ALLIED CAPITAL CORP
Form N-2
April 07, 2005

As filed with the Securities and Exchange Commission on April , 2005

Registration No. 333-

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM N-2

REGISTRATION STATEMENT

UNDER
THE SECURITIES ACT OF 1933

o **Pre-Effective Amendment No.**
o **Post-Effective Amendment No.**

ALLIED CAPITAL CORPORATION

(Exact Name of Registrant as Specified in Charter)

1919 Pennsylvania Avenue, N.W.

Washington, D.C. 20006-3434
(202) 331-1112
(Address and Telephone Number, including Area Code, of Principal Executive Offices)

William L. Walton, Chairman and Chief Executive Officer

Allied Capital Corporation
1919 Pennsylvania Avenue, N.W.
Washington, D.C. 20006-3434
(Name and Address of Agent for Service)

Copies of information to:

Steven B. Boehm, Esq.
Cynthia M. Krus, Esq.
Sutherland Asbill & Brennan LLP
1275 Pennsylvania Avenue, N.W.
Washington, D.C. 20004-2415

Approximate Date of Proposed Public Offering:

From time to time after the effective date of the Registration Statement.

If any securities being registered on this form will be offered on a delayed or continuous basis in reliance on Rule 415 under the Securities Act of 1933, other than securities offered in connection with a dividend reinvestment plan, check the following box. x

CALCULATION OF REGISTRATION FEE UNDER THE SECURITIES ACT OF 1933

Title of Securities Being Registered	Amount Being Registered(1)	Proposed Maximum Offering Price Per Share(2)	Proposed Maximum Aggregate Offering Price	Amount of Registration Fee(3)
Common Stock, $0.0001 par value per share	3,000,000 shares	$26.52	$79,545,000	$9,362

(1) In reliance upon Rule 429 under the Securities Act of 1933, this amount is in addition to the securities previously registered by the Registrant under a registration statement on Form N-2 (File No. 333-113671). All securities unsold under such prior registration (a total of 17,000,000 shares of common stock) are carried forward into this Registration Statement.

(2) Estimated solely for the purpose of calculating the registration fee pursuant to Rule 457(c) under the Securities Act of 1933 on the basis of the average of the high and low sales prices of the common stock on April 5, 2005, as reported on the New York Stock Exchange.

(3) In reliance upon Rule 429 under the Securities Act of 1933, all securities unsold under a registration statement on Form N-2 (File No. 333-113671) (a total of 17,000,000 shares of common stock) are carried forward into this Registration Statement. A registration fee of $63,332 has been paid previously with respect to such securities. The registration fee of $9,362 relates solely to the registration of 3,000,000 shares of common stock not previously registered.

The registrant hereby amends this registration statement on such date or dates as may be necessary to delay its effective date until the registrant shall file a further amendment which specifically states that this registration statement shall thereafter become effective in accordance with Section 8(a) of the Securities Act of 1933, as amended, or until this registration statement shall become effective on such date as the Commission, acting pursuant to Section 8(a), may determine.

The information in this prospectus is not complete and may be changed. We may not sell these securities until the registration statement filed with the Securities and Exchange Commission is effective. This prospectus is not an offer to sell these securities and is not soliciting an offer to buy these securities in any state where the offer or sale is not permitted.

PROSPECTUS (SUBJECT TO COMPLETION)
ISSUED , 2005

20,000,000 Shares

Common Stock

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

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

Please read this prospectus and the accompanying prospectus supplement before investing, and keep it for future reference. The prospectus and the accompanying prospectus supplement contain important information about us that a prospective investor should know before investing in our common stock. We file annual, quarterly and current reports, proxy statements and other information about us with the Securities and Exchange Commission. This information is available free of charge by contacting us at 1919 Pennsylvania Avenue, NW, Washington, DC, 20006 or by telephone at (202) 331-1112 or on our website at www.alliedcapital.com. The SEC also maintains a website at www.sec.gov that contains such information.

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

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

Our common stock is traded on the New York Stock Exchange under the symbol ALD. As of April , 2005, the last reported sale price on the New York Stock Exchange for the common stock was $.

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

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

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

, 2005

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

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ABOUT THIS PROSPECTUS

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

PROSPECTUS SUMMARY

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

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

BUSINESS *(Page 59)*

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

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

We invest in the American entrepreneurial economy. Our private finance portfolio includes investments in over 100 companies with aggregate annual revenue of approximately $11 billion that employ more than 100,000 jobs.

Our investment activity is primarily focused in three areas:

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

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

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

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

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

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

Our primary commercial real estate investments are in the non-investment grade classes of CMBS bonds. We generally invest at the initial issuance of the CMBS, and are able to review the underlying collateral of mortgage loans as if we were making an initial decision to fund such loans and to determine if we want to exclude loans that do not meet our credit, collateral, structural or other standards. We also negotiate to acquire the securities at significant discounts from their face amount. In addition to our CMBS investments, we have invested in the bonds and preferred shares of CDOs. Since we are limited as to the amount of debt capital we can use to finance our commercial real estate investments, we are evaluating various strategic alternatives for our commercial real estate platform. These alternatives may include the sale, spin-out or recapitalization of all or part of our commercial real estate investments.

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

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

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

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

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

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

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

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

Our Internet website address is *www.alliedcapital.com.* 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 84)*

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, 2004, portfolio investments recorded at fair value were approximately 92% of our total assets.

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

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

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

PLAN OF DISTRIBUTION *(Page 126)*

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

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

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

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

USE OF PROCEEDS *(Page 18)*

We intend to use the net proceeds from selling shares of common stock for general corporate purposes, which includes investing in debt or equity securities in primarily privately negotiated transactions, repayment of indebtedness, acquisitions and other general corporate purposes. The supplement to this prospectus relating to an offering will more fully identify the use of the proceeds from such offering.

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

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

DIVIDEND REINVESTMENT PLAN *(Page 119)*

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

RISK FACTORS *(Page 10)*

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

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

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

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

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

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

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

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

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

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

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

CERTAIN ANTI-TAKEOVER

PROVISIONS *(Page 122)*

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

FEES AND EXPENSES

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

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)]	4.5%
Interest payments on borrowed funds[(5)]	3.8%
Total annual expenses[(6)(7)]	8.3%

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

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

(3) Consolidated net assets attributable to common stock equals net assets (*i.e.*, total consolidated assets less total consolidated liabilities), which at December 31, 2004, was $1,979.8 million.

(4) Operating expenses represent our operating expenses for the year ending December 31, 2004, excluding interest on indebtedness.

(5) The Interest payments on borrowed funds represents our interest expense for the year ending December 31, 2004. We had outstanding borrowings of $1,176.6 million at December 31, 2004. See Risk Factors.

(6) Total annual expenses as a percentage of consolidated net assets attributable to common stock are higher than the total annual expenses percentage would be for a company that is not leveraged. We borrow money to leverage our net assets and increase our total assets. The SEC requires that Total annual expenses percentage be calculated as a percentage of *net* assets, rather than the total assets, including assets that have been funded with borrowed monies. If the Total annual expenses percentage were calculated instead as a percentage of consolidated total assets, our Total annual expenses would be 5.1% of consolidated total assets.

(7) The holders of shares of our common stock (and not the holders of our debt securities or preferred stock, if any) indirectly bear the cost associated with our annual expenses.

Example

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

	1 Year	3 Years	5 Years	10 Years
You would pay the following expenses on a $1,000 investment, assuming a 5.0% annual return	$126	$288	$450	$854

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

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

may be greater or less than those shown.

SELECTED CONDENSED CONSOLIDATED FINANCIAL DATA

You should read the condensed consolidated financial information below with the Consolidated Financial Statements and Notes thereto included in this prospectus. Financial information at and for the years ended December 31, 2004, 2003, and 2002, has been derived from our financial statements that were audited by KPMG LLP. Financial information at and for the years ended December 31, 2001 and 2000, 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 20 for more information.**

(in thousands, except per share data)	Year Ended December 31, 2004	2003	2002	2001	2000
Operating Data:					
Interest and related portfolio income:					
Interest and dividends	$319,642	$290,719	$264,042	$240,464	$182,307
Loan prepayment premiums and premiums from loan dispositions	5,502	8,172	2,776	2,504	16,138
Fees and other income	41,946	30,338	43,110	46,142	13,144
Total interest and related portfolio income	367,090	329,229	309,928	289,110	211,589
Expenses:					
Interest	75,650	77,233	70,443	65,104	57,412
Employee	40,728	36,945	33,126	29,656	26,025
Individual performance award	13,011				
Administrative	35,686	22,387	21,504	15,299	15,435
Total operating expenses	165,075	136,565	125,073	110,059	98,872
Net investment income before income taxes	202,015	192,664	184,855	179,051	112,717
Income tax expense (benefit)	1,057	(2,466)	930	(412)	
Net investment income	200,958	195,130	183,925	179,463	112,717
Net realized and unrealized gains (losses):					
Net realized gains	117,240	75,347	44,937	661	15,523
Net change in unrealized appreciation or depreciation	(68,712)	(78,466)	(571)	20,603	14,861
Total net gains (losses)	48,528	(3,119)	44,366	21,264	30,384
Net increase in net assets resulting from operations	$249,486	$192,011	$228,291	$200,727	$143,101
Per Share:					
Diluted earnings per common share	$ 1.88	$ 1.62	$ 2.20	$ 2.16	$ 1.94
Dividends per common share[1]	$ 2.30	$ 2.28	$ 2.23	$ 2.01	$ 1.82
Weighted average common shares outstanding diluted[2]	132,458	118,351	103,574	93,003	73,472

(in thousands, except per share data)	At December 31, 2004	2003	2002	2001	2000
Balance Sheet Data:					

Portfolio at value	$3,013,411	$2,584,599	$2,488,167	$2,329,590	$1,788,001
Total assets	3,260,998	3,019,870	2,794,319	2,460,713	1,853,817
Total debt outstanding(3)	1,176,568	954,200	998,450	1,020,806	786,648
Preferred stock issued to Small Business Administration(3)		6,000	7,000	7,000	7,000
Shareholders equity	1,979,778	1,914,577	1,546,071	1,352,123	1,029,692
Shareholders equity per common share (net asset value)(4)	$ 14.87	$ 14.94	$ 14.22	$ 13.57	$ 12.11
Common shares outstanding at year end(2)	133,099	128,118	108,698	99,607	85,057

	Year Ended December 31,				
	2004	2003	2002	2001	2000
Other Data:					
Investments funded	$1,524,523	$931,450	$506,376	$680,329	$901,545
Principal collections related to investment repayments or sales	909,189	788,328	356,641	204,441	391,275
Realized gains	267,702	94,305	95,562	10,107	28,604
Realized losses	(150,462)	(18,958)	(50,625)	(9,446)	(13,081)

(in thousands, except per share data)	2004				2003			
	Qtr 4	Qtr 3	Qtr 2	Qtr 1	Qtr 4	Qtr 3	Qtr 2	Qtr 1
Quarterly Data (unaudited):								
Total interest and related portfolio income	$100,962	$96,863	$87,500	$81,765	$90,015	$88,870	$77,214	$73,130
Net investment income	54,678	52,745	48,990	44,545	54,254	53,608	44,598	42,670
Net increase in net assets resulting from operations	47,837	85,999	95,342	20,308	78,454	33,744	59,940	19,873
Diluted earnings per common share	0.35	0.66	0.73	0.15	0.62	0.28	0.52	0.18
Dividends declared per common share(5)	0.59	0.57	0.57	0.57	0.57	0.57	0.57	0.57
Net asset value per common share(4)	14.87	14.90	14.77	14.60	14.94	14.46	14.23	14.05

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

(2) Excludes 234,977 common shares held in the deferred compensation trust at and for the year ended December 31, 2000.

