

ALLIED CAPITAL CORP
Form 10-Q
August 14, 2002

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 June 30, 2002 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 12 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

On August 13, 2002 there were 102,306,364 shares outstanding of the Registrant's common stock, \$0.0001 par value.

ALLIED CAPITAL CORPORATION

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PART I: FINANCIAL INFORMATION

Item 1. Financial Statements

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEET

	<u>June 30,</u> <u>2002</u>	<u>December</u> <u>31,</u> <u>2001</u>
	(in thousands, except share and per share amounts)	
	(unaudited)	
ASSETS		
Portfolio at value:		
Private finance		
Companies more than 25% owned (cost: 2002-\$512,468; 2001-\$451,705)	\$632,560	\$505,620
Companies 5% to 25% owned (cost: 2002-\$235,879; 2001-\$211,030)	264,691	232,399
Companies less than 5% owned (cost: 2002-\$832,665; 2001-\$891,231)	738,008	857,053
	<hr/>	
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Total private finance	1,635,259	1,595,072
Commercial real estate finance (cost: 2002-\$724,240; 2001-\$732,636)	745,710	734,518
	<hr/>	
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Total portfolio at value	2,380,969	2,329,590
	<hr/>	
	<hr/>	
Other assets	183,328	130,234
Cash and cash equivalents	4,319	889
	<hr/>	
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Total assets
\$2,568,616 \$2,460,713

**LIABILITIES AND
SHAREHOLDERS EQUITY**

Liabilities:

Notes payable and debentures
\$869,200 \$876,056
Revolving credit facility
139,750 144,750
Accounts payable and other liabilities
118,213 80,784

Total liabilities
1,127,163 1,101,590

Commitments and Contingencies

Preferred stock
7,000 7,000
Shareholders equity:

Common stock, \$0.0001 par value,
200,000,000 shares authorized;
102,296,392 and 99,607,396 shares
issued and outstanding at June 30, 2002
and December 31, 2001, respectively
10 10
Additional paid-in capital
1,417,356 1,352,688
Notes receivable from sale of common
stock
(28,190) (26,028)
Net unrealized appreciation on portfolio
64,118 39,981
Distributions in excess of earnings
(18,841) (14,528)

Total shareholders equity
1,434,453 1,352,123

Total liabilities and shareholders equity
\$2,568,616 \$2,460,713

Net asset value per common share
\$14.02 \$13.57

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

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENT OF OPERATIONS

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2002	2001	2002	2001
	(unaudited)		(unaudited)	
(in thousands, except per share amounts)				
Interest and related portfolio income:				
Interest and dividends				
Companies more than 25% owned	\$9,342	\$5,280	\$18,806	\$10,888
Companies 5% to 25% owned	7,305	6,680	14,385	12,911
Companies less than 5% owned	46,045	46,864	94,474	89,900
<hr/>				
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Total interest and dividends	62,692	58,824	127,665	113,699
Premiums from loan dispositions				
Companies more than 25% owned		511		
Companies less than 5% owned	46	910	1,659	1,220
<hr/>				
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Total premiums from loan dispositions	46	910	1,659	1,731
Fees and other income				
Companies more than 25% owned	6,890	4,284	13,865	8,113
Companies 5% to 25% owned	476	150	476	150
Companies less than 5% owned	3,089	4,571	11,919	10,117
<hr/>				
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Total fees and other income
10,455 9,005 26,260 18,380

Total interest and related portfolio income
73,193 68,739 155,584 133,810

Expenses:

Interest
17,515 15,951 34,984 31,881
Employee
8,274 7,610 16,309 14,056
Administrative
4,843 3,060 7,861 6,027

Total operating expenses
30,632 26,621 59,154 51,964

Net investment income before net realized and unrealized
gains
42,561 42,118 96,430 81,846

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Net realized and unrealized gains (losses):

Net realized gains (losses)

Companies more than 25% owned

(630) (731) (630) (731)

Companies 5% to 25% owned

4,571 718 4,571

Companies less than 5% owned

(125) (3) 8,762 1,151

Total net realized gains (losses)

(755) 3,837 8,850 4,991

Net unrealized gains

31,648 151 24,135 11,297

Total net realized and unrealized gains

30,893 3,988 32,985 16,288

Net increase in net assets resulting from operations

\$73,454 \$46,106 \$129,415 \$98,134

Basic earnings per common share

\$0.72 \$0.52 \$1.28 \$1.12

Diluted earnings per common share
\$0.71 \$0.51 \$1.26 \$1.10

Weighted average common shares outstanding basic
101,660 89,356 100,822 87,441

Weighted average common shares outstanding diluted
103,440 90,848 102,900 88,966

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

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

	For the Six Months Ended June 30,	
(in thousands, except per share amounts)	2002	2001
	(unaudited)	
Operations:		
Net investment income before net realized and unrealized gains	\$96,430	\$81,846
Net realized gains	8,850	4,991
Net unrealized gains	24,135	11,297
Net increase in net assets resulting from operations	129,415	98,134
Shareholder distributions:		
Common stock dividends	(109,482)	(87,836)
Preferred stock dividends	(110)	(110)
Net decrease in net assets resulting from shareholder distributions	(109,592)	(87,946)
Capital share transactions:		
Sale of common stock	49,920	123,262
Issuance of common stock upon the exercise of stock options	11,626	6,258

Issuance of common stock in lieu of
cash distributions
3,123 3,415
Net increase in notes receivable from
sale of common stock
(2,162) (1,154)

Net increase in net assets resulting
from capital share transactions
62,507 131,781

Total increase in net assets
\$82,330 \$141,969

Net assets at beginning of period
\$1,352,123 \$1,029,692

Net assets at end of period
\$1,434,453 \$1,171,661

Net asset value per common share
\$14.02 \$12.79

Common shares outstanding at end of
period
102,296 91,578

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

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENT OF CASH FLOWS

	For the Six Months Ended June 30,	
	2002	2001
	(unaudited)	
(in thousands)		
Cash flows from operating activities:		
Net increase in net assets resulting from operations	\$129,415	\$98,134
Adjustments		
Portfolio investments	(195,455)	(299,843)
Repayments of investment principal	67,017	42,544
Proceeds from investment sales	126,280	74,648
Change in accrued or reinvested interest and dividends	(19,463)	(25,493)
Changes in other assets and liabilities	(18,982)	(7,374)
Amortization of loan discounts and fees	(9,284)	(7,722)
Depreciation and amortization	657	479
Realized losses	6,579	1,605
Net unrealized gains	(24,135)	(11,297)
	<hr/>	
	<hr/>	
Net cash provided by (used in) operating activities	62,629	(134,319)
	<hr/>	
	<hr/>	
Cash flows from financing activities:		
Sale of common stock	49,920	123,262
Sale of common stock upon the exercise of stock options	9,245	2,103

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Collections of notes receivable from
sale of common stock
220 3,002
Common dividends and distributions
paid
(106,359) (84,422)
Preferred stock dividends paid
(110) (110)
Net borrowings under (repayments on)
notes payable and debentures
(6,856) 11,666
Net borrowings under (repayments on)
revolving line of credit
(5,000) 82,750
Other
(259) (2,948)

Net cash provided by (used in)
financing activities
(59,199) 135,303

Net increase in cash and cash
equivalents
\$3,430 \$984

Cash and cash equivalents at
beginning of period
\$889 \$2,449

Cash and cash equivalents at end of
period
\$4,319 \$3,433

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

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENT OF INVESTMENTS

Private Finance Portfolio Company (in thousands, except number of shares)	Investment(2)	June 30, 2002	
		(unaudited) Cost	Value
Companies More Than 25% Owned			
Acme Paging, L.P.			
Loan \$3,200	\$3,200		
(Telecommunications)			
Debt			
Securities 7,005	7,005		
Equity Interests 3,717	2,261		
<hr/>			
American Healthcare Services, Inc.			
Debt			
Securities 41,362	41,362		
(Healthcare)			
Common Stock (79,567,042 shares)	1,000	100	Guaranty (\$915)
<hr/>			
Business Loan Express, Inc.			
Loan 6,000	6,000		
(Financial Services)			
Debt			
Securities 80,809	80,809		
Preferred Stock (25,111 shares)	25,111	25,111	
Common Stock (25,503,043 shares)	104,641	140,000	
Guaranty (\$48,126	See Note 3)	Standby Letters of Credit (\$10,550	See Note 3)
<hr/>			
The Color Factory Inc.			
Loan 7,439	7,439		
(Consumer Products)			
Preferred Stock (1,000 shares)	1,002	1,002	
Common Stock (980 shares)	6,535	8,035	
<hr/>			
Directory Investment Corporation			

Common Stock (470
shares) 112 32
(Publishing)

Directory Lending Corporation
Series A Common Stock (34
shares)
(Publishing)
Series B Common Stock (6
shares) 8 Series C
Common Stock (10
shares) 22

EDM Consulting, LLC
Debt Securities 1,875 443
(Business Services)
Equity Interests 250

Elmhurst Consulting, LLC
Loan 12,530 12,530
(Business Services)
Equity
Interests 5,165 5,165
Guaranty (\$2,190)

Foresite Towers, LLC
Equity
Interests 15,522 15,522
(Tower Leasing)

Gordian Group, Inc.
Loan 6,965 6,965
(Business Services)
Common Stock
(1,000 shares) 1,300 1,300

HealthASPex, Inc.
Preferred Stock (1,451,380
shares) 4,900 2,617
(Business Services)
Preferred Stock (700,000
shares) 700 700 Common
Stock (1,451,380 shares) 4

The Hillman Companies Inc.(1)
Debt
Securities 41,012 41,012
(Consumer Products)
Common Stock (6,890,937
shares) 57,156 90,000

(1) Public company.

(2) Common stock, preferred
stock, warrants, options and

equity interests are generally
non-income producing and
restricted. (3) Non-U.S.
company. (4) Non-registered
investment company.

