

ALLIED CAPITAL CORP  
Form 10-Q  
May 15, 2003

**FORM 10-Q**

**SECURITIES AND EXCHANGE COMMISSION**

**WASHINGTON, DC 20549**

**QUARTERLY REPORT PURSUANT TO**

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

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**For The Quarterly Period  
Ended March 31, 2003**

**Commission File Number:  
0-22832**

**ALLIED CAPITAL CORPORATION**

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

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

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

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

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

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

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

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

On May 13, 2003, there were 113,090,292 shares outstanding of the Registrant's common stock, \$0.0001 par value.

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**ALLIED CAPITAL CORPORATION**

**FORM 10-Q INDEX**

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## PART I: FINANCIAL INFORMATION

## Item 1. Financial Statements

## ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

## CONSOLIDATED BALANCE SHEET

| (in thousands, except share and per share amounts)   | March 31,<br>2003 | December 31,<br>2002 |
|--|-------------------|----------------------|
|  | (unaudited)       |                      |
| <b>ASSETS</b>  |                   |                      |
| Portfolio at value:  |                   |                      |
| Private finance  |                   |                      |
| Companies more than 25% owned (cost: 2003-\$671,917;<br>2002-\$628,535)  | \$ 756,685        | \$ 710,587           |
| Companies 5% to 25% owned (cost: 2003-\$210,553;<br>2002-\$219,124)  | 232,568           | 255,677              |
| Companies less than 5% owned (cost: 2003-\$865,117;<br>2002-\$863,243)   | 752,831           | 776,951              |
| Total private finance  | 1,742,084         | 1,743,215            |
| Commercial real estate finance (cost: 2003-\$643,772;<br>2002-\$718,312)   | 634,853           | 744,952              |
| Total portfolio at value   | 2,376,937         | 2,488,167            |
| Other assets   | 106,031           | 100,221              |
| Deposits of proceeds from sales of borrowed Treasury securities  | 99,425            | 194,745              |
| Cash and cash equivalents  | 8,104             | 11,186               |
| Total assets   | \$2,590,497       | \$2,794,319          |
| <b>LIABILITIES AND SHAREHOLDERS EQUITY</b>   |                   |                      |
| Liabilities:   |                   |                      |
| Notes payable and debentures   | \$ 794,200        | \$ 794,200           |
| Revolving line of credit   | 61,750            | 204,250              |
| Obligations to replenish borrowed Treasury securities  | 100,339           | 197,027              |
| Accounts payable and other liabilities   | 38,915            | 45,771               |
| Total liabilities  | 995,204           | 1,241,248            |
| Commitments and contingencies  |                   |                      |
| Preferred stock  | 7,000             | 7,000                |
| Shareholders equity:   |                   |                      |
| Common stock, \$0.0001 par value, 200,000,000 shares<br>authorized; 113,056,001 and 108,698,409 shares issued and<br>outstanding at March 31, 2003, and December 31, 2002,<br>respectively | 11                | 11                   |
| Additional paid-in capital   | 1,631,745         | 1,547,183            |
| Notes receivable from sale of common stock   | (23,890)          | (24,704)             |
| Net unrealized appreciation (depreciation) on portfolio  | (31,725)          | 39,411               |
| Undistributed (distributions in excess of) earnings  | 12,152            | (15,830)             |

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|  |                    |                    |
|--|--------------------|--------------------|
| Total shareholders' equity                 | <u>1,588,293</u>   | <u>1,546,071</u>   |
| Total liabilities and shareholders' equity | <u>\$2,590,497</u> | <u>\$2,794,319</u> |
| Net asset value per common share           | <u>\$ 14.05</u>    | <u>\$ 14.22</u>    |

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

## ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

## CONSOLIDATED STATEMENT OF OPERATIONS

|   | For the Three Months<br>Ended March 31, |           |
|---|---|-----------|
|   | 2003                                    | 2002      |
|   | (unaudited)                             |           |
| <b>(in thousands, except per share amounts)</b>       |   |           |
| <b>Interest and Related Portfolio Income:</b>         |   |           |
| Interest and dividends                                |   |           |
| Companies more than 25% owned                         | \$ 15,203                               | \$ 9,473  |
| Companies 5% to 25% owned                             | 6,493                                   | 7,440     |
| Companies less than 5% owned                          | 43,825                                  | 48,060    |
|   |   |           |
| Total interest and dividends                          | 65,521                                  | 64,973    |
| Premiums from loan dispositions                       |   |           |
| Companies more than 25% owned                         | 108                                     |           |
| Companies 5% to 25% owned                             | 485                                     |           |
| Companies less than 5% owned                          | 528                                     | 1,613     |
|   |   |           |
| Total premiums from loan dispositions                 | 1,121                                   | 1,613     |
| Fees and other income                                 |   |           |
| Companies more than 25% owned                         | 5,709                                   | 6,975     |
| Companies 5% to 25% owned                             | 53                                      |           |
| Companies less than 5% owned                          | 726                                     | 8,830     |
|   |   |           |
| Total fees and other income                           | 6,488                                   | 15,805    |
|   |   |           |
| Total interest and related portfolio income           | 73,130                                  | 82,391    |
| <b>Expenses:</b>                                      |   |           |
| Interest  | 17,922                                  | 17,469    |
| Employee  | 8,121                                   | 8,035     |
| Administrative  | 4,417                                   | 3,018     |
|   |   |           |
| Total operating expenses                              | 30,460                                  | 28,522    |
|   |   |           |
| Net investment income                                 | 42,670                                  | 53,869    |
|   |   |           |
| <b>Net Realized and Unrealized Gains (Losses):</b>    |   |           |
| Net realized gains                                    |   |           |
| Companies 5% to 25% owned                             | 16,688                                  | 718       |
| Companies less than 5% owned                          | 31,651                                  | 8,887     |
|   |   |           |
| Total net realized gains                              | 48,339                                  | 9,605     |
| Net change in unrealized appreciation or depreciation | (71,136)                                | (7,513)   |
|   |   |           |
| Total net gains (losses)                              | (22,797)                                | 2,092     |
|   |   |           |
| Net increase in net assets resulting from operations  | \$ 19,873                               | \$ 55,961 |
|   |   |           |
| Basic earnings per common share                       | \$ 0.18                                 | \$ 0.56   |

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|  |         |         |
|--|---------|---------|
| Diluted earnings per common share                  | \$ 0.18 | \$ 0.55 |
| Weighted average common shares outstanding basic   | 109,458 | 99,977  |
| Weighted average common shares outstanding diluted | 110,098 | 102,364 |

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

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

| (in thousands, except per share amounts)                              | For the Three Months<br>Ended March 31, |              |
|---|---|--------------|
|   | 2003                                    | 2002         |
|   | (unaudited)                             |              |
| Operations:   |   |              |
| Net investment income   | \$ 42,670                               | \$ 53,869    |
| Net realized gains  | 48,339                                  | 9,605        |
| Net change in unrealized appreciation or depreciation                 | (71,136)                                | (7,513)      |
|   | 19,873                                  | 55,961       |
| Shareholder distributions:  |   |              |
| Common stock dividends  | (62,972)                                | (53,259)     |
| Preferred stock dividends   | (55)                                    | (55)         |
|   | (63,027)                                | (53,314)     |
| Capital share transactions:   |   |              |
| Sale of common stock  | 82,362                                  | 19,950       |
| Issuance of common stock upon the exercise of stock options           | 510                                     | 6,293        |
| Issuance of common stock in lieu of cash distributions                | 1,690                                   | 1,572        |
| Net decrease (increase) in notes receivable from sale of common stock | 814                                     | (1,244)      |
|   | 85,376                                  | 26,571       |
| Total increase in net assets  | 42,222                                  | 29,218       |
| Net assets at beginning of period                                     | 1,546,071                               | 1,352,123    |
| Net assets at end of period   | \$ 1,588,293                            | \$ 1,381,341 |
| Net asset value per common share                                      | \$ 14.05                                | \$ 13.71     |
| Common shares outstanding at end of period                            | 113,056                                 | 100,765      |

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



## ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

## CONSOLIDATED STATEMENT OF CASH FLOWS

|   | For the Three Months<br>Ended March 31, |                  |
|---|---|------------------|
|   | 2003                                    | 2002             |
|   | (unaudited)                             |                  |
| (in thousands)  |   |                  |
| Cash flows from operating activities:                     |   |                  |
| Net increase in net assets resulting from operations      | \$ 19,873                               | \$ 55,961        |
| Adjustments   |   |                  |
| Portfolio investments                                     | (269,007)                               | (80,040)         |
| Repayments of investment principal                        | 75,979                                  | 31,013           |
| Proceeds from investment sales                            | 244,092                                 | 125,099          |
| Change in accrued or reinvested interest and dividends    | (11,087)                                | (13,258)         |
| Amortization of loan discounts and fees                   | (5,535)                                 | (3,883)          |
| Changes in other assets and liabilities                   | (1,851)                                 | (10,033)         |
| Depreciation and amortization                             | 412                                     | 266              |
| Gain on cashless exercise of warrants                     | (3,876)                                 |                  |
| Realized losses   | 212                                     | 3,320            |
| Net change in unrealized appreciation or depreciation     | 71,136                                  | 7,513            |
|   | <u>120,348</u>                          | <u>115,958</u>   |
| Cash flows from financing activities:                     |   |                  |
| Sale of common stock                                      | 82,362                                  | 19,950           |
| Sale of common stock upon the exercise of stock options   | 510                                     | 4,832            |
| Collections of notes receivable from sale of common stock | 814                                     | 217              |
| Common dividends and distributions paid                   | (64,464)                                | (51,687)         |
| Preferred stock dividends paid                            | (55)                                    | (55)             |
| Net repayments on revolving line of credit                | (142,500)                               | (87,750)         |
| Other financing activities                                | (97)                                    | (57)             |
|   | <u>(123,430)</u>                        | <u>(114,550)</u> |
| Net increase (decrease) in cash and cash equivalents      | (3,082)                                 | 1,408            |
| Cash and cash equivalents at beginning of period          | 11,186                                  | 889              |
|   | <u>\$ 8,104</u>                         | <u>\$ 2,297</u>  |

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

## ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

## CONSOLIDATED STATEMENT OF INVESTMENTS

March 31, 2003

| Private Finance<br>Portfolio Company<br>(in thousands, except number of shares) | Investment <sup>(2)</sup>           | (unaudited) |          |
|---|-------------------------------------|-------------|----------|
|   |                                     | Cost        | Value    |
| <b>Companies More Than 25% Owned</b>  |                                     |             |          |
| Acme Paging, L.P.<br>(Telecommunications)                                       | Loan                                | \$ 4,042    | \$ 4,042 |
|   | Equity Interests                    | 13,274      | 7,723    |
|   | Common Stock (670 shares)           | 27          | 27       |
| Alaris Consulting, LLC<br>(Business Services)                                   | Loan                                | 16,660      | 16,014   |
|   | Equity Interests                    | 5,165       |          |
|   | Guaranty (\$1,100)                  |             |          |
| American Healthcare Services, Inc.<br>(Healthcare)                              | Loan                                | 22,601      | 22,601   |
|   | Debt Securities                     | 18,061      | 15,891   |
|   | Common Stock (79,567,042 shares)    | 1,000       |          |
|   | Guaranty (\$1,766)                  |             |          |
| Avborne, Inc.<br>(Business Services)  | Loan                                | 2,770       | 2,770    |
|   | Preferred Stock (12,500 shares)     | 14,138      | 2,300    |
|   | Common Stock (27,500 shares)        |             |          |
|   | Standby Letters of Credit (\$7,025) |             |          |
| Business Loan Express, LLC<br>(Financial Services)                              | Loans                               | 25,000      | 25,000   |
|   | Debt Securities                     | 37,960      | 37,960   |
|   | Class A Equity Interests            | 43,705      | 43,705   |
|   | Class B Equity Interests            | 51,111      | 70,918   |
|   | Class C Equity Interests            | 108,241     | 130,029  |
|   | Guaranty (\$57,246 See Note 3)      |             |          |
| The Color Factory, Inc.<br>(Consumer Products)                                  | Loan                                | 11,089      | 11,089   |
|   | Preferred Stock (1,000 shares)      | 1,002       | 1,002    |
|   | Common Stock (980,000 shares)       | 6,535       | 3,500    |
| Foresite Towers, LLC<br>(Tower Leasing)   | Equity Interests                    | 15,522      | 13,775   |
| Gordian Group, Inc.<br>(Business Services)                                      | Loan                                | 7,570       | 7,570    |
|   | Common Stock (1,000 shares)         | 2,088       | 3,200    |
| HealthASPex, Inc.<br>(Business Services)  | Preferred Stock (1,000,000 shares)  | 700         | 700      |
|   | Preferred Stock (1,451,380 shares)  | 4,900       | 2,551    |
|   | Common Stock (1,451,380 shares)     | 4           |          |
| The Hillman Companies, Inc. <sup>(1)</sup><br>(Consumer Products)               | Debt Securities                     | 42,472      | 42,472   |
|   | Common Stock (6,890,937 shares)     | 50,645      | 138,863  |
| HMT, Inc.   | Debt Securities                     | 9,104       | 9,104    |

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|                     |                                  |       |       |
|---------------------|----------------------------------|-------|-------|
| (Business Services) | Preferred Stock (554,052 shares) | 2,303 | 2,303 |
|                     | Common Stock (300,000 shares)    | 3,000 | 3,000 |
|                     | Warrants                         | 1,155 | 1,155 |

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

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

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|   |                                    | March 31, 2003 |           |
|---|------------------------------------|----------------|-----------|
| Private Finance<br>Portfolio Company<br>(in thousands, except number of shares) | Investment <sup>(2)</sup>          | (unaudited)    |           |
|   |                                    | Cost           | Value     |
| Housecall Medical Resources, Inc.<br>(Healthcare)                               | Loan                               | \$ 14,975      | \$ 14,975 |
|   | Preferred Stock (3,890,344 shares) | 3,889          | 3,889     |
|   | Common Stock (864,000 shares)      | 86             | 86        |
| Litterer Beteiligungs-GmbH <sup>(3)</sup><br>(Business Services)                | Debt Securities                    | 1,325          | 1,325     |
|   | Equity Interest                    | 295            | 318       |
| MVL Group, Inc.<br>(Business Services)  | Loan                               | 18,698         | 18,698    |
|   | Debt Securities                    | 16,398         | 16,398    |
|   | Common Stock (648,661 shares)      | 810            | 747       |
| Powell Plant Farms, Inc.<br>(Consumer Products)                                 | Loan                               | 26,832         | 26,832    |
|   | Debt Securities                    | 19,224         | 9,709     |
|   | Preferred Stock (1,483 shares)     |                |           |
|   | Warrants                           |                |           |
| Redox Brands, Inc.<br>(Consumer Products)                                       | Loan                               | 3,000          | 3,000     |
|   | Debt Securities                    | 9,940          | 9,940     |
|   | Preferred Stock (2,404,086 shares) | 6,965          | 6,965     |
|   | Warrants                           | 584            | 584       |
| Staffing Partners Holding<br>Company, Inc.<br>(Business Services)               | Debt Securities                    | 6,304          | 6,304     |
|   | Preferred Stock (414,600 shares)   | 4,968          | 4,335     |
|   | Common Stock (50,200 shares)       | 50             |           |
|   | Warrants                           | 10             |           |
| STS Operating, Inc.<br>(Industrial Products)                                    | Preferred Stock (5,769,424 shares) | 6,525          | 6,525     |
|   | Common Stock (3,000,000 shares)    | 3,177          | 3,177     |
| Sure-Tel, Inc.<br>(Consumer Services)   | Preferred Stock (1,000,000 shares) | 1,000          | 1,000     |
|   | Common Stock (37,000 shares)       | 5,018          | 2,614     |
| Total companies more than 25% owned   |                                    | \$671,917      | \$756,685 |
| <b>Companies 5% to 25% Owned</b>  |                                    |                |           |
| Aspen Pet Products, Inc.<br>(Consumer Products)                                 | Loans                              | \$ 16,886      | \$ 16,886 |
|   | Preferred Stock (2,067 shares)     | 2,024          | 2,024     |
|   | Common Stock (1,400 shares)        | 140            | 140       |
| Autania AG <sup>(1,3)</sup><br>(Industrial Products)                            | Common Stock (250,000 shares)      | 2,169          | 2,655     |
| Blue Rhino Corporation <sup>(1)</sup><br>(Consumer Products)                    | Debt Securities                    | 14,074         | 14,074    |
|   | Common Stock (1,070,179 shares)    | 5,076          | 10,926    |
| Border Foods, Inc.<br>(Consumer Products)                                       | Debt Securities                    | 9,402          | 9,402     |
|   | Preferred Stock (50,919 shares)    | 2,000          | 2,000     |

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|  |                             |       |       |
|--|-----------------------------|-------|-------|
|  | Common Stock (1,447 shares) | 35    | 35    |
|  | Warrants                    | 665   | 665   |
| CBA-Mezzanine Capital Finance, LLC<br>(Financial Services) | Loan                        | 6,531 | 6,531 |

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

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

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| Private Finance<br>Portfolio Company<br>(in thousands, except number of shares) | Investment <sup>(2)</sup>          | March 31, 2003 |                      |
|---|------------------------------------|----------------|----------------------|
|   |                                    | Cost           | (unaudited)<br>Value |
| CorrFlex Graphics, LLC<br>(Business Services)                                   | Debt Securities                    | \$ 12,135      | \$ 12,135            |
|   | Warrants                           |                | 19,332               |
|   | Options                            |                | 1,669                |
| The Debt Exchange Inc.<br>(Business Services)                                   | Preferred Stock (921,875 shares)   | 1,250          | 1,250                |
| EDM Consulting, LLC<br>(Business Services)                                      | Debt Securities                    | 1,802          | 269                  |
|   | Equity Interests                   | 250            |                      |
| International Fiber Corporation<br>(Industrial Products)                        | Debt Securities                    | 22,661         | 22,661               |
|   | Common Stock (1,029,069 shares)    | 5,483          | 6,816                |
|   | Warrants                           | 550            | 684                  |
| Liberty-Pittsburgh Systems, Inc.<br>(Business Services)                         | Debt Securities                    | 3,422          | 3,422                |
|   | Common Stock (123,929 shares)      | 142            | 67                   |
| Logic Bay Corporation<br>(Business Services)                                    | Common Stock (1,437,420 shares)    | 5,000          |                      |
| Magna Card, Inc.<br>(Consumer Products)   | Debt Securities                    | 153            | 153                  |
|   | Preferred Stock (1,875 shares)     | 94             | 94                   |
|   | Common Stock (4,687 shares)        |                |                      |
| Master Plan, Inc.<br>(Business Services)  | Loan                               | 959            | 959                  |
|   | Common Stock (156 shares)          | 42             |                      |
| MortgageRamp, Inc.<br>(Business Services)                                       | Common Stock (772,000 shares)      | 3,860          | 2,084                |
| Nobel Learning Communities,<br>Inc. <sup>(1)</sup><br>(Education)               | Debt Securities                    | 9,782          | 9,782                |
|   | Preferred Stock (1,063,830 shares) | 2,000          | 2,000                |
|   | Warrants                           | 575            | 218                  |
| Packaging Advantage Corporation<br>(Business Services)                          | Debt Securities                    | 14,262         | 14,262               |
|   | Common Stock (232,168 shares)      | 2,386          | 2,386                |
|   | Warrants                           | 963            | 963                  |
| Professional Paint, Inc.<br>(Consumer Products)                                 | Debt Securities                    | 23,507         | 23,507               |
|   | Preferred Stock (15,000 shares)    | 20,803         | 20,803               |
|   | Common Stock (110,000 shares)      | 69             | 5,995                |
| Progressive International<br>Corporation<br>(Consumer Products)                 | Debt Securities                    | 3,970          | 3,970                |
|   | Preferred Stock (500 shares)       | 500            | 500                  |
|   | Common Stock (197 shares)          | 13             | 150                  |
|   | Warrants                           |                |                      |
| Prosperco Finanz Holding AG <sup>(3)</sup><br>(Financial Services)              | Convertible Debentures             | 7,616          | 5,000                |
|   | Common Stock (1,528 shares)        | 1,059          |                      |

