Investments in the first quarter arose primarily from fundings under pre-existing investment commitments, including fundings under revolving line of credit instruments.

Historically, our focus for investments generally has been on higher return junior debt capital investments. Senior loans funded by us generally were funded with the intent to sell the loan or for the portfolio company to refinance the loan at some point in the future as discussed below. We have made fewer direct unitranche debt investments since the establishment of the Unitranche Fund LLC (Unitranche Fund) in the fourth quarter of 2007. Unitranche loans sourced by us generally are referred to the Unitranche Fund. Since its inception, we have invested \$125.4 million in the Unitranche Fund, which supported its closing of investments totaling \$789.3 million. The 9.2% yield on the subordinated certificates in the Unitranche Fund at March 31, 2009, represents the contractual coupon on the subordinated certificates and excludes any return from potential future excess cash flows from portfolio earnings available to the subordinated certificate holders and from related structuring fees and management and sourcing fees. See *Managed Funds* below.

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

We may underwrite or arrange senior loans related to our portfolio investments or for other companies that are not in our portfolio. When we underwrite or arrange senior loans, we may earn a fee for such activities. Senior loans underwritten or arranged by us may be funded by us at closing. When these senior loans are closed, we may fund all or a portion of the underwritten commitment pending sale of the loan to other investors, which may include loan sales to the Managed Funds or funds managed by Callidus Capital Corporation (Callidus), a portfolio company controlled by us. After completing loan sales, we may retain a position in these senior loans. We generally earn a fee on the senior loans we underwrite or arrange whether or not we fund the underwritten commitment. In addition, we may fund most or all of the debt and equity capital upon the closing of certain buyout transactions, which may include investments in lower-yielding senior debt. Subsequent to the closing, the portfolio company may refinance all or a portion of the lower-yielding senior debt, which would reduce our investment.

We have focused our efforts on selling assets in our portfolio to generate capital. Principal collections related to private finance investment repayments or sales were \$240.7 million for the three months ended March 31, 2009, including \$132.2 million of cash collections related to notes and other receivables received from the sale of investments in one portfolio company in prior periods. Principal collections include repayments of senior debt funded by us that was subsequently sold by us or refinanced or repaid by the portfolio companies.

**Outstanding Investment Commitments.** At March 31, 2009, we had outstanding private finance investment commitments as follows:

(\$ in millions)	Companies		Companies		Total
	More Than 25% Owned <sup>(1)</sup>	Companies 5% to 25% Owned	Less Than 5% Owned		
Senior loans	\$ 11.2	\$ 11.8	\$ 84.8	\$ 107.8 <sup>(2)</sup>	
Unitranche debt	3.0		15.6	18.6	
Subordinated debt	19.5	4.3	3.0	26.8	
Total loans and debt securities	33.7	16.1	103.4	153.2	
Unitranche Fund	399.6			399.6	
Equity securities	20.2	10.3	36.0	66.5 <sup>(3)</sup>	
Total	\$ 453.5	\$ 26.4	\$ 139.4	\$ 619.3	

- (1) Includes a \$4.0 million revolving line of credit commitment for working capital to Callidus Capital Corporation (Callidus), a portfolio company controlled by us, which owns 100% of Callidus Capital Management, LLC, an asset management company that structures and manages collateralized loan obligations (CLOs), collateralized debt obligations (CDOs), and other related investments.
- (2) Includes \$105.1 million in the form of revolving senior debt facilities to 27 companies.
- (3) Includes \$45.2 million to 11 private equity and venture capital funds, including \$3.3 million in co-investment commitments to one private equity fund. These fund commitments are generally drawn over a multi-year period of time as the funds make investments.

Total commitments were \$619.3 million at March 31, 2009, which included \$399.6 million in commitments to the Unitranche Fund (see *Managed Funds* ). Investments made by the Unitranche Fund must be approved by the investment committee of the Unitranche Fund, which includes a representative from us and GE. Therefore, our commitment to the Unitranche Fund cannot be drawn without our approval.

In addition to these outstanding investment commitments at March 31, 2009, we also had commitments to private finance portfolio companies in the form of standby letters of credit and guarantees. See *Financial Condition, Liquidity and Capital Resources* below. We intend to fund these commitments with existing cash and through cash flows from operations before new investments, although there can be no assurance that we will generate sufficient cash flows to satisfy these commitments.

**Investments in Collateralized Loan Obligations and Collateralized Debt Obligations (CLO/CDO Assets).** At both March 31, 2009, and December 31, 2008, we had investments in CLO issuances and a CDO bond, which totaled as follows:

(\$ in millions)	2009			2008		
	Cost	Value	Yield <sup>(1)</sup>	Cost	Value	Yield <sup>(1)</sup>

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CLO/CDO bonds <sup>(2)</sup>	\$ 128.0	\$ 81.9	12.9%	\$ 127.7	\$ 86.1	18.5%
Preferred shares/income notes of CLOs	250.4	104.4	7.9%	248.2	179.2	16.4%
Total	\$ 378.4	\$ 186.3		\$ 375.9	\$ 265.3	

Percentage of total assets 5.5% 7.1%

(1) The weighted average yield is calculated as the (a) annual stated interest or the effective interest yield on the accruing bonds or the effective interest yield on the preferred shares/income notes, divided by (b) CLO and CDO assets at value. The market yield used in the valuation of the CLO and CDO assets may be different than the interest yields shown above. See discussion below.

(2) Included in private finance subordinated debt.

The CLO and CDO issuances in which we have invested are primarily invested in senior corporate loans. Certain of these funds are managed by Callidus, and certain of these funds are managed by us. See also Note 3, Portfolio from our Notes to the Consolidated Financial Statements included in Item 1.

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

The CLO/CDO Assets in which we have invested are junior in priority for payment of interest and principal to the more senior notes issued by the CLOs and CDO. Cash flow from the underlying collateral assets in the CLOs and CDO generally is allocated first to the senior bonds in order of priority, then any remaining cash flow is generally distributed to the preferred shareholders and income note holders. To the extent there are defaults and unrecoverable losses on the underlying collateral assets that result in reduced cash flows, the preferred shares/income notes will bear this loss first and then the subordinated bonds would bear any loss after the preferred shares/income notes. At both March 31, 2009, and December 31, 2008, the face value of the CLO/CDO Assets held by us was subordinate to as much as 94% of the face value of the securities outstanding in these CLOs and CDO.

At March 31, 2009, and December 31, 2008, the underlying collateral assets of these CLO and CDO issuances, consisting primarily of senior corporate loans, were issued by 646 issuers and 658 issuers, respectively, and had balances as follows:

(\$ in millions)	2009	2008
Bonds	\$ 240.7	\$ 268.3
Syndicated loans	4,428.8	4,477.3
Cash <sup>(1)</sup>	130.6	89.6
Total underlying collateral assets at cost <sup>(2)</sup>	\$ 4,800.1	\$ 4,835.2

(1) Includes undrawn liability amounts.

(2) At March 31, 2009, and December 31, 2008, the total cost basis of defaulted obligations was \$134.0 million and \$95.0 million, respectively, or approximately 2.8% and 2.0%, respectively, of the total underlying collateral assets.

Throughout 2008, market yields for CLO securities increased. As the market yields for our investments in CLO preferred shares/income notes increased throughout 2008, the fair value of certain of our investments in these assets decreased. At March 31, 2009, the market yield used to value our preferred shares/income notes was 27.5%. Ratings agencies have continued to downgrade the underlying collateral in these types of structures regardless of the payment status of the loan or debt security. In the current economic environment, we expect ratings downgrades, defaults and losses to continue to increase, and we have also considered this in our valuation analysis. Net change in unrealized appreciation or depreciation for the three months ended March 31, 2009, included a net decrease of \$82.5 million related to our investments in CLO/CDO Assets. We received third-party valuation assistance for our investments in the CLO/CDO Assets in each quarter of 2008 and in the first quarter of 2009. See Results of Operations Valuation Methodology Private Finance below for further discussion of the third-party valuation assistance we received.

As the debt capital markets show significant volatility, yield spreads may widen further. As a result, if the market yields for our investments in CLOs continue to increase, or should the performance of the underlying assets in the CLOs decrease or additional ratings downgrades occur, the fair value of our investments may decrease further.

**Ciena Capital LLC.** Ciena Capital LLC (Ciena) has provided loans to commercial real estate owners and operators. Ciena has been a participant in the SBA's 7(a) Guaranteed Loan Program, and its wholly-owned subsidiary is licensed by the SBA as a Small Business Lending Company (SBLC). Ciena remains subject to SBA rules and regulations. Ciena is headquartered in New York, NY.

On September 30, 2008, Ciena voluntarily filed for bankruptcy protection under Chapter 11 of Title 11 of the United States Code (the Bankruptcy Code) in the United States Bankruptcy Court for the Southern District of



New York (the Court). Ciena continues to operate its servicing business and manage its assets as a debtor-in-possession under the jurisdiction of the Court and in accordance with the applicable provisions of the Bankruptcy Code and the orders of the Court.

At March 31, 2009 and December 31, 2008, our investment in Ciena was as follows:

(\$ in millions)	March 31, 2009		December 31, 2008	
	Cost	Value	Cost	Value
Senior Loan	\$ 319.0	\$ 64.1	\$ 319.0	\$ 104.9
Class B Equity Interests <sup>(1)</sup>	119.5		119.5	
Class C Equity Interests <sup>(1)</sup>	112.6		109.3	
Total	\$ 551.1	\$ 64.1	\$ 547.8	\$ 104.9

<sup>(1)</sup> At March 31, 2009 and December 31, 2008, we held 100% of the Class B equity interests and 94.9% of the Class C equity interests.

At March 31, 2009 and December 31, 2008, other assets includes amounts receivable from or related to Ciena totaling \$15.5 million and \$15.4 million, respectively, at cost and \$2.1 million and \$2.1 million at value, respectively. Net change in unrealized appreciation or depreciation included a net decrease in our investment in Ciena of \$44.1 million and \$39.3 million for the three months ended March 31, 2009 and 2008, respectively.

In addition, at March 31, 2009, we had standby letters of credit issued under our line of credit of \$94.1 million in connection with term securitization transactions completed by Ciena. The term securitizations have experienced increasing defaults as a result of the economic environment, which may require us to fund a portion of the standby letters of credit in 2009. Our asset coverage ratio is currently less than 200% and we currently are in default under our revolving line of credit. In addition, the financial institution that has issued these letters of credit has experienced a ratings downgrade. As a result, we may need to use cash to provide credit enhancement to these term securitizations if these letters of credit cannot be maintained through our revolving credit facility or if the issuer of these letters of credit is further downgraded. During the three months ended March 31, 2009, we contributed \$3.3 million to Ciena in exchange for additional Class C equity interests, which was used to support Ciena's term securitizations in lieu of a draw under the letters of credit. This investment was required as a result of the downgrade of the issuer of the letters of credit. We have considered any funding under the letters of credit in the valuation of Ciena at March 31, 2009 and December 31, 2008.

As a result of Ciena's decision to file for bankruptcy protection, our unconditional guaranty of the obligations outstanding under Ciena's revolving credit facility became due. As of March 31, 2009, the senior secured loan to Ciena had a cost basis of \$319.0 million and a value of \$64.1 million. We continue to guarantee the remaining principal balance of \$5 million, plus related interest, fees and expenses payable to a third party bank. In connection with our continuing guaranty of the amounts held by this bank, we have agreed that the amounts owing to the bank under the Ciena revolving credit facility will be paid before any of the secured obligations of Ciena now owed to us.

Our investment in Ciena was on non-accrual status, therefore we did not earn any interest and related portfolio income from our investment in Ciena for the three months ended March 31, 2009 and 2008.

