ALLIED CAPITAL CORP
Form 497
August 01, 2003

Prospectus Supplement
(To Prospectus dated June 11, 2003)

Filed Pursuant to Rule 497
Registration Statement No. 333-104149

3,000,000 Shares

Common Stock

We are offering for sale 3,000,000 shares of our common stock. Our common stock is traded on the New York Stock Exchange under the symbol ALD. The last reported sales price for our common stock on July 31, 2003 was $23.55 per share.

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

	Per Share	Total
Public offering price	$23.66	$70,980,000
Underwriting discount	$ 0.95	$ 2,850,000
Proceeds to Allied Capital Corporation(1)	$22.71	$68,130,000

(1) Before deducting expenses payable by us estimated to be $50,000.

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

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 shares of common stock will be ready for delivery on or about August 1, 2003.

JEFFERIES & COMPANY, INC.

The date of this prospectus supplement is July 31, 2003.

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

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Prospectus Supplement

Prospectus

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

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

(ii)

FEES AND EXPENSES

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

Shareholders Transaction Expenses	
Sales load (as a percentage of offering price)(1)	4.0%
Dividend reinvestment plan fees(2)	None
Annual Expenses (as a percentage of consolidated net assets attributable to common shares)(3)	
Operating expenses(4)	3.6%
Interest payments on borrowed funds(5)	4.8%
Total annual expenses(6)	8.4%

(1) Represents the underwriting discounts and commissions with respect to the shares sold by Allied Capital in this offering.

(2) The expenses of our dividend reinvestment plan are included in Operating expenses. We do not have a stock purchase plan. The participants in the dividend reinvestment plan will bear a pro rata share of brokerage commissions incurred with respect to open market purchases, if any. See Dividend Reinvestment Plan in the accompanying prospectus.

(3) Consolidated net assets attributable to common stock equals net assets (*i.e.*, total consolidated assets less total consolidated liabilities and preferred stock) at June 30, 2003.

(4) Operating expenses represent our estimated operating expenses for the year ending December 31, 2003 excluding interest on indebtedness. This percentage for the year ended December 31, 2002 was 3.5%.

(5) The Interest payments on borrowed funds represents our estimated interest expenses for the year ending December 31, 2003. We had outstanding borrowings of $979.7 million at June 30, 2003. This percentage for the year ended December 31, 2002 was 4.6%. See Risk Factors in the accompanying prospectus.

(6) Total annual expenses as a percentage of consolidated net assets attributable to common stock are higher than the total annual expenses percentage would be for a company that is not leveraged. We borrow money to leverage our net assets and increase our total assets. The SEC requires that the Total annual expenses percentage be calculated as a percentage of net assets, rather than the total assets, including assets that have been funded with borrowed monies. If the Total annual expenses percentage were calculated instead as a percentage of consolidated total assets, our Total annual expenses would be 4.9% of consolidated total assets.

Example

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

	1 Year	3 Years	5 Years	10 Years
You would pay the following expenses on a $1,000 investment, assuming a 5.0% annual return	$122	$288	$453	$867

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

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

USE OF PROCEEDS

The net proceeds from the sale of the shares of our common stock, after deducting estimated expenses of this offering, are estimated to be $68.1 million. We intend to use the net proceeds from selling our common stock for investment in the debt or equity securities of private companies, non-investment grade commercial mortgage-backed securities or collateralized debt obligation bonds and preferred shares and other general corporate purposes. We may also repay a portion of our revolving line of credit. At July 30, 2003, the interest rate on our revolving line of credit was 2.43% and there was approximately $22.8 million outstanding. This revolving line of credit terminates in April 2005 and may be extended under substantially similar terms for one additional year at our option.

UNDERWRITING

Subject to the terms and conditions stated in the underwriting agreement with Jefferies & Company, Inc., the underwriter has agreed to purchase, and we have agreed to sell to the underwriter, all 3,000,000 of the shares offered by this prospectus supplement.

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

The underwriter proposes to offer the shares to the public initially at the public offering price set forth on the cover of this prospectus supplement. The public offering price is equal to the volume weighted average price per share of our common stock on the New York Stock Exchange for each of the 26 trading days beginning on June 25, 2003 and ending on July 31, 2003. After the offering, the public offering price may be changed by the underwriter.

The following table shows the per share and total underwriting discounts and commissions to be paid to the underwriter by us.

Per share	$ 0.95
Total	$2,850,000

We estimate that the total expenses of this offering, excluding the underwriting discounts and commissions, will be approximately $50,000, which will be paid by us.

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

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

We have been advised by the underwriter that, in accordance with Regulation M under the Securities Act, some persons participating in this offering may engage in transactions, including syndicate covering transactions or stabilizing bids, that may have the effect of stabilizing or maintaining the market price of the shares at a level above that which might otherwise prevail in the open market.

A syndicate covering transaction is a bid for or the purchase of shares on behalf of the underwriter to reduce a syndicate short position incurred by the underwriter in connection with this offering. The underwriter may create a syndicate short position by making short sales of our shares and must then purchase our shares in the open market to cover the syndicate short positions created by these short sales. Short sales involve the sale by the underwriter of a greater number of shares than it is required to purchase in this offering. A short position is more likely to be created if the underwriter is concerned that there may be downward pressure in the price of the shares in the open market after pricing that could adversely affect investors who purchase in this offering.

A stabilizing bid is a bid for or the purchase of shares on behalf of the underwriter for the purpose of fixing or maintaining the price of our shares.

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

The underwriter expects to deliver the shares through the facilities of The Depository Trust Company in New York, New York, on or about August 1, 2003. At that time, the underwriter will pay us for the shares in immediately available funds.

This offering is being conducted in compliance with Rule 2810 of the Conduct Rules of the National Association of Securities Dealers, Inc.

The address for Jefferies & Company, Inc. is 520 Madison Avenue, 12th Floor, New York, NY 10022.

LEGAL MATTERS

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

INTERIM MANAGEMENT S DISCUSSION AND ANALYSIS

OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following analysis of our financial condition and results of operations should be read in conjunction with our Consolidated Financial Statements and the Notes thereto included herein and in the accompanying prospectus. The information herein 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 below in the Risk Factors section. Other factors that could cause actual results to differ materially include:

the ongoing global economic downturn;

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

future regulatory actions and conditions in our operating areas.

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

OVERVIEW

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

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

	2003	2002
Private Finance	72%	70%
Commercial Real Estate Finance	28%	30%

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

PORTFOLIO AND INVESTMENT ACTIVITY

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

($ in millions)	At and for the Three Months Ended June 30,		At and for the Six Months Ended June 30,		At and for the Year Ended December 31,
	2003	2002	2003	2002	2002
	(unaudited)		(unaudited)		
Portfolio at value	$2,546.1	$2,381.0	$2,546.1	$2,381.0	$2,488.2
Investments funded	$ 257.4	$ 115.5	$ 526.4	$ 195.5	$ 506.4
Change in accrued or reinvested interest and dividends	$ 9.3	$ 6.2	$ 20.4	$ 19.5	$ 44.7
Principal repayments	$ 74.3	$ 36.0	$ 150.3	$ 67.0	$ 143.2
Sales	$ 32.6	$ 1.2	$ 276.7	$ 126.3	$ 213.5
Yield(1)	14.1%	13.8%	14.1%	13.8%	14.0%

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

Private Finance

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

($ in millions)	At and for the Three Months Ended June 30,		At and for the Six Months Ended June 30,		At and for the Year Ended December 31,
	2003	2002	2003	2002	2002
	(unaudited)		(unaudited)		
Portfolio at value:					
Loans and debt securities	$1,192.4	$1,050.8	$1,192.4	$1,050.8	$1,151.2
Equity interests	646.8	584.5	646.8	584.5	592.0
Total portfolio	$1,839.2	$1,635.3	$1,839.2	$1,635.3	$1,743.2
Investments funded	$ 163.8	$ 32.2	$ 273.9	$ 69.8	$ 297.2
Change in accrued or reinvested interest and dividends	$ 8.1	$ 7.0	$ 19.4	$ 19.1	$ 42.6
Principal repayments	$ 70.9	$ 27.2	$ 146.0	$ 56.0	$ 129.3
Yield(1)	14.4%	13.9%	14.4%	13.9%	14.4%

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

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

($ in millions)	Loans and Debt Securities	Equity Interests	Total
For the Six Months Ended June 30, 2003[(1)]			
Companies more than 25% owned	$ 42.2	$25.2	$ 67.4
Companies 5% to 25% owned	9.5	1.0	10.5
Companies less than 5% owned	190.6	5.4	196.0
Total	$242.3	$31.6	$273.9
For the Six Months Ended June 30, 2002[(1)]			
Companies more than 25% owned	$ 16.0	$ 3.8	$ 19.8
Companies 5% to 25% owned	7.5	7.0	14.5
Companies less than 5% owned	34.0	1.5	35.5
Total	$ 57.5	$12.3	$ 69.8
For the Year Ended December 31, 2002[(1)]			
Companies more than 25% owned	$ 86.1	$18.7	$104.8
Companies 5% to 25% owned	22.3	0.4	22.7
Companies less than 5% owned	154.6	15.1	169.7
Total	$263.0	$34.2	$297.2

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

At June 30, 2003, we had outstanding funding commitments of $103.9 million to portfolio companies, including $27.4 million committed to private venture capital funds. At June 30, 2003, we also had total commitments to portfolio companies in the form of standby letters of credit and guarantees of $96.0 million.

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

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

Control investments provide the opportunity to invest meaningful amounts of capital with the potential for attractive current income returns as well as the potential for future capital gains. Control transactions are typically larger than our mezzanine investments. In some cases for companies that are more than 50% owned, we may not accrue interest on loans and debt securities if such company is in need of additional working capital. In such cases, we may defer current debt service. Our most significant investments acquired through control buyout transactions at June 30, 2003, were Business Loan Express, LLC (BLX), acquired in 2000, and The Hillman Companies, Inc., acquired in 2001.

Business Loan Express, LLC. At June 30, 2003, our investment in BLX totaled $264.7 million at cost and $356.8 million at value, or 12.6% of our total assets, which includes unrealized appreciation of $92.1 million.

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

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

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

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

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

Summary financial data for BLX at and for the twelve months ended June 30, 2003 and 2002, is presented below.

($ in millions)	For the Twelve Months Ended June 30, 2003[(1)]	For the Twelve Months Ended June 30, 2002
Operating Data		
Total revenue	$ 109.1	$ 84.6
Net income[(4)]	$ 7.5	$ 2.3
Earnings before interest, taxes and management fees (EBITM)[(4)]	$ 44.4	$ 43.0
Balance Sheet Data		
Total assets[(2)]	$ 340.0	$ 277.1
Total debt	$ 166.0	$ 183.0
Total owners equity	$ 137.0	$ 59.9
Other Data		
Total loan originations	$ 718.1	$ 565.1
Serviced loan portfolio	$2,165.5	$1,372.6
Number of loans	3,048	2,083
Loan delinquencies[(3)]	8.1%	9.4%
Serviced Loan Portfolio by Industry		
Hotels	24%	27%
Gas stations/convenience stores	18	16
Professional and retail services	12	10
Restaurants	9	10
Manufacturing and industrial	9	10
Car wash/auto repair services	7	3
Child care and health care services	6	4
Shrimp/fishing vessels	5	7
Recreation	5	5
Other	5	8
Total	100%	100%

(1) Post reorganization BLX s fiscal year end changed to September 30. The results of operations and loan originations for the twelve months ended June 30, 2003, are not necessarily indicative of the operating results to be expected for the fiscal twelve months ending September 30, 2003.

(2) Included in total assets is $6 million of goodwill at June 30, 2003 and 2002. There is no other goodwill on BLX s balance sheet. We acquired 94.9% of BLC Financial Services, Inc. on December 31, 2000. Push-down accounting was not required with respect to this transaction; accordingly, goodwill was not recorded by BLX.

(3) Represents the percentage of loans in the total serviced loan portfolio that are greater than 30 days delinquent, which includes loans in workout status. Loans greater than 30 days delinquent for the SBA 7(a) loan portfolio only, which are included in the total serviced loan portfolio, were 8.2% at June 30, 2003. SBA 7(a) loans greater than one year old at June 30, 2003, had a delinquency rate of 10.5%. BLX will from time to time grant a 90-day deferment to borrowers experiencing short-term cash flow shortfalls. Loans that have been granted a deferment that perform as required are not considered delinquent consistent with SBA practice.

The ability of small businesses to repay their loans may be adversely affected by numerous factors, including a downturn in their industry or negative economic conditions. Small businesses are also more vulnerable to customer preferences, competition, rising fuel prices and market conditions and, as a result, delinquencies in BLX s portfolio may increase. For instance, the shrimp and fishing industry has been affected by rising fuel costs and competition from imported shrimp. For these reasons, BLX focuses on collateral protection for each loan in addition to the cash flow of the small business and receives personal guarantees from the principal owners of the small business.

(4) As an LLC, BLX is generally not subject to a corporate income tax.

For the twelve months ended June 30, 2003, BLX earned revenue of $109.1 million and EBITM of $44.4 million. EBITM was reduced by $2.3 million due to costs associated

with the AIF acquisition and the LLC reorganization, as well as by $1.3 million because of the increased value of issued and outstanding equity appreciation rights to employees. Adding back these acquisition and reorganization costs, and expenses due to equity appreciation rights, BLX s EBITM increased by 11.6% on a comparative twelve month basis. BLX s revenues consist of cash premiums from guaranteed loan sales, gain on sale income arising from loans sold at par or securitized where BLX will receive future cash flows representing the spread between loan interest and the interest paid on bonds issued including service fee income, interest income on loans remaining in BLX s portfolio, and other income. Gain on sale income is a non-cash source of income when recognized, and as future cash flows are received, the resulting cash reduces the receivable or residual interest that is recognized when the loan is sold. The total of cash loan sale premiums, cash interest income and cash received from residual interests and other cash income is equal to approximately 77% of BLX s revenue of $109.1 million during the twelve months ended June 30, 2003.

BLX s business is to originate small business loans and then sell substantially all of the loans originated for cash proceeds. Loans originated during the twelve months ended June 30, 2003, totaled $718.1 million, including loans purchased from AIF. Proceeds from loan sales during the twelve months ended June 30, 2003, totaled approximately $699.4 million. BLX funds the construction of commercial real estate projects, and as a result is unable to sell a construction loan until the loan is fully-funded and the construction is complete. In addition, BLX typically does not immediately receive the proceeds from the sale of its SBA 7(a) guaranteed and unguaranteed loan strips sold, but receives the cash upon settlement. Therefore until BLX sells construction loans or fully funded loans held for sale, it will finance the origination of the loans through funding on its revolving line of credit, or through financing provided by us.

BLX has a three-year $164.0 million revolving credit facility that matures in March 2004. As the controlling equity owner in BLX, we have provided an unconditional guaranty to the revolving credit facility lenders in an amount of up to 50% of the total obligations (consisting of principal, accrued interest, and other fees) of BLX under the revolving credit facility. The amount guaranteed by us at June 30, 2003, was $53.6 million. This guaranty can be called by the lenders only in the event of a default by BLX. BLX was in compliance with the terms of the revolving credit facility at June 30, 2003. We have provided three standby letters of credit in connection with three term securitization transactions completed by BLX totaling $25.6 million.

BLX sells the guaranteed piece of guaranteed loans for cash premiums of up to 10% of the guaranteed loan amount plus a retained annual servicing fee generally between 1.0% and 2.0% of the guaranteed loan amount. Cash premiums received from guaranteed loan sales during the twelve months ended June 30, 2003, were approximately $30.3 million in total.

Alternatively, BLX may sell the guaranteed pieces of SBA 7(a) guaranteed loans at par and receive cash only for the face amount of the loan sold, and instead of receiving a cash premium, BLX will receive an annual servicing spread on the loans sold of between 4.0% and 4.8%. In addition, BLX will sell the unguaranteed pieces of the SBA 7(a) loans and conventional loans it originates into a conduit facility. The conduit loans are securitized and BLX retains an interest of up to 2.7% of the loan pool. BLX then receives the excess of loan interest payments on the loans sold over the interest cost on the securities issued in the securitization over the life of the loan pool. BLX generally receives between 4.3% and 4.9% annually on the loans sold into the securitization pools. For the twelve months ended June 30, 2003, BLX received cash payments from securitization pools of approximately $43.2 million.

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

At June 30, 2003, BLX s Residual Interest totaled $162 million, representing BLX s estimate of the net present value of future cash flows of scheduled loan payments, after estimated future loan losses and loan prepayments. If scheduled loan payments were to be received as stated in the loan agreements with no future losses or prepayments, BLX would receive future cash flows of $709 million over time, with approximately $52.3 million, $51.7 million, $50.4 million, and $49.0 million (or $203.4 million in the aggregate) scheduled to be received in the next four years ending on June 30, 2004, 2005, 2006, and 2007, respectively.

The Hillman Companies, Inc. At June 30, 2003, our investment in Hillman totaled $93.6 million at cost and $181.8 million at value, or 6.4% of total assets, which includes unrealized appreciation of $88.2 million.

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

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

Commercial Real Estate Finance

The commercial real estate finance portfolio, investment activity, and yields at and for the three and six months ended June 30, 2003 and 2002, and at and for the year ended December 31, 2002, 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, 2002	
	2003		2002		2003		2002			
	(unaudited)				(unaudited)					
($ in millions)	Value	Yield*	Value	Yield*	Value	Yield*	Value	Yield*	Value	Yield*
CMBS bonds	$423.6	13.9%	$560.9	14.6%	$423.6	13.9%	$560.9	14.6%	$555.5	14.2%
CDO bonds and preferred shares	167.4	16.6%	52.5	17.2%	167.4	16.6%	52.5	17.2%	52.8	17.2%
Commercial mortgage loans	105.4	7.8%	62.0	7.9%	105.4	7.8%	62.0	7.9%	63.7	7.5%
Residual interest			69.0	9.3%			69.0	9.3%	69.0	9.4%
Real estate owned	10.5		1.3		10.5		1.3		4.0	
Total portfolio	$706.9		$745.7		$706.9		$745.7		$745.0	
Investments funded	$ 93.6		$ 83.3		$252.5		$125.7		$209.2	
Change in accrued or reinvested interest	$ 1.2		$ (0.8)		$ 1.0		$ 0.4		$ 2.1	
Principal repayments	$ 3.4		$ 8.8		$ 4.3		$ 11.0		$ 13.9	
CMBS, CDO, and commercial real estate loan sales	$ 32.6		$ 1.2		$276.7		$126.3		$213.5	

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

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

($ in millions)	Face Amount	Discount	Amount Funded
For the Six Months Ended June 30, 2003			
CMBS bonds	$250.1	$(115.7)	$134.4
CDO bonds and preferred shares	118.4	(0.3)	118.1
Total	$368.5	$(116.0)	$252.5
For the Six Months Ended June 30, 2002			
CMBS bonds	$181.4	$ (83.8)	$ 97.6
CDO preferred shares	28.0		28.0
Commercial mortgage loans	0.1		0.1
Total	$209.5	$ (83.8)	$125.7

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

CMBS Bonds. During the six months ended June 30, 2003 and 2002, we invested $134.4 million in seven CMBS bond issuances and $97.6 million in three CMBS bond issuances, respectively. During the year ended December 31, 2002, we invested $162.3 million in five CMBS bond issuances.

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

	For the Six Months Ended June 30,				**For the Year Ended December 31, 2002**	
	2003		**2002**			
Loan to Value Ranges ($ in millions)	**Amount**	**Percentage**	**Amount**	**Percentage**	**Amount**	**Percentage**
Less than 60%	$1,971.8	28%	$ 401.9	16%	$ 909.3	20%
60-65%	527.2	8	178.7	7	287.3	6
65-70%	776.5	11	264.1	11	587.9	13
70-75%	1,217.3	18	799.5	32	1,214.5	27
75-80%	2,364.9	34	812.7	33	1,477.5	33
Greater than 80%	25.2	1	12.0	1	47.8	1
Total	$6,882.9	100%	$2,468.9	100%	$4,524.3	100%
Weighted average loan to value	67.1%		70.4%		68.5%	

	For the Six Months Ended June 30,				**For the Year Ended December 31, 2002**	
	2003		**2002**			
Debt Service Coverage Ratio[(1)] Ranges ($ in millions)	**Amount**	**Percentage**	**Amount**	**Percentage**	**Amount**	**Percentage**
Greater than 2.00	$2,042.6	30%	$ 103.3	4%	$ 366.9	8%
1.76-2.00	697.1	10	84.2	3	229.6	5
1.51-1.75	1,264.4	18	240.3	10	477.4	11
1.26-1.50	2,478.3	36	1,631.8	66	2,739.6	60
Less than 1.25	400.5	6	409.3	17	710.8	16
Total	$6,882.9	100%	$2,468.9	100%	$4,524.3	100%
Weighted average debt service coverage ratio	1.75		1.41		1.41	

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

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

($ in millions)	For the Six Months Ended June 30, 2003	For the Six Months Ended June 30, 2002	For the Year Ended December 31, 2002
Cost basis	$253.5	$123.3	$205.9
Sales proceeds	$284.8	$128.8	$225.6
Net realized gains (net of related hedge gains or losses)	$ 24.6	$ 7.1	$ 19.1
Weighted average yield	11.8%	11.2%	11.5%

The non-investment grade and unrated tranches of the CMBS bonds in which we invest are junior in priority for payment of interest and principal to the more senior tranches of the related CMBS bond issuance. Cash flow from the underlying mortgages generally is allocated first to the senior tranches, with the most senior tranches having a priority right to the cash flow. Then, any remaining cash flow is allocated, generally, among the other tranches in order of their relative seniority. To the extent there are defaults and unrecoverable losses on the underlying mortgages resulting in reduced cash flows, our most subordinate tranche will bear this loss first. At June 30, 2003, our CMBS bonds were subordinate to 91% to 99% of the tranches of bonds issued in various CMBS transactions. Given that the non-investment grade CMBS bonds in which we invest are junior in priority for payment of principal and interest, we invest in these CMBS bonds at a discount from the face amount of the bonds. The discount increases with the decrease in the seniority of the CMBS bonds. For the six months ended June 30, 2003 and 2002, and for the year ended December 31, 2002, the average discount for the CMBS bonds in which we invested was 46%.

At June 30, 2003, and December 31, 2002, the unamortized discount related to the CMBS bond portfolio was $580.2 million and $649.5 million, respectively. At June 30, 2003, we have set aside $261.2 million of this unamortized discount to absorb potential future losses, and therefore, the yield on the CMBS bonds of 13.9% assumes that this amount will not be amortized. At June 30, 2003, the CMBS bond portfolio had a fair value of $423.6 million, which included net unrealized appreciation on the CMBS bonds of $16.1 million.

The yield on our CMBS bond portfolio at June 30, 2003, and December 31, 2002, was 13.9% and 14.2%, respectively. The yield on the CMBS bond portfolio at any point in time will vary depending on the concentration of lower yielding BB+, BB, and BB- CMBS bonds held in the portfolio. The BB+, BB and BB- CMBS bonds totaled $147.7 million and $110.9 million and had a yield of 8.0% and 8.8% at June 30, 2003, and December 31, 2002, respectively.

At June 30, 2003, and December 31, 2002, the underlying collateral for our CMBS bonds consisted of approximately 5,100 and 4,500 commercial mortgage loans and real estate properties owned with a total outstanding principal balance of $32.0 billion and $25.0 billion, respectively. At June 30, 2003, and December 31, 2002, 1.2% and 1.0%, respectively, of the loans in the underlying collateral pool for our CMBS bonds were over 30 days delinquent or were classified as real estate owned.

Collateralized Debt Obligation Bonds and Preferred Shares. The yield on our CDO bonds and preferred shares at June 30, 2003, and December 31, 2002, was 16.6% and 17.2%, respectively. The yield on the CDO portfolio at any point in time will vary depending on the amount of lower yielding BBB rated CDO bonds held in the portfolio.

During the six months ended June 30, 2003 and 2002, and the year ended December 31, 2002, we invested in the BBB bonds and preferred shares of one, two, and three collateralized debt obligations, respectively, which are secured by investment grade unsecured debt issued by various real estate investment trusts, or REITs, and investment and non-investment grade CMBS bonds. The investment grade REIT collateral consists of debt with a cut-off balance of $1.2 billion and was issued by 39 REITs. The investment grade CMBS collateral consists of CMBS bonds with a face amount of $496.0 million issued in 41 separate CMBS transactions and the non-investment grade CMBS collateral consists of BB+, BB, BB , B+, and B rated CMBS bonds with a face amount of $873.7 million issued in 42 separate CMBS transactions. Included in the CMBS collateral for the CDOs are $793.7 million of CMBS bonds that are senior in priority of repayment to certain lower rated CMBS bonds held by us, which were issued in 27 separate CMBS transactions.

During the three months ended June 30, 2003, we sold $6.4 million of CDO bonds and preferred shares for a net realized loss of $85 thousand, net of the related hedge loss.

The BBB rated bonds and the preferred shares that we own are junior in priority for payment of principal and interest to the more senior tranches of debt issued by the CDOs. To the extent there are defaults and unrecoverable losses on the underlying collateral resulting in reduced cash flows, the preferred shares will bear this loss first and then the BBB rated bonds would bear any loss after the preferred shares. At June 30, 2003, our BBB bonds and preferred shares in the CDOs were subordinate to 61% to 98% of the more senior tranches of debt issued in various CDO transactions.

Portfolio Asset Quality

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

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

	At June 30, 2003		At December 31, 2002	
Grade	Portfolio at Value	Percentage of Total Portfolio	Portfolio at Value	Percentage of Total Portfolio
($ in millions)				
1	$ 839.0	32.9%	$ 801.0	32.1%
2	1,460.9	57.4	1,400.8	56.3
3	124.8	4.9	166.0	6.7
4	20.2	0.8	23.6	1.0
5	101.2	4.0	96.8	3.9
	$2,546.1	100.0%	$2,488.2	100.0%

Total Grade 4 and 5 assets as a percentage of the total portfolio at value at June 30, 2003, and December 31, 2002, were 4.8% and 4.9%, respectively. Included in Grade 4 and 5 assets at June 30, 2003, and December 31, 2002, were assets totaling $32.3 million and $24.1 million, respectively, that are secured by commercial real estate. Grade 4 and 5 assets include loans, debt securities, and equity securities. We expect that a number of portfolio companies will be in the Grade 4 or 5 categories from time to time. Part of the business of private finance is working with troubled portfolio companies to improve their businesses and protect our investment. The number of portfolio companies and related investment amount included in Grade 4 and 5 may fluctuate from period to period. We continue to follow our historical practice of working with a troubled portfolio company in order to recover the maximum amount of our investment, but record unrealized depreciation for the expected amount of the loss when such exposure is identified.