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

Private Finance Portfolio Company (in thousands, except number of shares)		Investment(2)	June 30, 2002	
			Cost	Value
xHMT, Inc. (Business Services)	Debt Securities	\$ 9,036	\$ 9,036	
	Preferred Stock (519,484 shares)	2,078	2,078	
	Common Stock (300,000 shares)	3,000	1,694	
	Warrants	1,155	651	
Monitoring Solutions, Inc. (Business Services)	Debt Securities	1,823	153	
	Common Stock (33,333 shares)			
	Warrants			
MVL Group, Inc. (Business Services)	Loan	16,963	16,963	
	Debt Securities	16,116	16,116	
	Common Stock (650,000 shares)	643	643	
Spa Lending Corporation (Recreation)	Preferred Stock (28,625 shares)	409	288	
	Common Stock (6,208 shares)			
STS Operating, Inc. (Industrial Products)	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	5,018	
Total Foam, Inc. (Industrial Products)	Debt Securities	260	125	
	Common Stock (910 shares)	10		
WyoTech Acquisition Corporation (Education)	Debt Securities	12,638	12,638	
	Preferred Stock (100 shares)	3,700	3,700	
	Common Stock (99 shares)	100	60,670	
Total companies more than 25% owned \$512,468 \$632,560				

**Companies 5% to 25%
Owned**

Aspen Pet Products, Inc.
Loans \$15,111 \$15,111
(Consumer Products)
Preferred Stock (2,021
shares) 1,981 1,981
Common Stock (1,400
shares) 140 140

Autania AG(1,3)
Debt
Securities 4,487 4,487
(Industrial Products)
Common Stock (250,000
shares) 2,169 2,169

CBA-Mezzanine Capital
Finance, LLC
Loan 313 313
(Financial Services)

Colibri Holding Corporation
Loans 3,478 3,478
(Consumer Products)
Preferred Stock (237
shares) 248 248 Common
Stock (3,362
shares) 1,250 1,250
Warrants 290 290

CorrFlex Graphics, LLC
Debt
Securities 2,393 2,393
(Business Services)
Warrants 17,490
Options 1,510

Csabai Canning Factory Rt(3)
Hungarian Quotas
(9.2%) 700
(Consumer Products)

(1) Public company.
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stock, warrants, options and
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restricted. (3) Non-U.S.
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investment company.

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		June 30, 2002	
Private Finance Portfolio Company (in thousands, except number of shares)	Investment(2)	(unaudited)	
		Cost	Value
CyberRep (Business Services)	Loan	\$ 1,184	\$ 1,184
	Debt Securities	14,550	14,550
	Warrants	660	3,310
The Debt Exchange Inc. (Business Services)	Preferred Stock (921,829 shares)	1,250	1,250
Gibson Guitar Corporation (Consumer Products)	Debt Securities	17,558	17,558
	Warrants	525	2,325
International Fiber Corporation (Industrial Products)	Debt Securities	22,499	22,499
	Common Stock (1,029,068 shares)	5,483	6,982
	Warrants	550	700
Liberty-Pittsburgh Systems, Inc. (Business Services)	Debt Securities	3,494	3,494
	Common Stock (123,929 shares)	142	142
Litterer Beteiligungs-GmbH(3) (Business Services)	Debt Securities	1,070	1,070
	Equity Interest	358	358
Logic Bay Corporation (Business Services)	Preferred Stock (1,131,222 shares)	5,000	1,000
Magna Card, Inc. (Consumer Products)	Debt Securities	153	153
	Preferred Stock (1,875 shares)	94	94
	Common Stock (4,687 shares)		
Master Plan, Inc. (Business Services)	Loan	1,204	1,204
	Common Stock (156 shares)	42	42
MortgageRamp.com, Inc. (Business Services)	Common Stock (772,000 shares)	3,860	3,860
Morton Grove Pharmaceuticals, Inc. (Consumer Products)	Loan	16,356	16,356
	Preferred Stock (106,947 shares)	5,000	12,000
Nobel Learning Communities, Inc.(1) (Education)	Debt Securities	9,704	9,704
	Preferred Stock (1,063,830 shares)	2,000	2,000
	Warrants	575	296
North American Archery, LLC (Consumer Products)	Loans	1,390	840
	Convertible Debentures	2,248	59
	Guaranty (\$1,020)		
Packaging Advantage Corporation (Business Services)	Debt Securities	11,635	11,635
	Common Stock (200,000 shares)	2,000	2,000
	Warrants	963	963

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Professional Paint, Inc.	Debt Securities	22,086	22,086
(Consumer Products)	Preferred Stock (15,000 shares)	18,309	18,309
	Common Stock (110,000 shares)	69	4,500

(1) Public company.

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

(3) Non-U.S. company.

(4) Non-registered investment company.

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

Private Finance Portfolio Company (in thousands, except number of shares)		Investment(2)	June 30, 2002	
			(unaudited)	
			Cost	Value
Progressive International Corporation (Consumer Products)	Debt Securities Preferred Stock (500 shares) Common Stock (197 shares) Warrants	\$3,963 500 13	\$3,963 500 13	
Redox Brands, Inc. (Consumer Products)	Debt Securities Preferred Stock (2,404,086 shares) Warrants	9,649 6,974 584	9,649 6,974 584	
Staffing Partners Holding Company, Inc. (Business Services)	Loan Debt Securities Preferred Stock (414,600 shares) Common Stock (50,200 shares) Warrants	2,500 4,992 2,073 50 10	2,500 4,992 2,073 50 10	
Total companies 5% to 25% owned \$235,879 \$264,691				
Companies Less Than 5% Owned				
ACE Products, Inc. Loans \$17,164 \$15,839 (Industrial Products)				
Advantage Mayer, Inc. Debt Securities 10,654 10,654 (Business Services) Warrants 382 1,455				
Alderwoods Group, Inc.(1) Common Stock (357,568 shares) 5,006 2,739 (Consumer Services)				
Allied Office Products, Inc. Debt Securities 7,628 50 (Business Services) Warrants 629				
American Barbecue & Grill, Inc. Warrants 125 (Retail)				

American Home Care Supply,
Debt
Securities 6,935 6,935
LLC
Warrants 579 1,579
(Consumer Products)

ASW Holding Corporation
Warrants 25 25
(Industrial Products)

Avborne, Inc.
Debt
Securities 12,959 3,500
(Business Services)
Warrants 1,180

Bakery Chef, Inc.
Loans 17,604 17,604
(Consumer Products)

Blue Rhino Corporation(1)
Debt
Securities 13,913 13,913
(Consumer Products)
Warrants 1,200 13,500

Border Foods, Inc.
Debt
Securities 9,347 9,347
(Consumer Products)
Preferred Stock (50,919
shares) 2,000 2,000
Warrants 665 665

Camden Partners Strategic
Fund II, L.P.(4)
Limited Partnership
Interest 1,879 2,002
(Private Equity Fund)

(1) Public company.

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

(3) Non-U.S. company.

(4) Non-registered investment company.

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		June 30, 2002	
Private Finance Portfolio Company (in thousands, except number of shares)	Investment(2)	(unaudited)	
		Cost	Value
Candlewood Hotel Company(1) (Hospitality)	Preferred Stock (3,250 shares)	\$ 3,250	\$ 1,300
Celebrities, Inc. (Broadcasting & Cable)	Loan	230	230
	Warrants	12	492
Component Hardware Group, Inc. (Industrial Products)	Debt Securities	11,032	11,032
	Preferred Stock (18,000 shares)	1,800	1,800
	Common Stock (2,000 shares)	200	200
Convenience Corporation of America (Retail)	Debt Securities	8,355	2,738
	Preferred Stock (22,301 shares)	334	
	Warrants		
Cooper Natural Resources, Inc. (Industrial Products)	Loan	299	299
	Debt Securities	1,815	1,815
	Preferred Stock (6,316 shares)	1,427	1,427
	Warrants	832	832
Coverall North America, Inc. (Business Services)	Loan	10,418	10,418
	Debt Securities	5,740	5,740
CPM Acquisition Corporation (Industrial Products)	Loan	9,902	9,902
CTT Holdings (Consumer Products)	Loan	1,478	1,478
Cumulus Media, Inc. (1) (Broadcasting & Cable)	Common Stock (11,037 shares)	198	152
Drilltec Patents & Technologies Company, Inc. (Industrial Products)	Loan	10,918	348
	Debt Securities	1,500	1,500
	Warrants		
eCentury Capital Partners, L.P.(4) (Private Equity Fund)	Limited Partnership Interest	1,875	1,691
El Dorado Communications, Inc. (Broadcasting & Cable)	Loans	306	306
Elexis Beta GmbH(3) (Industrial Products)	Options	426	426
Eparfin S.A.(3) (Consumer Products)	Loan	29	29
E-Talk Corporation	Debt Securities	8,852	1,000

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(Business Services)	Warrants	1,157	
Executive Greetings, Inc. (Business Services)	Debt Securities	17,327	17,327
	Warrants	360	360
ExTerra Credit Recovery, Inc. (Business Services)	Preferred Stock (500 shares)	568	103
	Common Stock (2,500 shares)		
	Warrants		

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Private Finance Portfolio Company (in thousands, except number of shares)	Investment(2)	June 30, 2002	
		(unaudited)	
		Cost	Value
Fairchild Industrial Products Company (Industrial Products)	Debt Securities Warrants	\$ 5,906 280	\$ 5,906 1,100
Galaxy American Communications, LLC (Broadcasting & Cable)	Debt Securities Options Standby Letter of Credit (\$750)	48,433	34,010
Garden Ridge Corporation (Retail)	Debt Securities Preferred Stock (1,130 shares) Common Stock (188,400 shares)	27,070 1,130 613	27,070 1,130 613
GC-Sun Holdings II, LP (Kar Products, LP) (Business Services)	Loans	8,167	8,167
Ginsey Industries, Inc. (Consumer Products)	Loans Convertible Debentures Warrants	5,000 500	5,000 500 1,500
Global Communications, LLC (Business Services)	Loan Debt Securities Equity Interest Options	1,997 15,262 11,067 1,639	1,997 15,262 11,067 1,639
Grant Broadcasting Systems II (Broadcasting & Cable)	Warrants	87	3,000
Grotech Partners, VI, L.P.(4) (Private Equity Fund)	Limited Partnership Interest	1,832	1,398
The Hartz Mountain Corporation (Consumer Products)	Debt Securities Common Stock (200,000 shares) Warrants	27,544 2,000 2,613	27,544 2,000 2,613
Hotelevision, Inc. (Broadcasting & Cable)	Preferred Stock (315,100 shares)	315	315
Icon International, Inc. (Business Services)	Common Stock (35,228 shares)	1,219	2,712
Impact Innovations Group, LLC (Business Services)	Debt Securities Warrants	6,727 1,674	3,436
Intellirisk Management Corporation (Business Services)	Loans	22,796	22,796
Interline Brands, Inc. (Business Services)	Debt Securities Preferred Stock (199,313 shares)	33,431 1,849	33,431 1,849