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| Warrants               |                                 |       |       |
|------------------------|---------------------------------|-------|-------|
| Sidarus Holdings, Inc. | Debt Securities                 | 4,975 | 4,975 |
| (Business Services)    | Preferred Stock (98,000 shares) | 980   | 980   |
|                        | Common Stock (492,941 shares)   | 20    | 20    |
|                        | Warrants                        |       |       |

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

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

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|   |  | March 31, 2003               |                              |
|---|--|------------------------------|------------------------------|
| Private Finance<br>Portfolio Company<br>(in thousands, except number of shares) | Investment <sup>(2)</sup>  | (unaudited)                  |                              |
|   |  | Cost                         | Value                        |
| Total Foam, Inc.<br>(Industrial Products)                                       | Debt Securities<br>Common Stock (164 shares)   | \$ 258<br>10                 | \$ 124                       |
| Total companies 5% to 25% owned   |  | \$210,553                    | \$232,568                    |
| <b>Companies Less Than 5% Owned</b>   |  |                              |                              |
| ACE Products, Inc.<br>(Industrial Products)                                     | Loans  | \$ 17,164                    | \$ 10,562                    |
| Advantage Sales and Marketing,<br>Inc.<br>(Business Services)                   | Debt Securities<br>Warrants  | 10,614<br>382                | 10,614<br>1,556              |
| Alderwoods Group, Inc. <sup>(1)</sup><br>(Consumer Services)                    | Common Stock (357,568 shares)  | 5,006                        | 1,255                        |
| Allied Office Products, Inc.<br>(Business Services)                             | Common Stock (31,333 shares)   | 7,695                        | 50                           |
| American Barbecue & Grill, Inc.<br>(Retail)                                     | Warrants   | 125                          |                              |
| ASW Holding Corporation<br>(Industrial Products)                                | Warrants   | 25                           | 25                           |
| Bakery Chef, Inc.<br>(Consumer Products)  | Loans  | 18,519                       | 18,519                       |
| Camden Partners Strategic Fund II, L.P. <sup>(4)</sup><br>(Private Equity Fund) | Limited Partnership Interest   | 2,425                        | 2,145                        |
| Candlewood Hotel Company <sup>(1)</sup><br>(Hospitality)                        | Preferred Stock (3,250 shares)   | 3,250                        | 635                          |
| Celebrities, Inc.<br>(Broadcasting & Cable)                                     | Loan<br>Warrants   | 198<br>12                    | 198<br>228                   |
| Clif Bar, Inc.<br>(Consumer Products)   | Loan   | 24,900                       | 24,900                       |
| Colibri Holding Corporation<br>(Consumer Products)                              | Debt Securities<br>Preferred Stock (237 shares)<br>Common Stock (3,362 shares)<br>Warrants | 3,493<br>300<br>1,250<br>290 | 3,493<br>300<br>1,088<br>252 |
| Component Hardware Group, Inc.<br>(Industrial Products)                         | Debt Securities<br>Preferred Stock (18,000 shares)   | 11,415<br>2,268              | 11,415<br>2,268              |



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|   |                                |       |       |
|---|--------------------------------|-------|-------|
|   | Common Stock (2,000 shares)    | 200   | 600   |
| Cooper Natural Resources, Inc.<br>(Industrial Products) | Loan                           | 299   | 299   |
|   | Debt Securities                | 1,919 | 1,919 |
|   | Preferred Stock (6,316 shares) | 1,427 | 1,427 |
|   | Warrants                       | 832   | 832   |

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

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

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|   |  | March 31, 2003         |                       |
|---|--|------------------------|-----------------------|
| Private Finance<br>Portfolio Company<br>(in thousands, except number of shares) | Investment <sup>(2)</sup>  | (unaudited)            |                       |
|   |  | Cost                   | Value                 |
| Coverall North America, Inc.<br>(Business Services)                             | Loan<br>Debt Securities  | \$12,407<br>6,425      | \$12,407<br>6,425     |
| CTT Holdings<br>(Consumer Products)   | Loan   | 1,250                  | 1,250                 |
| Drilltec Patents & Technologies<br>Company, Inc.<br>(Industrial Products)       | Loan<br>Debt Securities  | 10,918<br>1,500        |                       |
| eCentury Capital Partners, L.P. <sup>(4)</sup><br>(Private Equity Fund)         | Limited Partnership Interest   | 3,125                  | 1,071                 |
| Elaxis Beta GmbH <sup>(3)</sup><br>(Industrial Products)                        | Options  | 426                    | 289                   |
| Eparfin S.A. <sup>(3)</sup><br>(Consumer Products)                              | Loan   | 29                     | 29                    |
| E-Talk Corporation<br>(Business Services)                                       | Debt Securities<br>Warrants  | 8,852<br>1,157         |                       |
| Executive Greetings, Inc.<br>(Business Services)                                | Debt Securities<br>Warrants  | 18,830<br>360          | 14,315                |
| Fairchild Industrial Products<br>Company<br>(Industrial Products)               | Debt Securities<br>Warrants  | 5,954<br>280           | 5,954                 |
| Frozen Specialities, Inc.<br>(Consumer Products)                                | Debt Securities<br>Warrants  | 9,958<br>435           | 9,958<br>435          |
| Galaxy American<br>Communications, LLC<br>(Broadcasting & Cable)                | Debt Securities<br>Options<br>Standby Letter of Credit (\$37)                      | 49,704                 | 20,000                |
| Garden Ridge Corporation<br>(Retail)  | Debt Securities<br>Preferred Stock (1,130 shares)<br>Common Stock (847,800 shares) | 27,264<br>1,130<br>613 | 25,712                |
| Gibson Guitar Corporation<br>(Consumer Products)                                | Debt Securities<br>Warrants  | 18,154<br>525          | 18,154<br>2,325       |
| Ginsey Industries, Inc.<br>(Consumer Products)                                  | Loans<br>Convertible Debentures<br>Warrants  | 5,000<br>500           | 5,000<br>500<br>2,250 |
| Global Communications, LLC  | Loan   | 2,347                  | 2,347                 |

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|  |                              |        |        |
|--|------------------------------|--------|--------|
| (Business Services)  | Debt Securities              | 16,472 | 16,472 |
|  | Preferred Equity Interest    | 14,067 | 14,067 |
|  | Options                      | 1,639  | 1,639  |
| Grant Broadcasting Systems II<br>(Broadcasting & Cable)            | Warrants                     | 87     | 3,000  |
| Grotech Partners, VI, L.P. <sup>(4)</sup><br>(Private Equity Fund) | Limited Partnership Interest | 3,205  | 2,321  |

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

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| Private Finance<br>Portfolio Company<br>(in thousands, except number of shares) | Investment <sup>(2)</sup>        | March 31, 2003 |          |
|---|----------------------------------|----------------|----------|
|   |                                  | Cost           | Value    |
| The Hartz Mountain Corporation<br>(Consumer Products)                           | Debt Securities                  | \$27,766       | \$27,766 |
|   | Common Stock (200,000 shares)    | 2,000          | 2,000    |
|   | Warrants                         | 2,613          | 2,613    |
| Haven Eldercare of New England, LLC<br>(Healthcare)                             | Loan                             | 35,853         | 35,853   |
| Headwaters Incorporated <sup>(1)</sup><br>(Industrial Products)                 | Loan                             | 9,956          | 9,956    |
| Healthmarket, Inc.<br>(Health Insurance)  | Debt Securities                  | 9,518          | 9,518    |
|   | Warrants                         | 440            | 440      |
| Hotelevision, Inc.<br>(Broadcasting & Cable)                                    | Common Stock (315,100 shares)    | 315            |          |
| Icon International, Inc.<br>(Business Services)                                 | Common Stock (35,101 shares)     | 1,219          | 2,103    |
| Impact Innovations Group, LLC<br>(Business Services)                            | Debt Securities                  | 6,797          | 3,541    |
|   | Warrants                         | 1,674          |          |
| Intellirisk Management Corporation<br>(Business Services)                       | Loan                             | 23,519         | 23,519   |
| Interline Brands, Inc.<br>(Business Services)                                   | Debt Securities                  | 34,351         | 34,351   |
|   | Preferred Stock (199,313 shares) | 1,849          | 1,849    |
|   | Common Stock (15,615 shares)     | 139            | 139      |
|   | Warrants                         | 1,181          | 1,181    |
| Jakel, Inc.<br>(Industrial Products)  | Loan                             | 23,307         | 10,130   |
| JRI Industries, Inc.<br>(Industrial Products)                                   | Debt Securities                  | 1,541          | 1,541    |
|   | Warrants                         | 74             | 39       |
| Julius Koch USA, Inc.<br>(Industrial Products)                                  | Warrants                         | 259            | 5,174    |
| Kirker Enterprises, Inc.<br>(Industrial Products)                               | Equity Interest                  | 4              | 4        |
|   | Warrants                         | 348            | 3,501    |
| Kirkland's, Inc. <sup>(1)</sup><br>(Retail)                                     | Common Stock (122,142 shares)    | 38             | 1,527    |
| Kyrus Corporation<br>(Business Services)  | Debt Securities                  | 6,669          | 6,669    |
|   | Warrants                         | 348            | 450      |

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|  |  |     |     |
|--|--|-----|-----|
| Love Funding Corporation<br>(Financial Services) | Preferred Stock (26,000 shares)              | 359 | 213 |
| Matrics, Inc.<br>(Business Services)             | Preferred Stock (511,876 shares)<br>Warrants | 500 | 500 |

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

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|   |                                  | March 31, 2003 |           |
|---|----------------------------------|----------------|-----------|
| Private Finance<br>Portfolio Company<br>(in thousands, except number of shares) | Investment <sup>(2)</sup>        | (unaudited)    |           |
|   |                                  | Cost           | Value     |
| MedAssets, Inc.<br>(Business Services)  | Debt Securities                  | \$ 16,147      | \$ 16,147 |
|   | Preferred Stock (227,865 shares) | 2,049          | 2,049     |
|   | Warrants                         | 136            | 180       |
| Mid-Atlantic Venture Fund IV, L.P. <sup>(4)</sup><br>(Private Equity Fund)      | Limited Partnership Interest     | 4,725          | 2,838     |
| Midview Associates, L.P.<br>(Housing)   | Warrants                         |                |           |
| Norstan Apparel Shops, Inc.<br>(Retail)   | Debt Securities                  | 11,828         | 11,828    |
|   | Common Stock (29,622 shares)     | 4,750          | 4,750     |
|   | Warrants                         | 655            | 655       |
| North American Archery, LLC<br>(Consumer Products)                              | Loans                            | 1,390          | 840       |
|   | Convertible Debentures           | 2,248          | 59        |
|   | Guaranty (\$1,020)               |                |           |
| Northeast Broadcasting Group, L.P.<br>(Broadcasting & Cable)                    | Debt Securities                  | 254            | 254       |
| Novak Biddle Venture Partners III, L.P. <sup>(4)</sup><br>(Private Equity Fund) | Limited Partnership Interest     | 690            | 548       |
| Nursefinders, Inc.<br>(Business Services)                                       | Debt Securities                  | 11,233         | 11,233    |
|   | Warrants                         | 900            | 1,046     |
| Onyx Television GmbH <sup>(3)</sup><br>(Broadcasting & Cable)                   | Preferred Units                  | 201            |           |
| Opinion Research Corporation <sup>(1)</sup><br>(Business Services)              | Debt Securities                  | 14,401         | 14,401    |
|   | Warrants                         | 996            | 599       |
| Oriental Trading Company, Inc.<br>(Consumer Products)                           | Preferred Equity Interest        | 1,751          | 1,751     |
|   | Common Equity Interest           |                | 3,500     |
| Pico Products, Inc.<br>(Industrial Products)                                    | Loan                             | 1,406          | 1,406     |
| Polaris Pool Systems, Inc.<br>(Consumer Products)                               | Debt Securities                  | 10,814         | 10,814    |
|   | Warrants                         | 1,145          | 1,145     |
| Raytheon Aerospace, LLC<br>(Business Services)                                  | Debt Securities                  | 5,249          | 5,249     |
|   | Equity Interest                  |                | 350       |
| Resun Leasing, Inc.<br>(Business Services)                                      | Loan                             | 30,000         | 30,000    |

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|  |      |        |        |
|--|------|--------|--------|
| Scitor Corporation<br>(Business Services)            | Loan | 22,283 | 22,283 |
| Simula, Inc. <sup>(1)</sup><br>(Industrial Products) | Loan | 21,518 | 21,518 |

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|   |                                 | March 31, 2003 |          |
|---|---------------------------------|----------------|----------|
| Private Finance<br>Portfolio Company<br>(in thousands, except number of shares)     | Investment <sup>(2)</sup>       | (unaudited)    |          |
|   |                                 | Cost           | Value    |
| Soff-Cut Holdings, Inc.<br>(Industrial Products)                                    | Debt Securities                 | \$ 9,394       | \$ 9,394 |
|   | Preferred Stock (300 shares)    | 300            | 300      |
|   | Common Stock (2,000 shares)     | 200            | 200      |
| Southwest PCS, LLC<br>(Telecommunications)  | Loan                            | 1,000          | 1,000    |
| Spa Lending Corporation<br>(Recreation)   | Preferred Stock (28,672 shares) | 424            | 306      |
| Startec Global Communications<br>Corporation <sup>(1)</sup><br>(Telecommunications) | Loan                            | 25,715         | 25,715   |
|   | Debt Securities                 | 20,670         |          |
| SunStates Refrigerated Services,<br>Inc.<br>(Warehouse Facilities)                  | Loans                           | 4,592          | 1,490    |
|   | Debt Securities                 | 2,445          |          |
| Sydran Food Services II, L.P.<br>(Retail)   | Debt Securities                 | 12,973         | 9,949    |
|   | Equity Interests                | 3,747          |          |
|   | Warrants                        | 162            |          |
| Tubbs Snowshoe Company, LLC<br>(Consumer Products)                                  | Debt Securities                 | 3,931          | 3,931    |
|   | Equity Interests                | 500            | 379      |
|   | Warrants                        | 54             |          |
| United Pet Group, Inc.<br>(Consumer Products)                                       | Debt Securities                 | 9,091          | 9,091    |
|   | Warrants                        | 85             | 235      |
| Updata Venture Partners II, L.P. <sup>(4)</sup><br>(Private Equity Fund)            | Limited Partnership Interest    | 1,602          | 1,990    |
| U.S. Security Holdings, Inc.<br>(Business Services)                                 | Debt Securities                 | 24,134         | 24,134   |
|   | Warrants                        | 826            | 1,100    |
| Venturehouse Group, LLC <sup>(4)</sup><br>(Private Equity Fund)                     | Equity Interest                 | 1,000          | 384      |
| Walker Investment Fund II, LLLP <sup>(4)</sup><br>(Private Equity Fund)             | Limited Partnership Interest    | 1,178          | 419      |
| Warn Industries, Inc.<br>(Consumer Products)  | Debt Securities                 | 4,406          | 4,406    |
|   | Warrants                        | 1,429          | 4,000    |
| Wilshire Restaurant Group, Inc.<br>(Retail)   | Debt Securities                 | 16,437         | 16,437   |
|   | Warrants                        | 735            | 541      |
| Wilton Industries, Inc.   | Loan                            | 9,600          | 9,600    |



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|   |                           | March 31, 2003 |              |
|---|---------------------------|----------------|--------------|
| Private Finance<br>Portfolio Company<br>(in thousands, except number of shares) | Investment <sup>(2)</sup> | (unaudited)    |              |
|   |                           | Cost           | Value        |
| Woodstream Corporation<br>(Consumer Products)                                   | Loan                      | \$ 2,621       | \$ 2,621     |
|   | Debt Securities           | 7,689          | 7,689        |
|   | Equity Interests          | 1,700          | 5,535        |
|   | Warrants                  | 450            | 1,465        |
| Total companies less than 5% owned  |                           | \$ 865,117     | \$ 752,831   |
| Total private finance (121 portfolio companies)                                 |                           | \$ 1,747,587   | \$ 1,742,084 |