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

For the total investment portfolio, workout loans and debt securities (which excludes equity securities that are included in the total Grade 4 and 5 assets above) not accruing interest that were classified in Grade 4 and 5 were $75.0 million and $89.1 million at value at June 30, 2003, and December 31, 2002, respectively. Included in this category were loans of $17.0 million and $13.0 million, respectively, that were secured by commercial real estate. In addition to Grade 4 and 5 assets that are in workout, loans and debt securities to companies that are more than 50% owned by us that were not accruing interest totaled $72.2 million and $63.6 million at value at June 30, 2003, and December 31, 2002, respectively, and loans and debt securities to companies that are less than 50% owned by us and were not in workout but were not accruing interest totaled $3.9 million and $7.2 million at value at June 30, 2003, and December 31, 2002, respectively.

Loans and Debt Securities Over 90 Days Delinquent. Loans and debt securities greater than 90 days delinquent were $119.2 million and $103.1 million at value at June 30, 2003, and December 31, 2002, respectively, or 4.7% and 4.1% of the total portfolio. Included in this category were loans valued at $43.5 million and $26.0 million, respectively, that were secured by commercial real estate.

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

Hedging Activities

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

The total obligations to replenish borrowed Treasury securities, including accrued interest payable on the obligations, were $157.0 million and $197.0 million at June 30, 2003, and December 31, 2002, respectively, which included unrealized depreciation on the obligations of $3.9 million and $7.1 million, respectively, due to changes in the yield on the borrowed Treasury securities. The net proceeds related to the sales of the borrowed Treasury securities were $152.2 million and $189.3 million at June 30, 2003, and December 31, 2002, respectively. Under the terms of the transactions, we have provided additional cash collateral of $5.1 million and $5.4 million at June 30, 2003, and December 31, 2002, respectively, for the difference between the net proceeds related to the sales of the borrowed Treasury securities and the obligations to replenish the securities on the weekly settlement date, which is included in deposits of proceeds from sales of borrowed Treasury securities in the accompanying financial statements. The amount of the hedge will vary from period to period depending upon the amount of BB+ through B rated CMBS bonds and BBB rated CDO bonds that we own and have hedged on the balance sheet date.

RESULTS OF OPERATIONS

Comparison of Three Months Ended June 30, 2003 and 2002

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

($ in thousands, except per share amounts)	For the Three Months Ended June 30, 2003	2002	Change	Percentage Change
	(unaudited)			
Interest and Related Portfolio Income				
Interest and dividends	$ 67,137	$ 62,692	$ 4,445	7%
Premiums from loan dispositions	1,637	46	1,591	**
Fees and other income	8,440	10,455	(2,015)	(19)%
Total interest and related portfolio income	77,214	73,193	4,021	5%
Expenses				
Interest	19,358	17,515	1,843	11%
Employee	9,258	8,274	984	12%
Administrative	5,081	4,843	238	5%
Total operating expenses	33,697	30,632	3,065	10%
Net investment income before income taxes	43,517	42,561	956	2%
Income tax benefit	(1,081)		(1,081)	**
Net investment income	44,598	42,561	2,037	5%
Net Realized and Unrealized Gains (Losses)				
Net realized gains (losses)	8,540	(755)	9,295	*
Net change in unrealized appreciation or depreciation	6,802	31,648	(24,846)	*
Total net gains (losses)	15,342	30,893	(15,551)	*
Net income	$ 59,940	$ 73,454	$(13,514)	(18)%
Diluted earnings per common share	$ 0.52	$ 0.71	$ (0.19)	(27)%
Weighted average common shares outstanding diluted	114,552	103,440	11,112	11%

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

** Percentage change is not meaningful.

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

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

The level of interest income is directly related to the balance of the interest-bearing investment portfolio multiplied by the weighted average yield. The weighted average yield varies from period to period based on the current stated interest rate earned on interest-bearing investments and the amount of loans and debt securities for which interest is not accruing. Our interest-bearing investments in the portfolio increased by 5.7% to $1,899.3 million at June 30, 2003, from $1,796.5 million at June 30, 2002. The weighted average yield on the interest-bearing investments in the portfolio at June 30, 2003 and 2002, was as follows:

($ in millions)	2003	2002
Interest-bearing portfolio	$1,899.3	$1,796.5
Portfolio yield	14.1%	13.8%

Included in premiums from loan dispositions are prepayment premiums of $1.6 million and $46 thousand for the three months ended June 30, 2003 and 2002, respectively. While the scheduled maturities of private finance and commercial real estate loans range from five to ten years, it is not unusual for our borrowers to refinance or pay off their debts to us ahead of schedule. Because we seek to finance primarily seasoned, performing companies, such companies at times can secure lower cost financing as their balance sheets strengthen, or as more favorable interest rates become available, or a company may enter into a transaction that results in the early repayment of their debt to us. Therefore, we generally structure our loans to require a prepayment premium for the first three to five years of the loan.

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

Fees and other income for the quarters ended June 30, 2003 and 2002, primarily included fees of $3.1 million and $2.6 million, respectively, related to structuring and diligence; fees of $0.8 million and $1.8 million, respectively, related to transaction and other services provided to portfolio companies; and fees of $4.3 million and $6.0 million, respectively, related to management services provided to portfolio companies, other advisory services, and guaranty fees. Fees and other income are generally related to specific transactions or services, and therefore may vary substantially from period to period depending on the level and types of services provided. Points or loan origination fees that represent yield enhancement on a loan are capitalized and amortized into interest income over the life of the loan.

Business Loan Express and Hillman are our most significant portfolio investments and together represented 19.0% of our total assets at June 30, 2003. Total interest and related portfolio income earned from these investments for the three months ended June 30, 2003 and 2002, were $12.1 million and $12.2 million, respectively. In July 2002, we sold WyoTech Acquisition Corporation, which was a significant portfolio investment during 2002. Total interest and related portfolio income earned on this investment for the three months ended June 30, 2002, was $1.8 million.

Operating Expenses. Operating expenses include interest, employee, and administrative expenses. Our single largest expense is interest on our indebtedness. The fluctuations in interest expense during the three months ended June 30, 2003 and 2002, were attributable to changes in the level of our borrowings under various notes payable and debentures and our revolving line of credit. Our borrowing activity and weighted average interest cost, including fees and closing costs, were as follows:

($ in millions)	At and for the Three Months Ended June 30, 2003	2002
Total Outstanding Debt	$ 979.7	$ 1,009.0
Average Outstanding Debt	$ 962.3	$ 942.3
Weighted Average Cost	7.4%	7.2%
BDC Asset Coverage*	286%	256%

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

Employee expenses include salaries and employee benefits. The change in employee expenses reflects the effect of wage increases, increased staffing, and the change in mix of employees given their area of responsibility and relevant experience level. Total employees were 116 and 103 at June 30, 2003 and 2002, respectively. We no longer provide loans to our employees to exercise stock options because of recent legislation. This was an important benefit to our employees and as a result, we are considering compensation alternatives and expect to have a new program in place by the end of 2003.

Administrative expenses include the leases for our headquarters in Washington, DC, and our regional offices, travel costs, stock record expenses, directors fees, legal and accounting fees, insurance premiums, and various other expenses.

Income Tax Benefit. The Company s wholly owned subsidiary, AC Corp, is a corporation subject to federal and state income taxes and records a benefit or expense for income taxes as appropriate. For the three months ended June 30, 2003, we recorded a tax benefit of $1.1 million as a result of AC Corp s operating loss for the period.

Realized Gains and Losses. Net realized gains result from the sale of equity securities associated with certain private finance investments, the sale of CMBS bonds, and the realization of unamortized discount resulting from the sale and early repayment of private finance loans and commercial mortgage loans, offset by losses on investments. Net realized gains and losses for the three months ended June 30, 2003 and 2002, were as follows:

($ in millions)	For the Three Months Ended June 30, 2003	2002
Realized gains	$ 12.7	$ 2.5
Realized losses	(4.2)	(3.3)
Net realized gains (losses)	$ 8.5	$ (0.8)

Realized gains and losses for the three months ended June 30, 2003, resulted from various private finance and commercial real estate finance transactions. Realized gains for the three months ended June 30, 2003, primarily resulted from transactions involving three private finance portfolio companies, including Woodstream Corporation ($6.6 million), Kirkland s Inc. ($1.8 million), and Interline Brands, Inc. ($1.7 million). For the three months ended June 30, 2003 and 2002, we reversed previously recorded unrealized appreciation totaling $7.9 million and $2.1 million, respectively, when gains were realized. When we exit an investment and realize a gain, we make an accounting entry to reverse any unrealized appreciation we had previously recorded to reflect the appreciated value of the investment.

Realized losses for the three months ended June 30, 2003, primarily resulted from one transaction involving North American Archery, LLC ($2.1 million), and two transactions involving commercial mortgage loans ($2.0 million). For the three months ended June 30, 2003 and 2002, we reversed previously recorded unrealized depreciation totaling $4.7 million and $2.0 million, respectively, when losses were realized. When we exit an investment and realize a loss, we make an accounting entry to reverse any unrealized depreciation we had previously recorded to reflect the depreciated value of the investment.

Change in Unrealized Appreciation or Depreciation. We determine the value of each investment in our portfolio on a quarterly basis, and changes in value result in unrealized appreciation or depreciation being recognized. At June 30, 2003, approximately 89% of our total assets represented portfolio investments recorded at fair value. Value, as defined in Section 2(a)(41) of the Investment Company Act of 1940, is (i) the market price for those securities for which a market quotation is readily available and (ii) for all other securities and assets, fair value is as determined in good faith by the board of directors. Since there is typically no readily available market value for the investments in our portfolio, we value substantially all of our portfolio investments at fair value as determined in good faith by the board of directors pursuant to a valuation policy and a consistently applied valuation process. 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 company does not currently support the cost of our debt or equity investment. Enterprise value means the entire value of the company to a potential buyer, including the sum of the values of debt and equity securities used to capitalize the enterprise at a point in time. We will record unrealized appreciation if we believe that the underlying portfolio company has appreciated in value and, therefore, our equity security has also appreciated in value. Changes in fair value are recorded in the statement of operations as net change in unrealized appreciation or depreciation.

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

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

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

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

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

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

For the portfolio, net change in unrealized appreciation or depreciation for the three months ended June 30, 2003 and 2002, consisted of the following:

($ in millions)	**2003**[(1)]	**2002**[(1)]
Net unrealized appreciation or depreciation	$10.0	$31.7
Reversal of previously recorded unrealized appreciation associated with realized gains	(7.9)	(2.1)
Reversal of previously recorded unrealized depreciation associated with realized losses	4.7	2.0
Net change in unrealized appreciation or depreciation	$6.8	$31.6

(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.

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

Business Loan Express, LLC. The most significant change in the value of our portfolio this quarter was in our investment in BLX, which increased in value by $50.5 million. BLX continues to make solid progress in its business. EBITM increased by 11.6% for the twelve months ended June 30, 2003, as compared to the twelve months ended June 30, 2002, adjusted for certain non-recurring expenses and the expense of equity appreciation rights. In addition, BLX has significantly strengthened its loan origination platform by increasing its preferred lender designation to 74 out of 79 SBA markets and as a result of the AIF acquisition.

To determine the value of our investment in BLX at June 30, 2003, we performed four separate valuation analyses to determine its enterprise value: (1) analysis of comparable public company trading multiples, (2) analysis of BLX s value assuming an initial public offering, (3) analysis of merger and acquisition transactions for financial services companies, and (4) a discounted dividend analysis. In arriving at the value of our investment, we estimated that the total enterprise value of BLX increased from $407 million at March 31, 2003, to $465 million at June 30, 2003. This results in a total value of the Class B and Class C equity interests of $262.7 million at June 30, 2003, as compared to a total value for the Class B and Class C equity interests of $207.2 million at March 31, 2003, or an increase of 27%.

The 27% increase in the value of the Class B and Class C equity interests is a result of BLX s continued progress as well as the fact that there has been an overall increase in the market valuations for financial services companies during the quarter. We benchmarked the valuation of BLX against a public comparable group consisting of six public financial services companies, and during this quarter the median trailing price to earnings ratio for this comparable group increased by 29% and the median forward price to earnings ratio for this comparable group increased by 52%. The increases in the comparable group market valuations indicate that the fair value of BLX has increased by current market standards.

At a value of $262.7 million for the Class B and Class C equity interests, we are valuing BLX at a trailing price to pro-forma earnings ratio of approximately 10.5 times and on a forward projected price to pro-forma earnings ratio of approximately 9.4 times. The fair value of BLX s Class B and Class C equity interests is at a multiple of investor cost basis of 1.6 times.

The Hillman Companies, Inc. In performing our valuation analysis of Hillman at June 30, 2003, we determined normalized 2003 EBITDAM to be approximately $61.5 million. We believe the current enterprise value for Hillman is approximately $430.5 million, or 7.0 times 2003 normalized EBITDAM of $61.5 million. The multiple was determined by obtaining a range of multiples representing the multiple of enterprise value to EBITDA for comparable public companies and the multiple of enterprise value to EBITDA for acquisition transactions involving companies in Hillman s peer group. From this market comparable analysis, we selected a 7.0 times multiple for our valuation. Using an enterprise value of $430.5 million, the value of our equity investment in Hillman is approximately $138.8 million, or $88.2 million greater than our cost basis of $50.6 million at June 30, 2003.

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 common share, which were 114.6 million and 103.4 million for the three months ended June 30, 2003 and 2002, 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 capital gains, to the extent that such taxable income or gains are distributed, or deemed to be distributed, to shareholders on a timely basis. Annual tax distributions generally differ from net income for the fiscal year due to temporary and permanent timing differences in the recognition of income and expenses, returns of capital and net unrealized appreciation or depreciation, which are not included in taxable income.

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

RESULTS OF OPERATIONS

Comparison of Six Months Ended June 30, 2003 and 2002

The following table summarizes our condensed operating results for the six months ended June 30, 2003 and 2002.

($ in thousands, except per share amounts)	For the Six Months Ended June 30, 2003	2002	Change	Percentage Change
	(unaudited)			
Interest and Related Portfolio Income				
Interest and dividends	$132,658	$127,665	$ 4,993	4%
Premiums from loan dispositions	2,758	1,659	1,099	66%
Fees and other income	14,928	26,260	(11,332)	(43)%
Total interest and related portfolio income	150,344	155,584	(5,240)	(3)%
Expenses				
Interest	37,280	34,984	2,296	7%
Employee	17,379	16,309	1,070	7%
Administrative	9,498	7,861	1,637	21%
Total operating expenses	64,157	59,154	5,003	8%
Net investment income before income taxes	86,187	96,430	(10,243)	(11)%
Income tax benefit	(1,081)		(1,081)	**
Net investment income	87,268	96,430	(9,162)	(10)%
Net Realized and Unrealized Gains (Losses)				
Net realized gains (losses)	56,879	8,850	48,029	*
Net change in unrealized appreciation or depreciation	(64,334)	24,135	(88,469)	*
Total net gains (losses)	(7,455)	32,985	(40,440)	*
Net income	$ 79,813	$129,415	$(49,602)	(38)%
Diluted earnings per common share	$ 0.71	$ 1.26	$ (0.55)	(44)%
Weighted average common shares outstanding diluted	112,291	102,900	9,391	9%

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

** Percentage change is not meaningful.

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

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

The level of interest income is directly related to the balance of the interest-bearing investment portfolio multiplied by the weighted average yield. The weighted average yield varies from period to period based on the current stated interest rate earned on interest-bearing investments and the amount of loans and debt securities for which interest is not accruing. Our interest-bearing investments in the portfolio increased by 5.7% to $1,899.3 million at June 30, 2003, from $1,796.5 million at June 30, 2002. The weighted average yield on the interest-bearing investments in the portfolio at June 30, 2003 and 2002, was as follows:

($ in millions)	2003	2002
Interest-bearing portfolio	$1,899.3	$1,796.5
Portfolio yield	14.1%	13.8%

Included in premiums from loan dispositions are prepayment premiums of $2.8 million and $1.6 million for the six months ended June 30, 2003 and 2002, respectively. While the scheduled maturities of private finance and commercial real estate loans range from five to ten years, it is not unusual for our borrowers to refinance or pay off their debts to us ahead of schedule. Because we seek to finance primarily seasoned, performing companies, such companies at times can secure lower cost financing as their balance sheets strengthen, or as more favorable interest rates become available or a company may enter into a transaction that results in early repayment of their debt to us. Therefore, we generally structure our loans to require a prepayment premium for the first three to five years of the loan.

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

Fees and other income for the six months ended June 30, 2003 and 2002, included fees of $3.4 million and $10.6 million, respectively, related to structuring and diligence, fees of $1.2 million and $3.8 million, respectively, related to transaction and other services provided to portfolio companies, and fees of $9.9 million and $11.7 million, related to management services provided to portfolio companies, other advisory services and guaranty fees. Fees and other income are generally related to specific transactions or services, and therefore may vary substantially from period to period depending on the level and types of services provided. Points or loan origination fees that represent yield enhancement on a loan are capitalized and amortized into interest income over the life of the loan.

Business Loan Express and Hillman are our most significant portfolio investments and together represented 19.0% of our total assets at June 30, 2003. Total interest and related portfolio income earned from these investments for the six months ended June 30, 2003 and 2002, was $27.5 million and $24.5 million, respectively. Total interest and related portfolio income earned from WyoTech for the six months ended June 30, 2002 was $3.6 million, which no longer occurred after the sale of the investment on July 1, 2002.

Operating Expenses. Operating expenses include interest, employee, and administrative expenses. Our single largest expense is interest on our indebtedness. The fluctuations in interest expense during the six months ended June 30, 2003 and 2002, were attributable to changes in the level of our borrowings under various notes payable and debentures and our revolving line of credit. Our borrowing activity and weighted average interest cost, including fees and closing costs, were as follows:

($ in millions)	At and for the Six Months Ended June 30, 2003	2002
Total Outstanding Debt	$ 979.7	$ 1,009.0
Average Outstanding Debt	$ 927.0	$ 940.4
Weighted Average Cost	7.4%	7.2%
BDC Asset Coverage*	286%	256%

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

Employee expenses include salaries and employee benefits. The change in employee expenses reflects the effect of wage increases, increased staffing, and the change in mix of employees given their area of responsibility and relevant experience level. Total employees were 116 and 103 at June 30, 2003 and 2002, respectively. We no longer provide loans to our employees to exercise stock options because of recent legislation. This was an important benefit to our employees and as a result, we are considering compensation alternatives and expect to have a new program in place by the end of 2003.

Administrative expenses include the leases for our headquarters in Washington, DC, and our regional offices, travel costs, stock record expenses, directors fees, legal and accounting fees, insurance premiums, and various other expenses. The increase in administrative expenses as compared to the six months ended June 30, 2002, includes approximately $0.8 million from directors fees, legal and accounting fees, and consulting fees, and $0.8 million due to increased costs for corporate liability insurance.

Income Tax Benefit. The Company s wholly owned subsidiary, AC Corp, is a corporation subject to federal and state income taxes and records a benefit or expense for income taxes as appropriate. For the six months ended June 30, 2003, we recorded a tax benefit of $1.1 million as a result of AC Corp s operating loss for the period.

Realized Gains and Losses. Net realized gains result from the sale of equity securities associated with certain private finance investments, the sale of CMBS bonds, and the realization of unamortized discount resulting from the sale and early repayment of private finance loans and commercial mortgage loans, offset by losses on investments. Net realized gains and losses for the six months ended June 30, 2003 and 2002, were as follows:

($ in millions)	For the Six Months Ended June 30, 2003	2002
Realized gains	$ 61.3	$ 15.4
Realized losses	(4.4)	(6.5)
Net realized gains	$ 56.9	$ 8.9

Realized gains and losses for the six months ended June 30, 2003, resulted from various private finance and commercial real estate finance transactions. Realized gains for the six months ended June 30, 2003, primarily resulted from transactions involving seven private finance portfolio companies, including Morton Grove Pharmaceuticals, Inc.

($8.4 million), CyberRep ($8.3 million), Woodstream Corporation ($6.6 million), Blue Rhino Corporation ($3.9 million), Kirkland s Inc. ($3.0 million), GC-Sun Holdings II, LP ($2.5 million), and Interline Brands, Inc. ($1.7 million). In addition, gains were also realized on CMBS bonds ($24.6 million, net of a realized loss of $6.7 million from hedges related to the CMBS bonds sold). For the six months ended June 30, 2003 and 2002, we reversed previously recorded unrealized appreciation totaling $50.8 million and $7.3 million, respectively, when gains were realized. When we exit an investment and realize a gain, we make an accounting entry to reverse any unrealized appreciation we had previously recorded to reflect the appreciated value of the investment.

Realized losses for the six months ended June 30, 2003, primarily resulted from one transaction involving North American Archery, LLC ($2.1 million), and two transactions involving commercial mortgage loans ($2.0 million). For the six months ended June 30, 2003 and 2002, we reversed previously recorded unrealized depreciation totaling $4.9 million and $5.2 million, respectively, when losses were realized. When we exit an investment and realize a loss, we make an accounting entry to reverse any unrealized depreciation we had previously recorded to reflect the depreciated value of the investment.

Change in Unrealized Appreciation or Depreciation. For a discussion of our fair value methodology and how it affects the net change in unrealized appreciation or depreciation, see Change in Unrealized Appreciation or Depreciation included in the Comparison of Three Months Ended June 30, 2003 and 2002.

For the portfolio, net change in unrealized appreciation or depreciation for the six months ended June 30, 2003 and 2002, consisted of the following:

($ in millions)	2003(1)	2002(1)
Net unrealized appreciation or depreciation	$(18.4)	$26.2
Reversal of previously recorded unrealized appreciation associated with realized gains	(50.8)	(7.3)
Reversal of previously recorded unrealized depreciation associated with realized losses	4.9	5.2
Net change in unrealized appreciation or depreciation	$(64.3)	$24.1

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

Net change in unrealized appreciation or depreciation for the six months ended June 30, 2003 included those discussed under the caption Change in Unrealized Appreciation or Depreciation included in the Comparison of Three Months Ended June 30, 2003 and 2002.

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 common share, which were 112.3 million and 102.9 million for the six months ended June 30, 2003 and 2002, respectively.

FINANCIAL CONDITION, LIQUIDITY AND CAPITAL RESOURCES

Cash and Cash Equivalents

At June 30, 2003, we had $7.5 million in cash and cash equivalents. We invest otherwise uninvested cash in U.S. government- or agency-issued or guaranteed securities that are backed by the full faith and credit of the United States, or in high quality, short-term repurchase agreements fully collateralized by such securities. Our objective is to manage to a low cash balance and fund new originations with our revolving line of credit, and through the issuance of debt and equity securities.

Debt

At June 30, 2003, we had outstanding debt as follows:

($ in millions)	Facility Amount	Amount Outstanding	Annual Interest Cost[1]
Notes payable and debentures:			
Unsecured long-term notes	$ 854.0	$854.0	7.2%
SBA debentures	101.8	94.5	8.1%
OPIC loan	5.7	5.7	6.6%
Total notes payable and debentures	961.5	954.2	7.3%
Revolving line of credit	462.5	25.5	11.7%[2]
Total debt	$1,424.0	$979.7	7.4%

(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.

(2) The current interest rate payable on the revolving line of credit is 2.6%, which excludes the annual cost of commitment fees and other facility fees of $2.3 million.

Unsecured Long-Term Notes. We have issued long-term debt to institutional lenders, primarily insurance companies. The notes have five-or seven-year maturities, with maturity dates beginning in 2004. The notes require payment of interest only semi-annually, and all principal is due upon maturity. On May 14, 2003, we issued $153 million of five-year and $147 million of seven-year unsecured long-term notes, primarily to insurance companies. The five- and seven-year notes have fixed interest rates of 5.45% and 6.05%, respectively, and have substantially the same terms as our existing unsecured long-term notes. On May 30, 2003, $140 million of our existing unsecured long-term notes matured and we used the proceeds from the new long-term note issuance to repay this amount.

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

Revolving Line of Credit. We have a $462.5 million unsecured revolving line of credit that expires in April 2005, with the right to extend maturity for one additional year at our option under substantially similar terms. The revolving line of credit may be expanded through new or additional commitments up to $600 million at our option. As of June 30, 2003, $399.9 million remained unused and available, net of amounts committed for standby letters of credit of $37.1 million issued under the line of credit facility. Net repayments on the revolving line of credit for the six months ended June 30, 2003, were $178.8 million. The credit facility bears interest at a rate equal to (i) the one-month LIBOR plus 1.25%, (ii) the Bank of America, N.A. prime rate, or (iii) the Federal Funds rate plus 0.50% at our option. The line of credit generally requires monthly payments of interest, and all principal is due upon maturity.

We have various financial and operating covenants required by the revolving line of credit and notes payable and debentures. These covenants require us to maintain certain financial ratios, including debt to equity and interest coverage, and a minimum net worth. Our credit facilities limit our ability to declare dividends if we default under certain provisions. As of June 30, 2003, we were in compliance with these covenants.

The following table shows our significant contractual obligations as of June 30, 2003.

		Payments Due By Year					
($ in millions)	Total	2003	2004	2005	2006	2007	After 2007
Notes payable and debentures:							
Unsecured long-term notes	$854.0	$	$214.0	$165.0	$175.0	$	$300.0
Small Business Administration debentures	94.5		7.0	14.0			73.5
Overseas Private Investment Corporation loan	5.7				5.7		
Revolving line of credit(1)	25.5				25.5		
Operating Leases	19.7	1.3	2.7	2.7	2.6	2.5	7.9
Total contractual obligations	$999.4	$1.3	$223.7	$181.7	$208.8	$2.5	$381.4

(1) The revolving line of credit expires in April 2005 and may be extended under substantially similar terms for one additional year at our option. We assume that we would exercise our option to extend the revolving line of credit resulting in an assumed maturity of April 2006. At June 30, 2003, $399.9 million remains unused and available, net of amounts committed for standby letters of credit of $37.1 million issued under the credit facility.

