

ALLIED CAPITAL CORP
Form 10-Q
November 14, 2003

FORM 10-Q

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, DC 20549

QUARTERLY REPORT PURSUANT TO

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

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

**Commission File Number:
0-22832**

ALLIED CAPITAL CORPORATION

(Exact Name of Registrant as Specified in its Charter)

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

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

1919 Pennsylvania Avenue, N.W.

Washington, DC 20006
(Address of Principal Executive Offices)

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

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

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

On November 11, 2003, there were 125,662,365 shares outstanding of the Registrant's common stock, \$0.0001 par value.

ALLIED CAPITAL CORPORATION

FORM 10-Q INDEX

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PART I: FINANCIAL INFORMATION

Item 1. Financial Statements

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEET

(in thousands, except share and per share amounts)	September 30, 2003	December 31, 2002
	(unaudited)	
ASSETS		
Portfolio at value:		
Private finance		
Companies more than 25% owned (cost: 2003-\$732,578; 2002-\$628,535)	\$ 842,570	\$ 710,587
Companies 5% to 25% owned (cost: 2003-\$199,935; 2002-\$219,124)	224,886	255,677
Companies less than 5% owned (cost: 2003-\$895,888; 2002-\$863,243)	741,252	776,951
Total private finance	1,808,708	1,743,215
Commercial real estate finance (cost: 2003-\$789,370; 2002-\$718,312)	792,350	744,952
Total portfolio at value	2,601,058	2,488,167
Deposits of proceeds from sales of borrowed Treasury securities	221,732	194,745
Accrued interest and dividends receivable	52,370	40,354
Other assets	64,668	59,867
Cash and cash equivalents	69,071	11,186
Total assets	\$3,008,899	\$2,794,319
LIABILITIES AND SHAREHOLDERS EQUITY		
Liabilities:		
Notes payable and debentures	\$ 954,200	\$ 794,200
Revolving line of credit		204,250
Obligations to replenish borrowed Treasury securities	221,853	197,027
Accounts payable and other liabilities	51,259	45,771
Total liabilities	1,227,312	1,241,248
Commitments and contingencies		
Preferred stock	6,000	7,000
Shareholders' equity:		
Common stock, \$0.0001 par value, 200,000,000 shares authorized; 122,765,830 and 108,698,409 shares issued and outstanding at September 30, 2003, and December 31, 2002, respectively	12	11
Additional paid-in capital	1,854,253	1,547,183
Notes receivable from sale of common stock	(19,502)	(24,704)
Net unrealized appreciation (depreciation) on portfolio	(38,349)	39,411
Undistributed (distributions in excess of) earnings	(20,827)	(15,830)

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Total shareholders' equity	<u>1,775,587</u>	<u>1,546,071</u>
Total liabilities and shareholders' equity	<u>\$3,008,899</u>	<u>\$2,794,319</u>
Net asset value per common share	<u>\$ 14.46</u>	<u>\$ 14.22</u>

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

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENT OF OPERATIONS

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2003	2002	2003	2002
(in thousands, except per share amounts)				
	(unaudited)		(unaudited)	
Interest and Related Portfolio Income:				
Interest and dividends				
Companies more than 25% owned	\$ 14,533	\$ 10,125	\$ 42,464	\$ 28,972
Companies 5% to 25% owned	6,313	6,710	19,286	21,731
Companies less than 5% owned	58,049	50,789	149,803	144,586
	<u>78,895</u>	<u>67,624</u>	<u>211,553</u>	<u>195,289</u>
Premiums from loan dispositions				
Companies more than 25% owned	33		141	
Companies 5% to 25% owned	60		685	
Companies less than 5% owned	2,430	392	4,455	2,051
	<u>2,523</u>	<u>392</u>	<u>5,281</u>	<u>2,051</u>
Fees and other income				
Companies more than 25% owned	4,382	5,319	14,395	19,248
Companies 5% to 25% owned	229	734	459	1,149
Companies less than 5% owned	2,841	2,260	7,526	14,176
	<u>7,452</u>	<u>8,313</u>	<u>22,380</u>	<u>34,573</u>
Total interest and related portfolio income	<u>88,870</u>	<u>76,329</u>	<u>239,214</u>	<u>231,913</u>
Expenses:				
Interest	20,334	17,430	57,614	52,414
Employee	9,480	8,153	26,859	24,462
Administrative	5,897	5,052	15,395	12,913
	<u>35,711</u>	<u>30,635</u>	<u>99,868</u>	<u>89,789</u>
Net investment income before income taxes	53,159	45,694	139,346	142,124
Income tax expense (benefit)	(449)	600	(1,530)	600
Net investment income	<u>53,608</u>	<u>45,094</u>	<u>140,876</u>	<u>141,524</u>
Net Realized and Unrealized Gains (Losses):				
Net realized gains (losses)				
Companies more than 25% owned	(114)	60,063	1,200	59,433
Companies 5% to 25% owned	(5,895)	(700)	10,793	18
Companies less than 5% owned	(429)	(11,141)	38,448	(2,379)
	<u>(6,438)</u>	<u>48,222</u>	<u>50,441</u>	<u>57,072</u>
Net change in unrealized appreciation or depreciation	(13,426)	(47,796)	(77,760)	(23,661)

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Total net gains (losses)	<u>(19,864)</u>	<u>426</u>	<u>(27,319)</u>	<u>33,411</u>
Net increase in net assets resulting from operations	\$ 33,744	\$ 45,520	\$ 113,557	\$ 174,935
Basic earnings per common share	\$ 0.28	\$ 0.44	\$ 0.99	\$ 1.73
Diluted earnings per common share	\$ 0.28	\$ 0.44	\$ 0.98	\$ 1.70
Weighted average common shares outstanding basic	<u>118,855</u>	<u>102,327</u>	<u>113,985</u>	<u>101,329</u>
Weighted average common shares outstanding diluted	<u>120,906</u>	<u>103,302</u>	<u>115,228</u>	<u>103,040</u>

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

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

(in thousands, except per share amounts)	For the Nine Months Ended September 30,	
	2003	2002
	(unaudited)	
Operations:		
Net investment income	\$ 140,876	\$ 141,524
Net realized gains	50,441	57,072
Net change in unrealized appreciation or depreciation	(77,760)	(23,661)
	113,557	174,935
Shareholder distributions:		
Common stock dividends	(196,159)	(166,823)
Preferred stock dividends	(155)	(165)
	(196,314)	(166,988)
Capital share transactions:		
Sale of common stock	298,249	49,920
Issuance of common stock upon the exercise of stock options	3,674	13,290
Issuance of common stock in lieu of cash distributions	4,959	4,696
Net decrease in notes receivable from sale of common stock	5,202	672
Other	189	401
	312,273	68,979
Net increase in net assets resulting from capital share transactions		
	312,273	68,979
Total increase in net assets	229,516	76,926
Net assets at beginning of period	1,546,071	1,352,123
	1,775,587	1,429,049
Net assets at end of period	\$ 1,775,587	\$ 1,429,049
	14.46	13.95
Net asset value per common share	\$	\$
	122,766	102,468
Common shares outstanding at end of period	122,766	102,468

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

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENT OF CASH FLOWS

	For the Nine Months Ended September 30,	
	2003	2002
(in thousands)		
	(unaudited)	
Cash flows from operating activities:		
Net increase in net assets resulting from operations	\$ 113,557	\$ 174,935
Adjustments		
Portfolio investments	(664,814)	(353,026)
Repayments of investment principal	219,702	111,691
Proceeds from investment sales	281,826	213,474
Change in accrued or reinvested interest and dividends	(39,983)	(32,999)
Amortization of loan discounts and fees	(10,067)	(10,060)
Changes in other assets and liabilities	4,650	(13,264)
Depreciation and amortization	1,233	1,053
Gain on cashless exercise of warrants	(3,876)	
Realized losses	14,228	36,282
Net change in unrealized appreciation or depreciation	77,760	23,661
	<u>(5,784)</u>	<u>151,747</u>
Cash flows from financing activities:		
Sale of common stock	298,249	49,920
Sale of common stock upon the exercise of stock options	3,674	10,909
Collections of notes receivable from sale of common stock	5,202	3,053
Common stock dividends and distributions paid	(194,382)	(162,127)
Preferred stock dividends paid	(155)	(165)
Borrowings under notes payable and debentures	300,000	
Repayments on notes payable and debentures	(140,000)	(6,856)
Net repayments on revolving line of credit	(204,250)	(23,250)
Other financing activities	(4,669)	(490)
	<u>63,669</u>	<u>(129,006)</u>
Net increase in cash and cash equivalents	57,885	22,741
Cash and cash equivalents at beginning of period	11,186	889
	<u>\$ 69,071</u>	<u>\$ 23,630</u>

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ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENT OF INVESTMENTS

Private Finance Portfolio Company (in thousands, except number of shares)	Investment ⁽¹⁾	September 30, 2003	
		Cost	(unaudited) Value
Companies More Than 25% Owned			
Acme Paging, L.P. ⁽³⁾ (Telecommunications)	Loan Equity Interests Common Stock (1,145 shares)	\$ 4,395 13,274 27	\$ 4,395 6,087
Alaris Consulting, LLC (Business Services)	Loan Equity Interests Guaranty (\$1,100)	19,344 5,165	12,500
American Healthcare Services, Inc. (Healthcare Services)	Loan Debt Securities Common Stock (7,956,704 shares) Guaranty (\$1,415)	25,751 17,311 1,000	25,751 11,042
Avborne, Inc. (Business Services)	Loan Preferred Stock (12,500 shares) Common Stock (27,500 shares) Standby Letter of Credit (\$6,978)	2,863 14,138	2,863 2,300
Business Loan Express, LLC (Financial Services)	Loans Debt Securities Class A Equity Interests Class B Equity Interests Class C Equity Interests Guaranty (\$64,871 See Note 3) Standby Letters of Credit (\$25,550 See Note 3)	10,000 38,976 46,394 53,111 109,340	10,000 38,976 46,394 94,586 154,960
The Color Factory, Inc. (Consumer Products)	Loan Preferred Stock (1,000 shares) Common Stock (980,000 shares)	14,239 1,002 6,535	7,007
Foresite Towers, LLC (Tower Leasing)	Equity Interests	18,522	17,561
Global Communications, LLC (Business Services)	Loan Debt Securities Preferred Equity Interest Options	2,349 16,969 14,067 1,639	2,349 16,969 18,020 1,639
Gordian Group, Inc. (Business Services)	Loan Common Stock (1,000 shares)	9,155 2,385	9,155 3,500
HealthASPex, Inc.	Preferred Stock (1,000,000 shares)	700	700

