

ALLIED CAPITAL CORP  
Form 497  
September 30, 2004

Prospectus Supplement  
(To Prospectus dated September 14, 2004)

Filed Pursuant to Rule 497  
Registration Statement No. 333-113671

## 3,000,000 Shares

### Common Stock

We are offering for sale 3,000,000 shares of our common stock. Our common stock is traded on the New York Stock Exchange (the NYSE ) under the symbol ALD. The last reported sales price of our common stock on the NYSE on September 29, 2004, was \$25.11 per share.

**You should review the information, including the risk of leverage, set forth under Risk Factors on page 10 of the accompanying prospectus before investing in our common stock.**

	Per Share	Total
Public offering price	\$25.00	\$75,000,000
Underwriting discount	\$ 1.25	\$ 3,750,000
Proceeds to Allied Capital Corporation(1)	\$23.75	\$71,250,000

(1) Before deducting expenses payable by us estimated to be \$470,000.

Please read this prospectus supplement, and the accompanying prospectus, before investing, and keep it for future reference. The prospectus supplement and the accompanying prospectus contain important information about us. The Securities and Exchange Commission (the SEC ) maintains an Internet website (<http://www.sec.gov>) that contains other information about us.

We have granted the underwriters a 30-day option to purchase up to 450,000 additional shares of common stock to cover over-allotments. If the underwriters exercise the option in full, the public offering price, the underwriting discount and proceeds to us would be \$86,250,000, \$4,312,500 and \$81,937,500, respectively.

Neither the SEC nor any state securities commission has approved or disapproved of these securities or passed upon the adequacy or accuracy of this prospectus supplement or the accompanying prospectus. Any representation to the contrary is a criminal offense.

The shares of common stock will be ready for delivery on or about October 5, 2004.

*Joint Book-Running Managers*

**Banc of America Securities LLC**

**Deutsche Bank Securities**

**JMP Securities**

The date of this prospectus supplement is September 29, 2004.

You should rely only on the information contained in this prospectus supplement and the accompanying prospectus. We have not, and the underwriters have not, authorized any other person to provide you with different information. If anyone provides you with different or inconsistent information, you should not rely on it. We are not, and the underwriters are not, making an offer to sell these securities in any jurisdiction where the offer or sale is not permitted. You should assume that the information appearing in this prospectus supplement and the accompanying prospectus is accurate only as of their respective dates. Our business, financial condition, results of operations and prospects may have changed since those dates.

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In this prospectus supplement and the accompanying prospectus, unless otherwise indicated, Allied Capital, we, us or our refer to Allied Capital Corporation and its subsidiaries.

Information contained in this prospectus supplement and the accompanying prospectus may contain forward-looking statements, which can be identified by the use of forward-looking terminology such as may, will, expect, intend, anticipate, estimate, or continue or the negative thereof or other variations thereon or comparable terminology. The matters described in Risk Factors in the accompanying prospectus and certain other factors noted throughout this prospectus supplement and the accompanying prospectus constitute cautionary statements identifying important factors with respect to any such forward-looking statements, including certain risks and uncertainties, that could cause actual results to differ materially from those in such forward-looking statements.

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### FEES AND EXPENSES

This table describes the various costs and expenses that an investor of our common stock will bear directly or indirectly.

<b>Shareholders Transaction Expenses</b>	
Sales load (as a percentage of offering price) <sup>(1)</sup>	5.0%
Dividend reinvestment plan fees <sup>(2)</sup>	None
<b>Annual Expenses (as a percentage of consolidated net assets attributable to common shares)<sup>(3)</sup></b>	
Operating expenses <sup>(4)</sup>	4.6%
Interest payments on borrowed funds <sup>(5)</sup>	4.0%
<b>Total annual expenses<sup>(6)(7)</sup></b>	<b>8.6%</b>

- (1) Represents the underwriting discounts and commissions with respect to the shares sold by Allied Capital in this offering.
- (2) The expenses of our dividend reinvestment plan are included in Operating expenses. We do not have a stock purchase plan. The participants in the dividend reinvestment plan will bear a pro rata share of brokerage commissions incurred with respect to open market purchases, if any. See Dividend Reinvestment Plan in the accompanying prospectus.
- (3) Consolidated net assets attributable to common stock equals net assets (*i.e.*, total consolidated assets less total consolidated liabilities and preferred stock), which at June 30, 2004 was \$1.9 billion.
- (4) Operating expenses represent our estimated operating expenses for the year ending December 31, 2004, excluding interest on indebtedness. This percentage for the year ended December 31, 2003, was 3.1%.
- (5) The Interest payments on borrowed funds represents our estimated interest expenses for the year ending December 31, 2004. We had outstanding borrowings of \$1,058.8 million at June 30, 2004. This percentage for the year ended December 31, 2003, was 4.0%. See Risk Factors in the accompanying prospectus.
- (6) Total annual expenses as a percentage of consolidated net assets attributable to common stock are higher than the total annual expenses percentage would be for a company that is not leveraged. We borrow money to leverage our net assets and increase our total assets. The SEC requires that the Total annual expenses percentage be calculated as a percentage of net assets, rather than the total assets, including assets that have been funded with borrowed monies. If the Total annual expenses percentage were calculated instead as a percentage of consolidated total assets, our Total annual expenses would be 5.2% of consolidated total assets.
- (7) The holders of shares of our common stock (and not the holders of our debt securities or preferred stock, if any) indirectly bear the cost associated with our annual expenses.

#### Example

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

	<u>1 Year</u>	<u>3 Years</u>	<u>5 Years</u>	<u>10 Years</u>
You would pay the following expenses on a \$1,000 investment, assuming a 5.0% annual return	\$ 86	\$258	\$429	\$854

Although the example assumes (as required by the SEC) a 5.0% annual return, our performance will vary and may result in a return of greater or less than 5.0%. In addition, while the example assumes reinvestment of all dividends and distributions at net asset value, participants

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in the dividend reinvestment plan may receive shares of common stock that we issue at or above net asset value or purchased by the administrator of the dividend reinvestment plan, at the market price in effect at the time, which may be higher than, at, or below net asset value. See Dividend Reinvestment Plan in the accompanying prospectus.

**The example should not be considered a representation of future expenses, and the actual expenses may be greater or less than those shown.**

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**USE OF PROCEEDS**

The net proceeds from the sale of the shares of our common stock, after deducting estimated expenses of this offering, are estimated to be \$70.8 million. We intend to use the net proceeds from selling our common stock to reduce borrowings under our revolving line of credit. Amounts repaid under our revolving line of credit will remain available for future borrowing. At September 29, 2004, the interest rate on our revolving line of credit was 3.3% and there was approximately \$353.0 million outstanding. This revolving line of credit terminates in April 2005 and may be extended on substantially similar terms for one additional year at our option.

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**UNDERWRITING**

We are offering the shares of our common stock described in this prospectus through the underwriters named below. Banc of America Securities LLC and Deutsche Bank Securities Inc. are acting as joint book-running managers of the offering and representatives of the underwriters. We have entered into an underwriting agreement with the underwriters. Subject to the terms and conditions of the underwriting agreement, each of the underwriters has severally agreed to purchase the number of shares of common stock listed next to its name in the following table:

<b>Underwriters</b>	<b>Number of shares</b>
Banc of America Securities LLC	1,350,000
Deutsche Bank Securities Inc.	1,350,000
JMP Securities LLC	300,000
Total	3,000,000

The underwriting agreement provides that the obligation of the underwriters to purchase the shares offered by us is subject to some conditions. The underwriters are obligated to purchase all of the shares offered by us, if any of the shares are purchased.

This offering of the shares is made for delivery when, as and if accepted by the underwriters and subject to prior sale and to withdrawal, cancellation or modification of this offering without notice. The underwriters reserve the right to reject an order for the purchase of shares in whole or in part.

We have agreed to indemnify the underwriters against certain liabilities, including liabilities under the Securities Act, and to contribute to payments the underwriters may be required to make in respect of these liabilities.

**Commissions and Discounts**

The underwriters propose to offer the shares to the public initially at the public offering price set forth on the cover of this prospectus supplement and to dealers at that price, less a selling concession of \$0.75 per share. After the offering, the public price may be changed by the underwriters.

The following table shows the per share and total underwriting discounts and commissions to be paid to the underwriters by us assuming both no exercise and full exercise of the underwriters' option to purchase additional shares.

	<b>No Exercise of Option</b>	<b>Full Exercise of Option</b>
Per share	\$ 1.25	\$ 1.25
Total	\$3,750,000	\$4,312,500

We estimate that the total expenses of this offering, which will be paid by us, excluding the underwriting discounts and commissions, will be approximately \$470,000.



### **Overallotment Option**

The underwriters have the option to purchase up to 450,000 additional shares of common stock from us at the same price they are paying for the 3,000,000 shares offered hereby. The underwriters may purchase additional shares only to cover overallotments made in connection with this offering and only within 30 days after the date of this prospectus supplement. The underwriters will offer any additional shares that they purchase on the terms described in the preceding section.

### **No Sale of Similar Securities**

We and certain of our executive officers have agreed not to offer, sell, transfer or otherwise dispose of, or to engage in certain hedging and derivative transactions with respect to, the common stock or any securities convertible into or exchangeable for shares of common stock for a period of 60 days after the date of this prospectus supplement without first obtaining the written consent of Banc of America Securities LLC and Deutsche Bank Securities Inc., as representatives of the underwriters, except in certain limited circumstances, including (i) our additional issuance of equity securities through privately negotiated transactions that may or may not involve an underwriter, whether or not registered with the SEC, aggregating not more than \$50 million and (ii) our additional issuance of securities as all or part of the consideration paid for by us in connection with the acquisition of assets or securities of a third-party entity.

### **Price Stabilization and Short Positions**

In connection with this offering, the underwriters may purchase and sell shares of our common stock in the open market. These transactions may include stabilizing transactions, short sales and purchases to cover positions created by short sales. Stabilizing transactions consist of bids or purchases made for the purpose of preventing or retarding a decline in the market price of our common stock while this offering is in progress. Short sales involve the sale by the underwriters of a greater number of shares than they are required to purchase in this offering. Short sales may be either covered short sales or naked short sales. Covered short sales are sales made in an amount not greater than the underwriters over-allotment option to purchase additional shares in this offering. The underwriters may close out any covered short position by either exercising their over-allotment option or purchasing shares in the open market. In determining the source of shares to close out the covered short position, the underwriters will consider, among other things, the price of shares available for purchase in the open market as compared to the price at which they may purchase shares through the over-allotment option. Naked short sales are sales in excess of the over-allotment option. The underwriters must close out any naked short position by purchasing shares in the open market. A naked short position is more likely to be created if the underwriters are concerned there may be downward pressure on the price of shares in the open market after pricing that could adversely affect investors who purchase in this offering.

We have been advised by the representatives of the underwriters that these transactions may be effected on the NYSE or otherwise and, if commenced, may be discontinued at any time. Similar to other purchase activities, these activities may have the effect of raising or maintaining the market price of our shares or preventing a decline in the market price of our shares. As a result, the price of our shares may be higher than the price that might otherwise exist in the open market.

### **Settlement**

The underwriters expect to deliver the shares through the facilities of The Depository Trust Company in New York, New York, on or about October 5, 2004. At that time, the underwriters will pay us for the shares in immediately available funds. For the third quarter of 2004, our Board of Directors declared a dividend of \$0.57 per common share. The third quarter dividend is payable on September 30, 2004, with a record date of September 10, 2004. Accordingly, the shares offered by this prospectus supplement will not be entitled to the third quarter dividend.

### **Other Relationships**

In the ordinary course of business, the underwriters and/or their affiliates have in the past performed, and may continue to perform, commercial banking, financial advisory and investment banking services for us for which they have received, or may receive, customary compensation. Affiliates of Banc of America Securities LLC and Deutsche Bank Securities Inc. are members of the lending syndicate for our unsecured revolving line of credit. JMP Securities LLC provides portfolio valuation services to us.

### **Other Information**

This offering is being conducted in compliance with Rule 2810 of the Conduct Rules of the National Association of Securities Dealers, Inc. Because 10% or more of the net offering proceeds may be paid to affiliates of Banc of America Securities LLC and Deutsche Bank Securities Inc., the offering will also be conducted in compliance with NASD Rule 2710(h).

The address for Banc of America Securities LLC, 9 West 57th Street, 21st Floor, New York, NY 10019. The address for Deutsche Bank Securities Inc. is 60 Wall Street, 4th Floor, New York, NY 10005. The address for JMP Securities LLC is 600 Montgomery Street, Suite 1100, San Francisco, CA 94111.

### **LEGAL MATTERS**

Certain legal matters with respect to the validity of the shares of common stock we are offering will be passed upon for us by Sutherland Asbill & Brennan LLP, Washington, D.C. Certain legal matters related to the offering will be passed upon for the underwriters by Davis Polk & Wardwell, New York, New York.

## PROSPECTUS

20,000,000 Shares

### Common Stock

We are an internally managed closed-end, non-diversified management investment company that has elected to be regulated as a business development company under the Investment Company Act of 1940.

Our investment objective is to achieve current income and capital gains. We seek to achieve our investment objective by investing in companies in a variety of industries, non-investment grade commercial mortgage-backed securities, and collateralized debt obligation bonds and preferred shares. No assurances can be given that we will continue to achieve our objective.

Please read this prospectus, and the accompanying prospectus supplement, if any, before investing, and keep it for future reference. It contains important information about us. The SEC maintains an Internet website (<http://www.sec.gov>) that contains other information about us.

We may offer, from time to time, up to 20,000,000 shares of our common stock in one or more offerings.

The shares of common stock may be offered at prices and on terms to be described in one or more supplements to this prospectus. The offering price per share of our common stock less any underwriting commissions or discounts will not be less than the net asset value per share of our common stock at the time we make the offering.

Our common stock is traded on the New York Stock Exchange under the symbol ALD. As of September 13, 2004, the last reported sale price on the New York Stock Exchange for the common stock was \$25.48.

**You should review the information, including the risk of leverage, set forth under Risk Factors on page 10 of this prospectus before investing in our common stock.**

**Neither the Securities and Exchange Commission nor any state securities commission has approved or disapproved of these securities or passed upon the adequacy or accuracy of this prospectus. Any representations to the contrary is a criminal offense.**

**This prospectus may not be used to consummate sales of shares of common stock unless accompanied by a prospectus supplement.**

September 14, 2004

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We have not authorized any dealer, salesman or other person to give any information or to make any representation other than those contained in this prospectus or any accompanying supplement to this prospectus. You must not rely upon any information or representation not contained in this prospectus or the accompanying prospectus supplement as if we had authorized it. This prospectus and any prospectus supplement do not constitute an offer to sell or a solicitation of any offer to buy any security other than the registered securities to which they relate, nor do they constitute an offer to sell or a solicitation of an offer to buy any securities in any jurisdiction to any person to whom it is unlawful to make such an offer or solicitation in such jurisdiction. The information contained in this prospectus and any prospectus supplement is accurate as of the dates on their covers.

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## ABOUT THIS PROSPECTUS

This prospectus is part of a registration statement that we have filed with the Securities and Exchange Commission using the shelf registration process. Under the shelf registration process, we may offer, from time to time, up to 20,000,000 shares of our common stock on the terms to be determined at the time of the offering. Shares of our common stock may be offered at prices and on terms described in one or more supplements to this prospectus. This prospectus provides you with a general description of the shares of our common stock that we may offer. Each time we use this prospectus to offer shares of our common stock, we will provide a prospectus supplement that will contain specific information about the terms of that offering. The prospectus supplement may also add, update or change information contained in this prospectus. Please carefully read this prospectus and any prospectus supplement together with the additional information described under "Where You Can Find Additional Information" in the "Prospectus Summary" and "Risk Factors" sections before you make an investment decision.

## PROSPECTUS SUMMARY

*The following summary contains basic information about this offering. It may not contain all the information that is important to an investor. For a more complete understanding of this offering, we encourage you to read this entire prospectus and the documents that are referred to in this prospectus.*

*In this prospectus or any accompanying prospectus supplement, unless otherwise indicated, Allied Capital, we, us or our refer to Allied Capital Corporation and its subsidiaries.*

### BUSINESS (Page 64)

As a business development company, we are in the private equity business. We provide long-term debt and equity capital. We have participated in the private equity business for over 40 years and have financed thousands of companies nationwide. Our investment objective is to achieve current income and capital gains.

We believe the private equity capital markets are important to the growth of small and middle market companies because such companies often have difficulty accessing the public debt and equity capital markets because their capital needs are too small to be attractive to the public markets, or because they are in need of long-term growth capital, which banks do not generally provide. We believe that we are well positioned to be a source of capital for such companies.

Our investment activity is primarily focused in three areas:

Lending subordinated debt with or without equity features to middle market companies (mezzanine investing),

Buying controlling equity stakes in middle market companies (buyout investing), and

Investing in non-investment grade classes of commercial mortgage-backed securities (CMBS) and collateralized debt obligations (CDOs).

Our investments are long-term in nature, privately negotiated, and no readily available market exists for them. This makes our investments highly illiquid.

As a private equity investor, we spend significant time and effort identifying, structuring, performing due diligence, monitoring, valuing and ultimately exiting our investments. Each investment is subject to an extensive due diligence process. It is not uncommon for a single investment to take from two months to a year to complete, depending on the complexity of the transaction.

Our private finance portfolio is primarily composed of mezzanine loans and equity securities. This capital is used by portfolio companies to fund growth, acquisitions, buyouts, recapitalizations, note purchases, bridge financings, or other types of financings. We generally target companies in less cyclical industries with, among other things, high return on invested capital, management teams with meaningful equity ownership, well-constructed balance sheets, and that have the ability to generate free cash flow.

Our primary commercial real estate investments are in the non-investment grade classes of CMBS bonds. We generally invest at the initial issuance of the CMBS, and are able to review the underlying collateral of mortgage loans as if we were making an initial decision to fund such loans and to determine if we want to exclude any loans that do not meet our credit, collateral, structural or other standards. We are also able to negotiate to acquire the securities at significant discounts from their face value. In addition to our CMBS investments, we have invested in the bonds and preferred shares of CDOs.

Our investments are typically structured to provide recurring cash flow in the form of interest income to us as the investor. In addition to earning interest income, we may structure our investments

to generate income from management, diligence, structuring, or other fees. Our total return may be enhanced through capital gains.

As a private equity investor, we believe that we have certain competitive advantages including:

Access to public equity markets generally gives us a lower cost of capital than that of other private equity funds, and

Our capital structure is perpetual in nature and may enable us to be a better long-term partner for our portfolio companies than other private equity funds that may have a limited life.

We have elected to be treated as a regulated investment company under the Internal Revenue Code of 1986, as amended, which we refer to as the Code. Our status as a regulated investment company generally eliminates a corporate level income tax on taxable income we timely distribute to our stockholders as dividends, if certain requirements are met. See Tax Status . We pay regular quarterly dividends based upon an estimate of annual taxable income. Since 1963, our portfolio has generally provided sufficient ordinary taxable income and net capital gains to sustain or grow our dividends over time.

We are a Maryland corporation and a closed-end, non-diversified management investment company that has elected to be regulated as a business development company under the Investment Company Act of 1940, which we refer to as the 1940 Act.

As a business development company, we are required to meet certain regulatory tests, the most significant relating to our investments and borrowings. A business development company is required to invest at least 70% of its assets in eligible portfolio companies. A business development company must also maintain a coverage ratio of assets to senior securities of at least 200%. See Certain Government Regulations.

Our executive offices are located at 1919 Pennsylvania Avenue, NW, Washington, DC, 20006 and our telephone number is (202) 331-1112. In addition, we have regional offices in New York, Chicago and Los Angeles.

Our Internet website address is [www.alliedcapital.com](http://www.alliedcapital.com). Information contained on our website is not incorporated by reference into this prospectus and you should not consider information contained on our website to be part of this prospectus.

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

#### **DETERMINATION OF**

#### **NET ASSET VALUE (Page 86)**

Our portfolio investments are generally recorded at fair value as determined in good faith by our Board of Directors in the absence of readily available public market values. At June 30, 2004, portfolio investments recorded at fair value were approximately 87% of our total assets.

Pursuant to the requirements of the 1940 Act, we value substantially all of our portfolio investments at fair value as determined in good faith by the Board of Directors on a quarterly basis. Since there is typically no readily available market value for the investments in our portfolio, our Board of Directors determines in good faith the fair value of these portfolio 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. Instead we are required to specifically value each individual investment and record unrealized depreciation for an investment that we believe has become impaired including where collection of a loan or realization of an equity security is doubtful 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. Conversely, we will record unrealized appreciation if we believe that the underlying portfolio company has appreciated in value and, therefore, our equity security has also appreciated in value. Without a readily available market value and because of the inherent uncertainty of valuation, the fair value of our investments determined in good faith by the Board of Directors may differ significantly from the values that would have been used had a ready market existed for the investments, and the differences could be material.

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

#### **PLAN OF DISTRIBUTION** *(Page 120)*

We may offer, from time to time, up to 20,000,000 shares of our common stock, on terms to be determined at the time of the offering.

Shares of our common stock may be offered at prices and on terms described in one or more supplements to this prospectus. The offering price per share of our common stock less any underwriting commission or discount will not be less than the net asset value per share of our common stock at the time we make the offering.

Our shares of common stock may be offered directly to one or more purchasers, through agents designated from time to time by us, or to or through underwriters or dealers. The supplement to this prospectus relating to the offering will identify any agents or underwriters involved in the sale of our shares of common stock, and will set forth any applicable purchase price, fee and commission or discount arrangement or the basis upon which such amount may be calculated.

We may not sell shares of common stock pursuant to this prospectus without delivering a prospectus supplement describing the method and terms of the offering of such shares.

#### **USE OF PROCEEDS** *(Page 18)*

We intend to use the net proceeds from selling shares of common stock for general corporate purposes, which includes investments in the debt or equity securities of primarily private companies, non-investment grade commercial mortgage-backed securities or the bonds and preferred shares of collateralized debt obligations, repayment of indebtedness, acquisitions and other general corporate purposes. The supplement to this prospectus relating to an offering will more fully identify the use of the proceeds from such offering.

#### **PRICE RANGE OF COMMON STOCK AND DISTRIBUTIONS** *(Page 19)*

We intend to pay quarterly dividends to holders of our common stock. The amount of our quarterly dividends is determined by our Board of Directors on a quarterly basis.

**DIVIDEND REINVESTMENT PLAN** (Page 113)

We maintain an opt in dividend reinvestment plan for our common shareholders. As a result, if our Board of Directors declares a dividend, then our shareholders that have not opted in to our dividend reinvestment plan will receive cash dividends. New shareholders must notify our transfer agent in writing if they wish to enroll in the dividend reinvestment plan.

**RISK FACTORS** (Page 10)

Investment in our shares of common stock involves a number of significant risks relating to our business and our investment objective that you should consider before purchasing our shares of common stock.

Our portfolio of investments is generally illiquid. Our portfolio includes securities primarily issued by private companies. These investments may involve a high degree of business and financial risk; they are illiquid, and may not produce current returns or capital gains. If we were forced to immediately liquidate some or all of the investments in the portfolio, the proceeds of such liquidation would be significantly less than the current value of such investments. We may be required to liquidate some or all of our portfolio investments to meet our debt service obligations or in the event we are required to fulfill our obligations under agreements pursuant to which we guarantee the repayment of indebtedness by third parties.

An economic slowdown may affect the ability of a portfolio company to engage in a liquidity event, which is a transaction that involves the sale or recapitalization of all or part of a portfolio company. These conditions could lead to financial losses in our portfolio and a decrease in our revenues, net income and assets. Numerous other factors may affect a borrower's ability to repay its loan, including the failure to meet its business plan, a downturn in its industry or negative economic conditions.