The following table shows our contractual commitments that may have the effect of creating, increasing, or accelerating our liabilities as of June 30, 2003.

		Amount of Commitment Expiration Per Year					
($ in millions)	Total	2003	2004	2005	2006	2007	After 2007
Guarantees	$58.9	$0.4	$54.3	$0.4	$ 0.1	$0.1	$3.6
Standby letters of credit	37.1			4.5	32.6		
Total commitments	$96.0	$0.4	$54.3	$4.9	$32.7	$0.1	$3.6

Equity Capital and Dividends

Because we are a regulated investment company, we distribute our income and require external capital for growth. Because we are a business development company, we are limited in the amount of debt capital we may use to fund our growth, since we are generally required to maintain a minimum ratio of 200% of total assets to total borrowings, or approximately a 1 to 1 debt to equity ratio. At June 30, 2003, our asset coverage for senior indebtedness was 286% and our debt to equity ratio was 0.59 to 1.00.

To support our growth during the six months ended June 30, 2003 and 2002, we raised $145.1 million and $49.9 million, respectively, in new equity capital. In July 2003, we raised an additional $9.7 million in new equity capital. We issue equity from time to time when we have attractive investment opportunities. In addition, we raised $3.3 million and $3.1 million in new equity capital through the issuance of shares through our dividend reinvestment plan during the six months ended June 30, 2003 and 2002, respectively. During the six months ended June 30, 2003, total shareholder s equity had increased 6.8% to $1.7 billion.

Our Board of Directors reviews the dividend rate quarterly, and may adjust the quarterly dividend throughout the year. For the first, second and third quarters of 2003, the Board of Directors declared a dividend of $0.57 per common share. The third quarter dividend is payable on September 26, 2003, with a record date of September 12, 2003. Dividends are paid based on our taxable income, which includes our taxable interest and fee income as well as taxable net realized capital gains. Our Board of Directors evaluates whether to retain or distribute capital gains on an annual basis. Our dividend policy allows us to continue to distribute capital gains, but will also allow us to retain gains to support future growth.

Liquidity and Capital Resources. We plan to maintain a strategy of financing our business and related debt maturities with cash from operations, through borrowings under short- or long-term credit facilities or other debt securities, through asset sales, or through the sale or issuance of new equity capital. The need for private investment capital has increased in 2003 and we have funded new investments totaling $526.4 million for the six months ended June 30, 2003, as compared to $506.4 million for the year ended December 31, 2002. Although there can be no assurance that we will secure new investments, we plan to raise new debt and equity capital as appropriate to fund investment growth.

Dividends to shareholders for the six months ended June 30, 2003 and 2002, were $127.5 million and $109.5 million, respectively. Cash flow from operations before new investments has historically been sufficient to finance our operating expenses and pay dividends to shareholders.

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

At June 30, 2003, our debt to equity ratio was 0.59 to 1.00 and our weighted average cost of funds was 7.4%. Availability on the revolving line of credit, net of amounts committed for standby letters of credit issued under the line of credit facility, was $399.9 million on June 30, 2003. We believe that we have access to capital sufficient to fund our ongoing investment and operating activities.

CRITICAL ACCOUNTING POLICIES

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

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

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

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

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

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

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

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

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

Commercial Mortgage-Backed Securities (CMBS) and Collateralized Debt Obligations (CDO). CMBS bonds and CDO bonds and preferred shares are carried at fair value, which is based on a discounted cash flow model that utilizes prepayment and loss assumptions based on historical experience and projected performance, economic factors, the characteristics of the underlying cash flow, and comparable market yields for similar CMBS bonds and CDO bonds and preferred shares. We recognize income from the amortization of original issue discount using the effective interest method, using the anticipated yield over the projected life of the investment. Yields are revised when there are changes in estimates of future credit losses, actual losses incurred, or actual and estimated prepayment speeds. Changes in estimated yield are recognized as an adjustment to the estimated yield over the remaining life of the CMBS bonds and CDO bonds and preferred shares from the date the estimated yield is changed. We recognize unrealized appreciation or depreciation on our CMBS bonds and CDO bonds and preferred shares as comparable yields in the market change and based on changes in estimated cash flows resulting from changes in prepayment or loss assumptions in the underlying collateral pool.

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

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

RECENT DEVELOPMENTS

During the second quarter of 2003, our board of directors extended the term of all existing employment agreements with certain of our officers from June 30, 2003 to December 31, 2003.

In addition, our board of directors appointed Scott Binder, one of our managing directors, to the newly created position of Chief Valuation Officer.

INTERIM CONSOLIDATED FINANCIAL STATEMENTS

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEET

(in thousands, except share and per share amounts)	June 30, 2003 (unaudited)	December 31, 2002
ASSETS		
Portfolio at value:		
Private finance		
Companies more than 25% owned (cost: 2003-$694,891; 2002-$628,535)	$ 803,794	$ 710,587
Companies 5% to 25% owned (cost: 2003-$202,942; 2002-$219,124)	222,143	255,677
Companies less than 5% owned (cost: 2003-$946,750; 2002-$863,243)	813,307	776,951
Total private finance	1,839,244	1,743,215
Commercial real estate finance (cost: 2003-$702,887; 2002-$718,312)	706,896	744,952
Total portfolio at value	2,546,140	2,488,167
Other assets	118,698	100,221
Deposits of proceeds from sales of borrowed Treasury securities	157,262	194,745
Cash and cash equivalents	7,484	11,186
Total assets	$2,829,584	$2,794,319
LIABILITIES AND SHAREHOLDERS EQUITY		
Liabilities:		
Notes payable and debentures	$ 954,200	$ 794,200
Revolving line of credit	25,500	204,250
Obligations to replenish borrowed Treasury securities	156,986	197,027
Accounts payable and other liabilities	34,755	45,771
Total liabilities	1,171,441	1,241,248
Commitments and contingencies		
Preferred stock	7,000	7,000
Shareholders equity:		
Common stock, $0.0001 par value, 200,000,000 shares authorized; 116,034,030 and 108,698,409 shares issued and outstanding at June 30, 2003, and December 31, 2002, respectively	12	11
Additional paid-in capital	1,698,307	1,547,183
Notes receivable from sale of common stock	(22,985)	(24,704)
Net unrealized appreciation (depreciation) on portfolio	(24,923)	39,411
Undistributed (distributions in excess of) earnings	732	(15,830)

Total shareholders equity	1,651,143	1,546,071
Total liabilities and shareholders equity	$2,829,584	$2,794,319
Net asset value per common share	$ 14.23	$ 14.22

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, 2003	For the Three Months Ended June 30, 2002	For the Six Months Ended June 30, 2003	For the Six Months Ended June 30, 2002
	(unaudited)		(unaudited)	
Interest and Related Portfolio Income:				
Interest and dividends				
Companies more than 25% owned	$ 12,728	$ 9,374	$ 27,931	$ 18,847
Companies 5% to 25% owned	6,480	7,581	12,973	15,021
Companies less than 5% owned	47,929	45,737	91,754	93,797
Total interest and dividends	67,137	62,692	132,658	127,665
Premiums from loan dispositions				
Companies more than 25% owned			108	
Companies 5% to 25% owned	140		625	
Companies less than 5% owned	1,497	46	2,025	1,659
Total premiums from loan dispositions	1,637	46	2,758	1,659
Fees and other income				
Companies more than 25% owned	4,304	6,954	10,013	13,929
Companies 5% to 25% owned	177	415	230	415
Companies less than 5% owned	3,959	3,086	4,685	11,916
Total fees and other income	8,440	10,455	14,928	26,260
Total interest and related portfolio income	77,214	73,193	150,344	155,584
Expenses:				
Interest	19,358	17,515	37,280	34,984
Employee	9,258	8,274	17,379	16,309
Administrative	5,081	4,843	9,498	7,861
Total operating expenses	33,697	30,632	64,157	59,154
Net investment income before income taxes	43,517	42,561	86,187	96,430
Income tax benefit	(1,081)		(1,081)	
Net investment income	44,598	42,561	87,268	96,430
Net Realized and Unrealized Gains (Losses):				
Net realized gains (losses)				
Companies more than 25% owned	1,314	(630)	1,314	(630)
Companies 5% to 25% owned			16,688	718
Companies less than 5% owned	7,226	(125)	38,877	8,762
Total net realized gains (losses)	8,540	(755)	56,879	8,850
	6,802	31,648	(64,334)	24,135

Net change in unrealized appreciation or depreciation				
Total net gains (losses)	15,342	30,893	(7,455)	32,985
Net increase in net assets resulting from operations	$ 59,940	$ 73,454	$ 79,813	$ 129,415
Basic earnings per common share	$ 0.53	$ 0.72	$ 0.71	$ 1.28
Diluted earnings per common share	$ 0.52	$ 0.71	$ 0.71	$ 1.26
Weighted average common shares outstanding basic	113,539	101,660	111,510	100,822
Weighted average common shares outstanding diluted	114,552	103,440	112,291	102,900

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, 2003	2002
	(unaudited)	
Operations:		
Net investment income	$ 87,268	$ 96,430
Net realized gains	56,879	8,850
Net change in unrealized appreciation or depreciation	(64,334)	24,135
Net increase in net assets resulting from operations	79,813	129,415
Shareholder distributions:		
Common stock dividends	(127,474)	(109,482)
Preferred stock dividends	(110)	(110)
Net decrease in net assets resulting from shareholder distributions	(127,584)	(109,592)
Capital share transactions:		
Sale of common stock	145,126	49,920
Issuance of common stock upon the exercise of stock options	2,657	11,626
Issuance of common stock in lieu of cash distributions	3,327	3,123
Net decrease (increase) in notes receivable from sale of common stock	1,719	(2,162)
Other	14	
Net increase in net assets resulting from capital share transactions	152,843	62,507
Total increase in net assets	105,072	82,330
Net assets at beginning of period	1,546,071	1,352,123
Net assets at end of period	$ 1,651,143	$ 1,434,453
Net asset value per common share	$ 14.23	$ 14.02
Common shares outstanding at end of period	116,034	102,296

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, 2003	2002
	(unaudited)	
Cash flows from operating activities:		
Net increase in net assets resulting from operations	$ 79,813	$ 129,415
Adjustments		
Portfolio investments	(526,399)	(195,455)
Repayments of investment principal	150,277	67,017
Proceeds from investment sales	276,708	126,280
Change in accrued or reinvested interest and dividends	(20,405)	(19,463)
Amortization of loan discounts and fees	(7,233)	(6,478)
Changes in other assets and liabilities	(23,172)	(21,788)
Depreciation and amortization	826	657
Gain on cashless exercise of warrants	(3,876)	
Realized losses	4,347	6,579
Net change in unrealized appreciation or depreciation	64,334	(24,135)
Net cash provided by (used in) operating activities	(4,780)	62,629
Cash flows from financing activities:		
Sale of common stock	145,126	49,920
Sale of common stock upon the exercise of stock options	2,657	9,245
Collections of notes receivable from sale of common stock	1,719	220
Common dividends and distributions paid	(127,329)	(106,359)
Preferred stock dividends paid	(110)	(110)
Borrowings under notes payable and debentures	300,000	
Repayments on notes payable and debentures	(140,000)	(6,856)
Net repayments on revolving line of credit	(178,750)	(5,000)
Other financing activities	(2,235)	(259)
Net cash provided by (used in) financing activities	1,078	(59,199)
Net increase (decrease) in cash and cash equivalents	(3,702)	3,430
Cash and cash equivalents at beginning of period	11,186	889
Cash and cash equivalents at end of period	$ 7,484	$ 4,319

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

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENT OF INVESTMENTS

Private Finance Portfolio Company (in thousands, except number of shares)	Investment[2]	June 30, 2003 (unaudited) Cost	Value
Companies More Than 25% Owned			
Acme Paging, L.P.	Loan	$ 4,265	$ 4,265
(Telecommunications)	Equity Interests	13,274	6,525
	Common Stock (940 shares)	27	
Alaris Consulting, LLC	Loan	18,635	17,300
(Business Services)	Equity Interests	5,165	
	Guaranty ($1,100)		
American Healthcare Services, Inc.	Loan	24,851	24,851
(Healthcare)	Debt Securities	17,311	11,388
	Common Stock (7,956,704 shares)	1,000	
	Guaranty ($1,590)		
Avborne, Inc.	Loan	2,770	2,770
(Business Services)	Preferred Stock (12,500 shares)	14,138	2,300
	Common Stock (27,500 shares)		
	Standby Letter of Credit ($7,006)		
Business Loan Express, LLC	Loans	20,000	20,000
(Financial Services)	Debt Securities	39,267	39,267
	Class A Equity Interests	45,044	45,044
	Class B Equity Interests	52,111	95,986
	Class C Equity Interests	108,241	156,461
	Guaranty ($53,591 See Note 3)		
	Standby Letters of Credit ($25,550 See Note 3)		
The Color Factory, Inc.	Loan	13,389	9,854
(Consumer Products)	Preferred Stock (1,000 shares)	1,002	
	Common Stock (980,000 shares)	6,535	
Foresite Towers, LLC	Equity Interests	15,522	14,170
(Tower Leasing)			
Gordian Group, Inc.	Loan	8,935	8,935
(Business Services)	Common Stock (1,000 shares)	2,385	3,500
HealthASPex, Inc.	Preferred Stock (1,000,000 shares)	700	700
(Business Services)	Preferred Stock (1,451,380 shares)	4,900	2,601
	Common Stock (1,451,380 shares)	4	
The Hillman Companies, Inc.[1]	Debt Securities	42,953	42,953
(Consumer Products)	Common Stock (6,890,937 shares)	50,645	138,863

HMT, Inc.	Debt Securities	9,129	9,129
(Business Services)	Preferred Stock (554,052 shares)	2,303	2,303
	Common Stock (300,000 shares)	3,000	3,000
	Warrants	1,155	1,155

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

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

Private Finance Portfolio Company (in thousands, except number of shares)	Investment[2]	June 30, 2003 (unaudited) Cost	Value
Housecall Medical Resources, Inc.	Loan	$ 15,062	$ 15,062
(Healthcare)	Preferred Stock (3,890,344 shares)	3,889	3,889
	Common Stock (864,000 shares)	86	3,687
Jakel, Inc.	Loan	500	500
(Industrial Products)	Debt Securities	7,500	7,500
	Preferred Stock (6,460 shares)	6,460	3,467
	Common Stock (158,061 shares)	9,347	
	Standby Letter of Credit ($4,500)		
Litterer Beteiligungs-GmbH[3]	Debt Securities	1,404	1,032
(Business Services)	Equity Interest	295	
MVL Group, Inc.	Loan	18,765	18,570
(Business Services)	Debt Securities	16,525	15,132
	Common Stock (648,661 shares)	810	
Powell Plant Farms, Inc.	Loan	18,697	18,697
(Consumer Products)	Debt Securities	19,224	9,709
	Preferred Stock (1,483 shares)		
	Warrants		
Redox Brands, Inc.	Loan	3,031	3,031
(Consumer Products)	Debt Securities	10,039	10,039
	Preferred Stock (2,404,086 shares)	6,965	6,965
	Warrants	584	584
	Guaranty ($125)		
Staffing Partners Holding	Debt Securities	6,304	6,304
Company, Inc.	Preferred Stock (414,600 shares)	4,968	4,074
(Business Services)	Common Stock (50,200 shares)	50	
	Warrants	10	
STS Operating, Inc.	Preferred Stock (5,769,424 shares)	6,525	6,525
(Industrial Products)	Common Stock (3,000,000 shares)	3,177	3,177
Sure-Tel, Inc.	Preferred Stock (1,000,000 shares)	1,000	1,000
(Consumer Services)	Common Stock (37,000 shares)	5,018	1,530
Total companies more than 25% owned		$694,891	$803,794
Companies 5% to 25% Owned			
Allied Office Products, Inc.	Common Stock (31,333 shares)	$ 7,695	$ 50
(Business Services)			
Aspen Pet Products, Inc.	Loans	17,145	17,145

(Consumer Products)	Preferred Stock (2,112 shares)	2,024	1,348
	Common Stock (1,400 shares)	140	
	Warrants		
Autania AG[1,3]	Common Stock (250,000 shares)	2,169	2,900
(Industrial Products)			

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(3) Non-U.S. company.
(4) Non-registered investment company.

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

Private Finance Portfolio Company (in thousands, except number of shares)	Investment[2]	June 30, 2003 (unaudited) Cost	Value
Blue Rhino Corporation[1] (Consumer Products)	Debt Securities	$ 5,094	$ 5,094
	Common Stock (1,070,179 shares)	5,076	12,842
Border Foods, Inc. (Consumer Products)	Debt Securities	9,421	9,421
	Preferred Stock (50,919 shares)	2,000	2,000
	Common Stock (1,810 shares)	45	45
	Warrants	665	665
CBA-Mezzanine Capital Finance, LLC (Financial Services)	Loan	8,337	8,337
CorrFlex Graphics, LLC (Business Services)	Debt Securities	12,318	12,318
	Warrants		19,332
	Options		1,669
The Debt Exchange Inc. (Business Services)	Preferred Stock (921,875 shares)	1,250	1,250
EDM Consulting, LLC (Business Services)	Debt Securities	1,802	236
	Equity Interests	250	
International Fiber Corporation (Industrial Products)	Debt Securities	22,715	22,715
	Common Stock (1,029,069 shares)	5,483	6,816
	Warrants	550	684
Liberty-Pittsburgh Systems, Inc. (Business Services)	Debt Securities	3,384	3,384
	Common Stock (123,929 shares)	142	
Logic Bay Corporation (Business Services)	Common Stock (1,437,420 shares)	5,000	
Magna Card, Inc. (Consumer Products)	Debt Securities	154	154
	Preferred Stock (1,875 shares)	94	28
	Common Stock (4,687 shares)		
Master Plan, Inc. (Business Services)	Loan	959	959
	Common Stock (156 shares)	42	
MortgageRamp, Inc. (Business Services)	Common Stock (772,000 shares)	3,860	2,084
Nobel Learning Communities, Inc.[1] (Education)	Debt Securities	9,809	9,809
	Preferred Stock (1,063,830 shares)	2,000	2,000
	Warrants	575	191
Packaging Advantage Corporation (Business Services)	Debt Securities	14,290	14,290
	Common Stock (232,168 shares)	2,386	2,386
	Warrants	963	963

Professional Paint, Inc.	Debt Securities	23,507	23,507
(Consumer Products)	Preferred Stock (15,000 shares)	20,803	20,803
	Common Stock (110,000 shares)	69	5,995

(1) Public company.
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(3) Non-U.S. company.
(4) Non-registered investment company.

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

Private Finance Portfolio Company (in thousands, except number of shares)	Investment[2]	June 30, 2003 (unaudited) Cost	Value
Progressive International Corporation (Consumer Products)	Debt Securities	$ 3,973	$ 3,973
	Preferred Stock (500 shares)	500	500
	Common Stock (197 shares)	13	150
	Warrants		
Sidarus Holdings, Inc. (Business Services)	Debt Securities	4,976	4,976
	Preferred Stock (98,000 shares)	980	980
	Common Stock (492,941 shares)	20	20
	Warrants		
Total Foam, Inc. (Industrial Products)	Debt Securities	254	124
	Common Stock (164 shares)	10	
Total companies 5% to 25% owned		$202,942	$222,143
Companies Less Than 5% Owned			
ACE Products, Inc. (Industrial Products)	Loan	$ 17,164	$ 50
Advantage Sales and Marketing, Inc. (Business Services)	Debt Securities	10,625	10,625
	Warrants	382	1,556
Alderwoods Group, Inc.[1] (Consumer Services)	Common Stock (357,568 shares)	5,006	1,913
American Barbecue & Grill, Inc. (Retail)	Warrants	125	
ASW Holding Corporation (Industrial Products)	Warrants	25	
Aviation Technologies, Inc. (Industrial Products)	Loan	19,901	19,901
Bakery Chef, Inc. (Consumer Products)	Loans	18,838	18,838
Benchmark Medical, Inc. (Healthcare)	Debt Securities	13,414	13,414
	Warrants	18	18
Camden Partners Strategic Fund II, L.P.[4] (Private Equity Fund)	Limited Partnership Interest	3,247	3,095
Candlewood Hotel Company[1] (Hospitality)	Preferred Stock (3,250 shares)	3,250	635

Clif Bar, Inc. (Consumer Products)	Loan	24,906	24,906
Colibri Holding Corporation (Consumer Products)	Debt Securities	3,495	3,495
	Preferred Stock (237 shares)	300	300
	Common Stock (3,362 shares)	1,250	1,088
	Warrants	290	252

(1) Public company.
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(3) Non-U.S. company.
(4) Non-registered investment company.

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

Private Finance Portfolio Company (in thousands, except number of shares)	Investment[2]	June 30, 2003 (unaudited) Cost	Value
Component Hardware Group, Inc. (Industrial Products)	Debt Securities	$11,544	$11,544
	Preferred Stock (18,000 shares)	2,312	2,312
	Common Stock (2,000 shares)	200	700
Cooper Natural Resources, Inc. (Industrial Products)	Loan	299	299
	Debt Securities	1,955	1,955
	Preferred Stock (6,316 shares)	1,427	1,427
	Warrants	832	832
Coverall North America, Inc. (Business Services)	Loan	12,410	12,410
	Debt Securities	6,426	6,426
CTT Holdings (Consumer Products)	Loan	1,250	1,250
Drilltec Patents & Technologies Company, Inc. (Industrial Products)	Loan	10,918	
	Debt Securities	1,500	
eCentury Capital Partners, L.P.[4] (Private Equity Fund)	Limited Partnership Interest	3,125	735
Elexis Beta GmbH[3] (Industrial Products)	Options	426	289
Eparfin S.A.[3] (Consumer Products)	Loan	29	29
E-Talk Corporation (Business Services)	Debt Securities	8,852	
	Warrants	1,157	
Executive Greetings, Inc. (Business Services)	Debt Securities	18,830	50
	Warrants	360	
Fairchild Industrial Products Company (Industrial Products)	Debt Securities	5,954	5,426
	Warrants	280	
Frozen Specialties, Inc. (Consumer Products)	Debt Securities	10,050	10,050
	Warrants	435	435
Galaxy American Communications, LLC (Broadcasting & Cable)	Debt Securities	49,704	12,712
	Options		
	Standby Letter of Credit ($37)		
Garden Ridge Corporation (Retail)	Debt Securities	27,271	25,000
	Preferred Stock (1,130 shares)	1,130	
	Common Stock (847,800 shares)	613	

Gibson Guitar Corporation	Debt Securities	18,354	18,354
(Consumer Products)	Warrants	525	2,325
Ginsey Industries, Inc.	Loans	5,000	5,000
(Consumer Products)	Convertible Debentures	500	500
	Warrants		2,250

(1) Public company.
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(3) Non-U.S. company.
(4) Non-registered investment company.

