ALLIED CAPITAL CORP
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PROSPECTUS SUPPLEMENT
(To Prospectus dated June 22, 2006)

$1,000,000,000

This prospectus supplement supplements the prospectus dated June 22, 2006, relating to our offer, from time to time, of up to $1,000,000,000 in aggregate principal amount in one or more classes or series of debt securities, including notes, debentures, medium-term notes, commercial paper, retail notes or similar obligations evidencing indebtedness in one or more offerings, by providing certain information regarding our recent developments and our second quarter 2006 financial results. As of the date of this prospectus supplement, we have issued debt securities totaling $400,000,000 of the $1,000,000,000 of debt securities.

Please read this prospectus supplement, and the accompanying prospectus, before investing, and keep it for future reference. The prospectus supplement and the accompanying prospectus contain important information about us that a prospective investor should know before investing in our common stock. We file annual, quarterly and current reports, proxy statements and other information about us with the Securities and Exchange Commission. This information is available free of charge by contacting us at 1919 Pennsylvania Avenue, NW, Washington, DC, 20006, or by telephone at (202) 721-6100 or on our website at www.alliedcapital.com. The SEC also maintains a website at www.sec.gov that contains such information.

You should review the information, including the risk of leverage, set forth under Risk Factors on page 9 of the accompanying prospectus before investing.

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

The date of this prospectus supplement is August 15, 2006

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

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ABOUT THIS PROSPECTUS

This prospectus is part of a registration statement that we have filed with the Securities and Exchange Commission using the shelf registration process. Under the shelf registration process, which constitutes a delayed offering in reliance on Rule 415 under the Securities Act of 1933, as amended, we may offer, from time to time, up to $1,000,000,000 in aggregate principal amount of debt securities on the terms to be determined at the time of the offering. The debt securities may be offered at prices and on terms described in one or more supplements to this prospectus. This prospectus provides you with a general description of the debt securities that we may offer. Each time we use this prospectus to offer debt securities, we will provide a prospectus supplement and, if applicable, a pricing supplement that will contain specific information about the terms of that offering. Please carefully read this prospectus and any such supplements together with the additional information described under Where You Can Find Additional Information in the Prospectus Summary and Risk Factors sections before you make an investment decision.

A prospectus supplement and, if applicable, a pricing supplement may also add, update or change information contained in this prospectus.

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

The following analysis of the financial condition and results of operations of the Company should be read in conjunction with the Company s Consolidated Financial Statements and the Notes thereto included herein and in the Company s annual report on Form 10-K for the year ended December 31, 2005. In addition, this quarterly report on Form 10-Q contains certain forward-looking statements. These statements include the plans and objectives of management for future operations and financial objectives and can be identified by the use of forward-looking terminology such as may, will, expect, intend, anticipate, estimate, or continue or the negative thereof or o variations thereon or comparable terminology. These forward-looking statements are subject to the inherent uncertainties in predicting future results and conditions. Certain factors that could cause actual results and conditions to differ materially from those projected in these forward-looking statements are set forth below in the Risk Factors section. Other factors that could cause actual results to differ materially include:

changes in the economy and general economic conditions;

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

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

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

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

OVERVIEW

As a business development company, we are in the private equity business. Specifically, we provide long-term debt and equity investment capital to companies in a variety of industries. Our lending and investment activity has generally been focused on private finance and commercial real estate finance, which included primarily the investment in non-investment grade commercial mortgage-backed securities, which we refer to as CMBS, and collateralized debt obligation bonds and preferred shares, which we refer to as CDOs.

On May 3, 2005, we completed the sale of our portfolio of CMBS and real estate related CDO investments. Upon the completion of this transaction, our lending and investment activity has been focused primarily on private finance investments. Our private finance activity principally involves providing financing to middle market U.S. companies through privately negotiated long-term debt and equity investment capital. Our financing is generally used to fund growth, acquisitions, buyouts, recapitalizations, note purchases, bridge financings, and other types of financings. We generally invest in private companies though, from time to time, we may invest in companies that are public but lack access to additional public capital. Our investment objective is to achieve current income and capital gains.

Our portfolio composition at June 30, 2006 and 2005, and at December 31, 2005, was as follows:

	June 30,		December 31,
	2006	2005	2005
Private finance	96%	95%	96%
Commercial real estate finance	4%	5%	4%

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

Because we are a regulated investment company for tax purposes, we intend to distribute substantially all of our annual taxable income as dividends to our shareholders. See Other Matters below.

PORTFOLIO AND INVESTMENT ACTIVITY

The total portfolio at value, investment activity, and the yield on interest-bearing investments at and for the three and six months ended June 30, 2006 and 2005, and at and for the year ended December 31, 2005, were as follows:

	At and for the Three Months Ended June 30,		At and for the Six Months Ended June 30,		At and for the Year Ended December 31,
($ in millions)	2006	2005	2006	2005	2005
Portfolio at value	$3,593.5	$2,714.3	$3,593.5	$2,714.3	$3,606.4
Investments funded[1]	$ 453.4	$ 389.3	$1,251.2	$ 654.9	$1,675.8
Change in accrued or reinvested interest and dividends[2]	$ (7.0)	$ (14.1)	$ (9.1)	$ (3.6)	$ 6.6
Principal collections related to investment repayments or sales	$ 429.2	$ 932.6	$ 769.6	$1,090.8	$1,503.4
Yield on interest-bearing investments[3]	12.6%	13.2%	12.6%	13.2%	12.8%

(1) Investments funded for the six months ended June 30, 2006, included a $150 million subordinated debt investment in Advantage Sales & Marketing, Inc. received in conjunction with the sale of Advantage and a $30 million subordinated debt investment in STS Operating, Inc. received in conjunction with the sale of STS. See discussion below.

(2)

Includes changes in accrued or reinvested interest of $0.6 million and $1.7 million for the three and six months ended June 30, 2006, respectively, related to our investments in money market securities.

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

Private Finance

The private finance portfolio at value, investment activity, and the yield on loans and debt securities at and for the three and six months ended June 30, 2006 and 2005, and at and for the year ended December 31, 2005, were as follows:

	At and for the Three Months Ended June 30,				At and for the Six Months Ended June 30,				At and for the Year Ended December 31,	
	2006		2005		2006		2005		2005	
($ in millions)	Value	Yield[(2)]	Value	Yield[(2)]	Value	Yield[(2)]	Value	Yield[(2)]	Value	Yield[(2)]
Portfolio at value:										
Loans and debt securities:										
Senior loans	$ 275.9	9.5%	$ 203.3	10.0%	$ 275.9	9.5%	$ 203.3	10.0%	$ 239.8	9.5%
Unitranche debt	515.0	10.7%	67.3	13.3%	515.0	10.7%	67.3	13.3%	294.2	11.4%
Subordinated debt	1,700.3	13.9%	1,362.4	14.2%	1,700.3	13.9%	1,362.4	14.2%	1,560.9	13.8%
Total loans and debt securities	$2,491.2	12.7%	$1,633.0	13.7%	$2,491.2	12.7%	$1,633.0	13.7%	$2,094.9	13.0%
Equity securities	969.2		937.5		969.2		937.5		1,384.4	
Total portfolio	$3,460.4		$2,570.5		$3,460.4		$2,570.5		$3,479.3	
Investments funded[(1)]	$ 441.5		$ 298.0		$1,237.3		$ 466.3		$1,462.3	
Change in accrued or reinvested interest and dividends	$ (7.1)		$ 6.5		$ (11.3)		$ 14.4		$ 24.6	
Principal collections related to investment repayments or sales	$ 415.7		$ 178.8		$ 752.4		$ 330.0		$ 703.9	

(1)

Investments funded for the six months ended June 30, 2006, included a $150 million subordinated debt investment in Advantage Sales & Marketing, Inc. received in conjunction with the sale of Advantage and a $30 million subordinated debt investment in STS Operating, Inc. received in conjunction with the sale of STS. See discussion below.

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

Our investment activity is focused on making long-term investments in the debt and equity of primarily private middle market companies. Debt investments may include senior loans, unitranche debt (a single debt investment that is a blend of senior and subordinated debt), or subordinated debt (with or without equity features). The junior debt that we invest in that is lower in repayment priority than senior debt is also known as mezzanine debt. Equity investments may include a minority equity stake in connection with a debt investment or a substantial equity stake in connection with a buyout transaction. In a buyout transaction, we generally invest in senior and/or subordinated debt and equity (preferred and/or voting or non-voting common) where our equity ownership represents a significant portion of the equity, but may or may not represent a controlling interest.

In addition, we may fund most or all of the debt and equity capital upon the closing of certain buyout transactions, which may include investments in lower-yielding senior debt. Subsequent to the closing, the portfolio company may refinance all or a portion of the lower-yielding senior debt, which would reduce our investment. Senior loans at June 30, 2006, included approximately $30.1 million of senior loans that are currently in the process of being refinanced. Repayments include repayments of senior debt funded by us that was subsequently refinanced or repaid by the portfolio companies.

We intend to take a balanced approach to private equity investing that emphasizes a complementary mix of debt investments and buyout investments. The combination of these two types of investments provides current interest and related portfolio income and the potential for future capital gains. To address the current market, our strategy is to focus on buyout and recapitalization transactions where we can manage risk through the structure and terms of our debt and equity investments and where we can potentially realize more attractive total returns from both current interest and fee income and future capital gains. We are also focusing our debt investing on smaller middle market companies where we can provide both senior and subordinated debt or unitranche debt, where our combined current yield may be lower than traditional subordinated debt only. We believe that providing both senior and subordinated debt or unitranche debt provides us with greater protection in the capital structures of our portfolio companies.

Investments Funded. Investments funded and the weighted average yield on investments funded for the six months ended June 30, 2006 and 2005, and for the year ended December 31, 2005, consisted of the following:

	For the Six Months Ended June 30, 2006					
	Debt Investments		Buyout Investments		Total	
($ in millions)	**Amount**	**Weighted Average Yield[1]**	**Amount**	**Weighted Average Yield[1]**	**Amount**	**Weighted Average Yield[1]**
Loans and debt securities:						
Senior loans[4]	$149.4	9.3%	$121.6	8.8%	$ 271.0	9.1%
Unitranche debt[2]	255.9	10.6%			255.9	10.6%
Subordinated debt[3]	374.8	13.0%	189.1	13.7%	563.9	13.2%
Total loans and debt securities	780.1	11.5%	310.7	11.8%	1,090.8	11.5%
Equity	54.6		91.9		146.5	
Total	$834.7		$402.6		$1,237.3	

	For the Six Months Ended June 30, 2005					
	Debt Investments		Buyout Investments		Total	
($ in millions)	**Amount**	**Weighted Average Yield[1]**	**Amount**	**Weighted Average Yield[1]**	**Amount**	**Weighted Average Yield[1]**
Loans and debt securities:						
Senior loans	$ 19.5	12.1%	$ 77.7	5.9%	$ 97.2	7.1%
Unitranche debt[2]	59.2	10.8%			59.2	10.8%
Subordinated debt	140.0	12.9%	110.6	13.2%	250.6	13.0%
Total loans and debt securities	218.7	12.3%	188.3	10.2%	407.0	11.3%
Equity	15.5		43.8		59.3	
Total	$234.2		$232.1		$466.3	

(1) The weighted average yield on interest-bearing investments is computed as the (a) annual stated interest on accruing interest-bearing investments, divided by (b) total interest-bearing investments funded.

(2) Unitranche debt is a single debt investment that is a blend of senior and subordinated debt terms. The yield on a unitranche investment reflects the blended yield of senior and subordinated debt combined.

(3) Debt investments for the six months ended June 30, 2006, included a $150 million, 12.0% subordinated debt investment in Advantage Sales & Marketing, Inc. received in conjunction with the sale of Advantage and a $30 million, 15.0% subordinated debt investment in STS Operating, Inc. received in conjunction with the sale of STS. See discussion below.

(4) Senior loans funded for the six months ended June 30, 2006, included $163.6 million that was repaid during the six months ended June 30, 2006.

	For the Year Ended December 31, 2005					
	Debt Investments		Buyout Investments		Total	
($ in millions)	Amount	Weighted Average Yield(1)	Amount	Weighted Average Yield(1)	Amount	Weighted Average Yield(1)
Loans and debt securities:						
Senior loans(3)	$ 76.8	10.0%	$250.2	6.4%	$ 327.0	7.2%
Unitranche debt(2)	259.5	10.5%			259.5	10.5%
Subordinated debt	296.9	12.3%	330.9	12.5%	627.8	12.4%
Total loans and debt securities	633.2	11.3%	581.1	9.9%	1,214.3	10.6%
Equity	82.5		165.5		248.0	
Total	$715.7		$746.6		$1,462.3	

(1) The weighted average yield on interest-bearing investments is computed as the (a) annual stated interest on accruing interest-bearing investments, divided by (b) total interest-bearing investments funded.

(2) Unitranche debt is a single debt investment that is a blend of senior and subordinated debt terms. The yield on a unitranche investment reflects the blended yield of senior and subordinated debt combined.

(3) Buyout senior loans funded included $174.9 million that was repaid during the year.

In July 2006, we funded private finance investments totaling $274.8 million.

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

The level of investment activity for investments funded and principal repayments for private finance investments can vary substantially from period to period depending on the number and size of investments that we make or that we exit and many other factors, including the amount of debt and equity capital available to middle market companies, the level of merger and acquisition activity for such companies, the general economic environment, and the competitive environment for the types of investments we make. We believe that merger and acquisition activity in the middle market is strong, which has resulted in an increase in private finance investment opportunities, as well as increased repayments. We continue to have an active pipeline of new investments under consideration. We believe that merger and acquisition activity for middle market companies will remain strong for the remainder of 2006.

Through our wholly owned subsidiary, AC Finance LLC (AC Finance), we generally originate, underwrite and arrange senior loans. Senior loans originated and underwritten by AC Finance may or may not be funded by us at closing. When these senior loans are closed, we may fund all or a portion of the underwritten commitment pending sale of the loan to other investors, which may include loan sales to Callidus Capital Corporation (Callidus) or funds managed by Callidus, a portfolio company controlled by us. After completion of the sale process, we may or may not retain a position in these senior loans. AC Finance generally earns a fee on the senior loans originated and underwritten whether or not we fund the underwritten commitment.

Portfolio Yield. The weighted average yield on private finance loans and debt securities was 12.7% at June 30, 2006, as compared to 13.7% and 13.0% at June 30, 2005, and December 31, 2005, respectively. The weighted average yield on the private finance loans and debt securities may fluctuate from period to period depending on the yield on new loans and debt securities funded, the yield on loans and debt securities repaid, the amount of loans and debt securities for which interest is not accruing and the amount of lower-yielding senior or unitranche debt in the portfolio at the end of the period. The yield on the private finance portfolio has declined partly due to our strategy to pursue more buyout and recapitalization transactions, which may include investing in lower-yielding senior debt, and unitranche investments.

Outstanding Investment Commitments. At June 30, 2006, we had outstanding private finance investment commitments totaling $352.7 million, including the following:

$88.3 million in the form of revolving senior debt facilities to nineteen companies.

$50.7 million in the form of equity to fifteen private equity and venture capital funds.

$24.2 million in the form of debt to Promo Works, LLC.

$23.9 million in the form of debt to S.B. Restaurant Company.

$9.0 million in the form of debt to Integrity Interactive Corp.

$7.6 million in the form of debt to Carlisle Wide Plank Floors, Inc.

$6.5 million in co-investment commitments to Pine Creek Equity Partners, LLC.

We have various commitments to Callidus Capital Corporation (Callidus), which owns 80% (subject to dilution) of Callidus Capital Management, LLC, an asset management company that structures and manages collateralized debt obligations (CDOs), collateralized loan obligations (CLOs), and other related investments. Our commitment to Callidus consisted of the following at June 30, 2006:

($ in millions)	**Committed Amount**	**Amount Drawn**	**Amount Available to be Drawn**
Subordinated debt to support warehouse facilities & warehousing activities[1]	$36.0	$	$36.0
Revolving line of credit for working capital	4.0	1.6	2.4
Total	$40.0	$1.6	$38.4

(1) Callidus has a secured warehouse credit facility with a third party for up to $240 million. The facility is used primarily to finance the acquisition of loans pending securitization through a CDO or CLO. In conjunction with this warehouse credit facility, we have agreed to designate our $36 million subordinated debt commitment for Callidus to draw upon to provide first loss capital as needed to support the warehouse facility.

In addition, at June 30, 2006, we had a commitment to Callidus to purchase preferred equity in future CLO transactions of $77.0 million.

In addition to these outstanding investment commitments at June 30, 2006, we may be required to fund additional amounts under earn-out arrangements primarily related to buyout transactions in the future if those companies meet agreed-upon performance targets. We also had commitments to private finance portfolio companies in the form of standby letters of credit and guarantees totaling $194.7 million. See Financial Condition, Liquidity and Capital Resources.

Our largest investment at value at June 30, 2006, was in Business Loan Express, LLC (BLX) and our largest investments at value at December 31, 2005, were in Advantage Sales & Marketing, Inc. (Advantage) and BLX.

Business Loan Express, LLC. At June 30, 2006, our investment in BLX totaled $293.2 million at cost and $317.2 million at value, or 7.9% of our total assets, which includes unrealized appreciation of $24.0 million. We acquired BLX in 2000.

Total interest and related portfolio income earned from the Company s investment in BLX for the six months ended June 30, 2006 and 2005, was as follows:

($ in millions)	**2006**	**2005**
Interest income	$ 7.8	$ 6.9
Dividend income		5.0
Fees and other income	4.3	4.7
Total interest and related portfolio income	$12.1	$16.6

Interest income from BLX for the six months ended June 30, 2006 and 2005, included interest income of $3.7 million and $3.3 million, respectively, which was paid in kind. The interest paid in kind was paid to us through the issuance of additional Class A equity interests. Accrued interest and dividends receivable at June 30, 2006, included accrued interest due from BLX totaling $2.5 million, of which $2.1 million was paid in cash in July 2006.

Net change in unrealized appreciation or depreciation included a net decrease in unrealized appreciation on our investment in BLX of $33.6 million for the six months ended June 30, 2006, and a net increase in unrealized appreciation on our investment in BLX of $1.3 million for the six months ended June 30, 2005. See Results of Operations for a discussion of the net change in unrealized appreciation or depreciation related to this investment.

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

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

At December 31, 2005, BLX had a three-year $275.0 million revolving credit facility provided by third party lenders that was scheduled to mature in January 2007. As the controlling equity owner in BLX, we had provided an unconditional guaranty to the revolving credit facility lenders in an amount equal to 50% of the total obligations (consisting of principal, letters of credit issued under the facility, accrued interest, and other fees) of BLX under the revolving credit facility. At December 31, 2005, the principal amount of loans outstanding on the revolving credit facility was $228.2 million and letters of credit issued under the facility were $41.7 million. The total obligation guaranteed by us at December 31, 2005, was $135.4 million.

On March 17, 2006, BLX closed on a new three-year $500.0 million revolving credit facility that matures in March 2009, which replaced the existing facility. The revolving credit facility may be expanded through new or additional commitments up to $600.0 million at BLX s option. This new facility provides for a sub-facility for the issuance of letters of credit for up to an amount equal to 25% of the committed facility. We have provided an unconditional guaranty to these revolving credit facility lenders in an amount equal to 50% of the total obligations (consisting of principal, letters of credit issued under the facility, accrued interest, and other fees) of BLX under this facility. At June 30, 2006, the principal amount outstanding on the revolving credit facility was $238.7 million and letters of credit issued under the facility were $56.7 million. The total obligation guaranteed by us at June 30, 2006, was $149.2 million. This guaranty can be called by the lenders only in the event of a default under the BLX credit facility, which includes certain defaults under our revolving credit facility. BLX has determined it was in compliance with the terms of this facility at June 30, 2006.

At June 30, 2006, we had also provided four standby letters of credit totaling $32.0 million in connection with four term securitization transactions completed by BLX. In consideration for providing the revolving credit facility guaranty and the standby letters of credit, BLX paid us fees of $3.1 million and $3.2 million for the six months ended June 30, 2006 and 2005, respectively, which were included in fees and other income above.

Advantage Sales & Marketing, Inc. At December 31, 2005, our investment in Advantage totaled $257.7 million at cost and $660.4 million at value, or 16.4% of our total assets, which included unrealized appreciation of $402.7 million. We completed the purchase of a majority ownership in Advantage in June 2004.

On March 29, 2006, we sold our majority equity interest in Advantage. We were repaid our $184 million in subordinated debt outstanding and realized a gain on our equity investment sold of $433.7 million, subject to post-closing adjustments. As consideration for the common stock sold in the transaction, we received a $150 million subordinated note, with the balance of the consideration paid in cash. Approximately $34 million of our cash proceeds from the sale of the common stock were placed in escrow, subject to certain holdback provisions. In addition, there is potential for us to receive additional consideration through an earn-out payment that would be based on Advantage s 2006 audited results. Our realized gain of $433.7 million, subject to post-closing adjustments, excludes any earn-out amounts. For tax purposes, the receipt of the $150 million subordinated note as part of our consideration for the common stock sold will allow us, through installment treatment, to defer the recognition of taxable income for a portion of our realized gain until the note is collected. In connection with the transaction, we retained an equity investment in the business valued at $15 million at closing as a minority shareholder.

Total interest and related portfolio income earned from our investment in Advantage while we held a majority equity interest was $14.1 million for the six months ended June 30, 2006, which included a prepayment premium of $5.0 million, and $18.5 million for the six months ended June 30, 2005. In addition, we earned structuring fees of $2.3 million on our new $150 million subordinated debt investment in Advantage upon the closing of the sale transaction.

After the sale transaction, our investment in Advantage at June 30, 2006, which was composed of subordinated debt and a minority equity interest, totaled $152.1 million at cost and $165.1 million at value, which included unrealized appreciation of $13.0 million. Subsequent to the completion of the sale transaction, our interest income from our subordinated debt investment in Advantage for the three months ended June 30, 2006, was $4.6 million.

Advantage is a sales and marketing agency providing outsourced sales, merchandising, and marketing services to the consumer packaged goods industry. Advantage has offices across the United States and is headquartered in Irvine, CA.

Commercial Real Estate Finance

The commercial real estate finance portfolio at value, investment activity, and the yield on interest-bearing investments at and for the three and six months ended June 30, 2006 and 2005, and at and for the year ended December 31, 2005, were as follows:

	At and for the Three Months Ended June 30,				At and for the Six Months Ended June 30,				At and for the Year Ended December 31, 2005	
	2006		2005		2006		2005			
($ in millions)	Value	Yield[1]	Value	Yield[1]	Value	Yield[1]	Value	Yield[1]	Value	Yield[1]
Portfolio at value:										
Commercial mortgage loans	$ 96.5	8.1%	$116.1	6.7%	$ 96.5	8.1%	$116.1	6.7%	$102.6	7.6%
Real estate owned	14.6		16.6		14.6		16.6		13.9	
Equity interests	22.0		11.1		22.0		11.1		10.6	
Total portfolio	$133.1		$143.8		$133.1		$143.8		$127.1	
Investments funded	$ 11.9		$ 91.3		$ 13.9		$188.6		$213.5	
Change in accrued or reinvested interest	$ (0.5)		$ (20.6)		$ 0.5		$ (18.0)		$ (18.0)	
Principal collections related to investment repayments or sales[2]	$ 13.5		$753.8		$ 17.2		$760.8		$799.5	

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

(2) Principal collections related to investment repayments or sales for the year ended December 31, 2005, included $718.1 million related to the sale of our CMBS and CDO portfolio in May 2005.

Our commercial real estate investments funded for the six months ended June 30, 2006 and 2005, and for the year ended December 31, 2005, was as follows:

	Face	Amount

($ in millions)	Amount	Discount	Funded
For the Six Months Ended June 30, 2006			
Commercial mortgage loans	$ 7.4	$	$ 7.4
Equity interests	6.5		6.5
Total	$ 13.9	$	$ 13.9
For the Six Months Ended June 30, 2005			
CMBS bonds (4 new issuances)(1)	$211.5	$(90.5)	$121.0
Commercial mortgage loans	67.1	(0.9)	66.2
Equity interests	1.4		1.4
Total	$280.0	$(91.4)	$188.6
For the Year Ended December 31, 2005			
CMBS bonds (4 new issuances)(1)	$211.5	$(90.5)	$121.0
Commercial mortgage loans	88.5	(0.8)	87.7
Equity interests	4.8		4.8
Total	$304.8	$(91.3)	$213.5

(1) The CMBS bonds invested in during 2005 were sold on May 3, 2005.

At June 30, 2006, we had outstanding funding commitments related to commercial mortgage loans and equity interests of $9.4 million and commitments in the form of standby letters of credit and guarantees related to equity interests of $6.9 million.

Sale of CMBS Bonds and Collateralized Debt Obligation Bonds and Preferred Shares. On May 3, 2005, we completed the sale of our portfolio of commercial mortgage-backed securities (CMBS) and real estate related collateralized debt obligation (CDO) bonds and preferred shares to affiliates of Caisse de dépôt et placement du Québec (the Caisse) for cash proceeds of $976.0 million and a net realized gain of $227.7 million, after transaction and other costs of $7.8 million. Transaction costs included investment banking fees, legal and other professional fees, and other transaction costs. The CMBS and CDO assets sold had a cost basis at closing of $739.8 million, including accrued interest of $21.7 million. Upon the closing of the sale, we settled all the hedge positions relating to these assets, which resulted in a net realized loss of $0.7 million, which was included in the net realized gain on the sale.

Simultaneous with the sale of our CMBS and CDO portfolio, we entered into a platform assets purchase agreement with CWCapital Investments LLC, an affiliate of the Caisse (CWCapital), pursuant to which we agreed to sell certain commercial real estate related assets, including servicer advances, intellectual property, software and other platform assets, subject to certain adjustments. Under this agreement, we have agreed not to invest in CMBS and real estate-related CDOs and refrain from certain other real estate-related investing or servicing activities for a period of three years, or through May 2008, subject to certain limitations and excluding our existing portfolio and related activities.

The real estate securities purchase agreement, under which we sold the CMBS and CDO portfolio, and the platform asset purchase agreement contain customary representations and warranties, and require us to indemnify the affiliates of the Caisse that are parties to the agreements for certain liabilities arising under the agreements, subject to certain limitations and conditions.

Hedging Activities

We have invested in commercial mortgage loans, which were purchased at prices that were based in part on comparable Treasury rates. We have entered into transactions with one or more financial institutions to hedge against movement in Treasury rates on certain of these commercial mortgage loans. These transactions, referred to as short sales, involve receiving the proceeds from the short sales of borrowed Treasury securities, with the obligation to replenish the borrowed Treasury securities at a later date based on the then current market price, whatever that price may be. Risks in these contracts arise from movements in the value of the borrowed Treasury securities due to changes in interest rates and from the possible inability of counterparties to meet the terms of their contracts. If the value of the borrowed Treasury securities increases, we will incur losses on these transactions. These losses are limited to the increase in value of the borrowed Treasury securities; conversely, the value of the hedged commercial mortgage loans would likely increase. If the value of the borrowed Treasury securities decreases, we will incur gains on these transactions which are limited to the decline in value of the borrowed Treasury securities; conversely, the value of the hedged commercial mortgage loans would likely decrease. We do not anticipate nonperformance by any counterparty in connection with these transactions.

The total obligations to replenish borrowed Treasury securities, including accrued interest payable on the obligations, were $17.2 million and $17.7 million at June 30, 2006, and December 31, 2005, respectively. The net proceeds related to the sales of the borrowed Treasury securities plus or minus the additional cash collateral provided or received under the terms of the transactions were $17.2 million and $17.7 million at June 30, 2006, and December 31, 2005, respectively. The amount of the hedge will vary from period to period depending upon the amount of commercial mortgage loans that we own and have hedged as of the balance sheet date.

OTHER ASSETS

Other assets is composed primarily of fixed assets, assets held in deferred compensation trusts, deferred financing and offering costs, and accounts receivable, which includes amounts received in connection with the sale of portfolio companies, including amounts held in escrow, and other receivables from portfolio companies. At June 30, 2006, and December 31, 2005, other assets totaled $124.4 million and $87.9 million, respectively. The increase since year end was primarily the result of amounts received in connection with the sales of Advantage and STS Operating, Inc., that are being held in escrow. See Portfolio and Investment Activity Private Finance above.

PORTFOLIO ASSET QUALITY

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

At June 30, 2006, and December 31, 2005, our portfolio was graded as follows:

	2006		2005	
Grade	**Portfolio at Value**	**Percentage of Total Portfolio**	**Portfolio at Value**	**Percentage of Total Portfolio**
($ in millions)				
1	$1,241.2	34.5%	$1,643.0	45.6%
2	2,177.8	60.6	1,730.8	48.0
3	93.1	2.6	149.1	4.1
4	27.4	0.8	26.5	0.7
5	54.0	1.5	57.0	1.6
	$3,593.5	100.0%	$3,606.4	100.0%

The amount of the portfolio in each grading category may vary substantially from period to period resulting primarily from changes in the composition of the portfolio as a result of new investment, repayment, and exit activity, changes in the grade of investments to reflect our expectation of performance, and changes in investment values.

Total Grade 3, 4 and 5 portfolio assets were $174.5 million and $232.6 million, respectively, or were 4.9% and 6.4%, respectively, of the total portfolio at value at June 30, 2006, and December 31, 2005.

Grade 4 and 5 assets include loans, debt securities, and equity securities. We expect that a number of portfolio companies will be in the Grades 4 or 5 categories from time to time. Part of the private equity business is working with troubled portfolio companies to improve their businesses and protect our investment. The number of portfolio companies and related investment amount included in Grade 4 and 5 may fluctuate from period to period. We continue to follow our historical practice of working with such companies in order to recover the maximum amount of our investment.

Loans and Debt Securities on Non-Accrual Status. At June 30, 2006, and December 31, 2005, loans and debt securities at value not accruing interest for the total investment portfolio were as follows:

($ in millions)	2006	2005
Loans and debt securities in workout status (classified as Grade 4 or 5)[(1)]		
Private finance		
Companies more than 25% owned	$ 17.7	$ 15.6
Companies 5% to 25% owned	3.3	
Companies less than 5% owned	24.6	11.4
Commercial real estate finance	2.9	12.9
Loans and debt securities not in workout status		
Private finance		
Companies more than 25% owned	40.8	58.0
Companies 5% to 25% owned	6.6	0.5
Companies less than 5% owned	3.9	49.5
Commercial real estate finance	12.8	7.9
Total	$112.6	$155.8
Percentage of total portfolio	3.1%	4.3%

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

Loans and Debt Securities Over 90 Days Delinquent. Loans and debt securities greater than 90 days delinquent at value at June 30, 2006, and December 31, 2005, were as follows:

($ in millions)	2006	2005
Private finance	$ 47.2	$ 74.6
Commercial mortgage loans	3.7	6.1
Total	$ 50.9	$ 80.7
Percentage of total portfolio	1.4%	2.2%

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

As a result of these and other factors, the amount of the portfolio that is greater than 90 days delinquent or on non-accrual status may vary from period to period. Loans and debt securities on non-accrual status and over 90 days delinquent should not be added together as they are two separate measures of portfolio asset quality. Loans and debt securities that are in both categories (i.e., on non-accrual status and over 90 days delinquent) totaled $50.9 million and $60.7 million at June 30, 2006, and December 31, 2005, respectively.

PORTFOLIO RETURNS

Since our merger on December 31, 1997, through June 30, 2006, our combined aggregate cash flow Internal Rate of Return (IRR) has been approximately 22% for private finance and

CMBS/CDO investments exited during this period. The IRR is calculated using the aggregate portfolio cash flow for all investments exited over this period. For investments exited during this period, we invested capital totaling $3.7 billion. The weighted average holding period of these investments was 35 months. Investments are considered to be exited when the original investment objective has been achieved through the receipt of cash and/or non-cash consideration upon the repayment of our debt investment or sale of an equity investment, or through the determination that no further consideration was collectible and, thus, a loss may have been realized. The aggregate cash flow IRR for private finance investments was approximately 21% and for CMBS/CDO investments was approximately 24% for the same period. The weighted average holding period of the private finance and CMBS/CDO investments was 47 months and 22 months, respectively, for the same period. These IRR results represent historical results. Historical results are not necessarily indicative of future results.

RESULTS OF OPERATIONS

Comparison of Three and Six Months Ended June 30, 2006 and 2005

The following table summarizes the Company s operating results for the three and six months ended June 30, 2006 and 2005.