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(Business Services)	Preferred Stock (1,451,380 shares)	4,900	2,601
	Common Stock (1,451,380 shares)	4	
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The Hillman Companies, Inc. ⁽²⁾	Debt Securities	43,456	43,456
(Consumer Products)	Common Stock (6,890,937 shares)	50,645	142,519
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- (2) Public company.
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		September 30, 2003	
Private Finance Portfolio Company (in thousands, except number of shares)	Investment ⁽¹⁾	(unaudited)	
		Cost	Value
HMT, Inc. (Business Services)	Debt Securities	\$ 9,157	\$ 9,157
	Preferred Stock (554,052 shares)	2,303	2,303
	Common Stock (300,000 shares)	3,000	4,264
	Warrants	1,155	1,641
Housecall Medical Resources, Inc. (Healthcare Services)	Loan	15,151	15,151
	Preferred Stock (3,890,344 shares)	3,889	3,889
	Common Stock (864,000 shares)	86	10,600
Jakel, Inc. (Industrial Products)	Loan	1,624	1,624
	Debt Securities	7,551	7,551
	Preferred Stock (6,460 shares)	6,460	3,864
	Common Stock (158,061 shares)	9,347	
	Standby Letter of Credit (\$3,379)		
Litterer Beteiligungs-GmbH ⁽³⁾ (Business Services)	Debt Securities	1,423	825
	Equity Interest	295	
MVL Group, Inc. (Business Services)	Loan	19,002	18,708
	Debt Securities	16,655	16,015
	Common Stock (648,661 shares)	643	
Powell Plant Farms, Inc. (Consumer Products)	Loan	20,852	20,852
	Debt Securities	19,224	9,692
	Preferred Stock (1,483 shares)		
	Warrants		
Redox Brands, Inc. (Consumer Products)	Loan	3,079	3,079
	Debt Securities	10,140	10,140
	Preferred Stock (2,404,086 shares)	6,965	6,965
	Warrants	584	584
	Guaranty (\$125)		
Staffing Partners Holding Company, Inc. (Business Services)	Debt Securities	5,589	5,589
	Preferred Stock (414,600 shares)	4,968	3,058
	Common Stock (50,200 shares)	50	
	Warrants	10	
STS Operating, Inc. (Industrial Products)	Preferred Stock (5,769,424 shares)	6,525	6,525
	Common Stock (3,000,000 shares)	3,177	3,177
Sure-Tel, Inc. (Consumer Services)	Preferred Stock (1,000,000 shares)	1,000	1,000
	Common Stock (37,000 shares)	5,018	987
Total companies more than 25% owned		\$ 732,578	\$ 842,570
Companies 5% to 25% Owned			
Aspen Pet Products, Inc.	Loans	\$ 17,407	\$ 17,407

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(Consumer Products)	Preferred Stock (2,158 shares)	2,024	1,141
	Common Stock (1,400 shares)	140	
	Warrants		

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		September 30, 2003	
Private Finance Portfolio Company (in thousands, except number of shares)	Investment ⁽¹⁾	(unaudited)	
		Cost	Value
Blue Rhino Corporation ⁽²⁾ (Consumer Products)	Common Stock (1,070,179 shares)	\$ 5,076	\$ 11,858
Border Foods, Inc. (Consumer Products)	Debt Securities	9,442	9,442
	Preferred Stock (50,919 shares)	2,000	2,000
	Common Stock (1,810 shares)	45	71
	Warrants	665	1,059
CBA-Mezzanine Capital Finance, LLC (Financial Services)	Loan	12,072	12,072
CorrFlex Graphics, LLC (Business Services)	Debt Securities	12,506	12,506
	Warrants		18,411
	Options		1,589
The Debt Exchange Inc. (Business Services)	Preferred Stock (921,875 shares)	1,250	1,250
EDM Consulting, LLC (Business Services)	Debt Securities	1,802	207
	Equity Interests	250	
International Fiber Corporation (Industrial Products)	Debt Securities	22,771	22,771
	Common Stock (1,029,069 shares)	5,483	6,816
	Warrants	550	684
Liberty-Pittsburgh Systems, Inc. (Business Services)	Debt Securities	3,384	3,384
	Common Stock (123,929 shares)	142	
Logic Bay Corporation (Business Services)	Common Stock (1,437,420 shares)	5,000	
Master Plan, Inc. (Business Services)	Loan	959	959
	Common Stock (156 shares)	42	
MortgageRamp, Inc. (Business Services)	Common Stock (772,000 shares)	3,860	2,084
Nobel Learning Communities, Inc. ⁽²⁾ (Education)	Debt Securities	9,838	9,838
	Preferred Stock (1,214,356 shares)	2,764	2,764
	Warrants	575	166
Packaging Advantage Corporation (Business Services)	Debt Securities	14,320	14,320
	Common Stock (232,168 shares)	2,386	2,386
	Warrants	963	963
Professional Paint, Inc. (Consumer Products)	Loan	4,975	4,975
	Debt Securities	24,258	24,258
	Preferred Stock (15,000 shares)	22,156	22,156
	Common Stock (110,000 shares)	69	5,995

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Progressive International Corporation (Consumer Products)	Debt Securities	3,975	3,975
	Preferred Stock (500 shares)	500	696
	Common Stock (197 shares)	13	550
	Warrants		

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		September 30, 2003	
Private Finance Portfolio Company (in thousands, except number of shares)	Investment ⁽¹⁾	(unaudited)	
		Cost	Value
Sidarus Holdings, Inc. (Business Services)	Debt Securities Preferred Stock (98,000 shares) Common Stock (492,941 shares) Warrants	\$ 4,977 1,014 20	\$ 4,977 1,014 20
Total Foam, Inc. (Industrial Products)	Debt Securities Common Stock (164 shares)	252 10	122
Total companies 5% to 25% owned		\$ 199,935	\$ 224,886
Companies Less Than 5% Owned			
ACE Products, Inc. (Industrial Products)	Loan	\$ 17,164	\$ 50
Advantage Mayer, Inc. (Business Services)	Loan Debt Securities Warrants	6,668 10,637 382	6,668 10,637 1,556
Alderwoods Group, Inc. ⁽²⁾ (Consumer Services)	Common Stock (357,568 shares)	5,006	2,789
American Barbecue & Grill, Inc. (Retail)	Warrants	125	
Aviation Technologies, Inc. (Industrial Products)	Loan	20,009	20,009
Bakery Chef, Inc. (Consumer Products)	Loans	19,161	19,161
Benchmark Medical, Inc. (Healthcare Services)	Debt Securities Warrants	13,464 18	13,464 117
Camden Partners Strategic Fund II, L.P. ⁽⁴⁾ (Private Equity Fund)	Limited Partnership Interest	3,166	3,052
Candlewood Hotel Company ⁽²⁾ (Hospitality)	Preferred Stock (3,250 shares)	3,189	546
Clif Bar, Inc. (Consumer Products)	Loan	24,912	24,912
Colibri Holding Corporation (Consumer Products)	Debt Securities Preferred Stock (237 shares) Common Stock (3,362 shares) Warrants	3,498 300 1,250 290	3,498 388 679 158

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Component Hardware Group, Inc. (Industrial Products)	Debt Securities	11,675	11,675
	Preferred Stock (18,000 shares)	2,359	2,359
	Common Stock (2,000 shares)	200	750

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		September 30, 2003	
Private Finance Portfolio Company (in thousands, except number of shares)	Investment ⁽¹⁾	(unaudited)	
		Cost	Value
Cooper Natural Resources, Inc. (Industrial Products)	Loan Debt Securities Preferred Stock (6,316 shares) Warrants	\$ 299 1,993 1,427 832	\$ 299 1,993 1,427 405
Coverall North America, Inc. (Business Services)	Loan Debt Securities	13,804 7,148	13,804 7,148
CTT Holdings (Consumer Products)	Loan	1,250	1,250
Drilltec Patents & Technologies Company, Inc. (Industrial Products)	Loan Debt Securities	10,918 1,500	
eCentury Capital Partners, L.P. ⁽⁴⁾ (Private Equity Fund)	Limited Partnership Interest	3,125	
Elaxis Beta GmbH ⁽³⁾ (Industrial Products)	Options	426	289
Eparfin S.A. ⁽³⁾ (Consumer Products)	Loan	29	29
E-Talk Corporation (Business Services)	Debt Securities Warrants	8,852 1,157	
Executive Greetings, Inc. (Business Services)	Debt Securities Warrants	18,830 360	50
Fairchild Industrial Products Company (Industrial Products)	Debt Securities Warrants	5,954 280	3,534
Frozen Specialties, Inc. (Consumer Products)	Debt Securities Warrants	10,144 435	10,144 435
Galaxy American Communications, LLC (Broadcasting & Cable)	Loan Debt Securities Options Standby Letter of Credit (\$37)	501 49,703	501 12,211
Garden Ridge Corporation (Retail)	Debt Securities Preferred Stock (1,130 shares) Common Stock (847,800 shares)	27,271 1,130 613	25,000
Gibson Guitar Corporation (Consumer Products)	Debt Securities Warrants	18,559 525	18,559 2,000

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Ginsey Industries, Inc. (Consumer Products)	Loans	5,000	5,000
	Convertible Debentures	500	635
	Warrants		1,440
<hr/>			
Grant Broadcasting Systems II (Broadcasting & Cable)	Warrants	87	3,000
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		September 30, 2003	
Private Finance Portfolio Company (in thousands, except number of shares)	Investment ⁽¹⁾	(unaudited)	
		Cost	Value
Grotech Partners, VI, L.P. ⁽⁴⁾ (Private Equity Fund)	Limited Partnership Interest	\$ 3,599	\$ 2,621
The Hartz Mountain Corporation (Consumer Products)	Debt Securities Common Stock (200,000 shares) Warrants	27,927 2,000 2,613	27,927 899 1,174
Haven Eldercare of New England, LLC (Healthcare Services)	Loans	41,646	42,689
Headwaters Incorporated ⁽²⁾ (Industrial Products)	Loan	9,961	9,961
Healthmarket, Inc. (Health Insurance)	Debt Securities Warrants	9,704 440	9,704 440
Hotelevision, Inc. (Broadcasting & Cable)	Common Stock (315 shares)	315	
Icon International, Inc. (Business Services)	Common Stock (9,394 shares)	1,219	947
Impact Innovations Group, LLC (Business Services)	Debt Securities Warrants	7,278 1,674	50
Insight Pharmaceuticals Corporation (Consumer Products)	Loan	10,007	10,007
Intellirisk Management Corporation (Business Services)	Loan	24,005	24,005
Interline Brands, Inc. (Business Services)	Preferred Stock (199,313 shares) Common Stock (15,615 shares) Warrants	1,849 139 1,181	1,849
JRI Industries, Inc. (Industrial Products)	Debt Securities Warrants	1,545 74	1,545 39
Julius Koch USA, Inc. (Industrial Products)	Warrants	259	3,000
Kirker Enterprises, Inc. (Industrial Products)	Equity Interest Warrants	4 348	4 3,501
Love Funding Corporation (Financial Services)	Preferred Stock (26,000 shares)	359	359
Matrics, Inc.	Preferred Stock (511,876 shares)	500	930

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(Industrial Products)	Warrants		
MedAssets, Inc.	Debt Securities	16,685	16,685
(Business Services)	Preferred Stock (229,806 shares)	2,049	2,049
	Warrants	136	

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

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

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		September 30, 2003	
Private Finance Portfolio Company (in thousands, except number of shares)	Investment ⁽¹⁾	(unaudited)	
		Cost	Value
Mid-Atlantic Venture Fund IV, L.P. ⁽⁴⁾ (Private Equity Fund)	Limited Partnership Interest	\$ 4,725	\$ 2,500
Midview Associates, L.P. (Housing)	Warrants		
Mogas Energy, LLC (Energy Services)	Debt Securities Warrants	16,711 1,774	16,711 1,774
Norstan Apparel Shops, Inc. (Retail)	Debt Securities Common Stock (29,622 shares) Warrants	11,872 4,750 655	11,872 2,373 327
Northeast Broadcasting Group, L.P. (Broadcasting & Cable)	Debt Securities	222	222
Novak Biddle Venture Partners III, L.P. ⁽⁴⁾ (Private Equity Fund)	Limited Partnership Interest	1,020	771
Nursefinders, Inc. (Healthcare Services)	Debt Securities Warrants	11,293 900	11,293 780
Oahu Waste Services, Inc. (Business Services)	Debt Securities Stock Appreciation Rights	8,315 239	8,315 295
Onyx Television GmbH ⁽³⁾ (Broadcasting & Cable)	Preferred Units	201	
Opinion Research Corporation ⁽²⁾ (Business Services)	Debt Securities Warrants	14,401 996	14,401 800
Oriental Trading Company, Inc. (Consumer Products)	Equity Interests	1,500	4,000
Polaris Pool Systems, Inc. (Consumer Products)	Debt Securities Warrants	10,948 1,145	10,948 1,145
Prosperco Finanz Holding AG ⁽³⁾ (Financial Services)	Convertible Debentures Common Stock (1,528 shares) Warrants	7,802 1,059	5,000
Resun Leasing, Inc. (Business Services)	Loan	30,000	30,000
Simula, Inc. ⁽²⁾ (Industrial Products)	Loan	19,769	19,769
SmartMail, LLC	Loan	3,744	3,744