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	Common Stock (15,615 shares)	139	139
	Warrants	1,181	1,181
<hr/>			
Jakel, Inc. (Industrial Products)	Loan	23,307	16,047
<hr/>			

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

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

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		June 30, 2002	
Private Finance Portfolio Company (in thousands, except number of shares)	Investment(2)	(unaudited)	
		Cost	Value
JRI Industries, Inc. (Industrial Products)	Debt Securities Warrants	\$ 1,981 74	\$ 1,981 74
Julius Koch USA, Inc. (Industrial Products)	Debt Securities Warrants	453 259	453 8,000
Kirker Enterprises, Inc. (Industrial Products)	Warrants Equity Interest	348 4	3,501 4
Kirkland's, Inc. (Retail)	Debt Securities Preferred Stock (917 shares) Warrants	6,387 412 96	6,387 412 5,816
Kyrus Corporation (Business Services)	Debt Securities Warrants	7,380 348	7,380 348
Love Funding Corporation (Financial Services)	Preferred Stock (26,000 shares)	359	213
Matrics, Inc. (Business Services)	Preferred Stock (511,876 shares) Warrants	500	500
MedAssets.com, Inc. (Business Services)	Debt Securities Preferred Stock (260,417 shares) Warrants	15,363 2,049 136	15,363 2,049 136
Mid-Atlantic Venture Fund IV, L.P.(4) (Private Equity Fund)	Limited Partnership Interest	2,475	1,479
Midview Associates, L.P. (Housing)	Warrants		
Most Coniferie GmbH & Co KG(3) (Consumer Products)	Loan	950	50
NetCare, AG(3) (Business Services)	Loan Common Stock (262,784 shares)	760 230	50
NETtel Communications, Inc. (Telecommunications)	Debt Securities and Receivables	11,334	4,334
Northeast Broadcasting Group, L.P. (Broadcasting & Cable)	Debt Securities	289	289
Novak Biddle Venture Partners III, L.P.(4) (Private Equity Fund)	Limited Partnership Interest	420	420
Nursefinders, Inc.	Debt Securities	11,151	11,151

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(Business Services)	Warrants	900	3,060
Onyx Television GmbH(3) (Broadcasting & Cable)	Preferred Units (120,000 shares)	201	8

(1) Public company.

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(3) Non-U.S. company.

(4) Non-registered investment company.

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

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		June 30, 2002	
Private Finance Portfolio Company (in thousands, except number of shares)	Investment(2)	(unaudited)	
		Cost	Value
Opinion Research Corporation(1) (Business Services)	Debt Securities	\$ 14,269	\$ 14,269
	Warrants	996	881
Oriental Trading Company, Inc. (Consumer Products)	Debt Securities	12,920	12,920
	Preferred Equity Interest	1,500	1,500
	Common Equity Interest		2,000
	Warrants	13	2,300
Outsource Partners, Inc. (Business Services)	Debt Securities	24,048	24,048
	Warrants	826	826
Pico Products, Inc. (Industrial Products)	Loan	1,406	1,406
Polaris Pool Systems, Inc. (Consumer Products)	Debt Securities	10,630	10,630
	Warrants	1,145	1,145
Powell Plant Farms, Inc. (Consumer Products)	Loan	19,095	14,087
Proeducation GmbH(3) (Education)	Loan	321	321
Prosperco Finanz Holding AG(3) (Financial Services)	Convertible Debentures	5,492	5,492
	Common Stock (1,528 shares)	1,059	1,059
	Warrants		
Raytheon Aerospace, LLC (Business Services)	Debt Securities	5,130	5,130
	Equity Interest		
Schwinn Holdings Corporation (Consumer Products)	Debt Securities	10,195	1,835
Seasonal Expressions, Inc. (Consumer Products)	Preferred Stock (504 shares)	500	
Simula, Inc.(1) (Industrial Products)	Loan	20,539	20,539
Soff-Cut Holdings, Inc. (Industrial Products)	Debt Securities	8,807	8,807
	Preferred Stock (300 shares)	300	300
	Common Stock (2,000 shares)	200	200
Southwest PCS, LLC (Telecommunications)	Loan	6,059	6,059
Startec Global Communications Corporation(1)	Loan	23,815	23,815
	Debt Securities	21,432	245

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(Telecommunications)	Common Stock (258,064 shares) Warrants	3,000	
SunStates Refrigerated Services, Inc. (Warehouse Facilities)	Loans Debt Securities	6,062 2,445	4,188

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		June 30, 2002		
Private Finance Portfolio Company (in thousands, except number of shares)		Investment(2)	(unaudited) Cost Value	
Sydran Food Services II, L.P.	(Retail)	Debt Securities	\$ 12,973	\$ 12,973
		Equity Interests	3,909	3,909
		Warrants		
Tubbs Snowshoe	Company, LLC (Consumer Products)	Debt Securities	3,920	3,920
		Equity Interests	500	500
		Warrants	54	54
United Pet Group, Inc.	(Consumer Products)	Debt Securities	8,987	8,987
		Warrants	85	85
Udata Venture Partners, II, L.P.(4)	(Private Equity Fund)	Limited Partnership Interest	2	1,492
Velocita, Inc.	(Telecommunications)	Debt Securities	11,718	
		Warrants	3,540	
Venturehouse Group, LLC(4)	(Private Equity Fund)	Equity Interest	667	380
Walker Investment Fund II, LLLP(4)	(Private Equity Fund)	Limited Partnership Interest	1,200	943
Warn Industries, Inc.	(Consumer Products)	Debt Securities	11,513	11,513
		Warrants	1,429	3,129
Williams Brothers Lumber	Company (Retail)	Warrants	24	100
Wilshire Restaurant Group, Inc.	(Retail)	Debt Securities	15,630	15,630
		Warrants	735	735
Wilton Industries, Inc.	(Consumer Products)	Loan	12,000	12,000
Woodstream Corporation	(Consumer Products)	Loan	2,621	2,621
		Debt Securities	7,653	7,653
		Equity Interests	1,700	4,547
		Warrants	450	1,203
Total companies less than 5% owned \$832,665 \$738,008				
Total private finance (133 portfolio companies) \$1,581,012 \$1,635,259				

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(in thousands, except number of loans)	Stated Interest	Face	June 30, 2002 (unaudited)	
			Cost	Value
Commercial Real Estate Finance				
Commercial Mortgage-Backed Securities				
CMBS Bonds				
Mortgage Capital Funding, Series 1998-MC3	5.5%	\$ 54,491	\$ 27,330	\$ 27,344
Morgan Stanley Capital I, Series 1999-RM1	6.4%	51,046	21,553	21,395
COMM 1999-1	5.6%	74,879	36,316	36,409
Morgan Stanley Capital I, Series 1999-FNV1	6.1%	37,752	16,811	16,804
DLJ Commercial Mortgage Trust 1999-CG2	6.1%	83,210	36,674	36,783
Commercial Mortgage Acceptance Corp., Series 1999-C1	6.8%	34,856	16,301	16,340
LB Commercial Mortgage Trust, Series 1999-C2	6.7%	29,005	11,576	12,188
Chase Commercial Mortgage Securities Corp., Series 1999-2	6.5%	37,430	16,579	17,426
FUNB CMT, Series 1999-C4	6.5%	43,372	18,259	18,865
Heller Financial, HFCMC Series 2000 PH-1	6.8%	45,456	18,516	19,319
SBMS VII, Inc., Series 2000-NL1	7.2%	20,804	10,764	11,309
DLJ Commercial Mortgage Trust, Series 2000-CF1	7.0%	38,685	18,345	19,030
Deutsche Bank Alex. Brown, Series Comm 2000-C1	6.9%	39,379	17,523	18,722
LB-UBS Commercial Mortgage Trust, Series 2000-C4	6.9%	34,967	12,617	14,000
Credit Suisse First Boston Mortgage Securities Corp., Series 2001-CK1	5.9%	43,288	18,139	19,741
JP Morgan-CIBC-Deutsche 2001	5.8%	46,326	19,788	20,430
Lehman Brothers-UBS Warburg 2001-C4	6.4%	49,582	21,989	24,069
SBMS VII, Inc., Series 2001-C1	6.1%	41,109	16,017	16,774
GE Capital Commercial Mortgage Securities Corp., Series 2001-2	6.1%	45,218	19,947	20,699
Credit Suisse First Boston Mortgage Securities Corp., Series 2001-CKN5	5.2%	59,602	28,245	29,518
JP Morgan Chase Commercial Mortgage Securities Corp., Series 2001-C1	5.6%	42,747	16,142	16,881
SBMS VII, Inc., Series 2001-C2	6.2%	47,353	22,043	24,180
FUNB CMT, Series 2002-C1	6.0%	38,238	16,592	17,630
GE Capital Commercial Mortgage Corp., Series 2002-1	6.2%	80,490	44,316	48,976
GMAC Commercial Mortgage Securities, Inc., Series 2002-C2	5.8%	62,704	34,643	36,058
Total CMBS bonds		\$ 1,181,989	\$ 537,025	\$ 560,890
Collateralized Debt Obligations				
Crest 2001-1, Ltd.(3)		24,023	24,023	24,023
Crest 2002-1, Ltd.(3)		23,541	23,541	23,541
Crest 2002-IG, Ltd.(3)		4,969	4,969	4,969
Total collateralized debt obligations		\$ 52,533	\$ 52,533	\$ 52,533
Total CMBS		\$ 1,234,522	\$ 589,558	\$ 613,423

Interest Rate Ranges	Number of Loans	Cost	Value
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Commercial Mortgage Loans

	Up to 6.99%	9	\$ 8,108	\$ 9,122
	7.00%- 8.99%	19	21,252	20,555
	9.00%-10.99%	10	9,879	9,879
	11.00%-12.99%	10	14,746	14,540
	13.00%-14.99%	6	7,856	7,856
	15.00% and above	1	49	49
<hr/>				
	Total commercial mortgage loans	55	\$61,890	\$62,001
<hr/>				
Residual Interest			\$69,341	\$69,042
Real Estate Owned				
3,451	1,244			
<hr/>				
Total commercial real estate finance				
\$724,240	\$745,710			
<hr/>				
Total portfolio				
\$2,305,252	\$2,380,969			
<hr/>				

(3) Non-U.S. company.