At March 31, 2009, Ciena had two non-recourse securitization warehouse facilities, both of which have matured. In order to pay down debt under the conventional loan warehouse facility, Ciena is in the process of selling loans on

behalf of the conventional loan warehouse facility providers. Ciena is also working with the providers of the SBA loan warehouse facility with regard to the repayment of that facility. We have issued performance guaranties whereby we agreed to indemnify the warehouse providers for any damages, losses, liabilities and related costs and expenses that they may incur as a result of Ciena's failure to perform any of its obligations as loan originator, loan seller or loan servicer under the warehouse securitizations.

The Office of the Inspector General of the SBA (OIG) and the United States Secret Service are conducting ongoing investigations of allegedly fraudulently obtained SBA guaranteed loans issued by Ciena. Ciena also is subject to other SBA and OIG audits, investigations, and reviews. In addition, the Office of the Inspector General of the U.S. Department of Agriculture is conducting an investigation of Ciena's lending practices under the Business and Industry Loan (B&I) program. The OIG and the U.S. Department of Justice are also conducting a civil investigation of Ciena's lending

practices in various jurisdictions. We are unable to predict the outcome of these inquiries, and it is possible that third parties could try to seek to impose liability against us in connection with certain defaulted loans in Ciena's portfolio. These investigations, audits and reviews are ongoing.

These investigations, audits, reviews, and litigation have had and may continue to have a material adverse impact on Ciena and, as a result, could continue to negatively affect our financial results. We have considered Ciena's voluntary filing for bankruptcy protection, any funding under the letters of credit, current regulatory issues, ongoing investigations and litigation in performing the valuation of Ciena at March 31, 2009 and December 31, 2008.

### Commercial Real Estate Finance

The commercial real estate finance portfolio at value, investment activity, and the yield on interest-bearing investments at and for the three months ended March 31, 2009 and 2008, and at and for the year ended December 31, 2008, were as follows:

(\$ in millions)	At and for the Three Months Ended March 31,				At and for the Year Ended December 31,	
	2009		2008		2008	
	Value	Yield <sup>(1)</sup>	Value	Yield <sup>(1)</sup>	Value	Yield <sup>(1)</sup>
Portfolio at value:						
Commercial mortgage loans	\$ 53.9	6.7%	\$ 53.5	7.9%	\$ 53.5	7.4%
Real estate owned	7.8		30.2		20.8	
Equity interests	17.3		32.1		19.6	
Total portfolio	\$ 79.0		\$ 115.8		\$ 93.9	
Investments funded	\$ 1.1		\$ 0.5		\$ 10.1	
Payment-in-kind interest, net of cash collections	\$		\$ 0.2		\$ 0.2	
Principal collections related to investment repayments or sales	\$ 1.1		\$ 8.4		\$ 16.8	

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

At March 31, 2009, we had outstanding funding commitments related to the commercial real estate portfolio of \$32.3 million, and commitments in the form of standby letters of credit and guarantees related to equity interests of \$7.5 million.

### Managed Funds

In addition to managing our own assets, we manage certain funds that also invest in the debt and equity securities of primarily private middle market companies in a variety of industries. At March 31, 2009, we had eight separate funds

under our management (together, the Managed Funds) for which we may earn management or other fees for our services. We may invest in the equity of these funds, along with other third parties, from which we may earn a current return and/or a future incentive allocation.

On March 3, 2009, we announced the completion of the acquisition of the management contracts of three middle market senior debt CLOs (together, the Emporia Funds) and certain other related assets for approximately \$11 million (subject to post-closing adjustments). The acquired assets are included in other assets in the accompanying consolidated balance sheet and will be amortized over the life of the contracts. The Emporia Funds primarily invest in middle market and broadly syndicated senior secured loans. We are not an investor in the Emporia Funds.

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The assets of the Managed Funds at March 31, 2009 and December 31, 2008, and our management fees as of March 31, 2009 were as follows:

(\$ in millions) Name of Fund	Assets of Managed Funds		Management Fee <sup>(2)</sup>
	March 31, 2009	December 31, 2008	
Unitranche Fund LLC	\$ 781.3	\$ 789.8	0.375%
Allied Capital Senior Debt Fund, L.P.	397.7	412.9	1.625% <sup>(1)(2)</sup>
Knightsbridge CLO 2007-1 Ltd.	502.0	500.6	0.600%
Knightsbridge CLO 2008-1 Ltd.	304.6	304.8	0.600%
AGILE Fund I, LLC	83.2	99.3	(1)
Emporia Preferred Funding I, Ltd.	414.2		0.625% <sup>(1)</sup>
Emporia Preferred Funding II, Ltd.	352.5		0.650% <sup>(1)</sup>
Emporia Preferred Funding III, Ltd.	406.2		0.650% <sup>(1)</sup>
Total Assets	\$ 3,241.7	\$ 2,107.4	

(1) In addition to the management fees, we are entitled to an incentive allocation subject to certain performance benchmarks. There can be no assurance that the incentive allocation will be earned.

(2) Management fees are stated as a percent of assets except for the Allied Capital Senior Debt Fund, L.P. ( ACSDF ) which is stated as a percent of equity capital. The management fee paid by ACSDF was 2.000% at December 31, 2008 and reduced to 1.625% effective January 1, 2009.

A portion of the management fees earned by us may be deferred under certain circumstances. Collection of the fees earned is dependent in part on the performance of the fund. We may pay a portion of management fees we receive to Callidus Capital Corporation, a portfolio investment controlled by us, for services provided as special manager to the Allied Capital Senior Debt Fund, L.P., Knightsbridge CLO 2007-1 Ltd., Knightsbridge CLO 2008-1 Ltd. and the Emporia Funds.

Our responsibilities to the Managed Funds may include investment origination, underwriting, and portfolio monitoring services. Each of the Managed Funds may separately invest in the debt or equity of companies in our portfolio, and these investments may be senior, pari passu or junior to the debt and equity investments held by us. We may or may not participate in investments made by the Managed Funds. We intend to grow our managed capital base over time. By growing our privately managed capital base, we seek to diversify our sources of capital, leverage our core investment expertise and increase fees and other income from asset management activities.

During the three months ended March 31, 2009, we did not sell any assets to the funds. During the three months ended March 31, 2008, we sold \$166.7 million of assets to the AGILE Fund I, LLC, for which we recognized a realized gain of \$8.8 million and dividend income of \$5.4 million.

In addition to managing these funds, we hold certain investments in the Managed Funds as follows:

(\$ in millions) Name of Fund	Investment Description	March 31, 2009		December 31, 2008	
		Cost	Value	Cost	Value

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Unitranche Fund LLC <sup>(1)</sup>	Subordinated Certificates and Equity Interests	\$ 124.5	\$ 124.5	\$ 125.4	\$ 125.4
Allied Capital Senior Debt Fund, L.P.	Equity interests	31.8	32.9	31.8	31.8
Knightsbridge CLO 2007-1 Ltd.	Class E Notes and Income Notes	60.4	35.4	59.6	50.1
Knightsbridge CLO 2008-1 Ltd.	Class C Notes, Class D Notes, Class E Notes and Income Notes	52.3	47.9	52.7	52.7
AGILE Fund I, LLC	Equity Interests	0.7	0.4	0.7	0.5
Total		\$ 269.7	\$ 241.1	\$ 270.2	\$ 260.5

<sup>(1)</sup> We have committed up to \$525.0 million of subordinated certificates to the Unitranche Fund. The Unitranche Fund will be capitalized as investment transactions are completed. Investments made by the Unitranche Fund must be approved by the investment committee of the Unitranche Fund, which includes a representative from us. Therefore, our commitment to the Unitranche Fund cannot be drawn without our approval.

**PORTFOLIO ASSET QUALITY**

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

At March 31, 2009, and December 31, 2008, loans and debt securities at value not accruing interest for the total investment portfolio were as follows:

(\$ in millions)	2009	2008
Private finance		
Companies more than 25% owned	\$134.5	\$176.1
Companies 5% to 25% owned	13.6	
Companies less than 5% owned	69.3	151.8
Commercial real estate finance	11.0	7.7
Total	\$228.4	\$335.6
Percentage of total portfolio	7.9%	9.6%

At March 31, 2009 and December 31, 2008, private finance non-accruals included our senior secured debt in Ciena, which was \$64.1 million or 2.2% and \$104.9 million or 3.0%, respectively of the total portfolio at value. The Ciena senior secured loan was acquired in the third quarter of 2008 and was placed on nonaccrual status upon its purchase. See Private Finance Ciena Capital LLC above. During the quarter ended March 31, 2009, we placed certain interest bearing investments in six portfolio companies on non-accrual; however, non-accruals decreased primarily due to depreciation.

**Loans and Debt Securities Over 90 Days Delinquent.** Loans and debt securities greater than 90 days delinquent at value at March 31, 2009, and December 31, 2008, were as follows:

(\$ in millions)	2009	2008
Private finance	\$ 65.8	\$106.6
Commercial mortgage loans	1.4	1.4
Total	\$ 67.2	\$108.0
Percentage of total portfolio	2.3%	3.1%

At March 31, 2009 and December 31, 2008, private finance loans and debt securities over 90 days delinquent included our senior secured debt in Ciena, which was \$64.1 million or 2.2% and \$104.9 million or 3.0%, respectively of the total portfolio at value. The Ciena senior secured loan was acquired in the third quarter of 2008 and was placed on nonaccrual status upon its purchase. See Private Finance Ciena Capital LLC above.

The amount of the portfolio that is on non-accrual status or greater than 90 days delinquent may vary from period to period. Loans and debt securities on non-accrual status and over 90 days delinquent should not be added together as they are two separate measures of portfolio asset quality. Loans and debt securities that are in both categories (i.e., on non-accrual status and over 90 days delinquent) totaled \$67.2 million and \$108.0 million at March 31, 2009, and December 31, 2008, respectively. Our assets on non-accrual are higher than our loans over 90 days delinquent primarily due to the effect of payment-in-kind interest. Loans with payment-in-kind interest experience no payment delinquency, but collection of that payment-in-kind interest in the future may be doubtful and we may determine that the loan should be placed on non-accrual. Given the severity of this economic recession, we would expect that non-accruals and loans over 90 days delinquent may increase in the future.



**RESULTS OF OPERATIONS****Comparison of the Three Months Ended March 31, 2009 and 2008**

The following table summarizes our operating results for the three months ended March 31, 2009 and 2008.

(in thousands, except per share amounts)	For the Three Months Ended March 31, 2009                      2008		Change	Percent Change
	(unaudited)			
<b>Interest and Related Portfolio Income</b>				
Interest and dividends	\$ 88,730	\$ 134,660	\$ (45,930)	(34)%
Fees and other income	6,452	10,284	(3,832)	(37)%
Total interest and related portfolio income	95,182	144,944	(49,762)	(34)%
<b>Expenses</b>				
Interest	43,485	37,560	5,925	16%
Employee	11,070	22,652	(11,582)	(51)%
Employee stock options	773	4,195	(1,994)	(82)%
Administrative	9,845	9,019	826	9%
Impairment of long-lived asset	2,873		2,873	*
Total operating expenses	68,046	73,426	(5,380)	(8)%
Gain on repurchase of debt	1,995		1,995	*
Net investment income before income taxes	29,131	71,518	(42,387)	(59)%
Income tax expense (benefit), including excise tax	(378)	1,969	(2,347)	(119)%
Net investment income	29,509	69,549	(40,040)	(58)%
<b>Net Realized and Unrealized Gains (Losses)</b>				
Net realized gains (losses)	(27,109)	3,143	(30,252)	
Net change in unrealized appreciation or depreciation	(350,070)	(113,404)	(236,666)	
Total net gains (losses)	(377,179)	(110,261)	(266,918)	
Net income (loss)	\$ (347,670)	\$ (40,712)	\$ (309,958)	(754)%
Diluted earnings (loss) per common share	\$ (1.95)	\$ (0.25)	\$ (1.70)	(680)%
Weighted average common shares outstanding    diluted	178,692	161,507	17,185	11%

\* Comparisons may not be meaningful. Net change in unrealized appreciation or depreciation and net gains (losses) can fluctuate significantly from period to period.