We purchase controlling equity stakes in companies and our total debt and equity investment in controlled companies may be significant individually or in the aggregate. As a result, if a significant investment in one or more controlled companies fails to perform as expected, our financial results could be more negatively affected and the magnitude of the loss could be more significant than if we had made smaller investments in more companies.

We may not borrow money unless we maintain asset coverage for indebtedness of at least 200% which may affect returns to shareholders. We borrow funds to make investments. As a result, we are exposed to the risks of leverage, which may be considered a speculative investment technique. Borrowings, also known as leverage, magnify the potential for gain and loss on amounts invested and therefore increase the risks associated with investing in our securities.

A large number of entities and individuals compete for the same kind of investment opportunities as we do. 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.

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.

To maintain our status as a business development company, we must not acquire any assets other than qualifying assets unless, at the time of and after giving effect to such acquisition, at least 70% of our total assets are qualifying assets.



We may not be able to pay dividends and failure to qualify as a regulated investment company for tax purposes could have a material adverse effect on our total return, if any.

Also, we are subject to certain risks associated with valuing our portfolio, investing in non-investment grade commercial mortgage-backed securities and collateralized debt obligations, changing interest rates, accessing additional capital, fluctuating financial results, and operating in a regulated environment.

Our common stock price may be volatile due to market factors that may be beyond our control.

**CERTAIN ANTI-TAKEOVER**

**PROVISIONS** *(Page 116)*

Our charter and bylaws, as well as certain statutory and regulatory requirements, contain certain provisions that may have the effect of discouraging a third party from making an acquisition proposal for Allied Capital. These anti-takeover provisions may inhibit a change in control in circumstances that could give the holders of our common stock the opportunity to realize a premium over the market price for our common stock.

## FEES AND EXPENSES

This table describes the various costs and expenses that an investor in our shares of common stock will bear directly or indirectly.

<b>Shareholder Transaction Expenses</b>	
Sales load (as a percentage of offering price) <sup>(1)</sup>	%
Dividend reinvestment plan fees <sup>(2)</sup>	None
<b>Annual Expenses (as a percentage of consolidated net assets attributable to common stock)<sup>(3)</sup></b>	
Operating expenses <sup>(4)</sup>	4.4%
Interest payments on borrowed funds <sup>(5)</sup>	4.0%
	8.4%
	8.4%

- (1) In the event that the shares of common stock to which this prospectus relates are sold to or through underwriters, a corresponding prospectus supplement will disclose the applicable sales load.
- (2) The expenses of our dividend reinvestment plan are included in Operating expenses. We do not have a stock purchase plan. The participants in the dividend reinvestment plan will bear a pro rata share of brokerage commissions incurred with respect to open market purchases or sales, if any. See Dividend Reinvestment Plan.
- (3) Consolidated net assets attributable to common stock equals net assets (*i.e.*, total consolidated assets less total consolidated liabilities), which at June 30, 2004, was \$1.9 billion.
- (4) Operating expenses represent our estimated operating expenses for the year ending December 31, 2004, excluding interest on indebtedness. This percentage of consolidated net assets for the year ended December 31, 2003, was 3.1%.
- (5) The Interest payments on borrowed funds represents our estimated interest expenses for the year ending December 31, 2004. We had outstanding borrowings of \$1,058.8 million at June 30, 2004. This percentage for the year ended December 31, 2003, was 4.0%. See Risk Factors.
- (6) Total annual expenses as a percentage of consolidated net assets attributable to common stock are higher than the total annual expenses percentage would be for a company that is not leveraged. We borrow money to leverage our net assets and increase our total assets. The SEC requires that Total annual expenses percentage be calculated as a percentage of *net* assets, rather than the total assets, including assets that have been funded with borrowed monies. If the Total annual expenses percentage were calculated instead as a percentage of consolidated total assets, our Total annual expenses would be 5.0% of consolidated total assets.
- (7) The holders of shares of our common stock (and not the holders of our debt securities or preferred stock, if any) indirectly bear the cost associated with our annual expenses.

**Example**

The following example, required by the SEC, demonstrates the projected dollar amount of total cumulative expenses that would be incurred over various periods with respect to a hypothetical investment in us. In calculating the following expense amounts, we assumed we would have no additional leverage and that our operating expenses would remain at the levels set forth in the table above. In the event that shares to which this prospectus relates are sold to or through underwriters, a corresponding prospectus supplement will restate this example to reflect the applicable sales load.

	1 Year	3 Years	5 Years	10 Years
You would pay the following expenses on a \$1,000 investment, assuming a 5.0% annual return	\$ 84	\$ 252	\$ 420	\$ 840

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Although the example assumes (as required by the SEC) a 5.0% annual return, our performance will vary and may result in a return of greater or less than 5.0%. In addition, while the example assumes reinvestment of all dividends and distributions at net asset value, participants in the dividend reinvestment plan may receive shares of common stock that we issue at or above net asset value or are purchased by the administrator of the dividend reinvestment plan, at the market price in effect at the time, which may be higher than, at, or below net asset value.

**The example should not be considered a representation of future expenses, and the actual expenses**

**may be greater or less than those shown.**

## SELECTED CONDENSED CONSOLIDATED FINANCIAL DATA

You should read the condensed consolidated financial information below with the Consolidated Financial Statements and Notes thereto included in this prospectus. Financial information at and for the years ended December 31, 2003 and 2002, has been derived from our financial statements that were audited by KPMG LLP. Financial information at and for the years ended December 31, 2001, 2000, and 1999, has been derived from our financial statements that were audited by Arthur Andersen LLP. For important information about Arthur Andersen LLP, see the section entitled Notice Regarding Arthur Andersen LLP. Quarterly financial information is derived from unaudited financial data, but in the opinion of management, reflects all adjustments (consisting only of normal recurring adjustments) that are necessary to present fairly the results of such interim periods. Interim results at and for the six months ended June 30, 2004, are not necessarily indicative of the results that may be expected for the year ending December 31, 2004. See **Management's Discussion and Analysis of Financial Condition and Results of Operations** on page 20 for more information.

(in thousands, except per share data)	Six Months Ended June 30,		Year Ended December 31,				
	2004	2003	2003	2002	2001	2000	1999
	(unaudited)						
<b>Operating Data:</b>							
Interest and related portfolio income:							
Interest and dividends	\$ 147,712	\$ 132,658	\$ 290,719	\$ 264,042	\$ 240,464	\$ 182,307	\$ 121,112
Loan prepayment premiums and premiums from loan dispositions	4,017	2,758	8,172	2,776	2,504	16,138	14,284
Fees and other income	17,536	14,928	30,338	43,110	46,142	13,144	5,744
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
Total interest and related portfolio income	169,265	150,344	329,229	309,928	289,110	211,589	141,140
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
Expenses:							
Interest	37,096	37,280	77,233	70,443	65,104	57,412	34,860
Employee	17,893	17,379	36,945	33,126	29,656	26,025	22,889
Individual performance award	6,382						
Administrative	14,903	9,498	22,387	21,504	15,299	15,435	12,350
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
Total operating expenses	76,274	64,157	136,565	125,073	110,059	98,872	70,099
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
Net investment income before income taxes							
	92,991	86,187	192,664	184,855	179,051	112,717	71,041
Income tax expense (benefit)	(544)	(1,081)	(2,466)	930	(412)		
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
Net investment income	93,535	87,268	195,130	183,925	179,463	112,717	71,041
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
Net realized and unrealized gains (losses):							
Net realized gains	174,453	56,879	75,347	44,937	661	15,523	25,391
Net change in unrealized appreciation or depreciation	(152,338)	(64,334)	(78,466)	(571)	20,603	14,861	2,138
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
Total net gains (losses)	22,115	(7,455)	(3,119)	44,366	21,264	30,384	27,529
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
Net increase in net assets resulting from operations							
	\$ 115,650	\$ 79,813	\$ 192,011	\$ 228,291	\$ 200,727	\$ 143,101	\$ 98,570
	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>	<u>          </u>
<b>Per Share:</b>							
Diluted earnings per common share	\$ 0.88	\$ 0.71	\$ 1.62	\$ 2.20	\$ 2.16	\$ 1.94	\$ 1.64

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Dividends per common share <sup>(1)</sup>	\$ 1.14	\$ 1.14	\$ 2.28	\$ 2.23	\$ 2.01	\$ 1.82	\$ 1.60
Weighted average common shares outstanding diluted <sup>(2)</sup>	131,620	112,291	118,351	103,574	93,003	73,472	60,044

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(in thousands, except per share data)	At December 31,					
	At June 30, 2004	2003	2002	2001	2000	1999
	(unaudited)					
<b>Balance Sheet Data:</b>						
Portfolio at value	\$ 2,784,814	\$ 2,584,599	\$ 2,488,167	\$ 2,329,590	\$ 1,788,001	\$ 1,228,497
Total assets	3,180,387	3,019,870	2,794,319	2,460,713	1,853,817	1,290,038
Total debt outstanding <sup>(3)</sup>	1,058,780	954,200	998,450	1,020,806	786,648	592,850
Preferred stock issued to Small Business Administration <sup>(3)</sup>		6,000	7,000	7,000	7,000	7,000
Shareholders' equity	1,904,711	1,914,577	1,546,071	1,352,123	1,029,692	667,513
Shareholders' equity per common share (net asset value) <sup>(4)</sup>	\$ 14.77	\$ 14.94	\$ 14.22	\$ 13.57	\$ 12.11	\$ 10.20
Common shares outstanding at period end <sup>(2)</sup>	128,960	128,118	108,698	99,607	85,057	65,414

	Six Months Ended June 30,		Year Ended December 31,				
	2004	2003	2003	2002	2001	2000	1999
	(unaudited)						
<b>Other Data:</b>							
Investments funded	\$ 795,080	\$ 526,399	\$ 931,450	\$ 506,376	\$ 680,329	\$ 901,545	\$ 751,871
Principal collections related to investment repayments or sales	430,861	426,985	783,967	356,641	204,441	391,275	337,929
Realized gains	204,003	61,311	94,305	95,562	10,107	28,604	31,536
Realized losses	(29,550)	(4,432)	(18,958)	(50,625)	(9,446)	(13,081)	(6,145)

(in thousands, except per share data)	2004		2003				2002			
	Qtr 2	Qtr 1	Qtr 4	Qtr 3	Qtr 2	Qtr 1	Qtr 4	Qtr 3	Qtr 2	Qtr 1
	(unaudited)									
<b>Quarterly Data (unaudited):</b>										
Total interest and related portfolio income	\$ 87,500	\$ 81,765	\$ 90,015	\$ 88,870	\$ 77,214	\$ 73,130	\$ 78,015	\$ 76,329	\$ 73,193	\$ 82,391
Net investment income	48,990	44,545	54,254	53,608	44,598	42,670	42,401	45,094	42,561	53,869
Net increase in net assets resulting from operations	95,342	20,308	78,454	33,744	59,940	19,873	53,356	45,520	73,454	55,961
Diluted earnings per common share	0.73	0.15	0.62	0.28	0.52	0.18	0.51	0.44	0.71	0.55
Dividends declared per common share <sup>(5)</sup>	0.57	0.57	0.57	0.57	0.57	0.57	0.59	0.56	0.55	0.53
Net asset value per common share <sup>(4)</sup>	14.77	14.60	14.94	14.46	14.23	14.05	14.22	13.95	14.02	13.71

(1) Dividends are based on taxable income, which differs from income for financial reporting purposes.

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

(3) See "Senior Securities" on page 60 for more information regarding our level of indebtedness.

(4) We determine net asset value per common share as of the last day of the period. The net asset values shown are based on outstanding shares at the end of each period.

(5) Dividends declared per common share for the fourth quarter of 2002 included the regular quarterly dividend of \$0.56 per common share and an extra dividend of \$0.03 per common share.

**WHERE YOU CAN FIND**

**ADDITIONAL INFORMATION**

We have filed with the SEC a registration statement on Form N-2 together with all amendments and related exhibits under the Securities Act of 1933. The registration statement contains additional information about us and the securities being offered by this prospectus. You may inspect the registration statement and the exhibits without charge at the SEC at 450 Fifth Street, NW, Washington, DC 20549. You may obtain copies from the SEC at prescribed rates.

We file annual, quarterly and current reports, proxy statements and other information with the SEC. You can inspect our SEC filings, without charge, at the SEC's Public Reference Room at 450 Fifth Street, NW, Washington, DC 20549. The SEC also maintains a web site at <http://www.sec.gov> that contains our SEC filings. You can also obtain copies of these materials from the SEC's Public Reference Room at 450 Fifth Street, NW, Washington, DC 20549, at prescribed rates. Please call the SEC at 1-800-SEC-0330 for further information on the Public Reference Room. Copies may also be obtained, after paying a duplicating fee, by electronic request to [publicinfo@sec.gov](mailto:publicinfo@sec.gov) or by written request to Public Reference Section, Washington, DC 20549. You can also inspect reports and other information we file at the offices of the New York Stock Exchange, and you are able to inspect those at 20 Broad Street, New York, NY 10005.

## RISK FACTORS

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

**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.

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

**Substantially all of our portfolio investments are recorded at fair value as determined in good faith by our Board of Directors and, as a result, there is uncertainty regarding the value of our portfolio investments.** At June 30, 2004, portfolio investments recorded at fair value were approximately 87% of our total assets. Pursuant to the requirements of the 1940 Act, we value substantially all of our investments at fair value as determined in good faith by our Board of Directors on a quarterly basis. Since there is typically no readily available market value for the investments in our portfolio, our Board of Directors determines in good faith the fair value of these investments pursuant to a valuation policy and a consistently applied valuation process.

There is no single standard for determining fair value in good faith. As a result, determining fair value requires that judgment be applied to the specific facts and circumstances of each portfolio investment while employing a consistently applied valuation process for the types of investments we make. Unlike banks, we are not permitted to provide a general reserve for anticipated loan losses; we are instead required by the 1940 Act to specifically value each individual investment on a quarterly basis and record unrealized depreciation for an investment that we believe has become impaired, including where collection of a loan or realization of an equity security is doubtful, or when the enterprise value of the portfolio company does not currently support the cost of our debt or equity investment. Enterprise value means the entire value of the company to a potential buyer, including the sum of the values of debt and equity securities used to capitalize the enterprise at a point in time. We will record unrealized appreciation if we believe that the underlying portfolio company has appreciated in value and, therefore, our equity security



has also appreciated in value. Without a readily available market value and because of the inherent uncertainty of valuation, the fair value of our investments determined in good faith by the Board of Directors may differ significantly from the values that would have been used had a ready market existed for the investments, and the differences could be material.

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

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

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

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

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

**Our financial results could be negatively affected if Business Loan Express fails to perform as expected.** Business Loan Express, LLC (BLX) is our largest portfolio investment. Our financial results could be negatively affected if BLX, as a portfolio company, fails to perform as expected or if government funding for, or regulations related to the Small Business Administration 7(a) Guaranteed Loan Program change. At June 30, 2004, the investment totaled \$352.8 million at value, or 11.1% 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 \$275.0 million revolving credit facility. The amount we have guaranteed at June 30, 2004, was \$86.6 million. This guaranty can only be called in the event of a default by BLX. At June 30, 2004, we had also provided four standby letters of credit totaling \$35.6 million in connection with four term securitization transactions completed by BLX.

**Our financial results could be negatively affected if a significant portfolio investment fails to perform as expected.** We purchase controlling equity stakes in companies and our total debt and equity investment in controlled companies may be significant individually or in the aggregate. Investments in controlled portfolio companies are generally larger and in fewer companies than our investments in companies that we do not control. As a result, if a significant investment in one or more controlled companies fails to perform as expected, our financial results could be more negatively affected and the magnitude of the loss could be more significant than if we had made smaller investments in more companies.

**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 bonds and 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 bonds and 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. In addition, the fair value of these securities may change as interest rates change over time. 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, insurance companies or other lenders on favorable terms. There can be no assurance that we will be able to maintain such leverage. If asset coverage declines to less than 200%, we may be required to sell a portion of our investments when it is disadvantageous to do so. As of June 30, 2004, our asset coverage for senior indebtedness was 296%.

**We borrow money, which magnifies the potential for gain or loss on amounts invested and may increase the risk of investing in us.** Borrowings, also known as leverage, magnify the potential for gain or loss on amounts invested and, therefore, increase the risks associated with investing in our securities. We borrow from and issue senior debt securities to banks, insurance companies, and other lenders. Lenders of these senior securities have fixed dollar claims on our consolidated assets that are superior to the claims of our common shareholders. If the value of our consolidated assets increases, then leveraging would cause the net asset value attributable to our common stock to increase more sharply than it would have had we not leveraged. Conversely, if the value of our

consolidated assets decreases, leveraging would cause net asset value to decline more sharply than it otherwise would have had we not leveraged. Similarly, any increase in our consolidated income in excess of consolidated interest payable on the borrowed funds would cause our net income to increase more than it would without the leverage, while any decrease in our consolidated income would cause net income to decline more sharply than it would have had we not borrowed. Such a decline could negatively affect our ability to make common stock dividend payments. Leverage is generally considered a speculative investment technique.

At June 30, 2004, we had \$1,058.8 million of outstanding indebtedness bearing a weighted average annual interest cost of 6.8%. In order for us to cover these annual interest payments on indebtedness, we must achieve annual returns on our assets of at least 2.3%.

*Illustration.* The following table illustrates the effect of leverage on returns from an investment in our common stock assuming various annual returns, net of expenses. The calculations in the table below are hypothetical and actual returns may be higher or lower than those appearing below. The calculation assumes (i) \$3,180.4 million in total assets, (ii) an average cost of funds of 6.8%, (iii) \$1,058.8 million in debt outstanding and (iv) \$1,904.7 million of shareholders' equity.

	Assumed Return on Our Portfolio						
	(net of expenses)						
	-20%	-10%	-5%	0%	5%	10%	20%
Corresponding return to shareholder	-37.4%	-20.7%	-12.3%	-4.0%	4.4%	12.7%	29.4%

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

**We will continue to need additional capital to grow because we must distribute our income.** We will continue to need capital to fund growth in our investments. Historically, we have borrowed from financial institutions and have issued equity securities. A reduction in the availability of new capital could limit our ability to grow. We must distribute at least 90% of our taxable ordinary income, which excludes realized net 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 regulated investment company 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. If we meet source of income, asset diversification, and distribution requirements, we will not be subject to corporate level income taxation on income we timely distribute to our stockholders as dividends. We would cease to qualify for such 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. For additional information regarding the laws and regulations we are subject to, see the section entitled "Certain Government Regulations."

**Our ability to invest in private companies may be limited in certain circumstances.** If we are to maintain our status as a business development company, we must not acquire any assets other than "qualifying assets" unless, at the time of and after giving effect to such acquisition, at least 70% of our total assets are qualifying assets. If we acquire debt or equity securities from an issuer that has outstanding marginable securities at the time we make an investment, these acquired assets cannot be treated as qualifying assets. This result is dictated by the definition of "eligible portfolio company" under the 1940 Act, which in part looks to whether a company has outstanding marginable securities. For a more detailed discussion of the definition of an "eligible portfolio company" and the marginable securities requirement, see the section entitled "Certain Government Regulations."

Amendments promulgated in 1998 by the Federal Reserve expanded the definition of a marginable security under the Federal Reserve's margin rules to include any non-equity security. Thus, any debt securities issued by any entity are marginable securities under the Federal Reserve's current margin rules. As a result, the staff of the SEC has raised the question to the BDC industry as to whether a private company that has outstanding debt securities would qualify as an "eligible portfolio company" under the 1940 Act.

Until the question raised by the staff of the SEC pertaining to the Federal Reserve's 1998 change to its margin rules has been addressed by legislative, administrative or judicial action, we intend to treat as qualifying assets only those debt and equity securities that are issued by a private company that has no marginable securities outstanding at the time we purchase such securities. As a result, we will not invest in a private company with outstanding debt securities unless at the time of and after giving effect to such investment, at least 70% of our total assets are qualifying assets.

**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 gains or losses and changes in unrealized appreciation or depreciation, 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.

**Disclosure Regarding Forward-Looking Statements**

Information contained or incorporated by reference in this prospectus, and the accompanying prospectus supplement, if any, may contain forward-looking statements which can be identified by the use of forward-looking terminology such as may, will, expect, intend, anticipate, estimate or continue or the negative thereof or other variations or similar words or phrases. The matters described in Risk Factors and certain other factors noted throughout this prospectus, and the accompanying prospectus supplement, if any, and in any exhibits to the registration statement of which this prospectus, and the accompanying prospectus supplement, if any, is a part, constitute cautionary statements identifying important factors with respect to any such forward-looking statements, including certain risks and uncertainties, that could cause actual results to differ materially from those in such forward-looking statements.

Although we believe that the assumptions on which these forward-looking statements are based are reasonable, any of those assumptions could prove to be inaccurate, and as a result, the forward-looking statements based on those assumptions also could be incorrect. Important assumptions include our ability to originate new investments, maintain certain margins and levels of profitability, access the capital markets for debt and equity capital, the ability to meet regulatory requirements and the ability to maintain certain debt to asset ratios. In light of these and other uncertainties, the inclusion of a projection or forward-looking statement in this prospectus or any accompanying prospectus supplement should not be regarded as a representation by us that our plans and objectives will be achieved. You should not place undue reliance on these forward-looking statements, which apply only as of the date of this prospectus or any accompanying supplement to this prospectus.

**USE OF PROCEEDS**

We intend to use the net proceeds from selling shares of our common stock for general corporate purposes, which may include investment in the debt or equity securities of primarily private companies or non-investment grade commercial mortgage-backed securities and collateralized debt obligation bonds and preferred shares, repayment of indebtedness, acquisitions and other general corporate purposes. Because our primary business is to provide long-term debt and equity capital to small and middle-market companies, we are constantly identifying, reviewing and, to the extent consistent with our investment objective, funding new investments. As a result, we typically raise equity capital as we deem appropriate to fund such new investments. The supplement to this prospectus relating to an offering will more fully identify the use of the proceeds from such offering.

We anticipate that substantially all of the net proceeds of any offering of shares of our common stock will be used, as described above, within six months, but in no event longer than two years. Pending investment, we intend to invest the net proceeds of any offering of shares of our common stock in time deposits, income-producing securities with maturities of three months or less that are issued or guaranteed by the federal government or an agency of the federal government, and high quality debt securities maturing in one year or less from the time of investment. Our ability to achieve our investment objective may be limited to the extent that the net proceeds of any offering, pending full investment, are held in time deposits and other short-term instruments.



**PRICE RANGE OF COMMON STOCK AND DISTRIBUTIONS**

Our common stock is traded on the New York Stock Exchange under the symbol ALD. The following table lists the high and low closing sales prices for our common stock, the closing sales price as a percentage of net asset value (NAV) and quarterly dividends per share. On September 13, 2004, the last reported closing sale price of our common stock was \$25.48 per share.

	NAV <sup>(1)</sup>	Closing Sales Price		Premium of High Sales Price to NAV <sup>(2)</sup>	Premium of Low Sales Price to NAV <sup>(2)</sup>	Declared Dividends
		High	Low			
<b><i>Year ended December 31, 2002</i></b>						
First Quarter	\$ 13.71	\$28.93	\$25.84	211%	188%	\$0.53
Second Quarter	\$ 14.02	\$27.66	\$20.88	197%	149%	\$0.55
Third Quarter	\$ 13.95	\$24.49	\$18.90	176%	135%	\$0.56
Fourth Quarter	\$ 14.22	\$22.87	\$18.90	161%	133%	\$0.56
Extra Dividend						\$0.03
<b><i>Year ended December 31, 2003</i></b>						
First Quarter	\$ 14.05	\$23.85	\$19.82	170%	141%	\$0.57
Second Quarter	\$ 14.23	\$25.16	\$19.85	177%	139%	\$0.57
Third Quarter	\$ 14.46	\$26.60	\$22.97	184%	159%	\$0.57
Fourth Quarter	\$ 14.94	\$28.16	\$24.63	188%	165%	\$0.57
<b><i>Year ending December 31, 2004</i></b>						
First Quarter	\$ 14.60	\$30.85	\$27.15	211%	186%	\$0.57
Second Quarter	\$ 14.77	\$30.25	\$23.06	205%	156%	\$0.57
Third Quarter (through September 13, 2004)	*	\$25.67	\$22.22	*	*	\$0.57

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

(2) Calculated as the respective high or low closing sales price divided by NAV.