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| (in Thousands)   | Stated Interest | Face       | March 31, 2003 |            |
|--|-----------------|------------|----------------|------------|
|  |                 |            | Cost           | Value      |
| <b>Commercial Real Estate Finance</b>                                  |                 |            |                |            |
| <b>Commercial Mortgage-Backed Securities</b>                           |                 |            |                |            |
| Mortgage Capital Funding, Series 1998-MC3                              | 5.5%            | \$ 47,103  | \$ 25,475      | \$ 23,641  |
| Morgan Stanley Capital I, Series 1999-RM1                              | 6.4%            | 29,629     | 9,673          | 10,026     |
| COMM 1999-1  | 5.7%            | 57,163     | 26,081         | 27,158     |
| Morgan Stanley Capital I, Series 1999-FNV1                             | 6.1%            | 28,595     | 14,081         | 11,835     |
| DLJ Commercial Mortgage Trust 1999-CG2                                 | 6.1%            | 44,635     | 14,016         | 15,142     |
| Commercial Mortgage Acceptance Corp., Series 1999-C1                   | 6.8%            | 18,346     | 5,233          | 5,962      |
| LB Commercial Mortgage Trust, Series 1999-C2                           | 6.7%            | 11,603     | 1,781          | 1,768      |
| Chase Commercial Mortgage Securities Corp., Series 1999-2              | 6.5%            | 20,545     | 5,561          | 6,184      |
| FUNB CMT, Series 1999-C4   | 6.5%            | 22,887     | 7,869          | 7,048      |
| Heller Financial, HFCMC Series 2000 PH-1                               | 6.6%            | 25,767     | 8,796          | 9,096      |
| SBMS VII, Inc., Series 2000-NL1  | 7.2%            | 9,214      | 4,564          | 3,844      |
| DLJ Commercial Mortgage Trust, Series 2000-CF1                         | 7.0%            | 24,328     | 9,434          | 9,808      |
| Deutsche Bank Alex. Brown, Series Comm 2000-C1                         | 6.9%            | 17,922     | 5,284          | 4,009      |
| LB-UBS Commercial Mortgage Trust, Series 2000-C4                       | 6.9%            | 17,484     | 4,059          | 4,101      |
| Credit Suisse First Boston Mortgage Securities Corp., Series 2001-CK1  | 5.9%            | 16,805     | 4,109          | 3,954      |
| JP Morgan-CIBC-Deutsche 2001   | 5.8%            | 25,370     | 6,886          | 6,936      |
| Lehman Brothers-UBS Warburg 2001-C2                                    | 6.4%            | 22,756     | 6,623          | 6,606      |
| SBMS VII, Inc., Series 2001-C1   | 6.1%            | 23,049     | 5,664          | 5,169      |
| GE Capital Commercial Mortgage Securities Corp., Series 2001-2         | 6.1%            | 21,228     | 6,306          | 5,946      |
| Credit Suisse First Boston Mortgage Securities Corp., Series 2001-CKN5 | 5.2%            | 21,456     | 5,210          | 5,184      |
| JP Morgan Chase Commercial Mortgage Securities Corp., Series 2001-C1   | 5.6%            | 24,493     | 5,891          | 5,609      |
| SBMS VII, Inc., Series 2001-C2   | 6.2%            | 21,619     | 5,922          | 5,956      |
| FUNB CMT, Series 2002-C1   | 6.0%            | 28,303     | 11,526         | 12,123     |
| GE Capital Commercial Mortgage Corp., Series 2002-1                    | 6.2%            | 50,631     | 24,929         | 29,475     |
| GMAC Commercial Mortgage Securities, Inc., Series 2002-C2              | 5.8%            | 40,573     | 20,044         | 22,332     |
| GE Capital Commercial Mortgage Corp., Series 2002-3                    | 5.1%            | 50,047     | 22,548         | 23,340     |
| Morgan Stanley Dean Witter Capital I Trust 2002-IQ3                    | 6.0%            | 27,858     | 13,150         | 13,688     |
| LB-UBS Commercial Mortgage Trust 2003-C1                               | 4.6%            | 50,896     | 22,040         | 21,660     |
| GS Mortgage Securities Corporation II Series 2003-C1                   | 4.7%            | 39,543     | 19,046         | 18,900     |
| Total commercial mortgage-backed securities                            |                 | \$ 839,848 | \$ 321,801     | \$ 326,500 |
| <b>Collateralized Debt Obligations</b>                                 |                 |            |                |            |
| Crest 2001-1, Ltd. <sup>(3)</sup>                                      |                 |            | \$ 23,655      | \$ 23,655  |
| Crest 2002-1, Ltd. <sup>(3)</sup>                                      |                 |            | 23,728         | 23,728     |
| Crest 2002-IG, Ltd. <sup>(3)</sup>                                     |                 |            | 4,798          | 4,798      |
| Crest Clarendon Street 2002-1, Ltd. <sup>(3)</sup>                     |                 |            | 979            | 979        |
| Crest 2003-1, Ltd. <sup>(3)</sup>                                      |                 |            | 118,802        | 118,802    |
| Total collateralized debt obligations                                  |                 |            | \$ 171,962     | \$ 171,962 |

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(3) Non-U.S. company.

(4) Non-registered investment company.

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

|                                      |  | March 31, 2003     |             |             |
|--------------------------------------|--|--------------------|-------------|-------------|
|                                      |  | (unaudited)        |             |             |
| Interest<br>Rate Ranges              |  | Number of<br>Loans | Cost        | Value       |
| <b>Commercial Mortgage Loans</b>     |  |                    |             |             |
| Up to 6.99%                          |  | 13                 | \$ 11,122   | \$ 12,419   |
| 7.00% 8.99%                          |  | 20                 | 29,733      | 26,603      |
| 9.00% 10.99%                         |  | 6                  | 7,736       | 7,666       |
| 11.00% 12.99%                        |  | 15                 | 19,587      | 12,286      |
| 13.00% 14.99%                        |  | 6                  | 6,466       | 4,740       |
| Total commercial mortgage loans      |  | 60                 | \$ 74,644   | \$ 63,714   |
| <b>Residual Interest</b>             |  |                    | \$ 69,335   | \$ 69,035   |
| <b>Real Estate Owned</b>             |  |                    | 6,030       | 3,642       |
| Total commercial real estate finance |  |                    | \$ 643,772  | \$ 634,853  |
| Total portfolio                      |  |                    | \$2,391,359 | \$2,376,937 |

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**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**(Information at and for the three months ended March 31, 2003 and 2002 is unaudited)**

**Note 1. Organization**

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

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

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

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

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

***Basis of Presentation***

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

The accompanying unaudited consolidated financial statements of the Company have been prepared in accordance with accounting principles generally accepted in the United States of America ( GAAP ) for interim financial information. Accordingly, they do not include all of the information and footnotes required by GAAP for complete consolidated financial statements. In the opinion of management, the unaudited consolidated financial results of the Company included herein contain all adjustments (consisting of only normal recurring accruals) necessary to present fairly the financial position of the Company as of March 31, 2003, and the results of operations, changes in net assets, and cash flows for the three months ended March 31, 2003 and 2002. The results of operations for the three months ended March 31, 2003, are not necessarily indicative of the operating results to be expected for the full year.

During 2002, the Company revised its financial statement presentation to provide additional detail for the private finance portfolio, the interest and related portfolio income and net realized gains or losses by presenting these balances in the three categories described below. The consolidated

**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**

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

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

statement of operations for the three months ended March 31, 2002, has been revised to conform to this presentation.

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

***Valuation Of Portfolio Investments***

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

***Loans and Debt Securities***

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

When the Company receives nominal cost warrants or free equity securities (nominal cost equity), the Company allocates its cost basis in its investment between its debt securities and its

**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**

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

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

nominal cost equity at the time of origination. At that time, the original issue discount basis of the nominal cost equity is recorded by increasing the cost basis in the equity and decreasing the cost basis in the related debt securities.

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

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

***Equity Securities***

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

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

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

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

CMBS bonds and CDO bonds and preferred shares are carried at fair value, which is based on a discounted cash flow model that utilizes prepayment and loss assumptions based on historical experience and projected performance, economic factors, the characteristics of the underlying cash flow, and comparable market yields for similar CMBS bonds and CDO bonds and preferred shares. The Company's assumption with regard to the discount rate for determining fair value is based on the yield of comparable securities. The Company recognizes income from the amortization of original issue discount using the effective interest method, using the anticipated yield over the projected life of



**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**

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

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

the investment. Yields are revised when there are changes in estimates of future credit losses, actual losses incurred, or actual and estimated prepayment speeds. Changes in estimated yield are recognized as an adjustment to the estimated yield over the remaining life of the CMBS bonds and CDO bonds and preferred shares from the date the estimated yield is changed. The Company recognizes unrealized appreciation or depreciation on its CMBS bonds and CDO bonds and preferred shares as comparable yields in the market change and based on changes in estimated cash flows resulting from changes in prepayment or loss assumptions in the underlying collateral pool.

***Residual Interest***

The Company values its residual interest from a previous securitization and recognizes income using the same accounting policies used for the CMBS bonds. The residual interest is carried at fair value generally based on discounted estimated future cash flows (see Note 3). The Company recognizes income from the residual interest using the effective interest method. At each reporting date, the effective yield is recalculated and used to recognize income until the next reporting date.

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

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

***Fee Income***

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

***Deferred Financing Costs***

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

***Cash and Cash Equivalents***

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

## ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

*Dividends to Shareholders*

Dividends to shareholders are recorded on the record date.

*Stock Compensation Plans*

At March 31, 2003 and 2002, the Company had a stock-based employee compensation plan. The Company accounts for this plan under the recognition and measurement principles of APB Opinion No. 25, *Accounting for Stock Issued to Employees*, and related Interpretations. No stock-based employee compensation cost is reflected in net increase in net assets resulting from operations, as all options granted under this plan had an exercise price equal to the market value of the underlying common stock on the date of grant. The following table illustrates the effect on net increase in net assets resulting from operations and earnings per share if the Company had applied the fair value recognition provisions of FASB Statement No. 123, *Accounting for Stock-Based Compensation*, to stock-based employee compensation.

|  | For the Three<br>Months Ended<br>March 31, |           |
|--|--|-----------|
|  | 2003                                       | 2002      |
| (in thousands, except per share amounts)   |  |           |
| Net increase in net assets resulting from operations as reported   | \$ 19,873                                  | \$ 55,961 |
| Less total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects | (1,348)                                    | (1,658)   |
| Pro forma net increase in net assets resulting from operations   | 18,525                                     | 54,303    |
| Less preferred stock dividends   | (55)                                       | (55)      |
| Pro forma income available to common shareholders  | \$ 18,470                                  | \$ 54,248 |
| Basic earnings per common share:   |  |           |
| As reported  | \$ 0.18                                    | \$ 0.56   |
| Pro forma  | \$ 0.17                                    | \$ 0.54   |
| Diluted earnings per common share:   |  |           |
| As reported  | \$ 0.18                                    | \$ 0.55   |
| Pro forma  | \$ 0.17                                    | \$ 0.53   |

## ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

Pro forma expenses are based on the underlying value of the options granted by the Company. The fair value of each option grant is estimated on the date of grant using the Black-Scholes option pricing model, with the following weighted average assumptions for grants:

|  | <b>For the Three<br/>Months Ended<br/>March 31,</b> |             |
|--|---|-------------|
|  | <b>2003</b>   | <b>2002</b> |
| Risk-free interest rate                | 2.8%  | 4.4%        |
| Expected life                          | 5.0   | 5.0         |
| Expected volatility                    | 39.1%   | 39.7%       |
| Dividend yield                         | 8.9%  | 8.5%        |
| Weighted average fair value per option | \$3.23  | \$4.98      |

***Federal and State Income Taxes***

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

***Per Share Information***

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

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

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

The consolidated financial statements include portfolio investments at value of \$2.4 billion and \$2.5 billion as of March 31, 2003, and December 31, 2002, respectively (92% and 89%, respectively, of total assets). Substantially all of these investments represent investments whose fair values have been determined by the board of directors in good faith in the absence of readily ascertainable 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.

## ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

*New Accounting Pronouncements*

In November 2002, the FASB issued Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others* (the Interpretation) which expands on the accounting guidance of Statements No. 5, 57 and 107 and incorporates without change the provisions of FASB Interpretation No. 34, which is being superceded. The Interpretation will significantly change current practice in the accounting for and disclosure of guarantees. Guarantees meeting the characteristics described in the Interpretation are to be recognized at fair value and significant disclosure rules have been implemented even if the likelihood of the guarantor making payments is remote. The disclosure requirements are effective for financial statements of interim or annual periods ending after December 15, 2002, while the initial measurement provisions are applicable on a prospective basis to guarantees issued or modified after December 31, 2002. Certain guarantees are excluded from the initial recognition provisions of the Interpretation, however specific disclosures are still required. The Company has applied the initial recognition and measurement provisions for guarantees issued in the first quarter of 2003 and there was no material effect on the Company's financial position or its results of operations. See Note 5 for the disclosures related to the Company's guarantees.

In January 2003, the FASB issued Interpretation No. 46, *Consolidation of Variable Interest Entities* (the Interpretation) which provides new guidance on the consolidation of certain entities defined as variable interest entities. The Interpretation specifies that any enterprise subject to SEC Regulation S-X Rule 6-03(c)(1) shall not consolidate any entity that is not also subject to that same rule. As the Company is subject to this rule, it does not believe that the Interpretation will have an impact on its financial position or results of operations.

## Note 3. Portfolio

*Private Finance*

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

|                           | 2003         |              |                      | 2002         |              |                      |
|---------------------------|--------------|--------------|----------------------|--------------|--------------|----------------------|
|                           | Cost         | Value        | Yield                | Cost         | Value        | Yield                |
| (\$ in thousands)         |              |              |                      |              |              |                      |
| Loans and debt securities | \$ 1,276,957 | \$ 1,148,289 | 14.0% <sup>(1)</sup> | \$ 1,272,401 | \$ 1,151,256 | 14.4% <sup>(1)</sup> |
| Equity interests          | 470,630      | 593,795      |                      | 438,501      | 591,959      |                      |
| Total                     | \$ 1,747,587 | \$ 1,742,084 |                      | \$ 1,710,902 | \$ 1,743,215 |                      |

(1) The weighted average yield on loans and debt securities is computed as the (a) annual stated interest rate earned plus the annual amortization of loan origination fees, original issue discount, and market discount earned on accruing loans and debt securities, divided by (b) total loans and debt securities at value. At March 31, 2003, the cost and value of loans and debt securities include the Class A equity interests in BLX and the yield includes dividends earned on these equity interests. The weighted average yield is computed as of the balance sheet date.

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



ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

**Note 3. Portfolio, continued**

warrants or options in a private company. Private finance investments are generally issued by privately owned companies and are generally illiquid and subject to restrictions on resale or transferability.

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

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

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

At March 31, 2003, and December 31, 2002, the Company had an investment at value totaling \$307.6 million and \$256.8 million, respectively, in Business Loan Express, LLC (BLX), a small business lender that participates in the U.S. Small Business Administration 7(a) Guaranteed Loan Program. During the first quarter of 2003, the Company invested \$50 million in BLX in the form of a \$25 million short-term line of credit and \$25 million of preferred equity in connection with BLX's acquisition of \$128 million in assets from Amresco Independence Funding, Inc. BLX also completed its corporate reorganization to a limited liability company during the quarter by merging BLX, Inc. into BLX, LLC. Prior to this transaction, BLX converted \$43 million of the Company's subordinated debt to preferred stock in BLX, Inc., which was exchanged upon the merger for Class A equity interests of BLX, LLC. In addition, as part of the merger, the Company exchanged its existing preferred stock and common equity investments in BLX, Inc. for similar classes of member's equity in BLX, LLC represented by Class B and Class C equity interests, respectively. At March 31, 2003, the Company owned 94.9% of the voting Class C equity interests. BLX has a stock appreciation rights plan for management which will dilute the value available to the Class C equity interest holders.

At the time of the corporate reorganization of BLX, Inc. from a C corporation to a limited liability company, for tax purposes BLX had a built-in gain representing the aggregate fair market value of its assets in excess of the tax basis of its assets. As a regulated investment company, the Company will be subject to the built-in gain rules on the assets of BLX. Under these rules, taxes will be payable by the Company at the time and to the extent that the built-in gains on BLX's assets at the date of reorganization are recognized in a taxable disposition of such assets in the 10-year period following the date of the reorganization. At such time, the built-in gains realized upon the disposition of these assets will be included in the Company's taxable income, net of the corporate level taxes paid by the Company on the built-in gains. However, if these assets are disposed of after the 10-year period, there will be no corporate level taxes on these built-in gains.

While the Company has no obligation to pay the built-in gains tax until these assets are disposed of in the future, it may be necessary to record a liability for these taxes in the future should the Company intend to sell the assets of BLX within the 10-year period. The Company estimates its future tax liability resulting from the built-in gains at the date of BLX's reorganization may total up

## ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

**Note 3. Portfolio, continued**

to \$42 million. At March 31, 2003, the Company has considered the increase in fair value of its investment in BLX due to BLX's tax attributes as an LLC and has also considered the corresponding reduction in fair value of its investment due to these estimated built-in gain taxes in determining the fair value of its investment in BLX.

As the controlling equity owner of BLX, the Company has provided an unconditional guaranty to the BLX credit facility lenders in an amount up to 50% of the total obligations (consisting of principal, accrued interest, and other fees) on BLX's three-year unsecured \$149.0 million revolving credit facility that matures in March 2004. The amount guaranteed by the Company at March 31, 2003, was \$57.2 million. This guaranty can be called by the lenders only in the event of a default by BLX. BLX was in compliance with the terms of its credit facility at March 31, 2003. The Company has also provided two standby letters of credit in connection with two term securitization transactions completed by BLX totaling \$10.6 million. In consideration for providing this guaranty and the two standby letters of credit, BLX paid the Company a fee of \$1.0 million and \$0.8 million for the three months ended March 31, 2003 and 2002, respectively. BLX is headquartered in New York, NY.

At March 31, 2003, and December 31, 2002, the Company had an investment in The Hillman Companies, Inc. ( Hillman ) totaling \$181.3 million and \$180.5 million at value, respectively. At March 31, 2003, the Company owned 96.8% of Hillman's common stock. The Company's common stock ownership is subject to dilution by management options. Hillman is a leading manufacturer of key making equipment and distributor of key blanks, fasteners, signage, and other small hardware components and operates in multiple channels of the retail marketplace such as hardware stores, national and regional home centers, and mass merchants. Hillman has certain patent-protected products, including key duplication technology, that is important to its business. Hillman's primary operations are located in Cincinnati, Ohio.

Total interest and portfolio related income earned from the Company's investments in BLX and Hillman for the three months ended March 31, 2003 and 2002, was \$15.3 million and \$12.3 million, respectively.

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

| (in thousands)                | 2003     | 2002     |
|-------------------------------|----------|----------|
| Companies more than 25% owned | \$20,798 | \$ 9,709 |
| Companies 5% to 25% owned     | 393      | 411      |
| Companies less than 5% owned  | 60,936   | 65,931   |
| Total                         | \$82,127 | \$76,051 |

In addition to Grade 4 and 5 assets that are in workout, the Company may not accrue interest on loans and debt securities to companies that are more than 50% owned by the Company if such companies are in need of additional working capital and, therefore, the Company may defer current debt service. Loans and debt securities to such companies totaled \$58.5 million and \$63.6 million at value at March 31, 2003, and December 31, 2002, respectively. In addition, loans to companies that are less than 50% owned by the Company and were not in workout but were not accruing interest

## ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

**Note 3. Portfolio, continued**

totaled \$21.6 million and \$7.2 million at value at March 31, 2003, and December 31, 2002, respectively.