**Interest and Related Portfolio Income.** Interest and related portfolio income includes interest and dividend income and fees and other income.

**Interest and Dividends.** Interest and dividend income for the three months ended March 31, 2009 and 2008, was composed of the following:

(\$ in millions)	2009	2008
Interest		
Private finance loans and debt securities	\$ 70.8	\$ 107.0
Preferred shares/income notes of CLOs	9.6	7.5
Subordinated certificates in Unitranche Fund LLC	2.9	0.3
Commercial mortgage loans	0.9	1.2
Cash, U.S. Treasury bills, money market and other securities	0.0	1.8
Total interest	84.2	117.8
Dividends	4.5	16.9
Total interest and dividends	\$ 88.7	\$ 134.7

The level of interest income, which includes interest paid in cash and in kind, is directly related to the balance of the interest-bearing investment portfolio outstanding during the period multiplied by the weighted average yield. The interest-bearing investments in the portfolio at value and the yield on the interest-bearing investments in the portfolio at March 31, 2009 and 2008, were as follows:

(\$ in millions)	2009		2008	
	Value	Yield <sup>(1)</sup>	Value	Yield <sup>(1)</sup>
Private finance:				
Loans and debt securities:				
Senior loans	\$ 289.1	5.9%	\$ 325.7	7.0%
Unitranche debt	403.8	12.1%	655.7	11.8%
Subordinated debt	1,492.7	13.5%	2,430.4	13.0%
Equity securities:				
Preferred shares/income notes of CLOs	104.4	8.0%	197.4	15.8%
Subordinated certificates in Unitranche Fund LLC	124.5	9.2%	31.5	12.4%
Commercial real estate:				
Commercial Mortgage loans	53.9	6.7%	53.5	7.9%
Total interest-bearing investments	\$ 2,468.4	11.8%	\$ 3,694.2	12.3%

- (1) The weighted average yield on loans and debt securities is computed as the (a) annual stated interest on accruing loans and debt securities plus the annual amortization of loan origination fees, original issue discount, and market discount on accruing loans and debt securities less the annual amortization of loan origination costs, divided by (b) total interest-bearing investments at value. The weighted average yield on the preferred shares/income notes of CLOs is calculated as the (a) effective interest yield on the preferred

shares/income notes of CLOs, divided by (b) preferred shares/income notes of CLOs at value. The weighted average yield on the subordinated certificates in the Unitranche Fund LLC is computed as the (a) annual stated interest rate divided by (b) total investment at value. This yield excludes any return from the potential future excess cash flows from portfolio earnings available to the subordinated certificate holders and from related structuring fees and management and sourcing fees. See Fees and Other Income below. The weighted average yields are computed as of the balance sheet date.

Interest income has decreased over the 2008 period primarily as a result of decreases in the weighted average yield and decreases in the aggregate size of the interest-bearing portfolio due to disposition of certain investments as we have been harvesting capital from our portfolio in order to generate capital to repay our indebtedness and de-lever our balance sheet. Interest income also decreased by approximately \$2.9 million due to additional investments being placed on non-accrual status. The weighted average yield varies from period to period based on the current stated interest on interest-bearing investments, the yield on interest-bearing investments funded, the yield on amounts repaid, the amount of interest-bearing investments for which interest is not accruing, changes in value of interest-bearing investments and the

mix of interest-bearing investments in the portfolio, including the amount of lower-yielding senior or unitranche debt in the portfolio at the end of the period. We are studying various means to reduce the amount of non-interest bearing securities in our portfolio and redeploy the capital into interest bearing debt investments. However, because we recently have exited, and in the future intend to exit, several interest-bearing investments in order to accumulate capital for repayment of debt, we expect that income from our interest-bearing investments will continue to decrease in 2009.

Dividend income results from the dividend yield on preferred equity interests, if any, or the declaration of dividends by a portfolio company on preferred or common equity interests. Dividend income for the three months ended March 31, 2009, was \$4.5 million as compared to \$16.9 million for the three months ended March 31, 2008. Dividend income for the three months ended March 31, 2008 includes a \$7.1 million dividend received in connection with the recapitalization of Norwesco, Inc., and \$5.5 million of dividends received in connection with the sale to AGILE Fund I, LLC. Dividend income will vary from period to period depending upon the timing and amount of dividends that are declared or paid by a portfolio company on preferred or common equity interests.

*Fees and Other Income.* Fees and other income primarily include fees related to financial structuring, diligence, transaction services, management and consulting services to portfolio companies, commitments, guarantees, and other services and loan prepayment premiums. As a business development company, we are required to make significant managerial assistance available to the companies in our investment portfolio. Managerial assistance includes, but is not limited to, management and consulting services related to corporate finance, marketing, human resources, personnel and board member recruiting, business operations, corporate governance, risk management and other general business matters.

Fees and other income for the three months ended March 31, 2009 and 2008, included fees relating to the following:

(\$ in millions)	2009	2008
Fund management fees <sup>(1)</sup>	\$ 2.8	0.6
Management, consulting and other services provided to portfolio companies	2.2	2.9
Loan prepayment premiums	0.8	
Commitment, guaranty and other fees from portfolio companies	0.6	1.7
Structuring and diligence		\$ 5.1
Total fees and other income	\$ 6.4	\$ 10.3

<sup>(1)</sup> See Portfolio and Investment Activity Managed Funds above.

Fees and other income generally are related to specific transactions or services and therefore may vary substantially from period to period depending on the level of investment activity and types of services provided and the level of assets in managed funds for which we earn management or other fees. We have added several new Managed Funds since March 31, 2008, which resulted in an increase in fund management fees. Given our outlook for future investment activity for our balance sheet as well as for certain Managed Funds, we expect that total fee income in the future will reflect lower new investment levels. Loan origination fees that represent yield enhancement on a loan are capitalized and amortized into interest income over the life of the loan.

We earned no structuring and diligence fees in the first quarter of 2009. Structuring and diligence fees for the three months ended March 31, 2008, included \$1.8 million earned by us in connection with investments made by the Unitranche Fund LLC. See Managed Funds above. The remainder of the structuring and diligence fees for 2008 primarily related to the level of new investment originations. Because we expect new investment activity to continue

to be at a low level, we expect structuring and diligence fees to be lower in 2009 than in 2008.

**Operating Expenses.** Operating expenses include interest, employee, employee stock options, administrative expenses and the impairment of long-lived asset.

**Interest Expense.** The fluctuations in interest expense during the three months ended March 31, 2009 and 2008, primarily were attributable to increases in our weighted average cost of debt capital as well as changes in the

level of our borrowings under various notes payable and our revolving line of credit. Our borrowing activity and weighted average cost of debt, including fees and debt financing costs, at and for the three months ended March 31, 2009 and 2008, were as follows:

(\$ in millions)	2009	2008
Total outstanding debt	\$ 1,942.5	\$ 2,191.6
Average outstanding debt	\$ 1,945.0	\$ 2,209.5
Weighted average cost <sup>(1)</sup>	8.6%	6.2%

<sup>(1)</sup> 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, other facility fees and debt financing costs that are recognized into interest expense over the contractual life of the respective borrowings, divided by (b) debt outstanding on the balance sheet date.

At the end of the fourth quarter of 2008, we amended our private notes and revolving line of credit, which increased the stated interest rate on those obligations by 100 basis points. Subsequent to this amendment, events of default have occurred and are continuing on these instruments. Pursuant to the terms of the revolving credit facility, during the continuance of an event of default, the applicable spread on any borrowings outstanding and fees on any letters of credit outstanding under the revolving credit facility increase by up to an additional 200 basis points. Pursuant to the private notes, during the continuance of an event of default, the rate of interest borne by the private notes increases by an additional 200 basis points. During the three months ended March 31, 2009, we incurred additional interest expense totaling \$3.6 million related to the default interest. We are in discussions with our lenders regarding a more comprehensive restructuring of these debt agreements to provide us long-term operational flexibility in this difficult economy. See *Financial Condition, Liquidity and Capital Resources* below.

In addition, interest expense included interest paid to the Internal Revenue Service related to installment sale gains totaling \$2.0 million and \$1.9 million for the three months ended March 31, 2009 and 2008, respectively. Installment interest expense for the year ended December 31, 2009, is estimated to be approximately \$7.8 million. See *Dividends and Distributions* below.

*Employee Expense.* Employee expenses for the three months ended March 31, 2009 and 2008, were as follows:

(\$ in millions)	2009	2008
Salaries and employee benefits	\$ 8.8	\$ 12.4
Bonuses and performance awards	2.3	10.3
Individual performance award (IPA)		2.4
IPA mark to market expense (benefit)		(4.1)
Individual performance bonus (IPB)		1.7
Total employee expense <sup>(1)</sup>	\$ 11.1	\$ 22.7
Number of employees at end of period	134	186

<sup>(1)</sup> Excludes employee stock options expense. See below.

During the second half of 2008, we consolidated our investment execution activities to our Washington, DC headquarters and our office in New York in an effort to improve our operating efficiencies, reducing our headcount by

approximately 50 employees. Our employee expense for the first quarter of 2009 reflects this reduction in headcount.

The quarterly accrual for employee bonuses is based upon an estimate of annual bonuses and is subject to change. The amount of the current year bonuses will be finalized by the Compensation Committee and the Board of Directors at the end of the year. Employee bonuses generally are paid after the completion of the fiscal year.



The IPA and IPB are part of an incentive compensation program for certain officers and generally are determined annually at the beginning of each year but may be adjusted throughout the year. In 2008, IPAs were paid in cash in two equal installments during the year. Through December 31, 2007, the IPA amounts were contributed into a trust and invested in our common stock. The IPB was distributed in cash to award recipients throughout the year (beginning in February of each respective year) as long as the recipient remained employed by us. We currently have not established an IPA or IPB for 2009; however, depending upon our need to retain and motivate our employees, we may determine in conjunction with the Compensation Committee of the Board of Directors that some form of 2009 retention compensation or individual performance compensation may be in the best interests of the company.

The trusts for the IPA payments were consolidated with our accounts. The common stock was classified as common stock held in deferred compensation trust in the accompanying financial statements and the deferred compensation obligation, which represented the amount owed to the employees, was included in other liabilities. Changes in the value of our common stock held in the deferred compensation trust were not recognized. However, the liability was marked to market with a corresponding charge or credit to employee compensation expense. On December 14, 2007, our Board of Directors made a determination that it was in Allied Capital's best interest to terminate our deferred compensation arrangements. The Board of Directors' decision primarily was in response to increased complexity resulting from recent changes in the regulation of deferred compensation arrangements. The Board of Directors resolved that the accounts under these Plans would be distributed to participants in full on March 18, 2008, the termination and distribution date, or as soon as was reasonably practicable thereafter, in accordance with the provisions of each of these Plans.

The accounts under the deferred compensation arrangements totaled \$52.5 million at December 31, 2007. The balances on the termination date were distributed to participants in March 2008 subsequent to the termination date, in accordance with the transition rule for payment elections under Section 409A of the Code. Distributions from the plans were made in cash or shares of our common stock, net of required withholding taxes. The distribution of the accounts under the deferred compensation arrangements resulted in a tax deduction for 2008, subject to the limitations set by Section 162(m) of the Code for persons subject to such section.

*Employee Stock Options Expense.* The employee stock options expense for the three months ended March 31, 2009 and 2008, was as follows:

(\$ in millions)	2009	2008
Employee Stock Options Expense:		
Previously awarded, unvested options as of January 1, 2006	\$ 0.8	\$ 1.7
Options granted on or after January 1, 2006	0.8	2.5
Total employee stock options expense	\$ 0.8	\$ 4.2

On March 3, 2009, the Compensation Committee of our Board of Directors granted 10.6 million options with an exercise price of \$0.73 per share. The options vest in three equal installments on June 30, 2009, June 30, 2010 and June 30, 2011.