($ in thousands, except per share amounts)	For the Three Months Ended June 30, 2006 (unaudited)	For the Three Months Ended June 30, 2005 (unaudited)	Change	Percentage Change	For the Six Months Ended June 30, 2006 (unaudited)	For the Six Months Ended June 30, 2005 (unaudited)	Change	Percentage Change
Interest and Related Portfolio Income								
Interest and dividends	$ 95,433	$ 71,330	$ 24,103	34%	$ 184,314	$156,275	$ 28,039	18%
Loan prepayment premiums	1,745	853	892	105%	7,031	2,530	4,501	178%
Fees and other income	13,278	14,024	(746)	(5)%	30,122	22,321	7,801	35%
Total interest and related portfolio income	110,456	86,207	24,249	28%	221,467	181,126	40,341	22%
Expenses								
Interest	21,607	19,154	2,453	13%	45,907	39,379	6,528	17%
Employee	20,398	22,877	(2,479)	(11)%	41,826	38,333	3,493	9%
Stock options	4,597		4,597	100%	8,203		8,203	100%
Administrative	9,861	23,048	(13,187)	(57)%	21,380	43,802	(22,422)	(51)%
Total operating expenses	56,463	65,079	(8,616)	(13)%	117,316	121,514	(4,198)	(3)%
Net investment income before income taxes	53,993	21,128	32,865	156%	104,151	59,612	44,539	75%
Income tax expense, including excise tax	3,798	5,861	(2,063)	(35)%	12,656	5,593	7,063	126%
Net investment income	50,195	15,267	34,928	229%	91,495	54,019	37,476	69%

Net Realized and Unrealized Gains (Losses)								
Net realized gains	100,240	207,496	(107,256)	*	533,075	217,781	315,294	*
Net change in unrealized appreciation or depreciation	(116,706)	89,122	(205,828)	*	(491,254)	159,706	(650,960)	*
Total net gains	(16,466)	296,618	(313,084)	*	41,821	377,487	(335,666)	*
Net income	$ 33,729	$311,885	$(278,156)	(89)%	$ 133,316	$431,506	$(2 98,190)	(69)%
Diluted earnings per common share	$ 0.24	$ 2.29	$ (2.05)	(90)%	$ 0.94	$ 3.17	$ (2. 23)	(70)%
Weighted average common shares outstanding diluted	143,213	136,381	6,832	5%	142,466	135,982	6,484	5%

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

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

Interest and Dividends. Interest and dividend income for the three and six months ended June 30, 2006 and 2005, was composed of the following:

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
($ in millions)	**2006**	**2005**	**2006**	**2005**
Interest				
Private finance loans and debt securities	$88.6	$53.1	$171.2	$109.9
CMBS and CDO portfolio		7.3		29.4
Commercial mortgage loans	2.1	2.0	4.8	3.5
Cash and cash equivalents, U.S. Treasury bills and other	2.9	3.6	5.9	4.1
Total interest	93.6	66.0	181.9	146.9
Dividends	1.8	5.3	2.4	9.4
Total interest and dividends	$95.4	$71.3	$184.3	$156.3

Our interest income from our private finance loans and debt securities has increased period over period as a result of the growth in this portfolio as shown below. In addition, during the six months ended June 30, 2006, we resumed accruing interest on loans to two private finance portfolio companies. Such additional interest income totaled $2.4 million and $6.2 million for the three and six months ended June 30, 2006, respectively. In addition, one of these portfolio companies paid off during the second quarter and the accrued interest was collected.

There was no interest income from the CMBS and CDO portfolio in 2006 as we sold this portfolio on May 3, 2005. The CMBS and CDO portfolio sold had a cost basis of $718.1 million and a weighted average yield on the cost basis of the portfolio of approximately 13.8%. We generally reinvested the principal proceeds from the CMBS and CDO portfolio into our private finance portfolio.

The level of portfolio-related interest income, which includes interest paid in cash and in kind, is directly related to the balance of the interest-bearing investment portfolio outstanding during the period multiplied by the weighted average yield. The interest-bearing investments in the portfolio at value and the yield on the interest-bearing investments in the portfolio at June 30, 2006 and 2005, were as follows:

	2006		2005	
($ in millions)	**Value**	**Yield[(1)]**	**Value**	**Yield[(1)]**
Private finance loans and debt securities	$2,491.2	12.7%	$1,633.0	13.7%
CMBS and CDO portfolio[(2)]				
Commercial mortgage loans	96.5	8.1%	116.1	6.7%
Total	$2,587.7	12.6%	$1,749.1	13.2%

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

(2) The CMBS and CDO portfolio was sold on May 3, 2005. See discussion above.

The private finance portfolio yield at June 30, 2006, of 12.7% as compared to the private finance portfolio yield of 13.7% at June 30, 2005, reflects the mix of debt investments in the private finance portfolio. The weighted average yield varies from period to period based on the current stated interest on interest-bearing investments and the amount of loans and debt securities for which interest is not accruing. See the discussion of the private finance portfolio yield above under the caption Portfolio and Investment Activity Private Finance.

Dividend income results from the dividend yield on preferred equity interests, if any, or the declaration of dividends by a portfolio company on preferred or common equity interests. Dividend income will vary from period to period depending upon the timing and amount of dividends that are declared or paid by a portfolio company on preferred or common equity interests. Dividend income for the three and six months ended June 30, 2006, did not include any dividends from BLX. Dividend income for the three and six months ended June 30, 2005, included $3.0 million and $5.0 million, respectively, of dividends from BLX on the Class B equity interests held by us, which were paid in cash. See the discussion of BLX above under the caption Portfolio and Investment Activity Private Finance.

Loan Prepayment Premiums. Loan prepayment premiums were $1.7 million and $0.9 million for the three months ended June 30, 2006 and 2005, respectively, and $7.0 million and $2.5 million for the six months ended June 30, 2006 and 2005, respectively. Loan prepayment premiums for the six months ended June 30, 2006, included $5.0 million related to the repayment of our subordinated debt in connection with the sale of our majority equity interest in Advantage on March 29, 2006. See Portfolio and Investment Activity above for further discussion. While the scheduled maturities of private finance and commercial real estate loans generally range from five to ten years, it is not unusual for our borrowers to refinance or pay off their debts to us ahead of schedule. Therefore, we generally structure our loans to require a prepayment premium for the first three to five years of the loan. Accordingly, the amount of prepayment premiums will vary depending on the level of repayments and the age of the loans at the time of repayment.

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

Fees and other income for the three and six months ended June 30, 2006 and 2005, included fees relating to the following:

	For the Three Months Ended June 30,		**For the Six Months Ended June 30,**	
($ in millions)	**2006**	**2005**	**2006**	**2005**
Structuring and diligence	$ 8.0	$ 7.5	$19.0	$ 8.9
Management, consulting and other services provided to portfolio companies	2.3	3.6	6.4	6.8
Commitment, guaranty, transaction and other fees from portfolio companies	2.9	2.0	4.6	4.8
Other income	0.1	0.9	0.1	1.8
Total fees and other income	$13.3	$14.0	$30.1	$22.3

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

Structuring and diligence fees for the six months ended June 30, 2006, included structuring fees from Advantage Sales and Marketing, Cook Inlet Alternative Risk, CR Brands, Hot Stuff Foods, MHF Logistical Solutions, the Step 2 Company, and 3SI Security Systems totaling $13.0 million. Structuring and diligence fees may vary substantially from period to period based on the level of new investment originations and the market rates for these types of fees. Private finance investments funded were $1.2 billion for the six months ended June 30, 2006, as compared to $466.3 million for the six months ended June 30, 2005.

Management fees for the six months ended June 30, 2006, included $1.8 million in management fees from Advantage prior to its sale on March 29, 2006. See Portfolio and Investment Activity above for further discussion.

Fees and other income related to the CMBS and CDO portfolio for the six months ended June 30, 2005, were $4.1 million. As noted above, we sold our CMBS and CDO portfolio on May 3, 2005.

BLX and Advantage. BLX was our largest investment at value at June 30, 2006, and represented 7.9% of our total assets. Advantage and BLX were our largest investments at June 30, 2005, and together represented 22.2% of our total assets.

Total interest and related portfolio income from these investments for the three and six months ended June 30, 2006 and 2005, was as follows:

	For the Three Months Ended June 30,		**For the Six Months Ended June 30,**	
	2006	**2005**	**2006**	**2005**
($ in millions)				
BLX	$6.0	$8.8	$12.1	$16.6
Advantage[(1)]	$	$9.4	$14.1	$18.5

(1) Includes income from the period we held a majority equity interest only. See Portfolio and Investment Activity above for further discussion.

Operating Expenses. Operating expenses include interest, employee, stock options, and administrative expenses.

Interest Expense. The fluctuations in interest expense during the three and six months ended June 30, 2006 and 2005, were primarily attributable to changes in the level of our borrowings under various notes payable and debentures and our revolving line of credit. Our borrowing activity and weighted average cost of debt, including fees and debt financing costs, at and for the three and six months ended June 30, 2006 and 2005, were as follows:

	At and for the Three Months Ended June 30,		At and for the Six Months Ended June 30,	
($ in millions)	2006	2005	2006	2005
Total outstanding debt	$1,208.9	$ 986.5	$1,208.9	$ 986.5
Average outstanding debt	$1,301.1	$1,071.0	$1,395.8	$1,097.9
Weighted average cost[1]	6.6%	6.8%	6.6%	6.8%

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

In addition, interest expense includes interest on our obligations to replenish borrowed Treasury securities related to our hedging activities of $0.2 million and $0.5 million for the three months ended June 30, 2006 and 2005, respectively, and $0.4 million and $1.1 million for the six months ended June 30, 2006 and 2005, respectively.

Employee Expense. Employee expenses for the three and six months ended June 30, 2006 and 2005, were as follows:

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
($ in millions)	2006	2005	2006	2005
Salaries and employee benefits	$17.6	$11.7	$35.0	$23.5
Transition compensation, net		5.5		5.5
Individual performance award (IPA)	2.1	1.9	3.8	3.8
IPA mark to market expense (benefit)	(1.5)	1.8	(0.6)	1.9
Individual performance bonus (IPB)	2.2	2.0	3.6	3.6
Total employee expense	$20.4	$22.9	$41.8	$38.3
Number of employees at end of period	166	152	166	152

The change in salaries and employee benefits reflects the effect of wage increases and the change in mix of employees given their area of responsibility and relevant experience level. Salaries and employee benefits expense has generally increased due to changes in the composition of our employee resources and compensation increases. Salaries and employee benefits include an accrual for employee bonuses, which are generally paid annually after the completion of the fiscal year. The quarterly accrual is based upon an estimate of annual bonuses and is subject to change. The amount of the current year bonuses will be finalized by the Compensation Committee and the Board of Directors at the end of the year. Salaries and employee benefits include accrued bonuses of $9.0 million and $3.4 million for the three months ended June 30, 2006 and 2005, respectively, and $16.9 million and $7.1 million for the six months ended June 30, 2006 and 2005, respectively.

Transition compensation costs were $6.4 million for the six months ended June 30, 2005, including $3.7 million of costs under retention agreements and $2.7 million of transition services bonuses awarded to certain employees in the commercial real estate group as a result of the sale of the CMBS and CDO portfolio. Transition compensation expenses were reduced by $0.9 million for salary reimbursements from CWCapital under the transition services agreement resulting in net expense related to the sale of the CMBS and CDO portfolio of $5.5 million. See the caption

Portfolio and Investment Activity Commercial Real Estate Finance for additional information.

The Individual Performance Award (IPA) is a long-term incentive compensation program for certain officers. The IPA, which is generally determined annually at the beginning of each year, is deposited into a deferred compensation trust generally in four equal installments, on a quarterly basis, in the form of cash. The accounts of the trust are consolidated with our accounts. We are required to mark to market the liability of the trust and this adjustment is recorded to the IPA compensation expense. Because the IPA is deferred compensation, the cost of this award is not a current expense for purposes of computing our taxable income. The expense is deferred for tax purposes until distributions are made from the trust.

As a result of changes in regulation by the Jobs Creation Act of 2004 associated with deferred compensation arrangements, as well as an increase in the competitive market for recruiting talent in the private equity industry, the Compensation Committee and the Board of Directors determined that for 2005 and 2006 a portion of the IPA should be replaced with an individual performance bonus (IPB). The IPB is distributed in cash to award recipients in equal bi-weekly installments (beginning in February of each respective year) as long as the recipient remains employed by us.

The Compensation Committee and the Board of Directors have determined the IPA and the IPB for 2006. We currently estimate the IPA and IPB to be approximately $8.1 million each; however, the Compensation Committee may adjust the IPA or IPB as needed, or make new awards as new officers are hired. If a recipient terminates employment during the year, any further cash contribution for the IPA or remaining cash payments under the IPB would be forfeited.

In connection with our 2006 Annual Meeting of Stockholders, the stockholders approved the issuance of up to 2.5 million shares of our common stock in exchange for the cancellation of vested in-the-money stock options granted to certain officers and directors under our Amended Stock Option Plan. Under the initiative, which has been reviewed and approved by our Board of Directors, all optionees who hold vested stock options with exercise prices below the market value of the stock (or in-the-money options), would be offered the opportunity to receive an Option Cancellation Payment (OCP) equal to the in-the-money value of the stock options cancelled, which would be paid one-half in cash and one-half in shares of our common stock, in exchange for their voluntary cancellation of their vested stock options. As part of this initiative, the Board of Directors has adopted a target ownership structure that establishes minimum ownership levels for our senior officers and continues to further align the interests of our officers with those of our stockholders.

Unlike the accounting treatment typically associated with a stock option exercise, the OCP would be recorded as an expense for financial reporting purposes, and the expense may be significant. Based on the 13 million vested options outstanding and the market price of $30.50 of our stock on March 10, 2006, the date used for disclosure in our 2006 proxy, the expense related to the OCP would be approximately $106 million if all option holders choose to cancel all vested in-the-money options in exchange for the OCP. As of June 30, 2006, there were 17 million vested options outstanding, of which 13 million options were in-the-money. Using the market price of $28.77 of our stock on June 30, 2006, the expense related to the OCP would be approximately $86 million if all option holders chose to cancel all vested in-the-money options in exchange for the OCP. For income tax purposes, our tax expense resulting from the OCP would be similar to the tax expense that would result from an exercise of stock options in the market. Any tax deduction for us resulting from the OCP or an exercise of stock options in the market would be limited by Section 162(m) of the Code for persons subject to Section 162(m).

Employee Stock Options Expense. In December 2004, the FASB issued Statement No. 123 (Revised 2004), *Share-Based Payment* (the Statement), which requires companies to recognize the grant-date fair value of stock options and other equity-based compensation issued to employees in the income statement. The Statement was effective January 1, 2006, and it applies to our stock option plan. Our stock options are typically granted with ratable vesting provisions, and we amortize the compensation cost over the related service period. With respect to options granted prior to January 1, 2006, we have used the modified prospective method for adoption of the Statement. Under this method, the unamortized cost of previously awarded options that were unvested as of January 1, 2006, is recognized over the remaining service period in the statement of operations beginning in 2006. With respect to options granted on or after January 1, 2006, compensation cost is recognized in the statement of operations over the service period. The effect of this adoption for the six months ended June 30, 2006, was as follows:

($ in millions)	For the Three Months Ended June 30, 2006	For the Six Months Ended June 30, 2006
Employee Stock Option Expense:		
Previously awarded, unvested options as of January 1, 2006	$3.3	$6.7
Options granted on or after January 1, 2006	1.3	1.5
Total stock option expense	$4.6	$8.2

In addition to the employee stock option expense, for the three and six months ended June 30, 2006, administrative expense included $0.2 million of expense related to options granted to directors during the period. Options granted to non-officer directors vest on the grant date and therefore, the full expense is recorded on the grant date.

We estimate that the employee-related stock option expense under the Statement that will be recorded in our statement of operations will be approximately $16.1 million, $10.1 million, and $3.2 million for the years ended December 31, 2006, 2007, and 2008, respectively, which includes approximately $2.6 million, $1.4 million, and $0.7 million, respectively, related to options granted in the first and second quarters of 2006. This estimate may change if our assumptions related to future option forfeitures change. This estimate does not include any expense related to future stock option grants as the fair value of those stock options will be determined at the time of grant.

Administrative Expense. Administrative expenses include legal and accounting fees, valuation assistance fees, insurance premiums, the cost of leases for our headquarters in Washington, DC, and our regional offices, portfolio origination and development expenses, stock record expenses, directors fees, and various other expenses. Administrative expenses for the three and six months ended June 30, 2006 and 2005, were as follows:

	For the Three Months Ending June 30,		For the Six Months Ending June 30,	
($ in millions)	2006	2005	2006	2005
Administrative expenses	$9.4	$ 9.6	$18.0	$18.1
Investigation related costs	0.5	13.5	3.4	25.7
Total administrative expenses	$9.9	$23.1	$21.4	$43.8

Investigation related costs include costs associated with requests for information in connection with two government investigations. These expenses remain difficult to predict. See Legal Proceedings in the accompanying prospectus.

Income Tax Expense, Including Excise Tax. Income tax expense for the three and six months ended June 30, 2006 and 2005, was as follows:

($ in millions)	For the Three Months Ended June 30, 2006	For the Three Months Ended June 30, 2005	For the Six Months Ended June 30, 2006	For the Six Months Ended June 30, 2005
Income tax expense, net	$0.6	$1.9	$ 1.1	$1.6
Excise tax expense	3.2	4.0	11.6	4.0
Income tax expense, including excise tax	$3.8	$5.9	$12.7	$5.6

Our wholly owned subsidiary, A.C. Corporation, is a corporation subject to federal and state income taxes and records a benefit or expense for income taxes as appropriate based on its operating results in a given period. In addition, our estimated annual taxable income for 2006 currently exceeds our estimated dividend distributions to shareholders from such taxable income in 2006, and such estimated excess taxable income will be distributed in 2007. Therefore, we will be required to pay a 4% excise tax on the excess of 98% of our taxable income over the amount of actual distributions from such taxable income. Accordingly, we have accrued an estimated excise tax of $3.2 million and $11.6 million for the three and six months ended June 30, 2006, respectively, based upon our estimated excess taxable income earned for the period. We currently expect that the excise tax accrual in the first half of the year, which included accruals for the estimated taxable income earned from the gains realized on the sale of our equity investments in Advantage and STS Operating, Inc., will be materially higher than that accrued in the second half of the year. See Financial Condition, Liquidity and Capital Resources.

Realized Gains and Losses. Net realized gains primarily result from the sale of equity securities associated with certain private finance investments, the sale of CMBS bonds and CDO bonds and preferred shares, and the realization of unamortized discount resulting from the sale and early repayment of private finance loans and commercial mortgage loans, offset by losses on investments. Net realized gains for the three and six months ended June 30, 2006 and 2005, were as follows:

($ in millions)	For the Three Months Ended June 30, 2006	For the Three Months Ended June 30, 2005	For the Six Months Ended June 30, 2006	For the Six Months Ended June 30, 2005
Realized gains	$101.0	$244.7	$537.5	$259.4
Realized losses	(0.8)	(37.2)	(4.4)	(41.6)
Net realized gains	$100.2	$207.5	$533.1	$217.8

When we exit an investment and realize a gain or loss, we make an accounting entry to reverse any unrealized appreciation or depreciation, respectively, we had previously recorded to reflect the appreciated or depreciated value of the investment. For the three and six months ended June 30,

2006 and 2005, we reversed previously recorded unrealized appreciation or depreciation when gains or losses were realized as follows:

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
($ in millions)	**2006**	**2005**	**2006**	**2005**
Reversal of previously recorded unrealized appreciation associated with realized gains	$(95.6)	$(16.6)	$(489.2)	$(26.5)
Reversal of previously recorded unrealized depreciation associated with realized losses	0.5	37.1	3.2	41.9
Total reversal	$(95.1)	$ 20.5	$(486.0)	$ 15.4

Realized gains for the three months ended June 30, 2006 and 2005, were as follows:
($ in millions)

2006	
Portfolio Company	**Amount**
Private Finance:	
STS Operating, Inc.	$ 94.8
United Site Services, Inc.	3.3
MHF Logistical Solutions, Inc.	1.2
Advantage Sales & Marketing, Inc.	0.6
Other	1.1
Total private finance	101.0
Total gross realized gains	$101.0

($ in millions)

2005	
Portfolio Company	**Amount**
Private Finance:	
Master Plan, Inc.	$ 3.7
Ginsey Industries, Inc.	2.8
E-Talk Corporation	1.6
Professional Paint, Inc.	1.0
Other	1.0

Total private finance	10.1
Commercial Real Estate:	
CMBS/CDO asset net[1]	227.7
Other	6.9
Total commercial real estate	234.6
Total gross realized gains	$244.7

(1) Net of net realized losses from related hedges of $0.7 million for the three months ended June 30, 2005.

STS Operating, Inc. In the second quarter of 2006, we completed the sale of STS Operating, Inc. (STS). We were repaid our $6.8 million in subordinated debt outstanding and we realized a gain on the sale of our common stock in STS of $94.8 million, subject to post-closing adjustments. The cost basis of our equity was $3.5 million. As part of the consideration for the sale of our equity investment, we received a $30 million subordinated note. Approximately $11.2 million of our proceeds are subject to certain holdback provisions and post-closing adjustments. For tax purposes, the receipt of the $30 million subordinated note as part of our consideration for the common stock sold will allow us, through installment treatment, to defer the recognition of taxable income for a portion of our realized gain until the note is collected.

Realized losses for the three months ended June 30, 2006 and 2005, were as follows:
($ in millions)

2006

Portfolio Company	Amount
Private Finance:	
Other	$0.3
Total private finance	0.3
Commercial Real Estate:	
Other	0.5
Total commercial real estate	0.5
Total gross realized losses	$0.8

($ in millions)

2005

Portfolio Company	Amount
Private Finance:	
Norstan Apparel Shops, Inc.	$18.5
E-Talk Corporation	9.0
Garden Ridge Corporation	7.1
Other	0.3
Total private finance	34.9
Commercial Real Estate:	
Other	2.3
Total commercial real estate	2.3
Total gross realized losses	$37.2

Realized gains for the six months ended June 30, 2006 and 2005, were as follows:
($ in millions)

2006

Portfolio Company	Amount

Private Finance:	
Advantage Sales & Marketing, Inc.	$433.7
STS Operating, Inc.	94.8
United Site Services, Inc.	3.3
Nobel Learning Communities, Inc.	1.5
MHF Logisitical Solutions, Inc.	1.2
The Debt Exchange, Inc.	1.1
Other	1.3
Total private finance	536.9
Commercial Real Estate:	
Other	0.6
Total commercial real estate	0.6
Total gross realized gains	$537.5

($ in millions)

2005	
Portfolio Company	**Amount**
Private Finance:	
Polaris Pool System, Inc.	$ 7.4
Master Plan, Inc.	3.7
U.S. Security Holdings, Inc.	3.3
Ginsey Industries, Inc.	2.8
E-Talk Corporation	1.6
Professional Paint, Inc.	1.0
Oriental Trading Company, Inc.	1.0
Other	3.5
Total private finance	24.3
Commercial Real Estate:	
CMBS/CDO assets, net(1)	227.7
Other	7.4
Total commercial real estate	235.1
Total gross realized gains	$259.4

(1) Net of net realized losses from related hedges of $0.7 million for the six months ended June 30, 2005.

Realized losses for the six months ended June 30, 2006 and 2005, were as follows:
($ in millions)

2006

Portfolio Company	**Amount**
Private Finance:	
Aspen Pet Products, Inc.	$1.6
Nobel Learning Communities, Inc.	1.4
Other	0.6
Total private finance	3.6
Commercial Real Estate:	
Other	0.8
Total commercial real estate	0.8
Total gross realized losses	$4.4

($ in millions)

2005

Portfolio Company	**Amount**
Private Finance:	
Norstan Apparel Shops, Inc.	$18.5
E-Talk Corporation	9.0
Garden Ridge Corporation	7.1
Alderwoods Group, Inc.	0.8
Other	0.7
Total private finance	36.1
Commercial Real Estate:	
Other	5.5
Total commercial real estate	5.5
Total gross realized losses	$41.6

Change in Unrealized Appreciation or Depreciation. We determine the value of each investment in our portfolio on a quarterly basis, and changes in value result in unrealized appreciation or depreciation being recognized in our statement of operations. Value, as defined in Section 2(a)(41) of the Investment Company Act of 1940, is (i) the market price for those securities for which a market quotation is readily available and (ii) for all other securities and assets, fair value is as determined in good faith by the Board of Directors. Since there is typically no readily available market value for the investments in our portfolio, we value substantially all of our portfolio investments at fair value as determined in good faith by the Board of Directors pursuant to our valuation policy and a consistently applied valuation process. At June 30, 2006, portfolio investments recorded at fair value were approximately 90% of our total assets. Because of the inherent uncertainty of determining the fair value of investments that do not have a readily available market value, the fair value of our investments determined in good faith by the Board of Directors may differ significantly from the values that would have been used had a ready market existed for the investments, and the differences could be material.

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

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

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

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

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

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

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

We will continue to work with third-party consultants to obtain assistance in determining fair value for a portion of the private finance portfolio each quarter. We work with these consultants to obtain assistance as additional support in the preparation of our internal valuation analysis. In addition, we may receive third-party assessments of a particular private finance portfolio company s value in the ordinary course of business, most often in the context of a prospective sale transaction or in the context of a bankruptcy process. The valuation analysis prepared by management using these third-party valuation resources, when applicable, is submitted to our Board of Directors for its determination of fair value of the portfolio in good faith.

For 2006 and 2005, we received third-party valuation assistance from Duff & Phelps, LLC (Duff & Phelps) and Houlihan Lokey Howard and Zukin (Houlihan Lokey) for our private finance portfolio as follows:

	2006		**2005**	
	Q1	**Q2**	**Q1**	**Q2**
Number of private finance portfolio companies reviewed	78	78	36	72
Percentage of private finance portfolio reviewed at value	87.0%	89.6%	74.5%	83.0%

Professional fees for third-party valuation assistance were $1.4 million for the year ended December 31, 2005, and are estimated to be approximately $1.5 million for 2006.

Valuation Methodology CDO and CLO Bonds and Preferred Shares/Income Notes (CDO/CLO Assets). CDO/CLO Assets are carried at fair value, which is based on a discounted cash flow model that utilizes prepayment and loss assumptions based on historical experience and projected performance, economic factors, the characteristics of the underlying cash flow and comparable yields for similar bonds and preferred shares/income notes, when available. We recognize unrealized appreciation or depreciation on our CDO/CLO Assets as comparable yields in the market change and/ or based on changes in estimated cash flows resulting from changes in prepayment or loss assumptions in the underlying collateral pool. As each bond ages, the expected amount of losses and the expected timing of recognition of such losses in the underlying collateral pool is updated and the revised cash flows are used in determining the fair value of the bonds. We determine the fair value of our CDO/CLO Assets on an individual security-by-security basis. If we were to sell a group of these CDO/CLO Assets in a pool in one or more transactions, the total value received for that pool may be different than the sum of the fair values of the individual bonds or preferred shares/income notes.

Net Change in Unrealized Appreciation or Depreciation. Net change in unrealized appreciation or depreciation for the three and six months ended June 30, 2006 and 2005, consisted of the following:

	For the Three Months Ended June 30,		**For the Six Months Ended June 30,**	
($ in millions)	**2006[(1)]**	**2005[(1)]**	**2006[(1)]**	**2005[(1)]**
Net unrealized appreciation or depreciation	$ (21.6)	$ 68.6	$ (5.3)	$144.3
Reversal of previously recorded unrealized appreciation associated with realized gains	(95.6)	(16.6)	(489.2)	(26.5)
Reversal of previously recorded unrealized depreciation associated with realized losses	0.5	37.1	3.2	41.9
Net change in unrealized appreciation or depreciation	$(116.7)	$ 89.1	$(491.3)	$159.7

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

At June 30, 2006, our largest investment was in BLX. The following is a summary of the methodology that we used to determine the fair value of this investment.

Business Loan Express, LLC. To determine the value of our investment in BLX at June 30, 2006, we performed four separate valuation analyses to determine a range of values: (1) analysis of comparable public company trading multiples, (2) analysis of BLX s value assuming an initial public offering, (3) analysis of merger and acquisition transactions for financial services companies, and (4) a discounted dividend analysis. We received valuation assistance from Duff & Phelps for our investment in BLX at June 30, 2006, and December 31, 2005.

With respect to the analysis of comparable public company trading multiples and the analysis of BLX s value assuming an initial public offering, we compute a median trailing and forward price earnings multiple to apply to BLX s pro-forma net income adjusted for certain capital structure changes that we believe would likely occur should the company be sold. Each quarter we evaluate which public commercial finance companies should be included in the comparable group. The comparable group at June 30, 2006, was made up of CIT Group, Inc., Financial Federal Corporation, GATX Corporation, and Marlin Business Services Corporation, which is consistent with the comparable group at March 31, 2006, and December 31, 2005.

Our investment in BLX at June 30, 2006, was valued at $317.2 million. This fair value was within the range of values determined by the four valuation analyses. Unrealized appreciation on our investment was $24.0 million at June 30, 2006. We decreased unrealized appreciation for the three and six months ended June 30, 2006, by $10.9 million and $33.6 million, respectively. The decrease resulted from a reduction in enterprise value at June 30, 2006, of approximately 6% as compared to the enterprise value at December 31, 2005. BLX has experienced higher loan prepayments in recent months, which BLX management believes is due to a robust economy and increased competition from banks. BLX management has scaled back their traditional loan originations to remain selective in this competitive lending environment, and is also developing new loan products.

Per Share Amounts. All per share amounts included in the Management s Discussion and Analysis of Financial Condition and Results of Operations section have been computed using the weighted average common shares used to compute diluted earnings per share, which were 143.2 million and 136.4 million for the three months ended June 30, 2006 and 2005, respectively, and were 142.5 million and 136.0 million for the six months ended June 30, 2006 and

2005, respectively.

OTHER MATTERS

Regulated Investment Company Status. We have elected to be taxed as a regulated investment company under Subchapter M of the Internal Revenue Code of 1986. As long as we qualify as a regulated investment company, we are not taxed on our investment company taxable income or realized net capital gains, to the extent that such taxable income or gains are distributed, or deemed to be distributed, to shareholders on a timely basis.

Taxable income generally differs from net income for financial reporting purposes due to temporary and permanent differences in the recognition of income and expenses, and generally excludes net unrealized appreciation or depreciation, as gains or losses are not included in taxable income until they are realized. In addition, gains realized for financial reporting purposes may differ from gains included in taxable income as a result of our election to recognize gains using installment sale treatment, which results in the deferment of gains for tax purposes until notes or other amounts, including amounts held in escrow, received as consideration from the sale of investments are collected in cash.

Dividends declared and paid by us in a year generally differ from taxable income for that year as such dividends may include the distribution of current year taxable income, the distribution of prior year taxable income carried over into and distributed in the current year, or returns of capital. We are generally required to distribute 98% of our taxable income during the year the income is earned to avoid paying an excise tax. If this requirement is not met, the Internal Revenue Code imposes a nondeductible excise tax equal to 4% of the amount by which 98% of the current year s taxable income exceeds the distribution for the year. The taxable income on which an excise tax is paid is generally carried over and distributed to shareholders in the next tax year. Depending on the level of taxable income earned in a tax year, we may choose to carry over taxable income in excess of current year distributions from such taxable income into the next tax year and pay a 4% excise tax on such income, as required. See Financial Condition, Liquidity and Capital Resources below.

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

FINANCIAL CONDITION, LIQUIDITY AND CAPITAL RESOURCES

Dividends and Distributions

Dividends to common shareholders for the six months ended June 30, 2006 and 2005, were $166.6 million and $152.3 million, respectively, or $1.19 per common share for the first half of 2006 and $1.14 per common share for the first half of 2005. An extra cash dividend of $0.03 per common share was declared during 2005 and was paid to shareholders on January 27, 2006.

The Board of Directors has declared a dividend of $0.61 per common share for the third quarter of 2006.

Dividends are generally determined based upon an estimate of annual taxable income and the amount of taxable income carried over from the prior year for distribution in the current year.

Taxable income includes our taxable interest, dividend and fee income, as well as taxable net capital gains. As discussed above, taxable income generally differs from net income for financial reporting purposes due to temporary and permanent differences in the recognition of income and expenses, and generally excludes net unrealized appreciation or depreciation, as gains or losses are not included in taxable income until they are realized. Taxable income includes non-cash income, such as changes in accrued and reinvested interest and dividends and the amortization of discounts and fees. Cash collections of income resulting from contractual payment-in-kind interest or the amortization of discounts and fees generally occur upon the repayment of the loans or debt securities that include such items. Non-cash taxable income is reduced by non-cash expenses, such as realized losses and depreciation and amortization expense.

Our Board of Directors reviews the dividend rate quarterly, and may adjust the quarterly dividend throughout the year. Dividends are declared based upon our estimate of annual taxable income available for distribution to shareholders and the amount of taxable income carried over from the prior year for distribution in the current year. Our goal is to declare what we believe to be sustainable increases in our regular quarterly dividends. To the extent that we earn annual taxable income in excess of dividends paid from such taxable income for the year, we may carry over the excess taxable income into the next year and such excess taxable income will be available for distribution in the next year as permitted under the Internal Revenue Code of 1986. Excess taxable income carried over and paid out in the next year is generally subject to a 4% excise tax. See Other Matters Regulated Investment Company Status above. We believe that carrying over excess taxable income into future periods may provide increased visibility with respect to taxable earnings available to pay the regular quarterly dividend. We currently estimate that the taxable income carried over from 2005 for distribution to shareholders in 2006 is $163.8 million. However, our taxable income for 2005 is an estimate and will not be finally determined until we file our 2005 tax return in September 2006, and therefore, the amount of excess taxable income carried over from 2005 into 2006 may be different from this estimate.

We currently expect that our estimated annual taxable income for 2006 will be in excess of our estimated dividend distributions to shareholders in 2006 from such taxable income, and, therefore, we expect to carry over excess taxable income for distribution to shareholders in 2007. We expect that we will generally be required to pay a 4% excise tax on the excess of 98% of our taxable income for 2006 over the amount of actual distributions from such taxable income in 2006. Accordingly, for the six months ended June 30, 2006, we have accrued an excise tax of $11.6 million. Excise taxes are accrued based upon estimated excess taxable income as estimated taxable income is earned, therefore, the excise tax accrued to date in 2006 may be adjusted as appropriate in the remainder of 2006 to reflect changes in our estimate of the carry over amount and additional excise tax may be accrued during the remainder of 2006 as additional excess taxable income is earned, if any. Our ability to earn the estimated annual taxable income for 2006 depends on many factors, including our ability to make new investments at attractive yields, the level of repayments in the portfolio, the realization of gains or losses from portfolio exits, and the level of operating expenses incurred. See Management s Discussion and Analysis of Financial Condition and Results of Operations and Risk Factors.