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

Private Finance Portfolio Company (in thousands, except number of shares)	Investment[2]	June 30, 2003 (unaudited) Cost	Value
Global Communications, LLC (Business Services)	Loan	$ 2,348	$ 2,348
	Debt Securities	16,711	16,711
	Preferred Equity Interest	14,067	14,193
	Options	1,639	3,551
Grant Broadcasting Systems II (Broadcasting & Cable)	Warrants	87	3,000
Grotech Partners, VI, L.P.[4] (Private Equity Fund)	Limited Partnership Interest	3,520	2,591
The Hartz Mountain Corporation (Consumer Products)	Debt Securities	27,845	27,845
	Common Stock (200,000 shares)	2,000	1,821
	Warrants	2,613	2,379
Haven Eldercare of New England, LLC (Healthcare)	Loan	35,903	35,903
Headwaters Incorporated[1] (Industrial Products)	Loan	9,958	9,958
Healthmarket, Inc. (Health Insurance)	Debt Securities	9,583	9,583
	Warrants	440	440
Hotelevision, Inc. (Broadcasting & Cable)	Common Stock (315,100 shares)	315	
Icon International, Inc. (Business Services)	Common Stock (25,707 shares)	1,219	1,740
Impact Innovations Group, LLC (Business Services)	Debt Securities	6,797	3,541
	Warrants	1,674	
Insight Pharmaceuticals Corporation (Consumer Products)	Loan	9,952	9,952
Intellirisk Management Corporation (Business Services)	Loan	23,757	23,757
Interline Brands, Inc. (Business Services)	Preferred Stock (199,313 shares)	1,849	1,849
	Common Stock (15,615 shares)	139	
	Warrants	1,181	
JRI Industries, Inc. (Industrial Products)	Debt Securities	1,548	1,548
	Warrants	74	39
Julius Koch USA, Inc. (Industrial Products)	Warrants	259	4,750

Kirker Enterprises, Inc.	Equity Interest	4	4
(Industrial Products)	Warrants	348	3,501
Kyrus Corporation	Debt Securities	6,431	6,431
(Business Services)	Warrants	348	450

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

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

Private Finance Portfolio Company (in thousands, except number of shares)	Investment[2]	June 30, 2003 (unaudited) Cost	Value
Love Funding Corporation (Financial Services)	Preferred Stock (26,000 shares)	$ 359	$ 359
Matrics, Inc. (Business Services)	Preferred Stock (511,876 shares)	500	938
	Warrants		
MedAssets, Inc. (Business Services)	Debt Securities	16,412	16,412
	Preferred Stock (229,806 shares)	2,049	2,049
	Warrants	136	136
Mid-Atlantic Venture Fund IV, L.P.[4] (Private Equity Fund)	Limited Partnership Interest	4,725	2,674
Midview Associates, L.P. (Housing)	Warrants		
Mogas Energy, LLC (Natural Gas Pipelines)	Debt Securities	18,226	18,226
	Warrants	1,774	1,774
Norstan Apparel Shops, Inc. (Retail)	Debt Securities	11,850	11,850
	Common Stock (29,622 shares)	4,750	4,750
	Warrants	655	655
Northeast Broadcasting Group, L.P. (Broadcasting & Cable)	Debt Securities	235	235
Novak Biddle Venture Partners III, L.P.[4] (Private Equity Fund)	Limited Partnership Interest	870	694
Nursefinders, Inc. (Business Services)	Debt Securities	11,262	11,262
	Warrants	900	900
Oahu Waste Services, Inc. (Business Services)	Debt Securities	8,178	8,178
	Stock Appreciation Rights	239	239
Onyx Television GmbH [3] (Broadcasting & Cable)	Preferred Units	201	
Opinion Research Corporation[1] (Business Services)	Debt Securities	14,401	14,401
	Warrants	996	996
Oriental Trading Company, Inc. (Consumer Products)	Preferred Equity Interest	1,751	1,751
	Common Equity Interest		3,500
Pico Products, Inc. (Industrial Products)	Loan	1,406	1,406
Polaris Pool Systems, Inc.	Debt Securities	10,880	10,880

(Consumer Products)	Warrants	1,145	1,145
Prosperco Finanz Holding AG[3]	Convertible Debentures	7,738	5,000
(Financial Services)	Common Stock (1,528 shares)	1,059	
	Warrants		

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

Private Finance Portfolio Company (in thousands, except number of shares)	Investment[2]	June 30, 2003 (unaudited) Cost	Value
Resun Leasing, Inc. (Business Services)	Loan	$30,000	$30,000
Scitor Corporation (Business Services)	Loan	22,511	22,511
Simula, Inc.[1] (Industrial Products)	Loan	21,853	21,853
SmartMail, LLC (Business Services)	Loan	3,731	3,731
	Debt Securities	4,400	4,400
	Equity Interests	1,070	1,070
	Warrants	3	3
Soff-Cut Holdings, Inc. (Industrial Products)	Debt Securities	9,599	9,599
	Preferred Stock (300 shares)	300	300
	Common Stock (2,000 shares)	200	
Southwest PCS, LLC (Telecommunications)	Loan	500	500
Spa Lending Corporation (Recreation)	Preferred Stock (28,672 shares)	424	306
Startec Global Communications Corporation[1] (Telecommunications)	Loan	25,715	25,715
	Debt Securities	20,670	
SunStates Refrigerated Services, Inc. (Warehouse Facilities)	Loans	4,566	1,424
	Debt Securities	2,445	
Sydran Food Services II, L.P. (Retail)	Debt Securities	12,973	6,646
	Equity Interests	3,747	
	Warrants	162	
Tubbs Snowshoe Company, LLC (Consumer Products)	Debt Securities	4,036	4,036
	Equity Interests	500	500
	Warrants	54	20
United Pet Group, Inc. (Consumer Products)	Debt Securities	9,125	9,125
	Warrants	85	350
United Site Services, Inc. (Business Services)	Loan	14,925	14,925
Updata Venture Partners II, L.P.[4] (Private Equity Fund)	Limited Partnership Interest	1,705	2,036

U.S. Security Holdings, Inc. (Business Services)	Debt Securities Warrants	24,164 826	24,164 1,200
Venturehouse-Cibernet Investors, LLC (Business Services)	Equity Interest	34	34

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Private Finance Portfolio Company (in thousands, except number of shares)	Investment[2]	June 30, 2003 (unaudited) Cost	Value
Venturehouse Group, LLC[4] (Private Equity Fund)	Equity Interest	$ 1,000	$ 236
Vertex Aerospace, LLC (Business Services)	Debt Securities	5,290	5,290
	Equity Interest		400
VICORP Restaurants, Inc. (Retail)	Debt Securities	23,849	23,849
	Warrants	33	33
Walker Investment Fund II, LLLP[4] (Private Equity Fund)	Limited Partnership Interest	1,246	518
Warn Industries, Inc. (Consumer Products)	Debt Securities	4,439	4,439
	Warrants	1,429	5,352
Weston Solutions, Inc. (Business Services)	Loan	12,189	12,189
Wilshire Restaurant Group, Inc. (Retail)	Debt Securities	16,691	16,691
	Warrants	735	855
Wilton Industries, Inc. (Consumer Products)	Loan	9,600	9,600
Woodstream Corporation (Consumer Products)	Debt Securities	16,329	16,329
	Common Stock (180 shares)	1,800	1,800
	Warrants	587	587
Total companies less than 5% owned		$ 946,750	$ 813,307
Total private finance (128 portfolio companies)		$ 1,844,583	$ 1,839,244

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(in Thousands)	Stated Interest	Face	June 30, 2003 (unaudited) Cost	Value
Commercial Real Estate Finance				
Commercial Mortgage-Backed Securities				
Mortgage Capital Funding, Series 1998-MC3	5.5%	$ 47,103	$ 25,867	$ 25,543
Morgan Stanley Capital I, Series 1999-RM1	6.4%	29,629	9,685	9,999
COMM 1999-1	5.7%	57,163	26,336	27,489
Morgan Stanley Capital I, Series 1999-FNV1	6.1%	28,595	14,150	12,985
DLJ Commercial Mortgage Trust 1999-CG2	6.1%	44,635	13,913	14,446
Commercial Mortgage Acceptance Corp., Series 1999-C1	6.8%	18,346	5,146	5,911
LB Commercial Mortgage Trust, Series 1999-C2	6.7%	11,603	1,771	1,743
Chase Commercial Mortgage Securities Corp., Series 1999-2	6.5%	20,545	5,481	6,148
FUNB CMT, Series 1999-C4	6.5%	22,887	7,868	7,709
Heller Financial, HFCMC Series 2000 PH-1	6.6%	25,767	8,803	9,110
SBMS VII, Inc., Series 2000-NL1	7.2%	9,214	4,572	4,551
DLJ Commercial Mortgage Trust, Series 2000-CF1	7.0%	24,328	9,459	9,834
Deutsche Bank Alex. Brown, Series Comm 2000-C1	6.9%	17,922	5,127	3,975
LB-UBS Commercial Mortgage Trust, Series 2000-C4	6.9%	17,484	3,971	4,562
Credit Suisse First Boston Mortgage Securities Corp., Series 2001-CK1	5.9%	21,805	8,497	8,536
JP Morgan-CIBC-Deutsche 2001	5.8%	25,370	6,855	6,815
Lehman Brothers-UBS Warburg 2001-C2	6.4%	22,756	6,598	6,649
SBMS VII, Inc., Series 2001-C1	6.1%	23,049	5,648	4,988
GE Capital Commercial Mortgage Securities Corp., Series 2001-2	6.1%	21,228	6,355	5,985
Credit Suisse First Boston Mortgage Securities Corp., Series 2001-CKN5	5.2%	21,456	5,209	5,343
JP Morgan Chase Commercial Mortgage Securities Corp., Series 2001-C1	5.6%	24,493	5,855	5,575
SBMS VII, Inc., Series 2001-C2	6.2%	21,619	5,887	5,711
FUNB CMT, Series 2002-C1	6.0%	28,303	11,624	12,099
GE Capital Commercial Mortgage Corp., Series 2002-1	6.2%	50,631	24,998	30,182
GMAC Commercial Mortgage Securities, Inc., Series 2002-C2	5.8%	40,573	20,125	22,889
GE Capital Commercial Mortgage Corp., Series 2002-3	5.1%	50,047	22,604	24,218
Morgan Stanley Dean Witter Capital I Trust 2002-IQ3	6.0%	27,858	13,163	14,097
LB-UBS Commercial Mortgage Trust 2003-C1	4.6%	50,896	22,122	23,349
GS Mortgage Securities Corporation II Series 2003-C1	4.7%	39,543	19,148	19,570
J.P. Morgan Chase Commercial Mortgage Securities Corp., Series 2003-ML1	4.9%	15,946	12,315	12,738
Credit Suisse First Boston Mortgage Securities Corp., Series 2003-CK2	4.9%	69,680	37,674	39,150
GE Commercial Mortgage Corporation 2003-C1	5.1%	20,389	16,006	16,873
COMM 2003-LNB1	4.4%	36,803	14,668	14,865
Total commercial mortgage-backed securities		$987,666	$407,500	$423,637

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(in Thousands)	June 30, 2003 (unaudited) Cost	Value
Collateralized Debt Obligations		
Crest 2001-1, Ltd.[3]	$ 23,126	$ 23,126
Crest 2002-1, Ltd.[3]	23,811	23,811
Crest 2002-IG, Ltd.[3]	4,731	4,731
Crest Clarendon Street 2002-1, Ltd.[3]	1,023	1,023
Crest 2003-1, Ltd.[3]	114,139	114,684
Total collateralized debt obligations	$166,830	$167,375

	Interest Rate Ranges	Number of Loans	Cost	Value
Commercial Mortgage Loans				
	Up to 6.99%	11	$ 10,655	$ 11,485
	7.00% 8.99%	17	37,178	34,541
	9.00% 10.99%	9	43,972	43,901
	11.00% 12.99%	13	18,211	11,301
	13.00% 14.99%	4	4,824	3,275
	15.00% and above	1	876	876
Total commercial mortgage loans		55	$ 115,716	$ 105,379
Real Estate Owned			12,841	10,505
Total commercial real estate finance			702,887	706,896
Total portfolio			$2,547,470	$2,546,140

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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 six months ended June 30, 2003 and 2002 is unaudited)

Note 1. Organization

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

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

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

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

Note 2. Summary of Significant Accounting Policies

Basis of Presentation

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

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

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

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 2. Summary of Significant Accounting Policies, continued

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

Valuation Of Portfolio Investments

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

Loans and Debt Securities

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

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

Interest income is recorded on an accrual basis to the extent that such amounts are expected to be collected. For loans and debt securities with contractual payment-in-kind interest, which represents

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 2. Summary of Significant Accounting Policies, continued

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

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

Equity Securities

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

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

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

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

CMBS bonds and CDO bonds and preferred shares are carried at fair value, which is based on a discounted cash flow model that utilizes prepayment and loss assumptions based on historical experience and projected performance, economic factors, the characteristics of the underlying cash flow, and comparable market yields for similar CMBS bonds and CDO bonds and preferred shares. The Company recognizes income from the amortization of original issue discount using the effective interest method, using the anticipated yield over the projected life of the investment. Yields are revised when there are changes in estimates of future credit losses, actual losses incurred, or actual and estimated prepayment speeds. Changes in estimated yield are recognized as an adjustment to the estimated yield over the remaining life of the CMBS bonds and CDO bonds and preferred shares from the date the estimated yield is changed. The Company recognizes unrealized appreciation or depreciation on its CMBS bonds and CDO bonds and preferred shares as comparable yields in the

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 2. Summary of Significant Accounting Policies, continued

market change and based on changes in estimated cash flows resulting from changes in prepayment or loss assumptions in the underlying collateral pool.

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

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

Fee Income

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

Deferred Financing Costs

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

Cash and Cash Equivalents

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

Guarantees

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

Dividends to Shareholders

Dividends to shareholders are recorded on the record date.

Stock Compensation Plans

At June 30, 2003 and 2002, the Company had a stock-based employee compensation plan. The Company accounts for this plan under the recognition and measurement principles of APB Opinion No. 25, *Accounting for Stock Issued to Employees*, and related Interpretations. No stock-based employee compensation cost is reflected in net increase in net assets resulting from operations, as all

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 2. Summary of Significant Accounting Policies, continued

options granted under this plan had an exercise price equal to the market value of the underlying common stock on the date of grant. The following table illustrates the effect on net increase in net assets resulting from operations and earnings per share if the Company had applied the fair value recognition provisions of FASB Statement No. 123, *Accounting for Stock-Based Compensation*, to stock-based employee compensation.

	For the Six Months Ended June 30,	
(in thousands, except per share amounts)	**2003**	**2002**
Net increase in net assets resulting from operations as reported	$79,813	$129,415
Less total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	(8,078)	(3,632)
Pro forma net increase in net assets resulting from operations	71,735	125,783
Less preferred stock dividends	(110)	(110)
Pro forma income available to common shareholders	$71,625	$125,673
Basic earnings per common share:		
As reported	$ 0.71	$ 1.28
Pro forma	$ 0.64	$ 1.25
Diluted earnings per common share:		
As reported	$ 0.71	$ 1.26
Pro forma	$ 0.64	$ 1.22

Pro forma expenses are based on the underlying value of the options granted by the Company. The fair value of each option grant is estimated on the date of grant using the Black-Scholes option pricing model, with the following weighted average assumptions for options granted during the six months ended June 30, 2003 and 2002:

	For the Six Months Ended June 30,	
	2003	**2002**
Risk-free interest rate	2.6%	4.5%
Expected life	5.0	5.0
Expected volatility	38.8%	39.7%
Dividend yield	8.9%	8.5%
Weighted average fair value per option	$3.31	$4.82

Federal and State Income Taxes

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

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 2. Summary of Significant Accounting Policies, continued

Per Share Information

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

Use of Estimates in the Preparation of Financial Statements

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

The consolidated financial statements include portfolio investments at value of $2.5 billion as of June 30, 2003, and December 31, 2002. At June 30, 2003, and December 31, 2002, 89% and 88%, respectively, of our total assets represented investments whose fair values have been determined by the board of directors in good faith in the absence of readily available market values. Because of the inherent uncertainty of valuation, the board of directors determined values may differ significantly from the values that would have been used had a ready market existed for the investments, and the differences could be material.

New Accounting Pronouncements

In May 2003, the FASB issued Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of Both Liabilities and Equity* which provides guidance on how an entity classifies and measures certain financial instruments with characteristics of both liabilities and equity. This statement is effective for financial instruments entered into or modified after May 31, 2003, and otherwise is effective at the beginning of the first interim period beginning after June 15, 2003. The statement requires cumulative effect transition for financial instruments existing at adoption date. The Company does not expect the adoption of this statement to have a significant effect on the Company s financial position or its results of operations.

Note 3. Portfolio

Private Finance

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

	2003			2002		
($ in thousands)	**Cost**	**Value**	**Yield**	**Cost**	**Value**	**Yield**
Loans and debt securities	$1,351,947	$1,192,452	14.4% (1)	$1,272,401	$1,151,256	14.4% (1)
Equity interests	492,636	646,792		438,501	591,959	
Total	$1,844,583	$1,839,244		$1,710,902	$1,743,215	

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

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 3. Portfolio, continued

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

Loans and debt securities generally have a maturity of five to ten years, with interest-only payments in the early years and payments of both principal and interest in the later years, although debt maturities and principal amortization schedules vary. At June 30, 2003, and December 31, 2002, approximately 96% and 95%, respectively, of the Company s loans and debt securities had fixed interest rates.

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

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

At June 30, 2003, and December 31, 2002, the Company had an investment at value totaling $356.8 million and $256.8 million, respectively, in Business Loan Express, LLC (BLX), a small business lender that participates in the U.S. Small Business Administration s 7(a) Guaranteed Loan Program. During the first quarter of 2003, the Company invested $50 million in BLX in the form of a $25 million short-term line of credit and $25 million of preferred equity in connection with BLX s acquisition of $128 million in assets from Amresco Independence Funding, Inc. BLX also completed its corporate reorganization to a limited liability company during the first quarter by merging BLX, Inc. into BLX, LLC. Prior to this transaction, BLX converted $43 million of the Company s subordinated debt to preferred stock in BLX, Inc., which was exchanged upon the merger for Class A equity interests of BLX, LLC. In addition, as part of the merger, the Company exchanged its existing preferred stock and common equity investments in BLX, Inc. for similar classes of members equity in BLX, LLC represented by Class B and Class C equity interests, respectively. At June 30, 2003, the Company owned 94.9% of the voting Class C equity interests. BLX has an equity appreciation rights plan for management which will dilute the value available to the Class C equity interest holders.

At the time of the corporate reorganization of BLX, Inc. from a C corporation to a limited liability company, for tax purposes BLX had a built-in gain representing the aggregate fair market value of its assets in excess of the tax basis of its assets. As a regulated investment company, the Company will be subject to the built-in gain rules on the assets of BLX. Under these rules, taxes will be payable by the Company at the time and to the extent that the built-in gains on BLX s assets at the date of reorganization are recognized in a taxable disposition of such assets in the 10-year period following the date of the reorganization. At such time, the built-in gains realized upon the disposition

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 3. Portfolio, continued

of these assets will be included in the Company s taxable income, net of the corporate level taxes paid by the Company on the built-in gains. However, if these assets are disposed of after the 10-year period, there will be no corporate level taxes on these built-in gains.

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

As the controlling equity owner of BLX, the Company has provided an unconditional guaranty to the BLX credit facility lenders in an amount up to 50% of the total obligations (consisting of principal, accrued interest, and other fees) on BLX s three-year unsecured $164.0 million revolving credit facility that matures in March 2004. The amount guaranteed by the Company at June 30, 2003, was $53.6 million. This guaranty can be called by the lenders only in the event of a default by BLX. BLX was in compliance with the terms of its credit facility at June 30, 2003. The Company has also provided three standby letters of credit in connection with three term securitization transactions completed by BLX totaling $25.6 million. In consideration for providing this guaranty and the three standby letters of credit, BLX paid the Company fees of $1.9 million and $1.6 million for the six months ended June 30, 2003 and 2002, respectively. BLX is headquartered in New York, NY.

At June 30, 2003, and December 31, 2002, the Company had an investment in The Hillman Companies, Inc. (Hillman) totaling $181.8 million and $180.5 million at value, respectively. At June 30, 2003, the Company owned 96.8% of Hillman s common stock. The Company s common stock ownership is subject to dilution by management options. Hillman is a leading manufacturer of key making equipment and distributor of key blanks, fasteners, signage, and other small hardware components and operates in multiple channels of the retail marketplace such as hardware stores, national and regional home centers, and mass merchants. Hillman has certain patent-protected products including key duplication technology that is important to its business. Hillman s primary operations are located in Cincinnati, Ohio.

Total interest and portfolio related income earned from the Company s investments in BLX and Hillman for the six months ended June 30, 2003 and 2002, was $27.5 million and $24.5 million, respectively.

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 3. Portfolio, continued

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

(in thousands)	2003	2002
Companies more than 25% owned	$23,828	$ 9,709
Companies 5% to 25% owned	360	411
Companies less than 5% owned	33,801	65,931
Total	$57,989	$76,051

In addition to Grade 4 and 5 assets that are in workout, the Company may not accrue interest on loans and debt securities to companies that are more than 50% owned by the Company if such companies are in need of additional working capital and, therefore, the Company may defer current debt service. Loans and debt securities to such companies totaled $72.2 million and $63.6 million at value at June 30, 2003, and December 31, 2002, respectively. In addition, loans to companies that are less than 50% owned by the Company and were not in workout but were not accruing interest totaled $1.0 million and $7.2 million at value at June 30, 2003, and December 31, 2002, respectively.

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

	2003	2002
Industry		
Consumer products	30%	34%
Business services	24	26
Financial services	20	16
Industrial products	8	9
Healthcare	6	5
Retail	5	4
Telecommunications	2	2
Education	1	1
Broadcasting & cable	1	1
Other	3	2
Total	100%	100%

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 3. Portfolio, continued

	2003	2002
Geographic Region		
Mid-Atlantic	51%	45%
West	17	15
Southeast	14	16
Midwest	11	16
Northeast	6	7
International	1	1
Total	100%	100%

Commercial Real Estate Finance

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

	2003			2002		
($ in thousands)	Cost	Value	Yield(1)	Cost	Value	Yield(1)
CMBS bonds	$407,500	$423,637	13.9%	$523,671	$555,519	14.2%
Collateralized debt obligation bonds and preferred shares	166,830	167,375	16.6%	52,818	52,818	17.2%
Loans	115,716	105,379	7.8%	66,546	63,707	7.5%
Residual interest				69,335	69,035	9.4%
Real estate owned	12,841	10,505		5,942	3,873	
Total	$702,887	$706,896		$718,312	$744,952	

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

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

($ in thousands)	2003	2002
Face	$ 987,666	$1,173,194
Original issue discount	(580,166)	(649,523)
Cost	$ 407,500	$ 523,671

Value	$ 423,637	$ 555,519

The non-investment grade and unrated tranches of the CMBS bonds in which the Company invests are junior in priority for payment of interest and principal to the more senior tranches of the related CMBS bond issuance. Cash flow from the underlying mortgages generally is allocated first to the senior tranches, with the most senior tranches having a priority right to the cash flow. Then, any

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 3. Portfolio, continued

remaining cash flow is allocated, generally, among the other tranches in order of their relative seniority. To the extent there are defaults and unrecoverable losses on the underlying mortgages or the properties securing those mortgages resulting in reduced cash flows, the most subordinate tranche will bear this loss first. At June 30, 2003, the Company s CMBS bonds were subordinate to 91% to 99% of the tranches of bonds issued in various CMBS transactions. Given that the non-investment grade CMBS bonds in which the Company invests are junior in priority for payment of principal and interest, the Company invests in these CMBS bonds at a significant discount from the face amount of the bonds.

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

	2003		2002	
($ in thousands)	Value	Percentage of Total	Value	Percentage of Total
BB+	$ 68,699	16.2%	$ 49,811	9.0%
BB	51,011	12.0	39,011	7.0
BB-	28,015	6.6	22,030	4.0
B+	35,915	8.5	121,038	21.8
B	31,476	7.4	141,998	25.6
B-	79,245	18.7	83,493	15.0
CCC+	12,778	3.0		
CCC	18,398	4.4	8,634	1.5
Unrated	98,100	23.2	89,504	16.1
Total	$423,637	100.0%	$555,519	100.0%

At June 30, 2003, and December 31, 2002, the underlying collateral for the Company s CMBS bonds consisted of approximately 5,100 and 4,500 commercial mortgage loans and real estate properties owned with a total outstanding principal balance of $32.0 billion and $25.0 billion, respectively. At June 30, 2003, and December 31, 2002, 1.2% and 1.0%, respectively, of the mortgage loans in the underlying collateral pool for the Company s CMBS bonds were over 30 days delinquent or were classified as real estate owned.

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 3. Portfolio, continued

The property types and the geographic composition of the underlying mortgage loans and real estate properties owned in the underlying collateral pool calculated using the outstanding principal balance at June 30, 2003, and December 31, 2002, were as follows:

	2003	2002
Property Type		
Retail	34%	32%
Housing	25	27
Office	23	21
Industrial Real Estate	6	7
Hospitality	5	6
Other	7	7
Total	100%	100%
Geographic Region		
West	31%	31%
Mid-Atlantic	27	25
Midwest	22	22
Southeast	16	17
Northeast	4	5
Total	100%	100%

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

Collateralized Debt Obligation Bonds and Preferred Shares (CDOs). At June 30, 2003, the Company owned BBB rated bonds in one CDO totaling $24.3 million at value and preferred shares in five CDOs totaling $143.1 million at value secured by investment grade unsecured debt issued by various real estate investment trusts (REITs) and investment and non-investment grade CMBS bonds. The investment grade REIT collateral consists of debt with a cut-off balance of $1.2 billion and was issued by 39 REITs. The investment grade CMBS collateral consists of CMBS bonds with a face amount of $496.0 million issued in 41 separate CMBS transactions and the non-investment grade CMBS collateral consists of BB+, BB, BB , B+, and B rated CMBS bonds with a face amount of $873.7 million issued in 42 separate CMBS transactions (CMBS Collateral). Included in the CMBS Collateral for the CDOs are $793.7 million of CMBS bonds that are senior in priority of repayment to certain lower rated CMBS bonds held by the Company, which were issued in 27 separate CMBS transactions.

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 3. Portfolio, continued

The BBB rated bonds and the preferred shares owned by the Company are junior in priority for payment of principal and interest to the more senior tranches of debt issued by the CDOs. To the extent there are defaults and unrecoverable losses on the underlying collateral resulting in reduced cash flows, the preferred shares will bear this loss first and then the BBB rated bonds would bear any loss after the preferred shares. At June 30, 2003, the Company s BBB bonds and preferred shares in the CDOs were subordinate to 61% to 98% of the more senior tranches of debt issued in various CDO transactions.

As of June 30, 2003, the Company acted as the disposition consultant with respect to four of the CDOs, which allows the Company to approve disposition plans for individual collateral securities. As of June 30, 2002, the Company acted as the disposition consultant with respect to two of the CDOs. For these services, the Company collects annual fees based on the outstanding collateral pool balance, and for the six months ended June 30, 2003 and 2002, these fees totaled $515 thousand and $160 thousand, respectively.

Loans. The commercial mortgage loan portfolio contains loans that were originated by the Company or were purchased from third-party sellers. At June 30, 2003, approximately 92% and 8% of the Company s commercial mortgage loan portfolio was composed of fixed and adjustable interest rate loans, respectively. As of December 31, 2002, approximately 84% and 16% of the Company s commercial mortgage loan portfolio was composed of fixed and adjustable interest rate loans, respectively. As of June 30, 2003, and December 31, 2002, loans with a value of $19.9 million and $13.0 million, respectively, were not accruing interest. Loans greater than 120 days delinquent generally do not accrue interest.

The property types and the geographic composition securing the commercial mortgage loan portfolio at value at June 30, 2003, and December 31, 2002, were as follows:

	2003	2002
Property Type		
Hospitality	31%	23%
Office	29	20
Retail	22	21
Healthcare	8	15
Recreation	2	3
Other	8	18
Total	100%	100%
Geographic Region		
Southeast	34%	40%
Midwest	24	12
West	19	20
Mid-Atlantic	17	17
Northeast	6	11
Total	100%	100%

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 3. Portfolio, continued

Residual Interest. At June 30, 2003, and December 31, 2002, the residual interest consisted of the following:

	2003		2002	
(in thousands)	**Cost**	**Value**	**Cost**	**Value**
Residual interest	$	$	$68,853	$68,853
Residual interest spread			482	182
Total	$	$	$69,335	$69,035

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

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

Note 4. Debt

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

	2003			2002		
(in thousands)	**Facility Amount**	**Amount Drawn**	**Annual Interest Cost(1)**	**Facility Amount**	**Amount Drawn**	**Annual Interest Cost(1)**
Notes payable and debentures:						
Unsecured long-term notes payable	$ 854,000	$854,000	7.2%	$ 694,000	$694,000	7.7%
SBA debentures	101,800	94,500	8.1%	101,800	94,500	8.2%
OPIC loan	5,700	5,700	6.6%	5,700	5,700	6.6%
Total notes payable and debentures	961,500	954,200	7.3%	801,500	794,200	7.8%
Revolving line of credit	462,500	25,500	11.7%(2)	527,500	204,250	3.7%(2)

Total	$1,424,000	$979,700	7.4%	$1,329,000	$998,450	6.9%

(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.