\* Net asset value has not yet been calculated for this period.

Our common stock continues to trade in excess of net asset value. There can be no assurance, however, that our shares will continue to trade at a premium to our net asset value.

We intend to pay quarterly dividends to shareholders of our common stock. The amount of our quarterly dividends is determined by our Board of Directors. Our Board of Directors has established a dividend policy to review the dividend rate quarterly, and may adjust the quarterly dividend rate throughout the year. See Management's Discussion and Analysis of Financial Condition and Results of Operations Debt and Equity Capital and Tax Status. There can be no assurance that we will achieve investment results or maintain a tax status that will permit any particular level of dividend payment. Our credit facilities limit our ability to declare dividends if we default under certain provisions.

We maintain an opt in dividend reinvestment plan for our common shareholders. As a result, if our Board of Directors declares a dividend, then our shareholders will receive cash dividends, unless they specifically opt in to the dividend reinvestment plan to reinvest their dividends and receive additional shares of common stock. See Dividend Reinvestment Plan.

**MANAGEMENT'S DISCUSSION AND ANALYSIS**  
**OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

*The information contained in this section should be read in conjunction with our 2003 Consolidated Financial Statements and the Notes thereto. In addition, this prospectus 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 comparable terminology. These forward-looking statements are subject to the inherent uncertainties in predicting future results and conditions. Certain factors that could cause actual results and conditions to differ materially from those projected in these forward-looking statements are set forth above in the Risk Factors section. Other factors that could cause actual results to differ materially include:*

*changes in the economy;*

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

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

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

*Financial or other information presented for private finance portfolio companies has been obtained from the portfolio companies, and the financial information presented may represent unaudited, projected or pro forma financial information, and therefore may not be indicative of actual results. In addition, the private equity industry uses financial measures such as EBITDA or EBITDAM (Earnings Before Interest, Taxes, Depreciation, Amortization and, in some instances, Management fees) in order to assess a portfolio company's financial performance and to value a portfolio company. EBITDA and EBITDAM are not intended to represent cash flow from operations as defined by 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 is in the private equity business and provides long-term debt and equity capital. Our lending and investment activity is generally focused on private finance and commercial real estate finance, primarily the investment in non-investment grade commercial mortgage-backed securities, which we refer to as CMBS, and collateralized debt obligation bonds and preferred shares, which we refer to as CDOs. Our private finance activity principally involves providing financing through privately negotiated long-term debt and equity investment capital. Our private financing is generally used to fund growth, acquisitions, buyouts, recapitalizations, note purchases, bridge financings, and other types of financings. We generally invest in private companies though, from time to time, we may invest in companies that are public but lack access to additional public capital or whose securities may not be marginable.

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Our portfolio composition at June 30, 2004, and December 31, 2003, 2002, and 2001, was as follows:

	At June 30, 2004	At December 31,		
		2003	2002	2001
Private finance	69%	74%	70%	68%
Commercial real estate finance	31%	26%	30%	32%

Our earnings depend primarily on the level of interest and dividend income, fee and other income, and net gains or losses earned on our investment portfolio after deducting interest expense on borrowed capital and operating expenses. Interest income results from the interest 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 outstanding during the period multiplied by the weighted average yield. Our ability to generate interest income is dependent on economic, regulatory, and competitive factors that influence new investment activity, 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.

Because we are a regulated investment company for tax purposes, we distribute substantially all of our taxable income as dividends to our shareholders.

### PORTFOLIO AND INVESTMENT ACTIVITY

The total portfolio at value, investment activity, and the yield on interest-bearing investments at and for the six months ended June 30, 2004 and 2003, and the years ended December 31, 2003, 2002, and 2001, were as follows:

(\$ in millions)	At and for the Six Months Ended June 30,		At and for the Years Ended December 31,		
	2004	2003	2003	2002	2001
	(unaudited)				
Portfolio at value	\$ 2,784.8	\$ 2,546.1	\$ 2,584.6	\$ 2,488.2	\$ 2,329.6
Investments funded	\$ 795.1	\$ 526.4	\$ 931.5	\$ 506.4	\$ 680.3
Change in accrued or reinvested interest and dividends	\$ 26.1	\$ 20.4	\$ 45.0	\$ 44.7	\$ 51.6
Principal collections related to investment repayments or sales	\$ 430.9	\$ 427.0	\$ 784.0	\$ 356.6	\$ 204.4
Yield <sup>(1)</sup>	14.0%	14.1%	14.7%	14.0%	14.3%

(1) The weighted average yield on interest-bearing investments is computed as the (a) annual stated interest plus the annual amortization of loan origination fees, original issue discount, and market discount 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 at value, investment activity, and the yield on loans and debt securities at and for the six months ended June 30, 2004 and 2003, and the years ended December 31, 2003, 2002, and 2001, were as follows:

(\$ in millions)	At and for the Six Months Ended June 30,		At and for the Years Ended December 31,		
	2004	2003	2003	2002	2001
	(unaudited)				
Portfolio at value:					
Loans and debt securities	\$ 1,278.1	\$ 1,192.4	\$ 1,214.9	\$ 1,151.2	\$ 1,107.9
Equity interests	634.4	646.8	687.8	592.0	487.2
Total portfolio	\$ 1,912.5	\$ 1,839.2	\$ 1,902.7	\$ 1,743.2	\$ 1,595.1
Investments funded <sup>(1)</sup>	\$ 562.5	\$ 273.9	\$ 498.0	\$ 297.2	\$ 287.7
Change in accrued or reinvested interest and dividends	\$ 21.4	\$ 19.4	\$ 41.8	\$ 42.6	\$ 48.9
Principal collections related to investment repayments or sales	\$ 394.5	\$ 146.0	\$ 314.3	\$ 129.3	\$ 43.8
Yield <sup>(2)</sup>	14.6%	14.4%	15.0%	14.4%	14.8%

(1) Investments funded for the six months ended June 30, 2004, include a \$47.5 million subordinated debt investment in The Hillman Companies, Inc. received in conjunction with the sale of Hillman as discussed below.

(2) The weighted average yield on loans and debt securities is computed as the (a) annual stated interest plus the annual amortization of loan origination fees, original issue discount, and market discount 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 six months ended June 30, 2004 and 2003, and the years ended December 31, 2003, 2002, and 2001, consisted of the following:

(\$ in millions)	Loans and Debt Securities	Equity Interests	Total
<b>For the Six Months Ended June 30, 2004</b>			
Companies more than 25% owned	\$ 189.4	\$ 106.2	\$ 295.6
Companies 5% to 25% owned	24.8	16.4	41.2
Companies less than 5% owned	213.5	12.2	225.7
Total	\$427.7	\$ 134.8	\$562.5
<b>For the Six Months Ended June 30, 2003</b>			
Companies more than 25% owned	\$ 42.2	\$ 25.2	\$ 67.4
Companies 5% to 25% owned	9.5	1.0	10.5
Companies less than 5% owned	190.6	5.4	196.0
Total	\$242.3	\$ 31.6	\$273.9



(\$ in millions)	Loans and Debt Securities	Equity Interests	Total
<b>For the Year Ended December 31, 2003</b>			
Companies more than 25% owned	\$ 53.0	\$ 34.0	\$ 87.0
Companies 5% to 25% owned	23.8	1.9	25.7
Companies less than 5% owned	377.4	7.9	385.3
<b>Total</b>	<b>\$454.2</b>	<b>\$43.8</b>	<b>\$498.0</b>
<b>For the Year Ended December 31, 2002</b>			
Companies more than 25% owned	\$ 86.1	\$ 18.7	\$ 104.8
Companies 5% to 25% owned	22.3	0.4	22.7
Companies less than 5% owned	154.6	15.1	169.7
<b>Total</b>	<b>\$263.0</b>	<b>\$34.2</b>	<b>\$297.2</b>
<b>For the Year Ended December 31, 2001</b>			
Companies more than 25% owned	\$ 47.8	\$ 78.3	\$ 126.1
Companies 5% to 25% owned	13.5	4.5	18.0
Companies less than 5% owned	136.9	6.7	143.6
<b>Total</b>	<b>\$198.2</b>	<b>\$89.5</b>	<b>\$287.7</b>

The level of investment activity for investments funded and principal repayments for private finance investments can vary substantially from period to period depending on many factors, including the amount of debt and equity capital available to middle market companies, the level of merger and acquisition activity for such companies, the general economic environment, and the competitive environment for the types of investments we make. Over the last three years, we believe that there was a decline in the availability of senior debt capital from banks for middle market companies and there were fewer merger and acquisition transactions for these companies. In mid-2003, we began to see an increase in merger and acquisition activity and debt capital became more available. As a result, investments funded and principal repayments were higher for 2003 than for 2002 and 2001. Merger and acquisition activity in the middle market has been strong in the first half of 2004, which has resulted in an increase in private finance investments funded, as well as increased repayments.

On June 30, 2004, we completed the purchase of a majority ownership stake in the business of Advantage Sales & Marketing, Inc. (Advantage), a leading sales and marketing agency providing outsourced sales, merchandising, and marketing services to the consumer packaged goods industry. At June 30, 2004, our investment in Advantage totaled \$257.2 million at cost and value in debt and equity securities, including closing costs. At the closing of the transaction, we invested \$90.2 million in loans and subordinated debt and \$73.5 million in common stock. In addition, prior to completing the purchase, we had invested \$93.7 million in subordinated debt in certain predecessor companies of Advantage, of which \$45.5 million was invested during the second quarter of 2004. This existing debt was exchanged for new subordinated debt in Advantage as part of the transaction.

Also during the second quarter, we completed the purchase of a majority ownership stake in Mercury Air Centers, Inc. (Mercury), an operator of fixed base operations, from Mercury Air Group, Inc. At June 30, 2004, our investment in Mercury totaled \$82.7 million at cost and value, including closing costs. Our investment in Mercury consists of \$53.2 million in debt and \$29.5 million in common stock. We have an additional \$8.5 million commitment to fund senior subordinated debt for future working capital and construction commitments. In connection with the transaction, Mercury Air Group, Inc. repaid its \$24 million subordinated debt obligation to Allied Capital.

On March 31, 2004, we sold The Hillman Companies, Inc. (Hillman) for a total transaction value of \$510 million, including the repayment of outstanding debt and adding the value of Hillman's outstanding trust preferred shares. We were repaid our existing \$44.6 million in outstanding mezzanine debt. Total consideration to us from this sale at closing, including the repayment of debt, was \$244.3 million, which included net cash proceeds of \$196.8 million and the receipt of a new subordinated debt instrument of \$47.5 million. During the second quarter of 2004, we sold a \$5.0 million participation in our subordinated debt in Hillman to a third party, which reduced our investment, and no gain or loss resulted from the transaction. For the six months ended June 30, 2004, we realized a gain of \$150.2 million on the transaction, including a gain of \$1.2 million realized during the second quarter of 2004, resulting from post-closing adjustments, which provided additional cash consideration to us in the same amount. The sale of Hillman is subject to certain other post-closing adjustments.

In addition, investing activities in portfolio companies more than 25% owned during the six months ended June 30, 2004, included a \$6.6 million debt and equity investment, including closing costs, to purchase Legacy Partners Group, LLC; an equity investment of \$7.5 million and an exchange of existing subordinated debt with a cost basis of \$7.3 million for equity interests in an affiliate of Impact Innovations Group, LLC; and an exchange of existing debt securities, along with accrued and unpaid interest thereon, with a total cost basis of \$49.8 million for \$12.5 million of new debt and a 68.5% common stock interest in Startec Global Communications Corporation (Startec) upon its emergence from bankruptcy in May 2004. We also provided a \$2.2 million term loan to Startec for working capital.

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

At June 30, 2004, we had outstanding investment commitments to private finance portfolio companies totaling \$321.2 million. In addition, we had commitments to private finance portfolio companies in the form of standby letters of credit and guarantees totaling \$133.8 million.

Significant outstanding investment commitments at June 30, 2004, included the following:

\$93.0 million of financing and purchase commitments to Callidus Capital Corporation (Callidus), an asset management company that structures and manages collateralized debt obligations (CDOs), senior loan collateralized loan obligations (CLOs), and other related investments. Our commitment consists of \$50 million of subordinated debt to support Callidus' warehouse facilities and warehousing activities, \$41.8 million to purchase preferred equity securities in Callidus' future CDO or CLO transactions, and \$1.2 million for working capital needs. At June 30, 2004, we had an investment in Callidus totaling \$6.3 million at value, which included equity ownership for 80% of the management company. We made our initial investment in Callidus in the fourth quarter of 2003.

During the first quarter of 2004, Callidus obtained a secured warehouse credit facility for up to \$300 million to finance the acquisition of senior corporate loans pending securitization through a CDO or CLO. In conjunction with this warehouse

credit facility, we have agreed to designate \$32.3 million of our \$50 million subordinated debt commitment for Callidus to draw upon to provide first loss capital as needed to support the warehouse facility.

Subsequent to June 30, 2004, we made an additional investment commitment of \$150 million in the form of a revolving line of credit facility to support Callidus' middle-market underwriting and syndication activities. This commitment is not included in our outstanding investment commitments as of June 30, 2004.

Approximately \$93.3 million in the form of subordinated debt and equity to purchase Financial Pacific Company, a specialized commercial finance company focused on providing leases for business-essential equipment to small businesses nationwide. The purchase was completed on August 2, 2004.

\$55.1 million in the form of subordinated debt to CBA Mezzanine Capital Finance, LLC to support its loan origination activity. This commitment expires in April 2005 and there are currently no amounts outstanding under this facility.

\$20 million in the form of a revolving credit facility to Business Loan Express, LLC (BLX) to provide working capital to the company. At June 30, 2004, BLX had outstanding borrowings of \$10 million on the facility. This \$10 million was repaid by BLX after the end of the second quarter, and there are currently no amounts outstanding under this facility.

\$25.4 million in the form of equity to eight private venture capital funds.

Our most significant investments at June 30, 2004, were in Business Loan Express, LLC (BLX), which was acquired in 2000, and Advantage Sales & Marketing, Inc. (Advantage), which was acquired on June 30, 2004.

***Business Loan Express, LLC.*** At June 30, 2004, our investment in BLX totaled \$275.0 million at cost and \$352.8 million at value, or 11.1% of our total assets, which includes unrealized appreciation of \$77.8 million.

BLX is a national, non-bank 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 nationwide 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, originates loans under the USDA Business and Industry Guaranteed Loan Program (B&I) and during the quarter ended March 31, 2004, BLX began originating small investment real estate loans. BLX has offices across the United States and is headquartered in New York, New York. Changes in the laws or regulations that govern SBLCs or the SBA 7(a) Guaranteed Loan Program or changes in government funding for this program could have a material adverse impact on BLX and, as a result, could negatively affect our financial results.



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Summary financial data for BLX at and for the nine months ended June 30, 2004, and at and for its fiscal year ended September 30, 2003, is presented below. Summary financial data has been provided by BLX and is unaudited.

(\$ in millions)	At and for the Nine Months Ended June 30, 2004 <sup>(1)</sup>	At and for the Fiscal Year Ended September 30, 2003
<b>Operating Data</b>		
Total revenue	\$ 92.3	\$ 108.3
Net income <sup>(2)</sup>	\$ 13.0	\$ 4.7
Earnings before interest, taxes and management fees (EBITM) <sup>(2)</sup>	\$ 37.6	\$ 37.5
<b>Balance Sheet Data</b>		
Total assets	\$ 419.6	\$ 353.0
Total debt	\$ 208.1	\$ 178.5
Total owners equity	\$ 151.3	\$ 136.1
<b>Other Data</b>		
Loan originations		
7(a) originations	\$ 272.2	\$ 502.4
Conventional originations	212.1	151.6
B&I originations	11.4	31.8
	<u>          </u>	<u>          </u>
Total loan originations	\$ 495.7	\$ 685.8
	<u>          </u>	<u>          </u>
Serviced loan portfolio	\$2,507.1	\$2,227.4
Number of loans	3,501	3,136
Loan delinquencies <sup>(3)</sup>	8.7%	8.3%
<b>Serviced Loan Portfolio by Industry</b>		
Hotels	24%	24%
Gas stations/convenience stores	20	19
Professional and retail services	12	12
Restaurants	9	9
Manufacturing and industrial	9	9
Car wash/auto repair services	7	7
Child care and health care services	6	6
Recreation	4	5
Shrimp/fishing vessels	4	5
Other	5	4
	<u>          </u>	<u>          </u>
Total	100%	100%
	<u>          </u>	<u>          </u>

- (1) The results of operations for the nine months ended June 30, 2004, are not necessarily indicative of the operating results to be expected for the full fiscal year.
- (2) For the fiscal year ended September 30, 2003, EBITM and net income were reduced by \$2.3 million due to costs associated with its acquisition of Amresco Independence Funding, Inc. and its reorganization from a corporation to a limited liability company (LLC) and \$2.3 million due to the increased value of issued and outstanding equity appreciation rights. In addition, net income for the fiscal year ended September 30, 2003, was increased by \$3.4 million due to the reversal of certain net deferred tax liabilities upon the conversion of BLX from a corporation to a limited liability company. As an LLC, BLX is generally not subject to federal income tax; however, BLX is subject to certain state income and franchise taxes, and income taxes associated with a taxable subsidiary corporation.
- (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

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portfolio, were 8.7% at June 30, 2004. SBA 7(a) loans greater than one year old at June 30, 2004, had a delinquency rate of 10.5%. BLX will from time to time grant a 90-day deferment to borrowers experiencing short-term cash flow shortfalls. Loans that have been granted a deferment that perform as required are not considered delinquent consistent with SBA practice. The ability of small businesses to repay their loans may be adversely affected by numerous factors, including a downturn in their industry or negative economic conditions. Small businesses are also more vulnerable to customer preferences, competition, rising fuel prices and market conditions and, as a result, delinquencies in BLX's portfolio may increase. For instance, the shrimp and fishing industry has been affected by rising fuel costs and competition from imported shrimp. For these reasons, BLX focuses on collateral protection for each loan in addition to the cash flow of the small business and receives personal guarantees from the principal owners of the small business.

BLX's revenues consist of cash premiums from guaranteed loan sales, gain on sale income arising from loans sold at par or securitized where BLX will receive future cash flows representing the spread between loan interest and the interest paid on bonds issued including service fee income, interest income on loans remaining in BLX's portfolio, and other income. Gain on sale income is a non-cash source of income when recognized, and as future cash flows are received, the resulting cash reduces the receivable or residual interest that is recognized when the loan is sold. The total of cash loan sale premiums, cash interest income and cash received from residual interests and other cash income is equal to approximately 80% of BLX's revenue of \$92.3 million for the nine months ended June 30, 2004, and approximately 83% of BLX's revenue of \$108.3 million for the fiscal year ended September 30, 2003.

BLX's business is to originate small business loans and then sell substantially all of the loans originated for cash proceeds. Loans originated during the nine months ended June 30, 2004, totaled \$495.7 million. Proceeds from loan sales during the nine months ended June 30, 2004, totaled approximately \$477.6 million. Loans originated during the fiscal year ended September 30, 2003, totaled \$685.8 million. Proceeds from loan sales during the fiscal year ended September 30, 2003, totaled approximately \$664.2 million. From time to time, 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 sells the guaranteed piece of SBA 7(a) guaranteed loans for cash premiums of up to 10% of the guaranteed loan amount plus a retained annual servicing fee generally between 1.0% and 2.4% of the guaranteed loan amount. Cash premiums received from guaranteed loan sales during the nine months ended June 30, 2004, were approximately \$20.8 million in total. Cash premiums received from guaranteed loan sales during the fiscal year ended September 30, 2003, were approximately \$31.3 million in total. Alternatively, BLX may sell the guaranteed pieces of SBA 7(a) guaranteed loans at par and receive cash only for the face amount of the loan sold, and instead of receiving a cash premium, BLX will receive an annual servicing spread on the loans sold of between 4.0% and 5.0%.

In addition, BLX sells 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 5.0% 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, which is generally between 4.3% and 5.0% annually on the loans sold into the securitization pools.

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 the 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 expects to receive from the loans sold or securitized. In computing the Residual Interest, BLX discounts estimated future cash flows after making assumptions as to future loan losses and loan prepayments, which may reduce future cash flows. For the nine months ended June 30, 2004, BLX received cash payments from the Residual Interest of approximately \$44.4 million. For the fiscal year ended September 30, 2003, BLX received cash payments from the Residual Interest of approximately \$49.3 million.

At June 30, 2004, BLX's Residual Interest totaled \$197.9 million, representing BLX's estimate of the net present value of future cash flows of scheduled loan payments, after estimated future loan losses and loan prepayments. If scheduled loan payments were to be received as stated in the loan agreements with no future losses or prepayments, BLX would receive future cash flows of \$834.1 million over time, with approximately \$70.2 million, \$61.9 million, \$60.0 million, and \$58.2 million (or \$250.3 million in the aggregate) scheduled to be received in the next four years ending on June 30, 2005, 2006, 2007, and 2008, respectively.

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. In connection with the reorganization, BLX changed its fiscal year end to September 30.

As a limited liability company, BLX's taxable income flows through directly to its members. BLX's annual taxable income generally differs from its book income for the fiscal year due to temporary and permanent differences in the recognition of income and expenses. We hold all of BLX's Class A and Class B interests, and 94.9% of the Class C interests. BLX's taxable income is first allocated to the Class A interests to the extent that dividends are paid in cash or in kind on such interests, with the remainder being allocated to the Class B and Class C interests. BLX declares dividends on its Class B interests based on an estimate of its annual taxable income allocable to such interests.

BLX paid dividends to us in cash or in kind on the Class A interests totaling \$6.1 million and \$4.6 million, respectively, for the six months ended June 30, 2004 and 2003, and totaling \$10.4 million for the year ended December 31, 2003. The guaranteed dividend yield on these equity interests is included in interest income. In addition, BLX paid dividends to us on the Class B interests totaling \$4.8 million and \$2.0 million, respectively, for the six months ended June 30, 2004 and 2003, and totaling \$7.8 million for the year ended December 31, 2003, and these dividends were paid to us through the issuance of additional Class B equity interests.

In the last week of the second quarter of 2004, BLX had a high volume of loan closings and funded approximately \$49 million of new loans. In order to facilitate this high volume of loan originations, we provided BLX a \$10 million draw on a new \$20 million revolving credit facility to provide temporary working capital. This draw was repaid by BLX after the end of the second quarter, and there are currently no outstanding borrowings under this facility.

At June 30, 2004, BLX had a three-year \$275.0 million revolving credit facility that matures in January 2007. The facility provides for a sub-facility for the issuance of letters of credit for up to a total of \$50.0 million. 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, letters of credit issued under the facility, accrued interest, and other fees) of BLX under the revolving credit facility. The principal amount outstanding on the revolving credit facility at June 30, 2004, was \$155.8 million and the amount guaranteed by us was \$86.6 million. This

guaranty can be called by the lenders only in the event of a default by BLX. BLX was in compliance with the terms of the revolving credit facility at June 30, 2004. At June 30, 2004, we had also provided four standby letters of credit totaling \$35.6 million in connection with four term securitization transactions completed by BLX.

**Advantage Sales & Marketing, Inc.** At June 30, 2004, our investment in Advantage Sales & Marketing, Inc. totaled \$257.2 million at cost and value, or 8.1% of our total assets. As discussed above, we completed the purchase of a majority ownership stake in Advantage on June 30, 2004. Given that this investment was completed on June 30, 2004, the fair value of our investment in Advantage is equal to our cost. Advantage is a leading sales and marketing agency providing outsourced sales, merchandising, and marketing services to the consumer packaged goods industry. Advantage has offices across the country and is headquartered in Irvine, CA.