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(Business Services)	Debt Securities	4,471	4,471
	Equity Interests	1,070	1,070
	Warrants	3	3

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		September 30, 2003	
Private Finance Portfolio Company (in thousands, except number of shares)	Investment ⁽¹⁾	(unaudited)	
		Cost	Value
Soff-Cut Holdings, Inc. (Industrial Products)	Debt Securities	\$ 9,809	\$ 9,809
	Preferred Stock (300 shares)	300	300
	Common Stock (2,000 shares)	200	
Spa Lending Corporation (Recreation)	Preferred Stock (28,672 shares)	437	321
Startec Global Communications Corporation ⁽²⁾ (Telecommunications)	Loan	25,715	25,715
	Debt Securities	20,670	
SunStates Refrigerated Services, Inc. (Warehouse Facilities)	Loans	4,517	1,500
	Debt Securities	2,445	
Sydran Food Services II, L.P. (Retail)	Debt Securities	12,973	50
	Equity Interests	3,747	
	Warrants	162	
Tubbs Snowshoe Company, LLC (Consumer Products)	Debt Securities	4,164	4,164
	Equity Interests	500	500
	Warrants	54	54
United Pet Group, Inc. (Consumer Products)	Debt Securities	9,157	9,157
	Warrants	85	439
United Site Services, Inc. (Business Services)	Loan	15,029	15,029
Updata Venture Partners II, L.P. ⁽⁴⁾ (Private Equity Fund)	Limited Partnership Interest	1,705	1,984
U.S. Security Holdings, Inc. (Business Services)	Debt Securities	24,195	24,195
	Warrants	826	2,000
Venturehouse-Cibernet Investors, LLC (Business Services)	Equity Interest	34	34
Venturehouse Group, LLC ⁽⁴⁾ (Private Equity Fund)	Equity Interest	1,000	242
Vertex Aerospace, LLC (Business Services)	Debt Securities	5,330	5,330
	Equity Interest		400
VICORP Restaurants, Inc. (Retail)	Debt Securities	23,890	23,890
	Warrants	33	33
Walker Investment Fund II, LLLP ⁽⁴⁾ (Private Equity Fund)	Limited Partnership Interest	1,246	416

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Warn Industries, Inc. (Consumer Products)	Debt Securities Warrants	4,472 1,429	4,472 8,284
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		September 30, 2003	
Private Finance Portfolio Company (in thousands, except number of shares)	Investment ⁽¹⁾	(unaudited)	
		Cost	Value
Weston Solutions, Inc. (Business Services)	Loan	\$ 12,192	\$ 12,192
Wilshire Restaurant Group, Inc. (Retail)	Debt Securities Warrants	16,953 735	16,953 541
Wilton Industries, Inc. (Consumer Products)	Loan	9,600	9,600
Woodstream Corporation (Consumer Products)	Loan Debt Securities Common Stock (180 shares) Warrants	249 16,422 1,800 587	249 16,422 1,800 587
Total companies less than 5% owned		\$ 895,888	\$ 741,252
Total private finance (120 portfolio companies)		\$ 1,828,401	\$ 1,808,708

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(in Thousands)	Stated Interest	Face	September 30, 2003	
			Cost	Value
Commercial Real Estate Finance				
Commercial Mortgage-Backed Securities				
Mortgage Capital Funding, Series 1998-MC3	5.5%	\$ 47,103	\$ 26,221	\$ 24,413
Morgan Stanley Capital I, Series 1999-RM1	6.4%	29,629	9,658	9,658
COMM 1999-1	5.7%	62,163	31,252	33,884
Morgan Stanley Capital I, Series 1999-FNV1	6.1%	28,595	14,140	11,114
DLJ Commercial Mortgage Trust 1999-CG2	6.1%	44,635	13,787	13,787
Commercial Mortgage Acceptance Corp., Series 1999-C1	6.8%	18,346	5,054	6,917
LB Commercial Mortgage Trust, Series 1999-C2	6.7%	11,603	1,757	1,770
Chase Commercial Mortgage Securities Corp., Series 1999-2	6.5%	20,545	5,396	6,325
FUNB CMT, Series 1999-C4	6.5%	22,887	7,800	6,399
Heller Financial, HFCMC Series 2000 PH-1	6.6%	25,767	8,753	8,753
SBMS VII, Inc., Series 2000-NL1	7.2%	9,214	4,535	3,878
DLJ Commercial Mortgage Trust, Series 2000-CF1	7.0%	24,328	9,484	10,366
Deutsche Bank Alex. Brown, Series Comm 2000-C1	6.9%	17,922	4,937	3,166
LB-UBS Commercial Mortgage Trust, Series 2000-C4	6.9%	17,484	3,878	5,024
Credit Suisse First Boston Mortgage Securities Corp., Series 2001-CK1	5.9%	21,805	8,491	8,569
JP Morgan-CIBC-Deutsche 2001	5.8%	25,370	6,822	6,822
Lehman Brothers-UBS Warburg 2001-C2	6.4%	22,756	6,567	6,567
SBMS VII, Inc., Series 2001-C1	6.1%	23,049	5,618	5,618
GE Capital Commercial Mortgage Securities Corp., Series 2001-2	6.1%	21,228	6,384	6,384
Credit Suisse First Boston Mortgage Securities Corp., Series 2001-CKN5	5.2%	21,456	5,207	5,207
JP Morgan Chase Commercial Mortgage Securities Corp., Series 2001-C1	5.6%	24,493	5,816	5,816
SBMS VII, Inc., Series 2001-C2	6.2%	21,619	5,850	5,850
FUNB CMT, Series 2002-C1	6.0%	28,303	11,711	12,162
GE Capital Commercial Mortgage Corp., Series 2002-1	6.2%	50,631	25,062	28,746
GMAC Commercial Mortgage Securities, Inc., Series 2002-C2	5.8%	40,573	20,204	22,271
GE Capital Commercial Mortgage Corp., Series 2002-3	5.1%	50,047	22,655	23,446
Morgan Stanley Dean Witter Capital I Trust 2002-IQ3	6.0%	27,858	13,171	13,837
LB-UBS Commercial Mortgage Trust 2003-C1	4.6%	50,896	22,200	22,435
GS Mortgage Securities Corporation II Series 2003-C1	4.7%	39,543	19,249	19,501
J.P. Morgan Chase Commercial Mortgage Securities Corp., Series 2003-ML1	4.9%	15,946	12,357	12,694
Credit Suisse First Boston Mortgage Securities Corp., Series 2003-CK2	4.9%	69,680	37,884	38,811
GE Commercial Mortgage Corporation 2003-C1	5.1%	20,389	16,067	16,836
COMM 2003-LNB1	4.4%	36,803	14,742	14,660
Wachovia Bank Commercial Mortgage Trust, Series 2003-C5	4.3%	61,202	27,613	27,414
GE Commercial Mortgage Corporation, Series 2003-C2	5.1%	8,873	7,098	7,466
LB-UBS Commercial Mortgage Trust 2003-C5	4.9%	10,327	8,051	8,300
Credit Suisse First Boston Mortgage Securities Corp., Series 2003-CPN1	4.8%	11,850	9,261	9,815
GMAC Commercial Mortgage Securities, Inc., Series 2003-C2	5.5%	77,441	41,268	43,120
Credit Suisse First Boston Mortgage Securities Corp., Series 2003-C4	5.3%	7,369	5,508	5,791
Total commercial mortgage-backed securities (39 issuances)		\$ 1,169,728	\$ 511,508	\$ 523,592

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	September 30, 2003	
	(in Thousands)	(unaudited)
	Cost	Value
Collateralized Debt Obligations		
Crest 2001-1, Ltd. ⁽³⁾	\$ 22,852	\$ 22,852
Crest 2002-1, Ltd. ⁽³⁾	23,894	23,894
Crest 2002-IG, Ltd. ⁽³⁾	4,668	4,668
Crest Clarendon Street 2002-1, Ltd. ⁽³⁾	1,017	1,017
Crest 2003-1, Ltd. ⁽³⁾	112,538	112,349
Total collateralized debt obligations	\$ 164,969	\$ 164,780
	Interest Rate Ranges	Number of Loans
Commercial Mortgage Loans		
	Up to 6.99%	15
	7.00% 8.99%	13
	9.00% 10.99%	7
	11.00% 12.99%	9
	13.00% 14.99%	3
	15.00% and above	2
Total commercial mortgage loans		49
Real Estate Owned		
		17,419
		13,497
Equity Interests (Guarantees \$2,748)		5,322
		4,983
Total commercial real estate finance		\$ 789,370
		\$ 792,350
Total portfolio		\$2,617,771
		\$2,601,058

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ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Information at and for the nine months ended September 30, 2003 and 2002 is unaudited)

Note 1. Organization

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

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

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

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

Note 2. Summary of Significant Accounting Policies

Basis of Presentation

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

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

The private finance portfolio and the interest and related portfolio income and net realized gains (losses) earned on the private finance portfolio are presented in three categories: companies more

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 2. Summary of Significant Accounting Policies, continued

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

Valuation Of Portfolio Investments

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

Loans and Debt Securities

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

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

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 2. Summary of Significant Accounting Policies, continued

Interest income is recorded on an accrual basis to the extent that such amounts are expected to be collected. For loans and debt securities with contractual payment-in-kind interest, which represents contractual interest accrued and added to the loan balance that generally becomes due at maturity, the Company will not accrue payment-in-kind interest if the portfolio company valuation indicates that the payment-in-kind interest is not collectible. Interest on loans and debt securities is not accrued if the Company has doubt about interest collection. Loans in workout status classified as Grade 4 or 5 assets do not accrue interest. In addition, interest may not accrue on loans or debt securities to portfolio companies that are more than 50% owned by the Company 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.

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

Equity Securities

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

The value of the Company's equity interests in public companies for which market quotations are readily available is based 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. The Company recognizes unrealized appreciation or depreciation on its CMBS bonds and CDO bonds and preferred shares as comparable yields in the market change and/or based on changes in estimated cash flows resulting from changes in prepayment or loss assumptions in the underlying collateral pool.

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 2. Summary of Significant Accounting Policies, continued

The Company recognizes income from the amortization of original issue discount using the effective interest method, using the anticipated yield over the projected life of the investment. Yields are revised when there are changes in 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.

Fee Income

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

Guarantees

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

Financing Costs

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

Cash and Cash Equivalents

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

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 2. Summary of Significant Accounting Policies, continued

Dividends to Shareholders

Dividends to shareholders are recorded on the record date.

Stock Compensation Plans

At September 30, 2003 and 2002, the Company had a stock-based employee compensation plan. The Company accounts for this plan under the recognition and measurement principles of APB Opinion No. 25, *Accounting for Stock Issued to Employees*, and related interpretations. No stock-based employee compensation cost is reflected in net increase in net assets resulting from operations, as all options granted under this plan had an exercise price equal to the market value of the underlying common stock on the date of grant. The following table illustrates the effect on net increase in net assets resulting from operations and earnings per share if the Company had applied the fair value recognition provisions of FASB Statement No. 123, *Accounting for Stock-Based Compensation*, to stock-based employee compensation.

