

ALLIED CAPITAL CORP  
Form 497  
January 29, 2008

**The information in this prospectus supplement is not complete and may be changed. A registration statement relating to these securities has been declared effective by the Securities and Exchange Commission. This prospectus supplement is not an offer to sell these securities and is not soliciting offers to buy these securities in any state where such offer or sale is not permitted.**

**Filed Pursuant to Rule 497  
Registration Statement No. 333-141848**

**PROSPECTUS SUPPLEMENT  
(To Prospectus dated August 23, 2007)**

**Subject to Completion, January 29, 2008**

4,000,000 Shares

**Common Stock**

We are offering 4,000,000 shares of our common stock, par value \$0.0001 per share. We will receive all of the net proceeds from the sale of our common stock.

Our common stock is traded on the New York Stock Exchange under the symbol ALD. The last reported sale price for our common stock on January 28, 2008, was \$22.52 per share.

Please read this prospectus supplement, and the accompanying prospectus, before investing, and keep it for future reference. The prospectus supplement and the accompanying prospectus contain important information about us that a prospective investor should know before investing in our common stock. We file annual, quarterly and current reports, proxy statements and other information about us with the Securities and Exchange Commission. This information is available free of charge by contacting us at 1919 Pennsylvania Avenue, NW, Washington, DC, 20006, or by telephone at (202) 721-6100 or on our website at [www.alliedcapital.com](http://www.alliedcapital.com). The information on this website is not incorporated by reference into this prospectus supplement and the accompanying prospectus. The SEC also maintains a website at [www.sec.gov](http://www.sec.gov) that contains such information.

**Before buying any of these shares of our common stock, you should review the information, including the risk of leverage, set forth under Risk Factors on page 10 of the accompanying prospectus.**

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

	Per Share	Total
Public offering price	\$	\$
Underwriting discount	\$	\$
Proceeds, before expenses, to us(1)	\$	\$

(1) Expenses payable by us are estimated to be approximately \$230,000.

If all the shares are not sold at the public offering price, the underwriter may change the offering price and may offer shares from time to time for sale in negotiated transactions or otherwise, at market prices prevailing at the time of sale, at prices related to such prevailing market prices or otherwise.

The underwriters may also purchase from us up to an additional 600,000 shares of our common stock at the public offering price less the underwriting discount, to cover over-allotments, if any, within 30 days of the date of this prospectus supplement.

The underwriters are offering the shares of our common stock as described in Underwriting. Delivery of the shares will be made on or about February , 2008.

**Morgan Stanley**

**The date of this prospectus supplement is January , 2008**

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

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### **ABOUT THIS PROSPECTUS**

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

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

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**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.

<b>Shareholder Transaction Expenses</b>	
Sales load (as a percentage of offering price) <sup>(1)</sup>	%
Dividend reinvestment plan fees <sup>(2)</sup>	None
<b>Annual Expenses (as a percentage of consolidated net assets attributable to common stock)<sup>(3)</sup></b>	
Operating expenses <sup>(4)</sup>	6.95%
Interest payments on borrowed funds <sup>(5)</sup>	4.82%
Acquired fund fees and expenses <sup>(6)</sup>	%
 Total annual expenses <sup>(7)(8)</sup>	 11.77%

**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.

	<b>1 Year</b>	<b>3 Years</b>	<b>5 Years</b>	<b>10 Years</b>
You would pay the following expenses on a \$1,000 investment, assuming a 5.0% annual return	\$	\$	\$	\$

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.**

- (1) Represents the underwriting discounts or commissions with respect to the shares sold by us in this offering.
- (2) The expenses of our dividend reinvestment plan are included in Operating expenses. We do not have a stock purchase plan. The participants in the dividend reinvestment plan will bear a pro rata share of brokerage commissions incurred with respect to open market purchases or sales, if any. See Dividend Reinvestment Plan in the accompanying prospectus.
- (3) Consolidated net assets attributable to common stock equals net assets (i.e., total consolidated assets less total consolidated liabilities), which at September 30, 2007, was \$2.8 billion.
- (4) Operating expenses represent our estimated operating expenses for the year ending December 31, 2007, excluding interest on indebtedness. This percentage for the year ended December 31, 2006, was 5.2%. See Management's Discussion and Analysis of Financial Condition and Results of Operations in this prospectus supplement.

- (5) Interest payments on borrowed funds represents our estimated interest expense for the year ending December 31, 2007. We had outstanding borrowings of \$1.9 billion at September 30, 2007. This percentage for the year ended December 31, 2006, was 3.5%. See Risk Factors in the accompanying prospectus.
- (6) See our Consolidated Statement of Investments as of September 30, 2007, on pages S-59 through S-69 for our investments in funds.
- (7) 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 6.7% of consolidated total assets.
- (8) 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.