(3) See Senior Securities on page 56 for more information regarding our level of indebtedness.

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

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

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. You can also inspect reports and other information we file at the offices of the New York Stock Exchange, and you are able to inspect those at 20 Broad Street, New York, NY 10005.

RISK FACTORS

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

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

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

Substantially all of our portfolio investments are recorded at fair value as determined in good faith by our Board of Directors and, as a result, there is uncertainty regarding the value of our portfolio investments. At December 31, 2004, portfolio investments recorded at fair value were approximately 92% of our total assets. Pursuant to the requirements of the 1940 Act, we value substantially all of our investments at fair value as determined in good faith by our Board of Directors on a quarterly basis. Since there is typically no readily available market value for the investments in our portfolio, our Board of Directors determines in good faith the fair value of these investments pursuant to a valuation policy and a consistently applied valuation process.

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

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

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

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

Our borrowers may default on their payments, which may have a negative effect on our financial performance. We 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 and may have a negative effect on our financial results.

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

Our financial results could be negatively affected if Business Loan Express fails to perform as expected. Business Loan Express, LLC (BLX) is our largest portfolio investment. Our financial results could be negatively affected if BLX, as a portfolio company, fails to perform as expected or if government funding for, or regulations related to the Small Business Administration 7(a) Guaranteed Loan Program change. At

December 31, 2004, our investment in BLX totaled $335.2 million at value, or 10.3% of total assets and for the year ended December 31, 2004, interest and related portfolio income earned from our investment in BLX was $50.0 million, or 13.6% of total interest and related portfolio income.

In addition, as controlling equity owner of BLX, we have provided an unconditional guaranty to BLX s senior credit facility lenders in an amount equal to 50% of BLX s total obligations on its $275.0 million revolving credit facility. The amount we have guaranteed at December 31, 2004, was $94.6 million. This guaranty can only be called in the event of a default by BLX. At December 31, 2004, we had also provided four standby letters of credit totaling $35.6 million in connection with four term securitization transactions completed by BLX.

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

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

We 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, 2004, we had $1,176.6 million of outstanding indebtedness bearing a weighted average annual interest cost of 6.6%. In order for us to cover these annual interest payments on indebtedness, we must achieve annual returns on our assets of at least 2.4%.

Illustration. The following table illustrates the effect of leverage on returns from an investment in our common stock assuming various annual returns, net of expenses. The calculations in the table below are hypothetical and actual returns may be higher or lower than those appearing below. The calculation assumes (i) $3,261.0 million in total assets, (ii) an average cost of funds of 6.6%, (iii) $1,176.6 million in debt outstanding and (iv) $1,979.8 million of shareholders equity.

Assumed Return on Our Portfolio

(net of expenses)

	-20%	**-10%**	**-5%**	**0%**	**5%**	**10%**	**20%**
Corresponding return to shareholder	-36.8%	-20.3%	-12.1%	-3.8%	4.4%	12.7%	29.1%

We may not borrow money unless we maintain asset coverage for indebtedness of at least 200%, which may affect returns to shareholders. We must maintain asset coverage for total borrowings of at least 200%. Our ability to achieve our investment objective may depend in part on our continued ability to maintain a leveraged capital structure by borrowing from banks, insurance companies or other lenders on favorable terms. There can be no assurance that we will be able to maintain such leverage. If asset coverage declines to less than 200%, we may be required to sell a portion of our investments when it is disadvantageous to do so. As of December 31, 2004, our asset coverage for senior indebtedness was 280%.

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

Assuming that the balance sheet were to remain constant and no actions were taken to alter the existing interest rate sensitivity, a hypothetical immediate 1% change in interest rates would have affected 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 net assets resulting from operations, or net income. Accordingly, no assurances can be given that actual results would not differ materially from the potential outcome simulated by this estimate.

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

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

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 U.S. generally accepted accounting principles and tax regulations, we include in income certain amounts that we have not yet received in cash, such as contractual payment-in-kind interest which represents contractual interest added to the loan balance that becomes due at the end of the loan term. 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, other business development companies, investment banks, other equity and non-equity based investment funds, and other sources of financing, including specialty finance companies and traditional financial services companies such as commercial banks. Some of our competitors may have greater resources than we do. Increased competition would make it more difficult for us to purchase or originate investments at attractive prices. As a result of this competition, sometimes we may be precluded from making otherwise attractive investments.

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

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

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

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

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

The SEC has recently issued proposed rules to correct the unintended consequence of the Federal Reserve s 1998 margin rule amendments of apparently limiting the investment opportunities of business development companies. In general, the SEC s proposed rules would define an eligible portfolio company as any company that does not have securities listed on a national securities exchange or association. We are currently in the process of reviewing the SEC s proposed rules and assessing its impact, to the extent such proposed rules are subsequently approved by the SEC, on our investment activities. We do not believe that these proposed rules will have a material adverse effect on our operations.

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

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

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

Disclosure Regarding Forward-Looking Statements

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

- **changes in the economy;**
- **risks associated with possible disruption in our operations due to terrorism;**
- **future changes in laws or regulations and conditions in our operating areas; and**
- **other risks and uncertainties as may be detailed from time to time in our public announcements and SEC filings.**

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

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

USE OF PROCEEDS

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

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

PRICE RANGE OF COMMON STOCK AND DISTRIBUTIONS

Our common stock is traded on the New York Stock Exchange under the symbol ALD. The following table lists the high and low closing sales prices for our common stock, the closing sales price as a percentage of net asset value (NAV) and quarterly dividends per share. On April , 2005, the last reported closing sale price of our common stock was $ per share.

	NAV(1)	Closing Sales Price High	Closing Sales Price Low	Premium of High Sales Price to NAV(2)	Premium of Low Sales Price to NAV(2)	Declared Dividends
Year ended December 31, 2003						
First Quarter	$14.05	$23.85	$19.82	170%	141%	$0.57
Second Quarter	$14.23	$25.16	$19.85	177%	139%	$0.57
Third Quarter	$14.46	$26.60	$22.97	184%	159%	$0.57
Fourth Quarter	$14.94	$28.16	$24.63	188%	165%	$0.57
Year ending December 31, 2004						
First Quarter	$14.60	$30.85	$27.15	211%	186%	$0.57
Second Quarter	$14.77	$30.25	$23.06	205%	156%	$0.57
Third Quarter	$14.90	$25.80	$22.22	173%	149%	$0.57
Fourth Quarter	$14.87	$28.47	$24.46	191%	164%	$0.57
Extra Dividend						$0.02
Year ended December 31, 2005						
First Quarter 2005	*	$27.84	$24.89	*	*	$0.57
Second Quarter (through April , 2005)	*			*	*	*

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

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

* Not determinable at the time of filing.

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

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

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

MANAGEMENT S DISCUSSION AND ANALYSIS

OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The information contained in this section should be read in conjunction with our 2004 Consolidated Financial Statements and the Notes thereto. In addition, this prospectus contains certain forward-looking statements. These statements include the plans and objectives of management for future operations and financial objectives and can be identified by the use of forward-looking terminology such as may, will, expect, intend, anticipate, estimate, or continue or the negative thereof or other variations thereon or comparable terminology. These forward-looking statements are subject to the inherent uncertainties in predicting future results and conditions. Certain factors that could cause actual results and conditions to differ materially from those projected in these forward-looking statements are set forth above in the Risk Factors section. Other factors that could cause actual results to differ materially include:

changes in the economy;

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

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

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

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

OVERVIEW

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, acquisitions, buyouts, recapitalizations, note purchases, bridge financings, and other types of financings. We generally invest in private companies though, from time to time, we may invest in companies that are public but lack access to additional public capital or whose securities may not be marginable.

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

	At December 31,		
	2004	2003	2002
Private finance	76%	74%	70%
Commercial real estate finance	24%	26%	30%

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

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

PORTFOLIO AND INVESTMENT ACTIVITY

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

	At and for the Years Ended December 31,		
($ in millions)	2004	2003	2002
Portfolio at value	$3,013.4	$2,584.6	$2,488.2
Investments funded	$1,524.5	$ 931.5	$ 506.4
Change in accrued or reinvested interest and dividends	$ 52.2	$ 45.0	$ 45.8
Principal collections related to investment repayments or sales	$ 909.2	$ 788.3	$ 356.6
Yield on interest-bearing investments(1)	14.0%	14.7%	14.0%

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

Private Finance

The private finance portfolio at value, investment activity, and the yield on loans and debt securities at and for the years ended December 31, 2004, 2003, and 2002, were as follows:

($ in millions)	At and for the Years Ended December 31, 2004	2003	2002
Portfolio at value:			
Loans and debt securities	$1,602.9	$1,214.9	$1,151.2
Equity interests	699.2	687.8	592.0
Total portfolio	$2,302.1	$1,902.7	$1,743.2
Investments funded[1]	$1,140.8	$ 498.0	$ 297.2
Change in accrued or reinvested interest and dividends	$ 45.6	$ 41.8	$ 43.6
Principal collections related to investment repayments or sales	$ 551.9	$ 318.6	$ 129.3
Yield on interest-bearing investments[2]	13.9%	15.0%	14.4%

(1) Investments funded for the year ended December 31, 2004, include a $47.5 million subordinated debt investment in The Hillman Companies, Inc. received in conjunction with the sale of Hillman as discussed below.

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

The level of investment activity for investments funded and principal repayments for private finance investments can vary substantially from year to year depending on many factors, including the amount of debt and equity capital available to middle market companies, the level of merger and acquisition activity for such companies, the general economic environment, and the competitive environment for the types of investments we make. During 2002, we believed that there was a decline in the availability of senior debt capital from banks for middle market companies and there were fewer merger and acquisition transactions for these companies. By mid-2003, we began to see an increase in merger and acquisition activity for middle market companies and debt capital became more available. We believe that merger and acquisition activity in the middle market was stronger in 2004, which when combined with a lower interest rate environment resulted in an increase in private finance investments funded, as well as increased repayments.