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

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENT OF INVESTMENTS

Private Finance Portfolio Company (in thousands, except number of shares)	Investment(2)	December 31, 2001	
		Cost	Value
Companies More Than 25% Owned			
<hr/>			
Acme Paging, L.P.			
Debt			
Securities \$6,992	\$6,992		
(Telecommunications)			
Equity			
Interests 3,640	2,184		
<hr/>			
American Healthcare Services,			
Debt			
Securities 40,194	40,194		
Inc.			
Common Stock (79,567,042			
shares) 1,000	100		
(Healthcare)			
Guaranty (\$195)			
<hr/>			
Business Loan Express, Inc.			
Loan 6,000	6,000		
(Financial Services)			
Debt			
Securities 76,242	76,242		
Preferred Stock (25,111			
shares) 25,111	25,111		
Common Stock (25,503,043			
shares) 104,596	120,096		
Guaranty (\$51,350	See		
Note 3)			
<hr/>			
The Color Factory Inc.			
Loan 5,346	5,346		
(Consumer Products)			
Preferred Stock (600			
shares) 788	788	Common	
Stock (980			
shares) 6,535	8,035		
<hr/>			
Directory Investment			
Corporation			
Common Stock (470			
shares) 112	32		
(Publishing)			

Directory Lending Corporation
Series A Common Stock (34
shares)
(Publishing)
Series B Common Stock (6
shares) 8 Series C
Common Stock (10
shares) 22

EDM Consulting, LLC
Debt Securities 1,875 443
(Business Services)
Equity Interest 250

Elmhurst Consulting, LLC
Loan 7,762 7,762
(Business Services)
Equity
Interests 5,157 5,157
Guaranty (\$2,800)

Foresite Towers, LLC
Equity
Interests 15,500 15,500
(Tower Leasing)

HealthASPex, Inc.
Preferred Stock (1,451,380
shares) 4,900 3,900
(Business Services)
Preferred Stock (611,923
shares) 612 612 Common
Stock (1,451,380 shares) 4

The Hillman Companies, Inc.
Debt
Securities 40,071 40,071
(Consumer Products)
Common Stock (6,890,937
shares) 57,156 57,156

HMT, Inc.
Debt
Securities 8,995 8,995
(Business Services)
Common Stock (300,000
shares) 3,000 3,000
Warrants 1,155 1,155

Monitoring Solutions, Inc.
Debt Securities 1,823 153
(Business Services)
Common Stock (33,333

shares) Warrants

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Private Finance Portfolio Company (in thousands, except number of shares)		Investment(2)	December 31, 2001	
			Cost	Value
Spa Lending Corporation (Recreation)		Preferred Stock (28,625 shares)	\$ 485	\$ 375
		Common Stock (6,208 shares)	25	18
STS Operating, Inc. (Industrial Products)		Common Stock (3,000,000 shares)	3,177	3,177
Sure-Tel, Inc. (Consumer Services)		Loan	1,207	1,207
		Preferred Stock (1,116,902 shares)	4,642	4,642
		Warrants	662	662
		Options		
Total Foam, Inc. (Industrial Products)		Debt Securities	263	127
		Common Stock (910 shares)	10	
WyoTech Acquisition Corporation (Education)		Debt Securities	12,588	12,588
		Preferred Stock (100 shares)	3,700	3,700
		Common Stock (99 shares)	100	44,100

**Total companies more than
25%
owned \$451,705 \$505,620**

**Companies 5% to 25%
Owned**

Aspen Pet Products, Inc.
Loans \$14,576 \$14,576
(Consumer Products)
Preferred Stock (1,860
shares) 1,981 1,981
Common Stock (1,400
shares) 140 140

Autania AG(1,3)
Debt
Securities 4,762 4,762
(Industrial Products)
Common Stock (250,000
shares) 2,261 2,261

Colibri Holding Corporation
Loans 3,464 3,464
(Consumer Products)
Preferred Stock (237
shares) 237 237 Common
Stock (3,362
shares) 1,250 1,250
Warrants 290 290

CorrFlex Graphics, LLC

Debt
Securities 2,312 2,312
(Business Services)
Warrants 6,674
Options 576

Csabai Canning Factory Rt(3)

Hungarian Quotas
(9.2%) 700
(Consumer Products)

CyberRep

Loan 1,109 1,109
(Business Services)
Debt
Securities 14,209 14,209
Warrants 660 3,310

The Debt Exchange Inc.

Preferred Stock (921,829
shares) 1,250 1,250
(Business Services)

FTI Consulting, Inc.(1)

Warrants 510
(Business Services)

Gibson Guitar Corporation

Debt
Securities 17,175 17,175
(Consumer Products)
Warrants 525 2,325

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Private Finance Portfolio Company (in thousands, except number of shares)		Investment(2)	December 31, 2001	
			Cost	Value
International Fiber Corporation (Industrial Products)		Debt Securities	\$22,257	\$22,257
		Common Stock (1,029,068 shares)	5,483	6,982
		Warrants	550	700
Liberty-Pittsburgh Systems, Inc. (Business Services)		Debt Securities	3,487	3,487
		Common Stock (123,929 shares)	142	142
Logic Bay Corporation (Business Services)		Preferred Stock (1,131,222 shares)	5,000	5,000
Magna Card, Inc. (Consumer Products)		Debt Securities	153	153
		Preferred Stock (1,875 shares)	94	94
		Common Stock (4,687 shares)		
Master Plan, Inc. (Business Services)		Loan	1,204	1,204
		Common Stock (156 shares)	42	2,042
MortgageRamp.com, Inc. (Business Services)		Common Stock (772,000 shares)	3,860	3,860
Morton Grove Pharmaceuticals, Inc. (Consumer Products)		Loan	16,150	16,150
		Preferred Stock (106,947 shares)	5,000	9,000
Nobel Learning Communities, Inc.(1) (Education)		Debt Securities	9,656	9,656
		Preferred Stock (265,957 shares)	2,000	2,000
		Warrants	575	575
North American Archery, LLC (Consumer Products)		Loans	1,390	840
		Convertible Debentures	2,248	2,008
		Guaranty (\$270)		
Packaging Advantage Corporation (Business Services)		Debt Securities	11,586	11,586
		Common Stock (200,000 shares)	2,000	2,000
		Warrants	963	963
Professional Paint, Inc. (Consumer Products)		Debt Securities	21,409	21,409
		Preferred Stock (15,000 shares)	17,215	17,215
		Common Stock (110,000 shares)	69	3,069
Progressive International Corporation (Consumer Products)		Debt Securities	3,958	3,958
		Preferred Stock (500 shares)	500	500
		Common Stock (197 shares)	13	13
		Warrants		
Staffing Partners Holding Company, Inc. (Business Services)		Debt Securities	4,992	4,992
		Preferred Stock (414,600 shares)	2,073	2,073
		Common Stock (50,200 shares)	50	50
		Warrants	10	10

**Total companies 5% to
25%
owned \$211,030 \$232,399**

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Private Finance Portfolio Company (in thousands, except number of shares)	Investment(2)	December 31, 2001	
		Cost	Value
Companies Less Than 5% Owned			
<hr/>			
Ability One Corporation Loans \$10,657 \$10,657 (Consumer Products)			
<hr/>			
ACE Products, Inc. Loans 16,875 16,875 (Industrial Products)			
<hr/>			
Advantage Mayer, Inc. Debt Securities 10,945 10,945 (Business Services) Warrants			
<hr/>			
Allied Office Products, Inc. Debt Securities 7,491 7,491 (Business Services) Warrants 629 629			
<hr/>			
American Barbecue & Grill, Inc. Warrants 125 (Retail)			
<hr/>			
American Home Care Supply, LLC Debt Securities 6,906 6,906 (Consumer Products) Warrants 579 1,579			
<hr/>			
ASW Holding Corporation Warrants 25 25 (Industrial Products)			
<hr/>			
Aurora Communications, LLC Loans 15,809 15,809 (Broadcasting & Cable) Equity Interest 2,461 6,050			
<hr/>			
Avborne, Inc.			

Debt
Securities 12,750 6,375
(Business Services)
Warrants 1,180

Bakery Chef, Inc.
Loans 17,018 17,018
(Consumer Products)

Blue Rhino Corporation(1)
Debt
Securities 13,816 13,816
(Consumer Products)
Warrants 1,200 2,000

Border Foods, Inc.
Debt
Securities 9,313 9,313
(Consumer Products)
Preferred Stock (50,919
shares) 2,000 2,000
Warrants 665 665

Camden Partners Strategic
Fund II, L.P.(4)
Limited Partnership
Interest 1,295 1,295
(Private Equity Fund)

CampGroup, LLC
Debt
Securities 2,702 2,702
(Recreation)
Warrants 220 220

Candlewood Hotel
Company(1)
Preferred Stock (3,250
shares) 3,250 3,250
(Hospitality)

Celebrities, Inc.
Loan 244 244
(Broadcasting & Cable)
Warrants 12 550

Classic Vacation Group,
Inc.(1)
Loan 6,399 6,399
(Consumer Products)