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2003	2002	2003	2002
(in thousands, except per share amounts)				
Net increase in net assets resulting from operations as reported	\$ 33,744	\$ 45,520	\$ 113,557	\$ 174,935
Less total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	(2,043)	(1,779)	(10,121)	(5,410)
Pro forma net increase in net assets resulting from operations	31,701	43,741	103,436	169,525
Less preferred stock dividends	(45)	(55)	(155)	(165)
Pro forma net income available to common shareholders	\$ 31,656	\$ 43,686	\$ 103,281	\$ 169,360
Basic earnings per common share:				
As reported	\$ 0.28	\$ 0.44	\$ 0.99	\$ 1.73
Pro forma	\$ 0.27	\$ 0.43	\$ 0.91	\$ 1.67
Diluted earnings per common share:				
As reported	\$ 0.28	\$ 0.44	\$ 0.98	\$ 1.70
Pro forma	\$ 0.26	\$ 0.42	\$ 0.90	\$ 1.64

Pro forma expenses are based on the underlying value of the options granted by the Company. The fair value of each option grant is estimated on the date of grant using the Black-Scholes option

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 2. Summary of Significant Accounting Policies, continued

pricing model, with the following weighted average assumptions for options granted during the three and nine months ended September 30, 2003 and 2002:

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2003	2002 ⁽¹⁾	2003	2002
Risk-free interest rate	3.2%		2.7%	4.5%
Expected life	5.0		5.0	5.0
Expected volatility	38.1%		38.8%	39.7%
Dividend yield	8.9%		8.9%	8.5%
Weighted average fair value per option	\$3.67		\$3.35	\$4.82

(1) There were no stock options granted during the three months ended September 30, 2002.

Federal and State Income Taxes

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

Per Share Information

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

Use of Estimates in the Preparation of Financial Statements

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

The consolidated financial statements include portfolio investments at value of \$2.6 billion and \$2.5 billion at September 30, 2003, and December 31, 2002, respectively. At September 30, 2003, and December 31, 2002, 86% and 88%, respectively, of our total assets represented investments whose fair values have been determined by the board of directors in good faith in the absence of readily available market values. Because of the inherent uncertainty of valuation, the board of directors determined values may differ significantly from the values that would have been used had a ready market existed for the investments, and the differences could be material.

New Accounting Pronouncements

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In May 2003, the FASB issued Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity*, which provides guidance on how an

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 2. Summary of Significant Accounting Policies, continued

entity classifies and measures such instruments. This statement is effective for financial instruments entered into or modified after May 31, 2003, and otherwise is effective at the beginning of the first interim period beginning after June 15, 2003. The statement requires cumulative effect transition for financial instruments existing at adoption date. The Company has adopted this statement as discussed in Note 6 and this adoption did not have a significant effect on the Company's financial position or its results of operations.

In January 2003, the FASB issued Interpretation No. 46 (FIN No. 46), *Consolidation of Variable Interest Entities*, which provides new guidance on the consolidation of certain entities defined as variable interest entities. FIN No. 46 specifies that any enterprise subject to SEC Regulation S-X Rule 6-03(c)(1) shall not consolidate any entity that is not also subject to the same rule. The Company is subject to Rule 6-03(c)(1), therefore FIN No. 46 does not apply to its portfolio investments.

Note 3. Portfolio*Private Finance*

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

	2003			2002		
	Cost	Value	Yield	Cost	Value	Yield
(\$ in thousands)						
Loans and debt securities	\$ 1,339,131	\$ 1,158,745	15.3% ⁽¹⁾	\$ 1,272,401	\$ 1,151,256	14.4% ⁽¹⁾
Equity interests	489,270	649,963		438,501	591,959	
Total	\$ 1,828,401	\$ 1,808,708		\$ 1,710,902	\$ 1,743,215	

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

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

Loans and debt securities generally have a maturity of five to ten years, with interest-only payments in the early years and payments of both principal and interest in the later years, although debt maturities and principal amortization schedules vary. At September 30, 2003, and December 31, 2002, approximately 97% and 95%, respectively, of the Company's loans and debt securities had fixed interest rates.

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

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 3. Portfolio, continued

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

At September 30, 2003, and December 31, 2002, the Company had an investment at value totaling \$344.9 million and \$256.8 million, respectively, in Business Loan Express, LLC (BLX), a small business lender that participates in the U.S. Small Business Administration's 7(a) Guaranteed Loan Program. During the first quarter of 2003, the Company invested \$50 million in BLX in the form of a \$25 million short-term line of credit and \$25 million of preferred equity in connection with BLX's acquisition of \$128 million in assets from Amresco Independence Funding, Inc. BLX also completed its corporate reorganization to a limited liability company during the first quarter of 2003 by merging BLX, Inc. into BLX, LLC. Prior to this transaction, BLX converted \$43 million of the Company's subordinated debt to preferred stock in BLX, Inc., which was exchanged upon the merger for Class A equity interests of BLX, LLC. In addition, as part of the merger, the Company exchanged its existing preferred stock and common equity investments in BLX, Inc. for similar classes of members' equity in BLX, LLC represented by Class B and Class C equity interests, respectively. At September 30, 2003, the Company owned 94.9% of the voting Class C equity interests. BLX has an equity appreciation rights plan for management which will dilute the value available to the Class C equity interest holders.

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

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

As the controlling equity owner of BLX, the Company has provided an unconditional guaranty to the BLX credit facility lenders in an amount up to 50% of the total obligations (consisting of principal, accrued interest, and other fees) on BLX's three-year unsecured \$169.0 million revolving credit facility that matures in March 2004. The amount guaranteed by the Company at September 30, 2003, was \$64.9 million. This guaranty can be called by the lenders only in the event of a default by BLX. BLX was in compliance with the terms of its credit facility at September 30,

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 3. Portfolio, continued

2003. At September 30, 2003, the Company had also provided three standby letters of credit in connection with three term securitization transactions completed by BLX totaling \$25.6 million. In consideration for providing the guaranty and the three standby letters of credit, BLX paid the Company fees of \$2.9 million and \$2.3 million for the nine months ended September 30, 2003 and 2002, respectively. BLX is headquartered in New York, NY.

At September 30, 2003, and December 31, 2002, the Company had an investment in The Hillman Companies, Inc. (Hillman) totaling \$186.0 million and \$180.5 million at value, respectively. At September 30, 2003, the Company owned 96.8% of Hillman's common stock. The Company's common stock ownership is subject to dilution by management options. Hillman is a leading manufacturer of key making equipment and distributor of key blanks, fasteners, signage, and other small hardware components and operates in multiple channels of the retail marketplace such as hardware stores, national and regional home centers, and mass merchants. Hillman has certain patent-protected products including key duplication technology that is important to its business. Hillman's primary operations are located in Cincinnati, Ohio.

Total interest and related portfolio income earned from the Company's investments in BLX and Hillman for the nine months ended September 30, 2003 and 2002, was \$40.0 million and \$36.9 million, respectively.

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

(in thousands)	2003	2002
Companies more than 25% owned	\$21,093	\$ 9,709
Companies 5% to 25% owned	330	411
Companies less than 5% owned	22,946	65,931
Total	\$44,369	\$76,051

In addition to Grade 4 and 5 assets that are in workout, the Company may not accrue interest on loans and debt securities to companies that are more than 50% owned by the Company depending on such company's working capital needs and, therefore, the Company may defer current debt service. Loans and debt securities to such companies totaled \$49.3 million and \$63.6 million at value at September 30, 2003, and December 31, 2002, respectively. In addition, loans to companies that are less than 50% owned by the Company and were not in workout but were not accruing interest totaled \$3.4 million and \$7.2 million at value at September 30, 2003, and December 31, 2002, respectively.

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 3. Portfolio, continued

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

	<u>2003</u>	<u>2002</u>
Industry		
Consumer products	30%	34%
Business services	22	25
Financial services	20	16
Industrial products	8	9
Healthcare services	8	6
Retail	5	4
Telecommunications	2	2
Education	1	1
Broadcasting & cable	1	1
Other	3	2
	<u> </u>	<u> </u>
Total	100%	100%
	<u> </u>	<u> </u>
Geographic Region		
Mid-Atlantic	38%	33%
Midwest	25	30
West	17	15
Southeast	15	17
Northeast	4	4
International	1	1
	<u> </u>	<u> </u>
Total	100%	100%
	<u> </u>	<u> </u>

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 3. Portfolio, continued

Commercial Real Estate Finance

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

	2003			2002		
	Cost	Value	Yield ⁽¹⁾	Cost	Value	Yield ⁽¹⁾
(\$ in thousands)						
CMBS bonds	\$511,508	\$523,592	12.9%	\$523,671	\$555,519	14.2%
Collateralized debt obligation bonds and preferred shares	164,969	164,780	16.9%	52,818	52,818	17.2%
Loans	90,152	85,498	8.7%	66,546	63,707	7.5%
Residual interest				69,335	69,035	9.4%
Real estate owned	17,419	13,497		5,942	3,873	
Equity interests	5,322	4,983				
Total	\$789,370	\$792,350		\$718,312	\$744,952	

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

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

	2003	2002
(\$ in thousands)		
Face	\$1,169,728	\$1,173,194
Original issue discount	(658,220)	(649,523)
Cost	\$ 511,508	\$ 523,671
Value	\$ 523,592	\$ 555,519

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 3. Portfolio, continued

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

(\$ in thousands)	2003			2002		
	Cost	Value	Percentage of Total Value	Cost	Value	Percentage of Total Value
BB+	\$ 106,952	\$ 113,327	21.7%	\$ 45,609	\$ 49,811	9.0%
BB	72,943	77,217	14.7	34,603	39,011	7.0
BB-	36,693	39,420	7.5	19,629	22,030	4.0
B+	43,758	43,542	8.3	109,235	121,038	21.8
B	34,755	34,786	6.7	131,309	141,998	25.6
B-	82,498	82,736	15.8	83,493	83,493	15.0
CCC+	15,736	15,510	3.0			
CCC	13,377	11,255	2.1	8,634	8,634	1.5
CCC-	3,129	2,866	0.5			
Unrated	101,667	102,933	19.7	91,159	89,504	16.1
Total	\$ 511,508	\$ 523,592	100.0%	\$ 523,671	\$ 555,519	100.0%

The non-investment grade and unrated tranches of the CMBS bonds in which the Company invests are junior in priority for payment of interest and principal to the more senior tranches of the related CMBS bond issuance. Cash flow from the underlying mortgages generally is allocated first to the senior tranches, with the most senior tranches having a priority right to the cash flow. Then, any remaining cash flow is allocated, generally, among the other tranches in order of their relative seniority. To the extent there are defaults and unrecoverable losses on the underlying mortgages or the properties securing those mortgages resulting in reduced cash flows, the most subordinate tranche will bear this loss first. At September 30, 2003, the Company's CMBS bonds were subordinate to 87% to 99% of the tranches of bonds issued in these various CMBS transactions. Given that the non-investment grade CMBS bonds in which the Company invests are junior in priority for payment of interest and principal, the Company invests in these CMBS bonds at a significant discount from the face amount of the bonds.

At September 30, 2003, and December 31, 2002, the Company held CMBS bonds in 39 and 27 separate CMBS issuances, respectively. The underlying collateral pool, consisting of commercial mortgage loans and real estate owned (REO) properties, for these CMBS issuances consisted of the following at September 30, 2003, and December 31, 2002:

(\$ in millions)	2003	2002
Approximate number of loans and REO properties ⁽¹⁾	5,900	4,500
Total outstanding principal balance	\$ 39,475	\$ 24,974
Loans over 30 days delinquent or classified as REO properties ⁽²⁾	0.9% ⁽³⁾	1.0% ⁽³⁾

(1) Includes approximately 17 and 12 REO properties obtained through the foreclosure of commercial mortgage loans at September 30, 2003, and December 31, 2002, respectively.

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

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- (3) At September 30, 2003, and December 31, 2002, the Company's investments included bonds in the first loss, unrated bond class in 33 and 27 separate CMBS issuances, respectively. For these issuances, loans over 30 days delinquent or classified as REO properties were 1.1% and 1.0% of the total outstanding principal balance at September 30, 2003, and December 31, 2002, respectively.