Investments funded for the years ended December 31, 2004, 2003, and 2002, consisted of the following:

($ in millions)	Loans and Debt Securities	Equity Interests	Total
For the Year Ended December 31, 2004			
Companies more than 25% owned	$445.4	$171.2	$ 616.6
Companies 5% to 25% owned	112.0	14.4	126.4
Companies less than 5% owned	351.5	46.3	397.8
Total	$908.9	$231.9	$1,140.8

($ in millions)	Loans and Debt Securities	Equity Interests	Total
For the Year Ended December 31, 2003			
Companies more than 25% owned	$ 53.0	$34.0	$ 87.0
Companies 5% to 25% owned	23.8	1.9	25.7
Companies less than 5% owned	377.4	7.9	385.3
Total	$454.2	$43.8	$498.0
For the Year Ended December 31, 2002			
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

During 2004, we invested $616.6 million in companies where we acquired or owned a majority ownership position as compared to $87.0 million for 2003. Investments in controlled portfolio companies during 2004 included the following:

The purchase of a majority ownership in Advantage Sales & Marketing, Inc. (Advantage), a leading sales and marketing agency providing outsourced sales, merchandising, and marketing services to the consumer packaged goods industry. At the closing of the transaction in June 2004, we invested $90.2 million in loans and subordinated debt and $73.5 million in common stock. In addition, prior to completing the purchase, we had invested $93.7 million in subordinated debt in certain predecessor companies of Advantage, of which $63.5 million was invested in the first and second quarters of 2004. This existing debt was exchanged for new subordinated debt in Advantage as part of the transaction.

The purchase of a majority ownership in Insight Pharmaceuticals Corporation (Insight), a marketer and distributor of over-the-counter pharmaceutical products. At the closing of the transaction in December 2004, we invested $124.0 million in senior and subordinated debt and $31.3 million in preferred and common stock. Our debt investment in Insight includes a $19.0 million revolving line of credit facility, of which Insight had borrowed $14.4 million at December 31, 2004.

The purchase of a majority ownership in Financial Pacific Company (Financial Pacific), a specialized commercial finance company focused on providing leases for business-essential equipment to small businesses nationwide. At the closing of the transaction in August 2004, we invested $68.4 million in debt and $24.7 million in preferred and common stock.

The purchase of a majority ownership in Mercury Air Centers, Inc. (Mercury), an operator of fixed base operations, from Mercury Air Group, Inc. At the closing of the transaction in April 2004, we invested $53.4 million in debt and $29.6 million in common stock. Since closing, we have invested an additional $1.6 million in common stock. In addition, we have an $8.5 million commitment to fund senior subordinated debt for future working capital and construction commitments, of which $0.8 million was outstanding at December 31, 2004. In connection with the transaction, Mercury Air Group, Inc. repaid its $24 million subordinated debt obligation to Allied Capital.

The purchase of Legacy Partners Group, LLC, a financial advisory firm. At the closing of the transaction in May 2004, we invested $4.3 million in debt and $2.7 million in equity interests. Since closing, we have invested additional debt of $5.0 million for working capital.

We intend to continue a balanced approach to private finance investing that emphasizes a complementary mix of mezzanine investments and buyout investments, subject to regulatory diversity requirements. The combination of these two types of investments provides current interest and related portfolio income and the potential for future capital gains.

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

At December 31, 2004, we had outstanding investment commitments to private finance portfolio companies totaling $313.1 million including the following:

$96.4 million of financing and purchase commitments to Callidus Capital Corporation (Callidus), an asset management company that structures and manages collateralized debt obligations (CDOs), loan collateralized loan obligations (CLOs), and other related investments. We own 80% of the equity of the management company. Our commitment consists of $50 million of subordinated debt to support Callidus warehouse facilities and warehousing activities, $44.4 million to purchase below investment grade bonds and preferred equity securities in Callidus future CDO or CLO transactions, and $2.0 million for working capital needs. Callidus has a secured warehouse credit facility with a third party for up to $300 million to primarily finance the acquisition of loans pending securitization through a CDO or CLO. In conjunction with this warehouse credit facility, we have agreed to designate up to $45 million of our $50 million subordinated debt commitment for Callidus to draw upon to provide first loss capital as needed to support the warehouse facility.

$107.8 million of availability under our outstanding commitment in the form of a $150.0 million revolving line of credit facility to support Callidus middle market underwriting and syndication activities. At December 31, 2004, there was $42.2 million outstanding under this facility which had been funded during 2004.

$20.0 million in the form of a revolving credit facility to Business Loan Express, LLC (BLX) to provide working capital to the company. At December 31, 2004, BLX had no outstanding borrowings on the facility.

$17.5 million in the form of debt of financing commitments to S.B. Restaurant Company.

$18.9 million in the form of equity to eight private venture capital funds.

$9.0 million in the form of equity to Pennsylvania Avenue Investors, L.P., a limited partnership controlled by us that invests in private buyout equity funds.

We may have commitments to fund additional amounts under earn-out arrangements primarily related to the purchase of controlled portfolio companies in the future if those companies meet agreed-upon performance targets. In addition, we had commitments to private finance portfolio companies in the form of standby letters of credit and guarantees totaling $141.6 million.

On March 31, 2004, we sold our control investment in The Hillman Companies, Inc. (Hillman) for a total transaction value of $510 million, including the repayment of outstanding debt and adding the value of Hillman s outstanding trust preferred shares. We were repaid our existing $44.6 million in outstanding debt. Total consideration to us from this sale at closing, including the repayment of debt, was $244.3 million, which included net cash proceeds of $196.8 million and the receipt of a new subordinated debt instrument of $47.5 million. During the second quarter of 2004, we sold a $5.0 million participation in our subordinated debt in Hillman to a third party, which reduced our investment, and no gain or loss resulted from the transaction. For the year ended December 31, 2004, we realized a gain of $150.3 million on the transaction, including gains of $1.3 million realized after closing resulting from post-closing adjustments, which provided additional cash consideration to us in the same amount. The sale of Hillman is subject to certain other post-closing adjustments.

The yield on the private finance loans and debt securities was 13.9% at December 31, 2004, as compared to 15.0% at December 31, 2003. The yield at December 31, 2004, was lower in part due to lower yielding senior debt investments in controlled portfolio companies. During 2004, we funded most or all of the debt and equity capital upon the closing of certain buyout transactions, which included investments in lower-yielding senior debt. In addition, we have provided lower-yielding senior debt to other controlled portfolio companies during the course of 2004. We currently expect that a portion of this senior debt outstanding at December 31, 2004, may be refinanced by the portfolio companies during 2005. While senior debt in the portfolio at December 31, 2004, may be refinanced, we may continue to fund lower-yielding senior debt in new or existing portfolio companies in the future, which may cause the weighted average yield on the private finance debt portfolio to fluctuate.

Business Loan Express, LLC. Our largest investment at December 31, 2004, was in Business Loan Express, LLC (BLX). Our investment in BLX totaled $280.4 million at cost and $335.2 million at value, or 10.3% of our total assets, which includes unrealized appreciation of $54.8 million. BLX was acquired in 2000.

BLX is a national, non-bank lender utilizing the SBA s 7(a) Guaranteed Loan Program and is licensed by the SBA as a Small Business Lending Company (SBLC). BLX is a nationwide preferred lender, as designated by the SBA, and originates, sells, and services small business loans. In addition to the SBA 7(a) Guaranteed Loan Program, BLX originates conventional small business loans, originates loans under the USDA Business and Industry Guaranteed Loan Program (B&I) and during the quarter ended March 31, 2004, began originating small investment real estate loans. BLX has offices across the United States and is headquartered in New York, New York.

Changes in the laws or regulations that govern SBLCs or the SBA 7(a) Guaranteed Loan Program or changes in government funding for this program could have a material adverse impact on BLX and, as a result, could negatively affect our financial results. During 2004, the SBA 7(a) loan program was faced with funding challenges and operated under certain restrictions. In December 2004, the appropriations legislation for fiscal year 2005 was signed into law and the SBA 7(a) loan program received $16.0 billion in lending authority. The maximum loan guarantee was increased from $1.0 million to $1.5 million on a maximum loan amount of $2.0 million, but piggyback lending (where the SBA 7(a) loan is in a junior lien position) is not allowed under the current program.

Summary financial data for BLX at and for the three months ended December 31, 2004, and its fiscal year ended September 30, 2004, is presented below. Summary financial data has been provided by BLX and is unaudited.

($ in millions)	At and for the Three Months Ended December 31, 2004	At and for the Fiscal Year Ended September 30, 2004
Operating Data		
Total revenue	$ 28.0	$ 118.3
Net income	$ 3.2	$ 14.5
Earnings before interest, taxes and management fees (EBITM)	$ 10.3	$ 44.6
Balance Sheet Data		
Total assets	$ 433.9	$ 446.5
Total debt	$ 216.4	$ 229.2
Total owners equity	$ 155.3	$ 153.2
Other Data		
Loan originations		
SBA 7(a)	$ 75.7	$ 358.6
Conventional	55.7	287.0
B&I		11.4
Total loan originations	$ 131.4	$ 657.0
Serviced loan portfolio	$2,600.6	$2,572.9
Number of loans	3,694	3,573
Loan delinquencies[(1)]	8.4%	8.9%
Serviced Loan Portfolio by Industry		
Hotels	24%	24%
Gas stations/convenience stores	20	20
Professional and retail services	12	12
Restaurants	8	8
Manufacturing and industrial	8	8
Car wash/auto repair services	7	7
Child care and health care services	6	6
Recreation	5	5
Shrimp/fishing vessels	4	4
Other	6	6
Total	100%	100%

(1) 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 8.6% at December 31, 2004. SBA 7(a) loans greater than one year old at December 31, 2004, had a delinquency rate of 10.2%. BLX will from time to time grant a 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, which has resulted in an increase in loan delinquencies. For these reasons, BLX focuses on collateral protection for each loan in addition to the cash flow of the small business and generally receives personal guarantees from the principal owners of the small business.

BLX s business is to originate small business loans and then sell substantially all of the loans originated for cash proceeds. 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 93% of BLX s revenue of $28.0 million for the three months ended December 31, 2004, and approximately 83% of BLX s revenue of $118.3 million for the fiscal year ended September 30, 2004.

During the calendar year ended December 31, 2004, the SBA 7(a) loan program underwent periods of operational change due to government funding limitations. For instance, the program implemented caps on loan size and discontinued the availability of an SBA 7(a) loan in a second mortgage position, or piggy-back loan. As a result, BLX had difficulty in building a consistent pipeline of new loan originations particularly in the March and December quarters. Loans originated during the three months ended December 31, 2004, totaled $131.4 million versus $188.3 million during the three months ended December 31, 2003. Proceeds from loan sales during the three months ended December 31, 2004, totaled approximately $141.2 million. Loans originated during the fiscal year ended September 30, 2004, totaled $657.0 million. Proceeds from loan sales during the fiscal year ended September 30, 2004, totaled approximately $618.8 million. From time to time, BLX funds the construction of commercial real estate projects and as a result is unable to sell a construction loan until the loan is fully funded and the construction is complete. In addition, BLX typically does not immediately receive the proceeds from the sale of its SBA 7(a) guaranteed and unguaranteed loan strips sold, but receives the cash upon settlement. Therefore, until BLX sells construction loans or fully funded loans held for sale, it will finance the origination of the loans through funding on its revolving line of credit, or through financing provided by us.