We estimate that the employee-related stock options expense for outstanding unvested options as of March 31, 2009, will be approximately \$3.7 million, \$4.1 million, and \$3.7 million for the years ended December 31, 2009, 2010, and 2011, respectively. This estimate does not include any expense related to stock option grants after March 31, 2009, as the fair value of those stock options will be determined at the time of grant. This estimate may change if our

assumptions related to future option forfeitures change.

*Administrative Expense.* Administrative expenses include legal and accounting fees, valuation assistance fees, insurance premiums, the cost of leases for our headquarters in Washington, DC, and our regional offices, portfolio origination and development expenses, travel costs, stock record expenses, directors fees and stock option expense, and various other expenses.

Administrative expenses for the three months ended March 31, 2009 and 2008, were \$9.8 million and \$9.0 million, respectively. Administrative expenses increased primarily due to an increase in legal and other professional fees.

*Impairment of Long-Lived Asset.* In our efforts to reduce overall administrative expenses, we entered into an arrangement to sell our corporate aircraft. We expect the sale will be completed during the second quarter of 2009. The expected sales price of the aircraft is less than our carrying cost, therefore, we recorded an impairment charge of \$2.9 million during the three months ended March 31, 2009.

***Income Tax Expense (Benefit), Including Excise Tax.*** Income tax expense (benefit) for the three months ended March 31, 2009 and 2008, was as follows:

(\$ in millions)	2009	2008
Income tax expense (benefit)	\$ (0.4)	\$ (0.3)
Excise tax expense <sup>(1)</sup>		2.3
Income tax expense (benefit), including excise tax	\$ (0.4)	\$ 2.0

<sup>(1)</sup> While excise tax expense is presented in the consolidated statement of operations as a reduction to net investment income, excise tax relates to both net investment income and net realized gains (losses).

Our wholly-owned subsidiary, A.C. Corporation, is a corporation subject to federal and state income taxes and records a benefit or expense for income taxes as appropriate based on its operating results in a given period.

We did not record an excise tax for the three months ended March 31, 2009. See [Dividends and Distributions](#) below.

***Realized Gains and Losses.*** Net realized gains or losses primarily result from the sale of portfolio investments. Net realized gains (losses) for the three months ended March 31, 2009 and 2008, were as follows:

(\$ in millions)	2009	2008
Realized gains	\$ 12.8	\$ 32.7
Realized losses	(39.9)	(29.6)
Net realized gains (losses)	\$ (27.1)	\$ 3.1

When we exit an investment and realize a gain or loss, we make an accounting entry to reverse any unrealized appreciation or depreciation, respectively, that we had previously recorded to reflect the appreciated or depreciated value of the investment. For the three months ended March 31, 2009 and 2008, we reversed previously recorded unrealized appreciation or depreciation when gains or losses were realized or dividends were received as follows:

(\$ in millions)	2009	2008
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Reversal of previously recorded net unrealized appreciation associated with realized gains	\$ (1.0)	\$ (32.5)
Reversal of previously recorded net unrealized appreciation associated with dividends received	(3.4)	(13.5)
Reversal of previously recorded net unrealized depreciation associated with realized losses	17.0	28.5
Total reversal	\$ 12.6	\$ (17.5)

Realized gains for the three months ended March 31, 2009 and 2008, were as follows:

(\$ in millions)

	<b>2009</b>	<b>Amount</b>
<b>Portfolio Company</b>		
<b>Private Finance:</b>		
GC-Sun Holdings, LP	\$	6.8
Other		1.8
Total private finance		8.6
<b>Commercial Real Estate:</b>		
Real estate owned		4.1
Other		0.1
Total commercial real estate		4.2
Total realized gains	\$	12.8

	<b>2008</b>	<b>Amount</b>
<b>Portfolio Company</b>		
<b>Private Finance:</b>		
Norwesco, Inc.	\$	10.7
BenefitMall, Inc.		4.9
Financial Pacific Company		3.1
Penn Detroit Diesel Allison, LLC		1.7
Service Champ, Inc.		1.7
Advantage Sales & Marketing, Inc. <sup>(1)</sup>		3.2
Coverall North America, Inc.		1.4
CR Holding, Inc.		1.0
Other		4.9
Total private finance		32.6
<b>Commercial Real Estate:</b>		
Other		0.1
Total commercial real estate		0.1
Total realized gains	\$	32.7

(1) Includes an additional realized gain of \$1.7 million related to the release of escrowed funds from the sale of our majority equity investment in 2006.

Realized losses for the three months ended March 31, 2009 and 2008, were as follows:

(\$ in millions)

<b>Portfolio Company</b>	<b>2009</b>	<b>Amount</b>
<b>Private Finance:</b>		
Advantage Sales & Marketing, Inc.	\$	27.3
Becker Underwood, Inc.		2.8
Old Orchard Brands, LLC		4.5
Pro Mach, Inc.		2.9
Tank Intermediate Holding Corp.		2.2
Other		0.2
Total private finance		39.9
<b>Commercial Real Estate:</b>		
Other		
Total commercial real estate		
Total realized losses	\$	39.9

<b>Portfolio Company</b>	<b>2008</b>	<b>Amount</b>
<b>Private Finance:</b>		
Crescent Equity Corp. Longview Cable & Data, LLC	\$	8.4
Mid-Atlantic Venture Fund IV, L.P.		5.2
WMA Equity Corporation and Affiliates		4.5
Driven Brands, Inc.		1.9
Direct Capital Corporation		1.7
EarthColor, Inc.		1.7
Sweet Traditions, Inc.		1.0
Other		4.9
Total private finance		29.3
<b>Commercial Real Estate:</b>		
Other		0.3
Total commercial real estate		0.3

Total realized losses	\$	29.6
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During the three months ended March 31, 2009, we focused our efforts on harvesting capital from our portfolio in order to generate capital to repay indebtedness and de-lever our balance sheet. These asset sales have been completed under distressed conditions in a very difficult market and consequently we have realized net losses upon their disposition. For the three months ended March 31, 2009, we sold or had repayments on portfolio investments that generated cash proceeds of \$241.8 million, including cash proceeds of \$220.5 million related to asset sales. The

proceeds from these asset sales collectively represented 85% of our cost basis and 91% of our value at December 31, 2008.

Realized gains and losses for the three months ended March 31, 2008, include net realized gains totaling \$8.8 million (subsequent to post-closing adjustments) and net realized losses of \$5.5 million from the sales of certain investments to our Managed Funds. We did not sell any investments to our Managed Funds during the three months ended March 31, 2009. See [Managed Funds](#) above.

***Change in Unrealized Appreciation or Depreciation.*** We determine the value of each investment in our portfolio on a quarterly basis, and changes in value result in unrealized appreciation or depreciation being recognized in our statement of operations. Value, as defined in Section 2(a)(41) of the Investment Company Act of 1940, is (i) the market price for those securities for which a market quotation is readily available and (ii) for all other securities and assets, fair value is as determined in good faith by the Board of Directors. Since there is typically no readily available market value for the investments in our portfolio, we value substantially all of our portfolio investments at fair value as determined in good faith by the Board of Directors in accordance with our valuation policy and the provisions of the 1940 Act and FASB Statement No. 157, *Fair Value Measurements* (SFAS 157 or the Statement) and related interpretations. We determine fair value to be the price that would be received for an investment in a current sale, which assumes an orderly transaction between market participants on the measurement date. At March 31, 2009, portfolio investments recorded at fair value using level 3 inputs (as defined under the Statement) were approximately 86% of our total assets. Because of the inherent uncertainty of determining the fair value of investments that do not have a readily available market quotation in an active market, 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 approach 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 determine that the fair value of a security is less than its cost basis, and we will record unrealized appreciation when we determine that the fair value is greater than its cost basis. 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 portfolio companies, CLO bonds and preferred shares/income notes, CDO bonds and investment funds. The structure of each debt and equity security is specifically negotiated to enable us to protect our investment and maximize our returns. We include many terms governing interest rate, repayment terms, prepayment penalties, financial covenants, operating covenants, ownership parameters, dilution parameters, liquidation preferences, voting rights, and put or call rights. Our investments may be subject to certain restrictions on resale and generally have no established trading market.

Because of the type of investments that we make and the nature of our business, our valuation process requires an analysis of various factors. Our fair value methodology includes the examination of, among other things, the underlying investment performance, financial condition, and market changing events that impact valuation.

***Valuation Methodology.*** We adopted SFAS 157 on a prospective basis in the first quarter of 2008. SFAS 157 requires us to assume that the portfolio investment is assumed to be sold in the principal market to market participants, or in the absence of a principal market, the most advantageous market, which may be a hypothetical market. Market participants are defined as buyers and sellers in the principal or most advantageous market that are independent, knowledgeable, and willing and able to transact. In accordance with the Statement, we have considered our principal



market, or the market in which we exit our portfolio investments with the greatest volume and level of activity.

We have determined that for our buyout investments, where we have control or could gain control through an option or warrant security, both the debt and equity securities of the portfolio investment would exit in the merger and acquisition (M&A) market as the principal market generally through a sale or recapitalization of the portfolio company. We believe that the in-use premise of value (as defined in SFAS 157), which assumes the debt and equity securities are sold together, is appropriate as this would provide maximum proceeds to the seller. As a result, we use the enterprise value methodology to determine the fair value of these investments under SFAS 157. Enterprise value means the entire value of the company to a market participant, including the sum of the values of debt and equity securities used to capitalize the enterprise at a point in time. Enterprise value is determined using various factors, including cash flow from operations of the portfolio company, multiples at which private companies are bought and sold, and other pertinent factors, such as recent offers to purchase a portfolio company, recent transactions involving the purchase or sale of the portfolio company's equity securities, liquidation events, or other events. We allocate the enterprise value to these securities in order of the legal priority of the securities.

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. However, we must derive a single estimate of enterprise value. To determine the enterprise value of a portfolio company, we analyze its historical and projected financial results. This financial and other information is generally obtained from the portfolio companies, and may represent unaudited, projected or pro forma financial information. We generally require portfolio companies to provide annual audited and quarterly unaudited financial statements, as well as annual projections for the upcoming fiscal year. Typically in the private equity business, companies are bought and sold based on multiples of EBITDA, cash flow, net income, revenues or, in limited instances, book value. The private equity industry uses financial measures such as EBITDA or EBITDAM (Earnings Before Interest, Taxes, Depreciation, Amortization and, in some instances, Management fees) in order to assess a portfolio company's financial performance and to value a portfolio company. EBITDA and EBITDAM are not intended to represent cash flow from operations as defined by U.S. generally accepted accounting principles and such information should not be considered as an alternative to net income, cash flow from operations, or any other measure of performance prescribed by U.S. generally accepted accounting principles. When using EBITDA to determine enterprise value, we may adjust EBITDA for non-recurring items. Such adjustments are intended to normalize EBITDA to reflect the portfolio company's earnings power. Adjustments to EBITDA may include compensation to previous owners, acquisition, recapitalization, or restructuring related items or one-time non-recurring income or expense items.

In determining a multiple to use for valuation purposes, we generally look to private merger and acquisition statistics, the entry multiple for the transaction, 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.