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

|                          | <u>2003</u>       | <u>2002</u>       |
|--------------------------|-------------------|-------------------|
| <b>Industry</b>          |                   |                   |
| Consumer products        | 32%               | 34%               |
| Business services        | 26                | 26                |
| Financial services       | 18                | 16                |
| Industrial products      | 8                 | 9                 |
| Healthcare               | 5                 | 5                 |
| Retail                   | 4                 | 4                 |
| Telecommunications       | 2                 | 2                 |
| Education                | 1                 | 1                 |
| Broadcasting & cable     | 1                 | 1                 |
| Other                    | 3                 | 2                 |
|                          | <u>          </u> | <u>          </u> |
| Total                    | 100%              | 100%              |
|                          | <u>          </u> | <u>          </u> |
| <b>Geographic Region</b> |                   |                   |
| Mid-Atlantic             | 49%               | 45%               |
| Southeast                | 15                | 16                |
| West                     | 15                | 15                |
| Midwest                  | 13                | 16                |
| Northeast                | 7                 | 7                 |
| International            | 1                 | 1                 |
|                          | <u>          </u> | <u>          </u> |
| Total                    | 100%              | 100%              |
|                          | <u>          </u> | <u>          </u> |

**Commercial Real Estate Finance**

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

|   | <u>2003</u> |              |              | <u>2002</u> |              |              |
|---|-------------|--------------|--------------|-------------|--------------|--------------|
|   | <u>Cost</u> | <u>Value</u> | <u>Yield</u> | <u>Cost</u> | <u>Value</u> | <u>Yield</u> |
| (\$ in thousands)   |             |              |              |             |              |              |
| CMBS bonds  | \$321,801   | \$326,500    | 15.5%        | \$523,671   | \$555,519    | 14.2%        |
| Collateralized debt obligation bonds and preferred shares | 171,962     | 171,962      | 16.4%        | 52,818      | 52,818       | 17.2%        |
| Loans   | 74,644      | 63,714       | 7.0%         | 66,546      | 63,707       | 7.5%         |
| Residual interest   | 69,335      | 69,035       | 9.4%         | 69,335      | 69,035       | 9.4%         |
| Real estate owned   | 6,030       | 3,642        |              | 5,942       | 3,873        |              |



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|       |                  |                  |                  |                  |
|-------|------------------|------------------|------------------|------------------|
| Total | <u>\$643,772</u> | <u>\$634,853</u> | <u>\$718,312</u> | <u>\$744,952</u> |
|-------|------------------|------------------|------------------|------------------|

## ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

## Note 3. Portfolio, continued

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

| (\$ in thousands)       | 2003       | 2002         |
|-------------------------|------------|--------------|
| Face                    | \$ 839,848 | \$ 1,173,194 |
| Original issue discount | (518,047)  | (649,523)    |
| Cost                    | \$ 321,801 | \$ 523,671   |
| Value                   | \$ 326,500 | \$ 555,519   |

The non-investment grade and unrated tranches of the CMBS bonds in which the Company invests are junior in priority for payment of interest and principal to the more senior tranches of the related CMBS bond issuance. Cash flow from the underlying mortgages generally is allocated first to the senior tranches, with the most senior tranches having a priority right to the cash flow. Then, any remaining cash flow is allocated, generally, among the other tranches in order of their relative seniority. To the extent there are defaults and unrecoverable losses on the underlying mortgages or the properties securing those mortgages resulting in reduced cash flows, the most subordinate tranche will bear this loss first. At March 31, 2003, the Company's CMBS bonds were subordinate to 91% to 99% of the tranches of bonds issued in various CMBS transactions. Given that the non-investment grade CMBS bonds in which the Company invests are junior in priority for payment of principal, the Company invests in these CMBS bonds at a significant discount from the face amount of the bonds.

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

| (\$ in thousands) | 2003       |                     | 2002       |                     |
|-------------------|------------|---------------------|------------|---------------------|
|                   | Value      | Percentage of Total | Value      | Percentage of Total |
| BB+               | \$ 37,774  | 11.6%               | \$ 49,811  | 9.0%                |
| BB                | 25,493     | 7.8                 | 39,011     | 7.0                 |
| BB-               | 15,688     | 4.8                 | 22,030     | 4.0                 |
| B+                | 24,772     | 7.6                 | 121,038    | 21.8                |
| B                 | 23,961     | 7.3                 | 141,998    | 25.6                |
| B-                | 78,684     | 24.1                | 83,493     | 15.0                |
| CCC+              | 10,868     | 3.3                 |            |                     |
| CCC               | 15,030     | 4.6                 | 8,634      | 1.5                 |
| Unrated           | 94,230     | 28.9                | 89,504     | 16.1                |
| Total             | \$ 326,500 | 100.0%              | \$ 555,519 | 100.0%              |

At March 31, 2003, and December 31, 2002, the underlying collateral for the Company's CMBS bonds consisted of approximately 4,600 and 4,500 commercial mortgage loans and real estate properties owned with a total outstanding principal balance of \$27.8 billion and \$25.0 billion, respectively. At March 31, 2003, and December 31, 2002, 0.9% and 1.0%, respectively, of the mortgage loans in the underlying collateral pool for the Company's CMBS bonds were over 30 days delinquent or were classified as real estate owned.



## ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

## Note 3. Portfolio, continued

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

|                          | 2003  | 2002  |
|--------------------------|-------|-------|
|                          | _____ | _____ |
| <b>Property Type</b>     |       |       |
| Retail                   | 33%   | 32%   |
| Housing                  | 26    | 27    |
| Office                   | 23    | 21    |
| Industrial Real Estate   | 6     | 7     |
| Hospitality              | 6     | 6     |
| Other                    | 6     | 7     |
|                          | _____ | _____ |
| Total                    | 100%  | 100%  |
|                          | _____ | _____ |
| <b>Geographic Region</b> |       |       |
| West                     | 30%   | 31%   |
| Mid-Atlantic             | 27    | 25    |
| Midwest                  | 22    | 22    |
| Southeast                | 16    | 17    |
| Northeast                | 5     | 5     |
|                          | _____ | _____ |
| Total                    | 100%  | 100%  |
|                          | _____ | _____ |

The Company's yield on its CMBS bonds is based upon a number of assumptions that are subject to certain business and economic uncertainties and contingencies. Examples include the timing and magnitude of credit losses on the mortgage loans underlying the CMBS bonds that are a result of the general condition of the real estate market (including vacancies, rental rates and tenant credit quality) and changes in market rental rates. The initial yield on each CMBS bond has been computed assuming an approximate 1% loss rate on its entire underlying collateral mortgage pool, with the estimated losses being assumed to occur in three equal installments in years three, six, and nine. As each CMBS bond ages, the amount of losses and the expected timing of recognition of such losses will be updated, and the respective yield will be adjusted as necessary. As of March 31, 2003, the Company had identified and recorded specific losses of \$28.0 million, which reduced the face amount and original issue discount on the CMBS bonds, but did not result in a change in the cost and value of the CMBS bonds. As these uncertainties and contingencies are difficult to predict and are subject to future events which may alter these assumptions, no assurance can be given that the anticipated yields to maturity will be achieved.

**Collateralized Debt Obligation Bonds and Preferred Shares ( CDOs ).** At March 31, 2003, the Company owned BBB rated bonds in one CDO totaling \$29.7 million at value and preferred shares in five CDOs totaling \$142.3 million at value secured by investment grade unsecured debt issued by various real estate investment trusts ( REITs ) and investment and non-investment grade CMBS bonds. The investment grade REIT collateral consists of debt with a cut-off balance of \$1.2 billion and was issued by 44 REITs. The investment grade CMBS collateral consists of CMBS bonds with a face amount of \$496.0 million issued in 41 separate CMBS transactions and the non-investment grade CMBS collateral consists of BB+, BB, BB-, B+, and B rated CMBS bonds with a face amount of \$873.7 million issued in 42 separate CMBS transactions ( CMBS Collateral ). Included in the CMBS Collateral for the CDOs are \$793.7 million of CMBS bonds that are senior in priority

## ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

**Note 3. Portfolio, continued****of repayment to certain lower rated CMBS bonds held by the Company, which were issued in 27 separate CMBS transactions.**

The BBB rated bonds and the preferred shares owned by the Company are junior in priority for payment of principal and interest to the more senior tranches of debt issued by the CDOs. To the extent there are defaults and unrecoverable losses on the underlying collateral resulting in reduced cash flows, the preferred shares will bear this loss first and then the BBB rated bonds would bear any loss after the preferred shares. At March 31, 2003, the Company's BBB bonds and preferred shares in the CDOs were subordinate to 61% to 98% of the more senior tranches of debt issued in various CDO transactions.

As of March 31, 2003, the Company acts as the disposition consultant with respect to four of the CDOs, which allows the Company to approve disposition plans for individual collateral securities. As of March 31, 2002, the Company acted as the disposition consultant with respect to two of the CDOs. For these services, the Company collects annual fees based on the outstanding collateral pool balance, and for the quarters ended March 31, 2003 and 2002, this fee totaled \$201 thousand and \$37 thousand, respectively.

**Loans.** The commercial mortgage loan portfolio contains loans that were originated by the Company or were purchased from third-party sellers. At March 31, 2003, and December 31, 2002, approximately 85% and 15% and 84% and 16% of the Company's commercial mortgage loan portfolio was composed of fixed and adjustable interest rate loans, respectively. As of March 31, 2003, and December 31, 2002, loans with a value of \$16.3 million and \$13.0 million, respectively, were not accruing interest. Loans greater than 120 days delinquent generally do not accrue interest.

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

|                          | <u>2003</u> | <u>2002</u> |
|--------------------------|-------------|-------------|
| <b>Property Type</b>     |             |             |
| Retail                   | 25%         | 21%         |
| Office                   | 20          | 20          |
| Hospitality              | 20          | 23          |
| Healthcare               | 15          | 15          |
| Recreation               | 3           | 3           |
| Other                    | 17          | 18          |
|                          | <u>    </u> | <u>    </u> |
| Total                    | 100%        | 100%        |
|                          | <u>    </u> | <u>    </u> |
| <b>Geographic Region</b> |             |             |
| Southeast                | 39%         | 40%         |
| West                     | 22          | 20          |
| Mid-Atlantic             | 17          | 17          |
| Midwest                  | 11          | 12          |
| Northeast                | 11          | 11          |
|                          | <u>    </u> | <u>    </u> |
| Total                    | 100%        | 100%        |
|                          | <u>    </u> | <u>    </u> |

## ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

**Note 3. Portfolio, continued**

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

| (in thousands)           | 2003             |                  | 2002             |                  |
|--------------------------|------------------|------------------|------------------|------------------|
|                          | Cost             | Value            | Cost             | Value            |
| Residual interest        | \$ 68,853        | \$ 68,853        | \$ 68,853        | \$ 68,853        |
| Residual interest spread | 482              | 182              | 482              | 182              |
| <b>Total</b>             | <b>\$ 69,335</b> | <b>\$ 69,035</b> | <b>\$ 69,335</b> | <b>\$ 69,035</b> |

The residual interest primarily consists of a retained interest totaling \$68.9 million from a 1998 asset securitization. At March 31, 2003, one class of bonds rated AAA was outstanding, totaling \$6.0 million. The residual interest represents a right to cash flows from the underlying collateral pool of loans after these senior bond obligations are satisfied. The Company had the right to call the bonds upon a minimum of ten days notice to the bondholders. During April 2003, the call provision was exercised and, accordingly, the bondholders were repaid in full and the remaining available cash, loans, and real estate owned of the trust were subsequently returned to the Company as payment on the residual interest.

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

Because the Company was in the process of exercising its call provision at March 31, 2003, the fair value of the Residual was determined based upon an analysis of the value of each of the underlying assets and liabilities of the trust as opposed to a discounted cash flow analysis.

**Note 4. Debt**

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

| (in thousands)                            | 2003            |                | 2002            |                |
|---|-----------------|----------------|-----------------|----------------|
|   | Facility Amount | Amount Drawn   | Facility Amount | Amount Drawn   |
| Notes payable and debentures:             |                 |                |                 |                |
| Unsecured long-term notes payable         | \$ 694,000      | \$ 694,000     | \$ 694,000      | \$ 694,000     |
| SBA debentures                            | 101,800         | 94,500         | 101,800         | 94,500         |
| OPIC loan                                 | 5,700           | 5,700          | 5,700           | 5,700          |
| <b>Total notes payable and debentures</b> | <b>801,500</b>  | <b>794,200</b> | <b>801,500</b>  | <b>794,200</b> |

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|                          |                     |                   |                     |                   |
|--------------------------|---------------------|-------------------|---------------------|-------------------|
| Revolving line of credit | <u>527,500(1)</u>   | <u>61,750</u>     | <u>527,500</u>      | <u>204,250</u>    |
| Total                    | <u>\$ 1,329,000</u> | <u>\$ 855,950</u> | <u>\$ 1,329,000</u> | <u>\$ 998,450</u> |

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(1) On April 18, 2003, the Company renewed the revolving line of credit. The committed amount under the renewed facility is \$462.5 million.

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## ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

## Note 4. Debt, continued

*Notes Payable and Debentures*

**Unsecured Long-Term Notes Payable.** The Company issued unsecured long-term notes to private institutional investors. The notes require semi-annual interest payments until maturity and have original terms of five or seven years. At March 31, 2003, the notes had remaining maturities of two months to four years. The weighted average fixed interest rate on the notes was 7.6% at March 31, 2003, and December 31, 2002. The notes may be prepaid in whole or in part, together with an interest premium, as stipulated in the note agreement.

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

**SBA Debentures.** At March 31, 2003, and December 31, 2002, the Company had debentures payable to the SBA with original terms of ten years and at fixed interest rates ranging from 5.9% to 8.2%. At March 31, 2003, the debentures had remaining maturities of two to nine years. The weighted average interest rate was 7.0% at March 31, 2003, and December 31, 2002. The debentures require semi-annual interest-only payments with all principal due upon maturity. The SBA debentures are subject to prepayment penalties if paid prior to the fifth anniversary date of the notes. At March 31, 2003, the Company had a commitment from the SBA to borrow up to an additional \$7.3 million above the current amount outstanding. The commitment expires on September 30, 2005.

Scheduled future maturities of notes payable and debentures at March 31, 2003, are as follows:

| Year       | Amount Maturing<br>(in thousands) |
|------------|-----------------------------------|
| 2003       | \$ 140,000                        |
| 2004       | 221,000                           |
| 2005       | 179,000                           |
| 2006       | 180,700                           |
| 2007       |                                   |
| Thereafter | 73,500                            |
|            | <hr/>                             |
| Total      | \$ 794,200                        |
|            | <hr/>                             |

**Revolving Line of Credit**

On April 18, 2003, the Company renewed its unsecured revolving line of credit under substantially similar terms with a committed amount under the renewed facility of \$462.5 million. The revolving line of credit may be expanded through new or additional commitments up to \$600 million at the Company's option. The renewed line of credit expires in April 2005 and may be extended under substantially similar terms for one additional year at the Company's sole option. The facility bears interest at a rate equal to (i) the one-month LIBOR plus 1.25%, (ii) the Bank of America, N.A. prime rate, or (iii) the Federal Funds rate plus 0.50% at the Company's option. The interest rate adjusts at the beginning of each new interest period, usually every 30 days. The interest rates were 2.8% and 2.7% at March 31, 2003, and December 31, 2002, respectively, and the facility requires an annual commitment fee equal to 0.25% of the committed amount. The line of credit generally requires monthly payments of interest, and all principal is due upon maturity.





## ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

**Note 4. Debt, continued**

The average debt outstanding on the revolving line of credit was \$97.1 million and \$68.3 million for the three months ended March 31, 2003, and the year ended December 31, 2002, respectively. The maximum amount borrowed under this facility and the weighted average interest rate for the three months ended March 31, 2003, and the year ended December 31, 2002, were \$208.8 million and \$216.5 million, and 2.7% and 3.2%, respectively. As of March 31, 2003, the amount available under the revolving line of credit was \$461.2 million, net of amounts committed for standby letters of credit of \$4.6 million issued under the credit facility.

The Company has various financial and operating covenants required by the revolving line of credit and the notes payable and debentures. These covenants require the Company to maintain certain financial ratios, including debt to equity and interest coverage, and a minimum net worth. The Company's credit facilities limit its ability to declare dividends if the Company defaults under certain provisions. As of March 31, 2003, the Company was in compliance with these covenants.

**Note 5. Guarantees**

In the ordinary course of business, the Company has issued guarantees and has extended standby letters of credit through financial intermediaries on behalf of certain portfolio companies. As of March 31, 2003, and December 31, 2002, the Company had issued guarantees of debt, rental obligations, and lease obligations aggregating \$61.1 million and \$54.6 million, respectively, and had extended standby letters of credit aggregating \$17.6 million and \$11.3 million, respectively. Under these arrangements, the Company would be required to make payments to third-party beneficiaries if the portfolio companies were to default on their related payment obligations. The maximum amount of future payments is \$78.7 million and \$65.9 million at March 31, 2003, and December 31, 2002, respectively. At March 31, 2003, and December 31, 2002, no amounts had been recorded as a liability for the Company's guarantees or standby letters of credit.

As of March 31, 2003, the guarantees and standby letters of credit expire as follows:

| (in thousands)                           | Total    | 2003    | 2004     | 2005  | 2006    | 2007  | After 2007 |
|--|----------|---------|----------|-------|---------|-------|------------|
| Guarantees of debt and lease obligations | \$61,132 | \$1,547 | \$57,957 | \$270 | \$142   | \$114 | \$1,102    |
| Standby letters of credit                | 17,612   |         | 4,587    |       | 7,025   |       | 6,000      |
| Total                                    | \$78,744 | \$1,547 | \$62,544 | \$270 | \$7,167 | \$114 | \$7,102    |

**Note 6. Preferred Stock**

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

## ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

## Note 7. Shareholders Equity

Sales of common stock for the three months ended March 31, 2003 and 2002, were as follows:

|  | For the Three Months<br>Ended March 31, |           |
|--|---|-----------|
|  | 2003                                    | 2002      |
| (in thousands)                         |   |           |
| Number of common shares                | 4,250                                   | 785       |
| Gross proceeds                         | \$ 85,880                               | \$ 20,600 |
| Less costs including underwriting fees | (3,518)                                 | (650)     |
| Net proceeds                           | \$ 82,362                               | \$ 19,950 |

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 days immediately prior to the dividend payment date.

Dividend reinvestment plan activity for the three months ended March 31, 2003 and 2002 was as follows:

|  | For the Three Months<br>Ended March 31, |          |
|--|---|----------|
|  | 2003                                    | 2002     |
| (in thousands, except per share amounts) |   |          |
| Shares issued                            | 84                                      | 57       |
| Average price per share                  | \$ 20.13                                | \$ 27.64 |

## Note 8. Earnings Per Common Share

Earnings per common share for the three months ended March 31, 2003 and 2002, were as follows:

|  | For the Three Months<br>Ended March 31, |           |
|--|---|-----------|
|  | 2003                                    | 2002      |
| (in thousands, except per share amounts)             |   |           |
| Net increase in net assets resulting from operations | \$ 19,873                               | \$ 55,961 |
| Less preferred stock dividends                       | (55)                                    | (55)      |
| Income available to common shareholders              | \$ 19,818                               | \$ 55,906 |
| Weighted average common shares outstanding - basic   | 109,458                                 | 99,977    |
| Dilutive options outstanding to officers             | 640                                     | 2,387     |

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|  |         |                   |                   |
|--|---------|-------------------|-------------------|
| Weighted average common shares outstanding | diluted | 110,098           | 102,364           |
|  |         | <u>          </u> | <u>          </u> |
| Basic earnings per common share            |         | \$ 0.18           | \$ 0.56           |
|  |         | <u>          </u> | <u>          </u> |
| Diluted earnings per common share          |         | \$ 0.18           | \$ 0.55           |
|  |         | <u>          </u> | <u>          </u> |

**Note 9. Dividends and Distributions**

The Company's board of directors declared and the Company paid a \$0.57 per common share dividend, or \$63.0 million, for the three months ended March 31, 2003. The Company paid a dividend of \$53.3 million to common shareholders for the three months ended March 31, 2002.

## ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

The Company's board of directors also declared a dividend of \$0.57 per common share for the second quarter of 2003.

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

For the three months ended March 31, 2003 and 2002, the Company paid \$6.2 million and \$5.9 million, respectively, for interest. For the three months ended March 31, 2003 and 2002, the Company's non-cash financing activities totaled \$1.7 million and \$3.0 million, respectively, and includes stock option exercises and dividend reinvestment.

**Note 11. Hedging Activities**

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

| (in thousands)<br>Description of Issue         | 2003       | 2002       |
|--|------------|------------|
| 10-year Treasury securities, due February 2012 | \$         | \$ 52,053  |
| 10-year Treasury securities, due November 2012 | 44,450     | 107,327    |
| 10-year Treasury securities, due February 2013 | 41,259     |            |
| 5-year Treasury securities, due November 2007  | 9,872      | 37,647     |
| 5-year Treasury securities, due February 2008  | 4,758      |            |
|  | —————      | —————      |
| Total  | \$ 100,339 | \$ 197,027 |
|  | —————      | —————      |

As of March 31, 2003, and December 31, 2002, the total obligations to replenish borrowed Treasury securities had increased since the related original sale dates due to changes in the yield on the borrowed Treasury securities, resulting in unrealized depreciation on the obligations of \$0.2 million and \$7.1 million, respectively. The net proceeds related to the sales of the borrowed Treasury securities were \$99.4 million and \$189.3 million at March 31, 2003, and December 31, 2002, respectively. Under the terms of the transactions, the Company has provided additional cash collateral of \$17 thousand and \$5.4 million at March 31, 2003, and December 31, 2002, respectively, for the difference between the net proceeds related to the sales of the borrowed Treasury securities and the obligations to replenish the securities. The Company has deposited the proceeds related to the sales of the borrowed Treasury securities and the additional cash collateral with the financial institutions under repurchase agreements. The repurchase agreements are collateralized by U.S. Treasury securities and are settled weekly. As of March 31, 2003, the repurchase agreements were due on April 2, 2003, and had a weighted average interest rate of 0.6%. The weighted average interest rate on the repurchase agreements as of December 31, 2002, was 0.8%.

## ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

## Note 12. Financial Highlights

|  | At and for the<br>Three Months<br>Ended<br>March 31, |          | At and for the<br>Year Ended<br>December 31, |
|--|--|----------|--|
|  | 2003   | 2002     | 2002   |
| <b>Per Common Share Data</b>                               |  |          |  |
| Net asset value, beginning of period                       | \$ 14.22   | \$ 13.57 | \$ 13.57                                     |
| Net investment income*                                     | 0.39   | 0.53     | 1.77   |
| Net gains (losses)*  | (0.21)   | 0.02     | 0.43   |
| Net increase in net assets resulting from operations       | 0.18   | 0.55     | 2.20   |
| Net decrease in net assets from shareholder distributions  | (0.57)   | (0.53)   | (2.23)                                       |
| Net increase in net assets from capital share transactions | 0.22   | 0.12     | 0.68   |
| Net asset value, end of period                             | \$ 14.05   | \$ 13.71 | \$ 14.22                                     |
| Market value, end of period                                | \$ 19.98   | \$ 27.50 | \$ 21.83                                     |
| Total return   | (6)%   | 8%       | (7)%   |

\* Based on diluted weighted average number of shares outstanding for the period.

|   | At and for the<br>Three Months Ended<br>March 31, |              | At and for the<br>Year Ended<br>December 31, |
|---|---|--------------|--|
|   | 2003  | 2002         | 2002   |
| <b>Ratios and Supplemental Data</b>   |   |              |  |
| Ending net assets   | \$ 1,588,293                                      | \$ 1,381,341 | \$ 1,546,071                                 |
| Common shares outstanding at end of period  | 113,056   | 100,765      | 108,698                                      |
| Diluted weighted average common shares outstanding                                      | 110,098   | 102,364      | 103,574                                      |
| Employee and administrative expenses/ average net assets                                | 0.80%   | 0.81%        | 3.82%  |
| Total expenses/average net assets   | 1.94%   | 2.09%        | 8.75%  |
| Net investment income/average net assets  | 2.72%   | 3.94%        | 12.94%                                       |
| Net increase in net assets resulting from operations <sup>(1)</sup> /average net assets | 1.27%   | 4.09%        | 15.98%                                       |
| Portfolio turnover rate   | 11.06%  | 3.49%        | 15.12%                                       |
| Average debt outstanding  | \$ 891,325  | \$ 938,347   | \$ 938,148                                   |
| Average debt per share  | \$ 8.10   | \$ 9.17      | \$ 9.06                                      |

(1) Net gains and losses can fluctuate significantly from period to period. As a result, quarterly comparisons may not be meaningful.



**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**

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

**Note 13. Litigation**

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

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



**Independent Accountants Review Report**

The Board of Directors and Shareholders

Allied Capital Corporation and Subsidiaries:

We have reviewed the accompanying consolidated balance sheet of Allied Capital Corporation and subsidiaries, including the consolidated statement of investments, as of March 31, 2003, and 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, 2003 and 2002. These consolidated financial statements and financial highlights are the responsibility of the Company's management.

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

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

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

/s/ KPMG LLP

Washington, D.C.

April 21, 2003, except as to Note 4  
which is as of May 14, 2003

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

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

*the ongoing global economic downturn;*

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

*future regulatory actions and conditions in our operating areas; and*

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

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

**OVERVIEW**

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

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

|                                | 2003 | 2002 |
|--------------------------------|------|------|
| Private Finance                | 73%  | 70%  |
| Commercial Real Estate Finance | 27%  | 30%  |

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

### PORTFOLIO AND INVESTMENT ACTIVITY

Total portfolio investment activity, and yields at and for the three months ended March 31, 2003 and 2002, and at and for the year ended December 31, 2002, were as follows:

|  | At and for the<br>Three Months Ended<br>March 31, |           | At and for the<br>Year Ended<br>December 31, |
|--|---|-----------|--|
|  | 2003  | 2002      | 2002   |
| (\$ in millions)                                       |   |           |  |
| Portfolio at value                                     | \$2,376.9   | \$2,254.1 | \$2,488.2                                    |
| Investments funded                                     | \$ 269.0  | \$ 80.0   | \$ 506.4                                     |
| Change in accrued or reinvested interest and dividends | \$ 11.1   | \$ 13.3   | \$ 44.7                                      |
| Principal repayments                                   | \$ 76.0   | \$ 31.0   | \$ 143.2                                     |
| Sales  | \$ 244.1  | \$ 125.1  | \$ 213.5                                     |
| Yield <sup>(1)</sup>                                   | 14.0%   | 14.3%     | 14.0%  |

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

**Private Finance**

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

| (\$ in millions)                                       | At and for the<br>Three Months Ended<br>March 31, |            | At and for the<br>Year Ended<br>December 31, |
|--|---|------------|--|
|  | 2003  | 2002       | 2002   |
| Portfolio at value:                                    |   |            |  |
| Loans and debt securities                              | \$ 1,148.3  | \$ 1,105.8 | \$ 1,151.2                                   |
| Equity interests                                       | 593.8   | 499.1      | 592.0  |
| Total portfolio  | \$ 1,742.1  | \$ 1,604.9 | \$ 1,743.2                                   |
| Investments funded                                     | \$ 110.1  | \$ 37.6    | \$ 297.2                                     |
| Change in accrued or reinvested interest and dividends | \$ 11.3   | \$ 12.1    | \$ 42.6                                      |
| Principal repayments                                   | \$ 75.1   | \$ 28.8    | \$ 129.3                                     |
| Yield <sup>(1)</sup>                                   | 14.0%   | 14.3%      | 14.4%  |

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

Investments funded for the three months ended March 31, 2003 and 2002, and for the year ended December 31, 2002, consisted of the following:

| (\$ in millions)   | Loans and<br>Debt<br>Securities | Equity<br>Interests | Total    |
|--|---------------------------------|---------------------|----------|
| <b>For the Three Months Ended March 31, 2003<sup>(1)</sup></b> |                                 |                     |          |
| Companies more than 25% owned                                  | \$ 33.2                         | \$ 25.0             | \$ 58.2  |
| Companies 5% to 25% owned                                      | 7.9                             | 1.0                 | 8.9      |
| Companies less than 5% owned                                   | 41.2                            | 1.8                 | 43.0     |
| Total  | \$ 82.3                         | \$ 27.8             | \$ 110.1 |
| <b>For the Three Months Ended March 31, 2002<sup>(1)</sup></b> |                                 |                     |          |
| Companies more than 25% owned                                  | \$ 4.8                          | \$ 1.1              | \$ 5.9   |
| Companies 5% to 25% owned                                      |                                 |                     |          |
| Companies less than 5% owned                                   | 30.7                            | 1.0                 | 31.7     |
| Total  | \$ 35.5                         | \$ 2.1              | \$ 37.6  |

| (\$ in millions)  | Loans and<br>Debt<br>Securities | Equity<br>Interests | Total           |
|---|---------------------------------|---------------------|-----------------|
| <i>For the Year Ended December 31, 2002<sup>(1)</sup></i> |                                 |                     |                 |
| Companies more than 25% owned                             | \$ 86.1                         | \$ 18.7             | \$ 104.8        |
| Companies 5% to 25% owned                                 | 22.3                            | 0.4                 | 22.7            |
| Companies less than 5% owned                              | 154.6                           | 15.1                | 169.7           |
| <b>Total</b>  | <b>\$ 263.0</b>                 | <b>\$ 34.2</b>      | <b>\$ 297.2</b> |

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

At March 31, 2003, we had outstanding funding commitments of \$90.8 million to portfolio companies, including \$23.9 million committed to private venture capital funds. At March 31, 2003, we also had total commitments to private finance portfolio companies in the form of standby letters of credit and guarantees of \$78.7 million.

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

We may acquire more than 50% of the common stock of a company in a control buyout transaction. Control investments are generally structured such that we earn a current return through a combination of interest income on our senior loans and subordinated debt, dividends on our preferred and common stock, and management or transaction services fees to compensate us for the managerial assistance that we provide to a controlled portfolio company. In some cases for companies that are more than 50% owned, we may not accrue interest on loans and debt securities if such company is in need of additional working capital. In such cases, we may defer current debt service. Our most significant investments acquired through control buyout transactions at March 31, 2003, were Business Loan Express, LLC (BLX), acquired in 2000, and The Hillman Companies, Inc., acquired in 2001.

**Business Loan Express, LLC.** At March 31, 2003, our investment in BLX totaled \$266.0 million at cost and \$307.6 million at value, or 11.9% of our total assets, which includes unrealized appreciation of \$41.6 million.

BLX is the nation’s second largest non-bank government guaranteed lender utilizing the SBA’s 7(a) Guaranteed Loan Program and is licensed by the SBA as a Small Business Lending Company (SBLC). BLX is a preferred lender as designated by the SBA, and originates, sells, and services small business loans. In addition to the SBA 7(a) Guaranteed Loan Program, BLX originates conventional small business loans and originates loans under the USDA Business and Industry Guaranteed Loan Program. BLX has offices across the United States and is headquartered in New York, New York. Changes in the laws or regulations that govern SBLCs or the SBA 7(a)

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Guaranteed Loan Program or changes in government funding for this program could have a material impact on BLX or its operations.

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

In January 2003, BLX completed the acquisition of \$128.0 million of performing loans and other assets from AIF. BLX purchased \$121.5 million of performing SBA 7(a) unguaranteed loans at par and \$6.5 million of other assets. The acquisition increased BLX's serviced portfolio and enhanced its nationwide loan origination platform. BLX believes that the acquisition positions the company to increase its competitiveness in the marketplace, as well as improve the economics of its business over time.

The AIF acquisition increased BLX's serviced portfolio to over \$2.0 billion, represented by over 2,900 small business borrowers. We provided \$50 million of the capital to fund this acquisition. Our \$50 million financing was in the form of a short-term revolving credit facility of \$25 million to fund the temporary capital needs of construction loans purchased and loans pending sale, as well as \$25 million of preferred equity to support the future growth potential of BLX post acquisition.

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

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

Summary financial data for BLX at and for the nine months ended March 31, 2003, and the fiscal year ended June 30, 2002, is presented below. Data at and for the nine months ended March 31, 2003, includes the impact of the AIF asset purchase since the date of the acquisition as well as the reorganization transaction.

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| (\$ in millions)  | At and for the<br>Nine Months Ended<br>March 31, 2003 <sup>(1)</sup> | At and for the<br>Year Ended<br>June 30, 2002 |
|---|--|---|
| <b>Operating Data</b>   |  |   |
| Total revenue   | \$ 79.5  | \$ 84.6                                       |
| Net income <sup>(4)</sup>   | \$ 5.3   | \$ 2.3  |
| Earnings before interest, taxes and management fees<br>(EBITM) <sup>(4)</sup> | \$ 34.4  | \$ 43.0                                       |
| <b>Balance Sheet Data</b>   |  |   |
| Total assets <sup>(2)</sup>   | \$ 351.4   | \$ 277.1                                      |
| Total debt  | \$ 177.0   | \$ 183.0                                      |
| Total owners' equity  | \$ 140.8   | \$ 59.9                                       |
| <b>Other Data</b>   |  |   |
| Total loan originations   | \$ 569.4   | \$ 565.1                                      |
| Serviced loan portfolio   | \$2,062.8  | \$1,372.6                                     |
| Number of loans   | 2,928  | 2,083   |
| Loan delinquencies <sup>(3)</sup>   | 7.8%   | 9.4%  |
| <b>Serviced Loan Portfolio by Industry</b>                                    |  |   |
| Hotels  | 25%  | 27%   |
| Gas stations/convenience stores   | 18   | 16  |
| Professional and retail services  | 12   | 10  |
| Restaurants   | 9  | 10  |
| Manufacturing and industrial  | 9  | 10  |
| Car wash/auto repair services   | 7  | 3   |
| Shrimp/fishing vessels  | 5  | 7   |
| Recreation  | 5  | 5   |
| Child care and health care services   | 5  | 4   |
| Other   | 5  | 8   |
| Total   | 100%   | 100%  |

- (1) The results of operations, changes in cash flows, and loan originations for the nine months ended March 31, 2003, are not necessarily indicative of the operating results to be expected for the full year. Post reorganization BLX's fiscal year end changed to September 30.
- (2) Included in total assets is \$6 million of goodwill at March 31, 2003, and June 30, 2002. There is no other goodwill on BLX's balance sheet. We acquired 94.9% of BLC Financial Services, Inc. on December 31, 2000. Push-down accounting was not required with respect to this transaction; accordingly, goodwill was not recorded by BLX.
- (3) Represents the percentage of loans in the total serviced loan portfolio that are greater than 30 days delinquent, which includes loans in workout status. Loans greater than 30 days delinquent for the SBA 7(a) loan portfolio only, which are included in the total serviced loan portfolio, were 7.5% at March 31, 2003. BLX will from time to time grant a 90-day deferment to borrowers experiencing short-term cash flow shortfalls. Loans that have been granted a deferment that perform as required are not considered delinquent consistent with SBA practice. The ability of small businesses to repay their loans may be adversely affected by numerous factors, including a downturn in their industry or negative economic conditions. Small businesses are also more vulnerable to customer preferences, competition, rising fuel prices and market conditions and, as a result, delinquencies in BLX's portfolio may increase. For instance, the shrimp and fishing industry has been affected by rising fuel costs and competition from imported shrimp. For these reasons, BLX focuses on collateral protection for each loan in addition to the cash flow of the small business and receives personal guarantees from the principal owners of the small business.
- (4) BLX incurred certain expenses that reduced net income and EBITM by approximately \$2.3 million for the nine months ended March 31, 2003, associated with the Amresco Independence Funding transaction and its reorganization to an LLC.

For the nine months ended March 31, 2003, BLX earned revenue of \$79.5 million and EBITM of \$34.4 million. EBITM was reduced by \$2.3 million due to costs associated with the AIF acquisition and the LLC reorganization. BLX's revenues consist of cash premiums from guaranteed loan sales, gain on sale income arising from loans sold at par or securitized where BLX will receive future cash flows representing the spread between loan interest and the interest paid on bonds issued including service fee income, interest income on loans remaining in BLX's portfolio, and other





income. Gain on sale income is a non-cash source of income when recognized, and as future cash flows are received, the resulting cash reduces the receivable or residual interest that is recognized when the loan is sold. Cash loan sale premiums, cash interest income and cash received from residual interests and other cash income represented approximately 77% of BLX's revenue of \$79.5 million during the nine-months ended March 31, 2003.

BLX's business is to originate small business loans and then sell substantially all of the loans originated for cash proceeds. Loans originated during the nine-months ended March 31, 2003, totaled \$569.4 million, including loans purchased from AIF. Proceeds from loan sales during the nine months ended March 31, 2003, totaled approximately \$541 million. BLX funds the construction of commercial real estate projects, and as a result is unable to sell a construction loan until the loan is fully-funded and the construction is complete. In addition, BLX typically does not immediately receive the proceeds from the sale of its SBA 7(a) guaranteed and unguaranteed loan strips sold, but receives the cash upon settlement. Therefore until BLX sells construction loans or fully funded loans held for sale, it will finance the origination of the loans through funding on its revolving line of credit, or through financing provided by us.

BLX has a three-year \$149.0 million revolving credit facility that matures in March 2004. As the controlling equity owner in BLX, we have provided an unconditional guaranty to the revolving credit facility lenders in an amount of up to 50% of the total obligations (consisting of principal, accrued interest, and other fees) of BLX under the revolving credit facility. The amount guaranteed by us at March 31, 2003, was \$57.2 million. This guaranty can be called by the lenders only in the event of a default by BLX. BLX was in compliance with the terms of the revolving credit facility at March 31, 2003. We have provided two standby letters of credit in connection with two term securitization transactions completed by BLX totaling \$10.6 million.

BLX sells the guaranteed piece of guaranteed loans for cash premiums of up to 10% of the guaranteed loan amount plus a retained annual servicing fee generally between 1.0% and 2.0% of the guaranteed loan amount. Cash premiums received from guaranteed loans sales during the nine months ended March 31, 2003, were approximately \$22 million in total.

Alternatively, BLX may sell the guaranteed pieces of SBA 7(a) guaranteed loans at par and receive cash only for the face amount of the loan sold, and instead of receiving a cash premium, BLX will receive an annual servicing spread on the loans sold of between 4.0% and 4.8%. In addition, BLX will sell the unguaranteed pieces of the SBA 7(a) loans and conventional loans it originates into a conduit facility. The conduit loans are securitized and BLX retains an interest of up to 2.7% of the loan pool. BLX then receives the excess of loan interest payments on the loans sold over the interest cost on the securities issued in the securitization over the life of the loan pool. BLX generally receives between 4.3% and 4.9% annually on the loans sold into the securitization pools. During the nine months ended March 31, 2003, BLX received cash payments from securitization pools of approximately \$31 million.