BLX sells the guaranteed piece of SBA 7(a) guaranteed loans for cash premiums of up to 10% of the guaranteed loan amount plus a retained annual servicing fee generally between 1.0% and 2.4% of the guaranteed loan amount. Cash premiums received from guaranteed loan sales during the three months ended December 31, 2004, and the fiscal year ended September 30, 2004, were approximately $5.7 million and $27.1 million in total, respectively. Alternatively, BLX may sell the guaranteed pieces of SBA 7(a) guaranteed loans at par and receive cash only for the face amount of the loan sold, and instead of receiving a cash premium, BLX will receive an annual servicing spread on the loans sold of between 4.0% and 5.0%.

In addition, BLX sells the unguaranteed pieces of the SBA 7(a) loans and conventional loans it originates into a conduit facility. The conduit loans are securitized and BLX retains an interest of up to 5.0% of the loan pool. BLX then receives the excess of loan interest payments on the loans sold over the interest cost on the securities issued in the securitization over the life of the loan pool, which is generally between 4.3% and 5.0% annually on the loans sold into the securitization pools.

When BLX sells a guaranteed piece of an SBA 7(a) loan at par, or when BLX securitizes a loan, it records a residual interest and servicing asset, together referred to as the Residual Interest, in order to account for the retained interest in the loans sold and the net present value of the future cash flows it expects to receive from the loans sold or securitized. In computing the Residual Interest, BLX discounts estimated future cash flows after making assumptions as to future loan losses and loan prepayments, which may reduce future cash flows. For the three months ended December 31, 2004, and the fiscal year ended September 30, 2004, BLX received cash payments from the Residual Interest of approximately $17.1 million and $59.7 million, respectively.

At December 31, 2004, BLX s Residual Interest totaled $226.5 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 $970.4 million over time, with approximately $79.7 million, $67.6 million, $66.1 million, and $64.4 million (or $277.8 million in the aggregate) scheduled to be received in the next four years ending on December 31, 2005, 2006, 2007, and 2008, respectively.

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

At December 31, 2004, our subordinated debt investment in BLX was $44.6 million at cost and value. Effective January 1, 2005, this debt was exchanged for Class B equity interests, which will be included in private finance equity interests. Since the subordinated debt will no longer be outstanding, the amount of taxable income available to flow through to BLX s equity holders will increase by the amount of interest that would have otherwise been paid on this debt. As a result of this exchange, private finance loans and debt securities would be lower by $44.6 million and the weighted average yield on the remaining loans and debt securities in the private finance portfolio, assuming no other changes, at December 31, 2004, would have been 13.6%.

Total interest and related portfolio income earned from the Company s investment in BLX for the years ended December 31, 2004, 2003, and 2002, was $50.0 million, $46.7 million, and $40.2 million, respectively, which includes interest income on the subordinated debt and Class A equity interests of $23.2 million, $21.9 million, and $20.7 million, respectively, dividend income on Class B interests of $14.8 million, $7.8 million, and $0, respectively, loan prepayment premiums of $0, $0.1 million, and $0, respectively, and fees and other income of $12.0 million, $16.9 million, and $19.5 million, respectively. Interest and dividend income from BLX for the years ended December 31, 2004, 2003, and 2002, included interest and dividend income of $25.4 million, $17.5 million, and $9.5 million, respectively, which was paid in kind. The interest and dividends paid in kind were paid to the Company through the issuance of additional debt or equity interests. Accrued interest and dividends receivable at December 31, 2004, included accrued interest due from BLX totaling $4.0 million, of which $3.3 million was paid in cash in early January 2005.

We have a commitment to BLX of $20.0 million in the form of a revolving credit facility to provide working capital to the company. This facility matures on June 30, 2005. At December 31, 2004, BLX had no outstanding borrowings under this facility.

At December 31, 2004, BLX had a three-year $275.0 million revolving credit facility that matures in January 2007. The facility provides for a sub-facility for the issuance of letters of credit for up to a total of $50.0 million. As the controlling equity owner in BLX, we have provided an unconditional guaranty to the revolving credit facility lenders in an amount equal to 50% of the total obligations (consisting of principal, letters of credit issued under the facility, accrued interest, and other fees) of BLX under the revolving credit facility. At December 31, 2004, the principal amount outstanding on the revolving credit facility was $171.8 million and letters of credit issued under the facility were $17.0 million. The total obligation guaranteed by us at December 31, 2004, was $94.6 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, 2004. At December 31, 2004, we had also provided four standby letters of credit totaling $35.6 million in connection with four term securitization transactions completed by BLX.

Commercial Real Estate Finance

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

	At and for the Years Ended December 31,					
	2004		2003		2002	
($ in millions)	Value	Yield(1)	Value	Yield(1)	Value	Yield(1)
Portfolio at value:						
CMBS bonds	$373.8	14.6%	$394.0	14.1%	$555.5	14.2%
CDO bonds and preferred shares	212.6	16.8%	186.6	16.7%	52.8	17.2%
Commercial mortgage loans	95.0	6.8%	83.6	8.6%	63.7	7.5%
Residual interest					69.0	9.4%
Real estate owned	16.9		12.8		4.0	
Equity interests	13.0		4.9			
Total portfolio	$711.3		$681.9		$745.0	
Investments funded	$383.7		$433.5		$209.2	
Change in accrued or reinvested interest	$ 6.6		$ 3.2		$ 2.2	
Principal collections related to investment repayments or sales	$357.3		$469.7		$227.3	

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

Our commercial real estate investments funded for the years ended December 31, 2004, 2003, and 2002, were as follows:

($ in millions)	Face Amount	Discount	Amount Funded
For the Year Ended December 31, 2004			
CMBS bonds (13 new issuances[1])	$419.1	$(183.7)	$235.4
CDO bonds and preferred shares (3 issuances)	40.5	(0.1)	40.4
Commercial mortgage loans	112.1	(8.2)	103.9
Equity interests	4.0		4.0
Total	$575.7	$(192.0)	$383.7
For the Year Ended December 31, 2003			
CMBS bonds (15 new issuances[1])	$508.5	$(225.9)	$282.6
CDO bonds and preferred shares (3 issuances)	145.8	(0.4)	145.4
Commercial mortgage loans	3.0		3.0
Equity interests	2.5		2.5
Total	$659.8	$(226.3)	$433.5
For the Year Ended December 31, 2002			
CMBS bonds (5 new issuances)	$302.5	$(140.2)	$162.3
CDO preferred shares (3 issuances)	29.0		29.0
Commercial mortgage loans	11.7	(1.7)	10.0
Real estate owned	7.9		7.9
Total	$351.1	$(141.9)	$209.2

(1) CMBS investments also include investments in issuances in which we have previously purchased CMBS bonds.

At December 31, 2004, we had outstanding funding commitments related to commercial mortgage loans and equity interests of $17.1 million and commitments in the form of standby letters of credit and guarantees related to equity interests of $2.7 million.

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

	For the Years Ended December 31,					
	2004		2003		2002	
Loan to Value Ranges ($ in millions)	Amount	Percentage	Amount	Percentage	Amount	Percentage
Less than 60%	$ 3,581.6	22%	$ 4,114.3	22%	$ 909.3	20%
60-65%	1,436.1	9	1,582.8	9	287.3	6
65-70%	1,288.6	8	1,768.0	10	587.9	13
70-75%	3,561.2	22	4,024.3	22	1,214.5	27
75-80%	5,655.5	35	6,560.5	36	1,477.5	33
Greater than 80%	550.0	4	138.6	1	47.8	1
Total	$16,073.0	100%	$18,188.5	100%	$4,524.3	100%

Weighted average loan to value	68.6%	68.5%	68.5%

Debt Service Coverage Ratio Ranges ($ in millions)	For the Years Ended December 31, 2004 Amount	Percentage	2003 Amount	Percentage	2002 Amount	Percentage
Greater than 2.00	$ 2,317.1	14%	$ 4,208.7	23%	$ 366.9	8%
1.76 2.00	1,508.3	9	2,094.6	12	229.6	5
1.51 1.75	2,071.3	13	3,132.8	17	477.4	11
1.26 1.50	7,316.1	46	7,362.9	40	2,739.6	60
Less than 1.25	2,860.2	18	1,389.5	8	710.8	16
Total	$16,073.0	100%	$18,188.5	100%	$4,524.3	100%
Weighted average debt service coverage ratio	1.59		1.73		1.41	

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

($ in millions)	For the Years Ended December 31, 2004	2003	2002
Cost basis	$273.0	$412.3	$205.9
Gross sales proceeds(1)	$295.5	$446.8	$225.6
Net realized gains (net of related hedge gains or losses)	$ 17.4	$ 31.6	$ 19.1
Weighted average yield	8.5%	10.1%	11.5%

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

During 2004, we completed a securitization of $53.7 million of commercial mortgage loans. In connection with this securitization, we received proceeds, net of costs, of $54.0 million, including $28.3 million of cash and $25.7 million of A and AA rated bonds and LLC interests, which have been included in the CMBS portfolio at December 31, 2004. The realized gain from this securitization was $0.3 million.

The CMBS bonds in which we invest are junior in priority for payment of interest and principal to the more senior tranches of the related CMBS bond issuance. Cash flow from the underlying mortgages is generally allocated first to the senior tranches in order of priority, with the most senior tranches having a priority right to the cash flow. Then, any remaining cash flow is allocated, generally, among the other tranches in order of their relative seniority. To the extent there are defaults and unrecoverable losses on the underlying mortgages or properties securing those mortgages resulting in reduced cash flows, our most subordinate tranche will bear this loss first. At December 31, 2004, the face value of the CMBS bonds rated BBB- and below which we held were subordinate to 84% to 99% of the face value of the bonds issued in these various CMBS transactions. Given that the non-investment grade CMBS bonds in which we invest are junior in priority for payment of interest and principal, we invest in these CMBS bonds at a discount from the face amount of the bonds. The discount increases with the decrease in the seniority of the CMBS bonds. For the years ended December 31, 2004, 2003, and 2002, the average discount for the CMBS bonds in which we invested was 44%, 44%, and 46%, respectively.

At December 31, 2004, the unamortized discount related to the CMBS bond portfolio was $660.4 million, of which $346.5 million has been set aside to absorb potential future losses. The yield on the CMBS bonds of 14.6% assumes that this amount that has been set aside will not be amortized. As the amount of future losses and the expected timing of recognition of such losses is difficult to predict and is subject to future events which may alter these assumptions, no assurance can be given that the anticipated yield will be achieved. At December 31, 2004, the CMBS bond portfolio had a fair value of $373.8 million, which included net unrealized depreciation on the CMBS bonds of $9.5 million.