**The Hillman Companies, Inc.** At December 31, 2003, our investment in Hillman totaled \$94.6 million at cost and \$234.5 million at value, or 7.8% of total assets, which included unrealized appreciation of \$139.9 million. On March 31, 2004, we sold The Hillman Companies, Inc. (Hillman) for a total transaction value of \$510 million, including the repayment of outstanding debt and adding the value of Hillman's outstanding trust preferred shares. We were repaid our existing \$44.6 million in outstanding mezzanine debt. Total consideration to us from this sale at closing, including the repayment of debt, was \$244.3 million, which included net cash proceeds of \$196.8 million and the receipt of a new subordinated debt instrument of \$47.5 million. During the second quarter of 2004, we sold a \$5.0 million participation in our subordinated debt in Hillman to a third party, which reduced our investment, and no gain or loss resulted from the transaction. For the six months ended June 30, 2004, we realized a gain of \$150.2 million on the transaction, including a gain of \$1.2 million realized during the second quarter of 2004, resulting from post-closing adjustments, which provided additional cash consideration to us in the same amount. The sale of Hillman is subject to certain other post-closing adjustments.

**Commercial Real Estate Finance**

The commercial real estate finance portfolio at value, investment activity, and the yield on interest-bearing investments at and for the six months ended June 30, 2004 and 2003, and the years ended December 31, 2003, 2002, and 2001, were as follows:

(\$ in millions)	At and for Six Months Ended June 30,				At and for the Years Ended December 31,					
	2004		2003		2003		2002		2001	
	Value	Yield <sup>(1)</sup>	Value	Yield <sup>(1)</sup>	Value	Yield <sup>(1)</sup>	Value	Yield <sup>(1)</sup>	Value	Yield <sup>(1)</sup>
Portfolio at value:										
CMBS bonds	\$ 530.8	13.0%	\$ 423.6	13.9%	\$ 394.0	14.1%	\$ 555.5	14.2%	\$ 558.3	14.7%
CDO bonds and preferred shares	175.6	17.3%	167.4	16.6%	186.6	16.7%	52.8	17.2%	24.2	16.9%
Commercial mortgage loans	147.0	8.5%	105.4	7.8%	83.6	8.6%	63.7	7.5%	79.6	7.7%
Residual interest							69.0	9.4%	69.9	9.4%
Real estate owned	14.4		10.5		12.8		4.0		2.5	
Equity interests	4.5				4.9					
<b>Total portfolio</b>	<b>\$ 872.3</b>		<b>\$ 706.9</b>		<b>\$ 681.9</b>		<b>\$ 745.0</b>		<b>\$ 734.5</b>	
Investments funded	\$ 232.6		\$ 252.5		\$ 433.5		\$ 209.2		\$ 392.6	
Change in accrued or reinvested interest	\$ 4.7		\$ 1.0		\$ 3.2		\$ 2.1		\$ 2.7	
Principal collections related to investment repayments or sales	\$ 36.4		\$ 281.0		\$ 469.7		\$ 227.3		\$ 160.6	

(1) The weighted average yield on the interest-bearing investments is computed as the (a) annual stated interest plus the annual amortization of loan origination fees, original issue discount, and market discount 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 and equity interests.

Our commercial real estate investment activity for the six months ended June 30, 2004 and 2003, and the years ended December 31, 2003, 2002, and 2001, was as follows:

(\$ in millions)	Face Amount	Discount	Amount Funded
<b>For the Six Months Ended June 30, 2004</b>			
CMBS bonds (8 issuances)	\$ 262.3	\$(110.0)	\$ 152.3
CDO bonds and preferred shares (1 issuance)	4.0	(0.3)	3.7
Commercial mortgage loans	84.8	(8.3)	76.5
Equity interests	0.1		0.1
<b>Total</b>	<b>\$ 351.2</b>	<b>\$(118.6)</b>	<b>\$ 232.6</b>
<b>For the Six Months Ended June 30, 2003</b>			
CMBS bonds (7 issuances)	\$ 250.1	\$(115.7)	\$ 134.4
CDO bonds and preferred shares (1 issuance)	118.4	(0.3)	118.1
<b>Total</b>	<b>\$ 368.5</b>	<b>\$(116.0)</b>	<b>\$ 252.5</b>

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<b><i>For the Year Ended December 31, 2003</i></b>			
CMBS bonds (18 issuances)	\$ 508.5	\$ (225.9)	\$ 282.6
CDO bonds and preferred shares (3 issuances)	145.8	(0.4)	145.4
Commercial mortgage loans	3.0		3.0
Equity interests	2.5		2.5
	_____	_____	_____
Total	\$ 659.8	\$ (226.3)	\$ 433.5
	_____	_____	_____

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(\$ in millions)	Face Amount	Discount	Amount Funded
<b>For the Year Ended December 31, 2002</b>			
CMBS bonds (5 issuances)	\$302.5	\$(140.2)	\$162.3
CDO preferred shares (3 issuances)	29.0		29.0
Commercial mortgage loans	11.7	(1.7)	10.0
Real estate owned	7.9		7.9
<b>Total</b>	<b>\$351.1</b>	<b>\$(141.9)</b>	<b>\$209.2</b>
<b>For the Year Ended December 31, 2001</b>			
CMBS bonds (8 issuances)	\$661.4	\$(295.6)	\$365.8
CDO preferred shares (1 issuance)	24.6		24.6
Commercial mortgage loans	2.2		2.2
<b>Total</b>	<b>\$688.2</b>	<b>\$(295.6)</b>	<b>\$392.6</b>

At June 30, 2004, we had outstanding funding commitments related to commercial mortgage loans and equity interests of \$4.6 million and commitments in the form of standby letters of credit and guarantees related to equity interests of \$2.7 million.

**CMBS Bonds.** The underlying pools of mortgage loans that are collateral for our investments in new CMBS bond issuances for the six months ended June 30, 2004 and 2003, and the years ended December 31, 2003, 2002, and 2001, had respective original underwritten loan to value and underwritten debt service coverage ratios as follows:

Loan to Value Ranges (\$ in millions)	For the Six Months Ended June 30,				For the Years Ended December 31,					
	2004		2003		2003		2002		2001	
	Amount	Percentage	Amount	Percentage	Amount	Percentage	Amount	Percentage	Amount	Percentage
Less than 60%	\$2,396.9	26%	\$1,971.8	28%	\$4,114.3	22%	\$909.3	20%	\$1,259.7	15%
60-65%	702.0	8	527.2	8	1,582.8	9	287.3	6	941.6	11
65-70%	862.1	9	776.5	11	1,768.0	10	587.9	13	1,140.6	14
70-75%	1,837.6	20	1,217.3	18	4,024.3	22	1,214.5	27	2,400.4	29
75-80%	3,160.0	34	2,364.9	34	6,560.5	36	1,477.5	33	2,466.4	30
Greater than 80%	335.8	3	25.2	1	138.6	1	47.8	1	119.6	1
<b>Total</b>	<b>\$9,294.4</b>	<b>100%</b>	<b>\$6,882.9</b>	<b>100%</b>	<b>\$18,188.5</b>	<b>100%</b>	<b>\$4,524.3</b>	<b>100%</b>	<b>\$8,328.3</b>	<b>100%</b>

Weighted average loan to value	67.6%	67.1%	68.5%	68.5%	69.7%
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Debt Service Coverage Ratio Ranges (\$ in millions)	For the Six Months Ended June 30,				For the Years Ended December 31,					
	2004		2003		2003		2002		2001	
	Amount	Percentage	Amount	Percentage	Amount	Percentage	Amount	Percentage	Amount	Percentage
Greater than 2.00	\$1,570.8	16%	\$2,042.6	30%	\$4,208.7	23%	\$366.9	8%	\$484.8	6%



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1.76 2.00	894.9	10	697.1	10	2,094.6	12	229.6	5	158.2	2
1.51 1.75	1,094.8	12	1,264.4	18	3,132.8	17	477.4	11	855.0	10
1.26 1.50	4,375.3	47	2,478.3	36	7,362.9	40	2,739.6	60	5,008.3	60
Less than 1.25	1,358.6	15	400.5	6	1,389.5	8	710.8	16	1,822.0	22
	<u>          </u>	<u>      </u>	<u>          </u>	<u>      </u>	<u>          </u>	<u>      </u>	<u>          </u>	<u>      </u>	<u>          </u>	<u>      </u>
Total	\$9,294.4	100%	\$6,882.9	100%	\$18,188.5	100%	\$4,524.3	100%	\$8,328.3	100%
	<u>          </u>	<u>      </u>	<u>          </u>	<u>      </u>	<u>          </u>	<u>      </u>	<u>          </u>	<u>      </u>	<u>          </u>	<u>      </u>
Weighted average debt service coverage ratio	1.62		1.75		1.73		1.41		1.48	

From time to time, we may sell lower yielding CMBS bonds rated BB+ through BB-, and to a lesser extent CMBS bonds rated B+ and B, in order to maximize the return on our CMBS bond portfolio. The cost basis of and the gross sales proceeds from CMBS bonds sold, the related net realized gains from these sales, and the weighted average yield on the CMBS bonds sold for the six months ended June 30, 2004 and 2003, and the years ended December 31, 2003, 2002, and 2001, were as follows:

(\$ in millions)	For the Six Months Ended June 30,		For the Years Ended December 31,		
	2004	2003	2003	2002	2001
Cost basis	\$ 6.3	\$ 253.5	\$ 412.3	\$ 205.9	\$ 124.5
Gross sales proceeds <sup>(1)</sup>	\$ 6.4	\$ 284.8	\$ 446.8	\$ 225.6	\$ 126.8
Net realized gains (net of related hedge gains or losses)	\$ 0.1	\$ 24.6	\$ 31.6	\$ 19.1	\$ 1.7
Weighted average yield	7.7%	11.8%	10.1%	11.5%	10.3%

(1) Gross sales proceeds represent the total cash consideration received, including the repayment of the cost basis of the bonds and proceeds related to the net realized gains on the bonds.

The BBB- rated, 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 is generally allocated first to the senior tranches in order of priority, 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 properties securing those mortgages resulting in reduced cash flows, our most subordinate tranche will bear this loss first. At June 30, 2004, the face value of the CMBS bonds we held were subordinate to 80% to 99% of the face value of the bonds issued in these various CMBS transactions. Given that the non-investment grade CMBS bonds in which we invest are junior in priority for payment of interest and principal, we invest in these CMBS bonds at a discount from the face amount of the bonds. The discount increases with the decrease in the seniority of the CMBS bonds. For the six months ended June 30, 2004 and 2003, and the years ended December 31, 2003, 2002, and 2001, the average discount for the CMBS bonds in which we invested was 42%, 46%, 44%, 46% and 45%, respectively.

At June 30, 2004, the unamortized discount related to the CMBS bond portfolio was \$725.9 million, of which \$356.1 million has been set aside to absorb potential future losses. The yield on the CMBS bonds of 13.0% assumes that this amount that has been set aside will not be amortized. As the amount of future losses and the expected timing of recognition of such losses is difficult to predict and are subject to future events which may alter these assumptions, no assurance can be given that the anticipated yield will be achieved. At June 30, 2004, the CMBS bond portfolio had a fair value of \$530.8 million, which included net unrealized depreciation on the CMBS bonds of \$13.1 million.

The yield on the CMBS bond portfolio at any point in time will vary depending on the concentration of lower yielding BB- and above rated CMBS bonds held in the portfolio. Consistent with our historical practice, we may sell some of the higher rated

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bonds later in 2004. Our CMBS bond portfolio and the related yields at June 30, 2004, and December 31, 2003 and 2002, were as follows:

(\$ in millions)	June 30, 2004		December 31,			
			2003		2002	
	Value	Yield	Value	Yield	Value	Yield
CMBS bonds rated BB- and above	\$ 176.8	7.8%	\$ 88.4	8.2%	\$ 110.9	8.8%
CMBS bonds rated below BB-	354.0	15.6%	305.6	15.8%	444.6	15.5%
<b>Total</b>	<b>\$530.8</b>	<b>13.0%</b>	<b>\$394.0</b>	<b>14.1%</b>	<b>\$555.5</b>	<b>14.2%</b>

At June 30, 2004, and December 31, 2003 and 2002, the age of our bonds rated below BB- was as follows:

(\$ in millions)	June 30, 2004		December 31,			
			2003		2002	
	Value	Percentage	Value	Percentage	Value	Percentage
Less than one year old	\$ 102.9	29.1%	\$ 83.9	27.5%	\$ 66.6	15.0%
One to two years old	54.6	15.4	41.0	13.4	125.1	28.1
Two to three years old	52.8	14.9	43.8	14.3	73.2	16.5
Three years old or older	143.7	40.6	136.9	44.8	179.7	40.4
<b>Total</b>	<b>\$354.0</b>	<b>100.0%</b>	<b>\$305.6</b>	<b>100.0%</b>	<b>\$444.6</b>	<b>100.0%</b>

At June 30, 2004, and December 31, 2003 and 2002, we held CMBS bonds in 47, 38 and 27 separate CMBS issuances, respectively. The underlying collateral pool, consisting of commercial mortgage loans and real estate owned (REO) properties, for these CMBS bonds consisted of the following at June 30, 2004, and December 31, 2003 and 2002:

(\$ in millions)	June 30,	December 31,	
	2004	2003	2002
Approximate number of loans and REO properties <sup>(1)</sup>	6,400	5,600	4,500
Total outstanding principal balance	\$46,336	\$38,437	\$24,974
Loans over 30 days delinquent or classified as REO properties <sup>(2)</sup>	1.2% <sup>(3)</sup>	1.5% <sup>(3)</sup>	1.0% <sup>(3)</sup>

(1) Includes approximately 35, 22 and 12 REO properties obtained through the foreclosure of commercial mortgage loans at June 30, 2004, and December 31, 2003 and 2002, respectively.

(2) As a percentage of total outstanding principal balance.

(3) At June 30, 2004, and December 31, 2003 and 2002, our investments included bonds in the first loss, unrated bond class in 40, 34 and 27 separate CMBS issuances, respectively. For these issuances, loans over 30 days delinquent or classified as REO properties were 1.5%, 1.7% and 1.0% of the total outstanding principal balance at June 30, 2004, and December 31, 2003 and 2002, respectively.

***Collateralized Debt Obligation Bonds and Preferred Shares.*** During the six months ended June 30, 2004, we sold CDO bonds with a cost basis of \$16.3 million for a net realized gain of \$0.1 million, net of the related hedge gain. During the six months ended June 30, 2003, and the year ended December 31, 2003, we sold CDO bonds and preferred shares with a cost basis of \$6.4 million and \$13.9 million, respectively, for net realized losses of \$0.1 million for both periods, net of the related hedge gains. The yield on the

CDO bonds and preferred shares sold was 7.6%, 8.4%, and 8.0% for the six months ended June 30, 2004 and 2003, and for the year ended December 31, 2003, respectively.

The BB rated bonds and the preferred shares of the CDOs in which we have invested are junior in priority for payment of interest and principal to the more senior tranches of debt issued by the CDOs. To the extent there are defaults and unrecoverable losses on the underlying collateral that result in reduced cash flows, the preferred shares will bear this loss first and then the bonds would bear any loss after the preferred shares. At June 30, 2004, our bonds and preferred shares in the CDO were subordinate to 70% to 98% of the more senior tranches of debt issued in the various CDO transactions. In addition, included in the CMBS collateral for the CDOs at June 30, 2004, were certain CMBS bonds that are senior in priority of repayment to certain lower rated CMBS bonds held directly by us.

The yield on our CDO bonds and preferred shares at June 30, 2004, and December 31, 2003, 2002, and 2001, was 17.3%, 16.7%, 17.2%, and 16.9%, respectively. The yield on the CDO portfolio at any point in time will generally vary depending on the amount of lower yielding CDO bonds held in the portfolio.

At June 30, 2004, and December 31, 2003 and 2002, the underlying collateral for our investments in the outstanding CDO issuances had balances as follows:

(\$ in millions)	June 30, 2004	December 31,	
		2003	2002
Investment grade REIT debt <sup>(1)</sup>	\$ 1,404.1	\$ 1,338.0	\$ 1,016.9
Investment grade CMBS bonds <sup>(2)</sup>	805.6	662.3	494.2
Non-investment grade CMBS bonds <sup>(3)</sup>	1,185.3	1,133.7	438.3
Other collateral	120.2	32.4	8.2
<b>Total collateral</b>	<b>\$ 3,515.2</b>	<b>\$ 3,166.4</b>	<b>\$ 1,957.6</b>

(1) Issued by 44, 44 and 40 REITs, respectively, for the respective periods presented.

(2) Issued in 97, 78 and 43 transactions, respectively, for the respective periods presented.

(3) Issued in 77, 68 and 33 transactions, respectively, for the respective periods presented.

**Portfolio Asset Quality**

**Portfolio by Grade.** We employ a standard grading system for our 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.

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At June 30, 2004, and December 31, 2003 and 2002, our portfolio was graded as follows:

Grade	December 31,					
	At June 30, 2004		2003		2002	
	Portfolio at Value	Percentage of Total Portfolio	Portfolio at Value	Percentage of Total Portfolio	Portfolio at Value	Percentage of Total Portfolio
	(\$ in millions)					
1	\$ 748.4	26.9%	\$ 985.1	38.1%	\$ 801.0	32.1%
2	1,809.2	65.0	1,271.4	49.2	1,400.8	56.3
3	82.4	2.9	212.4	8.2	166.0	6.7
4	36.4	1.3	34.7	1.4	23.6	1.0
5	108.4	3.9	81.0	3.1	96.8	3.9
	<u>\$2,784.8</u>	<u>100.0%</u>	<u>\$2,584.6</u>	<u>100.0%</u>	<u>\$2,488.2</u>	<u>100.0%</u>

The decrease in Grade 1 assets at June 30, 2004, as compared to December 31, 2003, is primarily due to the sale of Hillman on March 31, 2004. The value of Hillman at December 31, 2003, was \$234.5 million, and this value was included in Grade 1 assets. We received \$47.5 million of new subordinated debt in Hillman in conjunction with the sale. During the second quarter of 2004, we sold a participation in this debt of \$5.0 million to a third party, which reduced our investment. The remaining balance of this new debt was included in Grade 2 assets at June 30, 2004. We continue to include our CMBS portfolio in Grade 2 assets, as we are uncertain as to whether the unrealized appreciation or depreciation on our CMBS portfolio at June 30, 2004, will necessarily result in a realized gain or loss.

Total Grade 3, 4 and 5 portfolio assets as a percentage of the total portfolio at value at June 30, 2004, and December 31, 2003 and 2002, were 8.2%, 12.7% and 11.6%, respectively. Included in Grade 3, 4 and 5 assets at June 30, 2004 and December 31, 2003 and 2002, were assets totaling \$35.4 million, \$31.1 million and \$25.8 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 Grades 4 or 5 categories from time to time. Part of the business of private finance is working with troubled portfolio companies to improve their businesses and protect our investment. The number of portfolio companies and related investment amount included in Grades 4 and 5 may fluctuate from period to period. We continue to follow our historical practice of working with such companies in order to recover the maximum amount of our investment.

**Loans and Debt Securities on Non-Accrual Status.** At June 30, 2004, and December 31, 2003 and 2002, loans and debt securities at value not accruing interest for the total investment portfolio were as follows:

(\$ in millions)	June 30,	December 31,	
	2004	2003	2002
Loans and debt securities in workout status (classified as Grade 4 or 5) <sup>(1)</sup>			
Private finance			
Companies more than 25% owned	\$ 32.7	\$ 31.9	\$ 9.7
Companies 5% to 25% owned	16.0	2.7	0.4
Companies less than 5% owned	42.3	28.0	66.0
Commercial real estate finance	11.2	6.8	13.0
Loans and debt securities not in workout status			
Private finance			
Companies more than 25% owned	22.2	31.9	63.6
Companies 5% to 25% owned			7.2
Companies less than 5% owned	40.3	16.5	
Commercial real estate finance	5.8	0.2	
<b>Total</b>	<b>\$ 170.5</b>	<b>\$ 118.0</b>	<b>\$ 159.9</b>
Percentage of total portfolio	6.1%	4.6%	6.4%

(1) Workout loans and debt securities exclude equity securities that are included in the total Grade 4 and 5 assets above.

**Loans and Debt Securities Over 90 Days Delinquent.** Loans and debt securities greater than 90 days delinquent at value at June 30, 2004, and December 31, 2003 and 2002, were as follows:

(\$ in millions)	June 30,	December 31,	
	2004	2003	2002
Private finance	\$ 61.0	\$ 85.6	\$ 77.1
Commercial real estate finance			
CMBS bonds	49.1	40.3	15.5
Commercial mortgage loans	6.3	3.7	10.5
<b>Total</b>	<b>\$ 116.4</b>	<b>\$ 129.6</b>	<b>\$ 103.1</b>
Percentage of total portfolio	4.2%	5.0%	4.1%

As a provider of long-term privately negotiated investment capital, we may defer payment of principal or interest from time to time. 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. As a result, the amount of the private finance portfolio that is greater than 90 days delinquent or on non-accrual status may vary from period to period. 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 private finance investments for a total return including interest or dividends plus capital gains from the sale of equity securities.





For CMBS bonds, interest payments are made to bondholders from the cash flow on the underlying collateral. To the extent there are defaults and unrecoverable losses on the underlying collateral resulting in reduced cash flows, the lower rated tranches of the CMBS bonds in which we invest may not receive current interest payments and, therefore, may become delinquent. However, if the reduced cash flows resulting from defaults or losses in the underlying collateral pool have been factored into our yield on the bonds, we may continue to accrue interest on the bonds to the extent that we expect to collect such interest over time.

Given these factors, the amount of loans, debt securities, or CMBS bonds on non-accrual status or greater than 90 days delinquent is not necessarily an indication of future principal loss or loss of anticipated investment return. Our portfolio grading system is used as a means to assess loss of investment return or investment principal.

### **Hedging Activities**

We have invested in CMBS and CDO bonds, which are purchased at prices that are 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 the higher rated CMBS and CDO bonds. These transactions, referred to as short sales, involve 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, 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. These losses are limited to the increase in value of the borrowed Treasury securities; conversely, the value of the hedged CMBS and CDO bonds would likely increase. If the value of the borrowed Treasury securities decreases, we will incur gains on these transactions which are limited to the decline in value of the borrowed Treasury securities; conversely, the value of the hedged CMBS and CDO bonds would likely decrease. We do not anticipate nonperformance by any counterparty in connection with these transactions.

The total obligations to replenish borrowed Treasury securities, including accrued interest payable on the obligations, were \$164.8 million, \$98.5 million and \$197.0 million at June 30, 2004, and December 31, 2003 and 2002, respectively. The net proceeds related to the sales of the borrowed Treasury securities plus or minus the additional cash collateral provided or received under the terms of the transactions were \$164.8 million, \$98.5 million and \$194.7 million at June 30, 2004, and December 31, 2003 and 2002, respectively. The amount of the hedge will vary from period to period depending upon the amount of higher rated CMBS and CDO bonds that we own and have hedged on the balance sheet date.

**RESULTS OF OPERATIONS****Comparison of Six Months Ended June 30, 2004 and 2003**

The following table summarizes our condensed operating results for the six months ended June 30, 2004 and 2003.