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ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 3. Portfolio, continued

The property types and the geographic composition of the underlying mortgage loans and REO properties in the underlying collateral pools for all CMBS issuances calculated using the outstanding principal balance at September 30, 2003, and December 31, 2002, were as follows:

	<u>2003</u>	<u>2002</u>
Property Type		
Retail	35%	32%
Housing	25	27
Office	24	21
Industrial Real Estate	5	7
Hospitality	4	6
Other	7	7
	<u> </u>	<u> </u>
Total	100%	100%
	<u> </u>	<u> </u>
Geographic Region		
West	30%	31%
Mid-Atlantic	26	25
Midwest	23	22
Southeast	16	17
Northeast	5	5
	<u> </u>	<u> </u>
Total	100%	100%
	<u> </u>	<u> </u>

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

At September 30, 2003, and December 31, 2002, the unamortized discount related to the CMBS bond portfolio was \$658.2 million and \$649.5 million, respectively. At September 30, 2003, the Company has set aside \$282.9 million of this unamortized discount to absorb potential future losses, and therefore, the yield on the CMBS bonds of 12.9% assumes that this amount will not be amortized. At September 30, 2003, and December 31, 2002, CMBS bonds with a value of \$14.0 million and \$28 thousand, respectively, were not accruing interest.

Collateralized Debt Obligation Bonds and Preferred Shares (CDOs). At September 30, 2003, the Company owned BBB rated bonds in one CDO totaling \$21.5 million at value and preferred shares in five CDOs totaling \$143.3 million at value. The BBB rated bonds and preferred shares of the five CDOs in which the Company has invested are junior in priority for payment of interest and principal to the more senior tranches of debt issued by the CDOs. The CDO investments are secured by investment grade unsecured debt issued by various real estate investment trusts (REITs) and investment and non-investment grade CMBS bonds. Cash flow from the underlying REIT debt and CMBS bonds generally is allocated first to the senior bond tranches in order of priority, with the most

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 3. Portfolio, continued

senior tranches having a priority right to the cash flow. Then, any remaining cash flow is generally distributed to the preferred shareholders. 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 BBB rated bonds would bear any loss after the preferred shares. At September 30, 2003, the Company's BBB bonds in the CDO were subordinate to 61% of the more senior tranches of debt issued in the CDO transaction and the preferred shares in the CDOs were subordinate to 90% to 98% of the more senior tranches of debt issued in the various CDO transactions.

The investment grade REIT collateral in the CDOs consists of debt with an original underwritten balance of \$1.2 billion and was issued by 39 REITs. The investment grade CMBS collateral consists of CMBS bonds with a face amount of \$496.0 million issued in 41 separate CMBS transactions and the non-investment grade CMBS collateral consists of BB+, BB, BB-, B+, and B rated CMBS bonds with a face amount of \$873.7 million issued in 42 separate CMBS transactions (CMBS Collateral). Included in the CMBS Collateral for the CDOs are CMBS bonds with a face amount of \$793.7 million that are senior in priority of repayment to certain lower rated CMBS bonds held by the Company, which were issued in 27 separate CMBS transactions.

The initial yields on the CDO bonds and preferred shares are based on the estimated future cash flows from the assets in the underlying collateral pool to be paid to these CDO classes. As each CDO bond and preferred share ages, the estimated future cash flows will be updated based on the performance of the collateral, and the respective yield will be adjusted as necessary. As future cash flows are subject to uncertainties and contingencies that are difficult to predict and are subject to future events which may alter current assumptions, no assurance can be given that the anticipated yields to maturity will be achieved.

As of September 30, 2003, the Company acted as the disposition consultant with respect to four of the CDOs, which allows the Company to approve disposition plans for individual collateral securities. As of September 30, 2002, the Company acted as the disposition consultant with respect to three of the CDOs. For these services, the Company collects annual fees based on the outstanding collateral pool balance, and for the nine months ended September 30, 2003 and 2002, these fees totaled \$864 thousand and \$322 thousand, respectively.

Loans and Equity Interests. The commercial mortgage loan portfolio contains loans that were originated by the Company or were purchased from third-party sellers. At September 30, 2003, approximately 92% and 8% of the Company's commercial mortgage loan portfolio was composed of fixed and adjustable interest rate loans, respectively. As of December 31, 2002, approximately 84% and 16% of the Company's commercial mortgage loan portfolio was composed of fixed and adjustable interest rate loans, respectively. As of September 30, 2003, and December 31, 2002, loans with a value of \$7.2 million and \$13.0 million, respectively, were not accruing interest. Loans greater than 120 days delinquent generally do not accrue interest.

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

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 3. Portfolio, continued

The property types and the geographic composition securing the commercial mortgage loans and equity interests at value at September 30, 2003, and December 31, 2002, were as follows:

	<u>2003</u>	<u>2002</u>
Property Type		
Hospitality	40%	23%
Office	21	20
Retail	20	21
Healthcare	10	15
Housing	4	8
Other	5	13
	<u> </u>	<u> </u>
Total	100%	100%
	<u> </u>	<u> </u>
Geographic Region		
Southeast	37%	40%
Midwest	26	12
West	23	20
Mid-Atlantic	8	17
Northeast	6	11
	<u> </u>	<u> </u>
Total	100%	100%
	<u> </u>	<u> </u>

Residual Interest. At December 31, 2002, the Company had \$68.8 million at cost and value of residual interest and \$0.5 million at cost and \$0.2 million at value of residual interest spread.

The residual interest primarily consisted of a retained interest from a 1998 asset securitization. At March 31, 2003, one class of bonds rated AAA was outstanding, totaling \$6.0 million. During April 2003, the call provision was exercised and, accordingly, the bondholders were repaid in full and the remaining available cash, loans, and real estate owned of the trust were subsequently returned to the Company as payment on the residual interest. Therefore, the cost and value were zero at September 30, 2003.

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

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 4. Debt

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

	2003			2002		
	Facility Amount	Amount Drawn	Annual Interest Cost ⁽¹⁾	Facility Amount	Amount Drawn	Annual Interest Cost ⁽¹⁾
<i>(in thousands)</i>						
Notes payable and debentures:						
Unsecured long-term notes payable	\$ 854,000	\$ 854,000	7.2%	\$ 694,000	\$ 694,000	7.7%
SBA debentures	101,800	94,500	8.1%	101,800	94,500	8.2%
OPIC loan	5,700	5,700	6.6%	5,700	5,700	6.6%
Total notes payable and debentures	961,500	954,200	7.3%	801,500	794,200	7.8%
Revolving line of credit	462,500		(2)	527,500	204,250	3.7% ⁽²⁾
Total debt	\$ 1,424,000	\$ 954,200	7.5% ⁽³⁾	\$ 1,329,000	\$ 998,450	6.9% ⁽³⁾

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

(2) The stated interest rate payable on the revolving line of credit was 2.7% at December 31, 2002, which excluded the annual cost of commitment fees and other facility fees of \$2.0 million. There were no amounts drawn on the revolving line of credit at September 30, 2003. The annual cost of commitment fees and other facility fees on the revolving line of credit is currently \$2.4 million.

(3) 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 drawn on the facility as of the balance sheet date.

Notes Payable and Debentures

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

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

SBA Debentures. At September 30, 2003, and December 31, 2002, the Company had debentures payable to the SBA with original terms of ten years and at fixed interest rates ranging from 5.9% to 8.2%. At September 30, 2003, the debentures had remaining maturities of one to nine years. The debentures require semi-annual interest-only payments with all principal due upon maturity. The SBA debentures are subject to prepayment penalties if paid prior to the fifth anniversary date of the notes. At September 30, 2003, the Company had a commitment from the

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 4. Debt, continued

SBA to borrow up to an additional \$7.3 million above the current amount outstanding. The commitment expires on September 30, 2005.

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

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

Revolving Line of Credit

On April 18, 2003, the Company renewed its unsecured revolving line of credit. The committed amount under the renewed facility is \$462.5 million and may be expanded through new or additional commitments up to \$600 million at the Company's option. The renewed line of credit expires in April 2005 and may be extended under substantially similar terms for one additional year at the Company's option. The facility bears interest at a rate, at the Company's option, equal to (i) the one-month LIBOR plus 1.25%, (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 interest rate adjusts at the beginning of each new interest period, usually every 30 days. There were no amounts drawn on the revolving line of credit at September 30, 2003. The stated interest rate was 2.7% at December 31, 2002, and the facility requires an annual commitment fee equal to 0.25% of the committed amount. The annual cost of commitment fees and other facility fees is currently \$2.4 million. The line of credit generally requires monthly payments of interest, and all principal is due upon maturity.

The average debt outstanding on the revolving line of credit was \$55.4 million and \$68.3 million for the nine months ended September 30, 2003, and the year ended December 31, 2002, respectively. The maximum amount borrowed under this facility and the weighted average stated interest rate for the nine months ended September 30, 2003, and the year ended December 31, 2002, were \$208.8 million and \$216.5 million, and 2.6% and 3.2%, respectively. As of September 30, 2003, the amount available under the revolving line of credit was \$426.6 million, net of amounts committed for standby letters of credit of \$35.9 million issued under the credit facility.

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

Note 5. Guarantees

In the ordinary course of business, the Company has issued guarantees and has extended standby letters of credit through financial intermediaries on behalf of certain portfolio companies. As of September 30, 2003, and December 31, 2002, the Company had issued guarantees of debt, rental

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 5. Guarantees, continued

obligations, lease obligations and severance obligations aggregating \$70.3 million and \$54.6 million, respectively, and had extended standby letters of credit aggregating \$35.9 million and \$11.3 million, respectively. Under these arrangements, the Company would be required to make payments to third-party beneficiaries if the portfolio companies were to default on their related payment obligations. The maximum amount of future payments was \$106.2 million and \$65.9 million at September 30, 2003, and December 31, 2002, respectively. At September 30, 2003, and December 31, 2002, no amounts had been recorded as a liability for the Company's guarantees or standby letters of credit.

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

(in millions)	Total	2003	2004	2005	2006	2007	After 2007
Guarantees	\$ 70.3	\$0.2	\$65.6	\$0.5	\$ 0.2	\$0.2	\$3.6
Standby letters of credit	35.9	—	—	3.4	32.5	—	—
Total	\$106.2	\$0.2	\$65.6	\$3.9	\$32.7	\$0.2	\$3.6

Note 6. Preferred Stock

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

In accordance with SFAS No. 150, *Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity*, (SFAS No. 150) the Company has reclassified the 10,000 shares of \$100 par value, 4% redeemable cumulative preferred securities to other liabilities on the accompanying consolidated balance sheet. Accordingly, the Company has also recorded the associated dividends as interest expense on the accompanying consolidated statement of operations beginning with the quarter ended September 30, 2003. The effect of this change in accounting principle was not material to the financial results or the results of operations of the Company. Also, in accordance with SFAS No. 150, no previously reported amounts have been reclassified.

Note 7. Shareholders' Equity

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

(in thousands)	For the Nine Months Ended September 30,	
	2003	2002
Number of common shares	13,670	1,946
Gross proceeds	\$312,845	\$51,800
Less costs, including underwriting fees	(14,596)	(1,880)
Net proceeds	\$298,249	\$49,920

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 7. Shareholders Equity, continued

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

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

	For the Nine Months Ended September 30,	
	2003	2002
(in thousands, except per share amounts)		
Shares issued	219	203
Average price per share	\$22.62	\$23.12

Note 8. Earnings Per Common Share

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

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2003	2002	2003	2002
(in thousands, except per share amounts)				
Net increase in net assets resulting from operations	\$ 33,744	\$ 45,520	\$ 113,557	\$ 174,935
Less preferred stock dividends	(45)	(55)	(155)	(165)
Income available to common shareholders	\$ 33,699	\$ 45,465	\$ 113,402	\$ 174,770
Weighted average common shares outstanding basic	118,855	102,327	113,985	101,329
Dilutive options outstanding to officers	2,051	975	1,243	1,711
Weighted average common shares outstanding diluted	120,906	103,302	115,228	103,040
Basic earnings per common share	\$ 0.28	\$ 0.44	\$ 0.99	\$ 1.73
Diluted earnings per common share	\$ 0.28	\$ 0.44	\$ 0.98	\$ 1.70

Note 9. Dividends and Distributions

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The Company's Board of Directors declared and the Company paid dividends of \$0.57 per common share for each of the first, second, and third quarters of 2003. The dividends totaled \$68.7 million and \$196.2 million for the three and nine months ended September 30, 2003, respectively. The Company declared an extra cash dividend of \$0.03 per share during 2002 and this was paid to shareholders on January 9, 2003. The Company paid dividends to common shareholders of \$57.3 million and \$166.8 million for the three and nine months ended September 30, 2002, respectively.