While we typically exit our securities upon the sale or recapitalization of the portfolio company in the M&A market, for investments in portfolio companies where we do not have control or the ability to gain control through an option or warrant security, we cannot typically control the exit of our investment into the principal market (the M&A market). As a result, in accordance with SFAS 157, we are required to determine the fair value of these investments assuming a sale of the individual investment in a hypothetical market to a hypothetical market participant (the in-exchange premise of value). We continue to perform an enterprise value analysis for investments in this category to assess the credit risk of the loan or debt security and to determine the fair value of our equity investment in these portfolio companies. The determined equity values are generally discounted when we have a minority ownership position, restrictions on resale, specific concerns about the receptivity of the capital markets to a specific company at a certain time, or other factors. For loan and debt securities, we perform a yield analysis assuming a hypothetical current sale of

the investment. The yield analysis requires us to estimate the expected repayment date of the instrument and a market participant's required yield. Our estimate of the expected repayment date of a loan or debt security is generally shorter than the legal maturity of the instruments as our loans have

historically been repaid prior to the maturity date. The yield analysis considers changes in interest rates and changes in leverage levels of the loan or debt security as compared to market interest rates and leverage levels. Assuming the credit quality of the loan or debt security remains stable, we will use the value determined by the yield analysis as the fair value for that security. A change in the assumptions that we use to estimate the fair value of our loans and debt securities using the yield analysis could have a material impact on the determination of fair value. If there is deterioration in credit quality or a loan or debt security is in workout status, we may consider other factors in determining the fair value of a loan or debt security, including the value attributable to the loan or debt security from the enterprise value of the portfolio company or the proceeds that would be received in a liquidation analysis.

Our equity investments in private debt and equity funds are generally valued at the fund's net asset value, unless other factors lead to a determination of fair value at a different amount. The value of our equity securities in public companies for which quoted prices in an active market are readily available is based on the closing public market price on the measurement date.

The fair value of our CLO/CDO Assets is generally based on a discounted cash flow model that utilizes prepayment, re-investment and loss assumptions based on historical experience and projected performance, economic factors, the characteristics of the underlying cash flow and comparable yields for similar bonds and preferred shares/ income notes, when available. We recognize unrealized appreciation or depreciation on our CLO/CDO Assets as comparable yields in the market change and/or based on changes in estimated cash flows resulting from changes in prepayment, re-investment or loss assumptions in the underlying collateral pool or changes in redemption assumptions for the CLO/CDO Assets, if applicable. We determine the fair value of our CLO/CDO Assets on an individual security-by-security basis. If we were to sell a group of these CLO/CDO Assets in a pool in one or more transactions, the total value received for that pool may be different than the sum of the fair values of the individual assets.

We will record unrealized depreciation on investments when we determine that the fair value of a security is less than its cost basis, and will record unrealized appreciation when we determine that the fair value is greater than its cost basis. Because of the inherent uncertainty of valuation, the values determined at the measurement date 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. Additionally, changes in the market environment and other events that may occur over the life of the investments may cause the gains or losses ultimately realized on these investments to be different than the values determined at the measurement date. In accordance with FSP 157-4 (discussed below), we do not consider a transaction price that is associated with a transaction that is not orderly to be indicative of fair value or market participant risk premiums, and accordingly would place little, if any, weight on transactions that are not orderly in determining fair value. When considering recent potential or completed transactions, we use judgment in determining if such offers or transactions were pursuant to an orderly process for purposes of determining how much weight is placed on these data points in accordance with the applicable guidelines in SFAS 157 and FSP 157-4.

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

We work with third-party consultants to obtain assistance in determining fair value for a portion of the private finance portfolio each quarter. We work with these consultants to obtain assistance as additional support in the preparation of our internal valuation analysis. In addition, we may receive third-party assessments of a particular private finance

portfolio company's value in the ordinary course of business, most often in the context of a prospective sale transaction or in the context of a bankruptcy process.

The valuation analysis prepared by management is submitted to our Board of Directors who is ultimately responsible for the determination of fair value of the portfolio in good faith. Valuation assistance from Duff & Phelps, LLC (Duff & Phelps) for our private finance portfolio consisted of certain limited procedures (the

Procedures) we identified and requested them to perform. Based upon the performance of the Procedures on a selection of our final portfolio company valuations, Duff & Phelps concluded that the fair value of those portfolio companies subjected to the Procedures did not appear unreasonable. In addition, we also received third-party valuation assistance from other third-party consultants for certain private finance portfolio companies. For the three months ended March 31, 2009 and 2008, we received third-party valuation assistance as follows:

	2009	2008
Number of private finance portfolio companies reviewed	93	124
Percentage of private finance portfolio reviewed at value	94.0%	94.0%

Professional fees for third-party valuation assistance were \$1.9 million for the year ended December 31, 2008, and are estimated to be approximately \$1.3 million for 2009.

*Net Change in Unrealized Appreciation or Depreciation.* Net change in unrealized appreciation or depreciation for the three months ended March 31, 2009 and 2008, consisted of the following:

(\$ in millions)	2009 <sup>(1)</sup>	2008 <sup>(1)</sup>
Net unrealized appreciation (depreciation)	\$ (362.7)	\$ (95.9)
Reversal of previously recorded unrealized appreciation associated with realized gains	(1.0)	(32.5)
Reversal of previously recorded net unrealized appreciation associated with dividends received	(3.4)	(13.5)
Reversal of previously recorded unrealized depreciation associated with realized losses	17.0	28.5
Net change in unrealized appreciation or depreciation	\$ (350.1)	\$ (113.4)

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

The primary drivers of the net unrealized depreciation of \$362.7 million resulting from changes in portfolio value for the quarter ended March 31, 2009, were (i) additional depreciation in our CLO/CDO investments, which totaled \$82.5 million (see Portfolio and Investment Activity, Private Finance), (ii) additional depreciation of \$77.2 million on our investment in EarthColor, Inc., a full service commercial printer, (iii) additional depreciation of \$44.1 million on our investment in Ciena Capital (see Portfolio and Investment Activity, Private Finance above), and (iv) additional depreciation of \$16.8 million on our investment in WMA Equity Corporation and Affiliates, a marketer of children's apparel.

Other investments in the portfolio, in the aggregate, accounted for the remaining 39% of the net unrealized depreciation in the first quarter of 2009. Within these other portfolio investments, for the companies where the value was determined based on an EBITDA multiple approach, enterprise values decreased primarily as a result of decreases in multiples. Multiple compression accounted for approximately 85% of the decrease in enterprise value and decreased EBITDA drivers accounted for approximately 15% of the decrease in enterprise value for these companies. Enterprise value multiples for these companies averaged 6.4x with a median multiple of 6.0x for the first quarter valuations. This compares to enterprise value multiples for these companies used for fourth quarter 2008 valuations that averaged 6.9x with a median multiple of 6.5x.

**Per Share Amounts.** All per share amounts included in the Management's Discussion and Analysis of Financial Condition and Results of Operations section have been computed using the weighted average common shares used to compute diluted earnings per share, which were 178.7 million and 161.5 million for the three months ended March 31, 2009 and 2008, respectively.

**OTHER MATTERS**

**Regulated Investment Company Status.** We have elected to be taxed as a regulated investment company under Subchapter M of the Code. In order to maintain our status as a regulated investment company and obtain regulated investment company tax benefits, we must, in general, (1) continue to qualify as a business development company; (2) derive at least 90% of our gross income from dividends, interest, gains from the sale of securities and

other specified types of income; (3) meet asset diversification requirements as defined in the Code; and (4) timely distribute to shareholders at least 90% of our annual investment company taxable income (i.e., net ordinary investment income) as defined in the Code. With respect to taxable realized net long-term capital gains, we may choose to (i) distribute, (ii) deem to distribute, or (iii) retain and pay corporate level tax on such gains. We currently qualify as a regulated investment company. However, there can be no assurance that we will continue to qualify for such treatment in future years.

As long as we qualify as a regulated investment company, we are not taxed on our investment company taxable income or realized net capital gains, to the extent that such taxable income or gains are distributed, or deemed to be distributed, to shareholders on a timely basis. Taxable income includes our taxable interest, dividend and fee income, as well as taxable net capital gains. Taxable income generally differs from net income for financial reporting purposes due to temporary and permanent differences in the recognition of income and expenses, and generally excludes net unrealized appreciation or depreciation, as gains or losses generally are not included in taxable income until they are realized. In addition, gains realized for financial reporting purposes may differ from gains included in taxable income as a result of our election to recognize gains using installment sale treatment, which generally results in the deferment of gains for tax purposes until notes or other amounts, including amounts held in escrow, received as consideration from the sale of investments are collected in cash. Taxable income includes non-cash income, such as payment-in-kind interest and dividends and the amortization of discounts and fees. Cash collections of income resulting from contractual payment-in-kind interest or the amortization of discounts and fees generally occur upon the repayment of the loans or debt securities that include such items. Noncash taxable income is reduced by non-cash expenses, such as realized losses and depreciation and amortization expense.

Taxable income available for distribution includes investment company taxable income and, to the extent not deemed to be distributed or retained, net long-term capital gains. To the extent that annual taxable income available for distribution exceeds dividends paid or deemed distributed from such taxable income for the year, we may carry over the excess taxable income into the next year and such excess income will be available for distribution in the next year as permitted under the Code (see discussion below). Such excess income will be treated under the Code as having been distributed during the prior year for purposes of our qualification for RIC tax treatment for such year. The maximum amount of excess taxable income that we may carry over for distribution in the next year under the Code is the total amount of dividends paid in the following year, subject to certain declaration and payment guidelines. Excess taxable income carried over and paid out in the next year is generally subject to a nondeductible 4% excise tax.

## **DIVIDENDS AND DISTRIBUTIONS**

We have elected to be taxed as a regulated investment company under Subchapter M of the Code. As a regulated investment company, we are required to distribute substantially all of our investment company taxable income to shareholders through the payment of dividends. In certain circumstances, we are restricted in our ability to pay dividends. Each of our private notes and our revolving credit facility contain provisions that limit the amount of dividends we can pay and have a covenant that requires a minimum 200% asset coverage ratio at all times, and at March 31, 2009, we were in default of that covenant. During the continuance of an event of default, we are precluded from declaring dividends or other distributions to our shareholders. In addition, pursuant to the 1940 Act, we may be precluded from declaring dividends or other distributions to our shareholders unless our asset coverage is at least 200%.

We estimate that we have met our dividend distribution requirements for the 2008 tax year. We intend to retain capital in 2009 in order to comply with the 200% asset coverage requirements of the 1940 Act and our debt agreements and therefore, would be able to carry forward any 2009 taxable income for distribution in 2010. We currently qualify as a regulated investment company. However there can be no assurance that we will be able to achieve 200% asset coverage or reach agreement with our lenders with respect to the payment of dividends; therefore, we may not be able



to comply with the regulated investment company requirements to distribute income for 2009 and other future years and we may be required to pay a corporate level income tax.

No dividends were paid or declared for the three months ended March 31, 2009. Dividends to common shareholders were \$0.65 per share for the three months ended March 31, 2008.

## FINANCIAL CONDITION, LIQUIDITY AND CAPITAL RESOURCES

**Events of Default, Liquidity and Operations.** We experienced a significant reduction in our net worth during the second half of 2008, primarily resulting from net unrealized depreciation on our portfolio, which reflected market conditions. As a result, on December 30, 2008, we entered into amendments relating to our private notes and revolving line of credit, including amendments which added new covenants. The amendments are more fully described in Note 4, Debt from our Notes to the Consolidated Financial Statements included in Item 1.

In January 2009 we re-opened discussions with the revolving line of credit lenders and the private noteholders to seek relief under certain terms of both the revolving credit facility and the private notes due to certain events of covenant default. At December 31, 2008, our asset coverage was less than the 200% required by the revolving credit facility and the private notes. We continued to experience additional net unrealized depreciation on our portfolio in the first quarter of 2009 and as a result, as of March 31, 2009, our asset coverage remained less than 200%. Asset coverage generally refers to the percentage resulting from assets less accounts payable and other liabilities, divided by total debt. In addition, we have not completed the documents contemplated by the December 30, 2008 amendments to the revolving credit facility and private notes, which were to include a grant of a first lien security interest on substantially all of our assets. Under these debt agreements, events of default have occurred and are continuing related to these covenants and certain financial and other covenants. Discussions with the revolving line of credit lenders and the private noteholders are continuing and the discussions encompass a more comprehensive restructuring of these debt agreements to provide long-term operational flexibility.