(2) The current interest rate payable on the revolving line of credit was 2.6% and 2.7% at June 30, 2003, and December 31, 2002, respectively, which excludes the annual cost of commitment fees and other facility fees of $2.3 million and $2.0 million, respectively.

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 4. Debt, continued

Notes Payable and Debentures

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

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

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

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

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

Revolving Line of Credit

On April 18, 2003, the Company renewed its unsecured revolving line of credit. The committed amount under the renewed facility is $462.5 million and may be expanded through new or additional commitments up to $600 million at the Company s option. The renewed line of credit expires in April 2005 and may be extended under substantially similar terms for one additional year at the Company s option. The facility bears interest at a rate equal to (i) the one-month LIBOR plus 1.25%, (ii) the Bank of America, N.A. prime rate, or (iii) the Federal Funds rate plus 0.50% at the Company s option. The interest rate adjusts at the beginning of each new interest period, usually every 30 days. The interest rates were 2.6% and 2.7% at June 30, 2003, and December 31, 2002, respectively, and the facility requires an annual commitment fee equal to 0.25% of the committed amount. The annual cost of commitment fees and other facility fees is $2.3 million. The line of credit generally requires monthly payments of interest, and all principal is due upon maturity.

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 4. Debt, continued

The average debt outstanding on the revolving line of credit was $78.0 million and $68.3 million for the six months ended June 30, 2003, and the year ended December 31, 2002, respectively. The maximum amount borrowed under this facility and the weighted average interest rate for the six months ended June 30, 2003, and the year ended December 31, 2002, were $208.8 million and $216.5 million, and 2.7% and 3.2%, respectively. As of June 30, 2003, the amount available under the revolving line of credit was $399.9 million, net of amounts committed for standby letters of credit of $37.1 million issued under the credit facility.

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

Note 5. Guarantees

In the ordinary course of business, the Company has issued guarantees and has extended standby letters of credit through financial intermediaries on behalf of certain portfolio companies. As of June 30, 2003, and December 31, 2002, the Company had issued guarantees of debt, rental obligations, lease obligations and severance obligations aggregating $58.9 million and $54.6 million, respectively, and had extended standby letters of credit aggregating $37.1 million and $11.3 million, respectively. Under these arrangements, the Company would be required to make payments to third-party beneficiaries if the portfolio companies were to default on their related payment obligations. The maximum amount of future payments was $96.0 million and $65.9 million at June 30, 2003, and December 31, 2002, respectively. At June 30, 2003, and December 31, 2002, no amounts had been recorded as a liability for the Company s guarantees or standby letters of credit.

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

(in thousands)	Total	2003	2004	2005	2006	2007	After 2007
Guarantees	$58,904	$351	$54,302	$ 395	$ 142	$114	$3,600
Standby letters of credit	37,093	37		4,500	32,556		
Total	$95,997	$388	$54,302	$4,895	$32,698	$114	$3,600

Note 6. Preferred Stock

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

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 7. Shareholders Equity

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

(in thousands)	For the Six Months Ended June 30, 2003	2002
Number of common shares	7,050	1,946
Gross proceeds	$152,632	$51,800
Less costs including underwriting fees	(7,506)	(1,880)
Net proceeds	$145,126	$49,920

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

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

(in thousands, except per share amounts)	For the Six Months Ended June 30, 2003	2002
Shares issued	154	128
Average price per share	$21.50	$24.34

Note 8. Earnings Per Common Share

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

(in thousands, except per share amounts)	For the Three Months Ended June 30, 2003	2002	For the Six Months Ended June 30, 2003	2002
Net increase in net assets resulting from operations	$ 59,940	$ 73,454	$ 79,813	$129,415
Less preferred stock dividends	(55)	(55)	(110)	(110)
Income available to common shareholders	$ 59,885	$ 73,399	$ 79,703	$129,305
	113,539	101,660	111,510	100,822

Weighted average common shares outstanding basic				
Dilutive options outstanding to officers	1,013	1,780	781	2,078
Weighted average common shares outstanding diluted	114,552	103,440	112,291	102,900
Basic earnings per common share	$ 0.53	$ 0.72	$ 0.71	$ 1.28
Diluted earnings per common share	$ 0.52	$ 0.71	$ 0.71	$ 1.26

Note 9. Dividends and Distributions

The Company s Board of Directors declared and the Company paid dividends of $0.57 per common share for each of the first and second quarters of 2003. The dividends totaled $64.5 million

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 9. Dividends and Distributions, continued

and $127.5 million for the three and six months ended June 30, 2003, respectively. The Company paid dividends to common shareholders of $56.2 million and $109.5 million for the three and six months ended June 30, 2002, respectively.

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

Note 10. Supplemental Disclosure of Cash Flow Information

For the six months ended June 30, 2003 and 2002, the Company paid $35.2 million and $34.1 million, respectively, for interest. For the six months ended June 30, 2003, the Company s non-cash financing activities totaled $3.3 million related to dividend reinvestment. For the six months ended June 30, 2002, the Company s non-cash financing activities totaled $5.5 million related to stock option exercises and dividend reinvestment.

Non-cash operating activities for the six months ended June 30, 2003, included transfers of commercial mortgage loans and real estate owned in the repayment of the Company s Residual Interest totaling $69.3 million, real estate owned received in connection with foreclosure on commercial mortgage loans of $2.2 million, and receipt of commercial mortgage loans in satisfaction of private finance loans and debt securities of $9.9 million. Non-cash operating activities for the six months ended June 30, 2002, included real estate owned received in connection with foreclosure on commercial mortgage loans of $2.5 million.

Note 11. Hedging Activities

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

(in thousands) Description of Issue	2003	2002
10-year Treasury securities, due February 2012	$	$ 52,053
10-year Treasury securities, due November 2012	45,064	107,327
10-year Treasury securities, due February 2013	85,800	
10-year Treasury securities, due May 2013	8,671	
5-year Treasury securities, due November 2007	9,959	37,647
5-year Treasury securities, due February 2008	7,492	
Total	$156,986	$197,027

As of June 30, 2003, and December 31, 2002, the total obligations to replenish borrowed Treasury securities had increased since the related original sale dates due to changes in the yield on the borrowed Treasury securities, resulting in unrealized depreciation on the obligations of $3.9 million and $7.1 million, respectively. The net proceeds related to the sales of the borrowed Treasury securities were $152.2 million and $189.3 million at June 30, 2003, and December 31, 2002,

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 11. Hedging Activities, continued

respectively. Under the terms of the transactions, the Company has provided additional cash collateral of $5.1 million and $5.4 million at June 30, 2003, and December 31, 2002, respectively, for the difference between the net proceeds related to the sales of the borrowed Treasury securities and the obligations to replenish the securities. The Company has deposited the proceeds related to the sales of the borrowed Treasury securities and the additional cash collateral with the financial institutions under repurchase agreements. The repurchase agreements are collateralized by U.S. Treasury securities and are settled weekly. As of June 30, 2003, the repurchase agreements were due on July 9, 2003, and had a weighted average interest rate of 0.6%. The weighted average interest rate on the repurchase agreements as of December 31, 2002, was 0.8%.

Note 12. Financial Highlights

	At and for the Six Months Ended June 30,		At and for the Year Ended December 31,
	2003[3]	2002[3]	2002
Per Common Share Data			
Net asset value, beginning of period	$14.22	$13.57	$13.57
Net investment income[1]	0.78	0.94	1.77
Net gains (losses)[1]	(0.07)	0.32	0.43
Net increase in net assets resulting from operations	0.71	1.26	2.20
Net decrease in net assets from shareholder distributions	(1.14)	(1.08)	(2.23)
Net increase in net assets from capital share transactions	0.44	0.27	0.68
Net asset value, end of period	$14.23	$14.02	$14.22
Market value, end of period	$23.10	$22.65	$21.83
Total return	12%	(9)%	(7)%

(1) Based on diluted weighted average number of common shares outstanding for the period.

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 12. Financial Highlights, continued

	At and for the Six Months Ended June 30, 2003(3)	At and for the Six Months Ended June 30, 2002(3)	At and for the Year Ended December 31, 2002
Ratios and Supplemental Data			
Ending net assets	$1,651,143	$1,434,453	$1,546,071
Common shares outstanding at end of period	116,034	102,296	108,698
Diluted weighted average common shares outstanding	112,291	102,900	103,574
Employee and administrative expenses/ average net assets	1.68%	1.74%	3.82%
Total expenses/average net assets	4.02%	4.26%	8.75%
Net investment income/average net assets	5.47%	6.94%	12.94%
Net increase in net assets resulting from operations(2)/average net assets	5.00%	9.32%	15.98%
Portfolio turnover rate	17.26%	8.33%	15.12%
Average debt outstanding	$ 927,009	$ 940,357	$ 938,148
Average debt per share	$ 8.26	$ 9.14	$ 9.06

(2) Net changes in unrealized appreciation or depreciation and net realized gains and losses can fluctuate significantly from period to period. As a result, quarterly comparisons may not be meaningful.
(3) The results for the six months ended June 30, 2003 and 2002, are not necessarily indicative of the operating results to be expected for the full year.

Note 13. Litigation

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

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

Independent Accountants Review Report

The Board of Directors and Shareholders

Allied Capital Corporation and Subsidiaries:

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

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

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

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

/s/ KPMG LLP

Washington, D.C.

July 28, 2003

NOTICE REGARDING INDEPENDENT PUBLIC ACCOUNTANTS REVIEW REPORT

With respect to the unaudited interim financial information as of June 30, 2003 and for the six-month periods ended June 30, 2003 and 2002, 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

18,000,000 Shares

Common Stock

We are an internally managed closed-end 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 primarily in private companies in a variety of industries throughout the United States. No assurances can be given that we will continue to achieve our objective.

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

We may offer, from time to time, up to 18,000,000 shares of our common stock in one or more offerings.

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

Our common stock is traded on the New York Stock Exchange under the symbol ALD. As of June 11, 2003, the last reported sale price on the New York Stock Exchange for the common stock was $23.94.

You should review the information, including the risk of leverage, set forth under Risk Factors on page 9 of this prospectus before investing in our common stock.

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

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

June 11, 2003

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

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ABOUT THIS PROSPECTUS

This prospectus is part of a registration statement that we have filed with the Securities and Exchange Commission using the shelf registration process. Under the shelf registration process, we may offer, from time to time, up to 18,000,000 shares of our common stock on the terms to be determined at the time of the offering. Shares of our common stock may be offered at prices and on terms described in one or more supplements to this prospectus. This prospectus provides you with a general description of the shares of our common stock that we may offer. Each time we use this prospectus to offer shares of our common stock, we will provide a prospectus supplement that will contain specific information about the terms of that offering. The prospectus supplement may also add, update or change information contained in this prospectus. Please carefully read this prospectus and any prospectus supplement together with the additional information described under Where You Can Find Additional Information in the Prospectus Summary section and Risk Factors before you make an investment decision.

PROSPECTUS SUMMARY

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

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

BUSINESS *(Page 49)*

We are a business development company that participates in the private equity market. We generally invest in illiquid securities through privately negotiated transactions. We provide long-term debt and equity investment capital to support the expansion of companies in a variety of industries. We generally invest in private middle market companies though, from time to time, we may invest in public companies that lack access to public capital or whose securities may not be marginable. We have been investing in businesses for over 40 years and have financed thousands of companies nationwide. Our investment and lending activity is generally focused in two areas:

- private finance, and
- commercial real estate finance, primarily the investment in non-investment grade commercial mortgage-backed securities.

Our investment portfolio generally includes:

- long-term unsecured loans with or without equity features known as mezzanine financing,
- equity investments in companies, which may or may not constitute a controlling equity interest,
- non-investment grade commercial mortgage-backed securities,
- preferred shares in collateralized debt obligations, and
- commercial mortgage loans.

We identify loans and investments through our numerous relationships with:

- mezzanine and private equity investors,
- investment banks, and
- other intermediaries, including professional services firms.

Our credit and investment approval process is centralized at our headquarters in Washington, DC.

Our tax structure generally allows us to pass-through our income to our shareholders through dividends without the imposition of a corporate level of taxation, if certain requirements are met. See Tax Status.

We are an internally managed diversified closed-end 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. Our investment objective is to achieve current income and capital gains. We seek to achieve our investment objective by investing primarily in private businesses in a variety of industries throughout the United States.

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, which includes private or thinly traded public, U.S.-based entities. A business development company must also maintain a coverage ratio of assets to senior securities of at least 200%. See Certain Government Regulations.

Our executive offices are located at 1919 Pennsylvania Avenue, NW,

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Washington, DC, 20006 and our telephone number is (202) 331-1112. In addition, we have regional offices in New York and Chicago.

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 74)*

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

At December 31, 2002, approximately 89% of our total assets represented portfolio investments recorded at fair value. Pursuant to the requirements of the 1940 Act, we value substantially all of our portfolio investments at fair value as determined in good faith by the board of directors on a quarterly basis. Since there is typically no readily available market value for the investments in our portfolio, our board of directors determines in good faith the fair value of these portfolio investments pursuant to a valuation policy and a consistently applied valuation process.

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

We adjust quarterly the valuation of our portfolio to reflect the change in the value of each investment in our portfolio. Any changes in value are recorded in our statement of operations as Net unrealized gains (losses).

PLAN OF DISTRIBUTION *(Page 105)*

We may offer, from time to time, up to 18,000,000 shares of our common stock, on terms to be determined at the time of the offering.

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

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

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

USE OF PROCEEDS *(Page 16)*

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

PRICE RANGE OF COMMON STOCK AND DISTRIBUTIONS *(Page 17)*

We intend to pay quarterly dividends to holders of our common stock. The amount of our quarterly dividends is determined by our board of directors.

DIVIDEND REINVESTMENT PLAN *(Page 100)*

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 new shareholders that have not opted in to our dividend reinvestment plan will receive cash dividends. New shareholders must notify our transfer agent in writing if they wish to enroll in the dividend reinvestment plan.

RISK FACTORS *(Page 9)*

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

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

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

We 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. Our business of making private equity investments may be affected by current and future market conditions. The absence of an active senior lending environment may slow the amount of private equity investment activity generally. As a result, the pace of our investment activity may slow.

We may not be able to pay dividends and the loss of pass-through tax treatment could have a material adverse effect on our total return, if any.

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

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

CERTAIN ANTI-TAKEOVER

PROVISIONS *(Page 102)*

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

LEGAL PROCEEDINGS *(Page 66)*

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

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

FEES AND EXPENSES

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

Shareholder Transaction Expenses	
Sales load (as a percentage of offering price)(1)	%
Dividend reinvestment plan fees(2)	None
Annual Expenses (as a percentage of consolidated net assets attributable to common stock)(3)	
Operating expenses(4)	3.5%
Interest payments on borrowed funds(5)	4.6%
Total annual expenses(6)	8.1%

(1) In the event that the shares of common stock to which this prospectus relates are sold to or through underwriters, a corresponding prospectus supplement will disclose the applicable sales load.

(2) The expenses of our dividend reinvestment plan are included in Operating expenses. We do not have a stock purchase plan. The participants in the dividend reinvestment plan will bear a pro rata share of brokerage commissions incurred with respect to open market purchases or sales, if any. See Dividend Reinvestment Plan.

(3) Consolidated net assets attributable to common stock equals net assets (*i.e.*, total consolidated assets less total consolidated liabilities and preferred stock) at December 31, 2002.

(4) Operating expenses represent our operating expenses for the year ending December 31, 2002 excluding interest on indebtedness.

(5) The Interest payments on borrowed funds represents our interest expenses for the year ending December 31, 2002. We had outstanding borrowings of $998.5 million at December 31, 2002. See Risk Factors.

(6) Total annual expenses as a percentage of consolidated net assets attributable to common stock are higher than the total annual expenses percentage would be for a company that is not leveraged. We borrow money to leverage our net assets and increase our total assets. The SEC requires that Total annual expenses percentage be calculated as a percentage of *net* assets, rather than the total assets, including assets that have been funded with borrowed monies. If the Total annual expenses percentage were calculated instead as a percentage of consolidated total assets, our Total annual expenses would be 4.5% of consolidated total assets.

Example

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

	1 Year	3 Years	5 Years	10 Years
You would pay the following expenses on a $1,000 investment, assuming a 5.0% annual return	$ 81	$245	$410	$832

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

See Dividend Reinvestment Plan.

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

SELECTED CONDENSED CONSOLIDATED FINANCIAL DATA

You should read the condensed consolidated financial information below with the Consolidated Financial Statements and Notes thereto included in this prospectus. Financial information for the year ended December 31, 2002 has been derived from our financial statements that were audited by KPMG LLP. Financial information for the years ended December 31, 2001, 2000, 1999 and 1998 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. **See Management s Discussion and Analysis of Financial Condition and Results of Operations on page 18 for more information.**

(in thousands, except per share data)	Year Ended December 31, 2002	2001	2000	1999	1998
Operating Data:					
Interest and related portfolio income:					
Interest and dividends	$264,042	$240,464	$182,307	$121,112	$ 80,281
Premiums from loan dispositions	2,776	2,504	16,138	14,284	5,949
Post-merger gain on securitization of commercial mortgage loans					14,812
Fees and other income	43,110	46,142	13,144	5,744	5,696
Total interest and related portfolio income	309,928	289,110	211,589	141,140	106,738
Expenses:					
Interest	70,443	65,104	57,412	34,860	20,694
Employee	33,126	29,656	26,025	22,889	18,878
Administrative	21,504	15,299	15,435	12,350	11,921
Total operating expenses	125,073	110,059	98,872	70,099	51,493
Net investment income before income taxes and net realized and unrealized gains	184,855	179,051	112,717	71,041	55,245
Income tax expense (benefit)	930	(412)			787
Net investment income before net realized and unrealized gains	183,925	179,463	112,717	71,041	54,458
Net realized and unrealized gains:					
Net realized gains	44,937	661	15,523	25,391	22,541
Net unrealized gains (losses)	(571)	20,603	14,861	2,138	1,079
Total net realized and unrealized gains	44,366	21,264	30,384	27,529	23,620
Net increase in net assets resulting from operations	$228,291	$200,727	$143,101	$ 98,570	$ 78,078
Per Share:					
Diluted earnings per common share	$ 2.20	$ 2.16	$ 1.94	$ 1.64	$ 1.50
Dividends per common share(1)	$ 2.23	$ 2.01	$ 1.82	$ 1.60	$ 1.43
Weighted average common shares outstanding diluted(2)	103,574	93,003	73,472	60,044	51,974

(in thousands, except per share data)	At December 31, 2002	2001	2000	1999	1998
Balance Sheet Data:					
Portfolio at value	$2,488,167	$2,329,590	$1,788,001	$1,228,497	$807,119
Portfolio at cost	2,429,214	2,286,602	1,765,895	1,222,901	803,479
Total assets	2,794,319	2,460,713	1,853,817	1,290,038	856,079
Total debt outstanding(3)	998,450	1,020,806	786,648	592,850	334,350
Preferred stock issued to Small Business Administration(3)	7,000	7,000	7,000	7,000	7,000
Shareholders equity	1,546,071	1,352,123	1,029,692	667,513	491,358
Shareholders equity per common share (net asset value)	$ 14.22	$ 13.57	$ 12.11	$ 10.20	$ 8.79
Common shares outstanding at period end(2)	108,698	99,607	85,057	65,414	55,919

	Year Ended December 31, 2002	2001	2000	1999	1998
Other Data:					
Investments funded	$506,376	$680,329	$901,545	$751,871	$524,530
Repayments	143,167	74,461	111,031	139,561	138,081
Sales	213,474	129,980	280,244	198,368	81,013
Realized gains	95,562	10,107	28,604	31,536	25,757
Realized losses	(50,625)	(9,446)	(13,081)	(6,145)	(3,216)
Return on average assets	9.0%	9.4%	9.1%	9.2%	10.1%
Return on average equity	16.0%	17.0%	17.2%	17.5%	18.0%

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

(2) Excludes 234,977, 516,779 and 810,456 common shares held in the deferred compensation trust at and for the years ended December 31, 2000, 1999, and 1998, respectively.

(3) See Senior Securities on page 45 for more information regarding our level of indebtedness.

(in thousands, except per share data)	2002 Qtr 4	2002 Qtr 3	2002 Qtr 2	2002 Qtr 1	2001 Qtr 4	2001 Qtr 3	2001 Qtr 2	2001 Qtr 1
Quarterly Data (unaudited):								
Total interest and related portfolio income	$78,015	$76,329	$73,193	$82,391	$82,666	$72,634	$68,739	$65,071
Net investment income before net realized and unrealized gains	42,401	45,094	42,561	53,869	53,428	44,189	42,118	39,728
Net increase in net assets resulting from operations	53,356	45,520	73,454	55,961	42,890	59,703	46,106	52,028
Diluted earnings per common share	0.51	0.44	0.71	0.55	0.43	0.63	0.51	0.60
Dividends declared per common share	0.59	0.56	0.55	0.53	0.51	0.51	0.50	0.49
Net asset value per common share(1)	14.22	13.95	14.02	13.71	13.57	13.42	12.79	12.26

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

WHERE YOU CAN FIND

ADDITIONAL INFORMATION

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

We file annual, quarterly and current reports, proxy statements and other information with the SEC. You can inspect our SEC filings, without charge, at the SEC s Public Reference Room at 450 Fifth Street, NW, Washington, DC 20549. The SEC also maintains a web site at *http://www.sec.gov* that contains our SEC filings. You can also obtain copies of these materials from the SEC s Public Reference Room at 450 Fifth Street, NW, Washington, DC 20549, at prescribed rates. Please call the SEC at 1-800-SEC-0330 for further information on the Public Reference Room. Copies may also be obtained, after paying a duplicating fee, by electronic request to publicinfo@sec.gov or by written request to Public Reference Section, Washington, DC 20549-0102. You can also inspect reports and other information we file at the offices of the New York Stock Exchange, and you are able to inspect those at 20 Broad Street, New York, NY 10005.

RISK FACTORS

Investing in Allied Capital involves a number of significant risks relating to our business and investment objective. As a result, there can be no assurance that we will achieve our investment objective. In addition to the other information contained in this prospectus, you should consider carefully the following information before making an investment in shares of our common stock. In addition to the risk factors described below, other factors that could cause actual results to differ materially include:

- *the ongoing global economic downturn;*
- *risk associated with possible disruption in our operations due to terrorism; and*
- *future regulatory actions and conditions in our operating areas.*

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

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

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 December 31, 2002, approximately 89% of our total assets represented portfolio investments recorded at fair value. Pursuant to the requirements of the 1940 Act, we value substantially all of our investments at fair value as determined in good faith by our board of directors on a quarterly basis. Since there is typically no readily 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 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 to be used to capitalize the enterprise at a point in time. Conversely, we will record unrealized appreciation if we believe that the underlying portfolio company has appreciated in value and, therefore, our equity security has also appreciated in value. Without a readily available market value and because of the inherent uncertainty of valuation, the fair value of our investments determined in good faith by the board of directors may differ significantly from the values that would have been used had a ready market existed for the investments, and the differences could be material.

We adjust quarterly the valuation of our portfolio to reflect the 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 unrealized gains (losses).

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

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

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

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

Our financial results could be negatively affected if Business Loan Express fails to perform as expected. Business Loan Express, Inc. (BLX) is our largest portfolio investment. Our financial results could be negatively affected if BLX, as a portfolio company, fails to perform as expected or if government funding for, or regulations related to, the Small Business Administration 7(a) Guaranteed Loan Program change. At December 31, 2002, the investment totaled $256.8 million at value, or 9.2% of total assets.

In addition, as controlling shareholder of BLX, we have provided an unconditional guaranty to BLX s senior credit facility lenders in an amount equal to 50% of BLX s total obligations on its $124.0 million revolving credit facility. The amount we have guaranteed at December 31, 2002, was $51.6 million. This guaranty can only be called in the event of a default by BLX. We have also provided two standby letters of credit in connection with two term loan securitizations completed by BLX totaling $10.6 million.

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

We may not borrow money unless we maintain asset coverage for indebtedness of at least 200%, which may affect returns to shareholders. We must maintain asset coverage for total borrowings of at least 200%. Our ability to achieve our investment objective may depend in part on our continued ability to maintain a leveraged capital structure by borrowing from banks or other lenders on favorable terms. There can be no assurance that we will be able to maintain such leverage. If asset coverage declines to less than 200%, we may be required to sell a portion of our investments when it is disadvantageous to do so. As of December 31, 2002, our asset coverage for senior indebtedness was 270%.

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

At December 31, 2002, we had $998.5 million of outstanding indebtedness, bearing a weighted average annual interest cost of 6.9%. In order for us to cover these annual interest payments on indebtedness, we must achieve annual returns on our assets of at least 2.5%.

Illustration. The following table illustrates the effect of leverage on returns from an investment on 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) $2,794.3 million in total assets, (ii) an average cost of funds of 6.9%, (iii) $998.5 million in debt outstanding and (iv) $1,546.1 million of shareholders equity.

Assumed Return on Our Portfolio

(net of expenses)

	-20%	-10%	-5%	0%	5%	10%	20%
Corresponding return to shareholder	-40.7%	-22.6%	-13.6%	-4.6%	4.5%	13.5%	31.6%

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 before net realized and unrealized gains or losses, or net investment income, is dependent upon the difference between the rate at which we borrow funds and the rate at which we invest these funds. As a result, there can be no assurance that a significant change in market interest rates will not have a material adverse effect on our net investment income. In periods of rising interest rates, our cost of funds would increase, which would reduce our net investment income. We use a combination of long-term and short-term borrowings and equity capital to finance our investing activities. We utilize our revolving line of credit as a means to bridge to long-term financing. Our long-term fixed-rate investments are financed primarily with long-term fixed-rate debt and equity. We may use interest rate risk management techniques in an effort to limit our exposure to interest rate fluctuations. Such techniques may include various interest rate hedging activities to the extent permitted by the 1940 Act. We have analyzed the potential impact of changes in interest rates on interest income net of interest expense. Assuming that the balance sheet were to remain constant and no actions were taken to alter the existing interest rate sensitivity, a hypothetical immediate 1% change in interest rates would have affected the net income by less than 1% over a one year horizon. Although management believes that this measure is indicative of our sensitivity to interest rate changes, it does not adjust for potential changes in credit quality, size and composition of the assets on the balance sheet and other business developments that could affect net increase in assets resulting from operations, or net income. Accordingly, no assurances can be given that actual results would not differ materially from the potential outcome simulated by this estimate.