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Private Finance Portfolio Company (in thousands, except number of shares)	Investment(2)	December 31, 2001	
		Cost	Value
Component Hardware Group, Inc. (Industrial Products)	Debt Securities	\$ 10,774	\$ 10,774
	Preferred Stock (18,000 shares)	1,800	1,800
	Common Stock (2,000 shares)	200	200
Convenience Corporation of America (Retail)	Debt Securities	8,355	2,738
	Preferred Stock (22,301 shares)	334	
	Warrants		
Cooper Natural Resources, Inc. (Industrial Products)	Debt Securities	1,750	1,750
	Preferred Stock (6,316 shares)	1,427	1,427
	Warrants	832	832
Coverall North America, Inc. (Business Services)	Loan	10,309	10,309
	Debt Securities	5,324	5,324
	Warrants		
CPM Acquisition Corporation (Industrial Products)	Loan	9,604	9,604
CTT Holdings (Consumer Products)	Loan	1,388	1,388
Drilltec Patents & Technologies Company, Inc. (Industrial Products)	Loan	10,918	9,262
	Debt Securities	1,500	1,500
	Warrants		
eCentury Capital Partners, L.P.(4) (Private Equity Fund)	Limited Partnership Interest	1,875	1,800
El Dorado Communications, Inc. (Broadcasting & Cable)	Loans	306	306
Elexis Beta GmbH(3) (Industrial Products)	Options	426	526
Eparfin S.A.(3) (Consumer Products)	Loan	29	29
E-Talk Corporation (Business Services)	Debt Securities	8,852	6,509
	Warrants	1,157	
Ex Terra Credit Recovery, Inc. (Business Services)	Preferred Stock (500 shares)	568	318
	Common Stock (2,500 shares)		
	Warrants		
Executive Greetings, Inc. (Business Services)	Debt Securities	15,938	15,938
	Warrants	360	360
Fairchild Industrial Products Company	Debt Securities	5,872	5,872
	Warrants	280	2,378

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(Industrial Products)

Galaxy American Communications, LLC (Broadcasting & Cable)	Debt Securities Options Standby Letter of Credit (\$750)	48,869	39,217
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Private Finance Portfolio Company (in thousands, except number of shares)	Investment(2)	December 31, 2001	
		Cost	Value
Garden Ridge Corporation (Retail)	Debt Securities	\$26,948	\$26,948
	Preferred Stock (1,130 shares)	1,130	1,130
	Common Stock (471 shares)	613	613
Ginsey Industries, Inc. (Consumer Products)	Loans	5,000	5,000
	Convertible Debentures	500	500
	Warrants		504
Global Communications, LLC (Business Services)	Loan	1,990	1,990
	Debt Securities	14,884	14,884
	Equity Interest	11,067	11,067
	Options	1,639	1,639
Grant Broadcasting Systems II (Broadcasting & Cable)	Warrants	87	5,976
Grant Television II LLC (Broadcasting & Cable)	Options	492	492
Grotech Partners, VI, L.P.(4) (Private Equity Fund)	Limited Partnership Interest	1,463	1,060
The Hartz Mountain Corporation (Consumer Products)	Debt Securities	27,408	27,408
	Common Stock (200,000 shares)	2,000	2,000
	Warrants	2,613	2,613
Hotelevision, Inc. (Broadcasting & Cable)	Preferred Stock (315,100 shares)	315	315
Icon International, Inc. (Business Services)	Common Stock (37,821 shares)	1,219	1,519
Impact Innovations Group, LLC (Business Services)	Debt Securities	6,598	6,598
	Warrants	1,674	1,674
Intellirisk Management Corporation (Business Services)	Loans	22,334	22,334
Interline Brands, Inc. (Business Services)	Debt Securities	32,839	32,839
	Warrants	3,169	3,169
iSolve Incorporated (Business Services)	Preferred Stock (14,853 shares)	874	
	Common Stock (13,306 shares)	14	
Jakel, Inc. (Industrial Products)	Loan	22,291	22,291
JRI Industries, Inc. (Industrial Products)	Debt Securities	1,972	1,972
	Warrants	74	74

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Julius Koch USA, Inc. (Industrial Products)	Debt Securities Warrants	1,066 259	1,066 7,000
Kirker Enterprises, Inc. (Industrial Products)	Warrants Equity Interest	348 4	3,501 4

(1) Public company.

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

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Private Finance Portfolio Company (in thousands, except number of shares)	Investment(2)	December 31, 2001	
		Cost	Value
Kirkland's, Inc. (Retail)	Debt Securities	\$ 7,676	\$ 7,676
	Preferred Stock (917 shares)	412	412
	Warrants	96	96
Kyrus Corporation (Business Services)	Debt Securities	7,810	7,810
	Warrants	348	348
The Loewen Group, Inc.(1) (Consumer Services)	High-Yield Senior Secured Debt	15,150	12,440
Love Funding Corporation (Financial Services)	Preferred Stock (26,000 shares)	359	213
Matrics, Inc. (Business Services)	Preferred Stock (511,876 shares)	500	500
	Warrants		
MedAssets.com, Inc. (Business Services)	Debt Securities	14,949	14,949
	Preferred Stock (260,417 shares)	2,049	2,049
	Warrants	136	136
Mid-Atlantic Venture Fund IV, L.P.(4) (Private Equity Fund)	Limited Partnership Interest	2,475	1,586
Midview Associates, L.P. (Housing)	Warrants		
Most Coniferie GmbH & Co KG(3) (Consumer Products)	Loan	933	933
MVL Group, Inc. (Business Services)	Loan	1,856	1,856
	Debt Securities	14,806	14,806
	Warrants	643	643
	Guaranty (\$1,357)		
NetCare, AG(3) (Business Services)	Loan	811	811
NETtel Communications, Inc. (Telecommunications)	Debt Securities and Receivables	11,334	4,334
Northeast Broadcasting Group, L.P. (Broadcasting & Cable)	Debt Securities	310	310
Novak Biddle Venture Partners III, L.P.(4) (Private Equity Fund)	Limited Partnership Interest	330	330
Nursefinders, Inc. (Business Services)	Debt Securities	11,341	11,341
	Warrants	900	1,500
Onyx Television GmbH(3)	Preferred Units (120,000 shares)	201	201

(Broadcasting & Cable)

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

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

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Private Finance Portfolio Company (in thousands, except number of shares)	Investment(2)	December 31, 2001	
		Cost	Value
Opinion Research Corporation(1) (Business Services)	Debt Securities Warrants	\$ 14,186 996	\$ 14,186 996
Oriental Trading Company, Inc. (Consumer Products)	Debt Securities Preferred Equity Interest Common Equity Interest Warrants	12,847 1,500 13	12,847 1,500 588
Outsource Partners, Inc. (Business Services)	Debt Securities Warrants	23,994 826	23,994 826
Pico Products, Inc. (Industrial Products)	Loan	1,406	1,406
Polaris Pool Systems, Inc. (Consumer Products)	Debt Securities Warrants	6,581 1,050	6,581 1,050
Powell Plant Farms, Inc. (Consumer Products)	Loan	16,993	16,993
Proeducation GmbH(3) (Education)	Loan	206	206
Prosperco Finanz Holding AG(3) (Financial Services)	Convertible Debentures Common Stock (1,528 shares) Warrants	4,899 956	4,899 956
Raytheon Aerospace, LLC (Business Services)	Debt Securities Equity Interest	5,051	5,051
Redox Brands, Inc. (Consumer Products)	Debt Securities Warrants	9,462 584	9,462 584
Schwinn Holdings Corporation (Consumer Products)	Debt Securities	10,195	1,835
Seasonal Expressions, Inc. (Consumer Products)	Preferred Stock (504 shares)	500	
Simula, Inc.(1) (Industrial Products)	Loan	19,914	19,914
Soff-Cut Holdings, Inc. (Industrial Products)	Debt Securities Preferred Stock (300 shares) Common Stock (2,000 shares) Warrants	8,569 300 200 446	8,569 300 200 446
Southwest PCS, LLC (Telecommunications)	Loan	8,243	8,243

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Startec Global Communications Corporation(1) (Telecommunications)	Loan Debt Securities Common Stock (258,064 shares) Warrants	22,815 21,286 3,000	22,815 10,301
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(1) Public company.

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

(3) Non-U.S. company.

(4) Non-registered investment company.

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

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Private Finance Portfolio Company (in thousands, except number of shares)		Investment(2)	December 31, 2001	
			Cost	Value
SunStates Refrigerated Services, Inc. (Warehouse Facilities)		Loans	\$ 6,062	\$ 4,573
		Debt Securities	2,445	877
Sydran Food Services II, L.P. (Retail)		Debt Securities	12,973	12,973
		Equity Interests	3,909	3,909
		Warrants		
Tubbs Snowshoe Company, LLC (Consumer Products)		Debt Securities	3,913	3,913
		Equity Interests	500	500
		Warrants	54	54
United Pet Group, Inc. (Consumer Products)		Debt Securities	4,965	4,965
		Warrants	15	15
Updata Venture Partners, II, L.P.(4) (Private Equity Fund)		Limited Partnership Interest	2,300	3,865
Velocita, Inc.(1) (Telecommunications)		Debt Securities	11,677	11,677
		Warrants	3,540	3,540
Venturehouse Group, LLC(4) (Private Equity Fund)		Equity Interest	667	398
Walker Investment Fund II, LLLP(4) (Private Equity Fund)		Limited Partnership Interest	1,000	743
Warn Industries, Inc. (Consumer Products)		Debt Securities	18,624	18,624
		Warrants	1,429	3,129
Williams Brothers Lumber Company (Retail)		Warrants	24	322
Wilshire Restaurant Group, Inc. (Retail)		Debt Securities	15,106	15,106
		Warrants	735	735
Wilton Industries, Inc. (Consumer Products)		Loan	12,000	12,000
Woodstream Corporation (Consumer Products)		Loan	572	572
		Debt Securities	7,631	7,631
		Equity Interests	1,700	4,547
		Warrants	450	1,203