The yield on the CMBS bond portfolio at any point in time will vary depending on the concentration of lower yielding BB- and above rated CMBS bonds held in the portfolio. Our CMBS bond portfolio and the related yields at December 31, 2004 and 2003, were as follows:

	December 31,			
	2004		2003	
($ in millions)	Value	Yield	Value	Yield
CMBS bonds rated BB- and above	$ 39.5	6.9%	$ 88.4	8.2%
CMBS bonds rated below BB-	334.3	15.5%	305.6	15.8%
Total	$373.8	14.6%	$394.0	14.1%

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

	December 31,			
	2004		2003	
($ in millions)	Value	Percentage	Value	Percentage
Less than one year old	$ 82.9	24.8%	$ 83.9	27.5%
One to two years old	55.4	16.6	41.0	13.4
Two to three years old	29.9	8.9	43.8	14.3
Three years old or older	166.1	49.7	136.9	44.8
Total	$334.3	100.0%	$305.6	100.0%

At December 31, 2004 and 2003, we held CMBS bonds in 45 and 38 separate CMBS issuances, respectively. The underlying collateral pool, consisting of commercial mortgage loans and real estate owned (REO) properties, for these CMBS bonds consisted of the following at December 31, 2004 and 2003:

	December 31,	
($ in millions)	2004	2003
Approximate number of loans and REO properties(1)	6,200	5,600
Total outstanding principal balance	$42,759	$38,437
Loans over 30 days delinquent or classified as REO properties(2)	1.6% (3)	1.5% (3)

(1) Includes approximately 39 and 22 REO properties obtained through the foreclosure of commercial mortgage loans at December 31, 2004 and 2003, respectively.

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

(3) At December 31, 2004 and 2003, our investments included bonds in the first loss, unrated bond class in 43 and 34 separate CMBS issuances, respectively. For these issuances, loans over 30 days delinquent or classified as REO properties were 1.7% of the total outstanding principal balance at both December 31, 2004 and 2003.

Collateralized Debt Obligation Bonds and Preferred Shares. During the year ended December 31, 2004, we sold CDO bonds with a cost basis of $19.2 million for a net realized gain of $0.2 million, net of the related hedge net gain. During the year ended December 31, 2003, we sold CDO bonds and preferred shares with a cost basis of $13.9 million, respectively, for net realized losses of $0.1 million net of the related hedge gains. The yield on the CDO bonds and preferred shares sold was 7.7% and 8.0% for the years ended December 31, 2004 and 2003, respectively.

The bonds and preferred shares of the CDOs in which we have invested are junior in priority for payment of interest and principal to the more senior tranches of debt issued by the CDOs. To the extent there are defaults and unrecoverable losses on the underlying collateral that result in reduced cash flows, the preferred shares will bear this loss first and then the bonds would bear any loss after the preferred shares. At December 31, 2004, our bonds and preferred shares in the CDOs were subordinate to 70% to 98% of the more senior tranches of debt issued in the various CDO transactions. In addition, included in the CMBS collateral for the CDOs at December 31, 2004, were certain CMBS bonds that are senior in priority of repayment to certain lower rated CMBS bonds held directly by us.

The yield on our CDO bonds and preferred shares at December 31, 2004, 2003, and 2002, was 16.8%, 16.7%, and 17.2%, respectively. The yield on the CDO portfolio at any point in time will generally vary depending on the amount of lower yielding CDO bonds held in the portfolio.

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

	December 31,	
($ in millions)	**2004**	**2003**
Investment grade REIT debt(1)	$1,532.5	$1,338.0
Investment grade CMBS bonds(2)	918.8	662.3
Non-investment grade CMBS bonds(3)	1,636.4	1,133.7
Other collateral	355.8	32.4
Total collateral	$4,443.5	$3,166.4

(1) Issued by 44 REITs for both periods presented.

(2) Issued in 121 and 78 transactions, respectively, for the periods presented.

(3) Issued in 109 and 68 transactions, respectively, for the periods presented.

Since we are limited as to the amount of debt capital we can use to finance our commercial real estate investments, we are evaluating various strategic alternatives for our commercial real estate platform. These alternatives may include the sale, spin-out or recapitalization of all or part of our commercial real estate investments.

Hedging Activities

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

The total obligations to replenish borrowed Treasury securities, including accrued interest payable on the obligations, were $38.2 million and $98.5 million at December 31, 2004 and 2003, respectively. The net proceeds related to the sales of the borrowed Treasury securities plus or minus the cash collateral provided or received under the terms of the transactions were $38.2 million and $98.5 million at December 31, 2004 and 2003, respectively. The amount of the hedge will vary from period to period depending upon the amount of higher rated CMBS and CDO bonds that we own and have hedged on the balance sheet date.

Portfolio Asset Quality

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

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

	December 31,			
	2004		2003	
Grade	Portfolio at Value	Percentage of Total Portfolio	Portfolio at Value	Percentage of Total Portfolio
($ in millions)				
1	$ 952.5	31.6%	$ 985.1	38.1%
2	1,850.5	61.4	1,271.4	49.2
3	121.2	4.0	212.4	8.2
4	11.7	0.4	34.7	1.4
5	77.5	2.6	81.0	3.1
	$3,013.4	100.0%	$2,584.6	100.0%

Grade 2 investments at December 31, 2004, increased over Grade 2 investments at December 31, 2003, primarily due to new investments made during 2004. Investments in new portfolio companies generally enter the portfolio as Grade 2 investments. We continue to include our CMBS portfolio in Grade 2 assets, as we are uncertain as to whether the unrealized appreciation or depreciation on our CMBS portfolio at December 31, 2004, will necessarily result in a realized gain or loss.

Total Grade 3, 4, and 5 portfolio assets as a percentage of the total portfolio at value at December 31, 2004 and 2003, were 7.0% and 12.7%, respectively. Included in Grade 3, 4, and 5 assets at December 31, 2004 and 2003, were assets totaling $38.3 million and $31.1 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 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 Grade 4 and 5 may fluctuate from period to period. We continue to follow our historical practice of working with such companies in order to recover the maximum amount of our investment.

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

	December 31,	
($ in millions)	2004	2003
Loans and debt securities in workout status (classified as Grade 4 or 5)[1]		
Private finance		
Companies more than 25% owned	$ 34.4	$ 31.9
Companies 5% to 25% owned		2.7
Companies less than 5% owned	16.5	28.0
Commercial real estate finance	5.6	6.8
Loans and debt securities not in workout status		
Private finance		
Companies more than 25% owned	29.4	31.9
Companies 5% to 25% owned	0.7	
Companies less than 5% owned	15.8	16.5
Commercial real estate finance	12.5	0.2
Total	$114.9	$118.0
Percentage of total portfolio	3.8%	4.6%

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

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

	December 31,	
($ in millions)	2004	2003
Private finance	$ 73.5	$ 85.6
Commercial real estate finance		
CMBS bonds	49.0	40.3
Commercial mortgage loans	10.1	3.7
Total	$132.6	$129.6

Percentage of total portfolio	4.4%	5.0%

Loans and debt securities on non-accrual status and over 90 days delinquent should not be added together as they are two separate measures of portfolio asset quality. Loans and debt securities that are in both categories (i.e., on non-accrual status and over 90 days delinquent) totaled $43.9 million and $46.1 million at December 31, 2004 and 2003, respectively, which included loans and debt securities that are secured by commercial real estate of $10.2 million and $3.9 million, respectively.

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

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

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

Accrued Interest and Dividends Receivable

Accrued interest and dividends receivable as of December 31, 2004 and 2003, was as follows:

	December 31,	
($ in millions)	2004	2003
Private finance	$59.8	$40.1
Commercial real estate finance		
CMBS and CDO bonds	18.9	12.1
Commercial mortgage loans and other	0.8	0.9
Total	$79.5	$53.1

RESULTS OF OPERATIONS

Comparison of the Years Ended December 31, 2004, 2003, and 2002

The following table summarizes our operating results for the years ended December 31, 2004, 2003, and 2002.

(in thousands, except per share amounts)	2004	2003	Change	Percent Change	2003	2002	Change	Percent Change
Interest and Related Portfolio Income								
Interest and dividends	$319,642	$290,719	$28,923	10%	$290,719	$264,042	$ 26,677	10%
Loan prepayment premiums	5,502	8,172	(2,670)	(33)%	8,172	2,776	5,396	194%
Fees and other income	41,946	30,338	11,608	38%	30,338	43,110	(12,772)	(30)%
Total interest and related portfolio income	367,090	329,229	37,861	11%	329,229	309,928	19,301	6%
Expenses								
Interest	75,650	77,233	(1,583)	(2)%	77,233	70,443	6,790	10%
Employee(1)	40,728	36,945	3,783	10%	36,945	33,126	3,819	12%
Individual performance award	13,011		13,011	**				
Administrative(1)	35,686	22,387	13,299	59%	22,387	21,504	883	4%
Total operating expenses	165,075	136,565	28,510	21%	136,565	125,073	11,492	9%
Net investment income before income taxes	202,015	192,664	9,351	5%	192,664	184,855	7,809	4%
Income tax expense (benefit)	1,057	(2,466)	3,523	**	(2,466)	930	(3,396)	**
Net investment income	200,958	195,130	5,828	3%	195,130	183,925	11,205	6%
Net Realized and Unrealized Gains (Losses)								
Net realized gains	117,240	75,347	41,893	56%	75,347	44,937	30,410	68%
Net change in unrealized appreciation or depreciation	(68,712)	(78,466)	9,754	*	(78,466)	(571)	(77,895)	*
Total net gains (losses)	48,528	(3,119)	51,647	*	(3,119)	44,366	(47,485)	*
Net income	$249,486	$192,011	$57,475	30%	$192,011	$228,291	$(36,280)	(16)%
Diluted earnings per common share	$ 1.88	$ 1.62	$ 0.26	16%	$ 1.62	$ 2.20	$ (0.58)	(26)%
Weighted average common shares outstanding diluted	132,458	118,351	14,107	12%	118,351	103,574	14,777	14%

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

* Net change in unrealized appreciation or depreciation and net gains (losses) can fluctuate significantly from year to year.

** Percentage change is not meaningful.

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

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Interest and dividend income for the years ended December 31, 2004, 2003, and 2002, was composed of the following:

($ in millions)	2004	2003	2002
Interest	$301.0	$275.3	$259.4
Dividends	18.6	15.4	4.6
Total	$319.6	$290.7	$264.0

The level of interest income, which includes interest paid in cash and in kind, is directly related to the balance of the interest-bearing investment portfolio outstanding during the period multiplied by the weighted average yield. The weighted average yield varies from period to period based on the current stated interest on interest-bearing investments and the amount of loans and debt securities for which interest is not accruing. The interest-bearing investments in the portfolio at value and the weighted average yield on the interest-bearing investments in the portfolio at December 31, 2004, 2003, and 2002, were as follows:

($ in millions)	2004	2003	2002
Interest-bearing portfolio	$2,301.2	$1,891.9	$1,896.2
Portfolio yield(1)	14.0%	14.7%	14.0%

(1) See discussion on portfolio yields above under Portfolio and Investment Activity.