Pursuant to the 1940 Act, we are not permitted to issue indebtedness unless immediately after such issuance we have asset coverage of all outstanding indebtedness of at least 200%. Our publicly issued notes require us to comply with this provision of the 1940 Act. At March 31, 2009, our asset coverage ratio was 171%, which is less than the 200% requirement. As a result, under the publicly issued unsecured notes payable, we will not be able to issue additional indebtedness until such time as our asset coverage returns to at least 200%. We have not experienced any default or cross default with respect to the publicly issued unsecured notes payable.

The existence of an event of default under the revolving line of credit and private notes restricts us from additional borrowing or obtaining letters of credit under our revolving credit facility, and from declaring dividends or other distributions to our shareholders. Pursuant to the terms of the revolving credit facility, during the continuance of an event of default, the applicable spread on any borrowings outstanding and fees on any letters of credit outstanding under the revolving credit facility increase by up to 200 basis points. Pursuant to the terms of the private notes, during the continuance of an event of default, the rate of interest borne by the private notes increases by 200 basis points.

On March 27, 2009, pursuant to the terms of the revolving line of credit, the administrative agent for the lenders terminated substantially all of the unused commitments under the revolving line of credit. As a result, the aggregate commitments under our revolving line of credit have been reduced to \$165.0 million. As of March 31, 2009, we had \$50 million in outstanding borrowings and \$113.5 million in outstanding letters of credit issued under the revolving line of credit.

Neither the lenders nor the noteholders have accelerated repayment of our obligations; however, the occurrence of an event of default permits the administrative agent for the lenders, or the holders of more than 51% of the commitments under the revolving credit facility, to accelerate repayment of all amounts due, to terminate commitments thereunder, and to require us to provide cash collateral equal to the face amount of all outstanding letters of credit. Pursuant to the terms of the private notes, the occurrence of an event of default permits the holders of 51% or more of any issue of

outstanding private notes to accelerate repayment of all amounts due thereunder.

Our consolidated financial statements have been prepared assuming that we will continue as a going concern. We do not have available cash resources sufficient to satisfy all of the obligations under these debt agreements should the

lenders accelerate these obligations. These factors raise substantial doubt about our ability to continue as a going concern. We continue to seek a comprehensive restructuring of these debt agreements to provide long-term operational flexibility. In addition, we continue to sell assets to generate capital to repay debt. There can be no assurance that our plans will be successful in addressing the liquidity uncertainties discussed above. In the event there is an acceleration of the amounts outstanding under the revolving credit facility or any issue of the private notes, it would cause us to evaluate other alternatives and would have a material adverse effect on our operations. The consolidated financial statements included in Item 1 herein do not include any adjustments that might result from these uncertainties.

We have continued to focus our efforts on generating capital in order to repay indebtedness and de-lever our balance sheet. During the three months ended March 31, 2009, we sold or had repayments on portfolio investments that generated \$241.8 million of cash proceeds. Subsequent to March 31, 2009, we sold portfolio investments that generated additional cash proceeds of \$78.4 million. These asset sales have been completed under distressed conditions in a very difficult market and consequently we have realized net losses upon their disposition (see *Realized Gains and Losses* above). We expect to complete additional asset sales throughout the course of the year and given the distressed market and our desire to sell assets to generate liquidity, we may incur additional realized losses upon such dispositions.

Also during the three months ended March 31, 2009, we repurchased \$2.5 million of our publicly issued notes at a cost of \$0.5 million, resulting in a net gain of \$2.0 million. Subsequent to March 31, 2009, we purchased publicly issued notes in the market with a total par value of \$56.8 million, which consisted of \$34.6 million of our 6.625% Notes due 2011 and \$22.2 million of our 6.000% Notes due 2012, for a total cost of \$17.7 million, resulting in a gain of \$39.1 million which will be reflected in our results of operations for the three months ending June 30, 2009.

We may continue to engage in a variety of activities as a means to improve our asset coverage ratio and net asset value, which may include but are not limited to: continuing to sell assets to generate capital to retire debt; refinancing or repurchasing, at par or at a discount, our outstanding debt; foregoing or limiting dividend payments in order to retain capital; and purchasing our common stock in the market to the extent permitted under the 1940 Act. We also plan to continue to carefully manage our employee and administrative expenses. There can be no assurance that we will be able to increase our asset coverage ratio or net asset value.

At March 31, 2009, and December 31, 2008, our cash and investments in money market and other securities, total assets, total debt outstanding, total shareholders' equity, debt to equity ratio and asset coverage for senior indebtedness were as follows:

<b>(\$ in millions)</b>	<b>2009</b>	<b>2008</b>
Cash and investments in money market and other securities (including money market and other securities: 2009-\$0.0; 2008-\$0.3)	\$ 290.2	\$ 50.7
Total assets	\$ 3,387.6	\$ 3,722.2
Total debt outstanding	\$ 1,942.5	\$ 1,945.0
Total shareholders' equity	\$ 1,369.8	\$ 1,718.4
Debt to equity ratio	1.42	1.13
Asset coverage ratio <sup>(1)</sup>	171%	188%

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

Also pursuant to the 1940 Act, we may be precluded from declaring dividends or other distributions to our shareholders, or repurchasing shares of our common stock until such time as our asset coverage would be at least 200%. At March 31, 2009, our asset coverage ratio was 171% and, as a result, we currently are unable to declare dividends or other distributions to our shareholders, or repurchase shares of our common stock. In addition, we generally are not able to issue and sell our common stock at a price below net asset value per share. Our common stock currently is trading at a price below our net asset value of \$7.67 per share.

Cash generated from the portfolio includes cash flow from net investment income and net realized gains and principal collections related to investment repayments or sales. Cash flow provided by our operating activities before new investment activity for the three months ended March 31, 2009 and 2008, was as follows:

(\$ in millions)	2009	2008
Net cash provided by operating activities	\$ 240.1	\$ 111.3
Add: portfolio investments funded	39.9	275.1
Total cash provided by operating activities before new investments	\$ 280.0	\$ 386.4

Given the severe economic recession we are experiencing in the United States, we believe that our cash flows from investment exits for 2009 will be lower than prior years when we were in a more robust economy. We believe, however, that we will generate sufficient cash flow to fund our operations and meet our scheduled debt service requirements, although there can be no assurance that we will generate sufficient cash flow.

At March 31, 2009, and December 31, 2008, the value and yield of the cash and investments in money market and other securities were as follows:

(\$ in millions)	2009		2008	
	Value	Yield	Value	Yield
Money market and other securities	\$ 0.0	0.2%	\$ 0.3	1.7%
Cash	290.2	0.0%	50.4	0.1%
Total	\$ 290.2	0.0%	\$ 50.7	0.1%

We invest otherwise uninvested cash in U.S. government- or agency-issued or guaranteed securities that are backed by the full faith and credit of the United States, or in high quality, short-term securities. We place our cash with financial institutions and, at times, cash held in checking accounts in financial institutions may be in excess of the Federal Deposit Insurance Corporation insured limit.

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

During the three months ended March 31, 2008, and for the year ended December 31, 2008, we sold new equity of \$170.9 million, and \$402.5 million, respectively, in public offerings. In addition, shareholders' equity increased through capital share transactions by \$3.9 million and \$5.4 million through the exercise of stock options, the collection of notes receivable from the sale of common stock, and the issuance of shares through our dividend reinvestment plan for the three months ended March 31, 2008, and the year ended December 31, 2008, respectively. Shareholders' equity also increased by \$26.4 million during the three months ended March 31, 2008, as a result of the distribution of the common stock held in deferred compensation trusts.

At March 31, 2009, and December 31, 2008, we had outstanding debt as follows:

(\$ in millions)	2009			2008		
	Facility Amount	Amount Outstanding	Annual Interest Cost <sup>(1)</sup>	Facility Amount	Amount Outstanding	Annual Interest Cost <sup>(1)</sup>
Notes payable:						
Privately issued unsecured notes payable	\$ 1,015.0	\$1,015.0	9.8% <sup>(5)</sup>	\$ 1,015.0	\$ 1,015.0	7.8%
Publicly issued unsecured notes payable	877.5	877.5	6.7%	880.0	880.0	6.7%
Total notes payable	1,892.5	1,892.5	8.3%	1,895.0	1,895.0	7.3%
Revolving line of credit <sup>(2)</sup>	165.0	50.0	6.3% <sup>(5)</sup>	632.5	50.0	4.3% <sup>(3)</sup>
Total debt	\$ 2,057.5	\$1,942.5	8.6% <sup>(5)</sup>	\$ 2,527.5	\$ 1,945.0	7.7% <sup>(4)</sup>

- (1) The weighted average annual interest cost is computed as the (a) annual stated interest on the debt plus any applicable default interest, plus the annual amortization of commitment fees, other facility fees and the amortization of debt financing costs that are recognized into interest expense over the contractual life of the respective borrowings, divided by (b) debt outstanding on the balance sheet date.
- (2) At March 31, 2009 and December 31, 2008, \$1.5 million and \$460.2 million, respectively, remained unused on the revolving line of credit, net of amounts committed for standby letters of credit of \$113.5 million and \$122.3 million, respectively, issued under the credit facility.
- (3) The annual interest cost reflects the interest rate payable for borrowings under the revolving line of credit. In addition to the current interest rate payable, annual costs of commitment fees, other facility fees and amortization of debt financing costs related to the line of credit are \$6.0 and \$8.5 million, respectively, at both March 31, 2009, and December 31, 2008.
- (4) The annual interest cost for total debt includes the annual cost of commitment fees and the amortization of debt financing costs on the revolving line of credit and other facility fees regardless of the amount outstanding on the facility as of the balance sheet date.
- (5) Events of default have occurred and are continuing under the revolving line of credit and private notes which have increased the interest rates by 2.00% during the continuance of such events of default. Excluding this default interest, the annual interest cost on total debt would have been 7.5%.

**Revolving Line of Credit.** We have an unsecured revolving line of credit with total commitments of \$165.0 million that expires on April 11, 2011. At March 31, 2009, there was \$50.0 million outstanding under our revolving line of credit and standby letters of credit of \$113.5 million were issued under the credit facility.

Borrowings under the revolving line of credit generally bear interest at a rate per annum equal to (i) LIBOR (for the period selected by us) plus 3.00% or (ii) the higher of (a) the Federal Funds rate plus 1.50% or (b) the Bank of America N.A. prime rate plus 1.00%. The revolving line of credit requires the payment of an annual commitment fee equal to 0.50% of the committed amount (whether used or unused). The revolving line of credit generally requires payments of interest at the end of each LIBOR interest period, but no less frequently than quarterly, on LIBOR-based loans, and monthly payments of interest on other loans. All principal is due upon maturity.

The revolving credit facility provides for a swingline sub-facility. The swingline sub-facility bears interest at the Bank of America N.A. cost of funds plus 2.00%. The revolving credit facility also provides for a sub-facility for the issuance of letters of credit for up to an aggregate amount of \$115 million. The letter of credit fee is 3.00% per annum on letters of credit issued, which is payable quarterly. Events of default have occurred which have increased the interest rate and fees on letters of credit by up to 2.00% during the continuance of such events of default. See *Events of Default, Liquidity and Operations* above.

**Privately Issued Unsecured Notes Payable.** We have privately issued unsecured long-term notes to institutional investors, primarily insurance companies. The private notes have five- or seven-year maturities and fixed rates of interest ranging from 6.53% to 9.14% at March 31, 2009. Events of default have occurred, which has increased these interest rates by 2.00% during the continuance of such events of default. See *Events of Default, Liquidity and Operations* above. The private notes generally require payment of interest only semi-annually, and all principal is due upon maturity. At March 31, 2009, the notes had maturities from November 2009 to June 2015. The private notes may be prepaid in whole or in part, together with an interest premium, if any, as stipulated in the note agreements.