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

At March 31, 2003, BLX's Residual Interest totaled \$150.8 million, representing BLX's estimate of the net present value of future cash flows of scheduled loan payments, after estimated future loan losses and loan prepayments. If scheduled loan payments were to be received as stated in the loan

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agreements with no future losses or prepayments, BLX would receive future cash flows of \$658.8 million over time, with approximately \$46.3 million, \$48.1 million, \$47.0 million, and \$45.7 million (or \$187.1 million in the aggregate) scheduled to be received in the next four years ending on March 31, 2004, 2005, 2006, and 2007, respectively.

**The Hillman Companies, Inc.** At March 31, 2003, our investment in Hillman totaled \$93.1 million at cost and \$181.3 million at value, or 7.0% of total assets.

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

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

### Commercial Real Estate Finance

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

| (\$ in millions)                           | At and for the<br>Three Months Ended March 31, |        |                |        | At and for<br>the Year Ended<br>December 31,<br>2002 |        |
|--|--|--------|----------------|--------|--|--------|
|  | 2003   |        | 2002           |        | Value  | Yield* |
|  | Value  | Yield* | Value          | Yield* |  |        |
| CMBS bonds                                 | \$326.5  | 15.5%  | \$456.4        | 15.7%  | \$555.5  | 14.2%  |
| CDO bonds and preferred shares             | 172.0  | 16.4%  | 47.3           | 17.3%  | 52.8   | 17.2%  |
| Commercial mortgage loans                  | 63.7   | 7.0%   | 72.9           | 8.3%   | 63.7   | 7.5%   |
| Residual interest                          | 69.0   | 9.4%   | 69.4           | 9.4%   | 69.0   | 9.4%   |
| Real estate owned                          | 3.6  |        | 3.2            |        | 4.0  |        |
| <b>Total portfolio</b>                     | <b>\$634.8</b>                                 |        | <b>\$649.2</b> |        | <b>\$745.0</b>                                       |        |
| Investments funded                         | \$158.9  |        | \$42.4         |        | \$209.2  |        |
| Change in accrued or reinvested interest   | (0.2)  |        | 1.2            |        | 2.1  |        |
| Principal repayments                       | 0.9  |        | 2.2            |        | 13.9   |        |
| CMBS and commercial real estate loan sales | 244.1  |        | 125.1          |        | 213.5  |        |

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

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Our commercial real estate investment activity for the three months ended March 31, 2003 and 2002, and for the year ended December 31, 2002, was as follows:

| (\$ in millions)                                 | Face<br>Amount | Discount  | Amount<br>Funded |
|--|----------------|-----------|------------------|
| <b>For the Three Months Ended March 31, 2003</b> |                |           |                  |
| CMBS bonds                                       | \$ 90.4        | \$ (49.6) | \$ 40.8          |
| CDO bonds and preferred shares                   | 118.4          | (0.3)     | 118.1            |
| Total  | \$208.8        | \$ (49.9) | \$158.9          |
| <b>For the Three Months Ended March 31, 2002</b> |                |           |                  |
| CMBS bonds                                       | \$ 45.6        | \$ (26.3) | \$ 19.3          |
| CDO preferred shares                             | 23.1           |           | 23.1             |
| Total  | \$ 68.7        | \$ (26.3) | \$ 42.4          |
| <b>For the Year Ended December 31, 2002</b>      |                |           |                  |
| CMBS bonds                                       | \$302.5        | \$(140.2) | \$162.3          |
| CDO preferred shares                             | 29.0           |           | 29.0             |
| Commercial mortgage loans                        | 11.7           | (1.7)     | 10.0             |
| Real estate owned                                | 7.9            |           | 7.9              |
| Total  | \$351.1        | \$(141.9) | \$209.2          |

**CMBS Bonds.** The yield on our CMBS bond portfolio at March 31, 2003, and December 31, 2002, was 15.5% and 14.2%, respectively. The yield on the CMBS bond portfolio at any point in time will vary depending on the concentration of lower yielding BB+, BB, and BB-CMBS bonds held in the portfolio.

During the three months ended March 31, 2003 and 2002, we invested \$40.8 million in two CMBS bond issuances and \$19.3 million in one CMBS bond issuance, respectively. During the year ended December 31, 2002, we invested \$162.3 million in three CMBS bond issuances.

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

| Loan to Value Ranges<br>(\$ in millions) | For the Three Months Ended<br>March 31, |            |         |            | For the Year<br>Ended December 31,<br>2002 |            |
|--|---|------------|---------|------------|--|------------|
|  | 2003                                    |            | 2002    |            | Amount                                     | Percentage |
|  | Amount                                  | Percentage | Amount  | Percentage |  |            |
| Less than 60%                            | \$1,217.0                               | 41%        | \$139.9 | 19%        | \$ 909.3                                   | 20%        |
| 60-65%                                   | 400.0                                   | 13         | 37.5    | 5          | 287.3                                      | 6          |
| 65-70%                                   | 237.7                                   | 8          | 45.3    | 6          | 587.9                                      | 13         |
| 70-75%                                   | 323.4                                   | 11         | 207.9   | 29         | 1,214.5                                    | 27         |
| 75-80%                                   | 795.1                                   | 27         | 291.6   | 40         | 1,477.5                                    | 33         |
| Greater than 80%                         | 9.5                                     |            | 5.3     | 1          | 47.8                                       | 1          |

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|                                |           |      |         |      |           |      |
|--------------------------------|-----------|------|---------|------|-----------|------|
| Total                          | \$2,982.7 | 100% | \$727.5 | 100% | \$4,524.3 | 100% |
| Weighted average loan to value | 63.4%     |      | 71.1%   |      | 68.5%     |      |

| Debt Service Coverage<br>Ratio <sup>(1)</sup> Ranges<br>(\$ in millions) | For the Three Months Ended<br>March 31, |            |          |            | For the Year<br>Ended December 31, |            |
|--|---|------------|----------|------------|------------------------------------|------------|
|  | Amount                                  | Percentage | Amount   | Percentage | Amount                             | Percentage |
| Greater than 2.00  | \$ 1,323.4                              | 45%        | \$ 4.0   | 1%         | \$ 366.9                           | 8%         |
| 1.76-2.00  | 368.7                                   | 12         | 4.7      | 1          | 229.6                              | 5          |
| 1.51-1.75  | 515.8                                   | 17         | 87.4     | 12         | 477.4                              | 11         |
| 1.26-1.50  | 741.5                                   | 25         | 460.4    | 63         | 2,739.6                            | 60         |
| Less than 1.25   | 33.3                                    | 1          | 171.0    | 23         | 710.8                              | 16         |
| Total  | \$ 2,982.7                              | 100%       | \$ 727.5 | 100%       | \$ 4,524.3                         | 100%       |
| Weighted average debt service coverage ratio                             | 1.91                                    |            | 1.35     |            | 1.41                               |            |

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

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

| (\$ in millions)  | For the Three<br>Months Ended<br>March 31, |          | For the Year<br>Ended<br>December 31, |
|---|--|----------|---------------------------------------|
|   | 2003                                       | 2002     | 2002                                  |
| Cost basis  | \$ 244.1                                   | \$ 123.3 | \$ 205.9                              |
| Sales proceeds  | 275.1                                      | 128.8    | 225.6                                 |
| Net realized gains (net of related hedge gains or losses) | 24.6                                       | 7.1      | 19.1                                  |
| Weighted average yield                                    | 11.9%                                      | 11.2%    | 11.5%                                 |

The non-investment grade and unrated tranches of the CMBS bonds in which we invest are junior in priority for payment of interest and principal to the more senior tranches of the related CMBS bond issuance. Cash flow from the underlying mortgages generally is allocated first to the senior tranches, with the most senior tranches having a priority right to the cash flow. Then, any remaining cash flow is allocated, generally, among the other tranches in order of their relative seniority. To the extent there are defaults and unrecoverable losses on the underlying mortgages resulting in reduced cash flows, our most subordinate tranche will bear this loss first. At March 31, 2003, our CMBS bonds were subordinate to 91% to 99% of the tranches of bonds issued in various CMBS transactions. Given that the non-investment grade CMBS bonds in which we invest are junior in priority for payment of principal and interest, we invest in these CMBS bonds at a discount from the face amount of the bonds. The discount increases with the decrease in the seniority of the CMBS bonds. For the three months ended March 31, 2003, and 2002, and for the year ended December 31, 2002, the average discount for the CMBS bonds in which we invested was 55%, 58%, and 46%, respectively.

At March 31, 2003, and December 31, 2002, the unamortized discount related to the CMBS bond portfolio was \$518.0 million and \$649.5 million, respectively. At March 31, 2003, the CMBS bond portfolio had a fair value of \$326.5 million, which included net unrealized appreciation on the CMBS bonds of \$4.7 million.

At March 31, 2003, and December 31, 2002, the underlying collateral for our CMBS bonds consisted of approximately 4,600 and 4,500 commercial mortgage loans and real estate properties

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owned with a total outstanding principal balance of \$27.8 billion and \$25.0 billion, respectively. At March 31, 2003, and December 31, 2002, 0.9% and 1.0%, respectively, of the loans in the underlying collateral pool for our CMBS bonds were over 30 days delinquent or were classified as real estate owned.

**Collateralized Debt Obligation Bonds and Preferred Shares.** The yield on our CDO bonds and preferred shares at March 31, 2003, and December 31, 2002, was 16.4% and 17.2%, respectively. The yield on the CDO portfolio at any point in time will vary depending on the amount of lower yielding BBB CDO bonds held in the portfolio. During the three months ended March 31, 2003 and 2002, and the year ended December 31, 2002, we invested in the BBB bonds and preferred shares of one, one, and three collateralized debt obligations, respectively, which are secured by investment grade unsecured debt issued by various real estate investment trusts, or REITs, and investment and non-investment grade CMBS bonds. The investment grade REIT collateral consists of debt with a cut-off balance of \$1.2 billion and was issued by 44 REITs. The investment grade CMBS collateral consists of CMBS bonds with a face amount of \$496.0 million issued in 41 separate CMBS transactions and the non-investment grade CMBS collateral consists of BB+, BB, BB-, B+, and B rated CMBS bonds with a face amount of \$873.7 million issued in 42 separate CMBS transactions. Included in the CMBS collateral for the CDOs are \$793.7 million of CMBS bonds that are senior in priority of repayment to certain lower rated CMBS bonds held by us, which were issued in 27 separate CMBS transactions.

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

### Portfolio Asset Quality

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

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

| Grade            | At March 31, 2003  |                               | At December 31, 2002 |                               |
|------------------|--------------------|-------------------------------|----------------------|-------------------------------|
|                  | Portfolio at Value | Percentage of Total Portfolio | Portfolio at Value   | Percentage of Total Portfolio |
| (\$ in millions) |                    |                               |                      |                               |
| 1                | \$ 762.2           | 32.1%                         | \$ 801.0             | 32.1%                         |
| 2                | 1,346.3            | 56.6                          | 1,400.8              | 56.3                          |
| 3                | 133.3              | 5.6                           | 166.0                | 6.7                           |
| 4                | 23.1               | 1.0                           | 23.6                 | 1.0                           |
| 5                | 112.0              | 4.7                           | 96.8                 | 3.9                           |
|                  | <u>\$2,376.9</u>   | <u>100.0%</u>                 | <u>\$2,488.2</u>     | <u>100.0%</u>                 |

Total Grade 4 and 5 assets as a percentage of the total portfolio at value at March 31, 2003, and December 31, 2002, were 5.7% and 4.9%, respectively. Included in Grade 4 and 5 assets at March 31, 2003 and December 31, 2002, were assets totaling \$27.2 million and \$24.1 million, respectively, that are secured by commercial real estate. Grade 4 and 5 assets include loans, debt securities, and equity securities. We expect that a number of portfolio companies will be in the Grade 4 or 5 categories from time to time. Part of the business of private finance is working with troubled portfolio companies to improve their businesses and protect our investment. The number of portfolio companies and related investment amount included in Grade 4 and 5 may fluctuate from period to period. We continue to follow our historical practice of working with a troubled portfolio company in order to recover the maximum amount of our investment, but record unrealized depreciation for the expected amount of the loss when such exposure is identified.

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

For the total investment portfolio, workout loans and debt securities (which excludes equity securities that are included in the total Grade 4 and 5 assets above) not accruing interest that were classified in Grade 4 and 5 were \$98.4 million and \$89.1 million at value at March 31, 2003, and December 31, 2002, respectively. Included in this category were loans of \$16.3 million and \$13.0 million, respectively, that were secured by commercial real estate. In addition to Grade 4 and 5 assets that are in workout, loans and debt securities to companies that are more than 50% owned by us that were not accruing interest totaled \$58.5 million and \$63.6 million at value at March 31, 2003, and December 31, 2002, respectively, and loans and debt securities to companies that are less than 50% owned by us and were not in workout but were not accruing interest totaled \$21.6 million and \$7.2 million at value at March 31, 2003, and December 31, 2002, respectively.

***Loans and Debt Securities Over 90 Days Delinquent.*** Loans and debt securities greater than 90 days delinquent were \$99.6 million and \$103.1 million at value at March 31, 2003, and December 31, 2002, respectively, or 4.2% and 4.1% of the total portfolio. Included in this category were loans valued at \$36.2 million and \$26.0 million, respectively, that were secured by commercial real estate.

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

#### **Hedging Activities**

Because we invest in BB+ through B rated CMBS bonds, which were purchased at prices based in part on comparable Treasury rates, we have entered into transactions with financial institutions to

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

The total obligations to replenish borrowed Treasury securities, including accrued interest payable on the obligations, were \$100.3 million and \$197.0 million at March 31, 2003, and December 31, 2002, respectively, which included unrealized depreciation on the obligations of \$0.2 million and \$7.1 million, respectively, due to changes in the yield on the borrowed Treasury securities. The net proceeds related to the sales of the borrowed Treasury securities were \$99.4 million and \$189.3 million at March 31, 2003, and December 31, 2002, respectively. Under the terms of the transactions, we have provided additional cash collateral of \$17 thousand and \$5.4 million at March 31, 2003, and December 31, 2002, respectively, for the difference between the net proceeds related to the sales of the borrowed Treasury securities and the obligations to replenish the securities on the weekly settlement date, which is included in deposits of proceeds from sales of borrowed Treasury securities in the accompanying financial statements. The amount of the hedge will vary from period to period depending upon the amount of BB+ through B rated CMBS bonds that we own and have hedged on the balance sheet date.



**RESULTS OF OPERATIONS****Comparison of Three Months Ended March 31, 2003 and 2002**

The following table summarizes the Company's operating results for the three months ended March 31, 2003 and 2002.

| (\$ in thousands, except per share amounts)               | For the Three Months Ended March 31, |                  | Change             | Percent Change |
|---|--------------------------------------|------------------|--------------------|----------------|
|   | 2003                                 | 2002             |                    |                |
|   | (unaudited)                          |                  |                    |                |
| <b>Interest and Related Portfolio Income</b>              |                                      |                  |                    |                |
| Interest and dividends                                    | \$ 65,521                            | \$ 64,973        | \$ 548             | 1%             |
| Premiums from loan dispositions                           | 1,121                                | 1,613            | (492)              | (31)%          |
| Fees and other income                                     | 6,488                                | 15,805           | (9,317)            | (59)%          |
| <b>Total interest and related portfolio income</b>        | <b>73,130</b>                        | <b>82,391</b>    | <b>(9,261)</b>     | <b>(11)%</b>   |
| <b>Expenses</b>   |                                      |                  |                    |                |
| Interest  | 17,922                               | 17,469           | 453                | 3%             |
| Employee  | 8,121                                | 8,035            | 86                 | 1%             |
| Administrative  | 4,417                                | 3,018            | 1,399              | 46%            |
| <b>Total operating expenses</b>                           | <b>30,460</b>                        | <b>28,522</b>    | <b>1,938</b>       | <b>7%</b>      |
| <b>Net investment income</b>                              | <b>42,670</b>                        | <b>53,869</b>    | <b>(11,199)</b>    | <b>(21)%</b>   |
| <b>Net Realized and Unrealized Gains (Losses)</b>         |                                      |                  |                    |                |
| Net realized gains  | 48,339                               | 9,605            | 38,734             | *              |
| Net change in unrealized appreciation or depreciation     | (71,136)                             | (7,513)          | (63,623)           | *              |
| <b>Total net gains (losses)</b>                           | <b>(22,797)</b>                      | <b>2,092</b>     | <b>(24,889)</b>    | <b>*</b>       |
| <b>Net income</b>   | <b>\$ 19,873</b>                     | <b>\$ 55,961</b> | <b>\$ (36,088)</b> | <b>(64)%</b>   |
| <b>Diluted earnings per common share</b>                  | <b>\$ 0.18</b>                       | <b>\$ 0.55</b>   | <b>\$ (0.37)</b>   | <b>(67)%</b>   |
| <b>Weighted average common shares outstanding diluted</b> | <b>110,098</b>                       | <b>102,364</b>   | <b>7,734</b>       | <b>8%</b>      |

\* Net gains and losses can fluctuate significantly from period to period. As a result, quarterly comparisons of net gains and losses may not be meaningful.

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

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

The level of interest income is directly related to the balance of the interest-bearing investment portfolio multiplied by the weighted average yield. The weighted average yield varies from period to period based on the current stated interest rate earned on interest-bearing investments and the amount of loans and debt securities for which interest is not accruing. Our interest-bearing investments in the portfolio increased by

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1.4% to \$1,779.5 million at March 31, 2003, from \$1,755.0 million at March 31, 2002. The weighted average yield on the interest-bearing investments in the portfolio at March 31, 2003 and 2002, was as follows:

| (\$ in millions)           | 2003      | 2002      |
|----------------------------|-----------|-----------|
| Interest-bearing portfolio | \$1,779.5 | \$1,755.0 |
| Portfolio yield            | 14.0%     | 14.3%     |

Included in premiums from loan dispositions are prepayment premiums of \$1.1 million and \$1.6 million for the three months ended March 31, 2003 and 2002, respectively. While the scheduled maturities of private finance and commercial real estate loans range from five to ten years, it is not unusual for our borrowers to refinance or pay off their debts to us ahead of schedule. Because we seek to finance primarily seasoned, performing companies, such companies at times can secure lower cost financing as their balance sheets strengthen, or as more favorable interest rates become available, or a company may enter into a transaction that triggers the early repayment of their debt to us. Therefore, we generally structure our loans to require a prepayment premium for the first three to five years of the loan.

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

Fees and other income for the quarter ended March 31, 2003, primarily included fees of \$0.3 million related to structuring and diligence, fees of \$0.3 million related to transaction services provided to portfolio companies, and fees of \$5.7 million related to management services provided to portfolio companies, other advisory services, and guaranty fees. Fees and other income for the quarter ended March 31, 2002, primarily included fees of \$8.0 million related to structuring and diligence, fees of \$2.0 million related to transaction services provided to portfolio companies, and fees of \$5.7 million related to management services provided to portfolio companies, other advisory services, and guaranty fees. Fees and other income are generally related to specific transactions or services, and therefore may vary substantially from period to period. Points or loan origination fees that represent yield enhancement on a loan are capitalized and amortized into interest income over the life of the loan. Fees and other income may vary from period to period depending on the level and types of services provided.