Dividend income results from the dividend yield on preferred equity interests, if any, or the declaration of dividends by a portfolio company on preferred or common equity interests. Dividend income will vary from period to period depending upon the level of yield on our preferred equity interests and the timing and amount of dividends that are declared by a portfolio company on preferred or common equity interests. Dividend income increased in 2004 and 2003 primarily due to the receipt of dividends from BLX on the Class B equity interests held by us. The total dividend declared by BLX was $14.8 million and $7.8 million for the years ended December 31, 2004 and 2003, respectively, and these dividends were paid through the issuance of additional Class B equity interests.

Loan prepayment premiums were $5.5 million, $8.2 million, and $2.8 million for the years ended December 31, 2004, 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. Therefore, we generally structure our loans to require a prepayment premium for the first three to five years of the loan. Accordingly, the amount of prepayment premiums will vary depending on the level of repayments and the age of the loans at the time of repayment. Prepayment premiums were higher in 2004 and 2003 as compared to 2002 as a result of an increase in loan prepayments during the prepayment penalty period. Prepayment premiums in 2004 were lower than in 2003 because the loans that prepaid in 2004 generally had lower prepayment penalty requirements than those that prepaid in 2003.

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

Fees and other income for the years ended December 31, 2004, 2003, and 2002, included fees relating to the following:

($ in millions)	2004	2003	2002
Structuring and diligence	$18.4	$ 6.1	$15.0
Transaction and other services provided to portfolio companies	3.2	4.5	4.4
Management services provided to portfolio companies, other advisory services and guaranty fees	17.4	18.7	23.2
Other income	2.9	1.0	0.5
Total	$41.9	$30.3	$43.1

Fees and other income are generally related to specific transactions or services and therefore may vary substantially from year to year depending on the level and types of services provided. Loan origination fees that represent yield enhancement on a loan are capitalized and amortized into interest income over the life of the loan. Fees and other income for the year ended December 31, 2004, include structuring fees related to the purchase of majority ownership in Advantage, Financial Pacific, Mercury, and Insight totaling $10.0 million.

BLX and Advantage were our largest investments at December 31, 2004, and together represented 19.0% of our total assets. Total interest and related portfolio income earned from BLX and Advantage for the year ended December 31, 2004, was $50.0 million and $21.3 million, respectively. Total interest and related portfolio income for the year ended December 31, 2004, included $2.5 million of income earned from Hillman prior to the sale of our control investment on March 31, 2004, as discussed above.

BLX and Hillman were our largest portfolio investments at December 31, 2003 and 2002, and together represented 19.1% and 15.6% of our total assets at December 31, 2003 and 2002, respectively. Total interest and related portfolio income earned from BLX for the years ended December 31, 2003 and 2002, was $46.7 million and $40.2 million, respectively. Total interest and related portfolio income earned from Hillman for the years ended December 31, 2003 and 2002, was $9.7 million and $9.3 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, 2004, 2003, and 2002, were primarily attributable to changes in the level of our borrowings under various notes payable and debentures and our revolving line of credit. Our borrowing activity and weighted average cost of debt, including fees and closing costs, at and for the years ended December 31, 2004, 2003, and 2002, were as follows:

($ in millions)	2004	2003	2002
Total outstanding debt	$1,176.6	$954.2	$998.5
Average outstanding debt	$ 985.6	$943.5	$938.1
Weighted average interest cost[1]	6.6%	7.5%	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 on the balance sheet date.

In addition to interest on indebtedness, interest expense includes interest on our obligations to replenish borrowed Treasury securities related to our hedging activities of $5.2 million, $5.9 million, and $1.7 million for the years ended December 31, 2004, 2003, and 2002, respectively.

Employee expenses include salaries and employee benefits. The change in employee expense reflects the effect of wage increases, increased staffing, and the change in mix of employees given their area of responsibility and relevant experience level. Total employees were 162, 125, and 105 at December 31, 2004, 2003, and 2002, respectively. During 2003 and 2002, employee expenses included a retention award program whereby senior officers received cash awards as part of their compensation. The retention award component for the years ended December 31, 2003 and 2002, was $8.6 million and $7.9 million, respectively. Beginning January 1, 2004, we no longer provided retention awards.

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

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

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

For the year ended December 31, 2004, we accrued $13.4 million in IPA expense, or $0.10 per share. We contributed these amounts into the DCP II trust during the year. Because the IPA is deferred compensation, the cost of this award is not a current expense for purposes of computing our taxable income. The expense is deferred for tax purposes until distributions are made from the trust. The accounts of the DCP II are consolidated with our accounts. Further, we are required to mark to market the liability to pay the employees in our stock and this adjustment is recorded to the IPA compensation expense. The effect of this adjustment for the year ended December 31, 2004, was to reduce the individual performance award expense by $0.4 million. The Compensation Committee and the Board of Directors have determined the IPA for 2005 and it is currently expected to be approximately $7.5 million.

As a result of recent changes in regulation by the Jobs Creation Act of 2004 associated with deferred compensation arrangements, as well as an increase in the competitive market for recruiting top performers in private equity firms, the Compensation Committee and the Board of Directors have determined for 2005 that a portion of the IPA should be replaced with an individual performance bonus (IPB). The IPB for 2005 has been determined to be approximately $7.5 million, and will be distributed in cash to award recipients in equal bi-weekly installments as long as the recipient remains employed by us. If a recipient terminates employment during the year, any remaining cash payments under the IPB would be forfeited.

The total of the IPA and IPB for 2005 is currently estimated to be $15.0 million. These amounts are subject to change if there is a change in the composition of the pool of award recipients during the year.

Administrative expenses include legal and accounting fees, valuation assistance fees, insurance premiums, the cost of leases for our headquarters in Washington, DC, and our regional offices, stock record expenses, directors fees, and various other expenses. Administrative expenses have increased to $35.7 million for the year ended December 31, 2004. This is a $13.3 million increase over administrative expenses of $22.4 million for the year ended December 31, 2003.

The largest component of the increase in expenses resulted from a net increase in legal, accounting, consulting, and other fees for 2004 as compared to 2003 of $4.9 million. This increase is primarily attributable to fees associated with the implementation of the requirements under the Sarbanes-Oxley Act of 2002 (including Section 404), the response to requests for information from regulatory and other government agencies, valuation assistance and other corporate matters.

Legal fees totaled $4.6 million for 2004 as compared to $1.4 million for 2003. We expect that legal expenses will continue to increase substantially in the near term as the result of ongoing requests for documents and information from regulatory and other government agencies related to ongoing investigations. As a result, we expect that total administrative expenses will also increase in 2005 as compared to 2004.

We have also incurred increased deal costs in 2004 related to evaluating potential new investments. Costs related to mezzanine lending are generally paid by the borrower, however, costs related to buyout investments are generally funded by us. Accordingly, if a prospective deal does not close, we incur expenses that are not recoverable. As a result, these related costs were $1.6 million higher for 2004 than for the prior year. We have increased our focus on managing buyout-related costs, however, we expect that there will be some increased costs from this activity going forward. In addition, expenses related to portfolio development and workout activities were $1.5 million higher for 2004 versus the prior year. We expect the costs related to workouts to decline given the decline in workout assets in the portfolio.

The remaining increase in administrative expenses for 2004 over 2003 was primarily due to increased rent of $1.4 million associated with the opening of an office in Los Angeles, CA and expanding our office space in Chicago, IL and New York, NY, increased other corporate expenses, including stock record expense, insurance premiums and directors fees, of $1.1 million, the incurrence of $1.0 million in excise tax related to excess taxable income carried forward into 2005, and increased travel expenses of $0.8 million.

Administrative expenses were $22.4 million for 2003, a $0.9 million increase over administrative expenses of $21.5 million for 2002. Excluding costs associated with closing the Germany office in 2002 totaling $2.5 million, administrative expenses for 2003 increased by $3.4 million over 2002. The net increase in legal, accounting, consulting and other fees for 2003 as compared to 2002 was $0.8 million. Fees related to market activity in our stock were substantially lower in 2003 as compared to 2002, however, the level of professional fees incurred in 2003 still increased over 2002 as we incurred significant legal, accounting, consulting and other fees in 2003 related to the implementation of the requirements under the Sarbanes-Oxley Act of 2002. The remaining increase in administrative expenses for 2003 over 2002 was primarily due to increased costs associated with corporate liability insurance of $1.4 million, travel costs of $0.6 million, and directors fees of $0.5 million.

Income Tax Expense (Benefit). Our wholly owned subsidiary, AC Corp, is a corporation subject to federal and state income taxes and records an expense or benefit for income taxes as appropriate. For the years ended December 31, 2004 and 2002, we recorded tax expense of $1.1 million and $0.9 million, respectively, primarily as a result of AC Corp s operating income for the periods. For the year ended December 31, 2003, we recorded a tax benefit of $2.5 million as a result of AC Corp s operating loss for the period.

Realized Gains and Losses. Net realized gains primarily result from the sale of equity securities associated with certain private finance investments, the sale of CMBS bonds and CDO bonds and preferred shares, and the realization of unamortized discount resulting from the sale and early repayment of private finance loans and commercial mortgage loans, offset by losses on investments. Net realized gains and losses for the years ended December 31, 2004, 2003, and 2002, were as follows:

($ in millions)	2004	2003	2002
Realized gains	$ 267.7	$ 94.3	$ 95.5
Realized losses	(150.5)	(19.0)	(50.6)
Net realized gains	$ 117.2	$ 75.3	$ 44.9

When we exit an investment and realize a gain or loss, we make an accounting entry to reverse any unrealized appreciation or depreciation, respectively, we had previously recorded to reflect the appreciated or depreciated value of the investment. For the years ended December 31, 2004, 2003, and 2002, we reversed previously recorded unrealized appreciation or depreciation when gains or losses were realized as follows:

($ in millions)	2004	2003	2002
Reversal of previously recorded unrealized appreciation associated with realized gains	$(210.5)	$(78.5)	$(78.8)
Reversal of previously recorded unrealized depreciation associated with realized losses	151.8	20.3	49.0
Total reversal	$ (58.7)	$(58.2)	$(29.8)

Realized gains and losses for the years ended December 31, 2004, 2003, and 2002, resulted from various private finance and commercial real estate finance transactions.