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

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 10. Supplemental Disclosure of Cash Flow Information

For the nine months ended September 30, 2003 and 2002, the Company paid \$42.3 million and \$40.6 million, respectively, for interest. For the nine months ended September 30, 2003, the Company's non-cash financing activities totaled \$5.0 million related to the issuance of common stock in lieu of cash distributions. For the nine months ended September 30, 2002, the Company's non-cash financing activities totaled \$7.1 million related to stock option exercises and dividend reinvestment.

Non-cash operating activities for the nine months ended September 30, 2003, included transfers of commercial mortgage loans and real estate owned in the repayment of the Company's residual interest totaling \$69.3 million, real estate owned received in connection with foreclosure on commercial mortgage loans of \$9.1 million, receipt of commercial mortgage loans in satisfaction of private finance loans and debt securities of \$9.1 million and receipt of a note as consideration from the sale of real estate owned of \$2.1 million. Non-cash operating activities for the nine months ended September 30, 2002, included real estate owned received in connection with foreclosure on commercial mortgage loans of \$2.5 million.

Note 11. Hedging Activities

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

(in thousands)		
Description of Issue	2003	2002
10-year Treasury securities, due February 2012	\$	\$ 52,053
10-year Treasury securities, due November 2012	43,985	107,327
10-year Treasury securities, due February 2013	80,590	
10-year Treasury securities, due May 2013	36,161	
10-year Treasury securities, due August 2013	39,582	
5-year Treasury securities, due November 2007	9,908	37,647
5-year Treasury securities, due February 2008	6,900	
5-year Treasury securities, due May 2008	4,727	
	_____	_____
Total	\$ 221,853	\$ 197,027
	_____	_____

As of September 30, 2003, the total obligations to replenish borrowed Treasury securities had decreased since the original sale dates due to changes in the yield on the borrowed Treasury securities, resulting in unrealized appreciation on the obligations of \$78 thousand. As of December 31, 2002, the total obligations to replenish borrowed Treasury securities had increased since the related original sale dates due to changes in the yield on the borrowed Treasury securities, resulting in unrealized depreciation on the obligations of \$7.1 million. The net proceeds related to the sales of the borrowed Treasury securities were \$220.9 million and \$189.3 million at September 30, 2003, and December 31, 2002, respectively. Under the terms of the transactions, the Company has provided additional cash collateral of \$0.8 million and \$5.4 million at September 30, 2003, and December 31,

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 11. Hedging Activities, continued

2002, respectively, for the difference between the net proceeds related to the sales of the borrowed Treasury securities and the obligations to replenish the securities. The Company has deposited the proceeds related to the sales of the borrowed Treasury securities and the additional cash collateral with the financial institutions under repurchase agreements. The repurchase agreements are collateralized by U.S. Treasury securities and are settled weekly. As of September 30, 2003, the repurchase agreements were due on October 8, 2003, and had a weighted average interest rate of 0.4%. The weighted average interest rate on the repurchase agreements as of December 31, 2002, was 0.8%.

Note 12. Financial Highlights

	At and for the Nine Months Ended September 30,		At and for the Year Ended December 31,
	2003 ⁽¹⁾	2002 ⁽¹⁾	2002
Per Common Share Data⁽²⁾			
Net asset value, beginning of period	\$ 14.22	\$ 13.57	\$ 13.57
Net investment income	1.22	1.37	1.77
Net gains (losses) ⁽³⁾	(0.24)	0.33	0.43
Net increase in net assets resulting from operations	0.98	1.70	2.20
Net decrease in net assets from shareholder distributions	(1.71)	(1.64)	(2.23)
Net increase in net assets from capital share transactions	0.97	0.32	0.68
Net asset value, end of period	\$ 14.46	\$ 13.95	\$ 14.22
Market value, end of period	\$ 24.59	\$ 21.89	\$ 21.83
Total return ⁽⁴⁾	21%	(10)%	(7)%
Ratios and Supplemental Data			
Ending net assets	\$ 1,775,587	\$ 1,429,049	\$ 1,546,071
Common shares outstanding at end of period	122,766	102,468	108,698
Diluted weighted average common shares outstanding	115,228	103,040	103,574
Employee and administrative expenses/ average net assets	2.58%	2.67%	3.82%
Total expenses/average net assets	6.09%	6.42%	8.75%
Net investment income/average net assets	8.59%	10.11%	12.94%
Net increase in net assets resulting from operations ⁽³⁾ / average net assets	6.92%	12.50%	15.98%
Portfolio turnover rate	20.04%	13.97%	15.12%
Average debt outstanding	\$ 939,903	\$ 927,270	\$ 938,148
Average debt per share ⁽²⁾	\$ 8.16	\$ 9.00	\$ 9.06

- (1) The results for the nine months ended September 30, 2003 and 2002, are not necessarily indicative of the operating results to be expected for the full year.
- (2) Based on diluted weighted average number of common shares outstanding for the period.
- (3) Net changes in unrealized appreciation or depreciation and net realized gains and losses can fluctuate significantly from period to period. As a result, quarterly comparisons may not be meaningful.
- (4) Total return assumes the reinvestment of all dividends paid for the periods presented.

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 13. Litigation

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

Independent Accountants Review Report

The Board of Directors and Shareholders

Allied Capital Corporation:

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

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

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

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

/s/ KPMG LLP

Washington, D.C.

October 27, 2003

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

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

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

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

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

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

PORTFOLIO AND INVESTMENT ACTIVITY

Total portfolio investment activity and yields at and for the three and nine months ended September 30, 2003 and 2002, and at and for the year ended December 31, 2002, were as follows:

(\$ in millions)	At and for the Three Months Ended September 30,		At and for the Nine Months Ended September 30,		At and for the Year Ended December 31,
	2003	2002	2003	2002	2002
	(unaudited)		(unaudited)		
Portfolio at value	\$2,601.1	\$2,343.6	\$2,601.1	\$2,343.6	\$2,488.2
Investments funded	\$ 138.4	\$ 157.6	\$ 664.8	\$ 353.0	\$ 506.4
Change in accrued or reinvested interest and dividends	\$ 19.6	\$ 13.5	\$ 40.0	\$ 33.0	\$ 44.7
Principal repayments	\$ 69.4	\$ 44.7	\$ 219.7	\$ 111.7	\$ 143.2
Sales	\$ 5.1	\$ 87.2	\$ 281.8	\$ 213.5	\$ 213.5
Yield ⁽¹⁾	14.5%	14.1%	14.5%	14.1%	14.0%

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

Private Finance

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

(\$ in millions)	At and for the Three Months Ended September 30,		At and for the Nine Months Ended September 30,		At and for the Year Ended December 31,
	2003	2002	2003	2002	2002
	(unaudited)		(unaudited)		
Portfolio at value:					
Loans and debt securities	\$1,158.7	\$1,122.6	\$1,158.7	\$1,122.6	\$1,151.2
Equity interests	650.0	540.0	650.0	540.0	592.0
Total portfolio	\$1,808.7	\$1,662.6	\$1,808.7	\$1,662.6	\$1,743.2
Investments funded	\$ 31.7	\$ 148.7	\$ 305.7	\$ 218.4	\$ 297.2
Change in accrued or reinvested interest and dividends	\$ 18.4	\$ 13.5	\$ 37.8	\$ 32.6	\$ 42.6
Principal repayments	\$ 53.7	\$ 44.2	\$ 199.7	\$ 100.2	\$ 129.3
Yield ⁽¹⁾	15.3%	14.4%	15.3%	14.4%	14.4%

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

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

(\$ in millions)	Loans and Debt Securities	Equity Interests	Total
<i>For the Nine Months Ended September 30, 2003⁽¹⁾</i>			
Companies more than 25% owned	\$ 48.0	\$28.2	\$ 76.2
Companies 5% to 25% owned	18.2	1.8	20.0
Companies less than 5% owned	203.8	5.7	209.5
Total	\$270.0	\$35.7	\$305.7
<i>For the Nine Months Ended September 30, 2002⁽¹⁾</i>			
Companies more than 25% owned	\$ 31.7	\$ 4.1	\$ 35.8
Companies 5% to 25% owned	24.8	7.4	32.2
Companies less than 5% owned	141.0	9.4	150.4
Total	\$197.5	\$20.9	\$218.4
<i>For the Year Ended December 31, 2002⁽¹⁾</i>			
Companies more than 25% owned	\$ 86.1	\$18.7	\$104.8
Companies 5% to 25% owned	22.3	0.4	22.7
Companies less than 5% owned	154.6	15.1	169.7
Total	\$263.0	\$34.2	\$297.2

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

At September 30, 2003, we had outstanding funding commitments of \$93.4 million to private finance portfolio companies, including \$27.2 million committed to private equity funds. At September 30, 2003, we also had total commitments to private finance portfolio companies in the form of standby letters of credit and guarantees of \$103.5 million.

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

We may acquire more than 50% of the common stock or equity interests of a company in a control buyout transaction. Buyout investments are generally structured such that we earn a current return through a combination of interest income on our senior loans and subordinated debt, dividends on our preferred and/or common stock, and management or transaction services fees to compensate us for the managerial assistance that we provide to a controlled portfolio company. We plan to continue to seek buyout investments. Buyout investments provide the opportunity to invest meaningful

amounts of capital with the potential for attractive current income returns as well as the potential for future capital gains. Buyout transactions are typically larger than our mezzanine investments. In some cases for companies that are more than 50% owned, we may not accrue interest on loans and debt securities depending on the working capital needs of such company. In such cases, we may defer current debt service.

Our most significant investments acquired through control buyout transactions at September 30, 2003, were Business Loan Express, LLC (BLX), acquired in 2000, and The Hillman Companies, Inc. (Hillman), acquired in 2001.

Business Loan Express, LLC. At September 30, 2003, our investment in BLX totaled \$257.8 million at cost and \$344.9 million at value, or 11.5% of our total assets, which includes unrealized appreciation of \$87.1 million.

BLX is a national, non-bank, government guaranteed lender utilizing the SBA's 7(a) Guaranteed Loan Program and is licensed by the SBA as a Small Business Lending Company (SBLC). BLX is a preferred lender in all 79 SBA districts as designated by the SBA, and originates, sells, and services small business loans. In addition to the SBA 7(a) Guaranteed Loan Program, BLX originates conventional small business loans and originates loans under the USDA Business and Industry Guaranteed Loan Program. BLX has offices across the United States and is headquartered in New York, New York. Changes in the laws or regulations that govern SBLCs or the SBA 7(a) Guaranteed Loan Program or changes in government funding for this program could have a material adverse impact on BLX and, as a result, negatively affect our financial results.

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

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

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

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

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Summary financial data for BLX at and for the year ended September 30, 2003 and 2002, is presented below. The September 30, 2003, financial data is preliminary and unaudited.