In addition to excess taxable income available to be carried over from the current tax year for distribution in the following tax year, we currently estimate that we have deferred taxable income related to installment sale gains of approximately $33 million as of December 31 2005, and approximately $170 million for the six months ended June 30, 2006, for a total of approximately $203 million as of June 30, 2006 . These gains have been recognized for financial reporting purposes in the respective years they were realized, but will be deferred for tax purposes until the notes or other amounts received from the sale of the related investments are collected in cash. These installment sale gains are estimates and will not be finally determined until we file our tax returns for the respective years. See Other Matters Regulated Investment Company Status above.

Because we are a regulated investment company, we distribute our taxable income and, therefore, from time to time we will raise new debt or equity capital in order to fund our investments and operations.

Liquidity and Capital Resources

At June 30, 2006, and December 31, 2005, our liquidity portfolio (see below), cash and investments in money market and other securities, total assets, total debt outstanding, total shareholders equity, debt to equity ratio and asset coverage for senior indebtedness were as follows:

($ in millions)	2006	2005
Liquidity portfolio (including money market and other securities: 2006-$75.3; 2005-$100.0)	$ 201.2	$ 200.3
Cash and investments in money market and other securities (including money market and other securities: 2006-$22.5; 2005-$22.0)	$ 25.6	$ 53.3
Total assets	$4,011.2	$4,025.9
Total debt outstanding	$1,208.9	$1,284.8
Total shareholders equity	$2,690.0	$2,620.5
Debt to equity ratio	0.45	0.49
Asset coverage ratio[1]	326%	309%

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

We have a liquidity portfolio that is composed of U.S. Treasury bills, money market securities and a certificate of deposit. At June 30, 2006, and December 31, 2005, the value and yield of the securities in the liquidity portfolio were as follows:

	2006		2005	
($ in millions)	Value	Yield	Value	Yield
U.S. Treasury bills[1]	$125.9	4.9%	$100.3	4.3%
Money market securities	55.3	5.0%	100.0	4.1%
Certificate of Deposit[1]	20.0	5.6%		
Total	$201.2	5.0%	$200.3	4.2%

[1] The Treasury bills and certificate of deposit mature in 2006.

The liquidity portfolio was established to provide a pool of liquid assets within our balance sheet. Our investment portfolio is primarily composed of private, illiquid assets for which there is no readily available market. Our portfolio s liquidity was reduced when we sold our portfolio of CMBS assets in May 2005, particularly BB rated bonds, which were generally more liquid than assets in our private finance portfolio. We will assess the amount held in and the composition of the liquidity portfolio throughout the year.

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

During the six months ended June 30, 2006, we sold equity of $83.0 million. We did not sell new equity in a public offering during the six months ended June 30, 2005, or for the year ended December 31, 2005. In addition, shareholders equity increased by $15.9 million, $17.1 million and $77.5 million through the exercise of employee options, the collection of notes receivable from the sale of common stock, and the issuance of shares through our dividend reinvestment plan for the six months ended June 30, 2006 and 2005, and the year ended December 31, 2005, respectively.

We employ an asset-liability management approach that focuses on matching the estimated maturities of our investment portfolio to the estimated maturities of our borrowings. We use our revolving line of credit facility as a means to bridge to long-term financing in the form of debt or equity capital, which may or may not result in temporary differences in the matching of estimated maturities. Availability on the revolving line of credit, net of amounts committed for standby letters of credit issued under the line of credit facility, was $882.5 million on June 30, 2006. We evaluate our interest rate exposure on an ongoing basis. Generally, we seek to fund our primarily fixed-rate investment portfolio with fixed-rate debt or equity capital. To the extent deemed necessary, we may hedge variable and short-term interest rate exposure through interest rate swaps or other techniques.

On July 24, 2006, we sold 4.5 million shares of our common stock for proceeds of $118.1 million, net of underwriting discounts and estimated offering expenses. In addition, on August 1, 2006, we sold 0.7 million shares of our common stock for proceeds of $17.8 million, net of underwriting discounts and estimated offering expenses, pursuant to the underwriters over-allotment option related to the sale of the 4.5 million shares.

On July 25, 2006, we completed a public issuance of $400 million of five-year, unsecured notes with a fixed interest rate of 6.625%. This debt matures on July 15, 2011. We have the option to redeem these notes in whole or in part, together with a redemption premium, as stipulated in the notes. We have certain financial and operating covenants that will be required by this public debt issuance, including that we will maintain a minimum ratio of 200% of total assets to total borrowings, as required by the Investment Company Act of 1940, as amended, while these notes are outstanding.

The net proceeds from the debt and equity issuances were used to reduce borrowings under our revolving line of credit, with the remainder being used to fund new portfolio investments and for general corporate purposes. We currently have no borrowings outstanding on our revolving line of credit.

As a result of the equity and debt issuances in the third quarter of 2006, we expect that our leverage ratio will increase by the end of the third quarter of 2006 from the 0.45:1.00 level at June 30, 2006. We currently target a debt to equity ratio ranging between 0.50:1.00 to 0.70:1.00 because we believe that it is prudent to operate with a larger equity capital base and less leverage.

At June 30, 2006, we had outstanding debt as follows:

($ in millions)	Facility Amount	Amount Outstanding	Annual Interest Cost[(1)]	Annual Return to Cover Interest Payments[(2)]
Notes payable and debentures:				
Unsecured notes payable	$1,190.6	$1,190.6	6.2%	1.9%
SBA debentures	16.5	16.5	7.4%	
Total notes payable and debentures	1,207.1	1,207.1	6.2%	1.9%
Revolving line of credit	922.5	1.8	6.4%(3)	0.1%
Total debt	$2,129.6	$1,208.9	6.6%(4)	2.0%

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

(2) The annual portfolio return to cover interest payments is calculated as the June 30, 2006, annualized cost of debt per class of financing outstanding divided by total assets at June 30, 2006.

(3) The annual interest cost reflects the interest rate payable for borrowings under the revolving line of credit. In addition to the current interest rate payable, there were annual costs of commitment fees, other facility fees and the amortization of debt financing costs of $3.8 million at June 30, 2006.

(4) The annual interest cost for total debt includes the annual cost of commitment fees, other facility fees and the amortization of debt financing costs on the revolving line of credit regardless of the amount outstanding on the facility as of the balance sheet date.

Unsecured Notes Payable. We have issued unsecured long-term notes to institutional investors, primarily insurance companies. The notes have five- or seven-year maturities, with maturity dates beginning in 2006 and generally have fixed rates of interest. The notes generally require payment of interest only semi-annually, and all principal is due upon maturity.

On May 1, 2006, we issued $50.0 million of long-term debt with a fixed interest rate of 6.75%. This debt matures in May 2013. The proceeds of this issuance were used to repay $25 million of 7.49% unsecured long-term debt that matured on May 1, 2006, with the remainder being used to fund new portfolio investments and for general corporate purposes.

Small Business Administration Debentures. Through our small business investment company subsidiary, we have debentures payable to the Small Business Administration (SBA) with contractual maturities of ten years. The notes require payment of interest only semi-annually, and all principal is due upon maturity. During the first half of 2006 and 2005, we repaid $12.0 million and $31.0 million, respectively, of this outstanding debt. We intend to repay the SBA in the third quarter of 2006 for the remaining outstanding borrowings of $16.5 million. The prepayment penalty upon repayment will be approximately $0.2 million. We currently do not have plans to borrow additional amounts from the SBA.

Revolving Line of Credit. At December 31, 2005, we had an unsecured revolving line of credit with a committed amount of $772.5 million that expires on September 30, 2008. In May 2006, we expanded the committed amount to 922.5 million. The revolving line of credit is now fully committed. The revolving line of credit generally bears interest at a rate equal to (i) LIBOR (for the period we select) plus 1.05% or (ii) the higher of the Federal Funds rate plus 0.50% or the Bank of America N.A. prime rate. The revolving line of credit requires the payment of an annual commitment fee equal to 0.20% of the committed amount. The revolving line of credit generally requires payments of interest at the end of each LIBOR interest period, but no less frequently than quarterly, on LIBOR based loans and monthly payments of interest on other loans. All principal is due upon maturity.

At June 30, 2006, there was $1.8 million outstanding on our unsecured revolving line of credit. The amount available under the line at June 30, 2006, was $882.5 million, net of amounts committed for standby letters of credit of $38.3 million. Net repayments under the revolving line of credit for the six months ended June 30, 2006, were $90.0 million.

We have various financial and operating covenants required by the revolving line of credit and notes payable and debentures outstanding at June 30, 2006. These covenants require us to maintain certain financial ratios, including debt to equity and interest coverage, and a minimum net worth. These credit facilities provide for customary events of default, including, but not limited to, payment defaults, breach of representations or covenants, cross-defaults, bankruptcy events, failure to pay judgments, attachment of our assets, change of control and the issuance of an order of dissolution. Certain of these events of default are subject to notice and cure periods or materiality thresholds. Our credit facilities also limit our ability to declare dividends if we default under certain provisions. As of June 30, 2006, we were in compliance with these covenants.

The following table shows our significant contractual obligations for the repayment of debt and payment of other contractual obligations as of June 30, 2006.

	Payments Due By Year						
($ in millions)	Total	2006	2007	2008	2009	2010	After 2010
Notes payable and debentures:							
Unsecured long-term notes payable	$1,190.6	$150.0	$	$153.0	$268.1	$408.0	$211.5
SBA debentures	16.5						16.5
Revolving line of credit[(1)]	1.8			1.8			
Operating leases	26.7	2.2	4.4	4.5	4.6	4.4	6.6
Total contractual obligations	$1,235.6	$152.2	$4.4	$159.3	$272.7	$412.4	$234.6

(1) At June 30, 2006, $882.5 million remained unused and available, net of amounts committed for standby letters of credit of $38.3 million issued under the credit facility.

Off-Balance Sheet Arrangements

The following table shows our contractual commitments that may have the effect of creating, increasing, or accelerating our liabilities as of June 30, 2006.

	Amount of Commitment Expiration Per Year						
($ in millions)	Total	2006	2007	2008	2009	2010	After 2010
Guarantees	$163.3	$2.5	$0.7	$ 3.0	$151.6	$	$5.5
Standby letters of credit[(1)]	38.3	0.1		38.2			
Total commitments	$201.6	$2.6	$0.7	$41.2	$151.6	$	$5.5

(1) Standby letters of credit are issued under our revolving line of credit that expires in September 2008. Therefore, unless a standby letter of credit is set to expire at an earlier date, we have assumed that the standby letters of credit

will expire contemporaneously with the expiration of our line of credit in September 2008.

In addition, we had outstanding commitments to fund investments totaling $362.1 million at June 30, 2006. We intend to fund these commitments and prospective investment opportunities with existing cash, through cash flow from operations before new investments, through borrowings under our line of credit or other long-term debt agreements, or through the sale or issuance of new equity capital.

CRITICAL ACCOUNTING POLICIES

The consolidated financial statements are based on the selection and application of critical accounting policies, which require management to make significant estimates and assumptions.

Critical accounting policies are those that are both important to the presentation of our financial condition and results of operations and require management s most difficult, complex, or subjective judgments. Our critical accounting policies are those applicable to the valuation of investments and certain revenue recognition matters as discussed below.

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

Loans and Debt Securities. For loans and debt securities, fair value generally approximates cost unless the borrower s enterprise value, overall financial condition or other factors lead to a determination of fair value at a different amount. The value of loan and debt securities may be greater than our cost basis if the amount that would be repaid on the loan or debt security upon the sale of the portfolio company is greater than our cost basis.

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

Interest income is recorded on an accrual basis to the extent that such amounts are expected to be collected. For loans and debt securities with contractual payment-in-kind interest, which represents contractual interest accrued and added to the loan balance that generally becomes due at maturity, we will not accrue payment-in-kind interest if the portfolio company valuation indicates that the payment-in-kind interest is not collectible. In general, interest is not accrued on loans and debt securities if we have doubt about interest collection or where the enterprise value of the portfolio company may not support further accrual. Loans in workout status that are classified as Grade 4 or 5 assets under our internal grading system do not accrue interest. In addition, interest may not accrue on loans or debt securities to portfolio companies that are more than 50% owned by us depending on such company s capital requirements. Loan origination fees, original issue discount, and market discount are capitalized and then amortized into interest income using a method that approximates the effective interest method. Upon the prepayment of a loan or debt security, any unamortized loan origination fees are recorded as interest income and any unamortized original issue discount or market discount is recorded as a realized gain. Prepayment premiums are recorded on loans and debt securities when received.

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

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

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

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

We recognize income from the amortization of original issue discount using the effective interest method using the anticipated yield over the projected life of the investment. Yields are revised when there are changes in actual and estimated prepayment speeds or actual and estimated credit losses. Changes in estimated yield are recognized as an adjustment to the estimated yield over the remaining life of the CDO/ CLO Assets from the date the estimated yield was changed.

Net Realized Gains or Losses and Net Change in Unrealized Appreciation or Depreciation. Realized gains or losses are measured by the difference between the net proceeds from the repayment or sale and the cost basis of the investment without regard to unrealized appreciation or depreciation previously recognized, and include investments charged off during the year, net of recoveries. Net change in unrealized appreciation or depreciation primarily reflects the change in portfolio investment values during the reporting period, including the reversal of previously recorded unrealized appreciation or depreciation when gains or losses are realized. Net change in unrealized appreciation or depreciation also reflects the change in the value of U.S. Treasury bills and deposits of proceeds from sales of borrowed Treasury securities, and depreciation on accrued interest and dividends receivable and other assets where collection is doubtful.

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

INTERIM CONSOLIDATED FINANCIAL STATEMENTS
ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEET

(in thousands, except per share amounts)	June 30, 2006 (unaudited)	December 31, 2005
ASSETS		
Portfolio at value:		
Private finance		
Companies more than 25% owned (cost: 2006-$1,282,768; 2005-$1,489,782)	$1,188,131	$1,887,651
Companies 5% to 25% owned (cost: 2006-$371,550; 2005-$168,373)	371,156	158,806
Companies less than 5% owned (cost: 2006-$1,933,932; 2005-$1,448,268)	1,901,139	1,432,833
Total private finance (cost: 2006-$3,588,250; 2005-$3,106,423)	3,460,426	3,479,290
Commercial real estate finance (cost: 2006-$127,748; 2005-$131,695)	133,051	127,065
Total portfolio at value (cost: 2006-$3,715,998; 2005-$3,238,118)	3,593,477	3,606,355
U.S. Treasury bills	125,940	100,305
Investments in money market and other securities	97,810	121,967
Deposits of proceeds from sales of borrowed Treasury securities	17,156	17,666
Accrued interest and dividends receivable	49,270	60,366
Other assets	124,448	87,858
Cash	3,106	31,363
Total assets	$4,011,207	$4,025,880
LIABILITIES AND SHAREHOLDERS EQUITY		
Liabilities:		
Notes payable and debentures (maturing within one year: 2006-$150,000; 2005-$175,000)	$1,207,137	$1,193,040
Revolving line of credit	1,750	91,750
Obligations to replenish borrowed Treasury securities	17,156	17,666
Accounts payable and other liabilities	95,145	102,878
Total liabilities	1,321,188	1,405,334
Commitments and contingencies		
Shareholders equity:		
Common stock, $0.0001 par value, 200,000 shares authorized; 140,312 and 136,697 shares issued and outstanding at June 30, 2006, and December 31, 2005, respectively	14	14

Additional paid-in capital	2,284,117	2,177,283
Common stock held in deferred compensation trust	(24,003)	(19,460)
Notes receivable from sale of common stock	(3,370)	(3,868)
Net unrealized appreciation (depreciation)	(136,929)	354,325
Undistributed earnings	570,190	112,252
Total shareholders equity	2,690,019	2,620,546
Total liabilities and shareholders equity	$4,011,207	$4,025,880
Net asset value per common share	$ 19.17	$ 19.17

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

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENT OF OPERATIONS

(in thousands, except per share amounts)	For the Three Months Ended June 30, 2006	For the Three Months Ended June 30, 2005	For the Six Months Ended June 30, 2006	For the Six Months Ended June 30, 2005
	(unaudited)		(unaudited)	
Interest and Related Portfolio Income:				
Interest and dividends				
Companies more than 25% owned	$ 23,419	$ 30,199	$ 53,565	$ 58,450
Companies 5% to 25% owned	11,419	5,597	17,069	11,518
Companies less than 5% owned	60,595	35,534	113,680	86,307
Total interest and dividends	95,433	71,330	184,314	156,275
Loan prepayment premiums				
Companies more than 25% owned	134		5,094	
Companies 5% to 25% owned				
Companies less than 5% owned	1,611	853	1,937	2,530
Total loan prepayment premiums	1,745	853	7,031	2,530
Fees and other income				
Companies more than 25% owned	5,515	7,877	12,642	12,758
Companies 5% to 25% owned	1,282	55	3,998	125
Companies less than 5% owned	6,481	6,092	13,482	9,438
Total fees and other income	13,278	14,024	30,122	22,321
Total interest and related portfolio income	110,456	86,207	221,467	181,126
Expenses:				
Interest	21,607	19,154	45,907	39,379
Employee	20,398	22,877	41,826	38,333
Stock options	4,597		8,203	
Administrative	9,861	23,048	21,380	43,802
Total operating expenses	56,463	65,079	117,316	121,514
Net investment income before income taxes	53,993	21,128	104,151	59,612
Income tax expense, including excise tax	3,798	5,861	12,656	5,593
Net investment income	50,195	15,267	91,495	54,019
Net Realized and Unrealized Gains (Losses):				
Net realized gains (losses)				

Companies more than 25% owned	95,212	(17,884)	528,399	(17,485)
Companies 5% to 25% owned	(74)	4,711	(417)	4,708
Companies less than 5% owned	5,102	220,669	5,093	230,558
Total net realized gains	100,240	207,496	533,075	217,781
Net change in unrealized appreciation or depreciation	(116,706)	89,122	(491,254)	159,706
Total net gains (losses)	(16,466)	296,618	41,821	377,487
Net increase in net assets resulting from operations	$ 33,729	$311,885	$ 133,316	$431,506
Basic earnings per common share	$ 0.24	$ 2.33	$ 0.96	$ 3.23
Diluted earnings per common share	$ 0.24	$ 2.29	$ 0.94	$ 3.17
Weighted average common shares outstanding basic	140,024	133,701	139,395	133,493
Weighted average common shares outstanding diluted	143,213	136,381	142,466	135,982

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

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

(in thousands, except per share amounts)	For the Six Months Ended June 30, 2006	2005
	(unaudited)	
Operations:		
Net investment income	$ 91,495	$ 54,019
Net realized gains	533,075	217,781
Net change in unrealized appreciation or depreciation	(491,254)	159,706
Net increase in net assets resulting from operations	133,316	431,506
Shareholder distributions:		
Common stock dividends	(166,632)	(152,329)
Net decrease in net assets resulting from shareholder distributions	(166,632)	(152,329)
Capital share transactions:		
Sale of common stock	82,970	
Issuance of common stock for portfolio investments		7,200
Issuance of common stock in lieu of cash distributions	7,199	4,163
Issuance of common stock upon the exercise of stock options	8,226	12,689
Stock option expense	8,439	
Net decrease in notes receivable from sale of common stock	498	200
Purchase of common stock held in deferred compensation trust	(4,649)	(3,976)
Distribution of common stock held in deferred compensation trust	106	
Other		2,056
Net increase in net assets resulting from capital share transactions	102,789	22,332
Total increase in net assets	69,473	301,509
Net assets at beginning of period	2,620,546	1,979,778
Net assets at end of period	$2,690,019	$2,281,287
Net asset value per common share	$ 19.17	$ 17.01
Common shares outstanding at end of period	140,312	134,131

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

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENT OF CASH FLOWS

(in thousands)	For the Six Months Ended June 30, 2006	2005
	(unaudited)	
Cash flows from operating activities:		
Net increase in net assets resulting from operations	$ 133,316	$ 431,506
Adjustments:		
Portfolio investments	(1,071,243)	(647,248)
Principal collections related to investment repayments or sales	769,598	1,090,813
Change in accrued or reinvested interest and dividends	9,064	3,567
Amortization of discounts and fees	(3,094)	(3,334)
Redemption of (investments in) U.S. Treasury bills	(22,875)	
Redemption of (investments in) money market securities	25,581	(74,200)
Stock option expense	8,439	
Changes in other assets and liabilities	(1,410)	8,136
Depreciation and amortization	870	963
Realized gains from the receipt of notes and other securities as consideration from sale of investments, net of collections	(217,086)	(916)
Realized losses	4,405	41,643
Net change in unrealized (appreciation) or depreciation	491,254	(159,706)
Net cash provided by (used in) operating activities	126,819	691,224
Cash flows from financing activities:		
Sale of common stock	82,970	
Sale of common stock upon the exercise of stock options	8,226	12,689
Collections of notes receivable from sale of common stock	498	200
Borrowings under notes payable and debentures	50,000	
Repayments on notes payable and debentures	(37,000)	(76,700)
Net borrowings under (repayments on) revolving line of credit	(90,000)	(112,000)
Purchase of common stock held in deferred compensation trust	(4,649)	(3,976)
Other financing activities	(1,590)	(1,958)
Common stock dividends and distributions paid	(163,531)	(150,826)
Net cash provided by (used in) financing activities	(155,076)	(332,571)
Net increase (decrease) in cash	(28,257)	358,653
Cash at beginning of period	31,363	57,160
Cash at end of period	$ 3,106	$ 415,813

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[1][2]	Principal	June 30, 2006 (unaudited) Cost	Value
Companies More Than 25% Owned				
Acme Paging, L.P.[4]	Senior Loan (6.0%, Due 12/07)[6]	$ 3,750	$ 3,750	$
(Telecommunications)	Subordinated Debt (10.0%, Due 1/08)[6]	881	881	
	Common Stock (23,513 shares)		27	
Alaris Consulting, LLC	Senior Loan (16.5%, Due 12/05 12/07)[6]	27,055	27,018	
(Business Services)	Equity Interests		5,305	
	Guaranty ($1,100)			
American Healthcare Services, Inc. and Affiliates (Healthcare Services)	Senior Loan (0.7%, Due 12/04 12/05)[6]	4,997	4,599	4,329
Avborne, Inc.[7]	Preferred Stock (12,500 shares)		658	773
(Business Services)	Common Stock (27,500 shares)			
Avborne Heavy Maintenance, Inc.[7]	Preferred Stock (1,568 shares)		2,401	
(Business Services)	Common Stock (2,750 shares)			
	Guaranty ($2,401)			
Business Loan Express, LLC	Class A Equity Interests	64,427	64,427	64,427
(Financial Services)	Class B Equity Interests		119,436	130,890
	Class C Equity Interests		109,301	121,900
	Guaranty ($149,162 See Note 3)			
	Standby Letters of Credit ($32,000 See Note 3)			
Callidus Capital Corporation	Senior Loan (12.0%, Due 12/06)	1,650	1,650	1,650
(Financial Services)	Subordinated Debt (18.0%, Due 10/08)	5,276	5,276	5,276

	Common Stock (10 shares)		2,058	12,093
Cambridge Capital Partners[5]	Senior Loan (8.0%, Due 5/09)[6]	250	250	250
(Financial Services)	Equity Interests		1,751	1,751
CR Brands, Inc.	Subordinated Debt (16.6%, Due 2/13)	38,898	38,712	38,712
(Consumer Products)	Common Stock (37,200,551 shares)		33,321	37,431
Diversified Group Administrators, Inc.	Preferred Stock (1,000,000 shares)		700	728
(Business Services)	Preferred Stock (1,451,380 shares)		841	841
	Common Stock (1,451,380 shares)			322
Financial Pacific Company	Subordinated Debt (17.4%, Due 2/12 8/12)	70,878	70,630	70,630
(Financial Services)	Preferred Stock (10,964 shares)		10,276	14,460
	Common Stock (14,735 shares)		14,819	44,418
ForeSite Towers, LLC (Tower Leasing)	Equity Interests		7,620	12,818

(1) Interest rates represent the weighted average annual stated interest rate on loans and debt securities, which are presented by nature of indebtedness for a single issuer. The maturity dates represent the earliest and the latest maturity dates.

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

(3) Public company.

(4) Non-U.S. company or principal place of business outside the U.S.

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(7) Avborne, Inc. and Avborne Heavy Maintenance, Inc. are affiliated companies.

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

Private Finance Portfolio Company (in thousands, except number of shares)	Investment[1][2]	June 30, 2006 (unaudited) Principal	Cost	Value
Global Communications, LLC	Senior Loan (10.7%, Due 9/02 11/07)[6]	$15,957	$15,957	$15,957
(Business Services)	Subordinated Debt (17.0%, Due 12/03 9/05)[6]	11,339	11,336	9,648
	Preferred Equity Interest		14,067	
	Options		1,639	
Gordian Group, Inc.	Senior Loan (10.0%, Due 6/06 12/08)[6]	11,792	11,812	
(Business Services)	Common Stock (1,000 shares)		6,762	
Healthy Pet Corp.	Senior Loan (9.5%, Due 8/10)	15,938	15,938	15,938
(Consumer Services)	Subordinated Debt (15.0%, Due 8/10)	43,286	43,125	43,125
	Common Stock (30,142 shares)		30,142	28,152
HMT, Inc.	Preferred Stock (554,052 shares)		2,637	2,637
(Energy Services)	Common Stock (300,000 shares)		3,000	7,942
	Warrants		1,155	3,058
Impact Innovations Group, LLC (Business Services)	Equity Interests in Affiliate			870
Insight Pharmaceuticals Corporation	Subordinated Debt (16.1%, Due 9/12)	59,284	59,067	59,067
(Consumer Products)	Preferred Stock (25,000 shares)		25,000	26,249
	Common Stock (620,000 shares)		6,325	218
Jakel, Inc.	Subordinated Debt (15.5%, Due 3/08)[6]	14,442	14,442	2,533
(Industrial Products)	Preferred Stock (6,460 shares)		6,460	
	Common Stock (158,061 shares)		9,347	
Legacy Partners Group, LLC	Senior Loan (14.0%, Due 5/09)[6]	7,646	7,646	5,048
(Financial Services)	Subordinated Debt (18.0%, Due 5/09)[6]	2,952	2,952	
	Equity Interests		4,248	
Litterer Beteiligungs-GmbH[4]	Subordinated Debt (8.0%, Due 3/07)	658	658	658
(Business Services)	Equity Interest		1,809	1,615

Mercury Air Centers, Inc.	Subordinated Debt (16.0%, Due 4/09			
(Business Services)	11/12)	48,369	48,198	48,198
	Common Stock (57,970 shares)		35,053	93,188
	Standby Letters of Credit ($1,968)			
MVL Group, Inc.	Senior Loan (12.0%, Due 10/07 7/09)	26,498	26,324	26,324
(Business Services)	Subordinated Debt (14.5%, Due 6/09)	34,354	33,921	33,921
	Common Stock (648,661 shares)		643	1,262
Powell Plant Farms, Inc.	Senior Loan (15.0%, Due 12/06)	30,490	21,642	21,642
(Consumer Products)	Subordinated Debt (20.0%, Due 6/03)(6)	19,291	19,223	
	Preferred Stock (1,483 shares)			
	Warrants			

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Private Finance Portfolio Company (in thousands, except number of shares)	Investment[1][2]	Principal	June 30, 2006 (unaudited) Cost	Value
Service Champ, Inc.	Subordinated Debt (15.5%, Due 4/12)	$ 27,384	$ 27,260	$ 27,260
(Business Services)	Common Stock (63,888 shares)		13,662	16,322
Staffing Partners Holding Company, Inc.	Subordinated Debt (13.5%, Due 1/07)[6]	5,987	5,987	1,160
(Business Services)	Preferred Stock (439,600 shares)		4,968	
	Common Stock (69,773 shares)		50	
	Warrants		10	
	Guaranty ($1,300)			
Startec Global Communications Corporation	Senior Loan (10.0%, Due 5/07 5/09)	21,926	21,926	21,926
(Telecommunications)	Common Stock (19,180,000 shares)		37,255	6,480
Triview Investments, Inc.[8]	Senior Loan (9.4%, Due 6/07)	14,325	14,301	14,301
(Broadcasting & Cable/ Consumer Products)	Subordinated Debt (15.0%, Due 7/12)	37,877	37,687	37,687
	Subordinated Debt (16.8%, Due 7/08 7/12)[6]	19,600	19,520	19,520
	Common Stock (202 shares)		93,907	32,526
	Guaranty ($800)			
	Standby Letter of Credit ($200)			
Total companies more than 25% owned			$1,282,768	$1,188,131
Companies 5% to 25% Owned				
Advantage Sales & Marketing, Inc.	Subordinated Debt (12.0%, Due 3/14)	$150,775	$ 150,056	$ 150,056
(Business Services)	Equity Interests		2,048	15,000
Air Medical Group Holdings LLC	Senior Loan (8.7%, Due 3/11 3/12)	1,584	1,512	1,512
(Healthcare Services)	Subordinated Debt (14.0%, Due 11/12)	34,646	34,590	34,590
	Equity Interests		3,470	4,200

Amerex Group, LLC	Subordinated Debt (12.0%, Due 1/13)	8,400	8,400	8,400
(Consumer Products)	Equity Interests		3,583	3,583
BB&T Capital Partners/Windsor Mezzanine Fund, LLC[5] (Private Equity Fund)	Equity Interests		5,867	5,867
Becker Underwood, Inc.	Subordinated Debt (14.5%, Due 8/12)	23,939	23,850	23,850
(Industrial Products)	Common Stock (5,073 shares)		5,813	2,400
BI Incorporated	Subordinated Debt (13.5%, Due 2/14)	30,000	29,856	29,856
(Business Services)	Common Stock (40,000 shares)		4,000	4,000

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(8) Triview Investments, Inc. holds investments in Longview Cable & Data, LLC (Broadcasting & Cable) with a cost of $66.5 million and value of $14.3 million and Triax Holdings, LLC (Consumer Products) with a cost of $98.9 million and a value of $89.7 million. The guaranty and standby letter of credit relate to Longview Cable & Data, LLC.

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Private Finance Portfolio Company (in thousands, except number of shares)	**Investment[1][2]**	**Principal**	**June 30, 2006 (unaudited) Cost**	**Value**
MedBridge Healthcare, LLC	Senior Loan (4.0%, Due 8/09)[6]	$ 7,164	$ 7,164	$ 6,595
(Healthcare Services)	Subordinated Debt (10.0%, Due 8/14)[6]	5,184	5,184	
	Convertible Subordinated Debt (2.0%, Due 8/14)[6]	2,970	984	
	Equity Interests		1,306	
Nexcel Synthetics, LLC	Subordinated Debt (14.5%, Due 6/09)	10,805	10,781	10,781
(Consumer Products)	Equity Interests		1,742	1,730
Pres Air Trol LLC	Unitranche Debt (12.0%, Due 4/10)[6]	5,911	5,593	3,312
(Industrial Products)	Equity Interests		1,361	
Progressive International	Subordinated Debt (16.0%, Due 12/09)	7,476	7,454	7,454
Corporation	Preferred Stock (500 shares)		500	920
(Consumer Products)	Common Stock (197 shares)		13	500
	Warrants			
Regency Healthcare Group, LLC	Senior Loan (11.1%, Due 6/12)	1,000	980	980
(Healthcare Services)	Unitranche Debt (11.1%, Due 6/12)	20,000	19,900	19,900
	Equity Interests		1,500	1,500
SGT India Private Limited[4] (Business Services)	Common Stock (109,524 shares)		3,608	3,608
Soteria Imaging Services, LLC	Subordinated Debt (11.7%, Due 11/10)	16,500	15,505	15,505
(Healthcare Services)	Equity Interests		2,163	2,400
Universal Environmental Services, LLC	Unitranche Debt (13.5%, Due 2/09)	10,989	10,956	10,956
(Business Services)	Equity Interests		1,811	1,701
Total companies 5% to 25% owned			$371,550	$371,156

Companies Less Than 5% Owned

3SI Security Systems, Inc.	Senior Loan (10.9%, Due 2/12 2/13)	$ 1,650	$ 1,640	$ 1,640
(Consumer Products)	Subordinated Debt (14.4%, Due 8/13)	26,377	26,252	26,252
Anthony, Inc. (Industrial Products)	Subordinated Debt (13.2%, Due 8/11 9/12)	14,743	14,688	14,688
Benchmark Medical, Inc. (Healthcare Services)	Warrants		18	
Border Foods, Inc.	Subordinated Debt (13.0%, Due 12/10)(6)	13,428	12,721	
(Consumer Products)	Preferred Stock (140,214 shares)		2,893	
	Common Stock (1,810 shares)		45	
	Warrants		910	
Broadcast Electronics, Inc. (Business Services)	Senior Loan (8.9%, Due 7/12)	4,988	4,953	4,953

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Private Finance Portfolio Company (in thousands, except number of shares)	Investment[1][2]	Principal	June 30, 2006 (unaudited) Cost	Value
C&K Market, Inc. (Retail)	Subordinated Debt (14.0%, Due 12/08)	$25,744	$25,651	$25,651
Callidus Debt Partners CDO Fund I, Ltd.[4][9] (Senior Debt Fund)	Class C Notes (12.9%, Due 12/13)	18,800	18,962	18,962
	Class D Notes (17.0%, Due 12/13)	9,400	9,481	9,481
Callidus Debt Partners CLO Fund III, Ltd. [4][9] (Senior Debt Fund)	Preferred Shares (23,600,000 shares)		23,804	23,804
Callidus Debt Partners CLO Fund IV, Ltd.[4][9] (Senior Debt Fund)	Income Notes		12,883	12,883
Callidus MAPS CLO Fund I LLC[9] (Senior Debt Fund)	Class E Notes (10.9%, Due 12/17)	17,000	17,000	17,000
	Income Notes		50,584	50,584
Camden Partners Strategic Fund II, L.P.[5] (Private Equity Fund)	Limited Partnership Interest		2,142	3,273
Carlisle Wide Plank Floors, Inc. (Consumer Products)	Unitranche Debt (10.5%, Due 6/11)	14,000	13,889	13,889
	Preferred Stock (400,000 Shares)		400	400
Catterton Partners V, L.P.[5] (Private Equity Fund)	Limited Partnership Interest		3,065	3,150
Centre Capital Investors IV, LP[5] (Private Equity Fund)	Limited Partnership Interest		1,753	1,655
Commercial Credit Group, Inc. (Financial Services)	Subordinated Debt (14.8%, Due 2/11)	5,000	4,954	4,954
	Preferred Stock (32,500 shares)		3,900	3,900
	Warrants			

Community Education Centers, Inc. (Education Services)	Subordinated Debt (16.0%, Due 12/10)	33,643	33,540	33,540
Component Hardware Group, Inc. (Industrial Products)	Preferred Stock (18,000 shares)		2,605	3,000
	Common Stock (2,000 shares)		200	3,001
Cook Inlet Alternative Risk, LLC (Business Services)	Unitranche Debt (10.5%, Due 4/12)	74,800	74,412	74,412
	Equity Interests		2,000	2,000
Cooper Natural Resources, Inc. (Industrial Products)	Subordinated Debt (0%, Due 11/07)	559	559	866
	Preferred Stock (6,316 shares)		1,424	20
	Warrants		830	
Coverall North America, Inc. (Business Services)	Subordinated Debt (14.6%, Due 2/11)	27,664	27,621	27,621
	Preferred Stock (6,500 shares)		6,500	7,073
	Warrants		2,950	3,890
Deluxe Entertainment Services Group, Inc. (Business Services)	Subordinated Debt (13.7%, Due 7/11)	30,000	30,000	30,000

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(9) The fund is managed by Callidus Capital, a portfolio company of Allied Capital.