The revolving line of credit and the private notes have similar financial and operating covenants. These covenants require us to maintain certain financial ratios, including asset coverage, debt to equity and interest coverage, and a minimum net worth. These debt agreements provide for customary events of default, including, but not limited to, payment defaults, breach of representations or covenants, crossdefaults, bankruptcy events, failure to pay judgments, attachment of our assets, change of control and the issuance of an order of dissolution. Certain of these events of



default are subject to notice and cure periods or materiality thresholds. These debt agreements limit our ability to declare dividends or repurchase our common stock during the existence of certain defaults and events of default.

***Amendments to Revolving Line of Credit and Privately Issued Unsecured Notes Payable.*** On December 30, 2008, we entered into amendments relating to our private notes and revolving line of credit. The amendments reduced our capital maintenance covenant to the greater of \$1.5 billion and 85% of consolidated adjusted debt, and reduced our interest charges coverage ratio covenant, determined as of the last day of each fiscal quarter for the period of four consecutive fiscal quarters ending on such day, to 1.4 to 1 for each fiscal quarter to and including the fiscal quarter ending December 31, 2009, to 1.6 to 1 for the fiscal quarter ending March 31, 2010 and each fiscal quarter thereafter to and including the fiscal quarter ending December 31, 2010, and to 1.7 to 1 for the fiscal quarter

ending March 31, 2011 and each fiscal quarter thereafter. The amendments did not modify our obligation to maintain a minimum 200% asset coverage ratio.

The amendments added new covenants that required us to grant to the private noteholders (the noteholders) and the revolving line of credit lenders (the lenders) a first lien security interest on substantially all of our assets no later than January 30, 2009, and to maintain a ratio of consolidated total adjusted assets to secured debt of not less than 2.25 to 1. Also, prior to December 31, 2010, the amendments (i) required us to limit the payment of dividends to a maximum of \$0.20 per share per fiscal quarter (or such greater amount required for us to maintain our regulated investment company status), and (ii) restricted us from purchasing, redeeming or retiring any shares of our common stock or any warrants, rights or options to purchase or acquire any shares of our common stock for an aggregate consideration in excess of \$60 million. In addition, the amendments restricted us from prepaying, redeeming, purchasing or otherwise acquiring any of our currently outstanding public notes prior to their stated maturity. The amendments also made certain other modifications. The amendments increased the rate of interest on the instruments by 100 basis points. In addition, these amendments required a 50 basis point amendment fee.

**Publicly Issued Unsecured Notes Payable.** At March 31, 2009, we had outstanding publicly issued unsecured notes as follows:

(\$ in millions)	Amount	Maturity Date
6.625% Notes due 2011	\$ 397.5	July 15, 2011
6.000% Notes due 2012	250.0	April 1, 2012
6.875% Notes due 2047	230.0	April 15, 2047
Total	\$ 877.5	

The 6.625% Notes due 2011 and the 6.000% Notes due 2012 require payment of interest only semi-annually, and all principal is due upon maturity. We have the option to redeem these notes in whole or in part, together with a redemption premium, if any, as stipulated in the notes. In addition, we may purchase these notes in the market at par or at a discount to the extent permitted by the 1940 Act. During the three months ended March 31, 2009, we paid \$0.5 million to repurchase certain of the 6.625% Notes due 2011 which had a face value of \$2.5 million.

The 6.875% Notes due 2047 require payment of interest only quarterly, and all principal is due upon maturity. We may redeem these notes in whole or in part at any time or from time to time on or after April 15, 2012, at par and upon the occurrence of certain tax events as stipulated in the notes. The notes are listed on the New York Stock Exchange under the trading symbol AFC.

We have certain financial and operating covenants that are required by the publicly issued unsecured notes payable. We are not permitted to issue indebtedness unless immediately after such issuance we have asset coverage of all outstanding indebtedness of at least 200% as required by the 1940 Act, as amended. At March 31, 2009, our asset coverage ratio was 171%, which is less than the 200% requirement. As a result under the publicly issued unsecured notes payable, we will not be able to issue indebtedness until such time as our asset coverage returns to at least 200%. We have not experienced any default or cross default with respect to the publicly issued unsecured notes payable.

**Contractual Obligations.** The following table shows our significant contractual obligations for the repayment of debt and payment of other contractual obligations as of March 31, 2009.

(\$ in millions)	Payments Due By Year						After 2013
	Total	2009	2010	2011	2012	2013	
Privately issued unsecured notes payable <sup>(1)</sup>	\$ 1,015.0	\$ 1,015.0	\$	\$	\$	\$	\$
Publicly issued unsecured notes payable	877.5			397.5	250.0		230.0
Revolving line of credit <sup>(2)</sup>	50.0	50.0					
Operating leases	14.1	3.4	4.4	1.7	1.7	1.7	1.2
Total contractual obligations	\$ 1,956.6	\$ 1,068.4	\$ 4.4	\$ 399.2	\$ 251.7	\$ 1.7	\$ 231.2

(1) The private notes have stated contractual maturities as follows: 2009-\$252.5 million, 2010-\$408.0 million, 2011-\$72.5 million, 2012-\$89.0 million, 2013-\$140.5 million and thereafter-\$52.5 million.

(2) At March 31, 2009, \$50.0 million was borrowed on the revolving line of credit and \$113.5 million of standby letters of credit were issued under the credit facility. In March 2009, the commitment under our unsecured revolving line of credit was reduced to \$165.0 million. See *Revolving Line of Credit* above.

As discussed above, events of default have occurred and are continuing under the revolving line of credit and private notes. Neither the lenders nor noteholders have accelerated repayment; however, if the administrative agent for the lenders under the revolving line of credit or the required percentage of lenders under the revolving line of credit or noteholders under the private notes, respectively, were to accelerate repayment, these obligations would become immediately due and payable. Therefore, in the table above, the private notes and revolving line of credit are shown as payable in 2009.

### Off-Balance Sheet Arrangements

In the ordinary course of business, we have issued guarantees and have extended standby letters of credit through financial intermediaries on behalf of certain portfolio companies. We generally have issued guarantees and have obtained standby letters of credit under our revolving line of credit for the benefit of counterparties to certain portfolio companies. Under these arrangements, we would be required to make payments to third parties if the portfolio companies were to default on their related payment obligations or if the expiration dates of the letters of credit are not extended. The following table shows our guarantees and standby letters of credit that may have the effect of creating, increasing, or accelerating our liabilities as of March 31, 2009.

(\$ in millions)	Amount of Commitment Expiration Per Year						After 2013
	Total	2009	2010	2011	2012	2013	
Guarantees	\$ 19.2	\$ 7.5	\$ 6.4	\$ 4.4	\$ 0.1	\$	\$ 0.8
Standby letters of credit	113.5	113.5					

Total commitments	\$ 132.7	\$ 121.0	\$ 6.4	\$ 4.4	\$ 0.1	\$	\$ 0.8
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Standby letters of credit have been issued under our revolving line of credit. Our asset coverage ratio is currently less than 200% and events of default have occurred and are continuing under our revolving line of credit. Therefore, we are precluded from borrowing under our revolving line of credit to fund these standby letters of credit and we may need to fund these letter of credit draws with cash in lieu of a borrowing. As a result, in the table above we have assumed that these standby letters of credit may not be able to be extended and may mature in 2009. During the existence of an event of default, the administrative agent is (i) permitted to require us to provide cash collateral equal to the face amount of all outstanding standby letters of credit and (ii) not required to extend the existing letters of credit beyond their maturity dates, all of which expire during the course of 2009. There can be no assurance that we will have cash resources sufficient to satisfy these commitments should the standby letters of credit not be extended.

In addition, we had outstanding commitments to fund investments totaling \$651.6 million at March 31, 2009, including \$619.3 million related to private finance investments and \$32.3 million related to commercial real estate finance investments. Outstanding commitments related to private finance investments included \$399.6 million to the Unitranche Fund LLC. Investments made by the Unitranche Fund must be approved by the investment committee of the Unitranche Fund, which includes a representative from us and GE. Therefore, our commitment to the Unitranche Fund cannot be drawn without our approval. See Portfolio and Investment Activity Outstanding Commitments above.

We intend to fund these commitments with existing cash and through cash flow from operations before new investments although there can be no assurance that we will generate sufficient cash flow to satisfy these commitments. Should we not be able to satisfy these commitments, there could be a material adverse effect on our financial condition, liquidity and results of operations.

### **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, certain revenue recognition matters and certain tax matters as discussed below.

**Valuation of Portfolio Investments.** We, as a BDC, have invested in illiquid securities including debt and equity securities of portfolio companies, CLO bonds and preferred shares/income notes, CDO bonds and investment funds. Our investments may be subject to certain restrictions on resale and generally have no established trading market. We value substantially all of our investments at fair value as determined in good faith by the Board of Directors in accordance with our valuation policy and the provisions of the Investment Company Act of 1940 and FASB Statement No. 157, *Fair Value Measurements* (SFAS 157 or the Statement) and related interpretations. We determine fair value to be the price that would be received for an investment in a current sale, which assumes an orderly transaction between market participants on the measurement date. Our valuation policy considers the fact that no ready market exists for substantially all of the securities in which it invests and that fair value for its investments must typically be determined using unobservable inputs. Our valuation policy is intended to provide a consistent basis for determining the fair value of the portfolio.

We adopted SFAS 157 on a prospective basis in the first quarter of 2008. SFAS 157 requires us to assume that the portfolio investment is to be sold in the principal market to market participants, or in the absence of a principal market, the most advantageous market, which may be a hypothetical market. Market participants are defined as buyers and sellers in the principal or most advantageous market that are independent, knowledgeable, and willing and able to transact. In accordance with the Statement, we have considered our principal market, or the market in which we exit our portfolio investments with the greatest volume and level of activity.

We have determined that for our buyout investments, where we have control or could gain control through an option or warrant security, both the debt and equity securities of the portfolio investment would exit in the merger and acquisition (M&A) market as the principal market generally through a sale or recapitalization of the portfolio company. We believe that the in-use premise of value (as defined in SFAS 157), which assumes the debt and equity securities are sold together, is appropriate as this would provide maximum proceeds to the seller. As a result, we use the enterprise value methodology to determine the fair value of these investments under SFAS 157. Enterprise value means the entire value of the company to a market participant, including the sum of the values of debt and equity securities used to capitalize the enterprise at a point in time. Enterprise value is determined using various factors, including cash flow from operations of the portfolio company, multiples at which private companies are bought and

sold, and other pertinent factors, such as recent offers to purchase a portfolio company, recent transactions involving the purchase or sale of the portfolio company's equity securities, liquidation events, or other events. We allocate the enterprise value to these securities in order of the legal priority of the securities.

While we typically exit our securities upon the sale or recapitalization of the portfolio company in the M&A market, for investments in portfolio companies where we do not have control or the ability to gain control through an option or warrant security, we cannot typically control the exit of our investment into our principal market (the M&A market). As a result, in accordance with SFAS 157, we are required to determine the fair value of these investments assuming a sale of the individual investment in a hypothetical market to a hypothetical market participant (the in-exchange premise of value). We continue to perform an enterprise value analysis for the investments in this category to assess the credit risk of the loan or debt security and to determine the fair value of our equity investment in these portfolio companies. The determined equity values are generally discounted when we have a minority ownership position, restrictions on resale, specific concerns about the receptivity of the capital markets to a specific company at a certain time, or other factors. For loan and debt securities, we perform a yield analysis assuming a hypothetical current sale of the investment. The yield analysis requires us to estimate the expected repayment date of the instrument and a market participant's required yield. The yield analysis considers changes in interest rates and changes in leverage levels of the loan or debt security as compared to current market interest rates and leverage levels. Assuming the credit quality of the loan or debt security remains stable, we will use the value determined by the yield analysis as the fair value for that security. If there is deterioration in credit quality or a loan or debt security is in workout status, we may consider other factors in determining the fair value of a loan or debt security, including the value attributable to the loan or debt security from the enterprise value of the portfolio company or the proceeds that would be received in a liquidation analysis.