BLX and Hillman are our most significant portfolio investments and together represented 18.9% of our total assets at March 31, 2003. Total interest and related portfolio income earned from these investments for the three months ended March 31, 2003 and 2002, were \$15.3 million and \$12.3 million, respectively. In July 2002, we sold WyoTech Acquisition Corporation, which was a significant portfolio investment during 2002. Total interest and related portfolio income earned on this investment for the three months ended March 31, 2002, was \$1.8 million.

**Operating Expenses.** Operating expenses include interest, employee, and administrative expenses. Our single largest expense is interest on our indebtedness. The fluctuations in interest expense during the three months ended March 31, 2003 and 2002, are attributable to changes in the level of our borrowings under various notes payable and debentures and our revolving line of credit.

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

|                          | At and for the<br>Three Months<br>Ended<br>March 31, |          |
|--------------------------|--|----------|
|                          | 2003   | 2002     |
| (\$ in millions)         |  |          |
| Total Outstanding Debt   | \$ 856.0   | \$ 933.1 |
| Average Outstanding Debt | \$ 891.3   | \$ 938.3 |
| Weighted Average Cost    | 7.6%   | 7.4%     |
| BDC Asset Coverage*      | 307%   | 264%     |

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

Employee expenses include salaries and employee benefits. The change in employee expenses reflects the effect of wage increases and the change in mix of employees given their area of responsibility and relevant experience level. Total employees were 110 and 101 at March 31, 2003 and 2002, respectively.

Administrative expenses include the leases for our headquarters in Washington, DC, and our regional offices, travel costs, stock record expenses, directors' fees, legal and accounting fees, insurance premiums, and various other expenses. The increase in administrative expenses as compared to the three months ended March 31, 2002, includes approximately \$0.6 million from directors' fees, legal and accounting fees, and consulting fees, and \$0.4 million due to increased costs for corporate liability insurance.

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

|                    | For the<br>Three Months<br>Ended<br>March 31, |         |
|--------------------|---|---------|
|                    | 2003  | 2002    |
| (\$ in millions)   |   |         |
| Realized gains     | \$ 48.5                                       | \$ 12.9 |
| Realized losses    | (0.2)   | (3.3)   |
| Net realized gains | \$ 48.3                                       | \$ 9.6  |

Realized gains and losses for the three months ended March 31, 2003, resulted from various private finance and commercial real estate finance transactions. Realized gains for the three months ended March 31, 2003, primarily resulted from transactions involving five private finance portfolio companies, including Morton Grove Pharmaceuticals, Inc. (\$8.4 million), CyberRep (\$8.3 million), Blue Rhino Corporation (\$3.9 million), GC-Sun Holdings II, LP (\$2.0 million), and Kirkland's, Inc. (\$1.2 million). In addition, gains were also realized on CMBS bonds (\$24.6 million, net of a realized loss of \$6.4 million from hedges related to the CMBS bonds sold). For the three months ended March 31, 2003, and 2002, we reversed previously recorded unrealized appreciation totaling \$43.0 million and \$5.2 million, respectively, when gains were realized. When we exit an investment

and realize a gain, we make an accounting entry to reverse any unrealized appreciation we had previously recorded to reflect the appreciated value of the investment.

For the three months ended March 31, 2003 and 2002, we reversed previously recorded unrealized depreciation totaling \$0.2 million and \$3.2 million, respectively, when losses were realized. When we exit an investment and realize a loss, we make an accounting entry to reverse any unrealized depreciation we had previously recorded to reflect the depreciated value of the investment.

***Change in Unrealized Appreciation or Depreciation.*** We determine the value of each investment in our portfolio on a quarterly basis, and changes in value result in unrealized appreciation or depreciation being recognized. At March 31, 2003, approximately 92% of our total assets represented portfolio investments recorded at fair value. Value, as defined in Section 2(a)(41) of the Investment Company Act of 1940, is (i) the market price for those securities for which a market quotation is readily available and (ii) for all other securities and assets, fair value is as determined in good faith by the board of directors. Since there is typically no readily ascertainable market value for the investments in our portfolio, we value substantially all of our portfolio investments at fair value as determined in good faith by the board of directors pursuant to a valuation policy and a consistently applied valuation process. Because of the inherent uncertainty of determining the fair value of investments that do not have a readily ascertainable market value, the fair value of our investments determined in good faith by the board of directors may differ significantly from the values that would have been used had a ready market existed for the investments, and the differences could be material.

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

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

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

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

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

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

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

*Valuation Methodology – CMBS Bonds and CDO Bonds and Preferred Shares* CMBS bonds and CDO bonds and preferred shares are carried at fair value, which is based on a discounted cash flow model, which utilizes prepayment and loss assumptions based on historical experience and projected performance, economic factors, the characteristics of the underlying cash flow and comparable market yields for similar CMBS bonds and CDO bonds and preferred shares. Our assumption with regard to discount rate is based on the yield of comparable securities. We recognize income from the amortization of original issue discount using the effective interest method, using the anticipated yield over the projected life of the investment. Yields are revised when there are changes in estimates of future credit losses, actual losses incurred, or actual and estimated prepayment speeds. Changes in estimated yield are recognized as an adjustment to the estimated yield over the remaining life of the CMBS bonds and CDO bonds and preferred shares from the date the estimated yield is

changed. We recognize unrealized appreciation or depreciation on our CMBS and CDO bonds and preferred shares bonds as comparable yields in the market change and based on changes in estimated cash flows resulting from changes in prepayment or loss assumptions in the underlying collateral pool.

For the portfolio, net change in unrealized appreciation or depreciation for the three months ended March 31, 2003 and 2002, consisted of the following:

| (\$ in millions)  | 2003     | 2002    |
|---|----------|---------|
| Net unrealized appreciation or depreciation   | \$(28.3) | \$(5.5) |
| Reversal of previously recorded unrealized appreciation associated with realized gains  | (43.0)   | (5.2)   |
| Reversal of previously recorded unrealized depreciation associated with realized losses | 0.2      | 3.2     |
|   |          |         |
| Net change in unrealized appreciation or depreciation                                   | \$(71.1) | \$(7.5) |

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

**Business Loan Express, LLC.** To determine the value of our investment in BLX at March 31, 2003, we performed four separate valuation analyses to determine its enterprise value: (1) analysis of comparable public company trading multiples, (2) analysis of BLX's value assuming an initial public offering, (3) analysis of merger and acquisition transactions for financial services companies, and (4) a discounted dividend analysis. The range of enterprise values resulting from these analyses was between \$360 million and \$530 million. We used an enterprise value of \$407 million to value our equity investment in BLX. This enterprise value is based on a pro forma equity value of 7.5 times trailing pro forma BLX net income adjusted for certain capital structure changes that would likely occur should the company be sold. Given an enterprise value of \$407 million, the fair value of our equity investment in BLX is \$244.7 million with a cost of \$203.1 million for total unrealized appreciation of \$41.6 million at March 31, 2003. Our valuation analysis also supports our newly invested capital to fund the Amresco Independence Funding purchase.

**The Hillman Companies, Inc.** Hillman achieved several milestones in 2002, including the completion of two acquisitions, the reduction of excess corporate overhead, and significant improvements to its operating structure. In performing our valuation analysis of Hillman at March 31, 2003, we quantified the impact of these milestones in order to determine normalized 2002 EBITDAM of approximately \$60.1 million.

We believe the current enterprise value for Hillman is approximately \$420.5 million, or 7.0 times 2002 normalized EBITDAM of \$60.1 million. The multiple was determined by obtaining a range of multiples representing the multiple of enterprise value to EBITDA for comparable public companies and the multiple of enterprise value to EBITDA for acquisition transactions involving companies in Hillman's peer group. From this market comparable analysis, we selected a 7.0 times multiple for our valuation. Using an enterprise value of \$420.5 million, the value of our equity investment in Hillman is approximately \$138.8 million, or \$88.2 million greater than our cost basis of \$50.6 million at March 31, 2003.

#### OTHER MATTERS

**Per Share Amounts.** All per share amounts included in Management's Discussion and Analysis of Financial Condition and Results of Operations section have been computed using the weighted

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average shares used to compute diluted earnings per share, which were 110.1 million and 102.4 million for the three months ended March 31, 2003 and 2002, respectively.

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

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

### FINANCIAL CONDITION, LIQUIDITY AND CAPITAL RESOURCES

#### Cash and Cash Equivalents

At March 31, 2003, we had \$8.1 million in cash and cash equivalents. We invest otherwise uninvested cash in U.S. government- or agency-issued or guaranteed securities that are backed by the full faith and credit of the United States, or in high quality, short-term repurchase agreements fully collateralized by such securities. Our objective is to manage to a low cash balance and fund new originations with our revolving line of credit.

#### Debt

At March 31, 2003, we had outstanding debt as follows:

| (\$ in millions)                          | Facility<br>Amount   | Amount<br>Outstanding | Annual<br>Interest<br>Cost <sup>(1)</sup> |
|---|----------------------|-----------------------|---|
| Notes payable and debentures:             |                      |                       |   |
| Unsecured long-term notes                 | \$ 694.0             | \$ 694.0              | 7.7%                                      |
| SBA debentures                            | 101.8                | 94.5                  | 8.1%                                      |
| OPIC loan                                 | 5.7                  | 5.7                   | 6.6%                                      |
| <b>Total notes payable and debentures</b> | <b>\$ 801.5</b>      | <b>\$ 794.2</b>       | <b>7.8%</b>                               |
| Revolving line of credit                  | 527.5 <sup>(3)</sup> | 61.8                  | 3.1% <sup>(2)</sup>                       |
| <b>Total debt</b>                         | <b>\$ 1,329.0</b>    | <b>\$ 856.0</b>       | <b>7.6%</b>                               |

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

(2) The current interest rate payable on the revolving line of credit is 2.8%, which excludes the annual cost of commitment fees and other facility fees of \$1.9 million.

(3) On April 18, 2003, we renewed the revolving line of credit and the committed amount under the renewed facility is \$462.5 million.

**Unsecured Long-Term Notes.** We have issued long-term debt to institutional lenders, primarily insurance companies. The notes have five-or seven-year maturities, with maturity dates beginning in





2003. The notes require payment of interest only semi-annually, and all principal is due upon maturity. On May 14, 2003, we issued \$153 million of five-year and \$147 million of seven-year unsecured long-term notes, primarily to insurance companies. The five- and seven-year notes have fixed interest rates of 5.45% and 6.05%, respectively, and have substantially the same terms as our existing unsecured long-term notes. On May 30, 2003, \$140 million of our existing unsecured long-term notes will mature and we will use that the proceeds from the new long-term note issuance to repay this amount.

**Small Business Administration Debentures.** We, through our small business investment company subsidiary, have debentures payable to the Small Business Administration with contractual maturities of ten years. The notes require payment of interest only semi-annually, and all principal is due upon maturity. Under the small business investment company program, we may borrow up to \$113.4 million from the Small Business Administration. At March 31, 2003, we had a commitment from the Small Business Administration to borrow up to an additional \$7.3 million above the current amount outstanding. The commitment expires on September 30, 2005.

**Revolving Line of Credit.** On April 18, 2003, we renewed our unsecured revolving line of credit under substantially similar terms with a committed amount under the renewed facility of \$462.5 million. The revolving line of credit may be expanded through new or additional commitments up to \$600 million at our option. As of March 31, 2003, \$61.8 million was drawn on the line of credit and \$4.6 million was committed for standby letters of credit issued under the credit facility. The renewed line of credit expires in April 2005 and may be extended under substantially similar terms for one additional year at our sole option. The credit facility bears interest at a rate equal to (i) the one-month LIBOR plus 1.25%, (ii) the Bank of America, N.A. prime rate, or (iii) the Federal Funds rate plus 0.50% at our option. The line of credit generally requires monthly payments of interest, and all principal is due upon maturity.

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

**Auction Rate Reset Note.** We repaid a \$75.0 million Auction Rate Reset Note Series A in December 2002. We have entered into an agreement with the placement agent of this note to serve as the placement agent on a future offering of \$75.0 million of debt, equity or other securities in one or more public or private transactions. If we do not conduct a capital raise, we will incur additional expenses of approximately \$3.2 million.

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The following table shows our significant contractual obligations as of March 31, 2003.

| (\$ in millions)                             | Payments Due By Year |                |                |                |                |              |               |
|--|----------------------|----------------|----------------|----------------|----------------|--------------|---------------|
|  | Total                | 2003           | 2004           | 2005           | 2006           | 2007         | After 2007    |
| Notes payable and debentures:                |                      |                |                |                |                |              |               |
| Unsecured long-term notes                    | \$694.0              | \$140.0        | \$214.0        | \$165.0        | \$175.0        | \$           | \$            |
| Small Business Administration debentures     | 94.5                 |                | 7.0            | 14.0           |                |              | 73.5          |
| Overseas Private Investment Corporation loan | 5.7                  |                |                |                | 5.7            |              |               |
| Revolving line of credit <sup>(1)</sup>      | 61.8                 |                | 61.8           |                |                |              |               |
| Operating Leases                             | 20.4                 | 2.0            | 2.7            | 2.7            | 2.6            | 2.5          | 7.9           |
| <b>Total contractual obligations</b>         | <b>\$876.4</b>       | <b>\$142.0</b> | <b>\$285.5</b> | <b>\$181.7</b> | <b>\$183.3</b> | <b>\$2.5</b> | <b>\$81.4</b> |

(1) As of March 31, 2003, the revolving line of credit had a committed amount of \$527.5 million and was to expire in August 2003, and could have been extended under substantially similar terms for one additional year at our sole option. We assumed that we would exercise our option to extend the revolving line of credit resulting in an assumed maturity of August 2004. At March 31, 2003, \$61.8 million was drawn on the line of credit and \$4.6 million was committed for standby letters of credit issued under the credit facility. On April 18, 2003, we renewed the revolving line of credit under substantially similar terms with a commitment amount under the renewed facility of \$462.5 million. The renewed line of credit expires in April 2005 and may be extended under substantially similar terms for one additional year at our sole option. Assuming that we would exercise our option to extend the revolving line of credit, the assumed maturity is April 2006.

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

| (\$ in millions)          | Amount of Commitment Expiration Per Year |              |               |              |              |              |              |
|---------------------------|--|--------------|---------------|--------------|--------------|--------------|--------------|
|                           | Total                                    | 2003         | 2004          | 2005         | 2006         | 2007         | After 2007   |
| Standby letters of credit | \$17.6                                   | \$           | \$4.6         | \$           | \$7.0        | \$           | \$6.0        |
| Guarantees                | 61.1                                     | 1.5          | 58.0          | 0.3          | 0.1          | 0.1          | 1.1          |
| <b>Total commitments</b>  | <b>\$78.7</b>                            | <b>\$1.5</b> | <b>\$62.6</b> | <b>\$0.3</b> | <b>\$7.1</b> | <b>\$0.1</b> | <b>\$7.1</b> |

### Equity Capital and Dividends

Because we are a regulated investment company, we distribute our income and require external capital for growth. Because we are a business development company, we are limited in the amount of debt capital we may use to fund our growth, since we are generally required to maintain a minimum ratio of 200% of total assets to total borrowings, or approximately a 1 to 1 debt to equity ratio. At March 31, 2003, our asset coverage for senior indebtedness was 307% and our debt to equity ratio was 0.54 to 1.00.

To support our growth during the three months ended March 31, 2003 and 2002, we raised \$82.4 million and \$20.0 million, respectively, in new equity capital. We issue equity from time to time when we have attractive investment opportunities. In addition, we raised \$1.7 million and \$1.6 million in new equity capital through the issuance of shares through our dividend reinvestment plan during the three months ended March 31, 2003 and 2002, respectively. During the quarter ended March 31, 2003, total shareholders' equity had increased \$42.2 million to \$1,588.3 million.

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Our Board of Directors reviews the dividend rate quarterly, and may adjust the quarterly dividend throughout the year. For the first and second quarters of 2003, the Board of Directors declared a dividend of \$0.57 per common share. The second quarter dividend is payable on June 27, 2003, with a record date of June 13, 2003. Dividends are paid based on our taxable income, which includes our taxable interest and fee income as well as taxable net realized capital gains. Our Board of Directors evaluates whether to retain or distribute capital gains on an annual basis. Our dividend

policy allows us to continue to distribute capital gains, but will also allow us to retain gains to support future growth.

**Liquidity and Capital Resources.** We plan to maintain a strategy of financing our business and related debt maturities with cash from operations, through borrowings under short- or long-term credit facilities or other debt securities, through asset sales, or through the sale or issuance of new equity capital. We anticipate an increased level of new investment activity during 2003 given the level of prospective investments currently under review. Although there can be no assurance that we will secure these new investments, we plan to raise new debt and equity capital as appropriate to fund investment growth prospectively.

Dividends to shareholders for the three months ended March 31, 2003 and 2002, were \$63.0 million and \$53.3 million, respectively. Cash flow from operations before new investments has historically been sufficient to finance our operations and pay dividends to shareholders.

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

At March 31, 2003, our debt to equity ratio was 0.54 to 1.00 and our weighted average cost of funds was 7.6%. Availability on the revolving line of credit, net of amounts committed for standby letters of credit issued under the line of credit facility, was \$461.2 million on March 31, 2003. We believe that we have access to capital sufficient to fund our ongoing investment and operating activities.

#### **CRITICAL ACCOUNTING POLICIES**

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

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

believe that the underlying portfolio company has appreciated in value and, therefore, our equity security has also appreciated in value. The value of investments in publicly traded securities are determined using quoted market prices discounted for restrictions on resale, if any.

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

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

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

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

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

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

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

**Commercial Mortgage-Backed Securities (CMBS) and Collateralized Debt Obligations (CDO) Bonds and CDO Bonds and Preferred Shares** are carried at fair value, which is based on a discounted cash flow model that utilizes prepayment and loss assumptions based on historical experience and projected performance, economic factors, the characteristics of the underlying cash flow, and comparable market yields for similar CMBS bonds and CDO bonds and preferred shares. Our assumption with regard to the discount rate for determining fair value is based on the yield of comparable securities. We recognize income from the amortization of original issue

discount using the effective interest method, using the anticipated yield over the projected life of the investment. Yields are revised when there are changes in estimates of future credit losses, actual losses incurred, or actual and estimated prepayment speeds. Changes in estimated yield are recognized as an adjustment to the estimated yield over the remaining life of the CMBS bonds and CDO bonds and preferred shares from the date the estimated yield is changed. We recognize unrealized appreciation or depreciation on our CMBS bonds and CDO bonds and preferred shares as comparable yields in the market change and based on changes in estimated cash flows resulting from changes in prepayment or loss assumptions in the underlying collateral pool.