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Private Finance Portfolio Company (in thousands, except number of shares)	Investment[1][2]	Principal	June 30, 2006 (unaudited) Cost	Value
Distant Lands Trading Co. (Consumer Products)	Senior Loan (9.2%, Due 1/11)	$ 500	$ 477	$ 477
	Unitranche Debt (10.3%, Due 1/11)	25,000	24,888	24,888
	Common Stock (1,500 shares)		1,500	1,500
Drilltec Patents & Technologies Company, Inc. (Energy Services)	Subordinated Debt (18.0%, Due 8/06)	4,119	4,119	4,119
	Subordinated Debt (10.0%, Due 8/06)[6]	10,994	10,918	16,018
DVS VideoStream, LLC (Business Services)	Unitranche Debt (11.0%, Due 2/12)	19,529	19,413	19,413
	Convertible Subordinated Debt (10.0%, Due 2/16)	3,551	3,534	3,534
Dynamic India Fund IV[4][5] (Private Equity Fund)	Equity Interests		3,850	3,850
eCentury Capital Partners, L.P.[5] (Private Equity Fund)	Limited Partnership Interest		5,649	194
Elexis Beta GmbH[4] (Industrial Products)	Options		426	50
Event Rentals, Inc. (Consumer Services)	Senior Loan (10.8%, Due 11/11)	23,739	23,631	23,631
Farley s & Sathers Candy Company, Inc. (Consumer Products)	Subordinated Debt (11.6%, Due 3/11)	20,000	19,905	19,905
Frozen Specialties, Inc. (Consumer Products)	Warrants		435	320
Garden Ridge Corporation (Retail)	Subordinated Debt (7.0%, Due 5/12)[6]	22,500	22,500	8,455
Geotrace Technologies, Inc. (Energy Services)	Subordinated Debt (10.0%, Due 6/09)	24,844	23,235	23,235
	Warrants		2,350	2,100

Ginsey Industries, Inc. (Consumer Products)	Subordinated Debt (12.5%, Due 3/07)	3,225	3,225	3,225
Grant Broadcasting Systems II (Broadcasting & Cable)	Subordinated Debt (5.0%, Due 6/09)	2,896	2,896	2,896
Grotech Partners, VI, L.P.[5] (Private Equity Fund)	Limited Partnership Interest		8,279	5,695
Havco Wood Products LLC (Industrial Products)	Senior Loan (11.3%, Due 8/11)	2,000	1,978	1,978
	Unitranche Debt (10.7%, Due 8/11)	24,054	22,950	22,950
	Equity Interests		1,049	1,800
Haven Eldercare of New England, LLC [10] (Healthcare Services)	Subordinated Debt (12.0%, Due 8/09)[6]	3,573	3,573	3,573
Haven Healthcare Management, LLC[10] (Healthcare Services)	Subordinated Debt (18.0%, Due 4/07)[6]	76	160	125
HealthASPex Services Inc. (Business Services)	Senior Loan (4.0%, Due 7/08)	500	500	468

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(10) Haven Eldercare of New England, LLC and Haven Healthcare Management, LLC are affiliated companies.

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Private Finance Portfolio Company (in thousands, except number of shares)	Investment[1][2]	Principal	June 30, 2006 (unaudited) Cost	Value
The Hillman Companies, Inc.[3]	Subordinated Debt (10.0%, Due 9/11)	$44,496	$44,327	$44,327
(Consumer Products)				
Homax Holdings, Inc.	Subordinated Debt (12.0%, Due 8/11)	14,000	13,110	13,110
(Consumer Products)	Preferred Stock (89 shares)		89	77
	Common Stock (28 shares)		6	6
	Warrants		1,106	1,261
Hot Stuff Foods, LLC	Senior Loan (8.7%, Due 2/11-2/12)	47,080	47,080	47,080
(Consumer Products)	Subordinated Debt (13.9%, Due 8/12 2/13)	72,967	72,688	72,688
	Common Stock (375,000 shares)[11]		37,445	8,791
	Warrants			
Integrity Interactive Corporation	Unitranche Debt (10.5%, Due 2/12)	30,000	29,795	29,795
(Business Services)				
International Fiber Corporation	Subordinated Debt (14.0%, Due 6/12)	21,764	21,685	21,685
(Industrial Products)	Preferred Stock (25,000 shares)		2,500	2,100
Kodiak Fund LP[5]	Equity Interests		4,975	4,975
(Private Equity Fund)				
Line-X, Inc.	Senior Loan (9.0%, Due 8/11)	3,000	2,978	2,978
(Consumer Products)	Unitranche Debt (10.0% Due 8/11)	50,225	50,001	50,001
	Standby Letter of Credit ($1,500)			
MedAssets, Inc.	Preferred Stock (227,865 shares)		2,049	3,485
(Business Services)	Warrants			200
Meineke Car Care Centers, Inc.	Senior Loan (8.8%, Due 6/11)	28,000	27,877	27,877
(Consumer Services)	Subordinated Debt (11.9%, Due 6/12 6/13)	72,000	71,705	71,705
			26,985	23,152

	Common Stock (10,696,308 shares)(11)			
	Warrants			
MHF Logistical Solutions, Inc.	Subordinated Debt (13.2%, Due 6/12 6/13)	45,075	44,853	44,853
(Business Services)	Common Stock (21,425 shares)(11)		21,425	21,425
	Warrants			
Mid-Atlantic Venture Fund IV, L.P.(5) (Private Equity Fund)	Limited Partnership Interest		6,600	2,908
Mogas Energy, LLC	Subordinated Debt (9.5%, Due 3/12 4/12)	16,570	15,259	15,259
(Energy Services)	Warrants		1,774	2,900
Network Hardware Resale, Inc.	Unitranche Debt (10.5%, Due 12/11)	38,060	38,283	38,283
(Business Services)	Convertible Subordinated Debt (9.8%, Due 12/15)	12,000	12,072	12,072
N.E.W. Customer Service Companies, Inc. (Business Services)	Subordinated Debt (11.6%, Due 7/12)	40,000	40,013	40,013
Norwesco, Inc.	Subordinated Debt (12.6%, Due 1/12 7/12)	82,271	81,925	81,925
(Industrial Products)	Common Stock (559,603 shares)(11)		38,313	55,992
	Warrants			
Novak Biddle Venture Partners III, L.P.(5) (Private Equity Fund)	Limited Partnership Interest		1,595	1,700

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Private Finance Portfolio Company (in thousands, except number of shares)	**Investment[1][2]**	**Principal**	**June 30, 2006 (unaudited) Cost**	**Value**
Oahu Waste Services, Inc. (Business Services)	Stock Appreciation Rights		$ 239	$ 1,200
Odyssey Investment Partners Fund III, LP[5] (Private Equity Fund)	Limited Partnership Interest		1,832	1,688
Opinion Research Corporation[3] (Business Services)	Warrants		996	166
Oriental Trading Company, Inc. (Consumer Products)	Common Stock (13,820 shares)			6,995
Palm Coast Data, LLC (Business Services)	Senior Loan (8.5%, Due 8/10)	$15,569	15,501	15,501
	Subordinated Debt (15.5%, Due 8/12 8/15)	30,126	29,997	29,997
	Common Stock (21,743 shares)[11]		21,743	19,003
	Warrants			
Passport Health Communications, Inc.	Subordinated Debt (14.0%, Due 4/12)	10,000	9,952	9,952
(Healthcare Services)	Preferred Stock (651,381 shares)		2,000	2,000
Performant Financial Corporation (Business Services)	Common Stock (478,816 shares)		734	150
Pro Mach, Inc.	Subordinated Debt (13.8%, Due 6/12)	14,471	14,396	14,396
(Industrial Products)	Equity Interests		1,500	2,650
Promo Works, LLC (Business Services)	Senior Loan (9.1%, Due 12/11)	3,000	2,953	2,953
	Unitranche Debt (10.3%, Due 12/11)	31,000	30,751	30,751
	Guaranty ($1,500)			
Red Hawk Industries, LLC (Business Services)	Unitranche Debt (11.0%, Due 4/11)	56,342	56,088	56,088

S.B. Restaurant Company	Unitranche Debt (10.3%, Due 4/11)	33,501	33,088	33,088
(Retail)	Preferred Stock (54,125 shares)		135	135
	Warrants		619	1,200
	Standby Letters of Credit ($2,611)			
SBBUT, LLC (Consumer Products)	Equity Interests			
Soff-Cut Holdings, Inc.	Preferred Stock (300 shares)		300	300
(Industrial Products)	Common Stock (2,000 shares)		200	114
SPP Mezzanine Fund, L.P.(5) (Private Equity Fund)	Limited Partnership Interest		2,594	2,675
STS Operating, Inc. (Industrial Products)	Subordinated Debt (15.0%, Due 1/13)	30,000	29,854	29,854

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Private Finance Portfolio Company (in thousands, except number of shares)	Investment[1][2]	Principal	June 30, 2006 (unaudited) Cost	Value
The Step2 Company, LLC (Consumer Products)	Unitranche Debt (10.5%, Due 4/12)	$68,000	$ 67,517	$ 67,517
	Equity Interests		2,000	2,000
Tradesmen International, Inc. (Business Services)	Subordinated Debt (12.0%, Due 12/09)	15,000	14,393	14,393
	Warrants		710	2,900
TransAmerican Auto Parts, LLC (Consumer Products)	Subordinated Debt (14.0%, Due 11/12)	12,818	12,760	12,760
	Equity Interests		1,190	1,039
TransTechnology Corporation[3] (Industrial Products)	Senior Loan (9.9%, Due 4/11)	10,000	10,000	10,000
Universal Air Filter Company (Industrial Products)	Unitranche Debt (11.0%, Due 11/11)	19,617	19,518	19,518
Universal Tax Systems, Inc. (Business Services)	Subordinated Debt (14.5%, Due 10/13)	19,310	19,243	19,243
Updata Venture Partners II, L.P.[5] (Private Equity Fund)	Limited Partnership Interest		5,077	4,898
Venturehouse-Cibernet Investors, LLC (Business Services)	Equity Interest		42	42
Venturehouse Group, LLC[5] (Private Equity Fund)	Equity Interest		598	407
VICORP Restaurants, Inc.[3] (Retail)	Warrants		33	33
Walker Investment Fund II, LLLP[5] (Private Equity Fund)	Limited Partnership Interest		1,330	521

Wear Me Apparel Corporation	Subordinated Debt (15.0%, Due 12/10)	40,000	39,190	39,190
(Consumer Products)	Warrants		1,219	2,900
Wilton Industries, Inc.	Subordinated Debt (16.0%, Due 6/08)	4,800	4,800	4,800
(Consumer Products)				
Woodstream Corporation	Subordinated Debt (13.4%, Due 11/12 5/13)	52,753	52,617	52,617
(Consumer Products)	Common Stock (180 shares)		673	3,352
	Warrants			2,348
York Insurance Services Group, Inc.	Subordinated Debt (14.5%, Due 10/13)	19,000	18,907	18,907
(Business Services)	Common Stock (10,000 shares)		1,000	1,000
Other companies	Other debt investments(6)	453	453	334
	Other equity investments		8	
	Guaranty ($159)			
Total companies less than 5% owned			$1,933,932	$1,901,139
Total private finance (131 portfolio companies)			$3,588,250	$3,460,426

(1) Interest rates represent the weighted average annual stated interest rate on loans and debt securities, which are presented by nature of indebtedness for a single issuer. The maturity dates represent the earliest and the latest maturity dates.

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

(3) Public company.

(4) Non-U.S. company or principal place of business outside the U.S.

(5) Non-registered investment company.

(6) Loan or debt security is on non-accrual status and therefore is considered non-income producing.

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

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

	Interest Rate Ranges	Number of Loans	June 30, 2006 (unaudited) Cost	Value
Commercial Mortgage Loans				
	Up to 6.99%	3	$ 20,314	$ 19,481
	7.00% 8.99%	25	48,798	49,024
	9.00% 10.99%	3	21,781	21,781
	11.00% 14.99%	1	2,291	2,291
	15.00% and above	2	3,970	3,970
Total commercial mortgage loans(12)		34	$ 97,154	$ 96,547
Real Estate Owned			$ 13,090	$ 14,553
Equity Interests(2) Companies more than 25% owned (Guarantees $6,871)			$ 17,504	$ 21,951
Total commercial real estate finance			$ 127,748	$ 133,051
Total portfolio			$3,715,998	$3,593,477

	Yield	Cost	Value
Liquidity Portfolio			
U.S. Treasury bills (Due October 2006)	4.9%	$ 24,996	$ 25,067
U.S. Treasury bills (Due December 2006)	4.9%	100,004	100,873
SEI Daily Income Tr Prime Obligation Fund(13)	5.0%	55,292	55,292
Certificate of Deposit (Due September 2006)(13)	5.6%	20,000	20,000
Total liquidity portfolio		$200,292	$201,232
Other Investments in Money Market Securities(13)			
Columbia Treasury Reserves Money Market Fund	5.2%	$ 19,280	$ 19,280
PNC Bank Corporate Money Market Deposit Account	4.8%	$ 524	$ 524
Columbia Money Market Reserves	5.0%	$ 2,714	$ 2,714

(1) Interest rates represent the weighted average annual stated interest rate on loans and debt securities, which are presented by nature of indebtedness for a single issuer. The maturity dates represent the earliest and the latest maturity dates.
(2) Common stock, preferred stock, warrants, options, and equity interests are generally non-income producing and restricted.
(3) Public company.
(4) Non-U.S. company or principal place of business outside the U.S.
(5) Non-registered investment company.
(12) Commercial mortgage loans totaling $15.7 million at value were on non-accrual status and therefore were considered non-income producing.
(13) Included in investments in money market and other securities on the accompanying Consolidated Balance Sheet.

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

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Information at and for the three and six months ended June 30, 2006 and 2005 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, Allied Investments L.P. (Allied Investments), 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 that are single member limited liability companies established primarily to hold real estate properties. ACC also has a subsidiary, A.C. Corporation (AC Corp), that generally provides diligence and structuring services as well as structuring, transaction, management, consulting and other services to the Company and its portfolio companies. AC Corp has a wholly-owned subsidiary, AC Finance LLC (AC Finance), that generally originates, underwrites and arranges senior loans.

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

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

Note 2. Summary of Significant Accounting Policies

Basis of Presentation

The consolidated financial statements include the accounts of the Company. All intercompany accounts and transactions have been eliminated in consolidation. Certain reclassifications have been made to the 2005 balances to conform with the 2006 financial statement presentation.

The accompanying unaudited consolidated financial statements of the Company have been prepared in accordance with U.S. generally accepted accounting principles (GAAP) for interim financial information. Accordingly, they do not include all of the information and footnotes required by GAAP for complete consolidated financial statements. In the opinion of management, the unaudited consolidated financial results of the Company included herein contain all adjustments (consisting of only normal recurring accruals) necessary to present fairly the financial position of the Company as of June 30, 2006, the results of operations for the three and six months ended June 30, 2006 and 2005, and changes in net assets and cash flows for the six months ended June 30, 2006 and 2005. The results of operations for the three and six months ended June 30, 2006, are not necessarily indicative of the operating results to be expected for the full year.

The private finance portfolio and the interest and related portfolio income and net realized gains (losses) on the private finance portfolio are presented in three categories: companies more than 25% owned, which represent portfolio companies where the Company directly or indirectly owns more than

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 2. Summary of Significant Accounting Policies, continued

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

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

Valuation Of Portfolio Investments

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

Loans and Debt Securities

For loans and debt securities, fair value generally approximates cost unless the borrower s enterprise value, overall financial condition or other factors lead to a determination of fair value at a different amount. The value of loan and debt securities may be greater than the Company s cost basis if the amount that would be repaid on the loan or debt security upon the sale of the portfolio company is greater than the Company s cost basis.

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 2. Summary of Significant Accounting Policies, continued

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, the Company will not accrue payment-in-kind interest if the portfolio company valuation indicates that the payment-in-kind interest is not collectible. In general, interest is not accrued if the Company has doubt about interest collection or where the enterprise value of the portfolio company may not support further accrual. Loans in workout status that are classified as Grade 4 or 5 assets under the Company s internal grading system do not accrue interest. In addition, interest may not accrue on loans or debt securities to portfolio companies that are more than 50% owned by the Company depending on such company s capital requirements. Loan origination fees, original issue discount, and market discount are capitalized and then amortized into interest income using a method that approximates the effective interest method. Upon the prepayment of a loan or debt security, any unamortized loan origination fees are recorded as interest income and any unamortized original issue discount or market discount is recorded as a realized gain. Prepayment premiums are recorded on loans and debt securities when received.

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

Equity Securities

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

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

Dividend income on preferred equity securities is recorded as dividend income on an accrual basis to the extent that such amounts are expected to be collected and to the extent that the Company has the option to receive the dividend in cash. Dividend income on common equity

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 2. Summary of Significant Accounting Policies, continued

securities is recorded on the record date for private companies or on the ex-dividend date for publicly traded companies.

Collateralized Debt Obligations (CDO) and Collateralized Loan Obligations (CLO)

CDO and CLO bonds and preferred shares/ income notes (CDO/ CLO Assets) are carried at fair value, which is based on a discounted cash flow model that utilizes prepayment and loss assumptions based on historical experience and projected performance, economic factors, the characteristics of the underlying cash flow, and comparable yields for similar bonds and preferred shares/income notes, when available. The Company recognizes unrealized appreciation or depreciation on its CDO/ CLO Assets as comparable yields in the market change and/or based on changes in estimated cash flows resulting from changes in prepayment or loss assumptions in the underlying collateral pool. The Company determines the fair value of its CDO/ CLO Assets on an individual security-by-security basis.

The Company recognizes income from the amortization of original issue discount using the effective interest method using the anticipated yield over the projected life of the investment. Yields are revised when there are changes in actual and estimated prepayment speeds or actual and estimated credit losses. Changes in estimated yield are recognized as an adjustment to the estimated yield over the remaining life of the CDO/ CLO Assets from the date the estimated yield was changed.

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

Realized gains or losses are measured by the difference between the net proceeds from the repayment or sale and the cost basis of the investment without regard to unrealized appreciation or depreciation previously recognized, and include investments charged off during the year, net of recoveries. Net change in unrealized appreciation or depreciation primarily reflects the change in portfolio investment values during the reporting period, including the reversal of previously recorded unrealized appreciation or depreciation when gains or losses are realized. Net change in unrealized appreciation or depreciation also reflects the change in the value of U.S. Treasury bills and deposits of proceeds from sales of borrowed Treasury securities, and depreciation on accrued interest and dividends receivable and other assets where collection is doubtful.

Fee Income

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

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 2. Summary of Significant Accounting Policies, continued

Guarantees

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

Financing Costs

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

Dividends to Shareholders

Dividends to shareholders are recorded on the record date.

Stock Compensation Plans

The Company has a stock-based employee compensation plan. See Note 9. Effective January 1, 2006, the Company adopted the provisions of Statement No. 123 (Revised 2004), *Share-Based Payment* (the Statement). With respect to options granted prior to January 1, 2006, the Company has used the modified prospective method for adoption of the Statement. Under this method, the unamortized cost of previously awarded options that were unvested as of January 1, 2006, is recognized over the remaining service period in the statement of operations beginning in 2006. With respect to options granted on or after January 1, 2006, compensation cost is recognized over the related service period in the statement of operations. The effect of this adoption for the three and six months ended June 30, 2006, was as follows:

($ in millions, except per share amounts)	For the Three Months Ended June 30, 2006	For the Six Months Ended June 30, 2006
Employee Stock Option Expense:		
Previously awarded, unvested options as of January 1, 2006	$ 3.3	$ 6.7
Options granted on or after January 1, 2006	1.3	1.5
Total stock option expense	$ 4.6	$ 8.2
Per basic share	$0.03	$0.06
Per diluted share	$0.03	$0.06

In addition to the employee stock option expense, for the three and six months ended June 30, 2006, administrative expense included $0.2 million of expense related to options granted to directors during the period. Options granted to non-officer directors vest on the grant date and therefore, the full expense is recorded on the grant date.

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 2. Summary of Significant Accounting Policies, continued

Prior to January 1, 2006, the Company accounted for this plan under the recognition and measurement principles of APB Opinion No. 25, *Accounting for Stock Issued to Employees*, and related interpretations. Prior to January 1, 2006, no stock-based compensation cost was reflected in net increase in net assets resulting from operations, as all options granted under this plan had an exercise price equal to the market value of the underlying common stock on the date of grant. The following table illustrates the effect on net increase in net assets resulting from operations and earnings per share if the Company had applied the fair value recognition provisions of FASB Statement No. 123, *Accounting for Stock-Based Compensation*, to stock-based compensation for the three and six months ended June 30, 2005.

($ in millions, except per share amounts)	For the Three Months Ended June 30, 2005	For the Six Months Ended June 30, 2005
Net increase in net assets resulting from operations as reported	$311.9	$431.5
Less total stock-based compensation expense determined under fair value based method for all awards, net of related tax effects	(4.1)	(7.0)
Pro forma net increase in net assets resulting from operations available to common shareholders	$307.8	$424.5
Basic earnings per common share:		
As reported	$ 2.33	$ 3.23
Pro forma	$ 2.30	$ 3.18
Diluted earnings per common share:		
As reported	$ 2.29	$ 3.17
Pro forma	$ 2.26	$ 3.12

The stock option expense for 2006 and the pro forma expense for 2005 shown in the tables above were based on the underlying value of the options granted by the Company. The fair value of each option grant was estimated on the date of grant using the Black-Scholes option pricing model and expensed over the vesting period. The following assumptions were used to calculate the fair value of options granted during the three and six months ended June 30, 2006 and 2005:

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2006	2005	2006	2005
Risk-free interest rate	5.0%	4.1%	4.8%	4.1%
Expected life (in years)	5.0	5.0	5.0	5.0
Expected volatility	29.6%	35.5%	29.6%	35.5%
Dividend yield	9.0%	9.0%	9.0%	9.0%
Weighted average fair value per option	$3.65	$3.87	$3.54	$3.87

The risk free rate was based on the U.S. Treasury bond yield curve at the date of grant. The expected life of the options granted represents the period of time that such options are expected to be outstanding. To determine the expected life of the options, the Company used historical data to

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 2. Summary of Significant Accounting Policies, continued

estimate option exercise time frames and option forfeitures, including considering employee terminations. Expected volatilities were determined based on the historical volatility of the Company s common stock. The dividend yield was determined based on the Company s historical dividend yield.

The Company estimates that the employee-related stock option expense under the Statement that will be recorded in the Company s statement of operations will be approximately $16.1 million, $10.1 million, and $3.2 million for the years ended December 31, 2006, 2007, and 2008, respectively, which includes approximately $2.6 million, $1.4 million, and $0.7 million, respectively, related to options granted in the first and second quarters of 2006. This estimate may change if the Company s assumptions related to future option forfeitures change. This estimate does not include any expense related to future stock option grants as the fair value of those stock options will be determined at the time of grant. The aggregate total stock option expense remaining as of June 30, 2006, is expected to be recognized over an estimated weighted-average period of 1.38 years.

Federal and State Income Taxes and Excise Tax

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). ACC and any subsidiaries that qualify as a RIC or a REIT intend to distribute or retain through a deemed distribution all of their annual taxable income to shareholders; therefore, the Company has made no provision for income taxes for these entities. Income taxes for AC Corp are accounted for under the asset and liability method. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases as well as operating loss and tax credit carryforwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled.

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

Per Share Information

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

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 2. Summary of Significant Accounting Policies, continued

Use of Estimates in the Preparation of Financial Statements

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

The consolidated financial statements include portfolio investments at value of $3.6 billion at both June 30, 2006, and December 31, 2005. At both June 30, 2006, and December 31, 2005, 90% of the Company s total assets represented portfolio investments whose fair values have been determined by the Board of Directors in good faith in the absence of readily available market values. Because of the inherent uncertainty of valuation, the Board of Directors determined values may differ significantly from the values that would have been used had a ready market existed for the investments, and the differences could be material.

Note 3. Portfolio

Private Finance

At June 30, 2006, and December 31, 2005, the private finance portfolio consisted of the following:

	2006			2005		
($ in thousands)	Cost	Value	Yield(1)	Cost	Value	Yield(1)
Loans and debt securities:						
Senior loans	$ 322,041	$ 275,874	9.5%	$ 284,680	$ 239,838	9.5%
Unitranche debt(2)	517,287	515,006	10.7%	294,201	294,201	11.4%
Subordinated debt	1,769,369	1,700,324	13.9%	1,610,228	1,560,851	13.8%
Total loans and debt securities(3)	2,608,697	2,491,204	12.7%	2,189,109	2,094,890	13.0%
Equity securities	979,553	969,222		917,314	1,384,400	
Total	$3,588,250	$3,460,426		$3,106,423	$3,479,290	

(1) The weighted average yield on loans and debt securities is computed as the (a) annual stated interest plus the annual amortization of loan origination fees, original issue discount, and market discount on accruing loans and debt securities less the annual amortization of loan origination costs, divided by (b) total loans and debt securities at value. At June 30, 2006, and December 31, 2005, the cost and value of subordinated debt include the Class A equity interests in BLX and the guaranteed dividend yield on these equity interests is included in interest income. The weighted average yield is computed as of the balance sheet date.

(2) Unitranche debt is a single debt investment that is a blend of senior and subordinated debt terms.

(3) The total principal balance outstanding on loans and debt securities was $2,637.0 million and $2,216.3 million at June 30, 2006, and December 31, 2005, respectively. The difference between principal and cost is represented by unamortized loan origination fees and costs, original issue discounts, and market discounts totaling $28.3 million

and $27.2 million at June 30, 2006, and December 31, 2005, respectively.

The Company s private finance investment activity principally involves providing financing through privately negotiated long-term debt and equity investments. The Company s private finance

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 3. Portfolio, continued

investments are generally issued by private companies and are generally illiquid and may be subject to certain restrictions on resale.

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

At June 30, 2006, 86% of the private finance loans and debt securities had a fixed rate of interest and 14% had a floating rate of interest. At December 31, 2005, 87% of the private finance loans and debt securities had a fixed rate of interest and 13% had a floating rate of interest. Senior loans generally carry a floating rate of interest, usually set as a spread over LIBOR. Senior loans generally have contractual maturities of three to six years and interest is generally paid to the Company monthly or quarterly. Loans other than senior loans generally carry a fixed rate of interest with contractual maturities of five to ten years. Loan and debt securities generally have interest-only payments in the early years and payments of both principal and interest in the later years, although maturities and principal amortization schedules may vary. Interest is generally paid to the Company quarterly.

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

The Company s largest investment at value at June 30, 2006, was in Business Loan Express, LLC (BLX). The Company s largest investments at value at December 31, 2005, were in Advantage Sales & Marketing, Inc. (Advantage) and BLX. On March 29, 2006, the Company sold its majority equity interest in Advantage.

Business Loan Express, LLC. The Company s investment in BLX totaled $293.2 million at cost and $317.2 million at value at June 30, 2006, and $299.4 million at cost and $357.1 million at value

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 3. Portfolio, continued

at December 31, 2005. BLX is a small business lender that participates in the U.S. Small Business Administration s 7(a) Guaranteed Loan Program. At June 30, 2006, and December 31, 2005, the Company owned 94.9% of the voting Class C equity interests. BLX has an equity appreciation rights plan for management which will dilute the value available to the Class C equity interest holders. BLX is headquartered in New York, NY.

Total interest and related portfolio income earned from the Company s investment in BLX for the three and six months ended June 30, 2006 and 2005, was as follows:

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
($ in millions)	2006	2005	2006	2005
Interest income on subordinated debt and Class A equity interests	$4.0	$3.5	$ 7.8	$ 6.9
Dividend income on Class B equity interests		3.0		5.0
Fees and other income	2.0	2.3	4.3	4.7
Total interest and related portfolio income	$6.0	$8.8	$12.1	$16.6

Interest income from BLX for the three and six months ended June 30, 2006 included interest income of $1.9 million and $3.7 million, respectively, which was paid in kind. Interest income from BLX for the three and six months ended June 30, 2005, included interest income of $1.7 million and $3.3 million, respectively, which was paid in kind. The interest paid in kind was paid to the Company through the issuance of additional Class A equity interests.

Net change in unrealized appreciation or depreciation included a net decrease in unrealized appreciation on the Company s investment in BLX of $10.9 million and $33.6 million for the three and six months ended June 30, 2006, respectively. Net change in unrealized appreciation or depreciation for the three and six months ended June 30, 2005, included a net increase in unrealized appreciation of $7.6 million and $1.3 million, respectively, on the Company s investment in BLX.

At December 31, 2005, the Company had a commitment to BLX of $30.0 million in the form of a subordinated revolving credit facility to provide working capital to BLX. There was $10.0 million outstanding under this facility at December 31, 2005. Outstanding borrowings under this facility were repaid in full and this facility matured on April 30, 2006.

As a limited liability company, BLX s taxable income flows through directly to its members. BLX s annual taxable income generally differs from its book income for the fiscal year due to temporary and permanent differences in the recognition of income and expenses. The Company holds all of BLX s Class A and Class B interests, and 94.9% of the Class C interests. BLX s taxable income is first allocated to the Class A interests to the extent that dividends are paid in cash or in kind on such interests, with the remainder being allocated to the Class B and Class C interests. BLX may declare dividends on its Class B interests. If declared, BLX would determine the amount of such dividend considering its estimated annual taxable income allocable to such interests.

At the time of the corporate reorganization of BLX, Inc. from a C corporation to a limited liability company in 2003, for tax purposes BLX had a built-in gain representing the aggregate fair market value of its assets in excess of the tax basis of its assets. As a RIC, the Company will be

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 3. Portfolio, continued

subject to special built-in gain rules on the assets of BLX. Under these rules, taxes will be payable by the Company at the time and to the extent that the built-in gains on BLX s assets at the date of reorganization are recognized in a taxable disposition of such assets in the 10-year period following the date of the reorganization. At such time, the built-in gains realized upon the disposition of these assets will be included in the Company s taxable income, net of the corporate level taxes paid by the Company on the built-in gains. At the date of BLX s reorganization, the Company estimated that its future tax liability resulting from the built-in gains may total up to a maximum of $40 million. However, if these assets are disposed of after the 10-year period, there will be no corporate level taxes on these built-in gains. While the Company has no obligation to pay the built-in gains tax until these assets or its interests in BLX are disposed of in the future, it may be necessary to record a liability for these taxes in the future should the Company intend to sell the assets of or its interests in BLX within the 10-year period.

At June 30, 2006, and December 31, 2005, the Company considered the increase in fair value of its investment in BLX due to BLX s tax attributes as an LLC and has also considered the reduction in fair value of its investment due to these estimated built-in gain taxes in determining the fair value of its investment in BLX. At June 30, 2006, the Company estimated that the built-in gain tax liability would be approximately $16 million.

At December 31, 2005, BLX had a three-year $275.0 million revolving credit facility provided by third party lenders that was scheduled to mature in January 2007. As the controlling equity owner in BLX, the Company had provided an unconditional guaranty to the revolving credit facility lenders in an amount equal to 50% of the total obligations (consisting of principal, letters of credit issued under the facility, accrued interest, and other fees) of BLX under the revolving credit facility. The total obligation guaranteed by the Company at December 31, 2005, was $135.4 million.