Realized gains for the year ended December 31, 2004, primarily resulted from transactions involving 13 private finance portfolio companies The Hillman Companies, Inc. ($150.3 million), CorrFlex Graphics, LLC ($25.7 million), Professional Paint, Inc. ($13.7 million), Impact Innovations Group, LLC ($9.4 million), The Hartz Mountain Corporation ($8.3 million), Housecall Medical Resources, Inc. ($7.2 million), International Fiber Corporation ($5.2 million), CBA-Mezzanine Capital Finance, LLC ($4.1 million), United Pet Group, Inc. ($3.8 million), Oahu Waste Services, Inc. ($2.8 million), Grant Broadcasting Systems II ($2.7 million), Matrics, Inc. ($2.1 million), and SmartMail, LLC ($2.1 million), and one transaction involving a commercial mortgage loan ($1.8 million). In addition, gains were also realized on CMBS bonds ($17.4 million, net of a net realized loss of $3.8 million from hedges related to the CMBS bonds sold).

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

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

Realized losses for the year ended December 31, 2004, primarily resulted from transactions involving 13 private finance portfolio companies American Healthcare Services, Inc. ($32.9 million), The Color Factory, Inc. ($24.5 million), Executive Greetings, Inc. ($19.3 million), Sydran Food Services II, L.P. ($18.2 million), Ace Products, Inc. ($17.6 million), Prosperco Finanz Holding AG ($7.5 million), Logic Bay Corporation ($5.0 million), Sun States Refrigerated Services, Inc. ($4.7 million), Chickasaw Sales & Marketing, Inc. ($3.8 million), Sure-Tel, Inc. ($2.3 million), Liberty-Pittsburgh Systems, Inc. ($2.0 million), EDM Consulting, LLC ($1.9 million), and Startec Global Communications Corporation ($1.1 million), and two transactions involving commercial mortgage loans ($2.1 million).

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

Realized losses for the year ended December 31, 2002, primarily resulted from transactions involving 11 private finance portfolio companies, including Velocita, Inc. ($16.0 million), Schwinn Holdings Corporation ($7.9 million), Convenience Corporation of America ($5.8 million), Startec Global Communications Corporation ($4.5 million), The Loewen Group, Inc. ($2.7 million), Monitoring Solutions, Inc. ($1.7 million), Most 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).

Change in Unrealized Appreciation or Depreciation. We determine the value of each investment in our portfolio on a quarterly basis, and changes in value result in unrealized appreciation or depreciation being recognized in our statement of operations. Value, as defined in Section 2(a)(41) of the Investment Company Act of 1940, is (i) the market price for those securities for which a market quotation is readily available and (ii) for all other securities and assets, fair value is as determined in good faith by the Board of Directors. Since there is typically no readily available market value for the investments in our portfolio, we value substantially all of our portfolio investments at fair value as determined in good faith by the Board of Directors pursuant to a valuation policy and a consistently applied valuation process. At December 31, 2004, portfolio investments recorded at fair value were approximately 92% of our total assets. Because of the inherent uncertainty of determining the fair value of investments that do not have a readily available market value, the fair value of our investments determined in good faith by the Board of Directors may differ significantly from the values that would have been used had a ready market existed for the investments, and the differences could be material.

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

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

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

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

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

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

In connection with our valuation process to determine the fair value of a private finance investment, we work with independent third-party consultants to obtain assistance and advice as additional support in the preparation of our internal valuation analysis for a portion of the portfolio each quarter (for all investments with a cost or value greater than $250,000). In addition, we may receive independent assessments of a particular private finance portfolio company s value in the ordinary course of business, most often in the context of a prospective sale transaction or in the context of a bankruptcy process. The valuation analysis prepared by management using these independent valuation resources is submitted to our Board of Directors for its determination of fair value of the portfolio in good faith.

We received quarterly valuation assistance from S&P Corporate Value Consulting (S&P CVC) during 2004, including assistance with the valuation of Business Loan Express (BLX) in the third and fourth quarters of 2004. For the full year, S&P CVC has assisted us with the valuation of 104 portfolio companies. S&P CVC has assisted us in valuing all of the portfolio company investments that were in our portfolio at December 31, 2003, and were still in the portfolio at December 31, 2004. In addition, S&P CVC has assisted us in valuing 11 portfolio company investments that were added to the portfolio during 2004, including Advantage Sales & Marketing, Inc.

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

Net Change in Unrealized Appreciation or Depreciation. For the portfolio, net change in unrealized appreciation or depreciation for the years ended December 31, 2004, 2003, and 2002, consisted of the following:

($ in millions)	2004	2003	2002
Net unrealized appreciation or depreciation	$ (10.0)	$ (20.3)	$ 29.2
Reversal of previously recorded unrealized appreciation associated with realized gains	(210.5)	(78.5)	(78.8)
Reversal of previously recorded unrealized depreciation associated with realized losses	151.8	20.3	49.0
Net change in unrealized appreciation or depreciation	$ (68.7)	$ (78.5)	$ (0.6)

For the year ended December 31, 2004, our two most significant changes in net unrealized appreciation were in BLX and Advantage. The following is a summary of the methodology that we used to determine the fair value of these investments.

Business Loan Express, LLC. To determine the value of our investment in BLX at December 31, 2004, we performed four separate valuation analyses to determine a range of values: (1) analysis of comparable public company trading multiples, (2) analysis of BLX s value assuming an initial public offering, (3) analysis of merger and acquisition transactions for financial services companies, and (4) a discounted dividend analysis. We performed the analyses with the assistance of JMP Securities. In addition, we received valuation assistance from S&P CVC for our investment in BLX at December 31, 2004.

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

Our investment in BLX at December 31, 2004, was valued at $335.2 million. This fair value was within the range of values determined by the four valuation analyses. Unrealized appreciation on our investment was $54.8 million at December 31, 2004. This is a decrease in unrealized appreciation of $32.3 million from December 31, 2003.

Advantage Sales & Marketing, Inc. S&P CVC assisted us with the valuation of our investment in Advantage at December 31, 2004. We determined the enterprise value of Advantage by using their trailing twelve month normalized EBITDA times a multiple. The multiple we used was consistent with our entry multiple when we acquired Advantage in June 2004. Using this enterprise value, we determined the value of our investments in Advantage to be $283.0 million, resulting in unrealized appreciation of $24.3 million.

OTHER MATTERS

Per Share Amounts. All per share amounts included in the Management s Discussion and Analysis of Financial Condition and Results of Operations section have been computed using the weighted average shares used to compute diluted earnings per share, which were 132.5 million, 118.4 million, and 103.6 million for the years ended December 31, 2004, 2003, and 2002, 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, otherwise referred to as the Code. As long as we qualify as a regulated investment company, we are not taxed on our investment company taxable income or realized net capital gains, to the extent that such taxable income or gains are distributed, or deemed to be distributed, to shareholders on a timely basis.

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

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

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

Legal Proceedings. On June 23, 2004, we were notified by the SEC that they are conducting an informal investigation of us. On December 22, 2004, we received letters from the U.S. Attorney for the District of Columbia requesting the preservation and production of information regarding us and Business Loan Express, LLC in connection with a criminal investigation. Based on the information available to us at this time, the inquiries appear to pertain to matters related to portfolio valuation and our portfolio company, Business Loan Express, LLC. We are cooperating with the SEC s and the U.S. Attorney s investigations.

In addition to the above matters, we are party to certain lawsuits in the normal course of business.

While the outcome of these legal proceedings and other matters cannot at this time be predicted with certainty, we do not expect that these matters will have a material effect upon our financial condition or results of operations.

FINANCIAL CONDITION, LIQUIDITY AND CAPITAL RESOURCES

Cash Flow From Operating Activities

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

	For the Years Ended December 31,		
($ in millions)	**2004**	**2003**	**2002**
Net cash provided by (used in) operating activities	$ (179.3)	$ 80.3	$ 65.3
Add: portfolio investments funded	1,472.4	930.6	506.4
Total cash provided by operating activities before new investments	$1,293.1	$1,010.9	$571.7

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

Dividends to common shareholders for the years ended December 31, 2004, 2003, and 2002, were $299.3 million, $267.8 million, and $229.9 million, respectively. Total regular quarterly dividends were $2.28, $2.28, and $2.20 per common share for the years ended December 31, 2004, 2003, and 2002, respectively. An extra cash dividend of $0.02 and $0.03 per common share was declared during 2004 and 2002, respectively, and was paid to shareholders on January 28, 2005, and January 9, 2003, respectively.

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

Our Board of Directors evaluates whether to retain or distribute taxable net capital gains on an annual basis. Our dividend policy allows us to continue to distribute capital gains, but would also allow us to retain gains to support future growth. Our Board of Directors reviews the dividend rate quarterly, and may adjust the quarterly dividend throughout the year.

At December 31, 2004, we had outstanding commitments to fund investments totaling $330.2 million. We intend to fund these commitments and prospective investment opportunities with existing cash, through cash flow from operations before new investments, through borrowings under our line of credit or other long-term debt agreements, or through the sale or issuance of new equity capital.

Debt and Equity Capital

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

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

	December 31,		
($ in millions)	**2004**	**2003**	**2002**
Total assets	$3,261.0	$3,019.9	$2,794.3
Total debt outstanding	$1,176.6	$ 954.2	$ 998.5
Total shareholders equity	$1,979.8	$1,914.6	$1,546.1
Debt to equity ratio	0.59	0.50	0.65
Asset coverage ratio[1]	280%	322%	270%

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

We currently target a debt to equity ratio ranging between 0.50:1.00 to 0.65:1.00. During 2003, we intentionally deleveraged the balance sheet to move the leverage ratio to the lower end of the target debt to equity ratio range and have remained within the range during 2004. We recently have been through a period of economic uncertainty, and we believed that it was prudent to operate with a larger equity capital base and less leverage. For the years ended December 31, 2004, 2003, and 2002, we raised equity of $73.5 million, $422.9 million, and $172.8 million, respectively, including $86.5 million raised through a non-transferable rights offering during 2002. In addition, shareholders equity increased by $51.3 million, $21.2 million, and $22.1 million through the exercise of employee options, the collection of notes receivable from the sale of common stock, and the issuance of shares through our dividend reinvestment plan for the years ended December 31, 2004, 2003, and 2002, respectively.

We employ an asset-liability management strategy that focuses on matching the estimated maturities of our loan and investment portfolio to the estimated maturities of our borrowings. We use our revolving line of credit facility as a means to bridge to long-term financing in the form of debt or equity capital, which may or may not result in temporary differences in the matching of estimated maturities. Availability on the revolving line of credit, net of amounts committed for standby letters of credit issued under the line of credit facility, was $396.4 million on December 31, 2004. We evaluate our interest rate exposure on an ongoing basis. Generally, we seek to fund our primarily fixed-rate investment portfolio with fixed-rate debt or equity capital. To the extent deemed necessary, we may hedge variable and short-term interest rate exposure through interest rate swaps or other techniques.