We will continue to need additional capital to grow because we must distribute our income. We will continue to need capital to fund incremental growth in our investments.

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

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

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

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

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

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

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

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

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

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

Disclosure Regarding Forward-Looking Statements

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

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

USE OF PROCEEDS

We intend to use the net proceeds from selling shares of our common stock for general corporate purposes, which include investment in the debt or equity securities of primarily private companies or non-investment grade commercial mortgage-backed securities, repayment of indebtedness, acquisitions and other general corporate purposes. We typically raise new equity when we have attractive investment opportunities. The supplement to this prospectus relating to an offering will more fully identify the use of the proceeds from such offering.

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

PRICE RANGE OF COMMON STOCK AND DISTRIBUTIONS

Our common stock is traded on the New York Stock Exchange under the symbol ALD. The following table lists the high and low closing sales prices for our common stock, the closing sales price as a percentage of net asset value (NAV) and quarterly dividends per share. On June 11, 2003, the last reported closing sale price of the common stock was $23.94 per share.

		Closing Sale Price(2)		Premium of High Sales Price to NAV	Premium of Low Sales Price to NAV	Declared Dividends
	NAV(1)	High	Low			
Year ended December 31, 2001						
First Quarter	$12.26	$24.44	$20.13	199%	164%	$0.49
Second Quarter	12.79	25.40	19.57	199	153	0.50
Third Quarter	13.42	24.83	21.50	185	160	0.51
Fourth Quarter	13.57	26.00	21.57	192	159	0.51
Year ending December 31, 2002						
First Quarter	$13.71	$28.93	$25.84	211%	188%	$0.53
Second Quarter	14.02	27.66	20.88	197	149	0.55
Third Quarter	13.95	24.49	18.90	176	135	0.56
Fourth Quarter	14.22	22.87	18.90	161	133	0.56
Extra Dividend						0.03
Year ended December 31, 2003						
First Quarter	$14.05	$23.18	$19.44	165%	138%	$0.57
Second Quarter (through June 11, 2003)	*	25.16	19.85	*	*	0.57

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

(2) Prior to June 6, 2001, our common stock was traded on the Nasdaq National Market under the symbol ALLC. The closing sale prices listed are as reflected on the respective exchanges for the periods presented.

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

Our common stock continues to trade in excess of net asset value. There can be no assurance, however, that we will maintain a premium to 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 Equity Capital and Dividends and Tax Status. We cannot assure that we will achieve investment results or maintain a tax status that will permit any particular level of dividend payment. Our credit facilities limit our ability to declare dividends if we default under certain provisions.

We maintain an opt in dividend reinvestment plan for our common shareholders. As a result, if our board of directors declares a dividend, then our new 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 2002 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:

- *the ongoing global economic downturn;*
- *risks associated with possible disruption in our operations due to terrorism; and*
- *future regulatory actions and conditions in our operating areas.*

Financial or other information presented for private finance portfolio companies has been obtained from the portfolio company, and the financial information presented may represent unaudited, projected or pro forma financial information, and therefore may not be indicative of actual results.

OVERVIEW

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

Our portfolio composition at December 31, 2002, 2001, and 2000, was as follows:

	2002	2001	2000
Private Finance	70%	68%	72%
Commercial Real Estate Finance	30%	32%	28%

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

PORTFOLIO AND INVESTMENT ACTIVITY

Total portfolio investment activity and yields at and for the years ended December 31, 2002, 2001, and 2000, were as follows:

($ in millions)	2002	2001	2000
Portfolio at value	$2,488.2	$2,329.6	$1,788.0
Investments funded	$ 506.4	$ 680.3	$ 901.5
Change in accrued or reinvested interest and dividends	$ 44.7	$ 51.6	$ 32.2
Principal repayments	$ 143.2	$ 74.5	$ 111.0
Sales(1)	$ 213.5	$ 130.0	$ 280.2
Yield(2)	14.0%	14.3%	14.1%

(1) Sales for the year ended December 31, 2000, include $128.5 million of small business loans sold.
(2) The weighted average yield on interest-bearing investments is computed as the (a) annual stated interest rate earned plus the annual amortization of loan origination fees, original issue discount, and market discount earned on accruing interest-bearing investments, divided by (b) total interest-bearing investments at value. The weighted average yield is computed as of the balance sheet date.

Private Finance

The private finance portfolio, investment activity, and yields at and for the years ended December 31, 2002, 2001, and 2000, were as follows:

($ in millions)	2002	2001	2000
Portfolio at value:			
Loans and debt securities	$1,151.2	$1,107.9	$ 966.3
Equity interests	592.0	487.2	316.2
Total portfolio	$1,743.2	$1,595.1	$1,282.5
Investments funded	$ 297.2	$ 287.7	$ 600.9
Change in accrued or reinvested interest and dividends	$ 42.6	$ 48.9	$ 31.8
Principal repayments	$ 129.3	$ 43.8	$ 75.7
Yield*	14.4%	14.8%	14.6%

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

Investments funded for the years ended December 31, 2002, 2001, and 2000, consisted of the following:

($ in millions)	Loans and Debt Securities	Equity Interests	Total
For the Year Ended December 31, 2002(1)			
Companies more than 25% owned	$ 86.1	$ 18.7	$104.8
Companies 5% to 25% owned	22.3	0.4	22.7
Companies less than 5% owned	154.6	15.1	169.7
Total	$263.0	$ 34.2	$297.2
For the Year Ended December 31, 2001(1)			
Companies more than 25% owned	$ 47.8	$ 78.3	$126.1
Companies 5% to 25% owned	13.5	4.5	18.0
Companies less than 5% owned	136.9	6.7	143.6
Total	$198.2	$ 89.5	$287.7
For the Year Ended December 31, 2000(1)			
Companies more than 25% owned	$ 10.8	$111.5	$122.3
Companies 5% to 25% owned	121.8	42.7	164.5
Companies less than 5% owned	288.7	25.4	314.1
Total	$421.3	$179.6	$600.9

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

At December 31, 2002, we had outstanding funding commitments of $92.8 million to portfolio companies, including $25.7 million committed to private venture capital funds. At December 31, 2002, we also had total commitments to private finance portfolio companies in the form of standby letters of credit and guarantees of $65.9 million.

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

We may acquire more than 50% of the common stock of a company in a control buyout transaction. Control investments are generally structured such that we earn a current return through a combination of interest income on our senior loans and subordinated debt, dividends on our preferred and common stock, and management or transaction services fees to compensate us for the managerial assistance that we provide to a controlled portfolio company. In some cases for companies that are more than 50%

owned, we may not accrue interest on loans and debt securities if such company is in need of additional capital. In such cases, we may defer current debt service. Our most significant investments acquired through control buyout transactions at December 31, 2002, were Business Loan Express, Inc. (BLX), acquired in 2000, and The Hillman Companies, Inc., acquired in 2001.

Business Loan Express, Inc. At December 31, 2002, our investment in BLX totaled $221.4 million at cost and $256.8 million at value, or 9.2% of our total assets, which includes unrealized appreciation of $35.4 million.

BLX is the nation s second largest non-bank government guaranteed lender utilizing the SBA s 7(a) Guaranteed Loan Program and is licensed by the SBA as a Small Business Lending Company (SBLC). BLX is a preferred lender as designated by the SBA in 68 markets across the United States, and originates, sells, and services small business loans. In addition to the 7(a) Guaranteed Loan Program, BLX originates conventional small business loans and originates loans under the USDA Business and Industry Guaranteed Loan Program. BLX has offices across the United States and is headquartered in New York, New York.

Summary financial data for BLX at and for the six months ended December 31, 2002, and their year ended June 30, 2002, was as follows:

($ in millions)	At and for the Six Months Ended December 31, 2002(1)	At and for the Year Ended June 30, 2002
Operating Data		
Total revenue	$ 51.1	$ 84.6
Profits before taxes(4)	$ 1.6	$ 3.6
Earnings before interest, taxes and management fees (EBITM)(4)	$ 24.5	$ 43.0
Balance Sheet Data		
Total assets(2)	$ 290.8	$ 277.1
Total debt	$ 194.9	$ 183.0
Total shareholders equity	$ 60.4	$ 59.9
Cash Flow Data		
Cash provided by operating activities	$ 8.0	$ 18.7
Cash used in investing activities	$ (14.3)	$ (37.1)
Cash provided by financing activities	$ 7.0	$ 3.0
Other Data		
Total loan originations	$ 308.8	$ 565.1
Serviced loan portfolio	$1,619.5	$1,372.6
Number of loans	2,373	2,083
Loan delinquencies(3)	8.6%	9.4%
Serviced Loan Portfolio by Industry		
Hotels	26%	27%
Gas stations/convenience stores	19	16
Restaurants	10	10
Manufacturing and industrial	10	10
Professional and retail services	9	10
Shrimp/fishing vessels	6	7
Recreation	5	5
Child care and health care services	4	4
Other	11	11
Total	100%	100%

(1) The results of operations, changes in cash flows, and loan originations for the six months ended December 31, 2002, are not necessarily indicative of the operating results to be expected for the full year.
(2) Included in total assets is $6 million of goodwill. There is no other goodwill on BLX s balance sheet. We acquired 94.9% of BLC Financial Services, Inc. on December 31, 2000. Push-down accounting was not required with respect to this transaction; accordingly, goodwill was not recorded by BLX.
(3) Represents the percentage of loans in the total serviced loan portfolio that are greater than 30 days delinquent, which includes loans in workout status. Loans greater than 30 days delinquent for the SBA 7(a) loan portfolio only, which are included in the total serviced loan portfolio, were 8.7% at December 31, 2002.
(4) BLX incurred certain one-time expenses of approximately $1 million for the six months ended December 31, 2002, associated with the Amresco Independence Funding transaction and its reorganization to an LLC.

BLX sells or securitizes substantially all of the loans it originates. BLX currently sells the guaranteed piece of SBA 7(a) guaranteed loans for cash premiums of up to 10% of the guaranteed loan amount plus a retained annual servicing fee generally between 1.0%

and 2.0% of the guaranteed loan amount. Alternatively, BLX may sell the guaranteed pieces of SBA 7(a) guaranteed loans at par and retain an annual servicing spread, at current prices of generally between 4.0% and 4.8%. BLX securitizes the unguaranteed pieces of the SBA 7(a) loans and conventional loans it originates. Typically, BLX retains up to 2.7% of the term loan securitization pools and receives a spread from the excess of loan interest received on the loans sold over the interest cost on the securities issued in the securitization generally between 4.7% and 4.9%. Over 90-day delinquencies in securitized pools were approximately 1% of loans securitized at December 31, 2002.

As a result of BLX s guaranteed loan sales and securitization transactions, BLX had assets at December 31, 2002, of approximately $124.3 million representing the residual interests in and servicing assets for loans sold or securitized, together referred to as Residual Interests. These Residual Interests represent the discounted present value of estimated future cash flow streams to be received from loans sold or securitized after making allowances for estimated prepayments, losses, and loan delinquencies.

If scheduled loan payments on all loans were to be received as stated in the loan agreements, estimated future cash flows to BLX from loans sold or securitized would total approximately $499.7 million in the aggregate over the remaining term of these loans. Of the approximate $499.7 million, estimated cash flows for the 12 months ended December 31, 2003, 2004, 2005, and 2006, would be approximately $38.5 million, $37.2 million, $36.3 million, and $35.3 million, respectively, although there can be no assurance that scheduled loan payments will approximate actual cash received.

The loans originated by BLX are generally secured by commercial real estate. Loans originated under the SBA 7(a) Guaranteed Loan Program also require the personal guarantee of the borrower and, in many cases, the loans are also secured by additional real estate collateral. Because the loans are secured by collateral, BLX s annual loan losses for its serviced SBA 7(a) loans, computed using the unguaranteed balance of the SBA 7(a) loan portfolio, were less than 1% on average for the last five fiscal years.

Because of the government guarantee attached to SBA 7(a) loans, BLX s loss of principal exposure to loans greater than 90 days delinquent at December 31, 2002, was $38.4 million in the aggregate. At December 31, 2002, BLX has accrued loss reserves of $10.6 million, which when deducted from 90-day delinquencies would reduce their unreserved financial exposure to 90-day delinquencies to $27.8 million. BLX s reserves represent 28% of over 90-day delinquent loans. BLX s loans are underwritten to have substantial collateral coverage and also carry personal guarantees of the borrowers.

BLX s sources of cash flow from operations include net income, cash proceeds from loan sales net of cash used for loans originated, and changes in working capital. BLX s cash used in investing activities includes the origination of residual interests from loans sold, net of collections of residual interests, and cash used to purchase fixed assets.

BLX has a three-year $124 million revolving credit facility that matures in March 2004. As the controlling shareholder of BLX, we have provided an unconditional guaranty to the revolving credit facility lenders in an amount of up to 50% of the total obligations (consisting of principal, accrued interest, and other fees) of BLX under the revolving credit facility. The amount guaranteed by us at December 31, 2002, was $51.6 million. This guaranty can be called by the lenders only in the event of a default by BLX. BLX was in compliance with the terms of the revolving credit facility at December 31, 2002.

We have also provided two standby letters of credit in connection with two term securitization transactions completed by BLX totaling $10.6 million.

In January 2003, BLX announced the completion of a $128.0 million acquisition of performing loans and other assets from Amresco Independence Funding. BLX purchased $121.5 million of performing loans at par and other assets purchased totaled $6.5 million. The acquisition has increased BLX s serviced portfolio to over $2 billion, and BLX now serves in excess of 2,800 small business borrowers. We provided $50 million of the capital to fund this acquisition. Our $50 million financing was in the form of a short-term revolving credit facility of $25 million to fund the temporary capital needs of construction loans purchased and loans pending sale, as well as $25 million of preferred equity to support the future growth potential of the company post acquisition.

In February 2003, BLX completed a corporate reorganization to a limited liability company. As BLX LLC moves forward, its taxable earnings will flow directly to its members and we represent approximately 95% of the economic interests in the LLC. In connection with the reorganization, BLX has changed its fiscal year end to September 30.

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 impact on BLX or its operations. As of October 1, 2002, the SBA implemented a maximum loan size of $500,000 for loans originated through the SBA 7(a) Guaranteed Loan Program due to Federal budget constraints. In February 2003, legislation was enacted to return the SBA 7(a) Guaranteed Loan Program to a sufficient level of funding. This legislation has enabled the SBA to return the maximum loan size to previous levels.

The Hillman Companies, Inc. At December 31, 2002, our investment in Hillman totaled $92.6 million at cost and $180.5 million at value, or 6.5% of total assets. During the fourth quarter of 2002, Hillman distributed $6.5 million of preferred stock in STS Operating, Inc. (STS) to us, which reduced our cost basis in Hillman s common stock and added to our investment in STS.

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

For the year ended December 31, 2002, Hillman had total revenue of $286.8 million, earnings before interest, taxes, depreciation, amortization, and management fees, or EBITDAM, of $50.2 million, and profits before taxes of $10.0 million. Hillman had total assets of $368.9 million and total debt of $146.7 million at December 31, 2002.

Commercial Real Estate Finance

The commercial real estate finance portfolio, investment activity, and yields at and for the years ended December 31, 2002, 2001, and 2000, were as follows:

($ in millions)	2002	2001	2000
Portfolio at value:			
CMBS bonds	$555.5	$558.3	$311.3
CDO preferred shares	52.8	24.2	
Commercial mortgage loans	63.7	79.6	106.4
Residual interest	69.0	69.9	81.7
Real estate owned	4.0	2.5	6.1
Total portfolio	$745.0	$734.5	$505.5
Investments funded	$209.2	$392.6	$149.0
Change in accrued or reinvested interest	$ 2.1	$ 2.7	$ 1.1
Principal repayments	$ 13.9	$ 30.7	$ 24.3
CMBS and commercial real estate loan sales	$213.5	$130.0	$151.7
Yield*	13.4%	13.5%	13.1%

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

Our primary commercial real estate finance investment activity is the investment in non-investment grade commercial mortgage-backed securities, or CMBS. We believe that CMBS is an attractive asset class because of the yields that can be earned on securities that are secured by commercial mortgage loans and ultimately commercial real estate properties. Our CMBS investment activity level will be dependent upon our ability to invest in CMBS at attractive yields. We plan to continue our CMBS investment activity; however, in order to maintain a balanced portfolio, we expect that CMBS will not exceed 25% of our total assets.

Our commercial real estate investment activity for the years ended December 31, 2002, 2001, and 2000, was as follows:

($ in millions)	Face Amount	Discount	Amount Funded	Yield(1)(2)
For the Year Ended December 31, 2002				
CMBS bonds	$302.5	$(140.2)	$162.3	13.4%
CDO preferred shares	29.0		29.0	17.5%
Commercial mortgage loans	11.7	(1.7)	10.0	13.5%
Real estate owned	7.9		7.9	
Total	$351.1	$(141.9)	$209.2	14.0%
For the Year Ended December 31, 2001				
CMBS bonds	$661.4	$(295.6)	$365.8	14.0%
CDO preferred shares	24.6		24.6	16.9%
Commercial mortgage loans	2.2		2.2	10.0%
Total	$688.2	$(295.6)	$392.6	14.2%

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($ in millions)	Face Amount	Discount	Amount Funded	Yield(1)(2)
For the Year Ended December 31, 2000				
CMBS bonds	$244.6	$(120.3)	$124.3	14.7%
Commercial mortgage loans	25.5	(0.8)	24.7	10.9%
Total	$270.1	$(121.1)	$149.0	14.1%

(1) The yield on new CMBS bond investments will vary from period to period depending on the concentration of lower yielding BB+, BB, and BB CMBS bonds purchased in that period to the total amount invested.
(2) Total yield calculation excludes new investments in real estate owned.

CMBS Bonds. The non-investment grade and unrated tranches of the CMBS bonds in which we invest are junior in priority for payment of interest and principal to the more senior tranches of the related CMBS bond issuance. Cash flow from the underlying mortgages generally is allocated first to the senior tranches, with the most senior tranches having a priority right to the cash flow. Then, any remaining cash flow is allocated, generally, among the other tranches in order of their relative seniority. To the extent there are defaults and unrecoverable losses on the underlying mortgages resulting in reduced cash flows, our most subordinate tranche will bear this loss first. At December 31, 2002, our CMBS bonds were subordinate to 91% to 97% of the tranches of bonds issued in various CMBS transactions. Given that the non-investment grade CMBS bonds in which we invest are junior in priority for payment of principal and interest, we invest in these CMBS bonds at a discount from the face amount of the bonds. The discount increases with the decrease in the seniority of the CMBS bonds. For the years ended December 31, 2002, 2001, and 2000, the average discount for the CMBS bonds in which we invested was 46%, 45%, and 49%, respectively.

The underlying pools of mortgage loans that are collateral for our new CMBS bond investments for the years ended December 31, 2002, 2001, and 2000, had respective underwritten loan to value and underwritten debt service coverage ratios as follows:

	2002		2001		2000	
Loan to Value Ranges ($ in millions)	**Amount**	**Percentage**	**Amount**	**Percentage**	**Amount**	**Percentage**
Less than 60%	$ 909.3	20%	$1,259.7	15%	$ 577.1	14%
60-65%	287.3	6	941.6	11	402.8	10
65-70%	587.9	13	1,140.6	14	648.1	16
70-75%	1,214.5	27	2,400.4	29	1,450.9	36
75-80%	1,477.5	33	2,466.4	30	958.9	23
Greater than 80%	47.8	1	119.6	1	36.6	1
Total	$4,524.3	100%	$8,328.3	100%	$4,074.4	100%
Weighted average loan to value	68.5%		69.7%		70.2%	

Debt Service Coverage Ratio(1) Ranges ($ in millions)	2002 Amount	2002 Percentage	2001 Amount	2001 Percentage	2000 Amount	2000 Percentage
Greater than 2.00	$ 366.9	8%	$ 484.8	6%	$ 197.0	5%
1.76-2.00	229.6	5	158.2	2	99.1	3
1.51-1.75	477.4	11	855.0	10	341.8	8
1.26-1.50	2,739.6	60	5,008.3	60	2,204.5	54
Less than 1.25	710.8	16	1,822.0	22	1,232.0	30
Total	$4,524.3	100%	$8,328.3	100%	$4,074.4	100%
Weighted average debt service coverage ratio	1.41		1.48		1.35	

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

As a part of our strategy to maximize our return on equity capital, we sold CMBS bonds rated BB+ through B during the year ended December 31, 2002, with a cost basis of $205.9 million, and bonds rated BB+ through BB-during the years ended December 31, 2001 and 2000, with a cost basis of $124.5 million and $98.7 million, respectively. These bonds had a weighted average effective yield of 11.5%, 10.3%, and 11.5% and were sold for $225.6 million, $126.8 million, and $102.5 million, respectively, resulting in realized gains on the sales. The sales of these primarily lower yielding bonds increased our overall liquidity.

The effective yield on our CMBS bond portfolio at December 31, 2002, 2001, and 2000, was 14.2%, 14.7%, and 15.4%, respectively. The yield on the CMBS bond portfolio at any point in time will vary depending on the concentration of lower yielding BB+, BB, and BB- CMBS bonds held in the portfolio. At December 31, 2002, 2001, and 2000, the unamortized discount related to the CMBS bond portfolio was $649.5 million, $611.9 million, and $364.9 million, respectively. At December 31, 2002, the CMBS bond portfolio had a fair value of $555.5 million, which included net unrealized appreciation on the CMBS bonds of $31.8 million.

During January 2003, we sold BB+ through B CMBS bonds with a cost basis of $115.7 million for $128.8 million in cash proceeds. We recognized a gain on this sale of $12.2 million, net of a realized loss of $0.9 million from a hedge related to the CMBS bonds sold. After completion of this sale, the CMBS bond portfolio yield increased to approximately 15%. However, the yield on the CMBS bond portfolio will continue to fluctuate as we invest in more CMBS bond issuances that contain higher rated, lower yielding BB+, BB, and BB-bonds.

At December 31, 2002, the underlying pools of mortgage loans that are collateral for our CMBS bonds consisted of approximately 4,500 commercial mortgage loans with a total outstanding principal balance of $25.0 billion. At December 31, 2002 and 2001, 1.0% and 0.5%, respectively, of the loans in the underlying collateral pool for our CMBS bonds were over 30 days delinquent or were classified as real estate owned.

Collateralized Debt Obligation Preferred Shares. During the years ended December 31, 2002 and 2001, we invested in the preferred shares of three and one, respectively, collateralized debt obligations, or CDOs, which are secured by investment grade unsecured debt issued by various real estate investment trusts, or REITs, and investment and non-investment grade CMBS bonds. The investment grade REIT collateral consists of debt with a cut-off balance of $1,017.6 million and was issued by 42 REITs. The investment grade CMBS collateral consists of CMBS bonds with a face amount of $479.0 million issued in 39 separate CMBS transactions. The non-investment grade CMBS collateral consists of BB+, BB, and BB CMBS bonds with a face amount of $463.4 million issued in 39 separate CMBS transactions. Included in the CMBS collateral for the CDOs are $397.9 million of CMBS bonds that are senior in priority of repayment to certain lower rated CMBS bonds held by us, which were issued in 23 separate CMBS transactions. The preferred shares are junior in priority for payment of principal to the more senior tranches of debt issued by the CDOs. To the extent there are defaults and unrecoverable losses on the underlying collateral resulting in reduced cash flows, the preferred shares will bear this loss first. At December 31, 2002, our preferred shares in the CDOs were subordinate to approximately 96% of the more senior tranches of debt issued by the CDOs. Income received from our CDO investments provided an effective yield of 17.2% and 16.9% at December 31, 2002 and 2001, respectively.

Commercial Mortgage Loans and Real Estate Owned. Since 1998, we have been liquidating much of our whole commercial mortgage loan portfolio so that we can redeploy the proceeds into higher yielding assets. For the years ended December 31, 2002, 2001, and 2000, we sold $7.5 million, $5.5 million, and $53.0 million, respectively, of commercial mortgage loans and real estate owned. At December 31, 2002, our whole commercial mortgage loan portfolio had been reduced to $63.7 million from $79.6 million at December 31, 2001.

Residual Interests. The residual interest primarily consists of a retained interest from a 1998 asset securitization whereby bonds were sold in three classes rated AAA, AA and A. The residual interest represents a right to cash flows from the underlying collateral pool of loans after these senior bond obligations are satisfied. At December 31, 2002, one class of bonds rated AAA was outstanding totaling $17.6 million. We have the right to call the bonds upon a minimum of ten days notice to the bondholders. Once the bonds are fully repaid, either through the cash flows from the securitized loans or due to us calling the bonds, the remaining loans in the trust will be returned to us as payment on the residual interest. At December 31, 2002, the value of the cash, loans and REO in the trust totaled $86.6 million.