(\$ in millions)	At and for the Year Ended September 30, 2003 ⁽¹⁾	At and for the Year Ended September 30, 2002
Operating Data		
Total revenue	\$ 108.3	\$ 94.0
Net income ⁽²⁾	\$ 4.7	\$ 3.4
Earnings before interest, taxes and management fees (EBITM)	\$ 37.5	\$ 47.0
Balance Sheet Data		
Total assets ⁽³⁾	\$ 353.0	\$ 281.1
Total debt	\$ 178.5	\$ 186.1
Total owners' equity	\$ 136.1	\$ 62.1
Other Data		
Total loan originations	\$ 685.8	\$ 624.5
Serviced loan portfolio	\$2,227.4	\$1,501.6
Number of loans	3,136	2,251
Loan delinquencies ⁽⁴⁾	8.3%	8.5%
Serviced Loan Portfolio by Industry		
Hotels	24%	27%
Gas stations/convenience stores	19	17
Professional and retail services	12	10
Restaurants	9	10
Manufacturing and industrial	9	10
Car wash/auto repair services	7	3
Child care and health care services	6	4
Shrimp/fishing vessels	5	7
Recreation	5	6
Other	4	6
Total	100%	100%

(1) Post reorganization BLX's fiscal year end changed to September 30.

(2) For the year ended September 30, 2003, net income was reduced by \$2.3 million due to costs associated with the AIF acquisition and the LLC reorganization and \$2.3 million due to the increased value of issued and outstanding equity appreciation rights. In addition, net income 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) Included in total assets is \$6 million of goodwill at September 30, 2003 and 2002. There is no other goodwill on BLX's balance sheet. We acquired 94.9% of BLC Financial Services, Inc. on December 31, 2000. Push-down accounting was not required with respect to this transaction; accordingly, goodwill was not recorded by BLX.

(4) Represents the percentage of loans in the total serviced loan portfolio that are greater than 30 days delinquent, which includes loans in workout status. Loans greater than 30 days delinquent for the SBA 7(a) loan portfolio only, which are included in the total serviced loan portfolio, were 8.5% at September 30, 2003. SBA 7(a) loans greater than one year old at September 30, 2003, had a delinquency rate of 10.6%. 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

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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.

For the year ended September 30, 2003, BLX earned revenue of \$108.3 million and EBITM of \$37.5 million. EBITM was reduced by \$2.3 million due to costs associated with the AIF acquisition

and the LLC reorganization, as well as by \$2.3 million due to the increased value of issued and outstanding equity appreciation rights to employees.

For the year ended September 30, 2003, EBITM before one-time costs and equity appreciation rights expense was \$42.1 million, which compares to EBITM of \$47.0 million for the year ended September 30, 2002. Because of the AIF acquisition, BLX increased its infrastructure and has been implementing a company-wide integration and process improvement plan. At the same time, BLX began to focus on diversifying its portfolio to better balance its securitization pools with respect to industry diversity. The combination of these changes in processes had a negative impact on BLX's loan originations in the latter part of its 2003 fiscal year, and loan originations in the fourth quarter of fiscal year 2003 were reduced to \$121.4 million from a level of \$148.7 million in the third quarter of 2003. The downturn in BLX's loan originations combined with a higher cost structure had the impact of decreasing BLX's EBITM for 2003 as compared to 2002. Management of BLX believes that its loan originations will begin to return to levels more consistent with the past in the upcoming quarters. Management of BLX also believes that the increased cost of infrastructure improvements will provide greater strength and stability for BLX in the future. As is discussed in the Results of Operations section below, we considered the decline in EBITM in our valuation analysis for our investment in BLX at September 30, 2003.

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 83% of BLX's revenue of \$108.3 million during the 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 year ended September 30, 2003, totaled \$685.8 million, including loans purchased from AIF. Proceeds from loan sales during the year ended September 30, 2003, totaled approximately \$664.2 million. BLX funds the construction of commercial real estate projects, and as a result is unable to sell a construction loan until the loan is fully funded and the construction is complete. In addition, BLX typically does not immediately receive the proceeds from the sale of its SBA 7(a) guaranteed and unguaranteed loan strips sold, but receives the cash upon settlement. Therefore until BLX sells construction loans or fully funded loans held for sale, it will finance the origination of the loans through funding on its revolving line of credit, or through financing provided by us.

BLX has a three-year \$169.0 million revolving credit facility that matures in March 2004. As the controlling equity owner in BLX, we have provided an unconditional guaranty to the revolving credit facility lenders in an amount of up to 50% of the total obligations (consisting of principal, accrued interest, and other fees) of BLX under the revolving credit facility. The principal amount outstanding on the revolving credit facility at September 30, 2003, was \$129.5 million and the amount guaranteed by us was \$64.9 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 September 30, 2003. At September 30, 2003, we had provided three standby letters of credit in connection with three term securitization transactions completed by BLX totaling \$25.6 million.

BLX sells the guaranteed piece of guaranteed loans for cash premiums of up to 10% of the guaranteed loan amount plus a retained annual servicing fee generally between 1.0% and 2.3% of the guaranteed loan amount. Cash premiums received from guaranteed loan sales during the 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 4.8%. In addition, BLX will sell the unguaranteed pieces of the SBA 7(a) loans and conventional loans it originates into a conduit facility. The conduit loans are securitized and BLX retains an interest of up to 2.7% of the loan pool. BLX then receives the excess of loan interest payments on the loans sold over the interest cost on the securities issued in the securitization over the life of the loan pool. BLX generally receives between 4.3% and 4.9% annually on the loans sold into the securitization pools.

When BLX sells a guaranteed piece of an SBA 7(a) loan at par, or when BLX securitizes a loan, it will record a residual interest and servicing asset together referred to as Residual Interest in order to account for the retained interest in the loans sold and the net present value of the future cash flows it will receive from the loans sold or securitized. In computing the Residual Interest, BLX discounts estimated future cash flows after making assumptions as to future loan losses and loan prepayments which may reduce future cash flows. For the year ended September 30, 2003, BLX received cash payments from Residual Interest of approximately \$49.3 million.

At September 30, 2003, BLX's Residual Interest totaled \$175.6 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 \$733.9 million over time, with approximately \$56.6 million, \$52.9 million, \$51.6 million, and \$50.2 million (or \$211.2 million in the aggregate) scheduled to be received in the next four years ending on September 30, 2004, 2005, 2006, and 2007, respectively.

The Hillman Companies, Inc. At September 30, 2003, our investment in Hillman totaled \$94.1 million at cost and \$186.0 million at value, or 6.2% of total assets, which includes unrealized appreciation of \$91.9 million.

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

For the year ended December 31, 2002, Hillman had total revenue of \$286.8 million, earnings before interest, taxes, depreciation, amortization, and management fees, or EBITDAM, of \$50.2 million, and profits before taxes of \$10.0 million. For the nine months ended September 30, 2003, Hillman had total revenue of \$240.3 million and EBITDAM of \$41.9 million. This EBITDAM is before the write-down of \$6.3 million of a note receivable related to an investment made by Hillman. For the nine months ended September 30, 2003, Hillman had income before taxes of \$1.9 million, which includes the write-down of the note receivable. The total revenue, EBITDAM, and loss before taxes for the nine months ended September 30, 2003, are not necessarily indicative of the operating results to be expected for the full year. Hillman had total assets of \$378.4 million, total debt of \$158.0 million and trust preferred obligations at par of \$105.4 million at September 30, 2003.

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Commercial Real Estate Finance

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

(\$ in millions)	At and for the Three Months Ended September 30,				At and for the Nine Months Ended September 30,				At and for the Year Ended December 31, 2002	
	2003		2002		2003		2002		Value	Yield ⁽¹⁾
	Value	(unaudited) Yield ⁽¹⁾	Value	Yield ⁽¹⁾	Value	(unaudited) Yield ⁽¹⁾	Value	Yield ⁽¹⁾		
CMBS bonds	\$523.6	12.9%	\$496.4	14.5%	\$523.6	12.9%	\$496.4	14.5%	\$555.5	14.2%
CDO bonds and preferred shares	164.8	16.9%	53.0	17.2%	164.8	16.9%	53.0	17.2%	52.8	17.2%
Commercial mortgage loans	85.5	8.7%	59.7	8.0%	85.5	8.7%	59.7	8.0%	63.7	7.5%
Residual interest			69.0	9.4%			69.0	9.4%	69.0	9.4%
Real estate owned	13.5		2.9		13.5		2.9		4.0	
Equity interests	5.0				5.0					
Total portfolio	\$792.4		\$681.0		\$792.4		\$681.0		\$745.0	
Investments funded	\$106.7		\$ 8.9		\$359.1		\$134.6		\$209.2	
Change in accrued or reinvested interest	\$ 1.2		\$		\$ 2.2		\$ 0.4		\$ 2.1	
Principal repayments	\$ 15.7		\$ 0.5		\$ 20.0		\$ 11.5		\$ 13.9	
CMBS, CDO, and commercial real estate loan sales	\$ 5.1		\$ 87.2		\$281.8		\$213.5		\$213.5	

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

Our commercial real estate investment activity for the nine months ended September 30, 2003 and 2002, and for the year ended December 31, 2002, was as follows:

(\$ in millions)	Face Amount	Discount	Amount Funded
For the Nine Months Ended September 30, 2003			
CMBS bonds	\$432.1	\$(195.1)	\$237.0
CDO bonds and preferred shares	118.4	(0.3)	118.1
Commercial mortgage loans	1.8		1.8
Equity interests	2.2		2.2
Total	\$554.5	\$(195.4)	\$359.1
For the Nine Months Ended September 30, 2002			
CMBS bonds	\$181.4	\$(83.8)	\$97.6
CDO preferred shares	29.0		29.0
Commercial mortgage loans	0.1		0.1
Real estate owned	7.9		7.9

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Total	\$218.4	\$ (83.8)	\$134.6
<i>For the Year Ended December 31, 2002</i>			
CMBS bonds	\$302.5	\$(140.2)	\$162.3
CDO preferred shares	29.0		29.0
Commercial mortgage loans	11.7	(1.7)	10.0
Real estate owned	7.9		7.9
Total	\$351.1	\$(141.9)	\$209.2

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At September 30, 2003, we had outstanding funding commitments of \$2.7 million and commitments in the form of standby letters of credit and guarantees of \$2.7 million to commercial real estate portfolio companies.

CMBS Bonds. During the nine months ended September 30, 2003, we invested \$237.0 million in 14 CMBS bond issuances, including \$62.4 million of investments in BB+, BB and BB- rated bonds in six CMBS issuances where the below BB- rated bonds were purchased by other parties, and \$97.6 million in three CMBS bond issuances during the nine months ended September 30, 2002. During the year ended December 31, 2002, we invested \$162.3 million in five CMBS bond issuances.

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

Loan to Value Ranges (\$ in millions)	For the Nine Months Ended September 30,				For the Year Ended December 31, 2002	
	2003		2002		Amount	Percentage
	Amount	Percentage	Amount	Percentage		
Less than 60%	\$ 3,265.2	23%	\$ 401.9	16%	\$ 909.3	20%
60-65%	1,091.1	8	178.7	7	287.3	6
65-70%	1,484.1	10	264.1	11	587.9	13
70-75%	3,065.8	21	799.5	32	1,214.5	27
75-80%	5,324.2	37	812.7	33	1,477.5	33
Greater than 80%	75.5	1	12.0	1	47.8	1
Total	\$ 14,305.9	100%	\$ 2,468.9	100%	\$ 4,524.3	100%
Weighted average loan to value	68.5%		70.4%		68.5%	

Debt Service Coverage Ratio ⁽¹⁾ Ranges (\$ in millions)	For the Nine Months Ended September 30,				For the Year Ended December 31, 2002	
	2003		2002		Amount	Percentage
	Amount	Percentage	Amount	Percentage		
Greater than 2.00	\$ 3,563.6	25%	\$ 103.3	4%	\$ 366.9	8%
1.76-2.00	1,439.9	10	84.2	3	229.6	5
1.51-1.75	2,589.5	18	240.3	10	477.4	11
1.26-1.50	5,654.4	40	1,631.8	66	2,739.6	60
Less than 1.25	1,058.5	7	409.3	17	710.8	16
Total	\$ 14,305.9	100%	\$ 2,468.9	100%	\$ 4,524.3	100%
Weighted average debt service coverage ratio	1.75		1.41		1.41	

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

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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 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 nine months ended September 30, 2003 and 2002, and for the year ended December 31, 2002, were as follows:

(\$ in millions)	For the Nine Months Ended September 30,		For the Year Ended December 31,
	2003	2002	2002
Cost basis	\$253.5	\$205.9	\$205.9
Sales proceeds	\$284.8	\$225.6	\$225.6
Net realized gains (net of related hedge gains or losses)	\$ 24.6	\$ 19.1	\$ 19.1
Weighted average yield	11.8%	11.5%	11.5%

The non-investment grade and unrated tranches of the CMBS bonds in which we invest are junior in priority for payment of interest and principal to the more senior tranches of the related CMBS bond issuance. Cash flow from the underlying mortgages generally is allocated first to the senior tranches, with the most senior tranches having a priority right to the cash flow. Then, any remaining cash flow is allocated, generally, among the other tranches in order of their relative seniority. To the extent there are defaults and unrecoverable losses on the underlying mortgages resulting in reduced cash flows, our most subordinate tranche will bear this loss first. At September 30, 2003, the CMBS bonds were subordinate to 87% to 99% of the tranches of 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 nine months ended September 30, 2003 and 2002, and for the year ended December 31, 2002, the average discount for the CMBS bonds in which we invested was 45%, 46% and 46%, respectively.