On March 17, 2006, BLX closed on a new three-year $500.0 million revolving credit facility that matures in March 2009, which replaced the existing facility. The revolving credit facility may be expanded through new or additional commitments up to $600.0 million at BLX s option. This new facility provides for a sub-facility for the issuance of letters of credit for up to an amount equal to 25% of the committed facility. The Company has provided an unconditional guaranty to these BLX credit facility lenders in an amount equal to 50% of the total obligations (consisting of principal, letters of credit issued under the facility, accrued interest, and other fees) on this facility. The amount guaranteed by the Company at June 30, 2006, was $149.2 million. This guaranty can be called by the lenders only in the event of a default under the BLX credit facility, which includes certain defaults under the Company s revolving credit facility. BLX has determined it was in compliance with the terms of this facility at June 30, 2006.

At June 30, 2006, the Company had also provided four standby letters of credit totaling $32.0 million in connection with four term securitization transactions completed by BLX. In consideration for providing the revolving credit facility guaranty and the standby letters of credit, BLX paid the Company fees of $1.6 million and $1.5 million for the three months ended June 30, 2006 and 2005, respectively, and $3.1 million and $3.2 million for the six months ended June 30, 2006 and 2005, respectively.

Advantage Sales and Marketing, Inc. In June 2004, the Company completed the purchase of a majority voting ownership in Advantage, which was subject to dilution by a management option pool.

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 3. Portfolio, continued

Advantage is a sales and marketing agency providing outsourced sales, merchandising, and marketing services to the consumer packaged goods industry. Advantage has offices across the United States and is headquartered in Irvine, CA.

At December 31, 2005, the Company s investment in Advantage totaled $257.7 million at cost and $660.4 million at value, which included unrealized appreciation of $402.7 million.

On March 29, 2006, the Company sold its majority equity interest in Advantage. The Company was repaid its $184 million in subordinated debt outstanding and realized a gain on its equity investment sold of $433.7 million, subject to post-closing adjustments. As consideration for the common stock sold in the transaction, the Company received a $150 million subordinated note, with the balance of the consideration paid in cash. Approximately $34 million of the Company s cash proceeds from the sale of the common stock were placed in escrow, subject to certain holdback provisions. In addition, there is potential for the Company to receive additional consideration through an earn-out payment that would be based on Advantage s 2006 audited results. The Company s realized gain of $433.7 million, subject to post-closing adjustments, excludes any earn-out amounts. In connection with the transaction, the Company retained an equity investment in the business valued at $15 million at closing as a minority shareholder.

After the sale transaction, the Company s investment in Advantage at June 30, 2006, which was composed of subordinated debt and a minority equity interest, totaled $152.1 million at cost and $165.1 million at value. This investment was included in companies 5% to 25% owned in the consolidated financial statements as the Company continues to hold a seat on Advantage s board of directors.

Total interest and related portfolio income earned from the Company s investment in Advantage while the Company held a majority equity interest for the six months ended June 30, 2006 and 2005, was $14.1 million and $18.5 million, respectively.

There was no net change in unrealized appreciation or depreciation for the three months ended June 30, 2006, related to the Company s investment in Advantage. Net change in unrealized appreciation or depreciation for the six months ended June 30, 2006, included the reversal of $389.7 million of previously recorded unrealized appreciation associated with the realization of a gain on the sale of the Company s majority equity interest in Advantage and for the three and six months ended June 30, 2005, included an increase in unrealized appreciation of $51.0 million and $119.9 million, respectively, related to the Company s investment in Advantage.

Collateralized Loan Obligations (CLOs) and Collateralized Debt Obligations (CDOs) At June 30, 2006, and December 31, 2005, the Company owned bonds and preferred shares/income

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 3. Portfolio, continued

notes in collateralized loan obligations (CLOs) and a collateralized debt obligation (CDO) as follows:

($ in millions)	2006 Cost	2006 Value	2005 Cost	2005 Value
Callidus Debt Partners CDO Fund I, Ltd.	$ 28.4	$ 28.4	$ 28.5	$ 28.5
Callidus Debt Partners CLO Fund III, Ltd.	23.8	23.8	24.2	24.2
Callidus Debt Partners CLO Fund IV, Ltd.	12.9	12.9		
Callidus MAPS CLO Fund I LLC	67.6	67.6	65.1	65.1
Total	$132.7	$132.7	$117.8	$117.8

These CLO and CDO investments are managed by Callidus Capital, a portfolio company controlled by the Company.

The bonds, preferred shares and income notes of the CLOs and CDO in which the Company has invested are junior in priority for payment of interest and principal to the more senior notes issued by the CLOs and CDO. Cash flow from the underlying collateral assets in the CLOs and CDO is generally allocated first to the senior bonds in order of priority, then any remaining cash flow is generally distributed to the preferred shareholders and income note holders. To the extent there are defaults and unrecoverable losses on the underlying collateral assets that result in reduced cash flows, the preferred shares/income notes would bear this loss first and then the subordinated bonds would bear any loss after the preferred shares/income notes.

At both June 30, 2006 and December 31, 2005, the face value of the CLO and CDO bonds held by the Company were subordinate to approximately 82% to 85% of the face value of the securities issued in these CLOs and CDO. At both June 30, 2006 and December 31, 2005, the face value of the CLO preferred shares/income notes held by the Company were subordinate to approximately 86% to 91% of the face value of the securities issued in these CLOs.

At June 30, 2006, and December 31, 2005, the underlying collateral assets of these CLO and CDO investments, consisting primarily of senior debt, were issued by 413 issuers and 336 issuers, respectively, and had balances as follows:

($ in millions)	2006	2005
Bonds	$ 242.8	$ 230.7
Syndicated Loans	1,304.9	704.0
Cash[(1)]	126.0	238.4
Total underlying collateral assets	$1,673.7	$1,173.1

(1) Includes undrawn liability amounts.

At June 30, 2006, and December 31, 2005, there were no delinquencies in the underlying collateral assets of the CLO and CDO issuances owned by the Company.

The initial yields on the CLO and CDO bonds, preferred shares and income notes are based on the estimated future cash flows from the underlying collateral assets expected to be paid to these CLO and CDO classes. As each CLO and CDO bond, preferred share or income note ages, the

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 3. Portfolio, continued

estimated future cash flows are updated based on the estimated performance of the underlying collateral assets, and the respective yield is adjusted as necessary. As future cash flows are subject to uncertainties and contingencies that are difficult to predict and are subject to future events that may alter current assumptions, no assurance can be given that the anticipated yields to maturity will be achieved.

Loans and Debt Securities on Non-Accrual Status. At June 30, 2006, and December 31, 2005, private finance loans and debt securities at value not accruing interest were as follows:

($ in thousands)	**2006**	**2005**
Loans and debt securities in workout status (classified as Grade 4 or 5)		
Companies more than 25% owned	$17,670	$ 15,622
Companies 5% to 25% owned	3,312	
Companies less than 5% owned	24,598	11,417
Loans and debt securities not in workout status		
Companies more than 25% owned	40,775	58,047
Companies 5% to 25% owned	6,595	534
Companies less than 5% owned	3,922	49,458
Total	$96,872	$135,078

Industry and Geographic Compositions. The industry and geographic compositions of the private finance portfolio at value at June 30, 2006, and December 31, 2005, were as follows:

	2006	**2005**
Industry		
Business services	31%	42%
Consumer products	24	14
Financial services	14	14
Industrial products	9	10
Consumer services	7	6
Healthcare services	3	2
Retail	2	3
Energy services	2	2
Other[1]	8	7
Total	100%	100%

(1) Includes investments in senior debt CDO and CLO funds. These funds invest in senior debt representing a variety of industries.

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 3. Portfolio, continued

Geographic Region[1]		
Mid-Atlantic	34%	29%
Midwest	26	21
West	20	34
Southeast	16	12
Northeast	4	4
Total	100%	100%

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

Commercial Real Estate Finance

At June 30, 2006, and December 31, 2005, the commercial real estate finance portfolio consisted of the following:

	2006			2005		
($ in thousands)	Cost	Value	Yield[1]	Cost	Value	Yield[1]
Commercial mortgage loans	$ 97,154	$ 96,547	8.1%	$103,878	$102,569	7.6%
Real estate owned	13,090	14,553		14,240	13,932	
Equity interests	17,504	21,951		13,577	10,564	
Total	$127,748	$133,051		$131,695	$127,065	

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

Commercial Mortgage Loans and Equity Interests. The commercial mortgage loan portfolio contains loans that were originated by the Company or were purchased from third-party sellers. At both June 30, 2006, and December 31, 2005, approximately 97% and 3% of the Company s commercial mortgage loan portfolio was composed of fixed and adjustable interest rate loans, respectively. At June 30, 2006, and December 31, 2005, loans with a value of $15.7 million and $20.8 million, respectively, were not accruing interest. Loans greater than 120 days delinquent generally do not accrue interest.

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

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 3. Portfolio, continued

The property types and the geographic composition securing the commercial mortgage loans and equity interests at value at June 30, 2006, and December 31, 2005, were as follows:

	2006	2005
Property Type		
Hospitality	36%	37%
Housing	27	30
Office	18	11
Retail	15	16
Other	4	6
Total	100%	100%
Geographic Region		
Mid-Atlantic	33%	31%
Southeast	30	25
West	16	18
Midwest	15	21
Northeast	6	5
Total	100%	100%

Note 4. Debt

At June 30, 2006, and December 31, 2005, the Company had the following debt:

	2006			2005		
($ in thousands)	**Facility Amount**	**Amount Drawn**	**Annual Interest Cost(1)**	**Facility Amount**	**Amount Drawn**	**Annual Interest Cost(1)**
Notes payable and debentures:						
Unsecured notes payable	$1,190,637	$1,190,637	6.2%	$1,164,540	$1,164,540	6.2%
SBA debentures	16,500	16,500	7.4%	28,500	28,500	7.5%
Total notes payable and debentures	1,207,137	1,207,137	6.2%	1,193,040	1,193,040	6.3%
Revolving line of credit	922,500	1,750	6.4%(2)	772,500	91,750	5.6%(2)
Total debt	$2,129,637	$1,208,887	6.6%(3)	$1,965,540	$1,284,790	6.5%(3)

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

(2) The annual interest cost reflects the interest rate payable for borrowings under the revolving line of credit. In addition to the current interest rate payable, there were annual costs of commitment fees, other facility fees and amortization of debt financing costs of $3.8 million and $3.3 million at June 30, 2006, and December 31, 2005, respectively.

(3) The annual interest cost for total debt includes the annual cost of commitment fees, other facility fees and amortization of debt financing costs on the revolving line of credit regardless of the amount outstanding on the facility as of the balance sheet date.

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 4. Debt, continued

Notes Payable and Debentures

Unsecured Notes Payable. The Company has issued unsecured long-term notes to institutional investors. The notes require semi-annual interest payments until maturity and have original terms of five or seven years. At June 30, 2006, the notes had maturities from October 2006 to May 2013. The notes may be prepaid in whole or in part, together with an interest premium, as stipulated in the note agreement.

On May 1, 2006, the Company issued $50 million of seven-year, unsecured notes with a fixed interest rate of 6.75%. This debt matures in May 2013. The proceeds from the issuance of the notes were used to repay $25 million of 7.49% unsecured long-term notes that matured on May 1, 2006, with the remainder being used to fund new portfolio investments and for general corporate purposes.

On July 25, 2006, the Company completed a public issuance of $400 million of five-year, unsecured notes with a fixed interest rate of 6.625%. This debt matures on July 15, 2011. The Company has the option to redeem these notes in whole or in part, together with a redemption premium, as stipulated in the notes. The Company has certain financial and operating covenants that will be required by this public debt issuance, including that the Company will maintain a minimum ratio of 200% of total assets to total borrowings, as required by the Investment Company Act of 1940, as amended, while these notes are outstanding.

SBA Debentures. At June 30, 2006, and December 31, 2005, the Company had debentures payable to the SBA with original terms of ten years and at fixed interest rates ranging from 5.9% to 6.3% and 5.9% to 6.4%, respectively. At June 30, 2006, the debentures had remaining maturities of five to six years. The debentures require semi-annual interest-only payments with all principal due upon maturity. The SBA debentures are subject to prepayment penalties if paid prior to the fifth anniversary date of the notes. During the first half of 2006 and 2005, the Company repaid $12.0 million and $31.0 million, respectively, of the SBA debentures.

Scheduled Maturities. Scheduled future maturities of notes payable and debentures at June 30, 2006, were as follows:

Year	Amount Maturing ($ in thousands)
2006	$ 150,000
2007	
2008	153,000
2009	268,137
2010	408,000
Thereafter	228,000
Total	$1,207,137

Revolving Line of Credit

At December 31, 2005, the Company had an unsecured revolving line of credit with a committed amount of $772.5 million that expires on September 30, 2008. In May 2006, the Company expanded the committed amount to $922.5 million. The revolving line of credit is now fully

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 4. Debt, continued

committed. At the Company s option, borrowings under the revolving line of credit generally bear interest at a rate equal to (i) LIBOR (for the period the Company selects) plus 1.05% or (ii) the higher of the Federal Funds rate plus 0.50% or the Bank of America, N.A. prime rate. The revolving line of credit requires the payment of an annual commitment fee equal to 0.20% of the committed amount (whether used or unused). The revolving line of credit generally requires payments of interest at the end of each LIBOR interest period, but no less frequently than quarterly, on LIBOR based loans and monthly payments of interest on other loans. All principal is due upon maturity.

The annual cost of commitment fees, other facility fees and amortization of debt financing costs was $3.8 million and $3.3 million at June 30, 2006 and December 31, 2005, respectively.

The revolving credit facility provides for a sub-facility for the issuance of letters of credit for up to an amount equal to 16.66% of the committed facility or $153.7 million. The letter of credit fee is 1.05% per annum on letters of credit issued, which is payable quarterly.

The average debt outstanding on the revolving line of credit was $201.7 million and $64.4 million for the six months ended June 30, 2006 and 2005, respectively. The maximum amount borrowed under this facility and the weighted average stated interest rate for the six months ended June 30, 2006 and 2005, were $540.3 million and 6.0%, respectively, and $263.3 million and 4.4%, respectively. As of June 30, 2006, the amount available under the revolving line of credit was $882.5 million, net of amounts committed for standby letters of credit of $38.3 million issued under the credit facility.

Covenant Compliance

The Company has various financial and operating covenants required by the notes payable and debentures and the revolving line of credit outstanding at June 30, 2006. These covenants require the Company to maintain certain financial ratios, including debt to equity and interest coverage, and a minimum net worth. These credit facilities provide for customary events of default, including, but not limited to, payment defaults, breach of representations or covenants, cross-defaults, bankruptcy events, failure to pay judgments, attachment of our assets, change of control and the issuance of an order of dissolution. Certain of these events of default are subject to notice and cure periods or materiality thresholds. The Company s credit facilities limit its ability to declare dividends if the Company defaults under certain provisions. As of June 30, 2006, and December 31, 2005, the Company was in compliance with these covenants.

Note 5. Guarantees and Commitments

In the ordinary course of business, the Company has issued guarantees and has extended standby letters of credit through financial intermediaries on behalf of certain portfolio companies. All standby letters of credit have been issued through Bank of America, N.A. As of June 30, 2006, and December 31, 2005, the Company had issued guarantees of debt, rental obligations, and lease obligations aggregating $163.3 million and $148.6 million, respectively, and had extended standby letters of credit aggregating $38.3 million and $37.1 million, respectively. Under these arrangements, the Company would be required to make payments to third-party beneficiaries if the portfolio companies were to default on their related payment obligations. The maximum amount of potential future payments was $201.6 million and $185.7 million at June 30, 2006, and December 31, 2005, respectively. At June 30, 2006, and December 31, 2005, $2.6 million and $2.5 million, respectively,

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 5. Guarantees, continued

had been recorded as a liability for the Company s guarantees and no amounts had been recorded as a liability for the Company s standby letters of credit.

As of June 30, 2006, the guarantees and standby letters of credit expire as follows:

(in millions)	Total	2006	2007	2008	2009	2010	After 2010
Guarantees	$163.3	$2.5	$0.7	$ 3.0	$151.6	$	$5.5
Standby letters of credit[1]	38.3	0.1		38.2			
Total	$201.6	$2.6	$0.7	$41.2	$151.6	$	$5.5

[1] Standby letters of credit are issued under the Company s revolving line of credit that expires in September 2008. Therefore, unless a standby letter of credit is set to expire at an earlier date, it is assumed that the standby letters of credit will expire contemporaneously with the expiration of the Company s line of credit in September 2008.

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

At June 30, 2006, the Company had outstanding commitments to fund investments totaling $362.1 million, including $352.7 million related to private finance investments and $9.4 million related to commercial real estate finance investments. In addition, during the fourth quarter of 2004 and the first quarter of 2005, the Company sold certain commercial mortgage loans that the Company may be required to repurchase under certain circumstances. These recourse provisions expire by April 2007. The aggregate outstanding principal balance of these sold loans was $11.2 million at June 30, 2006.

Note 6. Shareholders Equity

Sales of common stock for the six months ended June 30, 2006 and 2005, were as follows:

(in thousands)	2006	2005[1]
Number of common shares	3,000	
Gross proceeds	$87,750	$
Less costs, including underwriting fees	4,780	
Net proceeds	$82,970	$

[1] The Company did not sell any common stock during the six months ended June 30, 2005.

On July 24, 2006, the Company sold 4.5 million shares of its common stock for proceeds of $118.1 million, net of underwriting discounts and estimated offering expenses. On August 1, 2006, the Company completed the sale of 0.7 million shares of common stock pursuant to the underwriter s over-allotment option for net proceeds, after the underwriting discount and estimated offering expenses, of $17.8 million.

The Company issued 0.3 million shares of common stock with a value of $7.2 million as consideration for an additional investment in Mercury Air Centers, Inc. during the six months ended June 30, 2005.

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 6. Shareholders Equity, continued

The Company issued 0.4 million and 0.6 million shares of common stock upon the exercise of stock options during the six months ended June 30, 2006 and 2005, respectively.

The Company has a dividend reinvestment plan, whereby the Company may buy shares of its common stock in the open market or issue new shares in order to satisfy dividend reinvestment requests. If the Company issues new shares, the issue price is equal to the average of the closing sale prices reported for the Company s common stock for the five consecutive trading days immediately prior to the dividend payment date. For the six months ended June 30, 2006 and 2005, the Company issued new shares in order to satisfy dividend reinvestment requests.

Dividend reinvestment plan activity for the six months ended June 30, 2006 and 2005, was as follows:

	For the Six Months Ended June 30,	
	2006	**2005**
(in thousands, except per share amounts)		
Shares issued	243	151
Average price per share	$29.63	$27.58

Note 7. Earnings Per Common Share

Earnings per common share for the three and six months ended June 30, 2006 and 2005, were as follows:

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2006	**2005**	**2006**	**2005**
(in thousands, except per share amounts)				
Net increase in net assets resulting from operations available to common shareholders	$ 33,729	$311,885	$133,316	$431,506
Weighted average common shares outstanding basic	140,024	133,701	139,395	133,493
Dilutive options outstanding	3,189	2,680	3,071	2,489
Weighted average common shares outstanding diluted	143,213	136,381	142,466	135,982
Basic earnings per common share	$ 0.24	$ 2.33	$ 0.96	$ 3.23
Diluted earnings per common share	$ 0.24	$ 2.29	$ 0.94	$ 3.17

Note 8. Employee Compensation Plans

The Company has a deferred compensation plan. Amounts deferred by participants under the deferred compensation plan are funded to a trust, which is administered by trustees. The accounts of the deferred compensation trust are consolidated with the Company s accounts. The assets of the

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 8. Employee Compensation Plans, continued

trust are classified as other assets and the liability to the plan participants is included in other liabilities in the accompanying financial statements. The deferred compensation plan accounts at June 30, 2006, and December 31, 2005, totaled $17.1 million and $16.6 million, respectively.

The Company has an Individual Performance Award (IPA) plan, which was established as a long-term incentive compensation program for certain officers. In conjunction with the program, the Board of Directors has approved a non-qualified deferred compensation plan (DCP II), which is administered through a trust by a third-party trustee. The administrator of the DCP II is the Compensation Committee of the Company s Board of Directors (DCP II Administrator).

The IPA is generally determined annually at the beginning of each year but may be adjusted throughout the year. The IPA is deposited in the trust in four equal installments, generally on a quarterly basis, in the form of cash. The Compensation Committee of the Board of Directors designed the DCP II to require the trustee to use the cash to purchase shares of the Company s common stock in the open market. During both the six months ended June 30, 2006 and 2005, 0.2 million shares were purchased in the DCP II.

All amounts deposited and then credited to a participant s account in the trust, based on the amount of the IPA received by such participant, are credited solely for purposes of accounting and computation and remain assets of the Company and subject to the claims of the Company s general creditors. Amounts credited to participants under the DCP II are immediately vested and generally non-forfeitable once deposited by the Company into the trust. A participant s account shall generally become distributable only after his or her termination of employment, or in the event of a change of control of the Company. Upon the participant s termination of employment, one-third of the participant s account will be immediately distributed in accordance with the plan, one-half of the then current remaining balance will be distributed on the first anniversary of his or her employment termination date and the remainder of the account balance will be distributed on the second anniversary of the employment termination date. Distributions are subject to the participant s adherence to certain non-solicitation requirements. All DCP II accounts will be distributed in a single lump sum in the event of a change of control of the Company. To the extent that a participant has an employment agreement, such participant s DCP II account will be fully distributed in the event that such participant s employment is terminated for good reason as defined under that participant s employment agreement. Sixty days following a distributable event, the Company and each participant may, at the discretion of the Company and subject to the Company s trading window during that time, redirect the participant s account to other investment options.

During any period of time in which a participant has an account in the DCP II, any dividends declared and paid on shares of the Company s common stock allocated to the participant s account shall be reinvested by the trustee as soon as practicable in shares of the Company s common stock purchased in the open market.

The IPA amounts are contributed into the DCP II trust and invested in the Company s common stock. The accounts of the DCP II are consolidated with the Company s accounts. The common stock is classified as common stock held in deferred compensation trust in the accompanying financial statements and the deferred compensation obligation, which represents the amount owed to the employees, is included in other liabilities. Changes in the value of the Company s common stock held in the deferred compensation trust are not recognized. However, the liability is marked to market

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 8. Employee Compensation Plans, continued

with a corresponding charge or credit to employee compensation expense. At June 30, 2006, and December 31, 2005, common stock held in DCP II was $24.0 million and $19.5 million, respectively, and the IPA liability was $26.4 million and $22.3 million, respectively. At June 30, 2006, and December 31, 2005, the DCP II held 0.9 million and 0.7 million shares, respectively, of the Company s common stock.

The IPA expenses for the three and six months ended June 30, 2006 and 2005, were as follows:

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2006	**2005**	**2006**	**2005**
($ in millions)				
IPA contributions	$ 2.1	$1.9	$ 3.8	$3.8
IPA mark to market expense (benefit)	(1.5)	1.8	(0.6)	1.9
Total IPA expense	$ 0.6	$3.7	$ 3.2	$5.7

The Company also has an individual performance bonus (IPB) plan which is distributed in cash to award recipients in equal bi-weekly installments as long as the recipient remains employed by the Company. If a recipient terminated employment during the year, any remaining cash payments under the IPB would be forfeited. For the three months ended June 30, 2006 and 2005, the IPB expense was $2.2 million and $2.0 million, respectively. For both the six months ended June 30, 2006 and 2005, the IPB expense was $3.6 million. The IPA and IPB expenses are included in employee expenses.

Note 9. Stock Option Plan

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

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

There are 32.2 million shares authorized under the Option Plan. At June 30, 2006, and December 31, 2005, the number of shares available to be granted under the Option Plan was 1.8 million and 3.0 million, respectively.

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 9. Stock Option Plan, continued

Information with respect to options granted, exercised and forfeited under the Option Plan for the six months ended June 30, 2006, was as follows:

(in thousands, except per share amounts)	Shares	Weighted Average Exercise Price Per Share	Weighted Average Contractual Remaining Term (Years)	Aggregate Intrinsic Value at June 30, 2006[1]
Options outstanding at January 1, 2006	22,259	$24.52		
Granted	1,505	$29.75		
Exercised	(373)	$22.09		
Forfeited	(277)	$27.68		
Outstanding at June 30, 2006	23,114	$24.86	6.78	$92,792
Exercisable at June 30, 2006	16,848	$23.71	6.11	$86,399
Exercisable and expected to be exercisable at June 30, 2006[2]	22,442	$24.77	6.73	$92,101

(1) Represents the difference between the market value of the options at June 30, 2006, and the cost for the option holders to exercise the options.

(2) The amount of options expected to be exercisable at June 30, 2006, is calculated based on an estimate of expected forfeitures.

The fair value of the shares vested during the six months ended June 30, 2006 and 2005, was $16.1 million for both periods. The total intrinsic value of options exercised during the six months ended June 30, 2006 and 2005, was $2.9 million and $4.1 million, respectively.

Note 10. Dividends and Distributions and Taxes

The Company s Board of Directors declared and the Company paid a dividend of $0.59 and $0.60 per common share for the first and second quarters of 2006, respectively, and $0.57 per common share for each of the first and second quarters of 2005. These dividends totaled $166.6 million and $152.3 million for the six months ended June 30, 2006 and 2005, respectively. The Company declared an extra cash dividend of $0.03 per share during 2005 and this was paid to shareholders on January 27, 2006.

The Company s Board of Directors also declared a dividend of $0.61 per common share for the third quarter of 2006.

The Company will generally be required to pay a nondeductible excise tax equal to 4% of the amount by which 98% of the Company s annual taxable income exceeds the distributions for the year. The Company currently estimates that its 2006 annual taxable income will be in excess of its dividend distributions from such taxable income in 2006, and that such estimated excess taxable income will be carried over for distribution in 2007. The Company accrues an excise tax on the estimated excess taxable income earned for the respective periods. For the three and six months ended June 30, 2006, the Company accrued an excise tax of $3.2 million and $11.6 million, respectively. There was no excise tax accrual for the three months ended March 31, 2005, and the Company accrued an excise tax of $4.0 million for the three months ended June 30, 2005.

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 11. Supplemental Disclosure of Cash Flow Information

For the six months ended June 30, 2006 and 2005, the Company paid $46.0 million and $40.1 million, respectively, for interest.

Principal collections related to investment repayments or sales included the collection of discounts previously amortized into interest income and added to the cost basis of a loan or debt security totaling $0.2 million and $7.6 million for the six months ended June 30, 2006 and 2005, respectively.

Non-cash operating activities for the six months ended June 30, 2006, included the following:

- a note received as consideration from the sale of the Company s equity investment in Advantage of $150.0 million;
- a note received as consideration from the sale of the Company s equity investment in STS Operating, Inc. of $30.0 million;
- the exchange of existing debt securities and accrued interest of S.B. Restaurant Company with a cost basis of $29.2 million for new debt securities; and
- the exchange of existing preferred stock and common stock of Redox Brands, Inc. with a cost basis of $10.2 million for common stock in CR Brands, Inc.

Non-cash operating activities for the six months ended June 30, 2005, included the following:

- the exchange of existing subordinated debt securities and accrued interest of BLX with a cost basis of $44.8 million for additional Class B equity interests;
- the exchange of debt securities and accrued interest of Coverall North America, Inc. with a cost basis of $24.2 million for new debt securities and warrants with a total cost basis of $26.8 million;
- the exchange of debt securities of Garden Ridge Corporation with a cost basis of $25.0 million for a new loan with a cost basis of $22.5 million; and
- the contribution to capital of existing debt securities of GAC Investments, Inc. (GAC) with a cost basis of $11.0 million, resulting in a decrease in the Company s debt cost basis and an increase in the Company s common stock cost basis in GAC. During the third quarter of 2005, GAC changed its name to Triview Investments, Inc.

For the six months ended June 30, 2006 and 2005, the Company s non-cash financing activities included $7.2 million and $4.2 million, respectively, related to the issuance of common stock in lieu of cash distributions. In addition, the non-cash financing activities for the six months ended June 30, 2005, also included the issuance of $7.2 million of the Company s common stock as consideration for an additional investment in Mercury Air Centers, Inc.

Note 12. Hedging Activities

The Company has invested in commercial mortgage loans that were purchased at prices that were based in part on comparable Treasury rates. The Company has entered into transactions with one or more financial institutions to hedge against movement in Treasury rates on certain of these

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 12. Hedging Activities, continued

commercial mortgage loans. These transactions, referred to as short sales, involve the Company receiving the proceeds from the short sales of borrowed Treasury securities, with the obligation to replenish the borrowed Treasury securities at a later date based on the then current market price. Borrowed Treasury securities and the related obligations to replenish the borrowed Treasury securities at value, including accrued interest payable on the obligations, as of June 30, 2006, and December 31, 2005, consisted of the following:

($ in thousands) Description of Issue	2006	2005
5-year Treasury securities, due April 2010	$17,156	$17,666

As of June 30, 2006, and December 31, 2005, the total obligations to replenish borrowed Treasury securities had decreased since the related original sale dates due to changes in the yield on the borrowed Treasury securities, resulting in unrealized appreciation on the obligations of $0.9 million and $0.4 million, respectively.

The net proceeds related to the sales of the borrowed Treasury securities were $17.9 million at both June 30, 2006, and December 31, 2005. Under the terms of the transactions, the Company had received cash payments of $0.7 million and $0.2 million at June 30, 2006, and December 31, 2005, respectively, for the difference between the net proceeds related to the sales of the borrowed Treasury securities and the obligations to replenish the securities.

The Company has deposited the proceeds related to the sales of the borrowed Treasury securities and the additional cash collateral with Wachovia Capital Markets, LLC under repurchase agreements. The repurchase agreements are collateralized by U.S. Treasury securities and are settled weekly. As of June 30, 2006, the repurchase agreements were due on July 5, 2006, and had an interest rate of 4.6%. The interest rate on the repurchase agreements as of December 31, 2005, was 3.3%.

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 13. Financial Highlights

	At and for the Six Months Ended June 30, 2006[1]	At and for the Six Months Ended June 30, 2005	At and for the Year Ended December 31, 2005
Per Common Share Data			
Net asset value, beginning of period	$ 19.17	$ 14.87	$ 14.87
Net investment income[2]	0.64	0.40	1.00
Net realized gains[2][3]	3.74	1.60	1.99
Net investment income plus net realized gains[2]	4.38	2.00	2.99
Net change in unrealized appreciation or depreciation [2][3]	(3.44)	1.17	3.37
Net increase in net assets resulting from operations [2]	0.94	3.17	6.36
Net decrease in net assets from shareholder distributions	(1.19)	(1.14)	(2.33)
Net increase in net assets from capital share transactions[2]	0.25	0.11	0.27
Net asset value, end of period	$ 19.17	$ 17.01	$ 19.17
Market value, end of period	$ 28.77	$ 29.11	$ 29.37
Total return[4]	1.9%	17.4%	23.5%
Ratios and Supplemental Data ($ and shares in thousands, except per share amounts)			
Ending net assets	$2,690,019	$2,281,287	$2,620,546
Common shares outstanding at end of period	140,312	134,131	136,697
Diluted weighted average common shares outstanding	142,466	135,982	137,274
Employee, stock option and administrative expenses/average net assets	2.66%	3.91%	6.58%
Total operating expenses/average net assets	4.38%	5.79%	9.99%
Net investment income/average net assets	3.41%	2.57%	6.08%
Net increase in net assets resulting from operations/ average net assets	4.97%	20.57%	38.68%
Portfolio turnover rate	21.20%	21.76%	47.72%
Average debt outstanding	$1,395,791	$1,097,851	$1,087,118
Average debt per share[2]	$ 9.80	$ 8.07	$ 7.92

[1] The results for the six months ended June 30, 2006, are not necessarily indicative of the operating results to be expected for the full year.

[2] Based on diluted weighted average number of common shares outstanding for the period.

[3] Net realized gains and net change in unrealized appreciation or depreciation can fluctuate significantly from period to period. As a result, quarterly comparisons may not be meaningful.

[4] Total return assumes the reinvestment of all dividends paid for the periods presented.

Note 14. Litigation

On June 23, 2004, the Company was notified by the SEC that the SEC is conducting an informal investigation of the Company. On December 22, 2004, the Company received letters from the U.S. Attorney for the District of Columbia requesting the preservation and production of information regarding the Company and Business Loan Express, LLC in connection with a criminal investigation. Based on the information available to the Company at this time, the inquiries appear to

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 14. Litigation, continued

primarily pertain to matters related to portfolio valuation and the Company s portfolio company, Business Loan Express, LLC. To date, the Company has produced materials in response to requests from both the SEC and the U.S. Attorney s office, and certain current and former employees have provided testimony and have been interviewed by the staff of the SEC and the U.S. Attorney s Office. The Company is voluntarily cooperating with these investigations.

In addition, the Company is party to certain lawsuits in the normal course of business.

While the outcome of these legal proceedings cannot at this time be predicted with certainty, the Company does not expect that the outcome of these proceedings will have a material effect upon the Company s financial condition or results of operations.

Report of Independent Registered Public Accounting Firm

The Board of Directors and Shareholders
Allied Capital Corporation:

We have reviewed the accompanying consolidated balance sheet of Allied Capital Corporation and subsidiaries, including the consolidated statement of investments, as of June 30, 2006, the related consolidated statements of operations for the three- and six-month periods ended June 30, 2006 and 2005, and the consolidated statement of changes in net assets and cash flows and the financial highlights (included in Note 13) for the six-month periods ended June 30, 2006 and 2005. These consolidated financial statements and financial highlights are the responsibility of the Company s management.

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

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

We have previously audited, in accordance with standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheet of Allied Capital Corporation and subsidiaries, including the consolidated statement of investments, as of December 31, 2005, and the related consolidated statements of operations, changes in net assets and cash flows (not presented herein), and the financial highlights, for the year then ended; and in our report dated March 9, 2006, we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying condensed consolidated balance sheet as of December 31, 2005, is fairly stated, in all material respects, in relation to the consolidated balance sheet from which it has been derived.