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## RECENT DEVELOPMENTS

### **Investment Agreement with Goldman Sachs Private Equity Group**

On January 23, 2008, we announced an investment agreement between Goldman Sachs Private Equity Group (Goldman Sachs) and Allied Capital that includes commitments by Goldman Sachs to invest at least \$125 million in future investment vehicles managed by us. In addition, Goldman Sachs will purchase \$170 million in existing private equity and debt investments from Allied Capital and will have future opportunities to invest in our affiliates, or vehicles managed by them, and co-invest alongside us in the future, subject to various terms and conditions.

As part of this investment agreement with Goldman Sachs, we have agreed to sell a pro-rata strip of private equity and debt investments to AGILE Fund I, LLC (AGILE), a new Allied Capital managed fund in which Goldman Sachs owns substantially all of the interests, for a total transaction value of \$170 million. We are expected to realize a net gain and dividend income from the sale of our investments of approximately \$15 million, net of transaction and other costs. The purchase price of the equity investments represented a 9% premium to our fair value for these investments at September 30, 2007. The majority of the pro-rata equity and debt sale closed simultaneously with the execution of the investment agreement. The sales of the remaining assets are expected to close by the end of the first quarter of 2008.

The sale to AGILE includes 13.7% of our equity investments in 23 of our buyout portfolio companies and 36 of our minority equity portfolio companies for a total purchase price of \$109 million. The equity investments being sold had a fair value at September 30, 2007 of \$100 million. In addition, we are selling approximately \$60 million in debt investments at cost, representing 7.3% of our unitranche, second lien and subordinated debt investments in the 23 buyout investments included in the equity sale. We will act as the managing member of AGILE, and will be entitled to an incentive allocation subject to certain performance benchmarks. We own the remaining interests in AGILE not held by Goldman Sachs.

In addition, as part of this transaction, we have also agreed to sell eleven venture capital and private equity limited partnership investments for approximately \$28 million to Goldman Sachs, and expect to realize a loss on the sale of approximately \$7 million, including transaction costs. Goldman Sachs will assume the \$6.5 million of unfunded commitments related to these limited partnership investments. The sales of these investments are expected to be completed by May 2008.

### **Unitranche Fund LLC**

We have partnered with GE Commercial Finance (GE) to form a senior secured unitranche loan fund of up to \$3.6 billion that will focus on making unitranche loans to companies with EBITDA of at least \$15 million. GE has committed \$3.075 billion to Unitranche Loan Fund LLC and we have committed \$525.0 million.

### **Termination of Deferred Compensation Arrangements**

On December 14, 2007, our Board of Directors made a determination that it is in Allied Capital's best interest to terminate our deferred compensation arrangements as described more fully below (each individually a Plan, or collectively, the Plans). The



Board of Directors decision was primarily in response to increased complexity resulting from recent changes in the regulation of deferred compensation arrangements.

The Board of Directors resolved that The Allied Capital Corporation Non-Qualified Deferred Compensation Plan (DCP I) and The Allied Capital Corporation Non-Qualified Deferred Compensation Plan II (DCP II) will be terminated in accordance with the provisions of each of these Plans, and the accounts under these Plans will be distributed to participants in full on March 18, 2008, the termination and distribution date, or as soon as is reasonably practicable thereafter.

The Board of Directors also resolved to amend and restate The 2005 Allied Capital Corporation Non-Qualified Deferred Compensation Plan (2005 DCP I) and The 2005 Allied Capital Corporation Non-Qualified Deferred Compensation Plan II (2005 DCP II) to provide for termination of each of these Plans and distribution of the accounts under these Plans on March 18, 2008, or as soon as is reasonably practicable thereafter, in full in accordance with the transition rule for payment elections under Section 409A of the Internal Revenue Code of 1986.

Distributions from the Plans will be made in cash or shares of our common stock, net of required withholding taxes. The assets of the rabbi trust related to DCP I and 2005 DCP I are primarily invested in assets other than shares of our common stock. At September 30, 2007, the liability to participants related to DCP I and 2005 DCP I was valued at \$21.6 million in the aggregate, and that liability is fully funded by assets held in the rabbi trust.

The assets of the rabbi trust related to DCP II and 2005 DCP II are primarily invested in shares of our common stock. At September 30, 2007, the liability to participants related to DCP II and 2005 DCP II was valued at \$38.9 million in the aggregate, and that liability is fully funded by assets held in the rabbi trust. At September 30, 2007, the rabbi trust held approximately 1.3 million shares for DCP II and 2005 DCP II.