Portfolio Asset Quality

Portfolio by Grade. We employ a standard grading system for the entire portfolio. Grade 1 is used for those investments from which a capital gain is expected. Grade 2 is used for investments performing in accordance with plan. Grade 3 is used for investments that require closer monitoring; however, no loss of interest or principal is expected. Grade 4 is used for investments that are in workout and for which some loss of current interest 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 December 31, 2002 and 2001, our portfolio was graded as follows:

	2002		2001	
Grade	Portfolio at Value	Percentage of Total Portfolio	Portfolio at Value	Percentage of Total Portfolio
($ in millions)				
1	$ 801.0	32.1%	$ 603.3	25.9%
2	1,400.8	56.3	1,553.8	66.7
3	166.0	6.7	79.5	3.4
4	23.6	1.0	44.5	1.9
5	96.8	3.9	48.5	2.1
	$2,488.2	100.0%	$2,329.6	100.0%

Total Grades 4 and 5 assets as a percentage of the total portfolio at value at December 31, 2002 and 2001, were 4.9% and 4.0%, respectively. Included in Grades 4 and 5 assets at December 31, 2002 and 2001, were assets totaling $24.1 million and $6.6 million, respectively, that are secured by commercial real estate. Grade 4 and 5 assets include loans, debt securities, and equity securities. We expect that a number of portfolio companies will be in the Grades 4 or 5 categories from time to time. Part of the business of private finance is working with troubled portfolio companies to improve their businesses and protect our investment. The number of portfolio companies and related investment amount included in Grades 4 and 5 may fluctuate from period to period. We continue to follow our historical practice of working with a troubled portfolio company in order to recover the maximum amount of our investment, but record unrealized depreciation for the expected amount of the loss when such exposure is identified.

At December 31, 2002, we saw an increase in Grade 3 assets in this difficult economy. We have been working with a number of portfolio companies that are in the process of restructuring their operations or balance sheets due to changes in the economic environment or other changes in their business, and we have classified investments in these types of situations in Grade 3 because they are close monitoring situations. We may record some depreciation on a Grade 3 investment to reflect any decline in value while the company is in a close monitoring situation; however, we currently do not expect a loss of investment return or principal for these assets.

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

For the total investment portfolio, workout loans and debt securities (which excludes equity securities that are included in the total Grade 4 and 5 assets above) not accruing interest that were classified in Grade 4 and 5 were $89.1 million at value at December 31, 2002, or 3.6% of the total portfolio. Included in this category at December 31, 2002, were loans of $13.0 million that were secured by commercial real estate. Workout loans and debt securities not accruing interest were $85.0 million at value at December 31, 2001, or 3.6% of the total portfolio, of which $8.9 million was related to portfolio companies in liquidation and $4.1 million represented loans secured by commercial real estate. As of December 31, 2002, $7.6 million representing receivables related to portfolio companies in liquidation were included in other assets. In addition to Grade 4 and 5 assets that are in workout, loans and debt securities to companies that are more than 50% owned by us that were not accruing interest totaled $63.6 million at value at December 31, 2002, and loans and debt securities to companies that are less than 50% owned by us that were not in workout but were not accruing interest totaled $7.2 million and $23.9 million at value at December 31, 2002 and 2001, respectively.

Loans and Debt Securities Over 90 Days Delinquent. Loans and debt securities greater than 90 days delinquent were $103.1 million at value at December 31, 2002, or 4.1% of the total portfolio. Included in this category were loans valued at $26.0 million that were secured by commercial real estate. Loans and debt securities greater than 90 days delinquent were $39.1 million at value at December 31, 2001, or 1.7% of the total portfolio. Included in this category were loans valued at $14.1 million that were secured by commercial real estate.

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

Hedging Activities

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

The total obligations to replenish borrowed Treasury securities, including accrued interest payable on the obligations, were $197.0 million and $47.3 million at December 31, 2002 and 2001, respectively, which included unrealized depreciation on the obligations of $7.1 million and unrealized appreciation on the obligations of $1.2 million, respectively, due to changes in the yield on the borrowed Treasury securities. The net proceeds related to the sales of the borrowed Treasury securities were $189.3 million and $48.5 million at December 31, 2002 and 2001, respectively. Under the terms of the transactions, we have provided additional cash collateral of $5.4 million at December 31, 2002, for the difference between the net proceeds related to the sales of the borrowed Treasury securities and the obligations to replenish the securities on the weekly settlement date, which is included in deposits of proceeds from sales of borrowed Treasury securities in the accompanying financial statements.

RESULTS OF OPERATIONS

Comparison of the Years Ended December 31, 2002, 2001, and 2000

The following table summarizes our condensed operating results for the years ended December 31, 2002, 2001, and 2000.

(in thousands, except per share amounts)	2002	2001	Change	Percent Change	2001	2000	Change	Percent Change
Interest and Related Portfolio Income								
Interest and dividends	$264,042	$240,464	$ 23,578	10%	$240,464	$182,307	$ 58,157	32%
Premiums from loan dispositions	2,776	2,504	272	11%	2,504	16,138	(13,634)	(84)%
Fees and other income	43,110	46,142	(3,032)	(7)%	46,142	13,144	32,998	251%
Total interest and related portfolio income	309,928	289,110	20,818	7%	289,110	211,589	77,521	37%
Expenses								
Interest	70,443	65,104	5,339	8%	65,104	57,412	7,692	13%
Employee(1)	33,126	29,656	3,470	12%	29,656	26,025	3,631	14%
Administrative(1)	21,504	15,299	6,205	41%	15,299	15,435	(136)	(1)%
Total operating expenses	125,073	110,059	15,014	14%	110,059	98,872	11,187	11%
Net investment income before income taxes and net realized and unrealized gains	184,855	179,051	5,804	3%	179,051	112,717	66,334	59%
Income tax expense (benefit)	930	(412)	1,342	(326)%	(412)		(412)	
Net investment income before net realized and unrealized gains	183,925	179,463	4,462	2%	179,463	112,717	66,746	59%
Net Realized and Unrealized Gains								
Net realized gains	44,937	661	44,276	*	661	15,523	(14,862)	*
Net unrealized gains (losses)	(571)	20,603	(21,174)	*	20,603	14,861	5,742	*
Total net realized and unrealized gains	44,366	21,264	23,102	*	21,264	30,384	(9,120)	*
Net income	$228,291	$200,727	$ 27,564	14%	$200,727	$143,101	$ 57,626	40%
Diluted earnings per common share	$ 2.20	$ 2.16	$ 0.04	2%	$ 2.16	$ 1.94	$ 0.22	11%
Weighted average common shares outstanding diluted	103,574	93,003	10,571	11%	93,003	73,472	19,531	27%

* Net realized and net unrealized gains and losses can fluctuate significantly from year to year. As a result, annual comparisons of net realized and net unrealized gains and losses may not be meaningful.

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

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

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

The increase in interest and dividend income earned resulted primarily from the growth of our investment portfolio and the dividends earned on certain equity securities. The level of interest income is directly related to the balance of the interest-bearing investment portfolio multiplied by the weighted average yield. The weighted average yield varies from period to period based on the current stated interest rate earned on interest-bearing investments and the amount of loans and debt securities for which interest is not accruing. Our interest-bearing investments in the portfolio increased by 2.9% to $1,896.2 million at December 31, 2002, from $1,842.4 million at December 31, 2001, and increased by 25.2% during 2001 from $1,471.8 million at December 31, 2000. The weighted average yield on the interest-bearing investments in the portfolio at December 31, 2002, 2001, and 2000, was as follows:

Included in premiums from loan dispositions are prepayment premiums of $2.8 million, $2.0 million, and $2.8 million for the years ended December 31, 2002, 2001, and 2000, respectively. While the scheduled maturities of private finance and commercial real estate loans range from five to ten years, it is not unusual for our borrowers to refinance or pay off their debts to us ahead of schedule. Because we seek to finance primarily seasoned, performing companies, such companies at times can secure lower cost financing as their balance sheets strengthen or as more favorable interest rates become available, or a company may enter into a transaction that triggers the early repayment of their debt to us. Therefore, we generally structure our loans to require a prepayment premium for the first three to five years of the loan. Premiums from loan dispositions for the year ended December 31, 2000, included premiums from loan sales of $13.3 million primarily due to the loan sale activities of our small business lending operation prior to its merger with BLX at the end of 2000.

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

Fees and other income for the year ended December 31, 2002, included fees of $15.0 million related to structuring and diligence, fees of $4.4 million related to transaction services provided to portfolio companies, and fees of $23.2 million related to management services provided to portfolio companies, other advisory services, and guaranty fees. Fees and other income for the years ended December 31, 2001 and 2000, included structuring and diligence fees of $15.5 million and $6.0 million, respectively, and management services, other advisory services and guaranty fees of $13.1 million and $3.1 million, respectively. For the year ended December 31, 2001, fees and other income also included $16.6 million related to transaction services provided to portfolio companies. Fees and other income are generally related to specific transactions or services, and, therefore, may vary substantially from period to period. Points or loan origination fees that represent yield enhancement on a loan are capitalized and amortized into interest income over the life of the loan.

BLX and Hillman are our most significant portfolio investments and together represented 15.6% of our total assets at December 31, 2002. Total interest and related portfolio income earned from these investments for the years ended December 31, 2002, 2001, and 2000, were $49.5 million, $39.6 million, and $2.7 million, respectively. In July 2002, we sold WyoTech Acquisition Corporation, which was a significant portfolio investment during 2002, 2001, and 2000. Total interest and related portfolio income earned on this investment for the years ended December 31, 2002, 2001, and 2000 was $3.6 million, $5.5 million, and $2.4 million, respectively.

Operating Expenses. Operating expenses include interest, employee, and administrative expenses. Our single largest expense is interest on our indebtedness. The fluctuations in interest expense during the years ended December 31, 2002, 2001, and 2000, are attributable to changes in the level of our borrowings under various notes payable and debentures and our revolving credit facility. Our borrowing activity and weighted average interest cost, including fees and closing costs, at and for the years ended December 31, 2002, 2001, and 2000, were as follows:

($ in millions)	2002	2001	2000
Total Outstanding Debt	$998.5	$1,020.8	$786.6
Average Outstanding Debt	$938.1	$ 847.1	$707.4
Weighted Average Interest Cost	6.9%	7.0%	8.3%
BDC Asset Coverage*	270%	245%	245%

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

Employee expenses include salaries and employee benefits. The change in employee expense reflects the effect of wage increases and the change in mix of employees given their area of responsibility and relevant experience level. Total employees were 105, 97, and 97 at December 31, 2002, 2001, and 2000, respectively.

Administrative expenses include the leases for our headquarters in Washington, DC, and our regional offices, travel costs, stock record expenses, directors fees, legal and accounting fees, insurance premiums, and various other expenses. The increase in administrative expenses as compared to the year ended December 31, 2001, includes approximately $1.6 million from legal, consulting, and other fees, including costs incurred to defend against class action lawsuits alleging violations of securities laws and to respond to market activity in our stock. Administrative expenses also increased by approximately $0.9 million due to increased costs for corporate liability insurance, $0.7 million due to travel costs, including corporate aircraft depreciation, and $0.7 million due to outsourced technology assistance.

During the fourth quarter of 2002, we closed our office in Frankfurt, Germany, due to difficulty in finding attractive investment opportunities in Germany. In conjunction with this, we incurred employee and administrative costs of $0.5 million and $2.5 million, respectively, which reduced our net income for the year ended December 31, 2002, by a total of $3.0 million, or $0.03 per share.

Realized Gains and Losses. Net realized gains result from the sale of equity securities associated with certain private finance investments, the sale of CMBS bonds, and the realization of unamortized discount resulting from the sale and early repayment of private finance loans and commercial mortgage loans, offset by losses on investments. Net realized gains and losses for the years ended December 31, 2002, 2001, and 2000, were as follows:

($ in millions)	**2002**	**2001**	**2000**
Realized Gains	$ 95.5	$ 10.1	$ 28.6
Realized Losses	(50.6)	(9.4)	(13.1)
Net Realized Gains	$ 44.9	$ 0.7	$ 15.5

Realized gains and losses for the year ended December 31, 2002, resulted from various private finance and commercial real estate finance transactions. Realized gains for the year ended December 31, 2002, primarily resulted from transactions involving eight private finance portfolio companies, including WyoTech Acquisition Corporation ($60.8 million), Aurora Communications, LLC ($4.9 million), Oriental Trading Company, Inc. ($2.5 million), Kirkland s, Inc. ($2.2 million), American Home Care Supply, LLC ($1.3 million), Autania AG ($0.8 million), FTI Consulting, Inc. ($0.7 million), and Cumulus Media, Inc. ($0.5 million). In addition, gains were also realized on CMBS bonds ($19.1 million, net of a realized loss of $0.5 million from a hedge related to the CMBS bonds sold), and one commercial real estate investment ($1.3 million). For the years ended December 31, 2002, 2001, and 2000, we reversed previously recorded unrealized appreciation totaling $78.8 million, $6.5 million, and $7.5 million, respectively, when gains were realized. When we exit an investment and realize a gain, we make an accounting entry to reverse any unrealized appreciation we had previously recorded to reflect the appreciated value of the investment.

The most significant gain realized in 2002 was from the sale of WyoTech Acquisition Corporation. We acquired WyoTech in December of 1998 and owned 91% of the common equity of WyoTech. On July 1, 2002, WyoTech was sold for $84.4 million. At June 30, 2002, our investment had a cost basis of $16.4 million, which represented all of the debt ($12.6 million), preferred stock ($3.7 million) and 91% of the common equity capital ($0.1 million) of WyoTech. Our total proceeds from the sale of WyoTech, including the repayment of debt and preferred stock and the sale of our common equity ownership, were $77.2 million. We recognized a realized gain of $60.8 million on the transaction. The sale of WyoTech is subject to post-closing working capital adjustments, if any, and customary indemnification provisions.

Realized losses for the year ended December 31, 2002, primarily resulted from transactions involving eleven private finance portfolio companies, including Velocita, Inc. ($16.0 million), Schwinn Holdings Corporation ($7.9 million), Convenience Corporation of America ($5.8 million), Startec Global Communications Corporation ($4.5 million), The Loewen Group, Inc. ($2.7 million), Monitoring Solutions, Inc. ($1.7 million), Most Confiserie ($1.0 million), NetCare AG ($1.0 million), iSolve Incorporated ($0.9 million), Sure-Tel, Inc. ($0.5 million), and Soff-Cut Holdings, Inc. ($0.5 million), and also from nine commercial real estate investments ($4.7 million). For the years ended December 31, 2002, 2001, and 2000, we reversed previously recorded unrealized depreciation totaling $49.0 million, $8.9 million, and $12.0 million, respectively, when losses were realized. When we exit an investment and realize a loss, we make an accounting entry to reverse any realized depreciation we had previously recorded to reflect the depreciated value of the investment.

Unrealized Gains and Losses. We determine the value of each investment in our portfolio on a quarterly basis, and changes in value result in unrealized gains or losses being recognized. At December 31, 2002, approximately 89% of our total assets represented portfolio investments recorded at fair value. Value, as defined in Section 2(a)(41) of the Investment Company Act of 1940, is (i) the market price for those securities for which a market quotation is readily available and (ii) for all other securities and assets, fair value is as determined in good faith by the board of directors. Since there is typically no readily available market value for the investments in our portfolio, we value substantially all of our portfolio investments at fair value as determined in good faith by the board of directors pursuant to a valuation policy and a consistently applied valuation process. 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 company does not currently support the cost of our debt or equity investment. Conversely, we will record unrealized appreciation if we believe that the underlying portfolio company has appreciated in value and, therefore, our equity security has also appreciated in value. Changes in fair value are recorded in the statement of operations as unrealized gains and losses.

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

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

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

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

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

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

For the portfolio, net unrealized gains (losses) for the years ended December 31, 2002, 2001, and 2000, were as follows:

($ in millions)	2002	2001	2000
Unrealized gains:			
Unrealized gains	$ 215.0	$ 88.0	$ 29.2
Reversal of previously recorded unrealized depreciation associated with realized losses	49.0	8.9	12.0
Total unrealized gains	$ 264.0	$ 96.9	$ 41.2
Unrealized losses:			
Unrealized losses	$(185.8)	$(69.8)	$(18.8)
Reversal of previously recorded unrealized appreciation associated with realized gains	(78.8)	(6.5)	(7.5)
Total unrealized losses	$(264.6)	$(76.3)	$(26.3)
Net unrealized gains (losses)	$ (0.6)	$ 20.6	$ 14.9

Unrealized gains associated with changes in the value of investments in our portfolio of $215.0 million for the year ended December 31, 2002, resulted from the recording of new or additional unrealized appreciation of $214.6 million and the reversal of previously recorded unrealized depreciation of $0.4 million. Unrealized appreciation for the year resulted primarily from the increase in the value of our investments in The Hillman Companies, Inc. ($87.8 million), Business Loan Express, Inc. ($19.9 million), CMBS bonds ($29.6 million, net of an unrealized loss of $8.2 million from a hedge related to the CMBS bonds), WyoTech Acquisition Corporation ($16.6 million), Blue Rhino Corporation ($16.6 million), CorrFlex Graphics LLC ($13.8 million), Kirkland s, Inc. ($5.8 million), CyberRep ($4.9 million), Morton Grove Pharmaceuticals, Inc. ($4.4 million), and Oriental Trading Company, Inc. ($4.3 million).

The most significant components of unrealized gains resulted from our investments in Hillman, BLX, and CMBS bonds. The following is a simplified summary of the methodology that we used to determine the fair value of these investments.

The Hillman Companies, Inc. Hillman achieved several milestones in 2002, including the completion of two acquisitions, the reduction of excess corporate overhead, and significant improvements to its operating structure. In performing our valuation analysis of Hillman at December 31, 2002, we quantified the impact of these milestones in order to determine normalized EBITDAM of approximately $58.5 million.

We believe the current enterprise value for Hillman is approximately $409.5 million, or 7.0 times 2002 normalized EBITDAM of $58.5 million. The multiple was determined by obtaining a range of multiples representing the multiple of enterprise value to EBITDA for comparable public companies and the multiple of enterprise value to EBITDA for acquisition transactions involving companies in Hillman s peer group. From this market comparable analysis, we selected a 7.0 times multiple for our valuation. Using an enterprise value of $409.5 million, the value of our equity investment in Hillman is approximately $138.4 million, or $87.8 million greater than our cost basis of $50.6 million.

Business Loan Express, Inc. To determine the value of our investment in BLX at December 31, 2002, we performed four separate valuation analyses to determine its enterprise value: (1) analysis of comparable public company trading multiples, (2) analysis of BLX s value assuming an initial public offering, (3) analysis of merger and acquisition transactions for financial services companies, and (4) a discounted dividend analysis. The range of enterprise values resulting from these analyses was between $366 million and $504 million. We used an enterprise value of $373 million to value our equity investment in BLX. This enterprise value is based on a pro forma equity value of 7.4 times trailing pro forma BLX net income adjusted for certain capital structure changes that would likely occur should the company be sold. Given an enterprise value of $373 million, the equity value for our common stock investment has a value of $140.0 million. The common equity value of $140.0 million at December 31, 2002, increased by $19.9 million over the equity value of $120.1 million at December 31, 2001, resulting in an unrealized gain of $19.9 million during 2002. Our investment at fair value of $256.8 million at December 31, 2002, represents a multiple of 1.7 times our share of BLX s junior capital at December 31, 2002.

CMBS Bonds. We recorded a net unrealized gain on our CMBS bond portfolio of $37.8 million for 2002. We determined the fair value of our CMBS bond portfolio using a discounted cash flow model based upon (i) the current performance of the underlying collateral loans, which utilizes prepayment and loss assumptions based upon historical and projected experience, economic factors and the characteristics of the underlying cash flow, and (ii) current market yields for comparable CMBS bonds, based on comparable Treasury rates and market spreads. In addition, we recorded an unrealized loss of $8.2 million from a hedge related to the CMBS bonds. For 2002, the net unrealized gain on the CMBS bond portfolio, net of the unrealized loss from the related hedge, was $29.6 million.

Given that market yields fluctuate, it is possible that there may be future adjustments to the fair value of the CMBS bonds. As a result, we have not classified the appreciated CMBS bonds as Grade 1 assets at December 31, 2002, since they may not result in any future capital gain. Therefore, CMBS bonds remain in Grade 2.

Unrealized losses associated with the changes in the value of investments in our portfolio totaled $185.8 million for the year ended December 31, 2002, and resulted from the recording of new or additional unrealized depreciation of $178.4 million and the reversal of previously recorded unrealized appreciation of $7.4 million.

We experienced a significant level of new or additional unrealized depreciation in the portfolio during 2002, largely due to a struggling U.S. economy and continued deterioration in the technology, broadcasting and cable, and telecommunications sectors. Total unrealized losses on Grade 4 and Grade 5 investments related to the technology, broadcasting and cable, and telecommunications sectors were $64.2 million in 2002. In addition to investments in these industries, we also recorded $87.7 million in unrealized losses on other investments in workout status included in our Grade 4 and Grade 5 investments. We also recorded $21.4 million in unrealized losses related to Grade 3 investments where we do not currently expect any loss of principal or interest over time, but where we believe the enterprise value of a portfolio company has decreased such that our investment on a current sale basis has also decreased.

OTHER MATTERS

Per Share Amounts. All per share amounts included in Management s Discussion and Analysis of Financial Condition and Results of Operations section have been computed using the weighted average shares used to compute diluted earnings per share, which were 103.6 million, 93.0 million, and 73.5 million for the years ended December 31, 2002, 2001, and 2000, respectively.

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

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

FINANCIAL CONDITION, LIQUIDITY AND CAPITAL RESOURCES

Cash and Cash Equivalents

At December 31, 2002, we had $11.2 million in cash and cash equivalents. We invest otherwise uninvested cash in U.S. government- or agency-issued or guaranteed securities that are backed by the full faith and credit of the United States, or in high quality, short-term repurchase agreements fully collateralized by such securities. Our objective is to manage to a low cash balance and fund new originations with our revolving line of credit.

Debt and Other Commitments

We had outstanding debt at December 31, 2002, as follows:

($ in millions)	Facility Amount	Amount Outstanding	Annual Interest Cost(1)	Annual Portfolio Return to Cover Interest Payments(3)
Notes payable and debentures:				
Unsecured long-term notes	$ 694.0	$694.0	7.7%	1.9%
Small Business Administration debentures	101.8	94.5	8.2%	0.3%
Overseas Private Investment Corporation loan	5.7	5.7	6.6%	0.0%
Total notes payable and debentures	$ 801.5	$794.2	7.8%	2.2%
Revolving line of credit	527.5	204.3	3.7%(2)	0.3%
Total debt	$1,329.0	$998.5	6.9%	2.5%

(1) The annual interest cost on notes payable and debentures includes the cost of commitment fees and other facility fees that are recognized into interest expense over the contractual life of the respective borrowings.
(2) The current interest rate payable on the revolving line of credit was 2.7% at December 31, 2002, which excludes the annual cost of commitment fees and other facility fees of $2.0 million.
(3) The annual portfolio return to cover interest payments is calculated as the December 31, 2002 annualized cost of debt per class of financing divided by total assets at December 31, 2002.

Unsecured Long-Term Notes. We have issued long-term debt to institutional lenders, primarily insurance companies. The notes have five-or seven-year maturities, with maturity dates beginning in 2003. The notes require payment of interest only semi-annually, and all principal is due upon maturity.

Small Business Administration Debentures. We, through our small business investment company subsidiary, have debentures payable to the Small Business Administration with contractual maturities of ten years. The notes require payment of interest only semi-annually, and all principal is due upon maturity. Under the small business investment company program, we may borrow up to $113.4 million from the Small Business Administration. At December 31, 2002, the Small Business Administration has a commitment to lend up to an additional $7.3 million above the current amount outstanding. The commitment expires on September 30, 2005.

Revolving Line of Credit. As of December 31, 2002, we have a $527.5 million unsecured revolving line of credit that expires in August 2003, with the right to extend the maturity for one additional year at our sole option under substantially similar terms. This facility was increased by $30.0 million during 2002 from $497.5 million at December 31, 2001, and may be further expanded up to $600 million. As of December 31, 2002, $318.0 million remains unused and available, net of amounts committed for standby letters of credit of $5.3 million issued under the credit facility. The credit facility bears interest at a rate equal to (i) the one-month LIBOR plus 1.25%, (ii) the Bank of America, N.A. prime rate, or (iii) the Federal Funds rate plus 0.50% at our option. The credit facility requires monthly payments of interest, and all principal is due upon maturity.

We have various financial and operating covenants required by the revolving line of credit and the notes payable and debentures. These covenants require us to maintain certain financial ratios, including debt to equity and interest coverage, and a minimum net worth. Our credit facilities limit our ability to declare dividends if we default under certain provisions. As of December 31, 2002, we were in compliance with these covenants.

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

The following table shows our significant contractual obligations as of December 31, 2002.

		Payments Due By Year					
($ in millions)	Total	2003	2004	2005	2006	2007	After 2007
Notes payable and debentures:							
Unsecured long-term notes	$ 694.0	$140.0	$214.0	$165.0	$175.0	$	$
Small Business Administration debentures	94.5		7.0	14.0			73.5
Overseas Private Investment Corporation loan	5.7				5.7		
Revolving line of credit(1)	204.3		204.3				
Operating Leases	21.0	2.6	2.7	2.7	2.6	2.5	7.9
Total contractual obligations	$1,019.5	$142.6	$428.0	$181.7	$183.3	$2.5	$81.4

(1) The revolving line of credit expires in August 2003 and may be extended under substantially similar terms for one additional year at our sole option. We assume that we would exercise our option to extend the revolving line of credit resulting in an assumed maturity of August 2004. At December 31, 2002, $318.0 million remains unused and available, net of amounts committed for standby letters of credit of $5.3 million issued under the credit facility.

The following table shows our contractual commitments that may have the effect of creating, increasing, or accelerating our liabilities as of December 31, 2002.

		Amount of Commitment Expiration Per Year					
($ in millions)	Total	2003	2004	2005	2006	2007	After 2007
Standby letters of credit	$11.3	$	$ 5.3	$	$	$	$6.0
Guarantees	54.6	1.7	52.4	0.3	0.1	0.1	
Total commitments	$65.9	$1.7	$57.7	$0.3	$0.1	$0.1	$6.0

Equity Capital and Dividends

Because we are a regulated investment company, we distribute our income and require external capital for growth. Because we are a business development company, we are limited in the amount of debt capital we may use to fund our growth, since we are generally required to maintain a minimum ratio of 200% of total assets to total borrowings, or approximately a 1 to 1 debt to equity ratio.

To support our growth during the year ended December 31, 2002, we raised $172.8 million in new equity capital, including $86.5 million raised through a non-transferable rights offering. During 2001, we raised $286.9 million in new equity capital through the sale of shares from our shelf registration statement. We issue equity from time to time when we have attractive investment opportunities. In addition, we raised $6.3 million in new equity capital through the issuance of shares through our dividend reinvestment plan during both of the years ended December 31, 2002 and 2001. During

the year ended December 31, 2002, total shareholders equity had increased $193.9 million to $1,546.1 million.