Washington, D.C.
August 9, 2006

Schedule 12-14

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES
SCHEDULE OF INVESTMENTS IN AND ADVANCES TO AFFILIATES

PRIVATE FINANCE **Portfolio Company** **(in thousands)**	**Investment(1)**	**Amount of Interest or Dividends** **Credited to Income(6)**	**Other(2)**	**December 31, 2005 Value**	**Gross Additions(3)**	**Gross Reductions(4)**	**June 30, 2006 Value**
Companies More Than 25% Owned							
Acme Paging, L.P.	Senior Loan(5)			$	$	$	$
(Telecommunications)	Subordinated Debt(5)						
	Common Stock						
Advantage Sales &	Subordinated Debt	$ 1,712		59,787	213	(60,000)	
Marketing, Inc.(7)	Subordinated Debt	5,555		124,000	374	(124,374)	
(Business Services)	Common Stock			476,578		(476,578)	
Alaris Consulting, LLC	Senior Loan(5)	(32)			32	(32)	
(Business Services)	Equity Interests						
American Healthcare Services, Inc. and Affiliates (Healthcare Services)	Senior Loan(5)		$ 1	4,097	328	(96)	4,329
Avborne, Inc.	Preferred Stock			892		(119)	773
(Business Services)	Common Stock						
Avborne Heavy Maintenance, Inc.	Preferred Stock						
(Business Services)	Common Stock						

Business Loan Express, LLC (Financial Services)	Subordinated Debt	38	10,000	15,000	(25,000)	
	Class A Equity Interests	7,807	60,693	3,734		64,427
	Class B Equity Interests		146,910		(16,020)	130,890
	Class C Equity Interests		139,521		(17,621)	121,900
Callidus Capital Corporation (Financial Services)	Senior Loan	399	600	8,705	(7,655)	1,650
	Subordinated Debt	464	4,832	444		5,276
	Common Stock		7,968	4,125		12,093
Cambridge Capital Partners (Financial Services)	Senior Debt(5)			250		250
	Equity Interests			1,751		1,751
CR Brands, Inc. (Consumer Products)	Senior Loan	1,109		37,219	(37,219)	
	Subordinated Debt	2,344		38,712		38,712
	Common Stock			37,431		37,431
Diversified Group Administrators, Inc. (Business Services)	Preferred Stock	33	728	14	(14)	728
	Preferred Stock		841			841
	Common Stock	68	502	69	(249)	322
Financial Pacific Company (Financial Services)	Subordinated Debt	6,176	69,904	726		70,630
	Preferred Stock		13,116	1,344		14,460
	Common Stock		44,180	749	(511)	44,418
ForeSite Towers, LLC (Tower Leasing)	Equity Interests	161	9,750	3,068		12,818
Global Communications, LLC (Business Services)	Senior Loan(5)		15,957			15,957
	Subordinated Debt(5)		11,198	138	(1,688)	9,648

	Preferred Equity Interest Options		4,303		(4,303)	
Gordian Group, Inc. (Business Services)	Senior Loan(5)	(10)	4,161	400	(4,561)	
	Common Stock			220	(220)	
Healthy Pet Corp. (Consumer Services)	Senior Loan	772	4,086	12,652	(800)	15,938
	Subordinated Debt	3,258	38,535	4,776	(186)	43,125
	Common Stock		25,766	5,174	(2,788)	28,152
HMT, Inc. (Energy Services)	Preferred Stock		2,637			2,637
	Common Stock		5,343	2,599		7,942
	Warrants		2,057	1,001		3,058
Impact Innovations Group, LLC (Business Services)	Equity Interests in Affiliate		742	128		870

See related footnotes at the end of this schedule.

PRIVATE FINANCE Portfolio Company (in thousands)	Investment(1)	Amount of Interest or Dividends Credited to Income(6)	Other(2)	December 31, 2005 Value	Gross Additions(3)	Gross Reductions(4)	June 30, 2006 Value
Insight Pharmaceuticals	Subordinated Debt	$ 4,790		$ 58,298	$ 769	$	$ 59,067
Corporation	Preferred Stock			26,791	1,473	(2,015)	26,249
(Consumer Products)	Common Stock			236	218	(236)	218
Jakel, Inc.	Subordinated Debt(5)				2,533		2,533
(Industrial Products)	Preferred Stock						
	Common Stock						
Legacy Partners Group, LLC	Senior Loan (5)			5,029	93	(74)	5,048
(Financial Services)	Subordinated Debt(5)						
	Equity Interests				18	(18)	
Litterer Beteiligungs-GmbH	Subordinated Debt	21		621	37		658
(Business Services)	Equity Interest			2,226	763	(1,374)	1,615
Mercury Air Centers, Inc.	Senior Loan	1,231		31,720	4,000	(35,720)	
(Business Services)	Subordinated Debt	4,028		46,519	4,679	(3,000)	48,198
	Common Stock			88,898	4,702	(412)	93,188
MVL Group, Inc.	Senior Loan	1,742		27,218	79	(973)	26,324
(Business Services)	Subordinated Debt	2,506		32,417	1,504		33,921
	Common Stock			3,211		(1,949)	1,262
Pennsylvania Avenue				1,864	1,193	(3,057)	

Investors, L.P. (Private Equity Fund)	Equity Interests						
Powell Plant Farms, Inc. (Consumer Products)	Senior Loan	2,390		23,792	6,075	(8,225)	21,642
	Subordinated Debt(5)			7,364	1,093	(8,457)	
	Preferred Stock						
	Warrants						
Redox Brands, Inc. (Consumer Products)	Preferred Stock	363		12,097	1,708	(13,805)	
	Warrants			500	84	(584)	
Service Champ, Inc. (Business Services)	Subordinated Debt	2,138		26,906	354		27,260
	Common Stock			13,319	3,003		16,322
Staffing Partners Holding Company, Inc. (Business Services)	Subordinated Debt(5)		$355	6,343		(5,183)	1,160
	Preferred Stock			1,812		(1,812)	
	Common Stock						
	Warrants						
Startec Global Communications Corporation (Telecommunications)	Senior Loan	1,197		21,685	3,540	(3,299)	21,926
	Common Stock				6,480		6,480
STS Operating, Inc. (Industrial Products)	Subordinated Debt	328		6,593	123	(6,716)	
	Common Stock			64,963	32,039	(97,002)	
	Options			560	292	(852)	
Triview Investments, Inc. (Broadcasting & Cable/ Consumer Products)	Senior Loan	587		7,449	6,852		14,301
	Subordinated Debt	2,390		30,845	6,842		37,687
	Subordinated Debt(5)			19,520			19,520
	Common Stock			29,171	5,011	(1,656)	32,526

Total companies more than 25% owned		**$53,565**	**$1,887,651**			**$1,188,131**
Companies 5% to 25% Owned						
Advantage Sales & Marketing, Inc.(7) (Business Services)	Subordinated Debt	$ 4,732		$150,056	$	$ 150,056
	Equity Interests			15,000		15,000
Air Medical Group Holdings LLC (Healthcare Services)	Senior Loan	714		1,512		1,512
	Subordinated Debt	2,145	42,267	34,950	(42,627)	34,590
	Equity Interests	1,694	4,025	2,372	(2,197)	4,200
Amerex Group, LLC (Consumer Products)	Subordinated Debt	154		8,400		8,400
	Equity Interests			3,583		3,583
Aspen Pet Products, Inc. (Consumer Products)	Subordinated Debt	1,130	19,959	399	(20,358)	
	Preferred Stock	29	1,638	516	(2,154)	
	Common Stock		17	123	(140)	
	Warrants					
BB&T Capital Partners/Windsor Mezzanine Fund, LLC (Private Equity Fund)	Equity Interests			5,867		5,867
Becker Underwood, Inc. (Industrial Products)	Subordinated Debt	1,747	23,543	307		23,850
	Common Stock		2,200	900	(700)	2,400

See related footnotes at the end of this schedule.

PRIVATE FINANCE Portfolio Company (in thousands)	Investment(1)	Amount of Interest or Dividends Credited to Income(6)	Other(2)	December 31, 2005 Value	Gross Additions(3)	Gross Reductions(4)	June 30, 2006 Value
BI Incorporated (Business Services)	Senior Loan	$ 125		$	$ 15,000	$ (15,000)	$
	Subordinated Debt	1,390			29,856		29,856
	Common Stock				4,000		4,000
The Debt Exchange Inc. (Business Services)	Preferred Stock			3,219		(3,219)	
MedBridge Healthcare, LLC (Healthcare Services)	Senior Loan(5)			7,093	1,512	(2,010)	6,595
	Subordinated Debt(5)			534	1,364	(1,898)	
	Convertible Subordinated Debt(5)						
	Equity Interests				501	(501)	
Nexcel Synthetics, LLC (Consumer Products)	Subordinated Debt	788		10,588	193		10,781
	Equity Interests			1,367	363		1,730
Pres Air Trol LLC (Industrial Products)	Unitranche Debt(5)		$ 184	5,820	10	(2,518)	3,312
	Equity Interests			318	11	(329)	
Progressive International Corporation (Consumer Products)	Subordinated Debt	603		7,376	78		7,454
	Preferred Stock			884	36		920
				13	487		500

	Common Stock Warrants					
Regency Healthcare Group, LLC (Healthcare Services)	Senior Loan			980		980
	Unitranche Debt			19,900		19,900
	Equity Interests			1,500		1,500
SGT India Private Limited (Business Services)	Common Stock			3,608		3,608
Soteria Imaging Services, LLC (Healthcare Services)	Subordinated Debt	959	13,447	2,058		15,505
	Equity Interests		2,308	92		2,400
Universal Environmental Services, LLC (Business Services)	Unitranche Debt	859	10,862	94		10,956
	Equity Interests		1,328	651	(278)	1,701
Total companies 5% to 25% owned		**$17,069**	**$158,806**			**$371,156**

This schedule should be read in conjunction with the Company s consolidated financial statements, including the consolidated statement of investments and Note 3 to the consolidated financial statements. Note 3 includes additional information regarding activities in the private finance portfolio.

(1) Common stock, preferred stock, warrants, options, and equity interests are generally non-income producing and restricted. The principal amount for loans and debt securities and the number of shares of common stock and preferred stock is shown in the consolidated statement of investments as of June 30, 2006.

(2) Other includes interest, dividend, or other income which was applied to the principal of the investment and therefore reduced the total investment. These reductions are also included in the Gross Reductions for the investment, as applicable.

(3) Gross additions include increases in the cost basis of investments resulting from new portfolio investments, paid-in-kind interest or dividends, the amortization of discounts and closing fees, the exchange of one or more existing securities for one or more new securities and the movement of an existing portfolio company into this category from a different category. Gross additions also include net increases in unrealized appreciation or net decreases in unrealized depreciation.

(4) Gross reductions include decreases in the cost basis of investments resulting from principal collections related to investment repayments or sales, the exchange of one or more existing securities for one or more new securities and the movement of an existing portfolio company out of this category into a different category. Gross reductions also include net increases in unrealized depreciation or net decreases in unrealized appreciation.

(5) Loan or debt security is on non-accrual status at June 30, 2006, and is therefore considered non-income producing. Loans or debt securities on non-accrual status at the end of the period may or may not have been on non-accrual status for the full period.

(6) Represents the total amount of interest or dividends credited to income for the portion of the year an investment was included in the companies more than 25% owned or companies 5% to 25% owned categories, respectively.

(7) Included in the companies more than 25% owned category while the Company held a majority equity interest. On March 29, 2006, the Company sold its majority equity interest in Advantage. The Company s investment in Advantage after the sale transaction is included in the companies 5% to 25% owned category. See Note 3 to the consolidated financial statements for further information.

NOTICE REGARDING INDEPENDENT PUBLIC ACCOUNTANTS REVIEW REPORT

With respect to the unaudited interim financial information as of June 30, 2006, and for the three-month and six-month periods ended June 30, 2006 and 2005, included herein, KPMG LLP has reported that they applied limited procedures in accordance with professional standards for a review of such information. However, their separate report included herein states that they did not audit and they do not express an opinion on that interim financial information. Accordingly, the degree of reliance on their report on such information should be restricted in light of the limited nature of the review procedures applied. The accountants are not subject to the liability provisions of Section 11 of the Securities Act of 1933 for their report on the unaudited interim financial information because that report is not a report or a part of the registration statement prepared or certified by the accountants within the meaning of Sections 7 and 11 of the Securities Act of 1933.

PROSPECTUS

$1,000,000,000

Debt Securities

We may offer, from time to time, up to an aggregate principal amount of $1,000,000,000 of one or more classes or series of debt securities, including notes, debentures, medium-term notes, commercial paper, retail notes or similar obligations evidencing indebtedness in one or more offerings.

The debt securities may be offered at prices and on terms to be described in one or more supplements to this prospectus.

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

Our investment objective is to achieve current income and capital gains. We seek to achieve our investment objective by investing in primarily private middle market companies in a variety of industries. No assurances can be given that we will continue to achieve our objective.

Please read this prospectus, the accompanying prospectus supplement, if any, and the pricing supplement, if any, before investing in our debt securities and keep it for future reference. The prospectus contains and the accompanying prospectus supplement, if any, and the pricing supplement, if any, will contain important information about us that a prospective investor should know before investing in our debt securities. We file annual, quarterly and current reports, proxy statements and other information with the Securities and Exchange Commission. This information is available free of charge by contacting us at 1919 Pennsylvania Avenue, NW, Washington, DC, 20006 or by telephone at (202) 721-6100 or on our website at www.alliedcapital.com. The SEC also maintains a website at www.sec.gov that contains such information.

You should review the information set forth under Risk Factors on page 9 of this prospectus before investing in our debt securities.

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

This prospectus may not be used to consummate sales of our debt securities unless accompanied by a prospectus supplement and, if applicable, a pricing supplement.

June 22, 2006

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

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ABOUT THIS PROSPECTUS

This prospectus is part of a registration statement that we have filed with the Securities and Exchange Commission using the shelf registration process. Under the shelf registration process, which constitutes a delayed offering in reliance on Rule 415 under the Securities Act of 1933, as amended, we may offer, from time to time, up to $1,000,000,000 in aggregate principal amount of debt securities on the terms to be determined at the time of the offering. The debt securities may be offered at prices and on terms described in one or more supplements to this prospectus. This prospectus provides you with a general description of the debt securities we may offer. Each time we use this prospectus to offer debt securities, we will provide a prospectus supplement and, if applicable, a pricing supplement that will contain specific information about the terms of that offering. Please carefully read this prospectus and any such supplements together with the additional information described under Where You Can Find Additional Information in the Prospectus Summary and Risk Factors sections before you make an investment decision.

A prospectus supplement and, if applicable, a pricing supplement may also add to, update or change information contained in this prospectus.

PROSPECTUS SUMMARY

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

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

BUSINESS *(Page 71)*

We are a business development company and we are in the private equity business. We provide long-term debt and equity capital to primarily private middle market companies in a variety of industries. We have participated in the private equity business since we were founded in 1958 and have financed thousands of companies nationwide. Our investment objective is to achieve current income and capital gains.

We believe the private equity capital markets are important to the growth of small and middle market companies because such companies often have difficulty accessing the public debt and equity capital markets. We use the term middle market to include companies with annual revenues typically between $50 million and $500 million. We believe that we are well positioned to be a source of capital for such companies.

We primarily invest in the American entrepreneurial economy. Our private finance portfolio includes investments in over 100 companies with aggregate annual revenue of over $12 billion and employ more than 90,000 people.

We generally target companies in less cyclical industries in the middle market with, among other things, high return on invested capital, management teams with meaningful equity ownership, well-constructed balance sheets, and the ability to generate free cash flow. As a private equity investor, we spend significant time and effort identifying, structuring, performing due diligence, monitoring, developing, valuing and ultimately exiting our investments.

Our investment activity is primarily focused on making long-term investments in the debt and equity of primarily private middle market companies. Debt investments may include senior loans, unitranche debt (a single debt investment that is a blend of senior and subordinated debt), or subordinated debt (with or without equity features). Equity investments may include a minority equity stake in connection with a debt investment or a substantial equity stake in connection with a buyout transaction. In a buyout transaction, we generally invest in senior debt, subordinated debt and equity (preferred and/or voting or non-voting common) where our equity ownership represents a significant portion of the equity, but may or may not represent a controlling interest.

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

The capital we provide is used by portfolio companies to fund buyouts, acquisitions, growth, recapitalizations, note purchases, or other types of financings.

Our investments are typically structured to provide recurring cash flow in the form of interest income to us as the investor. In addition to earning interest income, we may structure our investments to generate income from management, consulting, diligence, structuring, or other fees. We may also enhance our total return from capital gains through equity features, such as nominal cost warrants, or by investing in equity investments.

We provide managerial assistance to our portfolio companies, including management and consulting services related to corporate finance, marketing, human resources, personnel and board member recruiting, business operations, corporate governance, risk management and other general business matters.

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

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

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

Our executive offices are located at 1919 Pennsylvania Avenue, NW, Washington, DC, 20006 and our telephone number is (202) 721-6100. In addition, we have regional offices in New York, Chicago and Los Angeles.

Our Internet website address is *www.alliedcapital.com.* Information contained on our website is not incorporated by reference into this prospectus and you should not consider information contained on our website to be part of this prospectus.

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

DETERMINATION OF NET ASSET VALUE *(Page 94)*

Our portfolio investments are generally recorded at fair value as determined in good faith by our Board of Directors in the absence of readily available public market values.

Pursuant to the requirements of the 1940 Act, we value substantially all of our portfolio investments at fair value as determined in good faith by the Board of Directors on a quarterly basis. Since there is typically no readily available market value for the investments in our portfolio, our Board of Directors determines in good faith the fair value of these portfolio investments pursuant to our valuation policy and consistently applied valuation process.

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

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

PLAN OF DISTRIBUTION *(Page 146)*

We may offer, from time to time, up to $1,000,000,000 aggregate principal amount of debt securities, including notes, debentures, medium-term notes, commercial paper, retail notes or similar obligations evidencing indebtedness, on terms to be determined at the time of the offering.

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

We may not sell debt securities pursuant to this prospectus without delivering a prospectus supplement and, if applicable, a pricing supplement describing the method and terms of the offering of such debt securities.

USE OF PROCEEDS *(Page 19)*

We intend to use the net proceeds from selling debt securities for general corporate purposes, which includes investing in debt or equity securities in primarily privately negotiated transactions, repayment of indebtedness, acquisitions and other general corporate purposes.

The supplements to this prospectus relating to any offering of debt securities will more fully identify the use of proceeds from such offering.

RISK FACTORS *(Page 9)*

Investment in our debt securities involves a number of significant risks relating to our business and our investment objective that you should consider before investing in our debt securities.

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

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

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

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

A large number of entities and individuals compete for the same kind of investment opportunities as we do. Increased competition would make it more difficult for us to purchase or originate investments at attractive prices. As a result of this competition, sometimes we may be precluded from making otherwise attractive investments.

Our business of making private equity investments and positioning them for liquidity events also may be affected by current and future market conditions.

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

We may not be able to pay dividends and failure to qualify as a regulated investment company for tax purposes could have a material adverse effect on the income available for debt service and distributions to our shareholders, which may have a material adverse effect on our total return to common shareholders, if any.

Also, we are subject to certain risks associated with valuing our portfolio, changing interest rates, accessing additional capital, fluctuating financial results, and operating in a regulated environment.

The market value of our debt securities may be volatile due to market factors that may be beyond our control.

RATIOS OF EARNINGS TO FIXED CHARGES (Page 17)

Our ratio of earnings to fixed charges for the five years ended December 31, 2005, was 12.4, 4.3, 3.4, 4.2 and 4.0, respectively, and was 5.4 for the three months ended March 31, 2006. For more information, see the section entitled Ratios of Earnings to Fixed Charges in this prospectus.

SENIOR SECURITIES (Page 67)

At March 31, 2006, we had $1.3 billion of outstanding indebtedness bearing a weighted average annual interest cost of 6.5%. If our portfolio fails to produce adequate returns, we may be unable to make interest or principal payments on our indebtedness when they are due, which could give rise to a default on and acceleration of our indebtedness. In order for us to cover annual interest payments on indebtedness, we had to achieve annual returns on our assets of at least 2.0% as of March 31, 2006, which returns were achieved.

SELECTED CONDENSED CONSOLIDATED FINANCIAL DATA

You should read the condensed consolidated financial information below with the Consolidated Financial Statements and Notes thereto included herein. Financial information at and for the years ended December 31, 2005, 2004, 2003, and 2002, has been derived from our financial statements that were audited by KPMG LLP. Financial information at and for the year ended December 31, 2001, has been derived from our financial statements that were audited by Arthur Andersen LLP. For important information about Arthur Andersen LLP, see the section entitled Notice Regarding Arthur Andersen LLP. Quarterly financial information is derived from unaudited financial data, but in the opinion of management, reflects all adjustments (consisting only of normal recurring adjustments) which are necessary to present fairly the results for such interim periods. Interim results at and for the three months ended March 31, 2006, are not necessarily indicative of the results that may be expected for the year ending December 31, 2006. **See Management s Discussion and Analysis of Financial Condition and Results of Operations below for more information.**

	Three Months Ended March 31,		**Year Ended December 31,**				
(in thousands, except per share data)	**2006**	**2005**	**2005**	**2004**	**2003**	**2002**	**2001**
	(unaudited)						
Operating Data:							
Interest and related portfolio income:							
Interest and dividends	$ 88,881	$ 84,945	$317,153	$319,642	$290,719	$264,042	$240,464
Loan prepayment premiums	5,286	1,677	6,250	5,502	8,172	2,776	2,504
Fees and other income	16,844	8,297	50,749	41,946	30,338	43,110	46,142
Total interest and related portfolio income	111,011	94,919	374,152	367,090	329,229	309,928	289,110
Expenses:							
Interest	24,300	20,225	76,798	75,650	77,233	70,443	65,104
Employee	21,428	15,456	78,300	53,739	36,945	33,126	29,656
Stock options	3,606						
Administrative	11,519	20,754	70,267	34,686	22,387	21,504	15,299
Total operating expenses	60,853	56,435	225,365	164,075	136,565	125,073	110,059
Net investment income before income taxes	50,158	38,484	148,787	203,015	192,664	184,855	179,051
Income tax expense (benefit), including excise tax	8,858	(268)	11,561	2,057	(2,466)	930	(412)
Net investment income	41,300	38,752	137,226	200,958	195,130	183,925	179,463

Net realized and unrealized gains (losses):							
Net realized gains	432,835	10,285	273,496	117,240	75,347	44,937	661
Net change in unrealized appreciation or depreciation	(374,548)	70,584	462,092	(68,712)	(78,466)	(571)	20,603
Total net gains (losses)	58,287	80,869	735,588	48,528	(3,119)	44,366	21,264
Net increase in net assets resulting from operations	$ 99,587	$119,621	$872,814	$249,486	$192,011	$228,291	$200,727
Per Share:							
Diluted earnings per common share	$ 0.70	$ 0.88	$ 6.36	$ 1.88	$ 1.62	$ 2.20	$ 2.16
Dividends per common share[1]	$ 0.59	$ 0.57	$ 2.33	$ 2.30	$ 2.28	$ 2.23	$ 2.01
Weighted average common shares outstanding diluted	141,738	135,579	137,274	132,458	118,351	103,574	93,003

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(in thousands, except per share data)	At March 31, 2006	At December 31, 2005	2004	2003	2002	2001
Balance Sheet Data:						
Portfolio at value	$3,691,002	$3,606,355	$3,013,411	$2,584,599	$2,488,167	$2,329,590
Total assets	4,121,225	4,025,880	3,260,998	3,019,870	2,794,319	2,460,713
Total debt outstanding(2)	1,274,245	1,284,790	1,176,568	954,200	998,450	1,020,806
Preferred stock issued to Small Business Administration(2)				6,000	7,000	7,000
Shareholders equity	2,729,813	2,620,546	1,979,778	1,914,577	1,546,071	1,352,123
Shareholders equity per common share (net asset value)(3)	$ 19.50	$ 19.17	$ 14.87	$ 14.94	$ 14.22	$ 13.57
Common shares outstanding at end of year	139,984	136,697	133,099	128,118	108,698	99,607
Asset coverage ratio(4)	317%	309%	280%	322%	270%	245%
Debt to equity ratio	0.47	0.49	0.59	0.50	0.65	0.75

	Three Months Ended March 31, 2006	Year Ended December 31, 2005	2004	2003	2002	2001
Other Data:						
Investments funded	$797,851	$1,675,773	$1,524,523	$931,450	$506,376	$680,329
Principal collections related to investment repayments or sales	340,410	1,503,388	909,189	788,328	356,641	204,441
Realized gains	436,486	343,061	267,702	94,305	95,562	10,107
Realized losses	(3,651)	(69,565)	(150,462)	(18,958)	(50,625)	(9,446)

(in thousands, except per share data)	2006 Qtr 1	2005 Qtr 4	2005 Qtr 3	2005 Qtr 2	2005 Qtr 1	2004 Qtr 4	2004 Qtr 3	2004 Qtr 2	2004 Qtr 1
Quarterly Data (unaudited):									
Total interest and related portfolio income	$111,011	$ 98,169	$ 94,857	$ 86,207	$ 94,919	$100,962	$96,863	$87,500	$81,765
Net investment income	41,300	37,073	46,134	15,267	38,752	54,678	52,745	48,990	44,545
Net increase in net assets resulting from	99,587	328,140	113,168	311,885	119,621	47,837	85,999	95,342	20,308

operations									
Diluted earnings per common share	$ 0.70	$ 2.36	$ 0.82	$ 2.29	$ 0.88	$ 0.35	$ 0.66	$ 0.73	$ 0.15
Dividends declared per common share [5]	0.59	0.61	0.58	0.57	0.57	0.59	0.57	0.57	0.57
Net asset value per common share[3]	19.50	19.17	17.37	17.01	15.22	14.87	14.90	14.77	14.60

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

(2) See Senior Securities for more information regarding our level of indebtedness.

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

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

(5) Dividends declared per common share for the fourth quarter of 2004 included the regular quarterly dividend of $0.57 per common share and an extra dividend of $0.02 per common share. Dividends declared per common share for the fourth quarter of 2005 included the regular quarterly dividend of $0.58 per common share and an extra dividend of $0.03 per common share.

WHERE YOU CAN FIND ADDITIONAL INFORMATION

We have filed with the SEC a registration statement on Form N-2 together with all amendments and related exhibits under the Securities Act of 1933. The registration statement contains additional information about us and the debt securities being offered by this prospectus.

We file annual, quarterly and current reports, proxy statements and other information with the Securities and Exchange Commission under the Securities Exchange Act of 1934. You can inspect any materials we file with the Securities and Exchange Commission, without charge, at the Securities and Exchange Commission s Public Reference Room at 100 F Street, N.E., Washington, D.C. 20549. Please call the Securities and Exchange Commission at 1-800-SEC-0330 for further information on the Public Reference Room. The Securities and Exchange Commission maintains a web site that contains reports, proxy statements and other information regarding registrants, including us, that file such information electronically with the Securities and Exchange Commission. The address of the Securities and Exchange Commission s web site is *www.sec.gov*. Information contained on the Securities and Exchange Commission s web site about us is not incorporated into this prospectus and you should not consider information contained on the Securities and Exchange Commission s web site to be part of this prospectus.

RISK FACTORS

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

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

Investing in private companies involves a high degree of risk. Our portfolio primarily consists of long-term loans to and investments in middle market private companies. Investments in private businesses involve a high degree of business and financial risk, which can result in substantial losses for us in those investments and accordingly should be considered speculative. There is generally no publicly available information about the companies in which we invest, and we rely significantly on the diligence of our employees and agents to obtain information in connection with our investment decisions. If we are unable to identify all material information about these companies, among other factors, we may fail to receive the expected return on our investment or lose some or all of the money invested in these companies. In addition, these businesses may have shorter operating histories, narrower product lines, smaller market shares and less experienced management than their competition and may be more vulnerable to customer preferences, market conditions, loss of key personnel, or economic downturns, which may adversely affect the return on, or the recovery of, our investment in such businesses. As an investor, we are subject to the risk that a portfolio company may make a business decision that does not serve our interest, which could decrease the value of our investment. Deterioration in a portfolio company s financial condition and prospects may be accompanied by deterioration in any collateral for the loan.

Substantially all of our portfolio investments are recorded at fair value as determined in good faith by our Board of Directors and, as a result, there is uncertainty regarding the value of our portfolio investments. At March 31, 2006, portfolio investments recorded at fair value were 90% of our total assets. Pursuant to the requirements of the 1940 Act, we value substantially all of our investments at fair value as determined in good faith by our Board of Directors on a quarterly basis. Since there is typically no readily available market value for the investments in our portfolio, our Board of Directors determines in good faith the fair value of these investments pursuant to a valuation policy and a consistently applied valuation process.

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

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

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

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

Our borrowers may default on their payments, which may have a negative effect on our financial performance. We primarily make long-term unsecured, subordinated loans and invest in equity securities, which may involve a higher degree of repayment risk. We primarily invest in companies that may have limited financial resources, may be highly leveraged and may be unable to obtain financing from traditional sources. Numerous factors may affect a borrower s ability to repay its loan, including the failure to meet its business plan, a downturn in its industry, or negative economic conditions. A portfolio company s failure to satisfy financial or operating covenants imposed by us or other lenders could lead to defaults and, potentially, termination of its loans or foreclosure on its secured assets, which could trigger cross defaults under other agreements and jeopardize our portfolio company s ability to meet its obligations under the loans or debt securities that we hold. In addition, our portfolio companies may have, or may be permitted to incur, other debt that ranks senior to or equally with our securities. This means that payments on such senior-ranking securities may have to be made before we receive any payments on our loans or debt securities. Deterioration in a borrower s financial condition and prospects may be accompanied by deterioration in any related collateral and may have a negative effect on our financial results.

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

Our financial results could be negatively affected if a significant portfolio investment fails to perform as expected. Our total investment in companies may be significant individually or in the aggregate. As a result, if a significant investment in one or more companies fails to perform as expected, our financial results could be more negatively affected and the magnitude of the loss could be more significant than if we had made smaller investments in more companies. At March 31, 2006, our largest investment at value was in Business Loan Express, LLC (BLX) and represented 7.9% of our total assets and 5.5% of our total interest and related portfolio income for the three months ended March 31, 2006. BLX is a lender under the Small Business Administration 7(a) Guaranteed Loan Program. Our financial results could be negatively affected if government funding for, or regulations related to, this program change.

We borrow money, which magnifies the potential for gain or loss on amounts invested and may increase the risk of investing in us. Borrowings, also known as leverage, magnify the potential for gain or loss on amounts invested and, therefore, increase the risks associated with investing in our securities. The debt securities we may issue pursuant to this prospectus, the prospectus supplement, and the applicable pricing supplement, if any, are a form of such borrowings. We borrow from and issue senior debt securities to banks, insurance companies, and other lenders or investors. Holders of these senior securities have fixed dollar claims on our consolidated assets that are superior to the claims of our common shareholders. If the value of our consolidated assets increases, then leveraging would cause the net asset value attributable to our common stock to increase more sharply than it would have had we not leveraged. Conversely, if the value of our consolidated assets decreases, leveraging would cause net asset value to decline more sharply than it otherwise would have had we not leveraged. Similarly, any increase in our consolidated income in excess of consolidated interest payable on the borrowed funds would cause our net income to increase more than it would without the leverage, while any decrease in our consolidated income would cause net income to decline more sharply than it would have had we not borrowed. Such a decline could negatively affect our ability to make common stock dividend payments. Leverage is generally considered a speculative investment technique. We and, indirectly, our shareholders will bear the cost associated with our leverage activity. Our revolving line of credit, notes payable and debentures contain financial and operating covenants that could restrict our business activities, including our ability to declare dividends if we default under certain provisions.

At March 31, 2006, we had $1.3 billion of outstanding indebtedness bearing a weighted average annual interest cost of 6.5%. If our portfolio of investments fails to produce adequate returns, we may be unable to make interest or principal payments on our indebtedness when they are due. In order for us to cover annual interest payments on indebtedness, we had to achieve annual returns on our assets of at least 2.0% as of March 31, 2006, which returns were achieved.

Illustration. The following table illustrates the effect of leverage on returns from an investment in our common stock assuming various annual returns, net of expenses. The calculations in the table below are hypothetical and actual returns may be higher or lower than those appearing below. The calculation assumes (i) $4,121.2 million in total assets, (ii) an average cost of funds of 6.5%, (iii) $1,274.2 million in debt outstanding and (iv) $2,729.8 million of shareholders equity.

	Assumed Return on Our Portfolio (net of expenses)						
	-20%	**-10%**	**-5%**	**0%**	**5%**	**10%**	**20%**
Corresponding return to shareholder	-33.23%	-18.13%	-10.58%	-3.03%	4.51%	12.06%	27.16%

We may not borrow money unless we maintain asset coverage for indebtedness of at least 200%, which may affect returns to shareholders. We must maintain asset coverage for total borrowings of at least 200%. Our ability to achieve our investment objective may depend in part on our continued ability to maintain a leveraged capital structure by borrowing from banks, insurance companies or other lenders or investors on favorable terms. There can be no assurance that we will be able to maintain such leverage. If asset coverage declines to less than 200%, we may be required to sell a portion of our investments when it is disadvantageous to do so. As of March 31, 2006, our asset coverage for senior indebtedness was 317%.

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

Assuming that the balance sheet as of March 31, 2006, were to remain constant and no actions were taken to alter the existing interest rate sensitivity, a hypothetical immediate 1% change in interest rates would have affected net income by approximately 1% over a one year horizon. Although management believes that this measure is indicative of our sensitivity to interest rate changes, it does not adjust for potential changes in credit quality, size and composition of the assets on the balance sheet and other business developments that could affect net increase in net assets resulting from operations, or net income. Accordingly, no assurances can be given that actual results would not differ materially from the potential outcome simulated by this estimate.