(\$ in thousands, except per share amounts)	For the Six Months Ended June 30,		Change	Percentage Change
	2004	2003		
	(unaudited)			
<b>Interest and Related Portfolio Income</b>				
Interest and dividends	\$ 147,712	\$ 132,658	\$ 15,054	11%
Loan prepayment premiums	4,017	2,758	1,259	46%
Fees and other income	17,536	14,928	2,608	17%
<b>Total interest and related portfolio income</b>	<b>169,265</b>	<b>150,344</b>	<b>18,921</b>	<b>13%</b>
<b>Expenses</b>				
Interest	37,096	37,280	(184)	(1)%
Employee	17,893	17,379	514	3%
Individual performance award	6,382		6,382	**
Administrative	14,903	9,498	5,405	57%
<b>Total operating expenses</b>	<b>76,274</b>	<b>64,157</b>	<b>12,117</b>	<b>19%</b>
Net investment income before income taxes	92,991	86,187	6,804	8%
Income tax benefit	(544)	(1,081)	537	**
Net investment income	93,535	87,268	6,267	7%
<b>Net Realized and Unrealized Gains (Losses)</b>				
Net realized gains (losses)	174,453	56,879	117,574	*
Net change in unrealized appreciation or depreciation	(152,338)	(64,334)	(88,004)	*
<b>Total net gains (losses)</b>	<b>22,115</b>	<b>(7,455)</b>	<b>29,570</b>	<b>*</b>
<b>Net income</b>	<b>\$ 115,650</b>	<b>\$ 79,813</b>	<b>\$ 35,837</b>	<b>45%</b>
Diluted earnings per common share	\$ 0.88	\$ 0.71	\$ 0.17	24%
Weighted average common shares outstanding diluted	131,620	112,291	19,329	17%

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

\*\* Percentage change is not meaningful.

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



Interest and dividend income for the six months ended June 30, 2004 and 2003, was composed of the following:

(\$ in millions)	2004	2003
Interest	\$ 139.9	\$ 127.5
Dividends	7.8	5.2
<b>Total interest and dividends</b>	<b>\$ 147.7</b>	<b>\$ 132.7</b>

The level of interest income is directly related to the balance of the interest-bearing investment portfolio outstanding during the period multiplied by the weighted average yield. The weighted average yield varies from period to period based on the current stated interest on interest-bearing investments and the amount of loans and debt securities for which interest is not accruing. The interest-bearing investments in the portfolio at value and the weighted average yield on the interest-bearing investments in the portfolio at June 30, 2004 and 2003, were as follows:

(\$ in millions)	2004	2003
Interest-bearing portfolio	\$ 2,145.9	\$ 1,899.3
Portfolio yield	14.0%	14.1%

Dividend income results from the dividend yield on preferred equity interests, if any, or the declaration of dividends by a portfolio company on preferred or common equity interests. Dividend income will vary from period to period depending upon the level of yield on our preferred equity interests and the timing and amount of dividends that are declared by a portfolio company on preferred or common equity interests. Dividend income for the six months ended June 30, 2004 and 2003, includes \$4.8 million and \$2.0 million, respectively, of dividends from BLX on the Class B equity interests held by us. These dividends were paid through the issuance of additional Class B equity interests.

Loan prepayment premiums were \$4.0 million and \$2.8 million for the six months ended June 30, 2004 and 2003, 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. Therefore, we generally structure our loans to require a prepayment premium for the first three to five years of the loan. Accordingly, the amount of prepayment premiums will vary depending on the level of repayments and the age of the loans at the time of repayment.

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, corporate finance, information technology, marketing, human resources, personnel and board member recruiting, corporate governance, and risk management.

Fees and other income for the six months ended June 30, 2004 and 2003, included fees relating to the following:

(\$ in millions)	2004	2003
Structuring and diligence	\$ 7.2	\$ 3.4
Transaction and other services provided to portfolio companies	1.3	1.2
Management services provided to portfolio companies, other advisory services and guaranty fees	8.0	9.9
Other income	1.0	0.4
<b>Total fees and other income</b>	<b>\$17.5</b>	<b>\$14.9</b>

Fees and other income are generally related to specific transactions or services and therefore may vary substantially from period to period depending on the level and types of services provided. 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 for the six months ended June 30, 2004, include structuring and diligence fees from Advantage and Mercury totaling \$4.5 million.

BLX and Advantage were our most significant investments at June 30, 2004, and together represented 19.2% of our total assets. Total interest and related portfolio income earned from BLX and Advantage for the six months ended June 30, 2004, was \$22.9 million and \$3.0 million, respectively. Total interest and related portfolio income for the six months ended June 30, 2004, included \$3.3 million of income earned from Hillman prior to the sale of our investment on March 31, 2004 as discussed above.

BLX and Hillman were our most significant investments at June 30, 2003, and together represented 19.0% of our total assets. Total interest and related portfolio income earned from BLX and Hillman for the six months ended June 30, 2003, was \$22.7 million and \$4.8 million, respectively.

**Operating Expenses.** Operating expenses include interest, employee, and administrative expenses. Our single largest expense is interest on our indebtedness. The fluctuations in interest expense during the six months ended June 30, 2004 and 2003, were primarily attributable to changes in the level of our borrowings under various notes payable and debentures and our revolving line of credit. Our borrowing activity and weighted average interest cost, including fees and closing costs, at and for the six months ended June 30, 2004 and 2003, were as follows:

(\$ in millions)	At and for the Six Months Ended June 30,	
	2004	2003
Total Outstanding Debt	\$ 1,058.8	\$ 979.7
Average Outstanding Debt	\$ 922.1	\$ 927.0
Weighted Average Cost	6.8%	7.4%

In addition to interest on indebtedness, interest expense includes interest on our obligations to replenish borrowed Treasury securities related to our hedging activities of \$2.3 million and \$2.7 million for the six months ended June 30, 2004 and 2003, respectively.

Employee expenses include salaries and employee benefits. The change in employee expenses reflects the effect of wage increases, increased staffing, and the change in mix of employees given their area of responsibility and relevant experience level. Total employees were 153 and 116 at June 30, 2004 and 2003, respectively. During 2003, employee expenses included a retention award program whereby senior officers received cash awards as part of their compensation. The retention award component for the six months ended June 30, 2003, was \$4.2 million. Beginning January 1, 2004, we no longer provided retention awards.

In the first quarter of 2004, we established the Individual Performance Award (IPA) as a long-term incentive compensation program for our senior officers. In conjunction with the program, the Board has approved a non-qualified deferred compensation plan (DCP II), which is administered through a trust.

The IPA, which will generally be determined annually at the beginning of each year, is deposited in the trust in four equal installments, generally on a quarterly basis, in the form of cash. The Compensation Committee of the Board of Directors has designed the DCP II to then require the trustee to use the cash exclusively to purchase shares of our common stock in the open market.

Amounts credited to participants under the DCP II are immediately vested once deposited by us into the trust. A participant's account shall generally become distributable only after his or her termination of employment, or in the event of a change of control of the Company. The Compensation Committee of the Board of Directors may also determine other distributable events and the timing of such distributions.

For the six months ended June 30, 2004, we accrued \$7.0 million in IPA expense, or \$0.053 per share. In addition, we are required to mark to market the liability to pay the employees in our stock and this adjustment is recorded to the IPA compensation expense. The effect of this adjustment for the six months ended June 30, 2004, was to reduce the individual performance award expense by \$0.6 million.

Administrative expenses include legal and accounting fees, insurance premiums, the cost of leases for our headquarters in Washington, DC, and our regional offices, stock record expenses, directors' fees, and various other expenses. Administrative expenses were \$14.9 million for the six months ended June 30, 2004, a \$5.4 million increase over administrative expenses of \$9.5 million for the six months ended June 30, 2003.

During the second quarter of 2004, we opened an office in Los Angeles, CA, and expanded our office space in New York, NY. We also expect to expand our Chicago office. Accordingly, occupancy costs and the costs associated with staffing these offices were \$1.1 million higher for the six months ended June 30, 2004, than for the same period in the prior year.

We have also incurred increased costs related to evaluating potential new investments. Costs related to mezzanine lending are generally funded by a borrower deposit, however, costs related to buyout investments are generally funded by us. Accordingly, if a prospective deal does not close, we incur expenses that are not recoverable. As a result, these related costs were \$1.0 million higher for the six months ended June 30, 2004, than for the same period in the prior year. We have increased our focus on managing these costs, however we expect that there will be some increased costs from this activity going forward.

Finally, another large component of the increase in expenses results from the costs of operating as a public company in today's environment. Accounting, legal, insurance, and directors' fees were \$1.7 million higher for the six months ended June 30, 2004, than for the same period in the prior year.

**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 for the six months ended June 30, 2004 and 2003, were as follows:

(\$ in millions)	For the Six Months Ended June 30,	
	2004	2003
Realized gains	\$ 204.0	\$ 61.3
Realized losses	(29.5)	(4.4)
Net realized gains	\$ 174.5	\$ 56.9

Realized gains and losses for the six months ended June 30, 2004 and 2003, resulted from various private finance and commercial real estate finance transactions.

Realized gains for the six months ended June 30, 2004, primarily resulted from transactions involving seven private finance portfolio companies: The Hillman Companies, Inc. (\$150.2 million), CorrFlex Graphics, LLC (\$25.7 million), The Hartz Mountain Corporation (\$8.2 million), International Fiber Corporation (\$5.3 million), Housecall Medical Resources, Inc. (\$4.6 million), CBA-Mezzanine Capital Finance, LLC (\$3.9 million), and SmartMail, LLC (\$2.1 million).

Realized gains for the six months ended June 30, 2003, primarily resulted from transactions involving seven private finance portfolio companies: Morton Grove Pharmaceuticals, Inc. (\$8.4 million), CyberRep (\$8.3 million), Woodstream Corporation (\$6.6 million), Blue Rhino Corporation (\$3.9 million), Kirkland's Inc. (\$3.0 million), GC-Sun Holdings II, LP (\$2.5 million), and Interline Brands, Inc. (\$1.7 million). In addition, gains were also realized on CMBS bonds (\$24.6 million, net of a realized loss of \$6.7 million from hedges related to the CMBS bonds sold).

For the six months ended June 30, 2004 and 2003, we reversed previously recorded unrealized appreciation totaling \$168.4 million and \$50.8 million, respectively, when gains were realized. When we exit an investment and realize a gain, we make an accounting entry to reverse any unrealized appreciation we had previously recorded to reflect the appreciated value of the investment.

Realized losses for the six months ended June 30, 2004, primarily resulted from transactions involving four private finance portfolio companies: Executive Greetings, Inc. (\$19.3 million), Logic Bay Corporation (\$5.7 million), Sure-Tel, Inc. (\$2.3 million), and Startec Global Communications Corporation (\$1.0 million), and one transaction involving a commercial mortgage loan (\$1.0 million).

Realized losses for the six months ended June 30, 2003, primarily resulted from one transaction involving North American Archery, LLC (\$2.1 million), and two transactions involving commercial mortgage loans (\$2.0 million).

For the six months ended June 30, 2004 and 2003, we reversed previously recorded unrealized depreciation totaling \$29.6 million and \$4.9 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 in our statement of operations. Value, as defined in Section 2(a)(41) of the Investment Company Act of 1940, is (i) the market price for those securities for which a market quotation is readily available and (ii) for all other securities and assets, fair value is as determined in good faith by the Board of Directors. Since there is typically no readily available market value for the investments in our portfolio, we value substantially all of our portfolio investments at fair value as determined in good faith by the Board of Directors pursuant to a valuation policy and a consistently applied valuation process. At June 30, 2004, portfolio investments recorded at fair value were approximately 87% of our total assets. Because of the inherent uncertainty of determining the fair value of investments that do not have a readily available market value, the fair value of our investments determined in good faith by the Board of Directors may differ significantly from the values that would have been used had a ready market existed for the investments, and the differences could be material.

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

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



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

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

There is no one methodology to determine enterprise value and, in fact, for any one portfolio company, enterprise value is best expressed as a range of fair values, from which we derive a single estimate of enterprise value. To determine the enterprise value of a portfolio company, we analyze its historical and projected financial results. We generally require portfolio companies to provide annual audited and quarterly unaudited financial statements, as well as annual projections for the upcoming fiscal year. Typically in the private equity business, companies are bought and sold based on multiples of EBITDA, cash flow, net income, revenues or, in limited instances, book value. The private equity industry uses financial measures such as EBITDA or EBITDAM (Earnings Before Interest, Taxes, Depreciation, Amortization and, in some instances, Management fees) in order to assess a portfolio company's financial performance and to value a portfolio company. EBITDA and EBITDAM are not intended to represent cash flow from operations as defined by 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 is determined based on various factors, including the enterprise value remaining for equity holders after the repayment of the portfolio company's debt and other preference capital, and other pertinent factors such as recent offers to purchase a portfolio company, recent transactions involving the purchase or sale of the portfolio company's equity securities, or other liquidation 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.

In connection with our valuation process to determine the fair value of a private finance investment, we may receive independent assessments of a particular private finance portfolio company's value in the ordinary course of business, most often in the context of a prospective sale transaction or in the context of the bankruptcy process, or we may work with independent third-party consultants to obtain assistance and advice as additional support in the preparation of our internal valuation analysis. The valuation analysis prepared by management using these independent valuation resources is submitted to our Board of Directors for its determination of fair value of the portfolio in good faith.

For the quarter ended June 30, 2004, we received valuation assistance from S&P Corporate Value Consulting (S&P CVC) in determining the fair value of 33 private finance portfolio companies. In addition, we continued to receive valuation assistance from JMP Securities, LLC (JMP) for our investment in Business Loan Express, LLC, as discussed below. In total we received valuation assistance from S&P CVC and JMP for 40% of the value of the private finance portfolio at June 30, 2004.

In addition, for the quarter ended March 31, 2004, we received valuation assistance from S&P CVC in determining the fair value of 22 private finance portfolio companies. We also received valuation assistance from JMP for our investment in Business Loan Express, LLC. In total, we received valuation assistance from S&P CVC and JMP for 40% of the value of the private finance portfolio at March 31, 2004.

*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 that utilizes prepayment and loss assumptions based on historical experience and projected performance, economic factors, the characteristics of the underlying cash flow and comparable 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 unrealized appreciation or depreciation on our CMBS bonds and CDO bonds and preferred shares as comparable yields in the market change and/or 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 six months ended June 30, 2004 and 2003, consisted of the following:

(\$ in millions)	2004 <sup>(1)</sup>	2003 <sup>(1)</sup>
Net unrealized appreciation or depreciation	\$ (13.5)	\$(18.4)
Reversal of previously recorded unrealized appreciation associated with realized gains	(168.4)	(50.8)
Reversal of previously recorded unrealized depreciation associated with realized losses	29.6	4.9
Net change in unrealized appreciation or depreciation	\$ (152.3)	\$(64.3)

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

At June 30, 2004, our most significant portfolio investment was in BLX. The following is a simplified summary of the methodology that we used to determine the fair value of this investment.

**Business Loan Express, LLC.** To determine the value of our investment in BLX at June 30, 2004, we performed four separate valuation analyses to determine a range of values: (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. We performed the analyses with the assistance of JMP.

With respect to the analysis of comparable public company trading multiples and the analysis of BLX's value assuming an initial public offering, we compute a median trailing and forward price earnings multiple to apply to BLX's pro-forma net income adjusted for certain capital structure changes that we believe would likely occur should the company be sold. Each quarter we evaluate which public commercial finance companies should be included in the comparable group. The comparable group at June 30, 2004, was made up of CapitalSource, Inc., CIT Group, Inc., Financial Federal Corporation, GATX Corporation, and Marlin Business Services Corporation, which is consistent with the comparable group at March 31, 2004 and December 31, 2003.

Our investment in BLX at June 30, 2004, was valued at \$352.8 million. This fair value was within the range of values determined by the four valuation analyses. Unrealized appreciation on our investment was \$77.8 million at June 30, 2004. The unrealized appreciation on our investment in BLX decreased by \$9.3 million for the six months ended June 30, 2004. This decrease was recorded in the first quarter of 2004.

The value of our investment in BLX's Class B and Class C equity interests was \$249.8 million at June 30, 2004. The value of our Class B and Class C equity interests are at an implied trailing price to pro-forma earnings ratio of approximately 11.8 times and on an implied forward projected price to pro-forma earnings ratio of approximately 9.1 times. The value of BLX's Class B and Class C equity interests is at an implied multiple of investor cost basis of approximately 1.5 times.

## RESULTS OF OPERATIONS

## Comparison of the Years Ended December 31, 2003, 2002, and 2001

The following table summarizes our operating results for the years ended December 31, 2003, 2002, and 2001.

(in thousands, except per share amounts)	2003	2002	Change	Percent Change	2002	2001	Change	Percent Change
<b>Interest and Related Portfolio Income</b>								
Interest and dividends	\$ 290,719	\$ 264,042	\$ 26,677	10%	\$ 264,042	\$ 240,464	\$ 23,578	10%
Loan prepayment premiums and premiums from loan dispositions	8,172	2,776	5,396	194%	2,776	2,504	272	11%
Fees and other income	30,338	43,110	(12,772)	(30)%	43,110	46,142	(3,032)	(7)%
<b>Total interest and related portfolio income</b>	<b>329,229</b>	<b>309,928</b>	<b>19,301</b>	<b>6%</b>	<b>309,928</b>	<b>289,110</b>	<b>20,818</b>	<b>7%</b>
<b>Expenses</b>								
Interest	77,233	70,443	6,790	10%	70,443	65,104	5,339	8%
Employee <sup>(1)</sup>	36,945	33,126	3,819	12%	33,126	29,656	3,470	12%
Administrative <sup>(1)</sup>	22,387	21,504	883	4%	21,504	15,299	6,205	41%
<b>Total operating expenses</b>	<b>136,565</b>	<b>125,073</b>	<b>11,492</b>	<b>9%</b>	<b>125,073</b>	<b>110,059</b>	<b>15,014</b>	<b>14%</b>
Net investment income before income taxes	192,664	184,855	7,809	4%	184,855	179,051	5,804	3%
Income tax expense (benefit)	(2,466)	930	(3,396)	365%	930	(412)	1,342	(326)%
<b>Net investment income</b>	<b>195,130</b>	<b>183,925</b>	<b>11,205</b>	<b>6%</b>	<b>183,925</b>	<b>179,463</b>	<b>4,462</b>	<b>2%</b>
<b>Net Realized and Unrealized Gains (Losses)</b>								
Net realized gains	75,347	44,937	30,410	68%	44,937	661	44,276	6,698%
Net change in unrealized appreciation or depreciation	(78,466)	(571)	(77,895)	*	(571)	20,603	(21,174)	*
<b>Total net gains (losses)</b>	<b>(3,119)</b>	<b>44,366</b>	<b>(47,485)</b>	<b>(107)%</b>	<b>44,366</b>	<b>21,264</b>	<b>23,102</b>	<b>109%</b>
<b>Net income</b>	<b>\$ 192,011</b>	<b>\$ 228,291</b>	<b>\$(36,280)</b>	<b>(16)%</b>	<b>\$ 228,291</b>	<b>\$ 200,727</b>	<b>\$ 27,564</b>	<b>14%</b>
Diluted earnings per common share	\$ 1.62	\$ 2.20	\$ (0.58)	(26)%	\$ 2.20	\$ 2.16	\$ 0.04	2%
Weighted average common shares outstanding diluted	118,351	103,574	14,777	14%	103,574	93,003	10,571	11%

(1) Employee and administrative expenses for the year ended December 31, 2002, include costs associated with the closing of our German office of \$0.5 million and \$2.5 million, respectively, for a total of \$3.0 million, or \$0.03 per common share.

\* Net change in unrealized appreciation or depreciation can fluctuate significantly from year to year.

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



Interest and dividend income for the years ended December 31, 2003, 2002, and 2001, was composed of the following:

(\$ in millions)	2003	2002	2001
Interest	\$275.3	\$259.4	\$237.1
Dividends	15.4	4.6	3.4
<b>Total</b>	<b>\$290.7</b>	<b>\$264.0</b>	<b>\$240.5</b>

The level of interest income is directly related to the balance of the interest-bearing investment portfolio outstanding during the period multiplied by the weighted average yield. The weighted average yield varies from period to period based on the current stated interest on interest-bearing investments and the amount of loans and debt securities for which interest is not accruing. The interest-bearing investments in the portfolio and the weighted average yield on the interest-bearing investments in the portfolio at December 31, 2003, 2002, and 2001, was as follows:

(\$ in millions)	2003	2002	2001
Interest-bearing portfolio	\$1,888.4	\$1,896.2	\$1,842.4
Portfolio yield	14.7%	14.0%	14.3%

Dividend income results from the dividend yield on preferred equity interests, if any, or the declaration of dividends by a portfolio company on preferred or common equity interests. Dividend income will vary from period to period depending upon the level of yield on our preferred equity interests and the timing and amount of dividends that are declared by a portfolio company on preferred or common equity interests. Dividend income increased in 2003 primarily due to the receipt of dividends from BLX on the Class B equity interests held by us. The total dividend declared by BLX was \$7.8 million and this dividend was paid through the issuance of additional Class B equity interests.

Loan prepayment premiums were \$8.2 million, \$2.8 million, and \$2.0 million for the years ended December 31, 2003, 2002, and 2001, respectively. Prepayment premiums increased in 2003 due to an increase in loan prepayments during the prepayment penalty period. 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. 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, corporate finance, information technology, marketing, human resources, personnel and board member recruiting, corporate governance, and risk management.

Fees and other income for the years ended December 31, 2003, 2002, and 2001, included fees relating to the following:

(\$ in millions)	2003	2002	2001
Structuring and diligence	\$ 6.1	\$ 15.0	\$ 15.5
Transaction and other services provided to portfolio companies	4.5	4.4	16.6
Management services provided to portfolio companies, other advisory services and guaranty fees	18.7	23.2	13.1
Other income	1.0	0.5	0.9
<b>Total</b>	<b>\$ 30.3</b>	<b>\$ 43.1</b>	<b>\$ 46.1</b>

Fees and other income are generally related to specific transactions or services and therefore may vary substantially from period to period depending on the level and types of services provided. Loan origination fees that represent yield enhancement on a loan are capitalized and amortized into interest income over the life of the loan.

BLX and Hillman were our most significant portfolio investments at December 31, 2003, and together represented 19.1%, 15.6%, and 13.2% of our total assets at December 31, 2003, 2002, and 2001, respectively. Total interest and related portfolio income earned from BLX for the years ended December 31, 2003, 2002, and 2001, was \$46.7 million, \$40.2 million, and \$33.1 million, respectively. Total interest and related portfolio income earned from Hillman for the years ended December 31, 2003, 2002, and 2001, was \$9.7 million, \$9.3 million, and \$6.5 million, respectively. As discussed above, on March 31, 2004, we sold Hillman. We estimate that this transaction will result in a net reduction to interest and related portfolio income for 2004 of approximately \$2.0 million.

In July 2002, we sold WyoTech Acquisition Corporation, which was a significant portfolio investment during 2002 and 2001. Total interest and related portfolio income earned on this investment for the years ended December 31, 2002 and 2001, was \$3.6 million and \$5.5 million, respectively.

**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 years ended December 31, 2003, 2002, and 2001, are primarily attributable to changes in the level of our borrowings under various notes payable and debentures and our revolving line of credit. Our borrowing activity and weighted average interest cost, including fees and closing costs, at and for the years ended December 31, 2003, 2002, and 2001, were as follows:

(\$ in millions)	2003	2002	2001
Total Outstanding Debt	\$954.2	\$998.5	\$1,020.8
Average Outstanding Debt	\$943.5	\$938.1	\$ 847.1
Weighted Average Interest Cost	7.5%	6.9%	7.0%

In addition to interest on indebtedness, interest expense includes interest on our obligations to replenish borrowed Treasury securities related to our hedging activities of \$5.9 million and \$1.7 million for the years ended December 31, 2003 and 2002, respectively.

Employee expenses include salaries and employee benefits. The change in employee expense reflects the effect of wage increases, increased staffing, and the change in mix of employees given their area of responsibility and relevant experience level. Total employees were 125, 105, and 97 at December 31, 2003, 2002, and 2001, respectively. During the

fourth quarter of 2002, we closed our office in Frankfurt, Germany, and as a result, we incurred additional employee costs of \$0.5 million for the year ended December 31, 2002.