Our board of directors reviews the dividend rate quarterly, and may adjust the quarterly dividend throughout the year. For the first, second, third, and fourth quarters of 2002, the board of directors declared a dividend of $0.53, $0.55, $0.56, and $0.56 per common share, respectively. An extra cash dividend of $0.03 per share was declared during 2002 and was paid to shareholders on January 9, 2003. For the first quarter of 2003, the board of directors has declared a dividend of $0.57 per common share. Dividends are paid based on our taxable income, which includes our taxable interest and fee income as well as taxable net realized capital gains. Our board of directors evaluates whether to retain or distribute capital gains on an annual basis. Our dividend policy allows us to continue to distribute capital gains, but will also allow us to retain gains to support future growth.

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

Dividends paid to shareholders for the years ended December 31, 2002 and 2001 were $229.9 million and $186.2 million, respectively. Cash flow from operations before new investments has historically been sufficient to finance our operations.

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

At December 31, 2002, our debt to equity ratio was 0.65 to 1 and our weighted average cost of funds was 6.9%. Availability on the revolving line of credit, net of amounts committed for standby letters of credit issued under the line of credit facility, was $318.0 million on December 31, 2002. We believe that we have access to capital sufficient to fund our ongoing investment and operating activities.

CRITICAL ACCOUNTING POLICIES

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

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

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

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

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

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

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

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

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

Commercial Mortgage-Backed Securities (CMBS). CMBS bonds are carried at fair value, which is based upon a discounted cash flow model that utilizes prepayment and loss assumptions based upon historical experience and projected performance, economic factors, the characteristics of the underlying cash flow and comparable market yields for similar CMBS bonds. Our assumption with regard to discount rate for determining fair value is based on the yield of comparable securities. We recognize income from the amortization of original issue discount using the effective interest method, using the anticipated yield over the projected life of the investment. Yields are revised when there are changes in estimates of future credit losses, actual losses incurred, or actual and estimated prepayment speeds. Changes in estimated yield are recognized as an adjustment to the estimated yield over the remaining life of the CMBS bonds from the date the estimated yield is changed. We recognize unrealized appreciation or depreciation on our CMBS bonds as comparable yields in the market change and based on changes in estimated cash flows resulting from changes in prepayment or loss assumptions in the underlying collateral pool.

Residual Interest. We value our residual interest from a previous securitization and recognize income using the same accounting policies used for the CMBS bonds. The residual interest is carried at fair value based on discounted estimated future cash flows. We recognize income from the residual interest using the effective interest method. At each reporting date, the effective yield is recalculated and used to recognize income until the next reporting date.

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

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

SENIOR SECURITIES

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

Class and Year	Total Amount Outstanding Exclusive of Treasury Securities(1)	Asset Coverage Per Unit(2)	Involuntary Liquidating Preference Per Unit(3)	Average Market Value Per Unit(4)
Unsecured Long-term Notes Payable				
1993	$ 0	$ 0	$	N/A
1994	0	0		N/A
1995	0	0		N/A
1996	0	0		N/A
1997	0	0		N/A
1998	180,000,000	2,734		N/A
1999	419,000,000	2,283		N/A
2000	544,000,000	2,445		N/A
2001	694,000,000	2,453		N/A
2002	694,000,000	2,704		N/A
Small Business Administration Debentures(5)				
1993	$ 49,800,000	$ 6,013	$	N/A
1994	54,800,000	3,695		N/A
1995	61,300,000	2,868		N/A
1996	61,300,000	2,485		N/A
1997	54,300,000	2,215		N/A
1998	47,650,000	2,734		N/A
1999	62,650,000	2,283		N/A
2000	78,350,000	2,445		N/A
2001	94,500,000	2,453		N/A
2002	94,500,000	2,704		N/A
Overseas Private Investment Corporation Loan				
1993	$ 0	$ 0	$	N/A
1994	0	0		N/A
1995	0	0		N/A
1996	8,700,000	2,485		N/A
1997	8,700,000	2,215		N/A
1998	5,700,000	2,734		N/A
1999	5,700,000	2,283		N/A
2000	5,700,000	2,445		N/A
2001	5,700,000	2,453		N/A
2002	5,700,000	2,704		N/A

Class and Year	Total Amount Outstanding Exclusive of Treasury Securities(1)	Asset Coverage Per Unit(2)	Involuntary Liquidating Preference Per Unit(3)	Average Market Value Per Unit(4)
Revolving Lines of Credit				
1993	$ 0	$ 0	$	N/A
1994	32,226,000	3,695		N/A
1995	20,414,000	2,868		N/A
1996	45,099,000	2,485		N/A
1997	38,842,000	2,215		N/A
1998	95,000,000	2,734		N/A
1999	82,000,000	2,283		N/A
2000	82,000,000	2,445		N/A
2001	144,750,000	2,453		N/A
2002	204,250,000	2,704		N/A
Auction Rate Reset Note				
1993	$ 0	$ 0	$	N/A
1994	0	0		N/A
1995	0	0		N/A
1996	0	0		N/A
1997	0	0		N/A
1998	0	0		N/A
1999	0	0		N/A
2000	76,598,000	2,445		N/A
2001	81,856,000	2,453		N/A
2002	0	0		N/A
Master Repurchase Agreement and Master Loan and Security Agreement				
1993	$ 0	$ 0	$	N/A
1994	23,210,000	3,695		N/A
1995	0	0		N/A
1996	85,775,000	2,485		N/A
1997	225,821,000	2,215		N/A
1998	6,000,000	2,734		N/A
1999	23,500,000	2,283		N/A
2000	0	0		N/A
2001	0	0		N/A
2002	0	0		N/A

Class and Year	Total Amount Outstanding Exclusive of Treasury Securities(1)	Asset Coverage Per Unit(2)	Involuntary Liquidating Preference Per Unit(3)	Average Market Value Per Unit(4)
Senior Note Payable(6)				
1993	$20,000,000	$6,013	$	N/A
1994	20,000,000	3,695		N/A
1995	20,000,000	2,868		N/A
1996	20,000,000	2,485		N/A
1997	20,000,000	2,215		N/A
1998	0	0		N/A
1999	0	0		N/A
2000	0	0		N/A
2001	0	0		N/A
2002	0	0		N/A
Bonds Payable				
1993	$ 0	$ 0	$	N/A
1994	0	0		N/A
1995	98,625,000	2,868		N/A
1996	54,123,000	2,485		N/A
1997	0	0		N/A
1998	0	0		N/A
1999	0	0		N/A
2000	0	0		N/A
2001	0	0		N/A
2002	0	0		N/A
Redeemable Cumulative Preferred Stock(5)				
1993	$ 1,000,000	$ 546	$100	N/A
1994	1,000,000	351	100	N/A
1995	1,000,000	277	100	N/A
1996	1,000,000	242	100	N/A
1997	1,000,000	217	100	N/A
1998	1,000,000	267	100	N/A
1999	1,000,000	225	100	N/A
2000	1,000,000	242	100	N/A
2001	1,000,000	244	100	N/A
2002	1,000,000	268	100	N/A
Non-Redeemable Cumulative Preferred Stock(5)				
1993	$ 6,000,000	$ 546	$100	N/A
1994	6,000,000	351	100	N/A
1995	6,000,000	277	100	N/A
1996	6,000,000	242	100	N/A
1997	6,000,000	217	100	N/A
1998	6,000,000	267	100	N/A
1999	6,000,000	225	100	N/A
2000	6,000,000	242	100	N/A
2001	6,000,000	244	100	N/A
2002	6,000,000	268	100	N/A

(1) Total amount of each class of senior securities outstanding at the end of the period presented.

(2) The asset coverage ratio for a class of senior securities representing indebtedness is calculated as our consolidated total assets, less all liabilities and indebtedness not represented by senior securities, divided by senior securities representing indebtedness. This asset coverage ratio is multiplied by $1,000 to determine the Asset Coverage Per Unit. The asset coverage ratio for a class of senior securities that is preferred stock is calculated as our consolidated total assets, less all liabilities and indebtedness not represented by senior securities, divided by senior securities representing indebtedness, plus the involuntary liquidation preference of the preferred stock (see footnote 3). The Asset Coverage Per Unit for preferred stock is expressed in terms of dollar amounts per share.

(3) The amount to which such class of senior security would be entitled upon the involuntary liquidation of the issuer in preference to any security junior to it.

(4) Not applicable, as senior securities are not registered for public trading.

(5) Issued by our small business investment company subsidiary to the Small Business Administration. These categories of senior securities are not subject to the asset coverage requirements of the 1940 Act. See Certain Government Regulations Small Business Administration Regulations.

(6) We were the obligor on $15 million of the senior notes. Our small business investment company subsidiary was the obligor on the remaining $5 million, which is not subject to the asset coverage requirements of the 1940 Act.

BUSINESS

General

As a business development company, we provide long-term debt and equity investment capital to support the expansion of companies in a variety of industries. We generally invest in illiquid securities through privately negotiated transactions. We generally invest in private middle market companies though, from time to time, we may invest in public companies that lack access to public capital or whose securities may not be marginable. We have been investing in businesses for over 40 years and have financed thousands of companies nationwide. Today, our investment and lending activity is generally focused in two areas:

Private finance and

Commercial real estate finance, primarily the investment in non-investment grade commercial mortgage-backed securities.

Our investment portfolio consists primarily of long-term unsecured loans with or without equity features, equity investments in companies, which may or may not constitute a controlling equity interest, non-investment grade commercial mortgage-backed securities, preferred shares in collateralized debt obligations, and commercial mortgage loans. At December 31, 2002, our investment portfolio totaled $2.5 billion at value. Our investment objective is to achieve current income and capital gains.

Corporate History and Offices

Allied Capital Corporation was formed in 1958. On December 31, 1997, Allied Capital Corporation, Allied Capital Corporation II, Allied Capital Commercial Corporation and Allied Capital Advisers, Inc. merged with and into Allied Capital Lending Corporation in a tax-free stock-for-stock exchange. Immediately following the merger, Allied Capital Lending Corporation changed its name to Allied Capital Corporation.

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

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

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

Private Finance

We participate in the private equity business by providing privately negotiated long-term debt and equity investment capital. Our private finance investment activity is generally focused on providing junior capital in the form of subordinated debt with or without equity features, such as warrants or options, often referred to as mezzanine financing. In certain situations, we may also take a controlling equity position in a company. Our private financing is generally used to fund growth, buyouts, acquisitions, recapitalizations, note purchases, and bridge financings. We generally invest in private companies though, from time to time, we may invest in public companies that lack access to public capital or whose securities may not be marginable.

At December 31, 2002, 66% of the private finance portfolio consisted of loans and debt securities and 34% consisted of equity securities.

Our private finance portfolio includes investments in a wide variety of industries, including non-durable consumer products, business services, financial services, light industrial products, healthcare services, retail, telecommunications, education and broadcasting. The industry and geographic compositions of the private finance portfolio at value at December 31, 2002 and 2001, were as follows:

	2002	2001
Industry		
Consumer products	34%	28%
Business services	26	22
Financial services	16	15
Industrial products	9	10
Healthcare	5	3
Retail	4	5
Telecommunications	2	4
Broadcasting & cable	1	4
Education	1	5
Other	2	4
Total	100%	100%
Geographic Region		
Mid-Atlantic	45%	43%
Midwest	16	17
Southeast	16	14
West	15	19
Northeast	7	5
International	1	2
Total	100%	100%

Market and Competition. Capital providers for the finance of private companies can be generally categorized as shown in the diagram below:

Capital Provider	Banks	Commercial Finance Companies	Private Placement/ High Yield	Private Mezzanine Funds	Allied Capital	Private Equity Funds
Primary Business Focus	Senior, short-term debt	Asset-based lending	Large credits (private > $50 mm) (public > $150 mm)	Unsecured long- term debt with warrants Preferred and common equity	Unsecured long- term debt with warrants Preferred and common equity	Equity
Typical Pricing Spectrum*	LIBOR+	[graphic of arrow stretching between LIBOR+ and 25%+]				25%+

* Based on our market experience.

Banks are primarily focused on providing senior secured and unsecured short-term debt. They typically do not provide meaningful long-term unsecured loans. Commercial finance companies are primarily focused on providing senior secured long-term debt. The private placement and high-yield debt markets are focused primarily on very large financing transactions, typically in excess of the financings we do. We typically do not compete with banks, commercial finance companies, or the private placement/high yield market. Instead, we compete directly with the private mezzanine sector of the private capital market. Private mezzanine funds are also focused on providing unsecured long-term debt to private companies for the types of transactions discussed above. We believe that we have key structural and operational advantages when compared to private mezzanine funds.

Many private mezzanine funds operate with a more expensive cost structure than ours because of carried interest fees paid to the management of the funds. In addition, our access to the public equity markets generally gives us a lower cost of capital than that of private mezzanine funds. Our lower cost of capital may give us a pricing advantage when competing for new investments. In addition, the perpetual nature of our corporate structure enables us to be a better long-term partner for our portfolio companies than a traditional mezzanine fund, which typically has a limited life.

Over our 42-year history, we have developed and maintained relationships with intermediaries including investment banks, financial services companies, and private mezzanine and equity sponsors, through which we source investment opportunities. Through these relationships, especially those with equity sponsors, we have been able to strengthen our position as a long-term investor. For the transactions in which we have provided debt capital, an equity sponsor provides a reliable source of additional equity capital if the portfolio company requires additional financing. Private equity sponsors also assist us in confirming our own due diligence findings when assessing a new investment opportunity, and they provide assistance and leadership to the portfolio company s management team throughout our investment period.

Investment Criteria. When assessing a prospective investment, we look for companies with certain target characteristics, which may or may not be present in the companies in which we invest. Our target characteristics generally include the following:

Management teams with meaningful equity ownership

Dominant or defensible market position

High return on invested capital

Revenues of $50 million to $500 million

Stable operating margins

EBITDA (or Earnings Before Interest, Taxes, Depreciation and Amortization) of at least $5 million

Solid cash flow margins

Sound balance sheets

We generally target and do not target the following industries, though we will consider investments in any industry if the prospective company demonstrates unique characteristics that make it an attractive investment opportunity:

Industries Targeted ***Less Cyclical/Cash Flow Intensive/ High Return on Capital***	**Industries Not Targeted** ***Cyclical/Capital Intensive/ Low Return on Capital***
Consumer products	Heavy equipment
Business services	Natural resources
Financial services	Commodity retail
Light industrial products	Low value-add distribution
Broadcasting	Agriculture
	Transportation

Investment Structure. Once we have determined that a prospective portfolio company is suitable for investment, we work with the management and the other capital providers, including senior, junior, and equity capital providers, to structure a deal. We negotiate among these parties to agree on how our investment is expected to perform relative to the other capital in the portfolio company s capital structure. Generally, our private finance portfolio companies seek a component of senior capital above us and an equity piece below us.

Our private finance mezzanine investments are generally structured as unsecured, subordinated loans that carry a relatively high contractual fixed interest rate generally in excess of 12%, to provide interest income. At December 31, 2002, approximately 95% of the loans and debt securities in the private finance portfolio have fixed rates of interest. The loans have interest-only payments in the early years and payments of both principal and interest in the later years, with maturities of five to ten years, although debt maturities and principal amortization schedules vary. Such payments are generally made to us quarterly.

Our mezzanine debt instruments are tailored to the facts and circumstances of the deal. The specific structure is negotiated over a period of several months and is designed to protect our rights and manage our risk in the transaction. We may structure the debt instrument to require restrictive affirmative and negative covenants, default penalties, lien protection, equity calls, take control provisions and board observation rights. Our private finance mezzanine investments may include equity features, such as warrants or options to buy a minority interest in the portfolio company. The warrants we receive with our debt securities generally require only a nominal cost to exercise, and thus, as the portfolio company appreciates in value, we achieve additional investment return from this equity interest. We may structure the warrants to provide minority rights provisions and event-driven puts. We seek to achieve additional investment return from the appreciation and sale of our warrants. We generally target a total return of 16% to 25% for our private finance mezzanine investments. The typical private finance structure focuses, first, on the protection of our investment principal and then on investment return.

We exit our private finance investments generally when a liquidity event takes place, such as the sale, recapitalization, or initial public offering of such portfolio company. Generally, our warrants expire five years after the related debt is repaid. The warrants typically include registration rights, which allow us to sell the securities if the portfolio company completes a public offering. Most of the gains we realize from our warrant portfolio arise as a result of the sale of the portfolio company to another business or through a recapitalization. Historically, we have not been dependent on the public equity markets for the sale of our warrant positions.

We may also acquire preferred or common equity in a company as a part of our private finance investing activities, particularly when we see a unique opportunity to profit from the growth of a company. Preferred equity investments may be structured with a dividend yield, which would provide us with a current return. With respect to preferred or common equity investments, we generally target an investment return of 25% to 40%.

In addition to our private finance mezzanine investment activities, we may acquire more than 50% of the common stock of a company in a control buyout transaction. In addition to our common equity investment, we may also provide additional capital to the controlled portfolio company in the form of senior loans, subordinated debt or preferred stock. The types of companies that we would acquire through a control buyout transaction are generally the same types of companies that we would invest in through our other private finance investing activities. In particular, we may see opportunities to acquire illiquid public companies and take them private. We intend to be selective about the companies in which we acquire a controlling interest to ensure that we maintain a diversified portfolio.

We generally structure our control investments such that we earn a current return through a combination of interest income on our senior loans and subordinated debt, dividends on our preferred and common stock, and management or transaction services fees to compensate us for the managerial assistance that we provide to a controlled portfolio company. For these types of investments, we generally target an overall investment return of 25% to 40%.

At December 31, 2002, our most significant investments acquired through control buyout transactions were Business Loan Express, Inc. (BLX) and The Hillman Companies, Inc.

At December 31, 2002, we had an investment at value totaling $256.8 million in BLX, a small business lender that participates in the U.S. Small Business Administration 7(a) Guaranteed Loan Program. At December 31, 2002, we owned 94.9% of BLX s common stock. Our common stock ownership is subject to dilution by management options. As the controlling shareholder of BLX, we have provided an unconditional guaranty to the BLX credit facility lenders in an amount up to 50% of the total obligations (consisting of principal, accrued interest and other fees) on BLX s three-year unsecured $124.0 million revolving credit facility that matures in March 2004. The amount guaranteed by us at December 31, 2002 was $51.6 million. This guaranty can be called by the lenders only in the event of a default by BLX. BLX was in compliance with the terms of its credit facility at December 31, 2002. We have also provided two standby letters of credit in connection with two term securitization transactions completed by BLX totaling $10.6 million.

BLX is the nation s second largest non-bank government guaranteed lender utilizing the SBA s 7(a) Guaranteed Loan Program and is licensed by the SBA as a Small Business Lending Company (SBLC). BLX is a preferred lender as designated by the SBA in 68 markets across the United States, and originates, sells, and services small business loans. In addition to the 7(a) Guaranteed Loan Program, BLX originates conventional small business loans and originates loans under the USDA Business and Industry Guaranteed Loan Program. In February 2003, BLX completed a corporate reorganization to a limited liability company. BLX has offices across the United States and is headquartered in New York, New York.

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

We fund new investments using cash, through the issuance of our common equity, the reinvestment of previously accrued interest and dividends in debt or equity securities, or the current reinvestment of interest and dividend income through the receipt of a debt or equity security (payment-in-kind income). From time to time, we may also opt to reinvest accrued interest receivable in a new debt or equity security, in lieu of receiving such interest in cash and providing a subsequent investment. When we acquire a controlling interest in a company, we may have the opportunity to acquire the company s equity with our common stock. The issuance of our stock as consideration may provide us with the benefit of raising equity without having to access the public markets in an underwritten offering, including the added benefit of the elimination of any underwriter commissions.

As a business development company, we are required to make significant managerial assistance available to the companies in our investment portfolio. In addition to the interest and dividends received from our private finance investments, we will often generate additional fee income for the structuring, diligence, transaction and management services and guarantees we provide to our portfolio companies.

Commercial Real Estate Finance

Our primary commercial real estate investment activity is the investment in non-investment grade commercial mortgage-backed securities, which we refer to as CMBS. As an investor, we believe that CMBS bonds have attractive risk/return characteristics. The CMBS bonds in which we invest are non-investment grade, which means that nationally recognized statistical rating organizations rate them below the top four investment-grade rating categories (i.e., AAA through BBB), and are sometimes referred to as junk bonds. Unlike most junk bonds, which are typically unsecured debt instruments, the non-investment grade CMBS bonds in which we invest are secured by an underlying collateral pool of commercial mortgage loans, which are, in turn, secured by commercial real estate. The underlying collateral for our CMBS bonds consists of senior mortgage loans on commercial real estate properties where the loans, on average, were underwritten to achieve a loan to value ratio of approximately 70%. We generally invest in CMBS bonds on the initial issuance of the CMBS bond offering, and are able to underwrite and negotiate to acquire the securities at a significant discount from their face amount, generally resulting in an estimated yield to maturity ranging from 13% to 16%. We find the yields for CMBS bonds attractive given their collateral protection.

We believe this risk/return dynamic exists in the market because there are significant barriers to entry for a non-investment grade CMBS investor. First, non-investment grade CMBS are long-term investments and require long-term investment capital. Our capital structure, which is in excess of 50% equity capital, is well suited for this asset class. Second, when we purchase CMBS bonds in an initial issuance, we re-underwrite the mortgage loans in the underlying collateral pool, and we meet with issuers to discuss the nature and type of loans we will accept into the pool. We have significant commercial mortgage loan underwriting expertise, both in terms of the number of professionals we employ and the depth of their commercial real estate experience. Access to this type of expertise is another barrier to entry into this market.

As a non-investment grade CMBS investor, we recognize that non-investment grade bonds have a higher degree of risk than do investment-grade bonds. Non-investment grade securities are considered speculative, and their capacity to pay principal and interest in accordance with the terms of their issue is not ensured. They tend to be less liquid, may have a higher risk of default, and may be more difficult to value. We invest in non-investment grade CMBS bonds represented by the BB+ to non-rated tranches of a CMBS issuance. The non-investment grade CMBS bonds in which we invest are junior in priority for payment of principal and interest to the more senior tranches of the related CMBS bond issuance. Cash flow from the underlying mortgages is allocated first to the senior tranches, with the most senior tranches having a priority right to the cash flow. Then, any remaining cash flow is allocated, among the other tranches in order of their relative seniority. To the extent there are defaults and unrecoverable losses on the underlying mortgages resulting in reduced cash flows, our most subordinate tranch will bear this loss first. At December 31, 2002, our CMBS bonds were subordinate to 91% to 97% of the tranches of bonds issued in various CMBS transactions.

To mitigate the risks associated with a CMBS investment discussed above, we perform extensive due diligence prior to each investment in CMBS. The underwriting procedures and criteria used to underwrite each of the commercial mortgage loans in each collateral pool are described in detail below. We will only invest in CMBS when we believe, as a result of our underwriting procedures, that the underlying mortgage pool adequately secures our position. At December 31, 2002, the underlying pools of mortgage loans that are collateral for our CMBS bonds consisted of approximately 4,500 commercial mortgage loans with a total outstanding principal balance of $25.0 billion. These mortgage loans are secured by properties located in diverse geographic locations across the United States, and include a variety of property types such as retail, multi-family housing, office, industrial real estate, and hospitality.

The property types and the geographic composition of the underlying mortgage loans securing the CMBS bonds, calculated using the outstanding principal balance, at December 31, 2002 and 2001, were as follows:

	2002	2001
Property Type		
Retail	32%	31%
Housing	27	27
Office	21	22
Industrial Real Estate	7	6
Hospitality	6	7
Other	7	7
Total	100%	100%
Geographic Region		
West	31%	32%
Mid-Atlantic	25	24
Midwest	22	21
Southeast	17	17
Northeast	5	6
Total	100%	100%

In addition to our CMBS bond investments, we have invested in the preferred shares of four collateralized debt obligations, or CDOs, secured by investment grade unsecured debt issued by various real estate investment trusts, or REITs, and CMBS bonds. The preferred shares are junior in priority for payment of principal and interest to the more senior tranches of debt issued by the CDOs. To the extent there are defaults and unrecoverable losses on the underlying collateral resulting in reduced cash flows, the preferred shares will bear this loss first. At December 31, 2002, our preferred shares in the CDOs were subordinate to approximately 96% of the more senior tranches of debt issued by the CDOs. The yield on the CDOs at December 31, 2002 was 17.2%.

Our CMBS investing activity complements our private finance activity because it provides a steady stream of recurring interest income. In addition, given the depth of our commercial real estate experience and the due diligence that we perform prior to an investment in CMBS, we have from time to time received structuring and diligence fees upon the investment in CMBS bonds. These fees are separately negotiated for each transaction. In order to maintain a balanced investment portfolio, we expect that our investment in CMBS will not exceed 25% of our total assets.

Investment Sourcing

We maintain a network of relationships with investors, lenders and intermediaries including:

- private mezzanine and equity investors;
- investment banks;
- business brokers;
- merger and acquisition advisors;
- financial services companies; and
- banks, law firms and accountants.

We believe that our experience and reputation provide a competitive advantage in originating new investments. We have established an extensive network of investment referral relationships over our history.

Investment Approval and Underwriting Procedures

In assessing new investment opportunities, we follow an institutionalized process which includes a due diligence process and a centralized credit and investment approval process requiring committee review, all of which are described below.

Private Finance. The typical private finance transaction requires two to four months of diligence and structuring before funding occurs. The due diligence process is significantly longer for those transactions in which we take a control position or substantial equity stake in the company. The key steps in our private finance investment process are as follows:

- Initial investment screening;
- Presentation of investment to investment professionals at weekly meeting;
- Initial approval of the investment by the investment committee;
- Due diligence completed and investment structured;
- Independent internal peer review of the investment completed;
- Final approval of the investment by the investment committee;
- Approval of the investment by the executive committee of the board of directors (for all investments greater than $10 million); and
- Investment is funded.

In a typical private financing, we thoroughly review, analyze, and substantiate, through due diligence, the business plan and operati