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

Loss of regulated investment company tax treatment would substantially reduce net assets and income available for debt service and dividends. We have operated so as to qualify as a regulated investment company under Subchapter M of the Code. If we meet source of income, asset diversification, and distribution requirements, we will not be subject to corporate level income taxation on income we timely distribute to our stockholders as dividends. We would cease to qualify for such tax treatment if we were unable to comply with these requirements. In addition, we may have difficulty meeting the requirement to make distributions to our shareholders because in certain cases we may recognize income before or without receiving cash representing such income. If we fail to qualify as a regulated investment company, we will have to pay corporate-level taxes on all of our income whether or not we distribute it, which would substantially reduce the amount of income available for debt service and distributions to our stockholders. Even if we qualify as a regulated investment company, we generally will be subject to a corporate-level income tax on the income we do not distribute. If we do not distribute at least 98% of our annual taxable income in the year earned, we generally will be required to pay an excise tax on amounts carried over and distributed to shareholders in the next year equal to 4% of the amount by which 98% of our annual taxable income exceeds the distributions from such income for the current year.

There is a risk that our common stockholders may not receive dividends or distributions. We intend to make distributions on a quarterly basis to our stockholders. We may not be able to achieve operating results that will allow us to make distributions at a specific level or to increase the amount of these distributions from time to time. In addition, due to the asset coverage test applicable to us as a business development company, we may be limited in our ability to make distributions. Also, certain of our credit facilities limit our ability to declare dividends if we default under certain provisions. If we do not distribute a certain percentage of our income annually, we will suffer adverse tax consequences, including possible loss of the tax benefits available to us as a regulated investment company. In addition, in accordance with U.S. generally accepted accounting principles and tax regulations, we include in income certain amounts that we have not yet received in cash, such as contractual payment-in-kind interest, which represents contractual interest added to the loan balance that becomes due at the end of the loan term, or the accrual of original issue discount. The increases in loan balances as a result of contractual payment-in-kind arrangements are included in income in advance of receiving cash payment and are separately included in the change in accrued or reinvested interest and dividends in our consolidated statement of cash flows. Since we may recognize income before or without receiving cash representing such income, we may have difficulty meeting the requirement to distribute at least 90% of our investment company taxable income to obtain tax benefits as a regulated investment company.

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

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

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

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

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

Until the question raised by the staff of the SEC pertaining to the Federal Reserve s 1998 change to its margin rules has been addressed by legislative, administrative or judicial action, we intend to treat as qualifying assets only those debt and equity securities that are issued by a private company that has no marginable securities outstanding at the time we purchase such securities or those that otherwise qualify as an eligible portfolio company under the 1940 Act.

In November 2004, the SEC issued proposed rules to correct the unintended consequence of the Federal Reserve s 1998 margin rule amendments of apparently limiting the investment opportunities of business development companies. In general, the SEC s proposed rules would define an eligible portfolio company as any company that does not have securities listed on a national securities exchange or association. We currently do not believe that these proposed rules will have a material adverse effect on our operations.

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

Our common stock price may be volatile. The trading price of our common stock may fluctuate substantially. The price of the common stock may be higher or lower than the price paid by stockholders, depending on many factors, some of which are beyond our control and may not be directly related to our operating performance. These factors include, but are not limited to, the following:

- price and volume fluctuations in the overall stock market from time to time;
- significant volatility in the market price and trading volume of securities of business development companies or other financial services companies;
- volatility resulting from trading in derivative securities related to our common stock including puts, calls, long-term equity anticipation securities, or LEAPs, or short trading positions;
- changes in laws or regulatory policies or tax guidelines with respect to business development companies or regulated investment companies;
- actual or anticipated changes in our earnings or fluctuations in our operating results or changes in the expectations of securities analysts;
- general economic conditions and trends;
- loss of a major funding source; or
- departures of key personnel.

The trading market or market value of our publicly issued debt securities may be volatile. Upon issuance, our publicly issued debt securities will not have an established trading market. We cannot assure you that a trading market for our publicly issued debt securities will ever develop or be maintained if developed. In addition to our creditworthiness, many factors may materially adversely affect the trading market for, and market value of, our publicly issued debt securities. These factors include, but are not limited to, the following:

- the time remaining to the maturity of these debt securities;
- the outstanding principal amount of debt securities with terms identical to these debt securities;
- the supply of debt securities trading in the secondary market, if any;
- the redemption or repayment features, if any, of these debt securities;

the level, direction and volatility of market interest rates generally; and

market rates of interest higher or lower than rates borne by the debt securities.

You should also be aware that there may be a limited number of buyers when you decide to sell your debt securities. This too may materially adversely affect the market value of the debt securities or the trading market for the debt securities.

Terms relating to redemption may materially adversely affect your return on the debt securities. If your debt securities are redeemable at our option, we may choose to redeem your debt securities at times when prevailing interest rates are lower than the interest rate paid on your debt securities. In addition, if your debt securities are subject to mandatory redemption, we may be required to redeem your debt securities also at times when prevailing interest rates are lower than the interest rate paid on your debt securities. In this circumstance, you may not be able to reinvest the redemption proceeds in a comparable security at an effective interest rate as high as your debt securities being redeemed.

Our credit ratings may not reflect all risks of an investment in the debt securities. Our credit ratings are an assessment of our ability to pay our obligations. Consequently, real or anticipated changes in our credit ratings will generally affect the market value of the publicly issued debt securities. Our credit ratings, however, may not reflect the potential impact of risks related to market conditions generally or other factors discussed above on the market value of or trading market for the publicly issued debt securities.

RATIOS OF EARNINGS TO FIXED CHARGES

For the three months ended March 31, 2006, and the five years ended December 31, 2005, the ratios of earnings to fixed charges of the Company, computed as set forth below, were as follows:

	Three Months Ended March 31,	Year Ended December 31,				
	2006[1]	2005	2004	2003	2002	2001
Earnings to Fixed Charges*	5.4	12.4	4.3	3.4	4.2	4.0

For purposes of computing the ratios of earnings to fixed charges, earnings represent net increase in net assets resulting from operations plus (or minus) income tax expense (benefit) plus excise tax expense plus fixed charges. Fixed charges include interest expense, a portion of rent expense and preferred stock dividend expense. We have assumed that one-third of the annual rent expense represents fixed charges.

* Earnings include the net change in unrealized appreciation or depreciation. Net change in unrealized appreciation or depreciation can vary substantially from year to year. Excluding the net change in unrealized appreciation or depreciation, the earnings to fixed charges ratio would be 20.6 for the three months ended March 31, 2006[1], and 6.4, 5.2, 4.4, 4.2 and 3.7 for the five years ended December 31, 2005, respectively.

(1) The results for the three months ended March 31, 2006, are not necessarily indicative of the operating results to be expected for the full year.

Disclosure Regarding Forward-Looking Statements

Information contained or incorporated by reference in this prospectus and any prospectus supplement and pricing supplement, if any, accompanying this prospectus contains forward-looking statements. These statements include the plans and objectives of management for future operations and financial objectives and can be identified by the use of forward-looking terminology such as may, will, expect, intend, anticipate, estimate or continue or the nega or other variations thereon or comparable terminology. These forward-looking statements are subject to the inherent uncertainties in predicting future results and conditions. Certain factors that could cause actual results and conditions to differ materially from those projected in these forward-looking statements are set forth above in the Risk Factors section. Other factors that could cause actual results to differ materially include:

- changes in the economy and general economic conditions;

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

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

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

The matters described in Risk Factors and certain other factors noted throughout this prospectus and any prospectus supplement and pricing supplement, if any, accompanying this prospectus and in any exhibits to the registration statement of which this prospectus is a part, constitute cautionary statements identifying important factors with respect to any such forward-looking statements, including certain risks and uncertainties, that could cause actual results to differ materially from those in such forward-looking statements.

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

USE OF PROCEEDS

We intend to use the net proceeds from selling debt securities for general corporate purposes, which may include investing in debt or equity securities in primarily privately negotiated transactions, repayment of indebtedness, acquisitions and other general corporate purposes. Because our primary business is to provide long-term debt and equity capital to primarily middle-market companies, we are continuously identifying, reviewing and, to the extent consistent with our investment objective, funding new investments. As a result, we typically raise equity capital or issue debt as we deem appropriate to fund such new investments.

We anticipate that substantially all of the net proceeds of any offering of debt securities will be used as described above or in any prospectus supplement and pricing supplement, if any, accompanying this prospectus. Pending investment, we intend to invest the net proceeds of any offering of debt securities in time deposits, income-producing securities with maturities of three months or less that are issued or guaranteed by the federal government or an agency of the federal government, high quality debt securities maturing in one year or less from the time of investment or other qualifying investments. Our ability to achieve our investment objective may be limited to the extent that the net proceeds of any offering of debt securities, pending full investment, are held in lower-yielding time deposits and other short-term instruments.

PRICE RANGE OF COMMON STOCK AND DISTRIBUTIONS

Our common stock is traded on the New York Stock Exchange under the symbol ALD. The following table lists the high and low closing sales prices for our common stock, the closing sales price as a percentage of net asset value (NAV) and quarterly dividends per share. On June 20, 2006, the last reported closing sale price of our common stock was $29.41 per share.

	NAV(1)	Closing Sales Price High	Closing Sales Price Low	Premium of High Sales Price to NAV(2)	Premium of Low Sales Price to NAV(2)	Declared Dividends
Year ending December 31, 2004						
First Quarter	$14.60	$30.85	$27.15	211%	186%	$0.57
Second Quarter	$14.77	$30.25	$23.06	205%	156%	$0.57
Third Quarter	$14.90	$25.80	$22.22	173%	149%	$0.57
Fourth Quarter	$14.87	$28.47	$24.46	191%	164%	$0.57
Extra Dividend						$0.02
Year ended December 31, 2005						
First Quarter	$15.22	$27.84	$24.89	183%	164%	$0.57
Second Quarter	$17.01	$29.29	$25.83	172%	152%	$0.57
Third Quarter	$17.37	$29.17	$26.92	168%	155%	$0.58
Fourth Quarter	$19.17	$30.80	$26.11	161%	136%	$0.58
Extra Dividend						$0.03
Year ended December 31, 2006						
First Quarter	$19.50	$30.68	$28.51	157%	146%	$0.59
Second Quarter (through June 20, 2006)	*	$31.32	$29.36	*	*	$0.60

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

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

* Not determinable at the time of filing.

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

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

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

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

The information contained in this section should be read in conjunction with our Consolidated Financial Statements and the Notes thereto. In addition, this prospectus contains certain forward-looking statements. These statements include the plans and objectives of management for future operations and financial objectives and can be identified by the use of forward-looking terminology such as may, will, expect, intend, anticipate, estimate, or continue or the negative thereof or other variations thereon or comparable terminology. These forward-looking statements are subject to the inherent uncertainties in predicting future results and conditions. Certain factors that could cause actual results and conditions to differ materially from those projected in these forward-looking statements are set forth above in the Risk Factors section. Other factors that could cause actual results to differ materially include:

changes in the economy and general economic conditions;

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

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

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

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

OVERVIEW

As a business development company, we are in the private equity business. Specifically, we provide long-term debt and equity investment capital to companies in a variety of industries. Our lending and investment activity has generally been focused on private finance and commercial real estate finance, which included primarily the investment in non-investment grade commercial mortgage-backed securities, which we refer to as CMBS, and collateralized debt obligation bonds and preferred shares, which we refer to as CDOs.

On May 3, 2005, we completed the sale of our portfolio of CMBS and real estate related CDO investments. Upon the completion of this transaction, our lending and investment activity has been focused primarily on private finance investments. Our private finance activity principally involves providing financing to middle market U.S. companies through privately negotiated long-term debt and equity investment capital. Our financing is generally used to fund growth, acquisitions, buyouts, recapitalizations, note purchases, bridge financings, and other types of financings. We generally invest in private companies though, from time to time, we may invest in companies that are public but lack access to additional public capital. Our investment objective is to achieve current income and capital gains.

Our portfolio composition at March 31, 2006 and 2005, and December 31, 2005, 2004, and 2003, was as follows:

	March 31,		December 31,		
	2006	**2005**	**2005**	**2004**	**2003**
Private finance	96%	74%	96%	76%	74%
Commercial real estate finance	4%	26%	4%	24%	26%

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

Because we are a regulated investment company for tax purposes, we intend to distribute substantially all of our annual taxable income as dividends to our shareholders. See Other Matters below.

PORTFOLIO AND INVESTMENT ACTIVITY

The total portfolio at value, investment activity, and the yield on interest-bearing investments at and for the three months ended March 31, 2006 and 2005, and at and for the years ended December 31, 2005, 2004, and 2003, were as follows:

	At and for the Three Months Ended March 31,		At and for the Year Ended December 31,		
	2006	2005	2005	2004	2003
($ in millions)					
Portfolio at value	$3,691.0	$3,195.0	$3,606.4	$3,013.4	$2,584.6
Investments funded[1]	$ 797.9	$ 265.6	$1,675.8	$1,524.5	$ 931.5
Change in accrued or reinvested interest and dividends [2]	$ (2.1)	$ 10.5	$ 6.6	$ 52.2	$ 45.0
Principal collections related to investment repayments or sales	$ 340.4	$ 158.3	$1,503.4	$ 909.2	$ 788.3
Yield on interest-bearing investments[3]	12.3%	13.6%	12.8%	14.0%	14.7%

(1) Investments funded for the three months ended March 31, 2006, included a $150 million subordinated debt investment in Advantage Sales & Marketing, Inc. received in conjunction with the sale of Advantage as discussed below.

(2) Includes a change in accrued or reinvested interest of $1.1 million for the three months ended March 31, 2006, related to our investments in money market securities.

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

Private Finance

The private finance portfolio at value, investment activity, and the yield on loans and debt securities at and for the three months ended March 31, 2006 and 2005, and at and for the years ended December 31, 2005, 2004, and 2003, were as follows:

	At and for the Three Months Ended March 31,				At and for the Year Ended December 31,					
	2006		2005		2005		2004		2003	
	Value	Yield[2]	Value	Yield[2]	Value	Yield[2]	Value	Yield[2]	Value	Yield[2]
($ in millions)										
Portfolio at value:										
Loans and debt										

securities:										
Senior loans	$ 420.1	9.3%	$ 253.5	8.6%	$ 239.8	9.5%	$ 234.6	8.5%	$ 165.5	9.2%
Unitranche debt	362.7	11.1%	44.2	14.8%	294.2	11.4%	43.9	14.8%	24.9	15.6%
Subordinated debt	1,747.2	13.6%	1,258.7	14.9%	1,560.9	13.8%	1,324.4	14.9%	1,024.5	16.0%
Total loans and debt securities	$2,530.0	12.5%	$1,556.4	13.8%	$2,094.9	13.0%	$1,602.9	13.9%	$1,214.9	15.0%
Equity securities	1,031.6		822.1		1,384.4		699.2		687.8	
Total portfolio	$3,561.6		$2,378.5		$3,479.3		$2,302.1		$1,902.7	
Investments funded[1]	$ 795.9		$ 168.2		$1,462.3		$1,140.8		$ 498.0	
Change in accrued or reinvested interest and dividends	$ (4.2)		$ 7.9		$ 24.6		$ 45.6		$ 41.8	
Principal collections related to investment repayments or sales	$ 336.6		$ 151.2		$ 703.9		$ 551.9		$ 318.6	

(1) Investments funded for the three months ended March 31, 2006, included a $150 million subordinated debt investment in Advantage Sales & Marketing, Inc. received in conjunction with the sale of Advantage as discussed below.

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

Our investment activity is focused on making long-term investments in the debt and equity of primarily private middle market companies. Debt investments may include senior loans, unitranche debt (a single debt investment that is a blend of senior and subordinated debt), or subordinated debt (with or without equity features). The junior debt that we invest in that is lower in repayment priority than senior debt is also known as mezzanine debt. Equity investments may include a minority equity stake in connection with a debt investment or a substantial equity stake in connection with a buyout transaction. In a buyout transaction, we generally invest in senior and/or subordinated debt and equity (preferred and/or voting or non-voting common) where our equity ownership represents a significant portion of the equity, but may or may not represent a controlling interest.

In addition, we may fund most or all of the debt and equity capital upon the closing of certain buyout transactions, which may include investments in lower-yielding senior debt. Subsequent to the closing, the portfolio company may refinance all or a portion of the lower-yielding senior debt, which would reduce our investment. Senior loans at March 31, 2006, included approximately $200 million of senior loans that are in various stages of being refinanced. Repayments include repayments of senior debt funded by us that was subsequently refinanced or repaid by the portfolio companies.

We intend to take a balanced approach to private equity investing that emphasizes a complementary mix of debt investments and buyout investments. The combination of these two types of investments provides current interest and related portfolio income and the potential for future capital gains. Recently, we believe many junior debt financing opportunities in the market have become less attractive from a risk/return perspective. To address the current market, our strategy is to focus on buyout and recapitalization transactions where we can manage risk through the structure and terms of our debt and equity investments and where we can potentially realize more attractive total returns from both current interest and fee income and future capital gains. We are also focusing our debt investing on smaller middle market companies where we can provide both senior and subordinated debt or unitranche debt, where our current yield may be lower than traditional subordinated debt. We believe that providing both senior and subordinated debt or unitranche debt provides greater protection in the capital structures of our portfolio companies.

Investments Funded. Investments funded and the weighted average yield on investments funded at and for the three months ended March 31, 2006, and at and for the years ended December 31, 2005, 2004, and 2003, consisted of the following:

	For the Three Months Ended March 31, 2006					
	Debt Investments		**Buyout Investments**		**Total**	
($ in millions)	**Amount**	**Weighted Average Yield[1]**	**Amount**	**Weighted Average Yield[1]**	**Amount**	**Weighted Average Yield[1]**
Loans and debt securities:						
Senior loans	$ 85.0	9.1%	$117.8	8.9%	$202.8	9.0%
Unitranche debt[2]	75.0	10.6%			75.0	10.6%
Subordinated debt[3]	279.3	12.5%	145.4	13.9%	424.7	13.0%
Total loans and debt securities	439.3	11.5%	263.2	11.6%	702.5	11.6%
Equity	24.6		68.8		93.4	
Total	$463.9		$332.0		$795.9	

	2005 Investments Funded					
	Debt Investments		Buyout Investments		Total	
($ in millions)	Amount	Weighted Average Yield(1)	Amount	Weighted Average Yield(1)	Amount	Weighted Average Yield(1)
Loans and debt securities:						
Senior loans(4)	$ 76.8	10.0%	$250.2	6.4%	$ 327.0	7.2%
Unitranche debt(2)	259.5	10.5%			259.5	10.5%
Subordinated debt	296.9	12.3%	330.9	12.5%	627.8	12.4%
Total loans and debt securities	633.2	11.3%	581.1	9.9%	1,214.3	10.6%
Equity	82.5		165.5		248.0	
Total	$715.7		$746.6		$1,462.3	

	2004 Investments Funded					
	Debt Investments		Buyout Investments		Total	
($ in millions)	Amount	Weighted Average Yield(1)	Amount	Weighted Average Yield(1)	Amount	Weighted Average Yield(1)
Loans and debt securities:						
Senior loans	$ 25.1	9.1%	$140.8	7.2%	$ 165.9	7.5%
Unitranche debt(2)	18.9	13.0%			18.9	13.0%
Subordinated debt	396.4	13.4%	320.1	15.5%	716.5	14.4%
Total loans and debt securities	440.4	13.2%	460.9	13.0%	901.3	13.1%
Equity	72.3		167.2		239.5	
Total	$512.7		$628.1		$1,140.8	

	2003 Investments Funded					
	Debt Investments		Buyout Investments		Total	
($ in millions)	Amount	Weighted Average Yield(1)	Amount	Weighted Average Yield(1)	Amount	Weighted Average Yield(1)

Loans and debt securities:						
Senior loans	$ 44.6	9.4%	$28.6	2.6%	$ 73.2	6.7%
Unitranche debt[2]	25.0	15.5%			25.0	15.5%
Subordinated debt	354.8	14.6%	1.2	25.0%	356.0	14.6%
Total loans and debt securities	424.4	14.1%	29.8	3.5%	454.2	13.4%
Equity	15.6		28.2		43.8	
Total	$440.0		$58.0		$498.0	

(1) The weighted average yield on interest-bearing investments is computed as the (a) annual stated interest on accruing interest-bearing investments, divided by (b) total interest-bearing investments funded.

(2) Unitranche debt is a single debt investment that is a blend of senior and subordinated debt. The yield on a unitranche investment reflects the blended yield of senior and subordinated debt combined.

(3) Debt investments for the three months ended March 31, 2006, included a $150 million, 12.0% subordinated debt investment in Advantage Sales & Marketing, Inc. received in conjunction with the sale of Advantage as discussed below.

(4) Buyout senior loans funded include $174.9 million which was repaid during the year.

In April 2006, we funded private finance investments totaling $254.9 million.

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

The level of investment activity for investments funded and principal repayments for private finance investments can vary substantially from period to period depending on the number and size of investments that we make or that we exit and many other factors, including the amount of debt and equity capital available to middle market companies, the level of merger and acquisition activity for such companies, the general economic environment, and the competitive environment for the types of investments we make. We believe that merger and acquisition activity in the middle market was strong in 2004 and 2005 and has continued into 2006, which has resulted in an increase in private finance investment opportunities, as well as increased repayments. We continue to have an active pipeline of new investments under consideration. We believe that merger and acquisition activity for middle market companies will remain strong in 2006.

Portfolio Yield. The yield on the private finance loans and debt securities was 12.5% at March 31, 2006, 13.8% at March 31, 2005, and 13.0%, 13.9%, and 15.0% at December 31, 2005, 2004, and 2003, respectively. The weighted average yield on the private finance loans and debt securities may fluctuate from period to period depending on the yield on new loans and debt securities funded, the yield on loans and debt securities repaid, the amount of loans and debt securities for which interest is not accruing and the amount of lower-yielding senior or unitranche debt in the portfolio at the end of the period. The yield on the private finance portfolio has declined partly due to our strategy to pursue more buyout and recapitalization transactions, which may include investing in lower-yielding senior debt, as well as pursue unitranche investments.

Outstanding Investment Commitments. At March 31, 2006, we had outstanding private finance investment commitments totaling $316.3 million, including the following:

$33.3 million in the form of debt to Promo Works, LLC.

$30.0 million in the form of debt to Business Loan Express, LLC.

$29.9 million in the form of equity to eleven private equity and venture capital funds.

$14.0 million in the form of debt to S.B. Restaurant Company.

$14.0 million in the form of debt to Integrity Interactive Corp.

$9.6 million in the form of debt to 3SI Security Systems Inc.

$8.3 million in the form of debt to Hot Stuff Foods, LLC.

$7.8 million in the form of debt to Mercury Air Centers, Inc.

$6.5 million in co-investment commitments to Pine Creek Equity Partners, LLC.

We have various commitments to Callidus Capital Corporation (Callidus), which owns 80% (subject to dilution) of Callidus Capital Management, LLC, an asset management company that structures and manages collateralized debt obligations (CDOs), collateralized loan obligations (CLOs), and other related investments. Our commitment to Callidus consisted of the following at March 31, 2006:

($ in millions)	Committed Amount	Amount Drawn	Amount Available to be Drawn
Subordinated debt to support warehouse facilities & warehousing activities[1]	$40.0	$	$40.0
Revolving line of credit facility to support warehousing activities[2]	50.0	3.7	46.3
Revolving line of credit for working capital	4.0	3.8	0.2
Total	$94.0	$7.5	$86.5

(1) Callidus has a secured warehouse credit facilities with a third party for up to $400 million. The facility is used primarily to finance the acquisition of loans pending securitization through a CDO or CLO. In conjunction with this warehouse credit facility, we have agreed to designate our $40 million subordinated debt commitment for Callidus to draw upon to provide first loss capital as needed to support the warehouse facility.

(2) This facility supports Callidus purchase of middle market senior loans pending the sale of such loans to its warehouse credit facilities.

In addition, at March 31, 2006, we had a commitment to Callidus to purchase preferred equity in future CLO transactions of $32.4 million.

In addition to these outstanding investment commitments at March 31, 2006, we may be required to fund additional amounts under earn-out arrangements primarily related to buyout transactions in the future if those companies meet agreed-upon performance targets. We also had commitments to private finance portfolio companies in the form of standby letters of credit and guarantees totaling $184.7 million. See Financial Condition, Liquidity and Capital Resources.

Our largest investment at value at March 31, 2006, was in Business Loan Express, LLC (BLX) and our largest investments at value at December 31, 2005, were in Advantage Sales & Marketing, Inc. and BLX. See Results of Operations for a discussion of the net change in unrealized appreciation or depreciation related to these investments.

Business Loan Express, LLC. At March 31, 2006, our investment in BLX totaled $291.3 million at cost and $326.2 million at value, or 7.9% of our total assets, which included unrealized appreciation of $35.0 million. At December 31, 2005, our investment in BLX totaled $299.4 million at cost and $357.1 million at value, or 8.9% of our total assets, which included unrealized appreciation of $57.7 million. We acquired BLX in 2000.

Total interest and related portfolio income earned from the Company s investment in BLX for the three months ended March 31, 2006 and 2005, and for the years ended December 31, 2005, 2004, and 2003, was as follows:

	Three Months Ended March 31,		Year Ended December 31,		
($ in millions)	2006	2005	2005	2004	2003
Interest income	$3.9	$3.4	$14.3	$23.2	$21.9
Dividend income		2.0	14.0	14.8	7.8
Loan prepayment premiums					0.1

Fees and other income	2.2	2.4	9.2	12.0	16.9
Total	$6.1	$7.8	$37.5	$50.0	$46.7

Interest and dividend income from BLX for the three months ended March 31, 2006 and 2005, and for the years ended December 31, 2005, 2004, and 2003, included interest and dividend income of $1.8 million, $1.6 million, $8.9 million, $25.4 million, and $17.5 million, respectively, which was paid in kind. The interest and dividends paid in kind were paid to us through the issuance of additional debt or equity interests. Accrued interest and dividends receivable and other assets at March 31, 2006, included accrued interest and fees due from BLX totaling $3.4 million, of which $2.2 million was paid in cash in the second quarter of 2006.

Net change in unrealized appreciation or depreciation included a net decrease in unrealized appreciation on our investment in BLX of $22.7 million and $6.3 million for the three months ended March 31, 2006 and 2005, respectively. Net change in unrealized appreciation or depreciation included a net increase in unrealized appreciation on our investment in BLX of $2.9 million for the year ended December 31, 2005, a net decrease in unrealized appreciation of $32.3 million for the year ended December 31, 2004, and a net increase in unrealized appreciation of $51.7 million for the year ended December 31, 2003. See Results of Operations for a discussion of the net change in unrealized appreciation or depreciation related to this investment.

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

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

We had a commitment to BLX of $30.0 million in the form of a subordinated revolving credit facility to provide working capital to the company that expired on April 30, 2006. There were no amounts outstanding under this facility at March 31, 2006.

At December 31, 2005, BLX had a three-year $275.0 million revolving credit facility provided by third party lenders that was scheduled to mature in January 2007. As the controlling equity owner in BLX, we had provided an unconditional guaranty to the revolving credit facility lenders in an amount equal to 50% of the total obligations (consisting of principal, letters of credit issued under the facility, accrued interest, and other fees) of BLX under the revolving credit facility. At December 31, 2005, the principal amount of loans outstanding on the revolving credit facility was $228.2 million and letters of credit issued under the facility were $41.7 million. The total obligation guaranteed by us at December 31, 2005, was $135.4 million.

On March 17, 2006, BLX closed on a new three-year $500.0 million revolving credit facility that matures in March 2009, which replaced the existing facility. The revolving credit facility may be expanded through new or additional commitments up to $600.0 million at BLX s option. This new facility provides for a sub-facility for the issuance of letters of credit for up to an amount equal to 25% of the committed facility. We have provided an unconditional guaranty to these revolving credit facility lenders in an amount equal to 50% of the total obligations (consisting of principal, letters of credit issued under the facility, accrued interest, and other fees) of BLX under this facility. At March 31, 2006, the principal amount outstanding on the revolving credit facility was $240.2 million and letters of credit issued under the facility were $41.7 million. The total obligation guaranteed by us at March 31, 2006, was $141.1 million. This guaranty can be called by the lenders only in the event of a default under the BLX credit facility, which includes certain defaults under our revolving credit facility. BLX was in compliance with the terms of this facility at March 31, 2006. At March 31, 2006, we had also provided four standby letters of credit totaling $34.1 million in connection with four term securitization transactions completed by BLX.

Advantage Sales & Marketing, Inc. At December 31, 2005, our investment in Advantage totaled $257.7 million at cost and $660.4 million at value, or 16.4% of our total assets, which included unrealized appreciation of $402.7 million. We completed the purchase of a majority ownership in Advantage in June 2004.

On March 29, 2006, we sold our majority equity interest in Advantage. We were repaid our $184 million in subordinated debt outstanding and realized a gain on our equity investment sold of $433.1 million, subject to post-closing adjustments. As consideration for the common stock sold in the transaction, we received a $150 million subordinated note, with the balance of the consideration paid in cash. Approximately $34 million of our cash proceeds from the sale of the common stock have been held in escrow, subject to certain holdback provisions. In addition, there is potential for us to receive additional consideration through an earn-out payment that would be based on Advantage s 2006 audited results. Our realized gain of $433.1 million excludes any earn-out amounts. For tax purposes, the receipt of the $150 million subordinated note as part of our consideration for the common stock sold will allow us, through installment treatment, to defer the recognition of taxable income for a portion of our realized gain until the note is collected. In connection with the transaction, we retained an equity investment in the business valued at $15 million as a minority shareholder.

Total interest and related portfolio income earned from our investment in Advantage while we held a majority equity interest for the three months ended March 31, 2006 and 2005, and for the years ended December 31, 2005 and 2004, was as follows:

	Three Months Ended March 31,		**Year Ended December 31,**	
	2006	**2005**	**2005**	**2004**
($ in millions)				
Interest income	$ 7.3	$7.7	$30.9	$15.5
Loan prepayment premiums	5.0			
Fees and other income	1.8	1.5	6.5	5.8
Total interest and related portfolio income	$14.1	$9.2	$37.4	$21.3

In addition, we earned structuring fees of $2.3 million on our new $150 million subordinated debt investment in Advantage upon the closing of the sale transaction.

After the completion of the sale transaction, our investment in Advantage at March 31, 2006, which was composed of subordinated debt and a minority equity interest, totaled $151.3 million at cost and $164.3 million at value, which included unrealized appreciation of $13.0 million. Subsequent to the completion of the sale transaction, we estimate that our interest income from our subordinated debt investment in Advantage will be approximately $4.5 million per quarter.

Advantage is a sales and marketing agency providing outsourced sales, merchandising, and marketing services to the consumer packaged goods industry. Advantage has offices across the United States and is headquartered in Irvine, CA.

STS Operating, Inc. On May 1, 2006, we announced the completion of the sale of STS Operating, Inc. (STS). We were repaid our $6.8 million in subordinated debt outstanding and we realized a gain on the sale of our common stock in STS of approximately $94 million, subject to post-closing adjustments. The cost basis of our equity was $3.5 million. As part of the consideration for the sale of our equity, we received a $30 million subordinated note. Approximately $10.7 million of our proceeds are subject to certain holdback provisions and post-closing adjustments. For tax purposes, the receipt of the $30 million subordinated note as part of our consideration for the common stock sold will allow us, through installment treatment, to defer the recognition of taxable income for a portion of our realized gain until the note is collected.

The Hillman Companies, Inc. On March 31, 2004, we sold our control investment in The Hillman Companies, Inc. (Hillman) for a total transaction value of $510 million, including the repayment of outstanding debt and adding the value of Hillman s outstanding trust preferred shares. We were repaid our existing $44.6 million in outstanding debt. Total consideration to us from this sale, including the repayment of debt, was $245.6 million, which included net cash proceeds of $198.1 million and the receipt of a new subordinated debt instrument of $47.5 million. During the second quarter of 2004, we sold a $5.0 million participation in our subordinated debt in Hillman to a third party, which reduced our investment, and no gain or loss resulted from the transaction. For the year ended December 31, 2004, we realized a gain of $150.3 million on the transaction.

Commercial Real Estate Finance

The commercial real estate finance portfolio at value, investment activity, and the yield on interest-bearing investments at and for the three months ended March 31, 2006 and 2005, and at and for the years ended December 31, 2005, 2004, and 2003, were as follows:

	At and for the Three Months Ended March 31,				At and for the Years Ended December 31,					
	2006		2005		2005		2004		2003	
($ in millions)	Value	Yield[1]	Value	Yield[1]	Value	Yield[1]	Value	Yield[1]	Value	Yield[1]
Portfolio at value:										
CMBS bonds	$		$466.1	13.0%	$		$373.8	14.6%	$394.0	14.1%
CDO bonds and preferred shares			227.1	15.8%			212.6	16.8%	186.6	16.7%
Commercial mortgage loans	102.7	7.6%	89.7	6.4%	102.6	7.6%	95.0	6.8%	83.6	8.6%
Real estate owned	15.0		18.4		13.9		16.9		12.8	
Equity interests	11.7		15.2		10.6		13.0		4.9	
Total portfolio	$129.4		$816.5		$127.1		$711.3		$681.9	
Investments funded	$ 2.0		$ 97.4		$213.5		$383.7		$433.5	
Change in accrued or reinvested interest[2]	$ 1.0		$ 2.6		$ (18.0)		$ 6.6		$ 3.2	
Principal collections related to investment repayments or sales[2]	$ 3.8		$ 7.1		$799.5		$357.3		$469.7	

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

(2) Principal collections related to investment repayments or sales for the year ended December 31, 2005, included $718.1 million related to the sale of our CMBS and CDO portfolio in May 2005. Change in accrued or reinvested interest for the year ended December 31, 2005, included the collection of $21.7 million related to the sale of this portfolio.