At September 30, 2003, and December 31, 2002, the unamortized discount related to the CMBS bond portfolio was \$658.2 million and \$649.5 million, respectively. At September 30, 2003, we have set aside \$282.9 million of this unamortized discount to absorb potential future losses, and therefore, the yield on the CMBS bonds of 12.9% assumes that this amount will not be amortized. At September 30, 2003, the CMBS bond portfolio had a fair value of \$523.6 million, which included net unrealized appreciation on the CMBS bonds of \$12.1 million.

The yield on our CMBS bond portfolio at September 30, 2003, and December 31, 2002, was 12.9% and 14.2%, respectively. The yield on the CMBS bond portfolio at any point in time will vary depending on the concentration of lower yielding BB+, BB, and BB- rated CMBS bonds held in the portfolio. The BB+, BB, and BB- rated CMBS bonds totaled \$230.0 million and \$110.9 million at value and had a yield of 8.0% and 8.8% at September 30, 2003, and December 31, 2002, respectively.

At September 30, 2003, and December 31, 2002, we held CMBS bonds in 39 and 27 separate CMBS issuances, respectively. The underlying collateral pool, consisting of commercial mortgage

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loans and real estate owned (REO) properties, for these CMBS bonds consisted of the following at September 30, 2003, and December 31, 2002:

(\$ in million)	2003	2002
Approximate number of loans and REO properties ⁽¹⁾	5,900	4,500
Total outstanding principal balance	\$39,475	\$24,974
Loans over 30 days delinquent or classified as REO properties ⁽²⁾	0.9% ⁽³⁾	1.0% ⁽³⁾

(1) Includes approximately 17 and 12 REO properties obtained through the foreclosure of commercial mortgage loans at September 30, 2003, and December 31, 2002, respectively.

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

(3) At September 30, 2003, and December 31, 2002, our investments included bonds in the first loss, unrated bond class in 33 and 27 separate CMBS issuances, respectively. For these issuances, loans over 30 days delinquent or classified as REO properties were 1.1% and 1.0% of the total outstanding principal balance at September 30, 2003, and December 31, 2002, respectively.

Collateralized Debt Obligation Bonds and Preferred Shares. During the nine months ended September 30, 2003 and 2002, and the year ended December 31, 2002, we invested in the BBB rated bonds and preferred shares of one, three, and three collateralized debt obligations, respectively, which are secured by investment grade unsecured debt issued by various real estate investment trusts, or REITs, and investment and non-investment grade CMBS bonds. For all five outstanding CDO issuances, the investment grade REIT collateral consists of debt with an original underwritten balance of \$1.2 billion and was issued by 39 REITs. The investment grade CMBS collateral consists of CMBS bonds with a face amount of \$496.0 million issued in 41 separate CMBS transactions and the non-investment grade CMBS collateral consists of BB+, BB, BB-, B+, and B rated CMBS bonds with a face amount of \$873.7 million issued in 42 separate CMBS transactions. Included in the CMBS collateral for the CDOs are CMBS bonds with a face amount of \$793.7 million that are senior in priority of repayment to certain lower rated CMBS bonds held by us, which were issued in 27 separate CMBS transactions.

During the nine months ended September 30, 2003, we sold \$8.6 million of CDO bonds and preferred shares for a net realized loss of \$114 thousand, net of the related hedge loss.

The BBB rated bonds and the preferred shares of the five 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 BBB rated bonds would bear any loss after the preferred shares. At September 30, 2003, our BBB bonds in the CDO were subordinate to 61% of the more senior tranches of debt issued in the CDO transaction and the preferred shares in the CDOs were subordinate to 90% to 98% of the more senior tranches of debt issued in the various CDO transactions.

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

Portfolio Asset Quality

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

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

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

Grade	At September 30, 2003		At December 31, 2002	
	Portfolio at Value	Percentage of Total Portfolio	Portfolio at Value	Percentage of Total Portfolio
(\$ in millions)				
1	\$ 941.8	36.2%	\$ 801.0	32.1%
2	1,383.8	53.2	1,400.8	56.3
3	165.5	6.4	166.0	6.7
4	16.2	0.6	23.6	1.0
5	93.8	3.6	96.8	3.9
	\$2,601.1	100.0%	\$2,488.2	100.0%

Total Grade 4 and 5 assets as a percentage of the total portfolio at value at September 30, 2003, and December 31, 2002, were 4.2% and 4.9%, respectively. Included in Grade 4 and 5 assets at September 30, 2003, and December 31, 2002, were assets totaling \$33.3 million and \$24.1 million, respectively, that are secured by commercial real estate. Grade 4 and 5 assets include loans, debt securities, and equity securities. We expect that a number of portfolio companies will be in the Grade 4 or 5 categories from time to time. Part of the business of private finance is working with troubled portfolio companies to improve their businesses and protect our investment. The number of portfolio companies and related investment amount included in Grade 4 and 5 may fluctuate from period to period. We continue to follow our historical practice of working with a troubled portfolio company in order to recover the maximum amount of our investment. 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 September 30, 2003, will necessarily result in a realized gain or loss.

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

For the total investment portfolio, workout loans and debt securities (which excludes equity securities that are included in the total Grade 4 and 5 assets above) not accruing interest that were classified in Grade 4 and 5 were \$51.6 million and \$89.1 million at value at September 30, 2003, and December 31, 2002, respectively. Included in this category were secured real estate loans of \$7.2 million and \$13.0 million, respectively. In addition to Grade 4 and 5 assets that are in workout, loans and debt securities to companies that are more than 50% owned by us that were not accruing interest totaled \$49.3 million and \$63.6 million at value at September 30, 2003, and December 31, 2002, respectively, and loans and debt securities to companies that are less than 50% owned by us and were not in workout but were not accruing interest totaled \$3.4 million and \$7.2 million at value at September 30, 2003, and December 31, 2002, respectively. In addition, CMBS bonds with a value of \$14.0 million and \$28 thousand were not accruing interest at September 30, 2003, and December 31, 2002, respectively.

Loans and Debt Securities Over 90 Days Delinquent. Loans and debt securities and CMBS bonds greater than 90 days delinquent were \$135.1 million and \$103.1 million at value at September 30, 2003, and December 31, 2002, respectively, or 5.2% and 4.1% of the total portfolio.

Included in this category were secured real estate loans and CMBS bonds valued at \$43.2 million and \$26.0 million, respectively.

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

Hedging Activities

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

The total obligations to replenish borrowed Treasury securities, including accrued interest payable on the obligations, were \$221.9 million and \$197.0 million at September 30, 2003, and December 31, 2002, respectively, which included unrealized appreciation on the obligations of \$78 thousand and unrealized depreciation on the obligations of \$7.1 million, respectively, due to changes in the yield on the borrowed Treasury securities. The net proceeds related to the sales of the borrowed Treasury securities were \$220.9 million and \$189.3 million at September 30, 2003, and December 31, 2002, respectively. Under the terms of the transactions, we have provided additional cash collateral of \$0.8 million and \$5.4 million at September 30, 2003, and December 31, 2002, respectively, for the difference between the net proceeds related to the sales of the borrowed Treasury securities and the obligations to replenish the securities on the weekly settlement date, which is included in deposits of proceeds from sales of borrowed Treasury securities in the accompanying financial statements. The amount of the hedge will vary from period to period depending upon the amount of BB+ through B rated CMBS bonds and BBB rated CDO bonds that we own and have hedged on the balance sheet date.

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

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

(\$ in thousands, except per share amounts)	For the Three Months Ended September 30,		Change	Percentage Change
	2003	2002		
	(unaudited)			
Interest and Related Portfolio Income				
Interest and dividends	\$ 78,895	\$ 67,624	\$ 11,271	17%
Premiums from loan dispositions	2,523	392	2,131	*
Fees and other income	7,452	8,313	(861)	(10)%
Total interest and related portfolio income	88,870	76,329	12,541	16%
Expenses				
Interest	20,334	17,430	2,904	17%
Employee	9,480	8,153	1,327	16%
Administrative	5,897	5,052	845	17%
Total operating expenses	35,711	30,635	5,076	17%
Net investment income before income taxes	53,159	45,694	7,465	16%
Income tax expense (benefit)	(449)	600	(1,049)	**
Net investment income	53,608	45,094	8,514	19%
Net Realized and Unrealized Gains (Losses)				
Net realized gains (losses)	(6,438)	48,222	(54,660)	*
Net change in unrealized appreciation or depreciation	(13,426)	(47,796)	34,370	*
Total net gains (losses)	(19,864)	426	(20,290)	*
Net income	\$ 33,744	\$ 45,520	\$ (11,776)	(26)%
Diluted earnings per common share	\$ 0.28	\$ 0.44	\$ (0.16)	(36)%
Weighted average common shares outstanding - diluted	120,906	103,302	17,604	17%

* Premiums from loan dispositions, net realized gains (losses) and net change in unrealized appreciation or depreciation can fluctuate significantly from period to period. As a result, quarterly comparisons may not be meaningful.

** Percentage change is not meaningful.

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

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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 rate earned on interest-bearing investments and the amount of loans and debt securities and CMBS bonds for which interest is not accruing. Our interest-bearing investments in the portfolio increased by 7.9% from September 30, 2002, to September 30, 2003. The interest bearing portfolio at value and the weighted average yield on the interest-bearing investments in the portfolio at September 30, 2003 and 2002, was as follows:

(\$ in millions)	2003	2002
Interest-bearing portfolio	\$ 1,946.1	\$ 1,803.6
Portfolio yield	14.5%	14.1%

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Interest income increased primarily due to portfolio growth and an increase in yield. In addition, we resumed accruing interest or were able to accrue interest that was contingent upon achieving performance milestones for certain portfolio companies during the quarter. Such additional interest income for the three months ended September 30, 2003, was \$3.7 million.

Included in premiums from loan dispositions are prepayment premiums of \$2.5 million and \$0.4 million for the three months ended September 30, 2003 and 2002, respectively. While the scheduled maturities of private finance and commercial real estate loans range from five to ten years, it is not unusual for our borrowers to refinance or pay off their debts to us ahead of schedule. Because we seek to finance primarily seasoned, performing companies, such companies at times can secure lower cost financing as their balance sheets strengthen, or as more favorable interest rates become available, or a company may enter into a transaction that results in the early repayment of their debt to us. Therefore, we generally structure our loans to require a prepayment premium for the first three to five years of the loan.

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

Fees and other income for the quarters ended September 30, 2003 and 2002, primarily included fees of \$0.7 million and \$2.2 million, respectively, related to structuring and diligence; fees of \$2.2 million and \$0.4 million, respectively, related to transaction a