The account balances in the Plans have accumulated as a result of prior compensation earned by the participants. The contributions to the Plans reflect a combination of participant elective compensation deferrals and non-elective employer contributions, including contributions related to previously earned individual performance awards. As of September 30, 2007, the account balances of the named executive officers related to these Plans were \$13.3 million for William Walton, \$6.8 million for Joan Sweeney, \$2.6 million for Penni Roll, \$2.8 million for John Shulman, and \$2.2 million for Michael Grisius.

The amounts related to the Plans as of September 30, 2007, as described above, do not include the fourth quarter contribution to the 2005 DCP II, any additional participant elective deferrals that occurred prior to January 1, 2008, or earnings on or changes in the value of Plan account balances through the distribution date.

#### **Equity Issuance**

On December 4, 2007, we completed a public offering of 3,250,000 shares of common stock at an offering price of \$24.75 per share for net proceeds, after the underwriting discount and estimated offering expenses, of \$77.5 million. The shares were issued from our shelf registration statement on file with the SEC.

**Portfolio Activity**

New investments totaled approximately \$580 million for the fourth quarter of 2007.

**Exemptive Application**

We have applied for an exemptive order of the SEC to permit us to issue restricted shares of our common stock as part of the compensation packages for certain of our employees and directors. There can be no assurance that the SEC will grant an exemptive order to allow the granting of restricted stock. In addition, the issuance of restricted shares of our common stock will require the approval of our stockholders.

**Investment Review Committee of the Board of Directors**

In January 2008, our board of directors established an Investment Review Committee and delegated authority to this committee to review and approve certain types of investments, which the Board's Executive Committee previously reviewed, among other duties. The Investment Review Committee is composed of five permanent board members, who have been appointed to serve for the year, and three additional board members, each of whom will serve during at least one quarter during the year on a rotating schedule.

**FASB Statement No. 157, Fair Value Measurements**

In September 2006, the FASB issued Statement No. 157, *Fair Value Measurements*. This statement defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. This statement is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. The Company is currently analyzing the effect of adoption of this statement on its consolidated financial position, including its net asset value, and results of operations. The Company will adopt this statement on a prospective basis for the quarter ending March 31, 2008. Adoption of this statement could have a material effect on our consolidated financial statements, including our net asset value. However, the actual impact on our consolidated financial statements in the period of adoption and subsequent to the period of adoption cannot be determined at this time as it will be influenced by the estimates of fair value for that period and the number and amount of investments we originate, acquire or exit.

**Business Loan Express, LLC**

On January 16, 2008, BLX announced that it has changed its name to Ciena Capital LLC (Ciena). The name change reflects a strategic shift in its business operations whereby Ciena will emphasize loan products that provide financing to commercial real estate owners and operators. As previously discussed, Ciena has reduced its annual loan origination volume, and over time, it plans to rebuild its loan origination volume in conventional and commercial real estate loans. There are inherent risks in repositioning the business and we continue to work with Ciena on restructuring its operations.

In September 2007, Ciena received waivers through January 31, 2008, from its lenders with respect to non-compliance with certain covenants in its revolving credit facility, and amended certain of the facility covenants through January 31, 2008. Ciena is currently in negotiations with its lenders to amend the terms of its revolving credit facility. The

amendment is expected to reduce the commitments from the lenders under the facility from \$500 million to \$450 million at the effective date of the amendment, with further periodic reductions in total commitments to \$325 million by December 31, 2008, and to amend certain financial and other covenants. In connection with this amendment, we expect to increase our unconditional guarantee from 60% to 100% of the total obligations under this facility and to replace approximately \$42.5 million in letters of credit currently issued under the Ciena credit facility by issuing new letters of credit under our revolving line of credit. The guaranty of the Ciena revolving line of credit can be called by the lenders in the event of a default, which, once amended, includes the occurrence of any event of default under our revolving credit facility, subject to grace periods in certain cases. The proposed amendment also prohibits cash payments from Ciena to Allied Capital for interest, guarantee fees, management fees and dividends. The Ciena credit facility will expire on March 17, 2009. We currently expect this amendment to be executed by January 31, 2008; however, there can be no assurance that the amendment will be executed. If the credit facility lenders do not agree to this amendment, Ciena would be in default under the credit facility and our guaranty would remain at 60% of Ciena's outstanding obligations under the facility. At January 25, 2008, the principal amount outstanding on Ciena's revolving credit facility was \$353.2 million and letters of credit issued under the facility were \$89.1 million. See Management's Discussion and Analysis of Financial Condition and Results of Operations - Portfolio and Investment Activity - Private Finance - Business Loan Express, LLC.