**Total companies less than 5%
owned \$891,231 \$857,053**

**Total private finance (135
portfolio**

companies) \$1,553,966 \$1,595,072

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

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

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(in thousands, except number of loans)	Stated Interest	Face	December 31, 2001	
			Cost	Value
Commercial Real Estate Finance				
Commercial Mortgage-Backed Securities				
CMBS Bonds				
Mortgage Capital Funding, Series 1998-MC3	5.5%	\$ 54,491	\$ 26,888	\$ 26,888
Morgan Stanley Capital I, Series 1999-RM1	6.4%	51,046	21,462	21,462
COMM 1999-1	5.6%	74,879	35,636	35,636
Morgan Stanley Capital I, Series 1999-FNV1	6.1%	45,527	22,272	22,272
DLJ Commercial Mortgage Trust 1999-CG2	6.1%	96,432	44,732	44,732
Commercial Mortgage Acceptance Corp., Series 1999-C1	6.8%	34,856	16,304	16,304
LB Commercial Mortgage Trust, Series 1999-C2	6.7%	29,005	11,326	11,326
Chase Commercial Mortgage Securities Corp., Series 1999-2	6.5%	43,046	20,535	20,535
FUNB CMT, Series 1999-C4	6.5%	49,287	22,253	22,253
Heller Financial, HFCMC Series 2000 PH-1	6.8%	45,456	18,657	18,657
SBMS VII, Inc., Series 2000-NL1	7.2%	24,230	13,309	13,309
DLJ Commercial Mortgage Trust, Series 2000-CF1	7.0%	40,502	19,481	19,481
Deutsche Bank Alex. Brown, Series Comm 2000-C1	6.9%	41,084	19,418	19,418
LB-UBS Commercial Mortgage Trust, Series 2000-C4	6.9%	31,471	11,455	11,455
Credit Suisse First Boston Mortgage Securities Corp., Series 2001-CK1	5.9%	58,786	29,050	29,050
JP Morgan-CIBC-Deutsche 2001	5.8%	60,889	29,584	29,584
Lehman Brothers-UBS Warburg 2001-C4	6.4%	65,130	32,326	32,326
SBMS VII, Inc., Series 2001-C1	6.1%	54,780	25,267	25,267
GE Capital Commercial Mortgage Securities Corp., Series 2001-2	6.1%	57,039	28,103	28,103
Credit Suisse First Boston Mortgage Securities Corp., Series 2001-CKN5	5.2%	84,482	46,176	46,176
JP Morgan Chase Commercial Mortgage Securities Corp., Series 2001-C1	5.6%	55,432	24,075	24,075
SBMS VII, Inc., Series 2001-C2	6.2%	72,422	40,037	40,037
Total CMBS bonds		1,170,272	558,346	558,346
Collateralized Debt Obligations				
Crest 2001-1, Ltd.(3)		24,207	24,207	24,207
Total CMBS		\$ 1,194,479	\$ 582,553	\$ 582,553

Commercial Mortgage Loans	Interest	Number of Loans	Cost	Value
	Rate Ranges			
	Up to 6.99%	7	\$ 3,404	\$ 5,100
	7.00%- 8.99%	30	34,583	36,589
	9.00%-10.99%	16	13,617	13,618
	11.00%-12.99%	14	11,977	11,979
	13.00%-14.99%	7	12,455	12,251

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15.00% and above 2 84 60

	Total commercial mortgage loans	76	\$76,120	\$79,597
Residual Interest			\$70,179	\$69,879
Real Estate Owned				
	3,784 2,489			
Total commercial real estate finance				
	\$732,636 \$734,518			
Total portfolio				
	\$2,286,602 \$2,329,590			

(3) Non-U.S. company.

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

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Information at June 30, 2002 and 2001 and for the three and six months ended June 30, 2002 and 2001 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. In April 2001, ACC established a subsidiary, A.C. Corporation (AC Corp), which provides diligence and structuring services on private finance and commercial real estate 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 hereinafter 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 primarily in private companies in a variety of industries and non-investment grade commercial mortgage-backed securities (CMBS).

Note 2. Summary of Significant Accounting Policies

Basis of Presentation

The consolidated financial statements include the accounts of the Company and its subsidiaries. All intercompany accounts and transactions have been eliminated in consolidation. Certain reclassifications have been made to the 2001 balances to conform with the 2002 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, the interim financial information does 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 statements of the Company included herein contain all adjustments (consisting of only normal recurring accruals) necessary to present fairly the financial position of the Company as of June 30, 2002 and December 31, 2001 and the results of operations for the three and six months ended June 30, 2002 and 2001, and changes in net assets and cash flows for the six months ended June 30, 2002 and 2001. The results of operations for the three and six months ended June 30, 2002 are not necessarily indicative of the operating results to be expected for

the full year.

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 2. Summary of Significant Accounting Policies, continued

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

Valuation of Portfolio Investments

The Company, as a BDC, invests primarily in illiquid securities including debt and equity securities of private companies and non-investment grade CMBS. 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 establishing 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. Conversely, the Company will record unrealized appreciation if it believes that the underlying portfolio company has appreciated in value and the Company’s equity security has also appreciated in value, where appropriate. The value of investments in public securities are determined using quoted market prices discounted for restrictions on resale.

Loans and Debt Securities

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

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

Interest income is recorded on an accrual basis to the extent that such amounts are expected to be collected. For loans and debt securities with contractual payment-in-kind interest, which represents contractual interest accrued and added to the loan balance that generally becomes due at maturity,

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 2. Summary of Significant Accounting Policies, continued

the Company will not accrue payment-in-kind interest if the portfolio company valuation indicates that the payment-in-kind interest is not collectible. Loans classified as Grade 4 or Grade 5 assets do not accrue interest. Loan origination fees, original issue discount and market discount are capitalized and then amortized into interest income using the effective interest method. Prepayment premiums are recorded on loans when received.

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

Equity Securities

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

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

Dividend income is recorded on cumulative 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)

CMBS are carried at fair value, which is based upon a discounted cash flow model that utilizes prepayment and loss assumptions based upon historical experience and projected performance, economic factors and the characteristics of the underlying cash flow. The Company's assumption with regard to discount rate is based upon the yield of comparable securities. The Company recognizes income from the amortization of original issue discount using the effective interest method, using the anticipated yield over the projected life of the investment. Yields are revised when there are changes in estimates of future credit losses, actual losses incurred, or actual and estimated prepayment speeds. Changes in estimated yield are recognized as an adjustment to the estimated yield over the remaining life of the CMBS from the date the estimated yield is changed. The Company recognizes unrealized appreciation or depreciation on its CMBS, as comparable yields in the market change and/or whenever it determines that the value of its CMBS is less than the cost basis due to impairment in the underlying collateral pool.

Residual Interest

The Company values its residual interest from a previous securitization and recognizes income using the same accounting policies used for the CMBS. The residual interest is carried at fair value based on discounted estimated

future cash flows. The Company recognizes income from the residual

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 2. Summary of Significant Accounting Policies, continued

interest using the effective interest method. At each reporting date, the effective yield is recalculated and used to recognize income until the next reporting date.

Net Realized and Unrealized Gains or Losses

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

Fee Income

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

Deferred Financing Costs

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

Derivative Financial Instruments

The Company may or may not use derivative financial instruments to reduce interest rate risk. The Company has established policies and procedures for risk assessment and the approval, reporting and monitoring of derivative financial instrument activities. The Company does not hold or issue derivative financial instruments for trading purposes. All derivative financial instruments are recorded at fair value with changes in value reflected in net unrealized gains or losses during the reporting period.

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.

Dividends to Shareholders

Dividends to shareholders are recorded on the record date.

Stock Compensation Plans

The Company applies the intrinsic value-based method of accounting prescribed by Accounting Principles Board (APB) Opinion No. 25, Accounting for Stock Issued to Employees, and related interpretations to account for its stock compensation plans. Under this method, the Company records compensation expense for awards of stock options to employees only if the market price of the stock on the grant date exceeds the amount the employee is required to pay to acquire the stock.

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 2. Summary of Significant Accounting Policies, continued

Federal and State Income Taxes

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

Per Share Information

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

Use of Estimates in the Preparation of Financial Statements

The preparation of financial statements in conformity with GAAP 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 investments at value of \$2,380,969,000 and \$2,329,590,000 as of June 30 2002 and December 31, 2001, respectively, (93% and 95%, respectively, of total assets). Substantially all of these investments represent investments whose fair values have been determined by the board of directors in good faith in the absence of readily ascertainable market values. Because of the inherent uncertainty of valuation, the board of directors estimated 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.

Note 3. Portfolio

Private Finance

At June 30, 2002 and December 31, 2001, the private finance portfolio consisted of the following:

	2002			2001		
	Cost	Value	Yield	Cost	Value	Yield
(\$ in thousands)						
Loans and debt securities	\$ 1,183,308	\$ 1,050,752	13.9%	\$ 1,169,673	\$ 1,107,890	14.8%
Equity interests	397,704	584,507	384,293	487,182		

Total
\$1,581,012 \$1,635,259 \$1,553,966 \$1,595,072

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

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 3. Portfolio, continued

privately-owned companies and are generally illiquid and subject to restrictions on resale or transferability.

Loans and debt securities generally have a maturity of five to ten years, with interest-only payments in the early years and payments of both principal and interest in the later years, although debt maturities and principal amortization schedules vary. At June 30, 2002 and December 31, 2001, approximately 97% and 98%, respectively, of the Company's private finance loan portfolio was composed of fixed interest rate loans.

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 gain on sale.

At June 30, 2002 and December 31, 2001, the Company had an investment at value totaling \$251,920,000 and \$227,449,000, respectively, in Business Loan Express, Inc. (BLX), a small business lender that participates in the SBA Section 7(a) Guaranteed Loan Program. The Company owns 94.9% of BLX's common stock. As the controlling shareholder 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 3-year unsecured revolving credit facility for \$124,000,000. The amount guaranteed by the Company at June 30, 2002 was \$48,100,000. This guaranty can be called by the lenders only in the event of a default by BLX. BLX was in compliance with the terms of its credit facility at June 30, 2002. In consideration for providing this guaranty, BLX will pay the Company an annual guaranty fee of approximately \$3,100,000 in 2002. BLX is headquartered in New York, NY. The Company has also provided two standby letters of credit in connection with two term securitization transactions completed by BLX in the second quarter of 2002 totaling \$10,550,000.

At June 30, 2002 and December 31, 2001, the Company had an investment in The Hillman Companies, Inc. (formerly SunSource, Inc.) totaling \$131,012,000 and \$97,227,000 at value, respectively. The Company owns 93.2% of Hillman's common stock. 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's primary operations are located in Cincinnati, Ohio.

At June 30, 2002 and December 31, 2001, the Company had an investment in WyoTech Acquisition Corporation at value totaling \$77,008,000 and \$60,388,000, respectively. The Company owned 91.35% of WyoTech's common stock. WyoTech is a proprietary trade school and its primary operations are in Laramie, Wyoming. WyoTech was sold on July 1, 2002. See Note 13 for the subsequent event.