Administrative expenses include legal and accounting fees, insurance premiums, the cost of leases for our headquarters in Washington, DC, and our regional offices, stock record expenses, directors' fees, and various other expenses. Administrative expenses have increased from \$15.3 million for the year ended December 31, 2001, to \$22.4 million for the year ended December 31, 2003.

Administrative expenses were \$21.5 million for 2002, a \$6.2 million increase over administrative expenses of \$15.3 million for 2001. Higher expenses for 2002 were related to increased costs associated with legal, consulting and other fees related to market activity in our stock, including costs incurred to defend against class action lawsuits, of approximately \$1.6 million, corporate liability insurance of \$0.9 million, travel costs of \$0.7 million, and outsourced technology assistance of \$0.7 million. In addition, for 2002 we incurred administrative costs of \$2.5 million related to the closing of our office in Frankfurt, Germany. Excluding costs associated with closing the Germany office, administrative expenses for 2002 were \$19.0 million, an increase of \$3.7 million over 2001.

Administrative expenses were \$22.4 million for 2003, a \$0.9 million increase over administrative expenses of \$21.5 million for 2002. Excluding costs associated with closing the Germany office in 2002, administrative expenses for 2003 increased by \$3.4 million over 2002. The net increase in legal, accounting, consulting and other fees for 2003 as compared to 2002 was \$0.8 million. While fees related to market activity in our stock were substantially lower in 2003 as compared to 2002, the level of professional fees incurred in 2003 still increased over 2002 as we incurred significant legal, accounting, consulting and other fees in 2003 related to the implementation of the requirements under the Sarbanes-Oxley Act of 2002. The remaining increase in administrative expenses for 2003 over 2002 was primarily due to increased costs associated with corporate liability insurance of \$1.4 million, travel costs of \$0.6 million, and directors' fees of \$0.5 million.

**Income Tax Expense (Benefit).** Our wholly owned subsidiary, AC Corp, is a corporation subject to federal and state income taxes and records an expense or benefit for income taxes as appropriate. For the years ended December 31, 2003 and 2001, we recorded a tax benefit of \$2.5 million and \$0.4 million, respectively, as a result of AC Corp's operating loss for the periods. For the year ended December 31, 2002, we recorded tax expense of \$0.9 million as a result of AC Corp's operating income for the period.

**Realized Gains and Losses.** Net realized gains result from the sale of equity securities associated with certain private finance investments, the sale of CMBS bonds, and the realization of unamortized discount resulting from the sale and early repayment of private finance loans and commercial mortgage loans, offset by losses on investments. Net realized gains and losses for the years ended December 31, 2003, 2002, and 2001, were as follows:

(\$ in millions)	2003	2002	2001
Realized Gains	\$ 94.3	\$ 95.5	\$ 10.1
Realized Losses	(19.0)	(50.6)	(9.4)
Net Realized Gains	\$ 75.3	\$ 44.9	\$ 0.7

Realized gains and losses for the years ended December 31, 2003, 2002, and 2001, resulted from various private finance and commercial real estate finance transactions.



Realized gains for the year ended December 31, 2003, primarily resulted from transactions involving 11 private finance portfolio companies, including Blue Rhino Corporation (\$12.6 million), CyberRep (\$9.6 million), Morton Grove Pharmaceuticals, Inc. (\$8.5 million), Warn Industries, Inc. (\$8.0 million), Woodstream Corporation (\$6.6 million), Kirkland's Inc. (\$3.0 million), Julius Koch USA, Inc. (\$2.8 million), GC-Sun Holdings II, LP (\$2.5 million), Interline Brands, Inc. (\$1.7 million), WyoTech Acquisition Corporation (\$1.3 million), and Advantage Mayer, Inc. (\$1.2 million). In addition, gains were also realized on CMBS bonds (\$31.6 million, net of a net realized loss of \$2.9 million from hedges related to the CMBS bonds sold) and commercial real estate investments (\$1.7 million).

Realized gains for the year ended December 31, 2002, primarily resulted from transactions involving eight private finance portfolio companies, including WyoTech Acquisition Corporation (\$60.8 million), Aurora Communications, LLC (\$4.9 million), Oriental Trading Company, Inc. (\$2.5 million), Kirkland's, Inc. (\$2.2 million), American Home Care Supply, LLC (\$1.3 million), Autania AG (\$0.8 million), FTI Consulting, Inc. (\$0.7 million), and Cumulus Media, Inc. (\$0.5 million). In addition, gains were also realized on CMBS bonds (\$19.1 million, net of a realized loss of \$0.5 million from a hedge related to the CMBS bonds sold), and one commercial real estate investment (\$1.3 million). The sale of WyoTech in 2002 was subject to post-closing adjustments, and during 2003, we recognized an additional realized gain of \$1.3 million related to post-closing items.

Realized gains for the year ended December 31, 2001, primarily resulted from transactions involving three private finance portfolio companies, including FTI Consulting, Inc. (\$4.6 million), SunSource Inc. (\$2.5 million), and Southwest PCS, LLC (\$0.8 million), and the sale of CMBS bonds (\$1.7 million).

For the years ended December 31, 2003, 2002, and 2001, we reversed previously recorded unrealized appreciation totaling \$78.5 million, \$78.8 million, and \$6.5 million, respectively, when gains were realized. When we exit an investment and realize a gain, we make an accounting entry to reverse any unrealized appreciation we had previously recorded to reflect the appreciated value of the investment.

Realized losses for the year ended December 31, 2003, primarily resulted from transactions involving three private finance portfolio companies, including Allied Office Products, Inc. (\$7.7 million), Candlewood Hotel Company (\$2.7 million), and North American Archery, LLC (\$2.1 million), and eight transactions involving commercial mortgage loans (\$5.9 million).

Realized losses for the year ended December 31, 2002, primarily resulted from transactions involving 11 private finance portfolio companies, including Velocita, Inc. (\$16.0 million), Schwinn Holdings Corporation (\$7.9 million), Convenience Corporation of America (\$5.8 million), Startec Global Communications Corporation (\$4.5 million), The Loewen Group, Inc. (\$2.7 million), Monitoring Solutions, Inc. (\$1.7 million), Most Coniferie (\$1.0 million), NetCare AG (\$1.0 million), iSolve Incorporated (\$0.9 million), Sure-Tel, Inc. (\$0.5 million), and Soff-Cut Holdings, Inc. (\$0.5 million), and also from nine commercial real estate investments (\$4.7 million).

Realized losses for the year ended December 31, 2001, primarily resulted from transactions involving three private finance portfolio companies, including Pico Products, Inc. (\$2.9 million), Allied Office Products, Inc. (\$2.5 million), and Genesis Worldwide,

Inc. (\$1.1 million), and the continued liquidation of our whole loan commercial real estate portfolio.

For the years ended December 31, 2003, 2002, and 2001, we reversed previously recorded unrealized depreciation totaling \$20.3 million, \$49.0 million, and \$8.9 million, respectively, when losses were realized. When we exit an investment and realize a loss, we make an accounting entry to reverse any unrealized depreciation we had previously recorded to reflect the depreciated value of the investment.

**Change in Unrealized Appreciation or Depreciation.** For a discussion of our fair value methodology, see Change in Unrealized Appreciation or Depreciation included in the Comparison of Six Months Ended June 30, 2004 and 2003.

**Net Change in Unrealized Appreciation or Depreciation.** For the portfolio, net change in unrealized appreciation or depreciation for the years ended December 31, 2003, 2002, and 2001, consisted of the following:

(\$ in millions)	2003	2002	2001
Net unrealized appreciation or depreciation	\$(20.3)	\$ 29.2	\$18.2
Reversal of previously recorded unrealized appreciation associated with realized gains	(78.5)	(78.8)	(6.5)
Reversal of previously recorded unrealized depreciation associated with realized losses	20.3	49.0	8.9
Net change in unrealized appreciation or depreciation	\$(78.5)	\$ (0.6)	\$20.6

At December 31, 2003, our two most significant portfolio investments were in BLX and Hillman. The following is a 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 December 31, 2003, we performed four separate valuation analyses to determine a range of values: (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. We performed the analyses with the assistance of a consultant, JMP Securities LLC.

With respect to the analysis of comparable public company trading multiples and the analysis of BLX's value assuming an initial public offering, we compute a median trailing and forward price earnings multiple to apply to BLX's pro-forma net income adjusted for certain capital structure changes that we believe would likely occur should the company be sold. Each quarter we evaluate which public commercial finance companies should be included in the comparable group. Since December 31, 2002, we have consistently used CIT Group, Inc., Financial Federal Corporation, GATX Corporation, PMC Capital, Inc., and HPSC, Inc. in the comparable group. At December 31, 2002, we also included DVI, Inc. and Vestin Group, Inc. in the group; however, beginning with the quarter ended September 30, 2003, these companies were no longer included in the group because they were no longer deemed comparable due to specific matters related to those companies. Beginning with the quarter ended September 30, 2003, we added CapitalSource Inc. to the group as this company went public during the third quarter of 2003. Beginning with December 31, 2003, we added Marlin Business Services Corp. to the comparable group since this company went public during the fourth quarter of 2003. As of December 31, 2003, PMC Capital, Inc. and HSPC, Inc. were removed from the public comparable group and instead included with the merger and acquisitions transactions for financial services

companies group because both companies announced agreements to sell their respective company.

The SBA 7(a) Guaranteed Loan Program was operating under certain limitations in the first quarter of 2004 due to a high demand for 7(a) loans and an inadequate federal budget authority. At the time, based upon our analysis of BLX's position in the market, the strength of its non-SBA conventional loan program and the current state of the SBA 7(a) loan program, we did not believe there would be any long-term adverse effect on BLX. At December 31, 2003, we did, however, take an additional discount in determining the value of our investment in BLX to account for the uncertainty surrounding the SBA 7(a) program. After this discount, our investment in BLX at December 31, 2003, was valued at \$342.2 million. This fair value was within the range of values determined by the four valuation analyses. Unrealized appreciation on our investment was \$87.1 million at December 31, 2003, an increase in unrealized appreciation of \$51.7 million for the year ended December 31, 2003.

The value of our investment in BLX's Class B and Class C equity interests was \$254.3 million at December 31, 2003. The value of our Class B and Class C equity interests are at an implied trailing price to pro-forma earnings ratio of approximately 10.8 times and on an implied forward projected price to pro-forma earnings ratio of approximately 8.7 times. The fair value of BLX's Class B and Class C equity interests is at an implied multiple of investor cost basis of approximately 1.5 times.

**The Hillman Companies, Inc.** In February of 2004, a definitive agreement was signed to sell Hillman that indicated an enterprise value for the company of \$510 million. At December 31, 2003, we estimated the enterprise value for Hillman to be approximately \$500 million, given that the sale was still subject to working capital and other adjustments and certain closing conditions. At an enterprise value of \$500 million, our investment in Hillman at value totaled \$234.5 million at December 31, 2003. This included unrealized appreciation of \$139.9 million, an increase in unrealized appreciation of \$52.0 million for the year ended December 31, 2003.

## OTHER MATTERS

**Per Share Amounts.** All per share amounts included in the Management's Discussion and Analysis of Financial Condition and Results of Operations section have been computed using the weighted average shares used to compute diluted earnings per share, which were 131.6 million and 112.3 million for the six months ended June 30, 2004 and 2003, respectively, and 118.4 million, 103.6 million, and 93.0 million for the years ended December 31, 2003, 2002, and 2001, respectively.

**Regulated Investment Company Status.** We have elected to be taxed as a regulated investment company under Subchapter M of the Code. 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, as dividends to our shareholders on a timely basis. Annual tax distributions generally differ from net income for the fiscal year due to temporary and permanent 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 asset diversification requirements as defined in the Code; and (4) distribute annually to shareholders at least 90% of our investment company taxable income as defined in the 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 Flow From Operating Activities

Our portfolio has historically generated significant cash flow from which we pay dividends to shareholders and fund new investment activity. Cash generated from the portfolio includes cash flow from net investment income and net realized gains and principal collections related to investment repayments or sales. Cash flow provided by our operating activities before new investment activity for the six months ended June 30, 2004 and 2003, and the years ended December 31, 2003, 2002, and 2001 was as follows:

(\$ in millions)	For the Six Months Ended June 30,		For the Years Ended December 31,		
	2004	2003	2003	2002	2001
Net cash provided by (used in) operating activities	\$ (89.8)	\$ (4.8)	\$ 79.9	\$ 65.3	\$ (344.4)
Add: portfolio investments funded	736.3	526.4	930.6	506.4	675.2
Total cash provided by operating activities before new investments	\$646.5	\$521.6	\$1,010.5	\$571.7	\$ 330.8

Because of the significant amount of cash provided by operating activities before new investments, we generate sufficient cash flow to fund our operating activities as well as pay dividends to shareholders.

Dividends to common shareholders for the six months ended June 30, 2004 and 2003, and the years ended December 31, 2003, 2002, and 2001, were \$146.8 million, \$127.5 million, \$267.8 million, \$229.9 million and \$186.2 million, respectively, for total regular quarterly dividends of \$1.14, \$1.14, \$2.28, \$2.20 and \$2.01 per common share, respectively. An extra cash dividend of \$0.03 per common share was declared during 2002 and was paid to shareholders on January 9, 2003. For the third quarter of 2004, the Board of Directors has declared a dividend of \$0.57 per common share payable on September 30, 2004 to stockholders of record on September 10, 2004.

Dividends are generally determined based upon an estimate of annual taxable income, which includes our taxable interest, dividend and fee income, as well as taxable net capital gains. Taxable income generally differs from net income for financial reporting purposes due to temporary and permanent differences in the recognition of income and expenses and generally excludes net unrealized appreciation or depreciation, as gains or losses are not included in taxable income until they are realized. Taxable income includes non-cash income, such as changes in accrued and reinvested interest and dividends and the amortization of discounts and fees. Non-cash taxable income is reduced by non-cash expenses, such as realized losses and depreciation and amortization expense.

Our Board of Directors evaluates whether to retain or distribute taxable net 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. Our Board of Directors

reviews the dividend rate quarterly, and may adjust the quarterly dividend throughout the year.

At June 30, 2004, we had significant outstanding commitments to fund investments totaling \$325.8 million. We intend to fund these commitments and prospective investment opportunities with existing cash, through cash flow from operations before new investments, through borrowings under our line of credit or other long-term debt agreements, or through the sale or issuance of new equity capital.

### Debt and Equity Capital

Because we are a regulated investment company, we distribute our taxable income and, therefore, require external capital for asset growth. As a result, from time to time we will raise growth capital in the form of new debt or equity capital.

At June 30, 2004, and December 31, 2003, 2002, and 2001, our total assets, total debt outstanding, total shareholders equity, debt to equity ratio and asset coverage for senior indebtedness were as follows:

(\$ in millions)	June 30, 2004	December 31,		
		2003	2002	2001
Total assets	\$ 3,180.4	\$ 3,019.9	\$ 2,794.3	\$ 2,460.7
Total debt outstanding	\$ 1,058.8	\$ 954.2	\$ 998.5	\$ 1,020.8
Total shareholders equity	\$ 1,904.7	\$ 1,914.6	\$ 1,546.1	\$ 1,352.1
Debt to equity ratio	0.56	0.50	0.65	0.75
Asset coverage ratio <sup>(1)</sup>	296%	322%	270%	245%

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

We currently target a debt to equity ratio ranging between 0.50:1.00 to 0.65:1.00, and over the past three years, we have intentionally deleveraged the balance sheet to move the leverage ratio to the lower end of the target debt to equity ratio range. We have been in a period of economic uncertainty, and we believe that it is prudent to operate with a larger equity capital base and less leverage. We did not sell equity during the six months ended June 30, 2004. For the years ended December 31, 2003 and 2002, we raised equity of \$422.9 million and \$172.8 million, respectively, including \$86.5 million raised through a non-transferable rights offering during 2002. In addition, shareholders equity increased by \$25.0 million, \$21.2 million and \$22.1 million through the exercise of employee options, the collection of notes receivable from the sale of common stock, and the issuance of shares through our dividend reinvestment plan for the six months ended June 30, 2004, and for the years ended December 31, 2003 and 2002, respectively.

We employ an asset-liability management strategy that focuses on matching the estimated maturities of our loan and investment portfolio to the estimated maturities of our borrowings. We use our revolving line of credit facility as a means to bridge to long-term financing in the form of debt or equity capital, which may or may not result in temporary differences in the matching of estimated maturities. Availability on the revolving line of credit, net of amounts committed for standby letters of credit issued under the line of credit facility, was \$300.1 million on June 30, 2004. We evaluate our interest rate exposure on an ongoing basis. Generally, we seek to fund our primarily fixed-rate investment portfolio with fixed-rate debt or equity capital. To the extent deemed necessary, we may

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hedge variable and short-term interest rate exposure through interest rate swaps or other techniques.

At June 30, 2004, and December 31, 2003, we had outstanding debt as follows:

(\$ in millions)	June 30, 2004				December 31, 2003			
	Facility Amount	Amount Outstanding	Annual Interest Cost <sup>(1)</sup>	Annual Portfolio Return to Cover Interest Payments <sup>(2)</sup>	Facility Amount	Amount Outstanding	Annual Interest Cost <sup>(1)</sup>	Annual Portfolio Return to Cover Interest Payments <sup>(2)</sup>
Notes payable and debentures:								
Unsecured notes payable	\$ 757.1	\$ 757.1	7.1%	1.7%	\$ 854.0	\$ 854.0	7.2%	2.0%
SBA debentures	94.8	87.5	8.1%	0.2%	101.8	94.5	8.1%	0.3%
OPIC loan	5.7	5.7	6.6%	0.0%	5.7	5.7	6.6%	0.0%
Total notes payable and debentures	857.6	850.3	7.2%	1.9%	961.5	954.2	7.3%	2.3%
Revolving line of credit	552.5	208.5	5.1% <sup>(3)</sup>	0.3%	532.5		(3)	0.1%
Total debt	\$ 1,410.1	\$ 1,058.8	6.8% <sup>(3)</sup>	2.3%	\$ 1,494.0	\$ 954.2	7.5% <sup>(3)</sup>	2.4%

- (1) The weighted average annual interest cost is computed as the (a) annual stated interest on the debt plus the annual amortization of commitment fees and other facility fees that are recognized into interest expense over the contractual life of the respective borrowings, divided by (b) debt outstanding on the balance sheet date.
- (2) The annual portfolio return to cover interest payments is calculated as the June 30, 2004, or December 31, 2003, annualized cost of debt per class of financing outstanding divided by total assets at June 30, 2004, or December 31, 2003, respectively.
- (3) The current interest rate payable on the revolving line of credit was 3.8% at June 30, 2004, which excluded the annual cost of commitment fees and other facility fees of \$2.8 million. There were no amounts drawn on the revolving line of credit at December 31, 2003. The annual cost of commitment fees and other facility fees on the revolving line of credit was \$2.7 million at December 31, 2003. The annual interest cost for total debt includes the annual cost of commitment fees and other facility fees on the revolving line of credit regardless of the amount outstanding on the facility as of the balance sheet date.

**Unsecured Notes Payable.** We have issued long-term debt to institutional lenders, primarily insurance companies. The notes have five- or seven-year maturities, with maturity dates beginning in 2004 and generally have fixed rates of interest. The notes generally require payment of interest only semi-annually, and all principal is due upon maturity.

On March 25, 2004, we issued five-year unsecured long-term notes denominated in Euros and Sterling for a total U.S. dollar equivalent of \$15.2 million. The notes have fixed interest rates and have substantially the same terms as our existing unsecured notes. Simultaneous with issuing the notes, we entered into a cross-currency swap with a financial institution which fixed our interest and principal payments in U.S. dollars for the life of the debt.

On April 30, 2004, we repaid \$112.0 million of unsecured notes payable that matured on May 1, 2004.

**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. During the first quarter of 2004, we repaid \$7.0 million of this outstanding debt. Under the small business investment company program, we may borrow up to \$116.0 million from the Small Business Administration. At June 30, 2004, we had a commitment from the Small Business Administration to borrow up to an additional \$7.3 million above the current amount outstanding. The commitment expires on September 30, 2005.



**Revolving Line of Credit.** We have an unsecured revolving line of credit with a committed amount of \$552.5 million. The line of credit may be expanded through new or additional commitments up to \$600 million at our option. The revolving line of credit expires in April 2005, with the right to extend the maturity for one additional year at our option under substantially similar terms. The credit facility generally bears interest at a rate, at our option, equal to (i) the one-month LIBOR plus 1.50%, (ii) the Bank of America, N.A. cost of funds plus 1.50% or (iii) the higher of the Bank of America, N.A. prime rate or the Federal Funds rate plus 0.50%. The line of credit generally requires monthly payments of interest, and all principal is due upon maturity.

Outstanding borrowings on the unsecured revolving line of credit at June 30, 2004, were \$208.5 million. The amount available under the line at June 30, 2004, was \$300.1 million, net of amounts committed for standby letters of credit of \$43.9 million. Net repayments on the revolving line of credit for the year ended December 31, 2003, were \$204.3 million.

We have various financial and operating covenants required by the revolving line of credit and notes payable and debentures. These covenants require us to maintain certain financial ratios, including debt to equity and interest coverage, and a minimum net worth. Our credit facilities limit our ability to declare dividends if we default under certain provisions. As of June 30, 2004, we were in compliance with these covenants.

The following table shows our significant contractual obligations for the repayment of debt and payment of other contractual obligations as of June 30, 2004.

(\$ in millions)	Payments Due By Year						
	Total	2004	2005	2006	2007	2008	After 2008
Notes payable and debentures:							
Unsecured notes payable	\$ 757.1	\$ 102.0	\$ 165.0	\$ 175.0	\$	\$ 153.0	\$ 162.1
SBA debentures	87.5		14.0				73.5
OPIC loan	5.7			5.7			
Revolving line of credit <sup>(1)</sup>	208.5			208.5			
Operating leases	33.3	1.8	4.2	4.2	4.1	4.1	14.9
<b>Total contractual obligations</b>	<b>\$ 1,092.1</b>	<b>\$ 103.8</b>	<b>\$ 183.2</b>	<b>\$ 393.4</b>	<b>\$ 4.1</b>	<b>\$ 157.1</b>	<b>\$ 250.5</b>

(1) The revolving line of credit expires in April 2005 and may be extended under substantially similar terms for one additional year at our option. We assume that we would exercise our option to extend the revolving line of credit resulting in an assumed maturity of April 2006. At June 30, 2004, \$300.1 million remains unused and available, net of amounts committed for standby letters of credit of \$43.9 million issued under the credit facility.

The following table shows our contractual commitments that may have the effect of creating, increasing, or accelerating our liabilities as of June 30, 2004.

(\$ in millions)	Amount of Commitment Expiration Per Year						
	Total	2004	2005	2006	2007	2008	After 2008
Guarantees	\$ 92.6	\$ 0.5	\$ 0.6	\$ 1.1	\$ 86.8	\$	\$ 3.6
Standby letters of credit <sup>(1)</sup>	43.9		1.2	42.7			
<b>Total commitments</b>	<b>\$ 136.5</b>	<b>\$ 0.5</b>	<b>\$ 1.8</b>	<b>\$ 43.8</b>	<b>\$ 86.8</b>	<b>\$</b>	<b>\$ 3.6</b>

(1)



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Standby letters of credit are issued under our revolving line of credit that expires in April 2005 and may be extended under substantially similar terms for one additional year at our option, for an assumed maturity of April 2006. Therefore, unless a standby letter of credit is set to expire at an earlier date, we have assumed that the standby letters of credit will expire contemporaneously with the expiration of our line of credit in April 2006.

In addition, we had outstanding commitments to fund investments totaling \$325.8 million at June 30, 2004, as discussed above.

Subsequent to June 30, 2004, we made an additional investment commitment of \$150 million in the form of a revolving line of credit facility to support Callidus middle-

market underwriting and syndication activities. This commitment is not included in our outstanding investment commitments as of June 30, 2004.