Our equity investments in private debt and equity funds generally are valued at such fund's net asset value, unless other factors lead to a determination of fair value at a different amount. The value of our equity securities in public companies for which quoted prices in an active market are readily available is based on the closing public market price on the measurement date.

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

We will record unrealized depreciation on investments when we determine that the fair value of a security is less than its cost basis, and will record unrealized appreciation when we determine that the fair value is greater than its cost basis. Because of the inherent uncertainty of valuation, the values determined at the measurement date 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. Additionally, changes in the market environment and other events that may occur over the life of the investments may cause the gains or losses ultimately realized on these investments to be different than the values determined at the measurement date. In accordance with FSP 157-4 (discussed below), we do not consider a transaction price that is associated with a transaction that is not orderly to be indicative of fair value or market participant risk premiums, and accordingly would place little, if any, weight on transactions that are not orderly in determining fair value. When considering recent potential or completed transactions, we use judgment in determining if such offers or transactions were pursuant to an orderly process for purposes of determining how much weight is placed on these data points in accordance with the applicable guidelines in SFAS 157 and FSP 157-4.

See **Results of Operations - Change in Unrealized Appreciation or Depreciation** above for more discussion on portfolio valuation.

***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



primarily reflects the change in portfolio investment values during the reporting period, including the reversal of previously recorded unrealized appreciation or depreciation when gains or losses are realized. Net change in unrealized appreciation or depreciation also reflects the change in the value of U.S. Treasury bills, when applicable, and depreciation on accrued interest and dividends receivable and other assets where collection is doubtful.

**Interest and Dividend Income.** Interest income is recorded on an accrual basis to the extent that such amounts are expected to be collected. For loans and debt securities with contractual payment-in-kind interest, which represents contractual interest accrued and added to the loan balance that generally becomes due at maturity, we will not accrue payment-in-kind interest if the portfolio company valuation indicates that the payment-in-kind interest is not collectible. In general, interest is not accrued on loans and debt securities if we have doubt about interest collection or where the enterprise value of the portfolio company may not support further accrual. Loans in workout status generally do not accrue interest. In addition, interest may not accrue on loans or debt securities to portfolio companies that are more than 50% owned by us depending on such company's capital requirements.

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. Loan origination fees, original issue discount, and market discount are capitalized and then amortized into interest income using a method that approximates the effective interest method. Upon the prepayment of a loan or debt security, any unamortized loan origination fees are recorded as interest income and any unamortized original issue discount or market discount is recorded as a realized gain.

We recognize interest income on the CLO preferred shares/income notes using the effective interest method, based on the anticipated yield that is determined using the estimated cash flows over the projected life of the investment. Yields are revised when there are changes in actual or estimated cash flows due to changes in prepayments and/or re-investments, credit losses or asset pricing. Changes in estimated yield are recognized as an adjustment to the estimated yield over the remaining life of the preferred shares/income notes from the date the estimated yield was changed. CLO and CDO bonds have stated interest rates. The weighted average yield on the CLO/CDO Assets is calculated as the (a) annual stated interest or the effective interest yield on the accruing bonds or the effective yield on the preferred shares/income notes, divided by (b) CLO/CDO Assets at value. The weighted average yields are computed as of the balance sheet date.

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

**Fee Income.** Fee income includes fees for loan prepayment premiums, guarantees, commitments, and services rendered by us to portfolio companies and other third parties such as diligence, structuring, transaction services, management and consulting services, and other services. Loan prepayment premiums are recognized at the time of prepayment. Guaranty and commitment fees are generally recognized as income over the related period of the guaranty or commitment, respectively. Diligence, structuring, and transaction services fees are generally recognized as income when services are rendered or when the related transactions are completed. Management, consulting and other services fees, including fund management fees, are generally recognized as income as the services are rendered. Fees are not accrued if we have doubt about collection of those fees.

**Federal and State Income Taxes and Excise Tax.** We intend to comply with the requirements of the Internal Revenue Code that are applicable to regulated investment companies (RIC) and real estate investment trusts (REIT). We and any of our subsidiaries that qualify as a RIC or a REIT intend to distribute or retain through a deemed

distribution all of our annual taxable income to shareholders; therefore, we have made no provision for income taxes for these entities.

If we do not distribute at least 98% of our annual taxable income in the year earned, we will generally be required to pay an excise tax equal to 4% of the amount by which 98% of our annual taxable income exceeds the distributions from such taxable income for the year. To the extent that we determine that our estimated current year annual taxable income will be in excess of estimated current year dividend distributions from such taxable income, we accrue excise taxes, if any, on estimated excess taxable income as taxable income is earned using an annual effective excise tax rate. The annual effective excise tax rate is determined by dividing the estimated annual excise tax by the estimated annual taxable income.

Income taxes for AC Corp are accounted for under the asset and liability method. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases as well as operating loss and tax credit carryforwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled.

***Recent Accounting Pronouncements.*** *Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions That Are Not Orderly* (FSP 157-4). In April 2009, the FASB issued FSP 157-4, which provides guidance on how to determine the fair value of assets under SFAS 157 in the current economic environment and reemphasizes that the objective of a fair-value measurement remains an orderly transaction (that is, not a forced liquidation or distressed sale) between market participants at the measurement date under current market conditions. FSP 157-4 states that a transaction price that is associated with a transaction that is not orderly is not determinative of fair value or market-participant risk premiums and companies should place little, if any, weight (compared with other indications of fair value) on transactions that are not orderly when estimating fair value or market risk premiums.

We adopted the provisions of FSP 157-4 on a prospective basis beginning in the quarter ending March 31, 2009. The adoption of the provisions of FSP 157-4 did not have a material effect on our consolidated financial statements.

***Fair Value Measurements.*** In September 2006, the FASB issued Statement No. 157, which defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements.

We adopted this statement on a prospective basis beginning in the quarter ended March 31, 2008. The initial adoption of this statement did not have a material effect on our consolidated financial statements.

### **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, 2008.

**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 chairman of the board, chief executive officer, chief financial officer and chief accounting 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 chairman of the board, chief executive officer, chief financial officer and chief accounting officer concluded that the Company's disclosure controls and procedures are effective to allow timely decisions regarding required disclosure 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 March 31, 2009, 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 June 23, 2004, we were notified by the SEC that they were conducting an informal investigation of us. The investigation related to the valuation of securities in our private finance portfolio and other matters. On June 20, 2007, we announced that we entered into a settlement with the SEC that resolved the SEC's informal investigation. As part of the settlement and without admitting or denying the SEC's allegations, we agreed to the entry of an administrative order. In the order the SEC alleged that, between June 30, 2001, and March 31, 2003, we did not maintain books, records and accounts which, in reasonable detail, supported or accurately and fairly reflected valuations of certain securities in our private finance portfolio and, as a result, did not meet certain recordkeeping and internal controls provisions of the federal securities laws. In the administrative order, the SEC ordered us to continue to maintain certain of our current valuation-related controls. Specifically, for a period of two years, we have undertaken to: (1) continue to employ a Chief Valuation Officer, or a similarly structured officer-level employee, to oversee our quarterly valuation processes; and (2) continue to employ third-party valuation consultants to assist in our quarterly valuation processes.

On December 22, 2004, we received letters from the U.S. Attorney for the District of Columbia requesting the preservation and production of information regarding us and Business Loan Express, LLC (currently known as Ciena Capital LLC) in connection with a criminal investigation relating to matters similar to those investigated by and settled with the SEC as discussed above. We produced materials in response to the requests from the U.S. Attorney's office and certain current and former employees were interviewed by the U.S. Attorney's Office. We have voluntarily cooperated with the investigation.

In late December 2006, we received a subpoena from the U.S. Attorney for the District of Columbia requesting, among other things, the production of records regarding the use of private investigators by us or our agents. The Board established a committee, which was advised by its own counsel, to review this matter. In the course of gathering documents responsive to the subpoena, we became aware that an agent of Allied Capital obtained what were represented to be telephone records of David Einhorn and which purport to be records of calls from Greenlight Capital during a period of time in 2005. Also, while we were gathering documents responsive to the subpoena, allegations were made that our management had authorized the acquisition of these records and that management was subsequently advised that these records had been obtained. Our management has stated that these allegations are not true. We have cooperated fully with the inquiry by the U.S. Attorney's Office.

On February 26, 2007, Dana Ross filed a class action complaint in the U.S. District Court for the District of Columbia in which she alleges that Allied Capital Corporation and certain members of management violated Sections 10(b) and 20(a) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder. Thereafter, the court appointed new lead counsel and approved new lead plaintiffs. On July 30, 2007, plaintiffs served an amended complaint. Plaintiffs claim that, between November 7, 2005, and January 22, 2007, Allied Capital either failed to disclose or misrepresented information about our portfolio company, Business Loan Express, LLC. Plaintiffs seek unspecified compensatory and other damages, as well as other relief. We believe the lawsuit is without merit, and we intend to defend the lawsuit vigorously. On September 13, 2007, we filed a motion to dismiss the lawsuit. The motion is pending.

On October 6, 2008, Rena Nadoff filed a shareholder derivative action in the Superior Court of the District of Columbia, captioned *Rena Nadoff v. Walton, et al.*, 2008 CA 007108, seeking unspecified compensatory and other damages, as well as equitable relief on behalf of Allied Capital Corporation. Ms. Nadoff's suit is substantially similar to a derivative action she filed in February 2007, which the Court dismissed in July 2007. On November 26, 2008, we

filed a motion to dismiss the second Nadoff lawsuit. On February 3, 2009, the Court denied the motion to dismiss but ordered Ms. Nadoff to file an amended complaint that clearly identifies and sets forth the breaches of fiduciary duty, if any, that are alleged to have occurred after the filing (or dismissal) of the first Nadoff derivative lawsuit. Ms. Nadoff filed an amended complaint alleging breaches of fiduciary duty by the Board of Directors. We

filed a motion to dismiss the amended complaint. In response, Ms. Nadoff requested that she be allowed to voluntarily dismiss the amended complaint without prejudice. The court denied her request and the motion to dismiss is pending.

In addition to the above matters, we are party to certain lawsuits in the normal course of business. Furthermore, third parties may try to seek to impose liability on us in connection with the activities of our portfolio companies. For a discussion of civil investigations being conducted regarding the lending practices of Ciena Capital LLC, one of our portfolio companies, see Note 3, Portfolio Ciena Capital LLC from our Notes to the Consolidated Financial Statements included in Item 1.

While the outcome of any of the open legal proceedings described above cannot at this time be predicted with certainty, we do not expect these matters will materially affect our financial condition or results of operations; however, there can be no assurance whether any pending legal proceedings will have a material adverse effect on our financial condition or results of operations in any future reporting period.

#### **Item 1A. 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.*

#### **Risks Related to Liquidity**

**Certain events of default have occurred under our revolving credit facility and our private notes and, as a result, these lenders are permitted to accelerate repayment of the outstanding obligations thereunder.** Certain events of default have occurred under our revolving credit facility and our private notes. The occurrence of an event of default permits the administrative agent for the lenders under the revolving credit facility, or the holders of more than 51% of the commitments under the revolving credit facility, to accelerate repayment of all amounts due, to terminate commitments thereunder, and to require us to provide cash collateral equal to the face amount of all outstanding letters of credit. Pursuant to the terms of the private notes, the occurrence of an event of default permits the holders of 51% or more of any issue of outstanding private notes to accelerate repayment of all amounts due thereunder.

As of March 31, 2009 we had \$50 mi