Our commercial real estate investments funded for the three months ended March 31, 2006, and for the years ended December 31, 2005, 2004, and 2003, were as follows:

($ in millions)	Face Amount	Discount	Amount Funded
For the Three Months Ended March 31, 2006			
Commercial mortgage loans	$ 0.6	$	$ 0.6
Equity interests	1.4		1.4
Total	$ 2.0	$	$ 2.0
For the Year Ended December 31, 2005			
CMBS bonds (4 new issuances)[2]	$211.5	$ (90.5)	$121.0
Commercial mortgage loans	88.5	(0.8)	87.7
Equity interests	4.8		4.8
Total	$304.8	$ (91.3)	$213.5
For the Year Ended December 31, 2004			
CMBS bonds (13 new issuances[1])	$419.1	$(183.7)	$235.4
CDO bonds and preferred shares (3 issuances)	40.5	(0.1)	40.4
Commercial mortgage loans	112.1	(8.2)	103.9
Equity interests	4.0		4.0
Total	$575.7	$(192.0)	$383.7

($ in millions)	Face Amount	Discount	Amount Funded
For the Year Ended December 31, 2003			
CMBS bonds (15 new issuances[1])	$508.5	$(225.9)	$282.6
CDO bonds and preferred shares (3 issuances)	145.8	(0.4)	145.4
Commercial mortgage loans	3.0		3.0
Equity interests	2.5		2.5
Total	$659.8	$(226.3)	$433.5

(1) CMBS investments also include investments in issuances in which we have previously purchased CMBS bonds.
(2) The CMBS bonds invested in during the year ended December 31, 2005, were sold on May 3, 2005.

At March 31, 2006, we had outstanding funding commitments related to commercial mortgage loans and equity interests of $13.6 million and commitments in the form of standby letters of credit and guarantees related to equity interests of $7.0 million.

Sale of CMBS Bonds and Collateralized Debt Obligation Bonds and Preferred Shares. On May 3, 2005, we completed the sale of our portfolio of commercial mortgage-backed securities (CMBS) and real estate related collateralized debt obligation (CDO) bonds and preferred shares to affiliates of Caisse de dépôt et placement du Québec (the Caisse) for cash proceeds of $976.0 million and a net realized gain of $227.7 million, after transaction and other costs of $7.8 million, in the second quarter of 2005. Transaction costs included investment banking fees, legal and other professional fees, and other transaction costs. The CMBS and CDO assets sold had a cost basis at closing of $739.8 million, including accrued interest of $21.7 million. Upon the closing of the sale, we settled all the hedge positions relating to these assets, which resulted in a net realized loss of $0.7 million, which was included in the net realized gain on the sale.

For tax purposes, we estimate that the net gain from the sale of the CMBS and CDO portfolio will be approximately $244 million, after transaction and other costs of $7.8 million. The difference between the net gain for book and tax purposes results from temporary differences in the recognition of income and expenses related to these assets.

Simultaneous with the sale of our CMBS and CDO portfolio, we entered into a platform assets purchase agreement with CWCapital Investments LLC, an affiliate of the Caisse (CWCapital), pursuant to which we agreed to sell certain commercial real estate related assets, including servicer advances, intellectual property, software and other platform assets, subject to certain adjustments. This transaction was completed on July 13, 2005, and we received total cash proceeds of approximately $5.3 million. No gain or loss resulted from the transaction. Under this agreement, we have agreed not to invest in CMBS and real estate-related CDOs and refrain from certain other real estate-related investing or servicing activities for a period of three years, or through May 2008, subject to certain limitations and excluding our existing portfolio and related activities.

The real estate securities purchase agreement, under which we sold the CMBS and CDO portfolio, and the platform asset purchase agreement contain customary representations and warranties, and require us to indemnify the affiliates of the Caisse that are parties to the agreements for certain liabilities arising under the agreements, subject to certain limitations and conditions.

We also entered into a transition services agreement with CWCapital pursuant to which we provided certain transition services to CWCapital for a limited transition period to facilitate the transfer of various servicing and other rights related to the CMBS and

CDO portfolio. During the transition period, we agreed, among other things, to continue to act as servicer or special servicer with respect to the CMBS and CDO portfolio. Services provided under the transition services agreement, except for certain information technology services, were completed on July 13, 2005. For the year ended December 31, 2005, we received a total of $1.4 million under the transition services agreement as reimbursement for employee and administrative expenses. These amounts reduced our employee expenses by $1.1 million and administrative expenses by $0.3 million.

Hedging Activities

We have invested in commercial mortgage loans and CMBS and CDO bonds, which were purchased at prices that were based in part on comparable Treasury rates. We have entered into transactions with one or more financial institutions to hedge against movement in Treasury rates on certain of the commercial mortgage loans and CMBS and CDO bonds. These transactions, referred to as short sales, involve receiving the proceeds from the short sales of borrowed Treasury securities, with the obligation to replenish the borrowed Treasury securities at a later date based on the then current market price, whatever that price may be. Risks in these contracts arise from movements in the value of the borrowed Treasury securities due to changes in interest rates and from the possible inability of counterparties to meet the terms of their contracts. If the value of the borrowed Treasury securities increases, we will incur losses on these transactions. These losses are limited to the increase in value of the borrowed Treasury securities; conversely, the value of the hedged commercial real estate assets would likely increase. If the value of the borrowed Treasury securities decreases, we will incur gains on these transactions which are limited to the decline in value of the borrowed Treasury securities; conversely, the value of the hedged commercial real estate assets would likely decrease. We do not anticipate nonperformance by any counterparty in connection with these transactions.

The total obligations to replenish borrowed Treasury securities, including accrued interest payable on the obligations, were $17.5 million, $17.7 million and $38.2 million at March 31, 2006, and December 31, 2005 and 2004, respectively. The net proceeds related to the sales of the borrowed Treasury securities plus or minus the additional cash collateral provided or received under the terms of the transactions were $17.5 million, $17.7 million and $38.2 million at March 31, 2006, and December 31, 2005 and 2004, respectively. The hedge at March 31, 2006, and December 31, 2005, related to commercial mortgage loans and the hedge at December 31, 2004, related primarily to CMBS and CDO bonds. The amount of the hedge will vary from period to period depending upon the amount of commercial real estate assets that we own and have hedged as of the balance sheet date.

Accrued Interest and Dividends Receivable

Accrued interest and dividends receivable as of March 31, 2006, and December 31, 2005 and 2004, was as follows:

($ in millions)	**2006**	**2005**	**2004**
Private finance	$47.5	$58.7	$59.8
Commercial real estate finance			
CMBS and CDO bonds			18.9
Commercial mortgage loans and other	2.5	1.7	0.8
Total	$50.0	$60.4	$79.5

Total accrued interest and dividends receivable declined from December 31, 2004, to December 31, 2005, primarily as a result of the sale of our portfolio of CMBS and CDO assets on May 3, 2005. See Commercial Real Estate Finance above.

Portfolio Asset Quality

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

At March 31, 2006, and December 31, 2005 and 2004, our portfolio was graded as follows:

	2006		2005		2004	
Grade	Portfolio at Value	Percentage of Total Portfolio	Portfolio at Value	Percentage of Total Portfolio	Portfolio at Value[1]	Percentage of Total Portfolio
($ in millions)						
1	$1,287.9	34.9%	$1,643.0	45.6%	$ 952.5	31.6%
2	2,183.2	59.2	1,730.8	48.0	1,850.5	61.4
3	89.1	2.4	149.1	4.1	121.2	4.0
4	64.5	1.7	26.5	0.7	11.7	0.4
5	66.3	1.8	57.0	1.6	77.5	2.6
	$3,691.0	100.0%	$3,606.4	100.0%	$3,013.4	100.0%

(1) The value of the CMBS and CDO assets sold on May 3, 2005, was $586.4 million at December 31, 2004, and this value was included in Grade 2 assets. See Commercial Real Estate Finance above.

Grade 1 portfolio assets decreased from $1.6 billion at December 31, 2005, to $1.3 billion at March 31, 2006, primarily as a result of the sale of Advantage Sales & Marketing, Inc. (Advantage) on March 29, 2006. Advantage had a value of $660.4 million, including $402.7 million of unrealized appreciation, at December 31, 2005. Our investment in Advantage after the sale transaction was $164.3 million at value, including $13.0 million of unrealized appreciation, at March 31, 2006, and was included in Grade 1 assets. See Portfolio and Investment Activity above for further discussion. Grade 2 portfolio assets increased from $1.7 billion at December 31, 2005, to $2.2 billion at March 31, 2006, primarily as a result of the level of new investments made during the first quarter of 2006, as new investments generally enter the portfolio as Grade 2 assets.

Grade 1 portfolio assets increased from $952.5 million at December 31, 2004, to $1.6 billion at December 31, 2005, primarily as a result of the appreciation in value of our investment in Advantage Sales & Marketing, Inc. (Advantage) as well as certain other companies. Advantage had a value of $660.4 million, including $402.7 million of unrealized appreciation, at December 31, 2005, as compared to a value of $283.0 million, including $24.3 million of unrealized appreciation, at December 31, 2004. See further discussion of the valuation of Advantage below. As noted above, in March 2006, we sold our majority interest in Advantage.

Total Grade 3, 4 and 5 portfolio assets were $219.9 million, $232.6 million, and $210.4 million, respectively, or were 5.9%, 6.4%, and 7.0%, respectively, of the total portfolio at value at March 31, 2006, and December 31, 2005 and 2004.

Grade 4 and 5 assets include loans, debt securities, and equity securities. We expect that a number of portfolio companies will be in the Grades 4 or 5 categories from time to time. Part of the private equity business is working with troubled portfolio companies to improve their businesses and protect our investment. The number of portfolio companies and related investment amount included in Grade 4 and 5 may fluctuate from period to period. We continue to follow our historical practice of working with such companies in order to recover the maximum amount of our investment.

Loans and Debt Securities on Non-Accrual Status. At March 31, 2006, and December 31, 2005 and 2004, loans and debt securities at value not accruing interest for the total investment portfolio were as follows:

($ in millions)	2006	2005	2004
Loans and debt securities in workout status (classified as Grade 4 or 5)[1]			
Private finance			
Companies more than 25% owned	$ 29.0	$ 15.6	$ 34.4
Companies 5% to 25% owned	5.6		
Companies less than 5% owned	51.8	11.4	16.5
Commercial real estate finance	12.6	12.9	5.6
Loans and debt securities not in workout status			
Private finance			
Companies more than 25% owned	40.6	58.0	29.4
Companies 5% to 25% owned	5.1	0.5	0.7
Companies less than 5% owned	4.4	49.5	15.8
Commercial real estate finance	8.6	7.9	12.5
Total	$157.7	$155.8	$114.9
Percentage of total portfolio	4.3%	4.3%	3.8%

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

Loans and Debt Securities Over 90 Days Delinquent. Loans and debt securities greater than 90 days delinquent at value at March 31, 2006, and December 31, 2005 and 2004, were as follows:

($ in millions)	2006	2005	2004
Private finance	$ 82.6	$ 74.6	$ 73.5
Commercial real estate finance			
CMBS bonds			49.0
Commercial mortgage loans	6.0	6.1	10.1
Total	$ 88.6	$ 80.7	$132.6
Percentage of total portfolio	2.4%	2.2%	4.4%

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

Our loans and debt securities on non-accrual status increased by $40.9 million during 2005. This net increase during the year resulted primarily from the move of two loans to non-accrual status totaling $46.7 million at value at December 31, 2005, offset by a net decrease in the value of loans that were on non-accrual status at both

December 31, 2005 and 2004.

As a result of these and other factors, the amount of the private finance portfolio that is greater than 90 days delinquent or on non-accrual status may vary from period to period. Loans and debt securities on non-accrual status and over 90 days delinquent should not be added together as they are two separate measures of portfolio asset quality. Loans and debt securities that are in both categories (i.e., on non-accrual status and over 90 days delinquent) totaled $88.6 million, $60.7 million and $43.9 million at March 31, 2006, and December 31, 2005 and 2004, respectively.

RESULTS OF OPERATIONS

Comparison of Three Months Ended March 31, 2006 and 2005

The following table summarizes the Company s operating results for the three months ended March 31, 2006 and 2005.

($ in thousands, except per share amounts)	For the Three Months Ended March 31, 2006	2005	Change	Percentage Change
	(unaudited)			
Interest and Related Portfolio Income				
Interest and dividends	$ 88,881	$ 84,945	$ 3,936	5%
Loan prepayment premiums	5,286	1,677	3,609	215%
Fees and other income	16,844	8,297	8,547	103%
Total interest and related portfolio income	111,011	94,919	16,092	17%
Expenses				
Interest	24,300	20,225	4,075	20%
Employee	21,428	15,456	5,972	39%
Stock options	3,606		3,606	100%
Administrative	11,519	20,754	(9,235)	(44)%
Total operating expenses	60,853	56,435	4,418	8%
Net investment income before income taxes	50,158	38,484	11,674	30%
Income tax expense (benefit), including excise tax	8,858	(268)	9,126	**
Net investment income	41,300	38,752	2,548	7%
Net Realized and Unrealized Gains (Losses)				
Net realized gains	432,835	10,285	422,550	*
Net change in unrealized appreciation or depreciation	(374,548)	70,584	(445,132)	*
Total net gains	58,287	80,869	(22,582)	*
Net income	$ 99,587	$119,621	$ (20,034)	(17)%
Diluted earnings per common share	$ 0.70	$ 0.88	$ (0.18)	(20)%
Weighted average common shares outstanding diluted	141,738	135,579	6,159	5%

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

** Percentage change is not meaningful.

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

Interest and Dividends. Interest and dividend income for the three months ended March 31, 2006 and 2005, was composed of the following:

($ in millions)	**2006**	**2005**
Interest		
Private finance loans and debt securities	$82.6	$56.8
CMBS and CDO portfolio		22.1
Commercial mortgage loans	2.8	1.5
Cash and cash equivalents and other	2.9	0.4
Total interest	88.3	80.8
Dividends	0.6	4.1
Total interest and dividends	$88.9	$84.9

Our interest income from our private finance loans and debt securities has increased period over period as a result of the growth in this portfolio since March 31, 2005, as shown below. In addition, during the first quarter of 2006, we resumed accruing interest for certain private finance portfolio companies. Such additional interest income totaled $3.8 million for the three months ended March 31, 2006.

There was no interest income from the CMBS and CDO portfolio in the first quarter of 2006 as we sold this portfolio on May 3, 2005. The CMBS and CDO portfolio sold had a cost basis of $718.1 million and a weighted average yield on the cost basis of the portfolio of approximately 13.8%. We generally reinvested the principal proceeds from the CMBS and CDO portfolio into our private finance portfolio.

The level of interest income, which includes interest paid in cash and in kind, is directly related to the balance of the interest-bearing investment portfolio outstanding during the period multiplied by the weighted average yield. The interest-bearing investments in the portfolio at value and the weighted average yield on the interest-bearing investments in the portfolio at March 31, 2006 and 2005, were as follows:

	2006		**2005**	
($ in millions)	**Value**	**Weighted Average Yield(1)**	**Value**	**Weighted Average Yield(1)**
Private finance loans and debt securities	$2,530.0	12.5%	$1,556.4	13.8%
CMBS and CDO portfolio			693.2	13.9%
Commercial mortgage loans	102.7	7.6%	89.7	6.4%
Total	$2,632.7	12.3%	$2,339.3	13.6%

(1) The weighted average yield on loans and debt securities is computed as the (a) annual stated interest plus the annual amortization of loan origination fees, original issue discount, and market discount on accruing loans and

debt securities less the annual amortization of loan origination costs, divided by (b) total loans and debt securities at value. The weighted average yield is computed as of the balance sheet date.

The private finance portfolio yield at March 31, 2006, of 12.5% as compared to the private finance portfolio yield of 13.8% at March 31, 2005, reflects the mix of debt investments in the private finance portfolio. The weighted average yield varies from period to period based on the current stated interest on interest-bearing investments and the amount of loans and debt securities for which interest is not accruing. See the discussion of the private finance portfolio yield above under the caption Private Finance.

Dividend income results from the dividend yield on preferred equity interests, if any, or the declaration of dividends by a portfolio company on preferred or common equity interests. Dividend income will vary from period to period depending upon the timing and amount of dividends that are declared or paid by a portfolio company on preferred or common equity interests. Dividend income for the three months ended March 31, 2006 and 2005, included $0 and $2.0 million, respectively, of dividends from BLX on the Class B equity interests held by us, which were paid in cash.

Loan Prepayment Premiums. Loan prepayment premiums were $5.3 million and $1.7 million for the three months ended March 31, 2006 and 2005, respectively. Loan prepayment premiums for the three months ended March 31, 2006, included $5.0 million related to the repayment of our subordinated debt in connection with the sale of our majority equity interest in Advantage. See Portfolio and Investment Activity above for further discussion. While the scheduled maturities of private finance and commercial real estate loans generally range from five to ten years, it is not unusual for our borrowers to refinance or pay off their debts to us ahead of schedule. Therefore, we generally structure our loans to require a prepayment premium for the first three to five years of the loan. Accordingly, the amount of prepayment premiums will vary depending on the level of repayments and the age of the loans at the time of repayment.

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

Fees and other income for the three months ended March 31, 2006 and 2005, included fees relating to the following:

($ in millions)	**2006**	**2005**
Structuring and diligence	$11.0	$1.3
Transaction and other services provided to portfolio companies	0.1	1.2
Management, consulting and other services provided to portfolio companies and guaranty fees	5.7	4.8
Other income		1.0
Total fees and other income	$16.8	$8.3

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

Structuring and diligence fees for the three months ended March 31, 2006, included structuring fees from Advantage Sales and Marketing, CR Brands, Hot Stuff Foods, and 3SI Security Systems totaling $8.1 million. Structuring and diligence fees may vary substantially from period to period based on the level of new investment originations and the market rates for these types of fees. Private finance investments funded were $795.9 million for the three months ended March 31, 2006, as compared to $168.2 million for the three months ended March 31, 2005.

Management fees for the three months ended March 31, 2006, included $1.8 million in management fees from Advantage prior to its sale on March 29, 2006. See Portfolio and Investment Activity above for further discussion.

Fees and other income related to the CMBS and CDO portfolio for the three months ended March 31, 2005, were $1.7 million. As noted above, we sold our CMBS and CDO portfolio on May 3, 2005.

BLX and Advantage. BLX was our largest investment at value at March 31, 2006, and represented 7.9% of our total assets. Advantage and BLX were our largest investments at March 31, 2005, and together represented 19.5% of our total assets.

Total interest and related portfolio income from these investments for the three months ended March 31, 2005 and 2006, was as follows:

	2006	2005
($ in millions)		
Advantage[1]	$14.1	$9.2
BLX	$ 6.1	$7.8

[1] Includes income from the period we held a majority equity interest only. See Portfolio and Investment Activity above for further discussion.

Operating Expenses. Operating expenses include interest, employee, and administrative expenses.

Interest Expense. The fluctuations in interest expense during the three months ended March 31, 2006 and 2005, were primarily attributable to changes in the level of our borrowings under various notes payable and debentures and our revolving line of credit. Our borrowing activity and weighted average cost of debt, including fees and closing costs, at and for the three months ended March 31, 2006 and 2005, were as follows:

	At and for the Three Months Ended March 31,	
	2006	2005
($ in millions)		
Total outstanding debt	$1,274.2	$1,296.4
Average outstanding debt	$1,491.5	$1,125.0
Weighted average cost[1]	6.5%	6.4%

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

In addition, interest expense includes interest on our obligations to replenish borrowed Treasury securities related to our hedging activities of $0.2 million and $0.5 million for the three months ended March 31, 2006 and 2005, respectively.

Employee Expense. Employee expenses for the three months ended March 31, 2006 and 2005, were as follows:

($ in millions)	2006	2005
Salaries and employee benefits[1]	$17.3	$12.0
Individual performance award (IPA)	1.7	1.9
IPA mark to market expense (benefit)	1.0	0.1
Individual performance bonus (IPB)	1.4	1.5
Total employee expense	$21.4	$15.5
Number of employees at end of period	155	158

(1) Salaries and employee benefits included accrued bonuses of $7.9 million and $3.7 million for the three months ended March 31, 2006 and 2005, respectively.

The change in salaries and employee benefits reflects the effect of wage increases and the change in mix of employees given their area of responsibility and relevant experience level. Salaries and employee benefits expense has generally increased due to changes in the composition of our employee resources and compensation increases.

The Individual Performance Award (IPA) is a long-term incentive compensation program for certain officers. The IPA, which is generally determined annually at the beginning of each year, is deposited into a deferred compensation trust generally in four equal installments, on a quarterly basis, in the form of cash. The accounts of the trust are consolidated with our accounts. We are required to mark to market the liability of the trust and this adjustment is recorded to the IPA compensation expense. Because the IPA is deferred compensation, the cost of this award is not a current expense for purposes of computing our taxable income. The expense is deferred for tax purposes until distributions are made from the trust.

As a result of changes in regulation by the Jobs Creation Act of 2004 associated with deferred compensation arrangements, as well as an increase in the competitive market for recruiting talent in the private equity industry, the Compensation Committee and the Board of Directors determined that for 2005 and 2006 a portion of the IPA should be replaced with an individual performance bonus (IPB). The IPB is distributed in cash to award recipients in equal bi-weekly installments (beginning in February of each respective year) as long as the recipient remains employed by us.

The Compensation Committee and the Board of Directors have determined the IPA and the IPB for 2006. We currently estimate the IPA and IPB to be approximately $8.1 million each; however, the Compensation Committee may adjust the IPA or IPB as needed, or make new awards as new officers are hired. If a recipient terminates employment during the year, any further cash contribution for the IPA or remaining cash payments under the IPB would be forfeited.

In connection with our 2006 Annual Meeting of Stockholders, the stockholders approved the issuance of up to 2,500,000 shares of our common stock in exchange for the cancellation of vested in-the-money stock options granted to certain officers and directors under the Amended Stock Option Plan. Under the initiative, which has been reviewed and approved by our Board of Directors, all optionees who hold vested stock options with exercise prices below the market value of the stock (or in-the-money options), would be offered the opportunity to receive cash and common stock in exchange for their voluntary cancellation of their vested stock options. The sum of the cash and common stock to be received by each optionee would equal the in-the-money value of the stock option cancelled. As part of this initiative, the Board of Directors is also considering the adoption of a target ownership structure that would establish minimum ownership levels for our senior officers and continue to further align the interests of our officers with those of our stockholders. Unlike the accounting treatment typically associated with a stock option exercise, the option cancellation payment (OCP) would be recorded as an expense for financial reporting purposes, and the expense may be significant. Based on the 13 million vested options outstanding and the market price of $30.50 of our stock on March 10, 2006, the expense related to the OCP would be approximately $106 million if all option holders choose to cancel all vested in-the-money options in exchange for the OCP. For income tax purposes, our tax expense resulting from the OCP would be similar to the tax expense that would result from an exercise of stock options in the market. Any tax deduction for us resulting from the OCP or an exercise of stock options in the market would be limited by Section 162(m) of the Code for persons subject to Section 162(m).

Employee Stock Options Expense. In December 2004, the FASB issued Statement No. 123 (Revised 2004), *Share-Based Payment* (the Statement), which requires companies to recognize the grant-date fair value of stock options and other equity-based compensation issued to employees in the income statement. The Statement was effective January 1, 2006, and it applies to our stock option plan. Our stock options are typically granted with ratable vesting provisions, and we amortize the compensation cost over the service period. With respect to options granted prior to January 1, 2006, we have used the modified prospective method for adoption of the Statement. Under this method, the unamortized cost of previously awarded options that were unvested as of January 1, 2006, is recognized over the service period in the statement of operations beginning in 2006. With respect to options granted on or after January 1, 2006, compensation cost is recognized in the statement of operations over the service period. The effect of this adoption for the three months ended March 31, 2006, was employee-related stock option expense of $3.6 million, which included $3.4 million related to previously awarded options that were unvested as of January 1, 2006, and $0.2 million related to options granted during the three months ended March 31, 2006.

We estimate that the stock option expense that will be recorded in our statement of operations under the Statement, will be approximately $14.3 million, $9.3 million, and $2.8 million for the years ended December 31, 2006, 2007, and 2008, respectively, which includes stock option expense related to options granted in the first quarter of 2006 of approximately $0.8 million, $0.5 million, and $0.2 million, respectively. This estimate may change if the Company s assumptions related to future option forfeitures change. This estimate does not include any expense related to future stock option grants as the fair value of those stock options will be determined at the time of grant.

Administrative Expense. Administrative expenses include legal and accounting fees, valuation assistance fees, insurance premiums, the cost of leases for our headquarters in Washington, DC, and our regional offices, portfolio origination and development expenses, stock record expenses, directors fees, and various other expenses. Administrative expenses for the three months ended March 31, 2006 and 2005, were as follows:

($ in millions)	**2006**	**2005**
Administrative expenses, excluding investigation related costs	$ 8.6	$ 8.5
Investigation related costs	2.9	12.3
Total administrative expenses	$11.5	$20.8

Investigation related costs include costs associated with requests for information in connection with two government investigations. These expenses remain difficult to predict. See Legal Proceedings.

Income Tax Expense (Benefit), Including Excise Tax. Income tax expense (benefit) for the three months ended March 31, 2006 and 2005, were as follows:

($ in millions)	2006	2005
Income tax expense (benefit)	$0.5	$(0.3)
Excise tax expense	8.4	
Income tax expense (benefit), including excise tax	$8.9	$(0.3)

Our wholly owned subsidiary, A.C. Corporation, is a corporation subject to federal and state income taxes and records a benefit or expense for income taxes as appropriate based on its operating results in a given period. In addition, our estimated annual taxable income for 2006 currently exceeds our estimated dividend distributions to shareholders from such taxable income in 2006, and such estimated excess taxable income will be distributed in 2007. Therefore, we will be required to pay a 4% excise tax on the excess of 98% of our taxable income over the amount of actual distributions from such taxable income. Accordingly, we have accrued an estimated excise tax of $8.4 million for the three months ended March 31, 2006, based upon our estimated excess taxable income earned for that period. See Financial Condition, Liquidity and Capital Resources.

Realized Gains and Losses. Net realized gains primarily result from the sale of equity securities associated with certain private finance investments, the sale of CMBS bonds and CDO bonds and preferred shares, and the realization of unamortized discount resulting from the sale and early repayment of private finance loans and commercial mortgage loans, offset by losses on investments. Net realized gains for the three months ended March 31, 2006 and 2005, were as follows:

	For the Three Months Ended March 31,	
($ in millions)	2006	2005
Realized gains	$436.5	$14.7
Realized losses	(3.7)	(4.4)
Net realized gains	$432.8	$10.3

When we exit an investment and realize a gain or loss, we make an accounting entry to reverse any unrealized appreciation or depreciation, respectively, we had previously recorded to reflect the appreciated or depreciated value of the investment. For the three months ended March 31, 2006 and 2005, we reversed previously recorded unrealized appreciation or depreciation when gains or losses were realized as follows:

($ in millions)	For the Three Months Ended March 31, 2006	2005
Reversal of previously recorded unrealized appreciation associated with realized gains	$(393.6)	$(9.9)
Reversal of previously recorded unrealized depreciation associated with realized losses	2.7	4.8
Total reversal	$(390.9)	$(5.1)

Realized gains for the three months ended March 31, 2006 and 2005, were as follows:
($ in millions)

2006

Portfolio Company	Amount
Private Finance:	
Advantage Sales & Marketing, Inc.	$433.1
Nobel Learning Communities, Inc.	1.5
The Debt Exchange Inc.	1.1
Other	0.2
Total private finance	435.9
Commercial Real Estate:	
Other	0.6
Total commercial real estate	0.6
Total gross realized gains	$436.5

2005

Portfolio Company	Amount
Private Finance:	
Polaris Pool Systems, Inc.	$ 7.4
U.S. Security Holdings, Inc.	3.3
Oriental Trading Company, Inc.	1.0

Woodstream Corporation	0.9
DCS Business Services, Inc.	0.7
Other	0.9
Total private finance	14.2
Commercial Real Estate:	
Other	0.5
Total commercial real estate	0.5
Total gross realized gains	$14.7

Realized losses for the three months ended March 31, 2006 and 2005, were as follows:
($ in millions)

2006

Portfolio Company	Amount
Private Finance:	
Aspen Pet Products, Inc.	$1.5
Nobel Learning Communities, Inc.	1.4
Other	0.5
Total private finance	3.4
Commercial Real Estate:	
Other	0.3
Total commercial real estate	0.3
Total gross realized losses	$3.7

2005

Portfolio Company	Amount
Private Finance:	
Alderwoods Group, Inc.	$0.8
Other	0.3
Total private finance	1.1
Commercial Real Estate:	
Other	3.3
Total commercial real estate	3.3

Total gross realized losses	$4.4

Change in Unrealized Appreciation or Depreciation. We determine the value of each investment in our portfolio on a quarterly basis, and changes in value result in unrealized appreciation or depreciation being recognized in our statement of operations. Value, as defined in Section 2(a)(41) of the Investment Company Act of 1940, is (i) the market price for those securities for which a market quotation is readily available and (ii) for all other securities and assets, fair value is as determined in good faith by the Board of

Directors. Since there is typically no readily available market value for the investments in our portfolio, we value substantially all of our portfolio investments at fair value as determined in good faith by the Board of Directors pursuant to our valuation policy and a consistently applied valuation process. At March 31, 2006, and December 31, 2005, portfolio investments recorded at fair value were approximately 90% of our total assets. Because of the inherent uncertainty of determining the fair value of investments that do not have a readily available market value, the fair value of our investments determined in good faith by the Board of Directors may differ significantly from the values that would have been used had a ready market existed for the investments, and the differences could be material.

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

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

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

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

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

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

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

We will continue to work with third-party consultants to obtain assistance in determining fair value for a portion of the private finance portfolio each quarter. We work with these consultants to obtain assistance as additional support in the preparation of our internal valuation analysis for a portion of the portfolio each quarter. In addition, we may receive third-party assessments of a particular private finance portfolio company s value in the ordinary course of business, most often in the context of a prospective sale transaction or in the context of a bankruptcy process. The valuation analysis prepared by management using these third-party valuation resources, when applicable, is submitted to our Board of Directors for its determination of fair value of the portfolio in good faith.

For the three months ended March 31, 2006 and 2005, we received third-party valuation assistance from Duff & Phelps, LLC (Duff & Phelps) and Houlihan Lokey Howard and Zukin (Houlihan Lokey) for our private finance portfolio as follows:

	2006	2005
Number of private finance portfolio companies reviewed:		
Duff & Phelps[(1)]	76	35
Houlihan Lokey	2	1
Total number of private finance portfolio companies reviewed	78	36
Percentage of private finance portfolio reviewed at value:		
Duff & Phelps[(1)]	82.2%	59.6%
Houlihan Lokey	4.8%	14.9%
Percentage of private finance portfolio reviewed at value	87.0%	74.5%

(1) During the third quarter of 2005, S&P Corporate Value Consulting merged with Duff & Phelps, LLC, a financial advisory and investment banking firm. The merged company operates under the name of Duff & Phelps, LLC.

Professional fees for third-party valuation assistance were $1.4 million for the year ended December 31, 2005, and are estimated to be approximately $1.5 million for 2006.

Valuation Methodology CMBS Bonds and CDO and CLO Bonds and Preferred Shares/Income Notes (CMBS/CDO/CLO Assets). CMBS/CDO/CLO Assets are carried at fair value, which is based on a discounted cash flow model that utilizes prepayment and loss assumptions based on historical experience and projected performance, economic factors, the characteristics of the underlying cash flow and comparable yields for similar bonds and preferred shares/income notes, when available. We recognize unrealized appreciation or depreciation on our CMBS/CDO/CLO Assets as comparable yields in the market change and/ or based on changes in estimated cash flows resulting from changes in prepayment or loss assumptions in the underlying collateral pool. As each bond ages, the expected amount of losses and the expected timing of recognition of such losses in the underlying collateral pool is updated and the revised cash flows are used in determining the fair value of the bonds. We determine the fair value of our CMBS/CDO/CLO Assets on an individual security-by-security basis. When we sold a group of these real estate related assets in a pool in one or more transactions, the total value received for that pool was generally different than the sum of the fair values of the individual bonds or preferred shares/income notes.

Net Change in Unrealized Appreciation or Depreciation. Net change in unrealized appreciation or depreciation for the three months ended March 31, 2006 and 2005, consisted of the following:

($ in millions)	2006[(1)]	2005[(1)]
Net unrealized appreciation or depreciation	$ 16.4	$75.7
Reversal of previously recorded unrealized appreciation associated with realized gains	(393.6)	(9.9)
Reversal of previously recorded unrealized depreciation associated with realized losses	2.7	4.8
Net change in unrealized appreciation or depreciation	$(374.5)	$70.6

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

At March 31, 2006, our largest investment was in BLX. The following is a summary of the methodology that we used to determine the fair value of this investment.

Business Loan Express, LLC. To determine the value of our investment in BLX at March 31, 2006, we performed four separate valuation analyses to determine a range of values: (1) analysis of comparable public company trading multiples, (2) analysis of BLX s value assuming an initial public offering, (3) analysis of merger and acquisition transactions for financial services companies, and (4)&nbs