## 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 the bonds and preferred shares of CDOs. Our investments are generally subject to restrictions on resale and generally have no established trading market. We value substantially all of our investments at fair value as determined in good faith by the Board of Directors in accordance with our valuation policy. We determine fair value to be the amount for which an investment could be exchanged in an orderly disposition over a reasonable period of time between willing parties other than in a forced or liquidation sale. Our valuation policy considers the fact that no ready market exists for substantially all of the securities in which we invest. Our valuation policy is intended to provide a consistent basis for determining the fair value of the portfolio. We will record unrealized depreciation on investments when we believe that an investment has become impaired, including where collection of a loan or realization of an equity security is doubtful, or when the enterprise value of the portfolio company does not currently support the cost of our debt or equity investments. Enterprise value means the entire value of the company to a potential buyer, including the sum of the values of debt and equity securities used to capitalize the enterprise at a point in time. We will record unrealized appreciation if we believe that the underlying portfolio company has appreciated in value and, therefore, our equity security has also appreciated in value. The value of investments in publicly traded securities are determined using quoted market prices discounted for restrictions on resale, if any.

**Loans and Debt Securities.** For loans and debt securities, fair value generally approximates cost unless the borrower's enterprise value, 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 that are classified as Grade 4 or 5 assets under our internal grading system do not accrue interest. In addition, interest may not accrue on loans or debt securities to portfolio companies that are more than 50% owned by us depending on such company's working capital needs. Loan origination fees, original issue discount, and market discount are capitalized and then amortized into interest income using the effective interest method. Upon the prepayment of a loan or debt security, any

unamortized loan origination fees are recorded as interest income and any unamortized original issue discount or market discount is recorded as a realized gain. Prepayment premiums are recorded on loans and debt securities when received.

**Equity Securities.** Our equity interests in portfolio companies for which there is no liquid public market are valued at fair value based on the enterprise value of the portfolio company, which is determined using various factors, including cash flow from operations of the portfolio company and other pertinent factors, such as recent offers to purchase a portfolio company, recent transactions involving the purchase or sale of the portfolio company's equity securities, or other liquidation events. The determined equity 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 on 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 yields for similar CMBS bonds and CDO bonds and preferred shares. We recognize unrealized appreciation or depreciation on our CMBS bonds and CDO bonds and preferred shares as comparable yields in the market change and/or based on changes in estimated cash flows resulting from changes in prepayment or loss assumptions in the underlying collateral pool.

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 actual and estimated prepayment speeds or actual and estimated credit losses. 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.

**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, including the reversal of previously recorded unrealized appreciation or depreciation when gains or losses are realized.

**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.

## SENIOR SECURITIES

Information about our senior securities is shown in the following tables as of the fiscal year ended December 31, unless otherwise noted. The indicates information which the SEC expressly does not require to be disclosed for certain types of senior securities.

Class and Year	Total Amount Outstanding Exclusive of Treasury Securities <sup>(1)</sup>	Asset Coverage Per Unit <sup>(2)</sup>	Involuntary Liquidating Preference Per Unit <sup>(3)</sup>	Average Market Value Per Unit <sup>(4)</sup>
<b>Unsecured Long-term Notes Payable</b>				
1994	\$ 0	\$ 0	\$	N/A
1995	0	0		N/A
1996	0	0		N/A
1997	0	0		N/A
1998	180,000,000	2,734		N/A
1999	419,000,000	2,283		N/A
2000	544,000,000	2,445		N/A
2001	694,000,000	2,453		N/A
2002	694,000,000	2,704		N/A
2003	854,000,000	3,219		N/A
2004 (as of June 30, unaudited)	757,080,000	2,961		N/A
<b>Small Business Administration Debentures</b>				
<sup>(5)</sup>				
1994	\$ 54,800,000	\$3,695	\$	N/A
1995	61,300,000	2,868		N/A
1996	61,300,000	2,485		N/A
1997	54,300,000	2,215		N/A
1998	47,650,000	2,734		N/A
1999	62,650,000	2,283		N/A
2000	78,350,000	2,445		N/A
2001	94,500,000	2,453		N/A
2002	94,500,000	2,704		N/A
2003	94,500,000	3,219		N/A
2004 (as of June 30, unaudited)	87,500,000	2,961		N/A
<b>Overseas Private Investment Corporation Loan</b>				
1994	\$ 0	\$ 0	\$	N/A
1995	0	0		N/A
1996	8,700,000	2,485		N/A
1997	8,700,000	2,215		N/A
1998	5,700,000	2,734		N/A
1999	5,700,000	2,283		N/A
2000	5,700,000	2,445		N/A
2001	5,700,000	2,453		N/A
2002	5,700,000	2,704		N/A
2003	5,700,000	3,219		N/A
2004 (as of June 30, unaudited)	5,700,000	2,961		N/A

Class and Year	Total Amount Outstanding Exclusive of Treasury Securities <sup>(1)</sup>	Asset Coverage Per Unit <sup>(2)</sup>	Involuntary Liquidating Preference Per Unit <sup>(3)</sup>	Average Market Value Per Unit <sup>(4)</sup>
<b>Revolving Lines of Credit</b>				
1994	\$ 32,226,000	\$ 3,695	\$	N/A
1995	20,414,000	2,868		N/A
1996	45,099,000	2,485		N/A
1997	38,842,000	2,215		N/A
1998	95,000,000	2,734		N/A
1999	82,000,000	2,283		N/A
2000	82,000,000	2,445		N/A
2001	144,750,000	2,453		N/A
2002	204,250,000	2,704		N/A
2003	0	0		N/A
2004 (as of June 30, unaudited)	208,500,000	2,961		N/A
<b>Auction Rate Reset Note</b>				
1994	\$ 0	\$ 0	\$	N/A
1995	0	0		N/A
1996	0	0		N/A
1997	0	0		N/A
1998	0	0		N/A
1999	0	0		N/A
2000	76,598,000	2,445		N/A
2001	81,856,000	2,453		N/A
2002	0	0		N/A
2003	0	0		N/A
2004 (as of June 30, unaudited)	0	0		N/A
<b>Master Repurchase Agreement and Master Loan and Security Agreement</b>				
1994	\$ 23,210,000	\$ 3,695	\$	N/A
1995	0	0		N/A
1996	85,775,000	2,485		N/A
1997	225,821,000	2,215		N/A
1998	6,000,000	2,734		N/A
1999	23,500,000	2,283		N/A
2000	0	0		N/A
2001	0	0		N/A
2002	0	0		N/A
2003	0	0		N/A
2004 (as of June 30, unaudited)	0	0		N/A

Class and Year	Total Amount Outstanding Exclusive of Treasury Securities <sup>(1)</sup>	Asset Coverage Per Unit <sup>(2)</sup>	Involuntary Liquidating Preference Per Unit <sup>(3)</sup>	Average Market Value Per Unit <sup>(4)</sup>
<b>Senior Note Payable<sup>(6)</sup></b>				
1994	\$20,000,000	\$3,695	\$	N/A
1995	20,000,000	2,868		N/A
1996	20,000,000	2,485		N/A
1997	20,000,000	2,215		N/A
1998	0	0		N/A
1999	0	0		N/A
2000	0	0		N/A
2001	0	0		N/A
2002	0	0		N/A
2003	0	0		N/A
2004 (as of June 30, unaudited)	0	0		N/A
<b>Bonds Payable</b>				
1994	\$ 0	\$ 0	\$	N/A
1995	98,625,000	2,868		N/A
1996	54,123,000	2,485		N/A
1997	0	0		N/A
1998	0	0		N/A
1999	0	0		N/A
2000	0	0		N/A
2001	0	0		N/A
2002	0	0		N/A
2003	0	0		N/A
2004 (as of June 30, unaudited)	0	0		N/A
<b>Redeemable Cumulative Preferred Stock<sup>(5)(7)</sup></b>				
1994	\$ 1,000,000	\$ 351	\$100	N/A
1995	1,000,000	277	100	N/A
1996	1,000,000	242	100	N/A
1997	1,000,000	217	100	N/A
1998	1,000,000	267	100	N/A
1999	1,000,000	225	100	N/A
2000	1,000,000	242	100	N/A
2001	1,000,000	244	100	N/A
2002	1,000,000	268	100	N/A
2003	1,000,000	319	100	N/A
2004 (as of June 30, unaudited)	0	0		N/A

Class and Year	Total Amount Outstanding Exclusive of Treasury Securities <sup>(1)</sup>	Asset Coverage Per Unit <sup>(2)</sup>	Involuntary Liquidating Preference Per Unit <sup>(3)</sup>	Average Market Value Per Unit <sup>(4)</sup>
<b>Non-Redeemable Cumulative Preferred Stock<sup>(5)</sup></b>				
1994	\$6,000,000	\$351	\$100	N/A
1995	6,000,000	277	100	N/A
1996	6,000,000	242	100	N/A
1997	6,000,000	217	100	N/A
1998	6,000,000	267	100	N/A
1999	6,000,000	225	100	N/A
2000	6,000,000	242	100	N/A
2001	6,000,000	244	100	N/A
2002	6,000,000	268	100	N/A
2003	6,000,000	319	100	N/A
2004 (as of June 30, unaudited)	0	0		N/A

- (1) Total amount of each class of senior securities outstanding at the end of the period presented.
- (2) The asset coverage ratio for a class of senior securities representing indebtedness is calculated as our consolidated total assets, less all liabilities and indebtedness not represented by senior securities, divided by senior securities representing indebtedness. This asset coverage ratio is multiplied by \$1,000 to determine the Asset Coverage Per Unit. The asset coverage ratio for a class of senior securities that is preferred stock is calculated as our consolidated total assets, less all liabilities and indebtedness not represented by senior securities, divided by senior securities representing indebtedness, plus the involuntary liquidation preference of the preferred stock (see footnote 3). The Asset Coverage Per Unit for preferred stock is expressed in terms of dollar amounts per share.
- (3) The amount to which such class of senior security would be entitled upon the involuntary liquidation of the issuer in preference to any security junior to it.
- (4) Not applicable, as senior securities are not registered for public trading.
- (5) Issued by our small business investment company subsidiary to the Small Business Administration. These categories of senior securities are not subject to the asset coverage requirements of the 1940 Act. See Certain Government Regulations Small Business Administration Regulations.
- (6) We were the obligor on \$15 million of the senior notes. Our small business investment company subsidiary was the obligor on the remaining \$5 million, which is not subject to the asset coverage requirements of the 1940 Act.
- (7) The Redeemable Cumulative Preferred Stock was reclassified to Other Liabilities on the accompanying financial statements during 2003 in accordance with SFAS No. 150.

## BUSINESS

### General

As a business development company, or BDC, we are in the private equity business. Specifically, we provide long-term debt and equity capital. We believe the private equity capital markets are important to the growth of small and middle market companies because such companies often have difficulty accessing the public debt and equity capital markets because their capital needs are too small to be attractive to the public markets, or because they are in need of long-term growth capital, which banks do not generally provide. We believe that we are well positioned to be a source of capital for such companies.

We have participated in the private equity business since Allied Capital was founded in 1958. We have financed thousands of companies nationwide. We generally invest in established, middle market companies with adequate cash flow for debt service. We are not venture capitalists, and we generally do not provide seed, or early stage, capital.

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

### Private Equity Investing

As a private equity investor, we spend significant time and effort identifying, structuring, performing due diligence, monitoring, valuing and ultimately exiting our investments. We generally target companies in less cyclical industries with, among other things, high return on invested capital, management teams with meaningful equity ownership, well-constructed balance sheets, and that have the ability to generate free cash flow. Each investment is subject to an extensive due diligence process. It is not uncommon for a single investment to take from two months to a full year to complete, depending on the complexity of the transaction.

Our investment activity is primarily focused in three areas:

Lending subordinated debt with or without equity features to middle market companies (also known as mezzanine investing),

Buying controlling equity stakes in middle market companies (also known as buyout investing), and

Investing in non-investment grade classes of commercial mortgage-backed securities (CMBS) and collateralized debt obligations (CDO).

We have chosen these investment classes because the investments can be structured to provide recurring cash flow to us as the investor. In addition to earning interest income, we may earn income from management, diligence, structuring or other fees. We may also enhance our total return through capital gains through equity features, such as nominal



cost warrants, or by investing in equity instruments. Net realized capital gains received over the past ten years as a percentage of total assets are shown in the chart below.

Our investments in mezzanine loans, equity investments in middle market companies, and non-investment grade tranches of CMBS and CDO pools are generally long-term in nature and privately negotiated, and no readily available market exists for them. This makes our investments highly illiquid and, as a result, we cannot trade them. When we make an investment, we enter into a long-term arrangement where our ultimate exit from that investment may be five to ten years in the future.

We believe illiquid investments generally provide better investment returns on average over time than do more liquid investments, such as public equities, public debt instruments, or large syndicated senior loans, because of the increased risk in holding such investments. Investors in illiquid investments cannot manage risk through investment trading techniques. In order to manage our risk, we focus on careful investment selection, thorough due diligence, consistent monitoring and portfolio diversification. Our investment management processes have been designed to incorporate these tools.

We believe our business model is well suited for long-term illiquid investing. Our balance sheet is capitalized with significant equity capital and we use only a modest level of debt capital, which allows us the ability to manage through difficult market conditions without the risk of liquidity issues. Under the Investment Company Act of 1940 we are restricted to a debt to equity ratio of approximately one-to-one. Thus, our long-term under-leveraged capital structure is well suited for long-term illiquid investments.

In general, we compete with a large number of financial services companies, including specialty and commercial financial companies, commercial banks and private equity funds. However, we primarily compete with private equity funds because they are also focused on

providing long-term debt and equity capital to middle market companies. We believe that we have key structural and operational advantages when compared to private equity funds.

Many private equity funds operate with different cost structures than ours, which often include management and carried interest fees (which are sometimes referred to as incentive fees) paid to the management of an external investment adviser. We are internally managed and have no external advisor. In addition, our access to the public equity markets generally allows us the opportunity to raise equity capital at a lower cost than that of private equity funds. Our lower cost of capital may give us a pricing advantage when competing for new investments. In addition, the perpetual nature of our corporate structure enables us to be a better long-term partner for our portfolio companies than a traditional private equity fund, which typically has a limited life. For additional information concerning the competitive risks we face, see [Risk Factors](#). We operate in a competitive market for investment opportunities.

### Private Finance Portfolio

Our private finance portfolio is primarily composed of mezzanine loans (junior capital in the form of subordinated debt, with or without equity features) and equity securities. Our capital is used to fund:

growth acquisitions	note purchases
buyouts	bridge financings
recapitalizations	other types of financings

At June 30, 2004, 67% of the private finance portfolio consisted of loans and debt securities and 33% consisted of equity securities.

We focus on mezzanine and buyout investments where we can select investments that are structured to generate current returns as well as potential future capital gains. It is our preference to structure our investments with a focus on current recurring income, with a lesser emphasis on future capital gains. Our loans generally have interest-only payments in the early years and payments of both principal and interest in the later years with maturities of five to ten years, although maturities and principal amortization schedules may vary. Our loans are also generally unsecured. We target a minimum 10% current yield on the debt component of our private finance portfolio and such payments are generally made to us quarterly. The weighted average yield on our private finance loans and debt securities was 14.6% at June 30, 2004.

To the extent that we buy a controlling equity stake in a company, we generally structure our investments such that we earn a current return through a combination of interest income on our senior loans and subordinated debt, dividends on our preferred and common equity, and management or transaction services fees to compensate us for the managerial assistance that we provide to a controlled portfolio company.

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. These investments are also generally illiquid. We generally target companies in less cyclical industries that tend to generate free cash flow and high returns on invested capital.

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The industry and geographic compositions of the private finance portfolio at value at June 30, 2004, and December 31, 2003 and 2002, were as follows:

	2004	2003	2002
<b>Industry</b>			
Business services	35%	22%	24%
Consumer products	19	30	34
Financial services	19	19	16
Healthcare services	8	8	6
Industrial products	5	6	8
Energy services	4	4	2
Retail	3	4	4
Telecommunications	2	2	2
Broadcasting & cable	2	2	1
Other	3	3	3
	100%	100%	100%
<b>Geographic Region</b>			
Mid-Atlantic	38%	40%	33%
West	33	16	15
Midwest	14	26	30
Southeast	10	13	17
Northeast	5	4	4
International		1	1
	100%	100%	100%

We monitor the portfolio to maintain diversity within the industries in which we invest. We currently do not have a policy with respect to concentrating (i.e., investing 25% or more of our total assets) in any industry or group of industries and currently our portfolio is not concentrated. We may or may not concentrate in any industry or group of industries in the future.

*Target Characteristics.* When assessing a prospective private finance investment, we look for companies with certain target characteristics, which may or may not be present in the companies in which we invest. Our target investments generally are in companies with the following characteristics:

Management team with meaningful equity ownership

Dominant or defensible market position

High return on invested capital

Stable operating margins

Ability to generate free cash flow

Well-constructed balance sheet

### **Commercial Real Estate Portfolio**

Our commercial real estate investments are generally in the non-investment grade tranches of commercial mortgage-backed securities, also known as CMBS. Non-investment grade means that nationally recognized statistical rating organizations rate these securities below the top four

investment-grade rating categories (i.e., AAA

through BBB ), and are sometimes referred to as junk bonds. Unlike most junk bonds, which are typically unsecured debt instruments, the non-investment grade CMBS bonds in which we invest are secured by an underlying collateral pool of commercial mortgage loans, which are, in turn, secured by commercial real estate. The underlying collateral for our CMBS bonds consist of senior mortgage loans on commercial real estate properties where the loans, on average, were underwritten to achieve a loan to value ratio of approximately 70%. We generally invest at the initial issuance of the CMBS, and are able to review the underlying collateral of mortgage loans as if we were making an initial decision to fund such loans and to determine if we want to exclude loans that do not meet our credit, collateral, structural or other standards. We are also able to negotiate to acquire the securities at significant discounts from their face amount. At June 30, 2004, our CMBS portfolio had a weighted average yield to maturity of 13.0%.

Our CMBS bonds by rating classification at June 30, 2004, were as follows:

(\$ in thousands)	June 30, 2004		
	Cost	Value	Percentage of Total Value
BBB-	\$ 22,295	\$ 21,495	4.0%
BB+	78,151	79,587	15.0
BB	44,418	45,410	8.6
BB-	29,754	30,281	5.7
B+	60,664	60,661	11.4
B	55,042	55,917	10.5
B-	89,236	87,537	16.5
CCC+	23,799	19,969	3.8
CCC	23,209	18,099	3.4
CCC-			
CC	1,474	965	0.2
Unrated	115,860	110,875	20.9
<b>Total</b>	<b>\$543,902</b>	<b>\$530,796</b>	<b>100.0%</b>

At June 30, 2004, the age of our bonds with a rating class of B+ and lower was as follows:

(\$ in thousands)	Value	Percentage
Less than one year old	\$ 102,859	29.1%
One to two years old	54,632	15.4
Two to three years old	52,779	14.9
Three years old or older	143,753	40.6
	<b>\$ 354,023</b>	<b>100.0%</b>

At June 30, 2004, the underlying pools of mortgage loans that are collateral for our CMBS consisted of approximately 6,400 commercial mortgage loans and real estate properties owned. The underlying mortgage loans securing the CMBS, calculated using the

outstanding principal balance, at June 30, 2004, and December 31, 2003 and 2002, were diversified over the following property types and geographic locations:

	2004	2003	2002
<b>Property Type</b>			
Retail	33%	35%	32%
Office	31	24	21
Housing	21	25	27
Industrial	5	5	7
Hospitality	4	5	6
Other	6	6	7
	—	—	—
Total	100%	100%	100%
<b>Geographic Region</b>			
West	28%	31%	31%
Mid-Atlantic	27	27	25
Midwest	22	21	22
Southeast	17	17	17
Northeast	6	4	5
	—	—	—
Total	100%	100%	100%

In addition to our CMBS investments, we have invested in the bonds and preferred shares of collateralized debt obligations, or CDOs, which are secured by investment grade unsecured debt issued by various real estate investment trusts, or REITs, investment grade and non-investment grade CMBS, and other real estate related collateral. The bonds and the preferred shares of the CDOs in which we have invested are junior in priority for payment of interest and principal to the more senior tranches of debt issued by the CDOs. The yield on our CDO bonds and preferred shares at June 30, 2004, was 17.3%.

### Business Processes

**Investment Sourcing.** Over the years, we have developed and maintained relationships with other private equity investors, investment banks, business brokers, merger and acquisition advisors, financial services companies, banks, law firms and accountants, through whom we source investment opportunities. Through these relationships, especially those with private equity sponsors, we have been able to strengthen our position as a long-term investor. We are well known in the private capital markets, and we believe that our experience and reputation provide a competitive advantage in originating new investments.

**Underwriting Process and Investment Approval.** In assessing new investment opportunities, we follow a documented process that includes centralized credit approval.

**Private Finance.** The typical mezzanine transaction requires two to six months of diligence and structuring before funding occurs. The typical buyout transaction may take up to one year to complete. The due diligence process is significantly longer for those transactions in which we take a controlling interest or substantial equity stake in the company.

In a typical private finance transaction, we thoroughly review, analyze, and substantiate, through due diligence, the business plan and operations of the potential portfolio company. We perform financial due diligence, often with the assistance of an accounting firm; perform operational due diligence, often with the assistance of an industry consultant; study the industry and competitive landscape; and conduct numerous reference

checks with current and former employees, customers, suppliers, and competitors. We typically work with a number of external consultants in performing due diligence and in monitoring our portfolio investments.

Once we have determined that a prospective portfolio company is suitable for investment, we work with the management and the other capital providers, including senior, junior, and equity capital providers, to structure a deal. We negotiate among these parties to agree on how our investment is expected to perform relative to the other capital in the portfolio company's capital structure.

Our mezzanine debt instruments are tailored to the facts and circumstances of the deal. The specific structure is negotiated over a period of several months and is designed to protect our rights and manage our risk in the transaction. We may structure the debt instrument to require restrictive affirmative and negative covenants, default penalties, lien protection, equity calls and take control provisions. Our loans and debt securities have an annual stated interest rate; however, that interest rate is only one factor in pricing the investment relative to our rights and priority in the portfolio company's capital structure. The annual stated interest rate may include some component of contractual payment-in-kind interest, which represents contractual interest accrued and added to the loan balance that generally becomes due at maturity. In addition to the interest earned on loans and debt securities, our mezzanine investments may include equity features, such as warrants or options to buy a minority interest in the portfolio company. The warrants we receive with our debt securities generally require only a nominal cost to exercise, and thus, as the portfolio company appreciates in value, we achieve additional investment return from this equity interest. We may structure the warrants to provide minority rights provisions and event-driven puts. In many cases, we will also obtain registration rights in connection with these equity interests, which may include demand and piggyback registration rights.

The key steps in our private finance investment process are:

Initial investment screening;

Initial investment committee approval;

Due diligence, structuring and negotiation;

Independent internal review of diligence results;

Final investment committee approval;

Approval by the Executive Committee of the Board of Directors (for all mezzanine investments that are equal to or greater than \$20 million and every buyout transaction); and

Funding of the investment.

The investment process benefits from the significant professional experience of the members of our investment committee, which is chaired by our Chief Executive Officer and includes our Chief Operating Officer, our Chief Financial Officer and other senior investment officers.

Every mezzanine transaction that represents a commitment equal to or greater than \$20 million and every buyout transaction requires approval by the Executive Committee of the Board of Directors in addition to investment committee approval. Due diligence must be successfully completed with final investment committee approval before funds are disbursed to a portfolio company.