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 3. Portfolio, continued

At June 30, 2002 and December 31, 2001, Grade 4 and 5 loans and debt securities that were not accruing interest at value were as follows:

(in thousands)	2002	2001
Companies more than 25% owned	\$721	\$930
Companies 5% to 25% owned		
899 2,848		
Companies less than 5% owned		
103,562 89,966		
<hr/>		
\$105,182 \$93,744		
<hr/>		
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Included in Grade 4 and 5 loans and debt securities not accruing interest were assets valued at \$8.9 million at June 30, 2002 and December 31, 2001 that represented receivables related to companies in liquidation. In addition to Grade 4 and 5 assets that are in workout, we may not accrue interest on loans to companies that are more than 50% owned by the Company if such companies are in need of additional capital and, therefore, the Company may defer current debt service. Loans and debt securities to such companies totaled \$61,331,000 at value at June 30, 2002.

The industry and geographic compositions of the private finance portfolio at value at June 30, 2002 and December 31, 2001 were as follows:

Industry	2002	2001
Consumer products		
30% 28%		
Business services		
24 22		
Financial services		
16 15		
Industrial products		
10 10		
Retail		
5 5		
Education		
5 5		
Telecommunications		
3 4		

Broadcasting & cable

2 4

Other

5 7

Total

100% 100%

Geographic Region

Mid-Atlantic

42% 43%

West

20 19

Midwest

17 17

Southeast

14 14

Northeast

6 5

International

1 2

Total

100% 100%

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 3. Portfolio, continued

Commercial Real Estate Finance

At June 30, 2002 and December 31, 2001, the commercial real estate finance portfolio consisted of the following:

	2002			2001		
	Cost	Value	Yield	Cost	Value	Yield
(\$ in thousands)						
CMBS	\$589,558	\$613,423	14.8%	\$582,553	\$582,553	14.8%
Loans						
61,890 62,001 7.9% 76,120 79,597 7.7%						
Residual interest						
69,341 69,042 9.3% 70,179 69,879 9.4%						
Real estate owned						
3,451 1,244 3,784 2,489						
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Total	\$724,240	\$745,710		\$732,636	\$734,518	
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CMBS

At June 30, 2002 and December 31, 2001, the CMBS portfolio consisted of the following:

	2002			2001		
	Cost	Value	Yield	Cost	Value	Yield
(in thousands)						
CMBS bonds	\$537,025	\$560,890	14.6%	\$558,346	\$558,346	14.7%
Collateralized debt obligations						

52,533 52,533 17.2% 24,207 24,207 16.9%

Total
\$589,558 \$613,423 \$582,553 \$582,553

CMBS Bonds. At June 30, 2002 and December 31, 2001, the CMBS bonds, which were purchased from the original issuer, consisted of the following:

(\$ in thousands)	2002	2001
Face	\$ 1,181,989	\$ 1,170,272
Original issue discount (644,964) (611,926)		
Cost		
\$537,025 \$558,346		
Value		
\$560,890 \$558,346		
Yield		
14.6% 14.7%		

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 resulting in reduced cash flows, the Company's most subordinate tranche will bear this loss first. At June 30,

2002, the Company's CMBS bonds were subordinate to 92% to 97% of the tranches of bonds issued in various CMBS transactions. Given that the non-investment grade CMBS bonds in which the Company invests are junior in priority for payment of principal, the Company invests in these CMBS bonds at an approximate discount of 50% from the face amount of the bonds.

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 3. Portfolio, continued

The underlying rating classes of the CMBS bonds at value at June 30, 2002 and December 31, 2001 were as follows:

	2002		2001	
	Value	Percentage of Total	Value	Percentage of Total
(\$ in thousands)				
BB+	\$28,668	5.1%	\$24,785	4.4%
BB	40,701	7.3	69,404	12.4
BB-	33,452	6.0	67,460	12.1
B+	123,056	21.9	103,560	18.6
B	158,035	28.2	131,362	23.5
B-	79,664	14.2	73,572	13.2
CCC	9,119	1.6	8,893	1.6
Unrated	88,195	15.7	79,310	14.2
<hr/>				
<hr/>				
<hr/>				
<hr/>				
Total	\$560,890	100.0%	\$558,346	100.0%
<hr/>				
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At June 30, 2002 and December 31, 2001, the underlying pools of mortgage loans that are collateral for our CMBS bonds consisted of approximately 4,100 and 3,800 commercial mortgage loans with a total outstanding principal balance of \$22.9 billion and \$20.5 billion, respectively. At June 30, 2002 and December 31, 2001, 0.75% and 0.52%, respectively, of the mortgage loans in the underlying collateral pool for the Company's CMBS bonds were

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over 30 days delinquent or were classified as real estate owned. The property types and the geographic composition of the mortgage loans in the underlying collateral pool calculated using the outstanding principal balance at June 30, 2002 and December 31, 2001 were as follows:

	<u>2002</u>	<u>2001</u>
Property Type		
Retail		
31%	31%	
Housing		
27	27	
Office		
21	22	
Hospitality		
7	7	
Other		
14	13	
<hr/>		
<hr/>		
Total		
100%	100%	
<hr/>		
<hr/>		

Geographic Region

West		
31%	32%	
Mid-Atlantic		
25	24	
Midwest		
22	21	
Southeast		
17	17	
Northeast		
5	6	
<hr/>		
<hr/>		
Total		
100%	100%	
<hr/>		
<hr/>		

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 that are a result of the general condition of the real estate market

(including competition for tenants and their related credit quality) and changes in market rental rates. The initial yield on each CMBS bond has been computed assuming an approximate 1% loss rate on its entire underlying collateral mortgage pool, with the estimated losses being assumed to occur in three equal installments in years three, six and nine. As each CMBS bond ages, the amount of losses and the expected timing of recognition of such

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 3. Portfolio, continued

losses will be updated, and the respective yield will be adjusted as necessary. As these uncertainties and contingencies are difficult to predict and are subject to future events which may alter these assumptions, no assurance can be given that the anticipated yields to maturity will be achieved.

Collateralized Debt Obligations. At June 30, 2002, the Company owned preferred shares in three collateralized debt obligations (CDOs) secured by investment grade unsecured debt issued by various real estate investment trusts (REITs) and investment and non-investment grade CMBS bonds. The investment grade REIT debt collateral consists of \$852,826,000 issued by 39 REITs. The investment grade CMBS collateral consisted of bonds with a face amount of \$402,142,000 issued in 26 separate CMBS transactions. The non-investment grade CMBS collateral consists of BB+, BB and BB- CMBS bonds with a face amount of \$405,032,000 that were issued in 30 separate CMBS transactions (CMBS Collateral). Included in the CMBS Collateral for the CDOs are \$393,832,000 of CMBS bonds that are senior in priority of repayment to certain lower rated CMBS bonds held by the Company, which were issued in 22 separate CMBS transactions. The preferred shares are junior in priority for payment of 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 resulting in reduced cash flows, the preferred shares will bear this loss first. At June 30, 2002, the Company's preferred shares in the CDOs were subordinate to approximately 95% of the more senior tranches of debt issued by the CDOs. The yield on the CDOs at June 30, 2002 and December 31, 2001 was 17.2% and 16.9%, respectively.

The Company acts as the directing certificate holder for the CMBS bonds and as the disposition consultant with respect to two of the CDOs, which allows the Company to approve disposition plans for individual collateral securities. For these services with respect to the CDOs, the Company collects annual fees based on the outstanding collateral pool balance, and for the six months ended June 30, 2002, this fee totaled \$160,000.

Loans

The commercial mortgage loan portfolio contains loans that were originated by the Company or were purchased from third-party sellers.

At June 30, 2002 and December 31, 2001, approximately 75% and 25% and 76% and 24%, of the Company's commercial mortgage loan portfolio was composed of fixed and adjustable interest rate loans, respectively. As of June 30, 2002 and December 31, 2001, workout loans, or those loans in Grade 4 and 5, with a value of \$15,860,000 and \$15,241,000, respectively, were not accruing interest.

The property types and the geographic composition securing the commercial mortgage loan portfolio at value at June 30, 2002 and December 31, 2001 were as follows:

	<u>2002</u>	<u>2001</u>
Property Type		
Office		
28% 34%		
Hospitality		
28 25		

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Retail
24 21
Recreation
3 4
Other
17 16

Total
100% 100%

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 3. Portfolio, continued

Geographic Region

Southeast
40% 36%

Mid-Atlantic
17 23

West
23 20

Midwest
13 16

Northeast
7 5

Total
100% 100%

Residual Interest

At June 30, 2002 and December 31, 2001, the residual interest consisted of the following:

	2002		2001	
	Cost	Value	Cost	Value
(in thousands)				
Residual interest	\$68,853	\$68,853	\$68,853	\$68,853
Residual interest spread				
488 189 1,326 1,026				
<hr/>				
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<hr/>				
Total	\$69,341	\$69,042	\$70,179	\$69,879



The residual interest primarily consists of a retained interest totaling \$68,853,000 from a 1998 asset securitization whereby bonds were sold in three classes rated AAA, AA and A. The residual interest represents a right to cash flows from the underlying collateral pool of loans after these senior bond obligations are satisfied. At June 30, 2002, two classes of bonds rated AAA and AA+ are outstanding, for total bonds outstanding of \$29,600,000. The Company has the right to call the bonds when the outstanding bond balance is less than \$23,900,000. Once the bonds are fully repaid, either through the cash flows from the securitized loans or due to the Company calling the bonds, the remaining loans in the trust will be returned to the Company as payment on the residual interest.

The Company sold \$295 million of loans, and received cash proceeds, net of costs, of approximately \$223 million in January 1998. The Company retained a trust certificate for its residual interest in a loan pool sold, and will receive interest income from this residual interest as well as the residual interest spread (Residual) from the interest earned on the loans sold less the interest paid on the bonds over the life of the bonds. As of June 30, 2002 and December 31, 2001, the mortgage loan pool had an approximate weighted average stated interest rate of 9.3%. The outstanding bond classes sold had an aggregate weighted average interest rate of 6.7% and 6.6% as of June 30, 2002 and December 31, 2001, respectively.