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

($ in millions)	December 31, 2004 Facility Amount	December 31, 2004 Amount Outstanding	December 31, 2004 Annual Interest Cost[1]	December 31, 2004 Annual Return to Cover Interest Payments[2]	December 31, 2003 Facility Amount	December 31, 2003 Amount Outstanding	December 31, 2003 Annual Interest Cost[1]	December 31, 2003 Annual Return to Cover Interest Payments[2]
Notes payable and debentures:								
Unsecured notes payable	$ 981.4	$ 981.4	6.5%	2.0%	$ 854.0	$ 854.0	7.2%	2.0%
SBA debentures	84.8	77.5	8.2%	0.2%	101.8	94.5	8.1%	0.3%
OPIC loan	5.7	5.7	6.6%	0.0%	5.7	5.7	6.6%	0.0%
Total notes payable and debentures	1,071.9	1,064.6	6.6%	2.2%	961.5	954.2	7.3%	2.3%
Revolving line of credit	552.5	112.0	6.3% [3]	0.2%	532.5		[3]	0.1%
Total debt	$ 1,624.4	$ 1,176.6	6.6% [3]	2.4%	$ 1,494.0	$ 954.2	7.5% [3]	2.4%

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

(2) The annual portfolio return to cover interest payments is calculated as the December 31, 2004 and 2003, annualized cost of debt per class of financing outstanding divided by total assets at December 31, 2004 and 2003.

(3) The current interest rate payable on the revolving line of credit was 4.7% at December 31, 2004, which excluded the annual cost of commitment fees and other facility fees of $1.8 million. There were no amounts drawn on the revolving line of credit at December 31, 2003. The annual cost of commitment fees and other facility fees on the revolving line of credit was $2.7 million at December 31, 2003. The annual interest cost for total debt includes the annual cost of commitment fees and other facility fees on the revolving line of credit regardless of the amount outstanding on the facility as of the balance sheet date.

Unsecured Notes Payable. We have issued long-term debt to institutional lenders, primarily insurance companies. The notes have five- or seven-year maturities, with maturity dates beginning in 2005 and generally have fixed rates of interest. The notes generally require payment of interest only semi-annually, and all principal is due upon maturity.

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

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

On November 15, 2004, we issued $252.5 million of five-year and $72.5 million of seven-year unsecured long-term notes, primarily to insurance companies. The five- and seven-year notes have fixed interest rates of 5.53% and 5.99%, respectively, and have substantially the same terms as our existing unsecured long-term notes. We used a portion of the proceeds from the new long-term note issuance to repay $102.0 million of our existing unsecured long-term notes that matured on November 15, 2004, with an interest cost of 8.5%.

Small Business Administration Debentures. We, through our small business investment company subsidiary, have debentures payable to the Small Business Administration with contractual maturities of ten years. The notes require payment of interest only semi-annually, and all principal is due upon maturity. During 2004, we repaid $17.0 million of this outstanding debt. Under the small business investment company program, we may borrow up to $119.0 million from the Small Business Administration. At December 31,

2004, we had a commitment from the Small Business Administration to borrow up to an additional $7.3 million above the current amount outstanding. The commitment expires on September 30, 2005.

Revolving Line of Credit. We have an unsecured revolving line of credit with a committed amount of $587.5 million. The commitments under the line of credit were expanded by $35.0 million on March 29, 2005. The line of credit may be expanded through new or additional commitments up to $600.0 million at our option. The credit facility generally bears interest at a rate, at our option, equal to (i) the one-month LIBOR plus 1.50%, (ii) the Bank of America, N.A. cost of funds plus 1.50% or (iii) the higher of the Bank of America, N.A. prime rate or the Federal Funds rate plus 0.50%. The line of credit generally requires monthly payments of interest, and all principal is due upon maturity. The revolving line of credit expires in April 2005, with the right to extend the maturity for one additional year at our option under substantially similar terms. We plan to exercise our option to extend the maturity to April 2006, which will require the payment of an extension fee of 0.3% on existing commitments. The interest rate on outstanding borrowings will increase by 0.5% during the extension period.

Outstanding borrowings on the unsecured revolving line of credit at December 31, 2004, were $112.0 million. The amount available under the line at December 31, 2004, was $396.4 million, net of amounts committed for standby letters of credit of $44.1 million. Net borrowings under the revolving line of credit for the year ended December 31, 2004, were $112.0 million.

We have various financial and operating covenants required by the revolving line of credit and notes payable and debentures. These covenants require us to maintain certain financial ratios, including debt to equity and interest coverage, and a minimum net worth. Our credit facilities limit our ability to declare dividends if we default under certain provisions. As of December 31, 2004, we were in compliance with these covenants.

The following table shows our significant contractual obligations for the repayment of debt and payment of other contractual obligations as of December 31, 2004.

		Payments Due By Year					
($ in millions)	**Total**	**2005**	**2006**	**2007**	**2008**	**2009**	**After 2009**
Notes payable and debentures:							
Unsecured notes payable	$ 981.4	$165.0	$175.0	$	$153.0	$268.9	$219.5
SBA debentures	77.5	4.0					73.5
OPIC loan	5.7		5.7				
Revolving line of credit[(1)]	112.0		112.0				
Operating leases	33.5	4.6	4.5	4.4	4.4	4.6	11.0
Total contractual obligations	$1,210.1	$173.6	$297.2	$4.4	$157.4	$273.5	$304.0

(1) As discussed above, we plan to exercise our option to extend the maturity of the revolving line of credit to April 2006. At December 31, 2004, $396.4 million remained unused and available, net of amounts committed for standby letters of credit of $44.1 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 December 31, 2004.

		Amount of Commitment Expiration Per Year					
($ in millions)	Total	2005	2006	2007	2008	2009	After 2009
Guarantees	$100.2	$0.6	$ 1.1	$94.8	$0.1	$2.5	$1.1
Standby letters of credit[1]	44.1		44.1				
Total commitments	$144.3	$0.6	$45.2	$94.8	$0.1	$2.5	$1.1

(1) Standby letters of credit are issued under our revolving line of credit. As discussed above, we plan to exercise our option to extend the maturity of the revolving line of credit to April 2006. Therefore, unless a standby letter of credit is set to expire at an earlier date, we have assumed that the standby letters of credit will expire contemporaneously with the expiration of our line of credit in April 2006.

In addition, we had outstanding commitments to fund investments totaling $330.2 million at December 31, 2004, as discussed above.

CRITICAL ACCOUNTING POLICIES

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

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

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

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

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

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

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

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

Commercial Mortgage-Backed Securities (CMBS) and Collateralized Debt Obligations (CDO). CMBS bonds and CDO bonds and preferred shares are carried at fair value, which is based on a discounted cash flow model that utilizes prepayment and loss assumptions based on historical experience and projected performance, economic factors, the characteristics of the underlying cash flow, and comparable yields for similar CMBS bonds and CDO bonds and preferred shares, when available. We recognize unrealized appreciation or depreciation on our CMBS bonds and CDO bonds and preferred shares as comparable yields in the market change and/or based on changes in estimated cash flows resulting from changes in prepayment or loss assumptions in the underlying collateral pool.

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

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

Fee Income. Fee income includes fees for guarantees and services rendered by us to portfolio companies and other third parties such as diligence, structuring, transaction services, management services, and other 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 other 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				
1995	$ 0	$ 0	$	N/A
1996	0	0		N/A
1997	0	0		N/A
1998	180,000,000	2,734		N/A
1999	419,000,000	2,283		N/A
2000	544,000,000	2,445		N/A
2001	694,000,000	2,453		N/A
2002	694,000,000	2,704		N/A
2003	854,000,000	3,219		N/A
2004	981,368,000	2,801		N/A
Small Business Administration Debentures [5]				
1995	$ 61,300,000	$ 2,868	$	N/A
1996	61,300,000	2,485		N/A
1997	54,300,000	2,215		N/A
1998	47,650,000	2,734		N/A
1999	62,650,000	2,283		N/A
2000	78,350,000	2,445		N/A
2001	94,500,000	2,453		N/A
2002	94,500,000	2,704		N/A
2003	94,500,000	3,219		N/A
2004	77,500,000	2,801		N/A
Overseas Private Investment Corporation Loan				
1995	$ 0	$ 0	$	N/A
1996	8,700,000	2,485		N/A
1997	8,700,000	2,215		N/A
1998	5,700,000	2,734		N/A
1999	5,700,000	2,283		N/A
2000	5,700,000	2,445		N/A
2001	5,700,000	2,453		N/A
2002	5,700,000	2,704		N/A
2003	5,700,000	3,219		N/A
2004	5,700,000	2,801		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				
1995	$ 20,414,000	$ 2,868	$	N/A
1996	45,099,000	2,485		N/A
1997	38,842,000	2,215		N/A
1998	95,000,000	2,734		N/A
1999	82,000,000	2,283		N/A
2000	82,000,000	2,445		N/A
2001	144,750,000	2,453		N/A
2002	204,250,000	2,704		N/A
2003	0	0		N/A
2004	112,000,000	2,801		N/A
Auction Rate Reset Note				
1995	$ 0	$ 0	$	N/A
1996	0	0		N/A
1997	0	0		N/A
1998	0	0		N/A
1999	0	0		N/A
2000	76,598,000	2,445		N/A
2001	81,856,000	2,453		N/A
2002	0	0		N/A
2003	0	0		N/A
2004	0	0		N/A
Master Repurchase Agreement and Master Loan and Security Agreement				
1995	$ 0	$ 0	$	N/A
1996	85,775,000	2,485		N/A
1997	225,821,000	2,215		N/A
1998	6,000,000	2,734		N/A
1999	23,500,000	2,283		N/A
2000	0	0		N/A
2001	0	0		N/A
2002	0	0		N/A
2003	0	0		N/A
2004	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)				
1995	$20,000,000	$2,868	$	N/A
1996	20,000,000	2,485		N/A
1997	20,000,000	2,215		N/A
1998	0	0		N/A
1999	0	0		N/A
2000	0	0		N/A
2001	0	0		N/A
2002	0	0		N/A
2003	0	0		N/A
2004	0	0		N/A
Bonds Payable				
1995	$98,625,000	$2,868	$	N/A
1996	54,123,000	2,485		N/A
1997	0	0		N/A
1998	0	0		N/A
1999	0	0		N/A
2000	0	0		N/A
2001	0	0		N/A
2002	0	0		N/A
2003	0	0		N/A
2004	0	0		N/A
Redeemable Cumulative Preferred Stock(5)(7)				
1995	$ 1,000,000	$ 277	$100	N/A
1996	1,000,000	242	100	N/A
1997	1,000,000	217	100	N/A
1998	1,000,000	267	100	N/A
1999	1,000,000	225	100	N/A
2000	1,000,000	242	100	N/A
2001	1,000,000	244	100	N/A
2002	1,000,000	268	100	N/A
2003	1,000,000	319	100	N/A
2004	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)
Non-Redeemable Cumulative Preferred Stock(5)				
1995	$6,000,000	$277	$100	N/A
1996	6,000,000	242	100	N/A
1997	6,000,000	217	100	N/A
1998	6,000,000	267	100	N/A
1999	6,000,000	225	100	N/A
2000	6,000,000	242	100	N/A
2001	6,000,000	244	100	N/A
2002	6,000,000	268	100	N/A
2003	6,000,000	319	100	N/A
2004				