**CMBS and CDOs.** The typical CMBS or CDO investment takes between two to three months to complete. We receive extensive underwriting information regarding the mortgage loans and other securities comprising a CMBS or CDO pool from the issuer. We then work with the issuer, the investment bank, and the rating agencies to underwrite the collateral securing our investment. For instance, when we review the underlying commercial mortgage loans securing a CMBS transaction, we analyze the estimate of cash flow and debt service coverage, and assess the collateral value and loan-to-value ratios. We study the local real estate market trends and form an opinion as to whether the loan as originally underwritten by the issuer is sound. Based on the findings of our diligence procedures, we may reject certain mortgage loans from inclusion in the pool.

The key steps in our CMBS and CDO investment process are:

Initial assessment of collateral pool data;

Preparation of preliminary bid letter;

Due diligence, structuring and negotiation;

Investment committee approval;

Approval by the Executive Committee of the Board of Directors (for all investments that are equal to or greater than \$20 million); and

Funding of the investment.

The investment process benefits from the significant professional experience of our real estate investment committee members. CMBS and CDO transactions are approved by the commercial real estate investment committee, which is chaired by our Chief Executive Officer and includes our Chief Operating Officer, our Chief Financial Officer and other senior investment officers. CMBS and CDO transactions that are equal to or greater than \$20 million are also reviewed and approved by the Executive Committee of the Board of Directors.

**Portfolio Management.** We monitor the progress of each portfolio company or collateral loan underlying a CMBS or CDO investment. Middle market companies often lack the management expertise and experience found in larger companies. As a BDC, we are required by the 1940 Act to make available significant managerial assistance to our portfolio companies. Our senior level professionals work with portfolio company management teams to assist them to acquire other companies, to optimize their cost structures, to recruit management talent, to develop their marketing strategies, and to provide a variety of other services. We also support our portfolio companies' efforts to structure and attract additional capital.

With respect to our private finance portfolio, investment professionals regularly monitor the status and performance of each individual investment. This portfolio company monitoring process includes review of the company's financial performance against its business plan, review of current financial statements and compliance with financial covenants, evaluation of significant current developments and assessment of future exit strategies. We typically have board observation rights for mezzanine investments, which allows us to attend portfolio company board meetings. For buyout investments, we generally hold a majority of the seats on the board of directors.



From time to time we will identify investments that require closer monitoring or become workout assets. We develop a workout strategy for workout assets and gauge our progress against the strategy at periodic portfolio management committee meetings. Our portfolio management committee is chaired by our Chief Executive Officer and includes our Chief Operating Officer, our Chief Financial Officer, and other senior professionals.

Private finance investments are priced to provide an investment return considering the fact that certain investments in the portfolio may underperform or result in loss of investment return or investment principal. As a private equity investor we will incur losses from our investing activities, however we have a history of working with troubled portfolio companies in order to recover as much of our investments as is practicable.

With respect to our CMBS and CDO portfolio, we monitor the performance of the underlying collateral pool through data provided by third party master and special servicers. These master servicers are responsible for the day-to-day loan servicing functions, including billing, payment processing, collections on loans less than 60 days past due, tax and insurance escrow processing, and property inspections. Special servicers are responsible for collections on loans greater than 60 days past due, including workout administration and management of foreclosed properties, and loans less than 60 days past due that have had a transfer event.

When a loan moves to the designated special servicer, a workout plan is formulated by the special servicer and reviewed by us when we hold the controlling interest in the lowest rated tranche outstanding, which is generally the non-rated tranche at issuance. Once reviewed by us, the special servicer carries out the workout plan, updating us on the status. With respect to certain CMBS issuances where we own the controlling class of securities, we are the named special servicer, and where we are not the named special servicer, we generally have the ability to replace the existing named special servicer at any time. In addition, we act as the disposition consultant with respect to certain of our CDO investments, which allows us to approve disposition plans for individual collateral securities.

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

**Portfolio Valuation.** We determine the value of each investment in our portfolio on a quarterly basis and changes in value result in unrealized appreciation or depreciation being recognized in our statement of operations. Value, as defined in Section 2(a)(41) of the Investment Company Act of 1940, is (i) the market price for those securities for which a market quotation is readily available and (ii) for all other securities and assets, fair value is as determined in good faith by the Board of Directors. Since there is typically no readily available market value for the investments in our portfolio, we value substantially all of our portfolio investments at fair value as determined in good faith by the Board of Directors pursuant to a valuation policy and a consistently applied valuation process. At June 30, 2004, portfolio investments recorded at fair value were approximately 87% of our total assets. Because of the inherent uncertainty of determining the fair value of investments that do not have a readily available market value, the fair value of our investments determined in good faith by the Board of Directors may differ significantly

from the values that would have been used had a ready market existed for the investments, and the differences could be material.

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

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

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

There is no one methodology to determine enterprise value and, in fact, for any one portfolio company, enterprise value is best expressed as a range of fair values, from which we derive a single estimate of enterprise value. To determine the enterprise value of a portfolio company, we analyze its historical and projected financial results. We generally require portfolio companies to provide annual audited and quarterly unaudited financial statements, as well as annual projections for the upcoming fiscal year. Typically in the private equity business, companies are bought and sold based on multiples of EBITDA, cash flow, net income, revenues or, in limited instances, book value. The private equity industry uses financial measures such as EBITDA or EBITDAM (Earnings Before Interest, Taxes, Depreciation, Amortization and, in some instances, Management fees) in order to assess a portfolio company's financial performance and to value a portfolio company. EBITDA and EBITDAM are not intended to represent cash flow from

operations as defined by 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 is determined based on various factors, including the enterprise value remaining for equity holders after the repayment of the portfolio company's debt and other preference capital, and other pertinent factors such as recent offers to purchase a portfolio company, recent transactions involving the purchase or sale of the portfolio company's equity securities, or other liquidation 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 that utilizes prepayment and loss assumptions based on historical experience and projected performance, economic factors, the characteristics of the underlying cash flow and comparable 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 unrealized appreciation or depreciation on our CMBS bonds and CDO bonds and preferred shares as comparable yields in the market change and/or based on changes in estimated cash flows resulting from changes in prepayment or loss assumptions in the underlying collateral pool.

**Valuation Process.** The portfolio valuation process is managed by our Chief Valuation Officer ( CVO ). The CVO works with the investment professionals responsible for each investment. The following is a description of the steps we take each quarter to determine the value of our portfolio.

Our valuation process begins with each portfolio company or investment being initially valued by the Allied Capital deal team, led by the Managing Director or senior officer who is responsible for the portfolio company relationship.

The CVO meets with each Managing Director or responsible senior officer to discuss the preliminary valuation determined and documented by the deal team for each of their respective investments. The CVO reviews the valuation data and conclusions.

Each investment committee meets with the CVO to discuss the valuation results. Members of the investment committees have the opportunity to discuss the preliminary valuation of each portfolio investment and to question the valuation conclusions arrived at by the CVO and the respective deal teams.

Valuation documentation is distributed to the members of the Board of Directors.

The Board of Directors meets to discuss valuations and review the input of the CVO and management.

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

The Board of Directors determines the fair value of the portfolio in good faith.

In connection with our valuation process to determine the fair value of a private finance investment, we may receive independent assessments of a particular private finance portfolio company's value in the ordinary course of business, most often in the context of a prospective sale transaction or in the context of the bankruptcy process, or we may work with independent third-party consultants to obtain assistance and advice as additional support in the preparation of our internal valuation analysis. The valuation analysis prepared by management using these independent valuation resources is submitted to our Board of Directors for their determination of fair value of the portfolio in good faith.

**Disposition of Investments.** We manage our portfolio of investments in an effort to maximize our expected returns. Our portfolio is large and diverse and we frequently are repaid by our borrowers and exit our debt and equity investments as portfolio companies are sold or recapitalized. In our mezzanine investments, we frequently are in a minority ownership position in a portfolio company, and as a result, generally exit the investment when the majority equity stakeholder decides to sell or recapitalize the company. Where we have a control position in our investment, as we frequently have in buyout investments and in CMBS and CDO investments, we have more flexibility and can determine whether or not we should exit our investment. Our most common exit strategy is the sale of a portfolio company to a strategic or financial buyer. If an investment has appreciated in value, we may realize a capital gain when we exit the investment. If an investment has depreciated in value, we may realize a loss when we exit the investment.

#### **Dividends**

We have elected to be taxed as a regulated investment company under subchapter M of the Internal Revenue Code. As such, we are not subject to corporate level income taxation on income we timely distribute to our stockholders as dividends. We pay regular quarterly dividends based upon an estimate of annual taxable income, which includes our taxable interest, dividend and fee income, as well as taxable net capital gains. Taxable income generally differs from net income for financial reporting purposes due to temporary and permanent differences in the recognition of income and expenses and generally excludes net unrealized appreciation or depreciation, as gains or losses are not included in taxable income until they are realized. Taxable income includes non-cash income, such as changes

in accrued and reinvested interest and dividends and the amortization of discounts and fees. Non-cash taxable income is reduced by non-cash expenses, such as realized losses and depreciation and amortization expense.

We began paying quarterly dividends in 1963, and our portfolio has provided sufficient ordinary taxable income and realized net capital gains to sustain or grow our dividends over time. The percentage of our dividend generated by ordinary taxable income versus capital gain income will vary from year to year, but we believe that the ability to generate both ordinary and capital gain income builds predictability in the dividends we pay. The percentage of ordinary taxable income versus capital gain income supporting the dividend for the past five years is shown below.

### **Corporate Structure and Offices**

We were founded in 1958. We are a Maryland corporation and a closed-end, non-diversified management investment company that has elected to be regulated as a business development company under the 1940 Act. We have a subsidiary, Allied Investment Corporation, which has also elected to be regulated as a BDC and is licensed under the Small Business Investment Act of 1958 as a Small Business Investment Company. See [Certain Government Regulations](#) below for further information about small business investment company regulation.

In addition, we have a real estate investment trust subsidiary, Allied Capital REIT, Inc., and several subsidiaries that are single-member limited liability companies established primarily to hold real estate properties. We also have a subsidiary, A.C. Corporation, that provides diligence and structuring services on private finance and commercial real estate transactions, as well as structuring, transaction, management and advisory services to Allied Capital, our portfolio companies and other third parties.

Our executive offices are located at 1919 Pennsylvania Avenue, NW, Washington, DC 20006 and our telephone number is (202) 331-1112. In addition, we have regional offices in New York, Chicago and Los Angeles.

## Employees

At June 30, 2004, we employed 153 individuals including investment and portfolio management professionals, operations professionals and administrative staff. The majority of these individuals are located in our Washington, DC office. We believe that our relations with our employees are excellent.

## Legal Proceedings

On June 23, 2004, the SEC notified us that they are conducting an informal investigation of us. Based on the documentation requested by the SEC, the nature of the inquiry appears to pertain to matters related to our portfolio company, Business Loan Express, LLC and allegations made by short sellers over the last two years. We have voluntarily agreed to cooperate fully with the SEC's investigation.

On June 2, 2004, Ferolie Corporation, a food broker with business and contractual relationships with an entity that is now affiliated with one of our portfolio companies, Advantage Sales & Marketing Inc., filed suit against us, Advantage Sales & Marketing and the affiliated entity in the United States District Court for the District of Columbia alleging that, among other things, we and Advantage Sales & Marketing had tortiously interfered with Ferolie's contract with the affiliated entity by causing the affiliated entity (i) to breach its obligations to Ferolie regarding Ferolie's participation in a reorganization transaction involving the affiliated entity and (ii) to induce clients of Ferolie to transfer their business to the affiliated entity. Ferolie seeks actual and punitive damages against us and Advantage Sales & Marketing and declaratory and injunctive relief. On July 15, 2004, the United States District Court for the District of Columbia dismissed the lawsuit for lack of jurisdiction. On August 17, 2004, Ferolie filed a Petition to Compel Arbitration in the United States District Court for the Northern District of Illinois naming us, Advantage Sales & Marketing and the affiliated entity as respondents. Ferolie attached to its petition an Amended Demand for Arbitration and Statement of Claims that asserts essentially the same claims as were asserted in the lawsuit that was dismissed by the United States District Court for the District of Columbia.

In addition to the above matters, we are party to certain lawsuits in the normal course of business. While the outcome of these legal proceedings and other matters cannot at this time be predicted with certainty, we do not expect that these matters will have a material effect upon our financial condition or results of operations.

### PORTFOLIO COMPANIES

The following is a listing of each portfolio company or its affiliate, together referred to as portfolio companies, in which we had an equity investment at June 30, 2004. Percentages shown for class of securities held by us represent percentage of the class owned and do not necessarily represent voting ownership. Percentages shown for equity securities other than warrants or options represent the actual percentage of the class of security held before dilution. Percentages shown for warrants and options held represent the percentage of class of security we may own assuming we exercise our warrants or options before dilution.

The portfolio companies are presented in three categories: companies more than 25% owned which represent portfolio companies where we directly or indirectly own more than 25% of the outstanding voting securities of such portfolio company and, therefore, are deemed controlled by us under the 1940 Act; companies owned 5% to 25% which represent portfolio companies where we directly or indirectly own 5% to 25% of the outstanding voting securities of such portfolio company or where we hold one or more seats on the portfolio company's board of directors and, therefore, are deemed to be an affiliated person under the 1940 Act; and companies less than 5% owned which represent portfolio companies where we directly or indirectly own less than 5% of the outstanding voting securities of such portfolio company and where we have no other affiliations with such portfolio company. We make available significant managerial assistance to our portfolio companies. We generally receive rights to observe the meetings of our portfolio companies' board of directors, and may have one or more voting seats on their boards.

For information relating to the amount and nature of our investments in portfolio companies, see our consolidated statement of investments at June 30, 2004, at pages F-6 to F-15.

Name and Address of Portfolio Company	Nature of its Principal Business	Title of Securities Held by the Company	Percentage of Class Held
<b>Companies More Than 25% Owned</b>			
ACE Products, Inc. <sup>(1)</sup> 850 Industrial Boulevard Newport, TN 37821	Rubber and Plastic Tire Manufacturer	Class A Common Stock Class B Common Stock	47.4% 100.0%
Acme Paging, L.P. <sup>(1)</sup> 6080 SW 40th Street, Suite 3 Miami, FL 33155	Paging Services	Class A Equity Interests Class B Equity Interests Common Stock in Affiliate	100.0% 1.7% 15.8%
Advantage Sales & Marketing, Inc. <sup>(1)(6)</sup> 19100 Von Karman Avenue Suite 600 Irvine, CA 92612	Sales and Marketing Agency	Class A Common Stock	100.0%
Alaris Consulting, LLC <sup>(1)(2)</sup> 360 W. Butterfield Road Suite 400 Elmhurst, IL 60126	Consulting Firm	Equity Interests	100.0%
American Healthcare Services, Inc. <sup>(1)</sup> 3600 Mansell Road Suite 150 Alpharetta, GA 30022	Consumer Health Services Provider	Common Stock	68.6%
Avborne, Inc. <sup>(1)</sup> c/o Trinvest, Inc. 7500 NW 26th Street Miami, FL 33122	Aviation Services	Series B Preferred Stock Common Stock	23.8% 27.2%

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Name and Address of Portfolio Company	Nature of its Principal Business	Title of Securities Held by the Company	Percentage of Class Held
Business Loan Express, LLC <sup>(1)</sup> 645 Madison Ave. 19th Floor New York, NY 10022	Small Business Lender	Class A Equity Interests	100.0%
		Class B Equity Interests	100.0%
		Class C Equity Interests	94.9%
		Equity Interest in BLX Subsidiary <sup>(3)</sup>	20.0%
Callidus Capital Corporation <sup>(1)(4)</sup> 520 Madison Avenue, 27th Floor New York, NY 10022	Asset Manager and Finance Company	Common stock	100.0%
Chickasaw Sales & Marketing, Inc. <sup>(1)</sup> 5 North McCormick Oklahoma City, OK 73127	Prepaid Telephone Services Company	Convertible Preferred Stock	50.0%
		Common Stock	37.0%
The Color Factory Inc. <sup>(1)</sup> 11312 Penrose Street Sun Valley, CA 91352	Cosmetic Manufacturer	Redeemable Preferred Stock	100.0%
		Common Stock	100.0%
		Foresite Towers, LLC <sup>(1)</sup> 22 Iverness Center Parkway Suite 50 Birmingham, AL 35242	Tower Leasing
Global Communications, LLC <sup>(1)</sup> 201 East 69th Street New York, NY 10021	Muzak Franchisee	Series B Preferred Equity Interest	100.0%
		Series D Preferred Equity Interest	100.0%
		Common Equity Interest Preferred Equity Interest	70.0%
		Options for Common Equity Interest	77.8%
Gordian Group, Inc. <sup>(1)</sup> 499 Park Avenue 5th Floor New York, NY 10022	Financial Advisory Services	Equity Interest	59.3%
		Common Stock	100.0%
HealthASPex, Inc. <sup>(1)</sup> Foxpointe Centre Building 1; Suite 301 201 South Johnson Road Houston, PA 15342	Third Party Administrator	Class A Convertible Preferred Stock	69.9%
		Class B Convertible Preferred Stock	64.8%
		Common Stock	45.8%
		HMT, Inc. 4422 FM 1960 West Suite 350 Houston, TX 77068	Storage Tank Maintenance & Repair
Housecall Medical Resources, Inc. <sup>(1)</sup> 6501 Deane Hill Drive Knoxville, TN 37919	Home Healthcare Services	Common Stock	26.1%
		Warrants to Purchase Common Stock	10.0%
Impact Innovations Group, LLC 12 Piedmont Center, Suite 210 Atlanta, GA 30305	Information Technology Services Provider	Common Stock	76.8%
		Equity Interest in Affiliate <sup>(5)</sup> Warrant to Purchase Common Stock	50.0%
Jakel, Inc. <sup>(1)</sup> 400 Broadway Highlands, IL 62249	Manufacturer of Electric Motors and Blowers	Series A-1 Preferred Stock	3.5%
		Class B Common Stock	32.3%
		Equity Interests	100.0%
Legacy Partners Group, LLC <sup>(1)</sup> 520 Madison Avenue, 27th Floor New York, NY 10022	Merger and Acquisition Advisor	Equity Interests	100.0%
Litterer Beteiligungs-GmbH Uhlandstrasse 1	Scaffolding Company	Equity Interest	29.1%



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69493 Hirschberg Germany			
Mercury Air Centers, Inc. <sup>(1)</sup>	Fixed Base Operations	Common Stock	99.6%
1951 Airport Road Atlanta, GA 30341			

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Name and Address of Portfolio Company	Nature of its Principal Business	Title of Securities Held by the Company	Percentage of Class Held
MVL Group, Inc. <sup>(1)</sup> 1061 E. Indiantown Road Suite 300 Jupiter, FL 33477	Market Research Services	Common Stock	64.9%
Powell Plant Farms, Inc. <sup>(1)</sup> Route 3, Box 1058 Troup, TX 75789	Plant Producer & Wholesaler	Preferred Stock Warrants to Purchase Common Stock	100.0% 83.5%
Redox Brands, Inc. <sup>(1)</sup> 9100 Centre Point Drive Suite 200 West Chester, OH 45069	Household Cleaning Products	Series A Convertible Preferred Stock Warrants to Purchase Class A Common Stock	100.0% 9.4%
Staffing Partners Holding Company, Inc. <sup>(1)</sup> 104 Church Lane, #100 Baltimore, MD 21208	Temporary Employee Services	Series B Preferred Stock Redeemable Preferred Stock Class A-1 Common Stock Class A-2 Common Stock Class B Common Stock Warrants to purchase Class B Common Stock Common Stock	71.4% 48.3% 50.0% 24.4% 48.8% 30.3% 68.5%
Startec Global Communications Corporation <sup>(1)</sup> 1151 Seven Locks Road Potomac, MD 20854	Telecommunications Services	Common Stock	68.5%
STS Operating, Inc. (d/b/a SunSource Technology Services, Inc.) <sup>(1)</sup> 2301 Windsor Court Addison, IL 60101	Engineering Design and Services	Preferred Stock Common Stock Options to Purchase Common Stock	96.2% 39.7% 0.4%
<b>Companies 5% to 25% Owned</b>			
Aspen Pet Products, Inc. 4735 North Florence Street Denver, CO 80238	Pet Product Provider	Series B Preferred Stock Series D Preferred Stock Series A Common Stock Warrants to purchase Series A Common Stock	8.7% 6.5% 6.5% 4.1%
Border Foods, Inc. J Street Deming Industrial Park Deming, NM 88030	Mexican Ingredient & Food Product Manufacturer	Series A Convertible Preferred Stock Common Stock Warrants to Purchase Common Stock	9.4% 12.4% 73.8%
The Debt Exchange, Inc. <sup>(1)</sup> 101 Arch Street, Suite 410 Boston, MA 02110	Online Sales of Distressed Assets	Series B Convertible Preferred Stock	40.0%
EDM Consulting, LLC 81 Two Bridges Road Fairfield, NJ 07004	Environmental Consulting	Equity Interests	25.0%
GFC Holdings, LLC <sup>(1)</sup> 701 Rickert Street Statesville, NC 28677	Packaging Manufacturer	Warrants to Purchase Equity Interest	13.3%
Liberty-Pittsburgh Systems, Inc. 3498 Grand Avenue Pittsburgh, PA 15225	Business Forms Printing	Class A Common Stock Class B	10.4%

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MasterPlan, Inc.	Healthcare Outsourcing	Common Stock	44.1%
21540 Plummer Street		Common Stock	7.5%
Chatsworth, CA 91311			

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Name and Address of Portfolio Company	Nature of its Principal Business	Title of Securities Held by the Company	Percentage of Class Held
MortgageRamp.com, Inc. <sup>(1)</sup> 116 Welsh Road Horsham, PA 19044	Internet Based Loan Origination Service Platform	Class A Common Stock	7.7%
Nexcel Synthetics, LLC 6076 Southern Industrial Drive Birmingham, AL 35235	Manufacturer of Carpet Backing	Class A Equity Interest Class B Equity Interest	6.8% 6.8%
Nobel Learning Communities, Inc. <sup>(1)</sup> 1400 N. Providence Road Suite 3055 Media, PA 19063	Educational Services	Series D Preferred Stock Series F Convertible Preferred Stock Warrants to Purchase Common Stock	100.0% 25.6% 7.2%
Packaging Advantage Corporation 4633 Downey Road Los Angeles, CA 90058	Personal Care, Household and Disinfectant Product Packager	Common Stock Warrants to Purchase Common Stock	5.7% 5.4%
Pres Air Trol LLC 1009 W. Boston Post Road Mamaroneck, NY 10543	Pressure Switch Manufacturer	Class A Equity Interests	32.8%
Professional Paint, Inc. 8600 Park Meadow Drive, #300 Lone Tree, CO 80124	Paint Manufacturer	Series A-1 Senior Exchangeable Preferred Stock Common Stock	50.0% 11.6%
Progressive International Corporation 6111 S. 228th Street Kent, WA 98064	Retail Kitchenware	Series A Redeemable Preferred Stock Class A Common Stock Warrants to Purchase Class A Common Stock	12.5% 1.0% 41.6%
Total Foam, Inc. <sup>(1)</sup> P.O. Box 688 Ridgefield, CT 06877	Packaging Systems	Common Stock	8.8%
Universal Environmental Services, LLC 411 Dividend Drive Peachtree City, GA 30269	Used Oil Recycling	Preferred Equity Interests	15.0%
<b>Companies Less Than 5% Owned</b>			
Alderwoods Group, Inc. 311 Elm Street, Suite 1000 Cincinnati, OH 45202	Death Care Services	Common Stock	0.9%
American Barbecue & Grill, Inc. 7300 W. 110th Street, Suite 570 Overland Park, KS 66210	Restaurant Chain	Warrants to Purchase Common Stock	18.7%
Apogen Technologies, Inc. 7450-B Boston Blvd. Springfield, VA 22153	Government Information Technology Services	Series A Preferred Stock Common Stock Warrant to Purchase Series A Preferred Stock Warrant to Purchase Common Stock	5.2% 4.8% 0.7% 0.8%
Benchmark Medical, Inc.	Outpatient Physical	Warrant to Purchase	