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

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

## RISK FACTORS

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

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

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

**Substantially all of our portfolio investments are recorded at fair value as determined in good faith by our board of directors and, as a result, there is uncertainty regarding the value of our portfolio investments.** At March 31, 2003, approximately 92% of our total assets represented portfolio investments recorded at fair value. Pursuant to the requirements of the 1940 Act, we value substantially all of our investments at fair value as determined in good faith by our board of directors on a quarterly basis. Since there is typically no readily ascertainable market value for the investments in our portfolio, our board of directors determines in good faith the fair value of these investments pursuant to a valuation policy and a consistently applied valuation process.

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



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

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

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

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

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

**Our financial results could be negatively affected if Business Loan Express fails to perform as expected.** Business Loan Express, LLC (BLX) is our largest portfolio investment. Our financial results could be negatively affected if BLX, as a portfolio company, fails to perform as expected or if government funding for, or regulations related to the Small Business Administration 7(a) Guaranteed Loan Program change. At March 31, 2003, the investment totaled \$307.6 million at value, or 11.9% of total assets.

In addition, as controlling equity owner of BLX, we have provided an unconditional guaranty to BLX's senior credit facility lenders in an amount equal to 50% of BLX's total obligations on its \$149.0 million revolving credit facility. The amount we have guaranteed at March 31, 2003, was \$57.2 million. This guaranty can only be called in the event of a default by BLX. We have also provided two standby letters of credit in connection with two term securitization transactions completed by BLX totaling \$10.6 million.

**Investments in non-investment grade commercial mortgage-backed securities and collateralized debt obligations may be illiquid, may have a higher risk of default, and may not produce current returns.** The commercial mortgage-backed securities and collateralized debt obligation preferred

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

**We may not borrow money unless we maintain asset coverage for indebtedness of at least 200%, which may affect returns to shareholders.** We must maintain asset coverage for total borrowings of at least 200%. Our ability to achieve our investment objective may depend in part on our continued ability to maintain a leveraged capital structure by borrowing from banks or other lenders on favorable terms. There can be no assurance that we will be able to maintain such leverage. If asset coverage declines to less than 200%, we may be required to sell a portion of our investments when it is disadvantageous to do so. As of March 31, 2003, our asset coverage for senior indebtedness was 307%.

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

At March 31, 2003, we had \$856.0 million of outstanding indebtedness, bearing a weighted average annual interest cost of 7.6%. In order for us to cover these annual interest payments on indebtedness, we must achieve annual returns on our assets of at least 2.5%.

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

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

**We will continue to need additional capital to grow because we must distribute our income.** We will continue to need capital to fund incremental growth in our investments. Historically, we have borrowed from financial institutions and have issued equity securities. A reduction in the availability of new capital could limit our ability to grow. We must distribute at least 90% of our taxable ordinary income, which excludes net realized long-term capital gains, to our shareholders to maintain our regulated investment company status. As a result, such earnings will not be available to fund investment originations. We expect to continue to borrow from financial institutions and issue additional debt and equity securities. If we fail to obtain funds from such sources or from other sources to fund our investments, it could limit our ability to grow, which could have a material adverse effect on the value of our common stock. In addition, as a business development company, we are generally required to maintain a ratio of at least 200% of total assets to total borrowings, which may restrict our ability to borrow in certain circumstances.

**Loss of pass-through tax treatment would substantially reduce net assets and income available for dividends.** We have operated so as to qualify as a regulated investment company under Subchapter M of the Internal Revenue Code of 1986. If we meet source of income, diversification, and distribution requirements, we will qualify for effective pass-through tax treatment. We would cease to qualify for such pass-through tax treatment if we were unable to comply with these requirements. In addition, we may have difficulty meeting the requirement to make distributions to our shareholders because in certain cases we may recognize income before or without receiving cash representing such income. If we fail to qualify as a regulated investment company, we will have to pay corporate-level taxes on all of our income whether or not we distribute it, which would substantially reduce the amount of income available for distribution to our stockholders. Even if we qualify as a regulated investment company, we generally will be subject to a corporate-level income tax on the income we do not distribute. Moreover, if we do not distribute at least 98% of our taxable income, we generally will be subject to a 4% excise tax.

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

income, we may have difficulty meeting the requirement to distribute at least 90% of our investment company taxable income to maintain our status as a regulated investment company.

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

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

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

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

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

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

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

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

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

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

general economic conditions and trends;

loss of a major funding source; or

departures of key personnel.

Recently, the trading price of our common stock has been volatile. Due to the continued potential volatility of our stock price, we may be the target of securities litigation in the future. Securities litigation could result in substantial costs and divert management's attention and resources from our business.

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

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

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

(a) Within the 90-day period prior to the filing date of this quarterly report, the Company's chief executive officer and chief financial officer conducted an evaluation of the Company's disclosure controls and procedures (as defined in Rules 13a-14 and 15d-14 of the Securities Exchange Act of 1934). Based upon this evaluation, the Company's chief executive officer and chief financial officer concluded that the Company's disclosure controls and procedures are effective in timely alerting them of any material information relating to the Company that is required to be disclosed by the Company in the reports it files or submits under the Securities Exchange Act of 1934.

(b) There have not been any significant changes in the Company's internal controls or in other factors that could significantly affect those controls subsequent to the date of their evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

**PART II. OTHER INFORMATION**

**Item 1. *Legal Proceedings***

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

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

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

During the three months ended March 31, 2003, Allied Capital issued a total of 83,925 shares of common stock under its dividend reinvestment plan pursuant to an exemption from the registration requirements of the Securities Act of 1933. The aggregate offering price for the shares of common stock sold under the dividend reinvestment plan was approximately \$1.7 million.

**Item 3. *Defaults Upon Senior Securities***

Not applicable.

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

None.

**Item 5. *Other Information***

Not applicable.

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

(a) List of Exhibits

| Exhibit<br>Number | Description  |
|-------------------|--|
| 3.1               | Restated Articles of Incorporation. (Incorporated by reference to Exhibit a.1 filed with Allied Capital's Post-Effective Amendment No. 2 to registration statement on Form N-2 (File No. 333-67336) filed on March 22, 2002).  |
| 3.2               | Amended and Restated Bylaws. (Incorporated by reference to Exhibit b. filed with Allied Capital's Post-Effective Amendment No. 2 to registration statement on Form N-2 (File No. 333-67336) filed on March 22, 2002).  |
| 4.1               | Specimen Certificate of Allied Capital's Common Stock, par value \$0.0001 per share. (Incorporated by reference to Exhibit d. filed with Allied Capital's registration statement on Form N-2 (File No. 333-51899) filed on May 6, 1998).   |
| 4.2               | Form of debenture between certain subsidiaries of Allied Capital and the U.S. Small Business Administration. (Incorporated by reference to Exhibit 4.2 filed by a predecessor entity to Allied Capital on Form 10-K for the year ended December 31, 1996).   |
| 10.1              | Dividend Reinvestment Plan, as amended. (Incorporated by reference to Exhibit e. filed with Allied Capital's registration statement on Form N-2 (File No. 333-87862) filed on May 8, 2002).  |
| 10.2*             | Third Amended and Restated Credit Agreement, dated April 18, 2003.   |
| 10.3              | Note Agreement, dated as of April 30, 1998. (Incorporated by reference to Exhibit 10.2 filed with Allied Capital's Form 10-Q for the period ended June 30, 1998).  |
| 10.4              | Loan Agreement between a predecessor entity to Allied Capital and Overseas Private Investment Corporation, dated April 10, 1995. (Incorporated by reference to Exhibit f.7 filed by a predecessor entity to Allied Capital to Pre-Effective Amendment No. 2 to registration statement on Form N-2 (File No. 333-64629) filed on January 24, 1996). Letter, dated December 11, 1997, evidencing assignment of Loan Agreement from the predecessor entity of Allied Capital to Allied Capital. (Incorporated by reference to Exhibit 10.3 to Allied Capital's Form 10-K for the year ended December 31, 1997). |
| 10.5              | Note Agreement, dated as of May 1, 1999. (Incorporated by reference to Exhibit 10.5 filed with Allied Capital Form 10-Q for the period ended June 30, 1999).   |
| 10.6              | Amendment and Consent Agreement, dated December 11, 2000, to the Amended and Restated Credit Agreement, dated May 17, 2000. (Incorporated by reference to Exhibit f.6 filed with Allied Capital's Post-Effective Amendment No. 2 to the registration statement on Form N-2 (File No. 333-43534) filed on March 21, 2001).  |
| 10.7              | Sale and Servicing Agreement, dated as of January 1, 1998, among Allied Capital CMT, Inc., Allied Capital Commercial Mortgage Trust 1998-1, Allied Capital Corporation, LaSalle National Bank and ABN AMRO Bank N.V. (Incorporated by reference to Exhibit f.7.a filed with Allied Capital's registration statement on Form N-2 (File No. 333-51899) filed on May 6, 1998).  |
| 10.8              | Indenture, dated as of January 1, 1998, between Allied Capital Commercial Mortgage Trust 1998-1 and LaSalle National Bank. (Incorporated by reference to Exhibit f.7.b filed with Allied Capital's registration statement on Form N-2 (File No. 333-51899) filed on May 6, 1998).  |
| 10.9              | Amended and Restated Trust Agreement, dated January 1, 1998, between Allied Capital CMT, Inc., LaSalle National Bank Inc. and Wilmington Trust Company. (Incorporated by reference to Exhibit f.7.c filed with Allied Capital's registration statement on Form N-2 (File No. 333-51899) filed on May 6, 1998).   |

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| Exhibit<br>Number | Description   |
|-------------------|---|
| 10.10             | Guaranty, dated as of January 1, 1998, by Allied Capital. (Incorporated by reference to Exhibit f.7.d filed with Allied Capital's registration statement on Form N-2 (File No. 333-51899) filed on May 6, 1998).  |
| 10.11             | Note Agreement, dated as of November 15, 1999. (Incorporated by reference to Exhibit 10.4a of Allied Capital's Form 10-K for the year ended December 31, 1999).   |
| 10.12             | Note Agreement, dated as of October 15, 2000. (Incorporated by reference to Exhibit 10.4b filed with Allied Capital's Form 10-Q for the period ended September 30, 2000).   |
| 10.13             | Note Agreement, dated as of October 15, 2001. (Incorporated by reference to Exhibit f.10 filed with Allied Capital's Post-Effective Amendment No. 1 to registration statement on Form N-2 (File No. 333-67336) filed on November 14, 2001).   |
| 10.14(a)          | Auction Rate Reset Note Agreement, dated as of August 31, 2000, between Allied Capital and Intrepid Funding Master Trust; Forward Issuance Agreement, dated as of August 31, 2000, between Allied Capital and Banc of America Securities LLC; Remarketing and Contingency Purchase Agreement, dated as of August 31, 2000, between Allied Capital and Banc of America Securities LLC; (Incorporated by reference to Exhibit f.12 filed with Allied Capital's Pre-Effective Amendment No. 1 to registration statement on Form N-2 (File No. 333-43534) filed on September 12, 2000). |
| 10.14(b)          | Amended Auction Rate Reset Note Agreement, dated as of September 30, 2002, between Allied Capital and Intrepid Funding Master Trust; Amended Forward Issuance Agreement, dated as of September 30, 2002, between Allied Capital and Banc of America Securities LLC; Amendment Remarketing and Contingency Purchase Agreement, dated as of September 30, 2002, between Allied Capital and Banc of America Securities LLC. (Incorporated by reference to Exhibit 10.29 filed with Allied Capital's Form 10-Q for the period ended September 30, 2002).                                |
| 10.14(c)          | Amendment to the Letter Agreement and Forward Issuance Agreement, dated as of December 19, 2002, between Allied Capital and Banc of America Securities LLC. (Incorporated by reference to Exhibit 10.14(c) filed with Allied Capital's Form 10-K for the year ended December 31, 2002).   |
| 10.14(d)          | Amendment to the Letter Agreement and Forward Issuance Agreement dated as of March 28, 2003, between Allied Capital and Banc of America Securities LLC. (Incorporated by reference to Exhibit 10.14(d) filed with Allied Capital's Form 10-K for the year ended December 31, 2002).   |
| 10.15             | Control Investor Guaranty Agreement, dated as of March 28, 2001, between Allied Capital and Fleet National Bank and Business Loan Express, Inc. (Incorporated by reference to Exhibit f.14 filed with Allied Capital's Post-Effective Amendment No. 3 to registration statement on Form N-2 (File No. 333-43534) filed on May 15, 2001).  |
| 10.16             | Amended and Restated Deferred Compensation Plan, dated December 30, 1998. (Incorporated by reference to Exhibit 10.11 to Allied Capital's Form 10-K for the year ended December 31, 1998).  |
| 10.17             | Amended to Deferred Compensation Plan, dated October 18, 2000. (Incorporated by reference to Exhibit i.2.a filed with Allied Capital's Post-Effective Amendment No. 1 to registration statement on Form N-2 (File No. 333-43534) filed on January 19, 2001).  |



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| Exhibit Number | Description   |
|----------------|---|
| 10.18          | Amended and Restated Deferred Compensation Plan, dated May 15, 2001. (Incorporated by reference to Exhibit i.2.b filed with Allied Capital's Post-Effective Amendment No. 1 to registration statement on Form N-2 (File No. 333-67336) filed on November 14, 2001).                                     |
| 10.19          | Amended Stock Option Plan. (Incorporated by reference to Exhibit A of Allied Capital's definitive proxy statement for Allied Capital's 2002 Annual Meeting of Stockholders filed on April 3, 2002).   |
| 10.20(a)       | Allied Capital Corporation 401(k) Plan, dated September 1, 1999. (Incorporated by reference to Exhibit 4.4 filed with Allied Capital's registration statement on Form S-8 (File No. 333-88681) filed on October 8, 1999).   |
| 10.20(b)       | Amendment to Allied Capital Corporation 401(k) Plan, dated December 31, 2000. (Incorporated by reference to Exhibit i.5.a filed with Allied Capital's Post-Effective Amendment No. 1 to registration statement on Form N-2 (File No. 333-43534) filed on January 19, 2001).                             |
| 10.21          | Employment Agreement, dated June 15, 2000, between Allied Capital and William L. Walton. (Incorporated by reference to Exhibit f.9 filed with Allied Capital's registration statement on Form N-2 (File No. 333-43534) filed on August 11, 2000).   |
| 10.22          | Employment Agreement, dated June 15, 2000, between Allied Capital and Joan M. Sweeney. (Incorporated by reference to Exhibit f.10 filed with Allied Capital's registration statement on Form N-2 (File No. 333-43534) filed on August 11, 2000).  |
| 10.23          | Employment Agreement, dated June 15, 2000, between Allied Capital and John M. Scheurer. (Incorporated by reference to Exhibit i.8 filed with Allied Capital's Post-Effective Amendment No. 2 to registration statement on Form N-2 (File No. 333-43534) filed on March 21, 2001).                       |
| 10.24          | Employment Agreement, dated June 15, 2002, between Allied Capital and Thomas H. Westbrook and amended as of March 10, 2003. (Incorporated by reference to Exhibit 10.24 filed with Allied Capital's Form 10-K for the year ended December 31, 2002).  |
| 10.25          | Form of Custody Agreement with Riggs Bank N.A. (Incorporated by reference to Exhibit j.1 filed with Allied Capital's registration statement on Form N-2 (File No. 333-51899) filed on May 6, 1998).   |
| 10.26          | Form of Custody Agreement with LaSalle National Bank. (Incorporated by reference to Exhibit j.2 filed with Allied Capital's registration statement on Form N-2 (File No. 333-51899) filed on May 6, 1998).  |
| 10.27          | Custodian Agreement with LaSalle National Bank Association dated July 9, 2001. (Incorporated by reference to Exhibit j.3 filed with Allied Capital's registration statement on Form N-2 (File No. 333-67336) filed on August 10, 2001).   |
| 10.28          | Code of Ethics. (Incorporated by reference to Exhibit r. filed with Allied Capital's Pre-Effective Amendment No. 1 to the registration statement on Form N-2 (File No. 333-43534) on September 12, 2000).   |
| 10.30          | Agreement and Plan of Merger by and among Allied Capital, Allied Capital Lock Acquisition Corporation, and Suncourse, Inc dated June 18, 2001. (Incorporated by reference to Exhibit k.1 filed with Allied Capital's registration statement on Form N-2 (File No. 333-67336) filed on August 10, 2001). |
| 10.31*         | Note Agreement, dated as of May 14, 2003.   |
| 10.32*         | Amendment, dated as of April 30, 2003, to Note Agreement, dated as of April 30, 1998.   |

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| <b>Exhibit<br/>Number</b> | <b>Description</b>   |
|---------------------------|--|
| 10.33*                    | Amendment, dated as of April 30, 2003, to Note Agreement, dated as of May 1, 1999.   |
| 10.34*                    | Amendment, dated as of April 30, 2003, to Note Agreement, dated as of November 15, 1999.   |
| 10.35*                    | Amendment, dated as of April 30, 2003, to Note Agreement, dated as of October 15, 2000.  |
| 10.36*                    | Amendment, dated as of April 30, 2003, to Note Agreement, dated as of October 15, 2001.  |
| 15.*                      | Letter regarding Unaudited Interim Financial Information   |
| 99.1*                     | Certification of Chief Executive Officer Pursuant to 18 U.S.C. 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |
| 99.2*                     | Certification of Chief Financial Officer Pursuant to 18 U.S.C. 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002. |

\* Filed herewith.

(b) Reports on Form 8-K

None.

**SIGNATURES**

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

ALLIED CAPITAL CORPORATION  
(Registrant)

Dated: May 15, 2003

/s/ WILLIAM L. WALTON

-----  
William L. Walton  
Chairman and Chief Executive Officer

/s/ PENNI F. ROLL

-----  
Penni F. Roll  
Chief Financial Officer

**Certification of Chief Executive Officer**

I, William L. Walton, Chief Executive Officer of Allied Capital Corporation, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Allied Capital Corporation;
2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;
3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and we have:
  - a. designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;
  - b. evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the "Evaluation Date"); and
  - c. presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent functions):
  - a. all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and
  - b. any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and

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6. The registrant's other certifying officer and I have indicated in this quarterly report whether there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Date: May 15, 2003

By: /s/ WILLIAM L. WALTON

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William L. Walton  
Chief Executive Officer

**Certification of Chief Financial Officer**

I, Penni F. Roll, Chief Financial Officer of Allied Capital Corporation, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Allied Capital Corporation;
2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;
3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and we have:
  - a. designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;
  - b. evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the "Evaluation Date"); and
  - c. presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent functions):
  - a. all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and
  - b. any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and

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6. The registrant's other certifying officer and I have indicated in this quarterly report whether there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

Date: May 15, 2003

By: /s/ PENNI F. ROLL

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Penni F. Roll  
Chief Financial Officer

## EXHIBIT INDEX

| <b>Exhibit<br/>Number</b> | <b>Description</b>   |
|---------------------------|--|
| 10.2*                     | Third Amended and Restated Credit Agreement, dated April 18, 2003.   |
| 10.31*                    | Note Agreement, dated as of May 14, 2003.  |
| 10.32*                    | Amendment, dated as of April 30, 2003, to Note Agreement, dated as of April 30, 1998.  |
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