The Company uses a discounted cash flow methodology for determining the value of its retained Residual. In determining the cash flow of the Residual, the Company assumes a prepayment speed of 15% after the applicable prepayment lockout period and credit losses of 1% or approximately \$1.1 million of the total principal balance of the underlying collateral throughout the life of the collateral. These assumptions result in an expected weighted average life of the bonds of 0.5 years. The value of the resulting Residual cash flows is then determined by applying a discount rate of 9% which, in the Company's view, is commensurate with the market risk of comparable assets.

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 4. Debt

The Company records debt at cost. At June 30, 2002 and December 31, 2001, the Company had the following debt:

	2002		2001	
	Facility Amount	Amount Drawn	Facility Amount	Amount Drawn
(in thousands)				
Notes payable and debentures:				
Unsecured long-term notes payable	\$694,000	\$694,000	\$694,000	\$694,000
SBA debentures	101,800	94,500	101,800	94,500
Auction rate reset note	75,000	75,000	81,856	81,856
OPIC loan	5,700	5,700	5,700	5,700
<hr/>				
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Total notes payable and debentures	876,500	869,200	883,356	876,056
<hr/>				
<hr/>				
<hr/>				
<hr/>				
Revolving line of credit	527,500	139,750	497,500	144,750
<hr/>				
<hr/>				
<hr/>				
<hr/>				
Total				

\$1,404,000 \$1,008,950 \$1,380,856 \$1,020,806

Notes Payable and Debentures

Unsecured Long-Term Notes Payable. The Company issued unsecured long-term notes to private institutional investors. The notes require semi-annual interest payments until maturity and have original terms of five or seven years. At June 30, 2002, the notes had remaining maturities of one to four years. The weighted average fixed interest rate on the notes was 7.6% at June 30, 2002 and December 31, 2001. The notes may be prepaid in whole or in part, together with an interest premium, as stipulated in the note agreement.

SBA Debentures. At June 30, 2002 and December 31, 2001, the Company had debentures payable to the SBA with terms of ten years and at fixed interest rates ranging from 5.9% to 8.2% and 2.4% to 8.2%, respectively. At June 30, 2002, the debentures had remaining maturities of three to ten years. The weighted average interest rate was 7.0% and 6.7% at June 30, 2002 and December 31, 2001, respectively. 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 maturity. At June 30, 2002, the Company has a commitment from the SBA to borrow up to an additional \$7,300,000 above the amount outstanding. The commitment expires on September 30, 2005.

Auction Rate Reset Note. The Company has an Auction Rate Reset Senior Note Series A that matures on December 2, 2002, and bears interest at the three-month London Interbank Offered Rate (LIBOR) plus 1.75%, which adjusts quarterly. Interest is due quarterly and the Company, at its option, may pay or defer such interest payments. The amount outstanding on the note will increase as interest due is deferred. Deferred interest may be repaid at any time without penalties.

As a means to repay the note, the Company has entered into an agreement with the placement agent of this note to serve as the placement agent on a future issuance of \$75.0 million of debt, equity or other securities in one or more public or private transactions. Alternatively, the Company may repay the note in cash without conducting a capital raise. If the Company chooses to pay in cash without conducting a capital raise, the Company will incur additional expense of approximately \$2,063,000.

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 4. Debt, continued

Scheduled future maturities of notes payable and debentures at June 30, 2002, are as follows:

Year	Amount Maturing (in thousands)
2002	\$75,000
2003	
140,000	
2004	
221,000	
2005	
179,000	
2006	
180,700	
Thereafter	
73,500	
<hr/>	
Total	
\$869,200	

Revolving Line of Credit

The Company has an unsecured revolving line of credit for \$527,500,000. The facility may be expanded up to \$600,000,000 at the Company's option. The facility bears interest at a rate equal to (i) the one-month LIBOR plus 1.25% or (ii) the higher of (a) the Bank of America, N.A. prime rate or (b) the Federal Funds rate plus 0.50%. The interest rate adjusts at the beginning of each new interest period, usually every thirty days. The interest rates were 4.1% and 3.2% at June 30, 2002 and December 31, 2001, respectively, and the facility requires an annual commitment fee equal to 0.25% of the committed amount. The line expires in August 2003, and may be extended under substantially similar terms for one additional year at the Company's sole option. The line of credit requires monthly interest payments and all principal is due upon its expiration.

The average debt outstanding on the revolving line of credit was \$67,710,000 and \$106,338,000 for the six months ended June 30, 2002 and for the year ended December 31, 2001, respectively. The maximum amount borrowed under this facility and the weighted average interest rate for the six months ended June 30, 2002 and for the year ended December 31, 2001, were \$145,250,000 and \$213,500,000, and 3.2% and 5.4%, respectively.

The Company has various financial and operating covenants required by the revolving line of credit and the notes payable and debentures. These covenants require the Company to maintain certain financial ratios, including debt to equity and interest coverage, and a minimum net worth. The Company's credit facilities limit its ability to declare dividends if the Company defaults under certain provisions. As of June 30, 2002, the Company was in compliance with these covenants.

Note 5. Preferred Stock

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

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 6. Shareholders Equity

Sales of common stock for the six months ended June 30, 2002, and the year ended December 31, 2001 were as follows:

(in thousands)	<u>2002</u>	<u>2001</u>
Number of common shares	1,946	13,286
Gross proceeds		
\$51,800 \$301,539		
Less costs including underwriting fees		
(1,880) (14,651)		
<hr/>		
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Net proceeds		
\$49,920 \$286,888		
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In addition, the Company issued 204,855 shares of common stock with a value of \$5,157,000 to acquire one portfolio investment in a stock-for-stock exchange during 2001.

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

Dividend reinvestment plan activity for the six months ended June 30, 2002 and for the year ended December 31, 2001 was as follows:

(in thousands, except per share amounts)	<u>2002</u>	<u>2001</u>
Shares issued	128	271
Average price per share		
\$24.34 \$23.32		

Note 7. Earnings Per Common Share

Earnings per common share for the three and six months ended June 30, 2002 and 2001 were as follows:

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	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2002	2001	2002	2001
(in thousands, except per share amounts)				
Net increase in net assets resulting from operations	\$73,454	\$46,106	\$129,415	\$98,134
Less preferred stock dividends				
(55) (55) (110) (110)				
<hr/>				
<hr/>				
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Income available to common shareholders				
\$73,399 \$46,051 \$129,305 \$98,024				
<hr/>				
<hr/>				
<hr/>				
<hr/>				
Basic shares outstanding				
101,660 89,356 100,822 87,441				
Dilutive options outstanding to officers				
1,780 1,492 2,078 1,525				
<hr/>				
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<hr/>				
<hr/>				
Diluted shares outstanding				
103,440 90,848 102,900 88,966				
<hr/>				
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<hr/>				
<hr/>				
Basic earnings per common share				
\$0.72 \$0.52 \$1.28 \$1.12				
<hr/>				
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Diluted earnings per common share
\$0.71 \$0.51 \$1.26 \$1.10

Note 8. Dividends and Distributions

The Company's Board of Directors declared and the Company paid dividends of \$0.53 and \$0.55 per common share for the first and second quarters of 2002, respectively. The dividends totaled \$56,223,000 and \$109,482,000 for the three and six months ended June 30, 2002, respectively. The

Obligations to replenish borrowed Treasury securities as of June 30, 2002 and December 31, 2001 were \$84,789,000 and \$47,263,000, respectively, and are recorded as other liabilities. As of June 30, 2002, the total obligations on the hedge had increased since the original sale date due to changes in the yield on the borrowed Treasury securities, resulting in unrealized depreciation on the obligations of \$2,161,000. The net proceeds related to the sales of the borrowed Treasury securities of \$82,628,000 and \$48,504,000 have been recorded as an other asset at June 30, 2002 and December 31, 2001, respectively.

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 11. Financial Highlights

	At and for the Six Months Ended						At and for the Years Ended December 31,					
	June 30,						2002(2001)2001 2000 1999 1998 1997					
Per Common Share Data												
Net asset value, beginning of period	\$13.57	\$12.11	\$12.11	\$10.20	\$8.79	\$8.07	\$8.34					
Net investment income before income tax benefit (expense) and net realized and unrealized gains(1)	0.94	0.92	1.92	1.53	1.18	1.06	0.94					
Income tax benefit (expense)(1)		0.01		(0.01)	(0.03)							
Net realized and unrealized gains(1)	0.32	0.18	0.23	0.41	0.46	0.45	0.36					
Minority interests(1)					(0.03)							

Net increase in net assets resulting from operations

1.26 1.10 2.16 1.94 1.64 1.50 1.24

Net decrease in net assets from shareholder distributions(2)

(1.08) (0.99) (2.01) (1.82) (1.60) (1.43) (1.71)

Net increase in net assets from capital share transactions

0.27 0.57 1.31 1.79 1.37 0.65 0.20

Net asset value, end of period

\$14.02 \$12.79 \$13.57 \$12.11 \$10.20 \$8.79 \$8.07

Market value, end of period

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\$22.65 \$23.15 \$26.00 \$20.88 \$18.31 \$17.31 \$22.25

Total return

(9.18)% 15.56% 35.43% 25.47% 14.99% (15.74)% 77.76%

Ratios and Supplemental Data (\$ and shares in thousands, except per share amounts)

Ending net assets

\$1,434,453 \$1,171,661 \$1,352,123 \$1,029,692 \$667,513 \$491,358 \$420,060

Common shares outstanding at end of period(3)

102,296 91,578 99,607 85,057 65,414 55,919 52,047

Diluted weighted average shares outstanding

102,900 88,966 93,003 73,472 60,044 51,974 49,251

Employee and administrative expenses/ average net assets

1.74% 1.85% 3.80% 4.98% 6.25% 7.09% 4.66%

Total expenses/average net assets(4)

4.26% 4.79% 9.31% 11.88% 12.44% 11.86% 12.43%

Net investment income/ average net assets(4)

6.94% 7.54% 15.15% 13.55% 12.61% 12.72% 11.15%

Portfolio turnover rate

8.33% 6.27% 10.04% 28.92% 34.19% 63.53% 42.72%

Average debt outstanding

\$940,357 \$812,500 \$847,121 \$707,400 \$461,500 \$261,300 \$336,800

Average debt per share

\$9.14 \$9.13 \$9.11 \$9.63 \$7.69 \$5.03 \$6.84