On December 18, 2007, the United States District Court for the Northern District of Georgia dismissed all claims in an action filed under the federal False Claims Act against BLX, its current chairman, and others. The action was brought by Greenlight Capital, Inc., a hedge fund controlled by David Einhorn, and James Brickman. In January 2008, the plaintiffs filed a notice of their intention to appeal the dismissal.

**USE OF PROCEEDS**

We estimate that our net proceeds from the sale of the 4,000,000 shares of common stock we are offering will be approximately \$    million and approximately \$    million, if the underwriters' over-allotment option is exercised in full, and after deducting the underwriting discount and estimated offering expenses payable by us. We may change the size of this offering based on demand and market conditions.

We expect to use the net proceeds from this offering to reduce borrowings under our revolving line of credit, if any, to invest in debt or equity securities in primarily privately negotiated transactions, and for other general corporate purposes. Amounts repaid under our revolving line of credit will remain available for future borrowings. At January 28, 2008, the interest rate on our revolving line of credit was approximately 5.1% and there was approximately \$306.8 million outstanding. This revolving line of credit expires on September 30, 2008.

## UNDERWRITING

Subject to the terms and conditions set forth in our underwriting agreement, we are offering the shares of our common stock described in this prospectus supplement through Morgan Stanley & Co. Incorporated, the underwriter. The underwriter has agreed to purchase and we have agreed to sell to the underwriter, all of the shares offered by this prospectus supplement.

The underwriting agreement provides that the obligation of the underwriter to purchase the shares of common stock offered hereby is subject to certain conditions precedent and that the underwriter will purchase all of the shares of common stock offered by this prospectus supplement, other than those covered by the over-allotment option described below, if any of these shares are purchased.

The underwriter proposes to offer the shares of common stock to the public at the public offering price set forth on the cover of this prospectus supplement. If all the shares are not sold at the public offering price, the underwriter may change the offering price and may offer shares from time to time for sale in negotiated transactions or otherwise, at market prices prevailing at the time of sale, at prices related to such prevailing market prices or otherwise.

The underwriter has the option to purchase up to 600,000 additional shares of common stock from us at the same price it is paying for the 4,000,000 shares offered hereby. The underwriter may purchase additional shares only to cover over-allotments made in connection with this offering and only within 30 days after the date of this prospectus supplement. The underwriter will offer any additional shares that it purchases on the terms described above.

The underwriting discount per share is equal to the public offering price per share of common stock less the amount paid by the underwriter to us per share of common stock. These amounts are shown assuming either no exercise or full exercise by the underwriter of the underwriter's over-allotment option:

	<b>Total Fees</b>		
<b>Fee Per Share</b>	<b>Without Exercise of Over-Allotment Option</b>	<b>With Full Exercise of Over-Allotment Option</b>	
<b>Underwriting Discount</b>	\$	\$	\$

We estimate that the total expenses of this offering, which will be paid by us, excluding the underwriting discount, will be approximately \$230,000.

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

We and certain of our executive officers have agreed not to offer, sell, contract to sell or otherwise dispose of, or to engage in certain hedging and derivative transactions with respect to, our common stock for a period of 30 days after the date of this prospectus supplement, without first obtaining the written consent of Morgan Stanley & Co. Incorporated, except in limited circumstances. This consent may be given at any time without public notice.

In connection with this offering, the underwriter may purchase and sell shares of our common stock in the open market. These transactions may include stabilizing transactions,

short sales and purchases to cover positions created by short sales and stabilizing transactions.

Short sales involve the sale by the underwriter of a greater number of shares than it is required to purchase in this offering. Covered short sales are sales made in an amount not greater than the underwriter's over-allotment option to purchase additional shares in this offering. The underwriter may close out any covered short position by either exercising its over-allotment option or purchasing shares in the open market. In determining the source of shares to close out the covered short position, the underwriter will consider, among other things, the price of shares available for purchase in the open market as compared to the price at which they may purchase shares through the over-allotment option.

Naked short sales are sales in excess of the over-allotment option. The underwriter must close out any naked short position by purchasing shares in the open market. A naked short position is more likely to be created if the underwriter is concerned there may be downward pressure on the price of shares in the open market prior to the completion of this offering.

Stabilizing transactions consist of various bids for or purchases of our common stock made by the underwriter in the open market prior to the completion of this offering.

Purchases to cover a short position and stabilizing transactions may have the effect of preventing or slowing a decline in the market price of our common stock. Additionally, these purchases may stabilize, maintain or otherwise affect the market price for our common stock. As a result, the price of our common stock may be higher than the price that might otherwise exist in the open market. These transactions may be effected on the New York Stock Exchange, in the over-the-counter market or otherwise.

In the ordinary course of business, the underwriter or its affiliates have engaged and may in the future engage in various financing, commercial banking and investment banking services with, and provide financial advisory services to, us and our affiliates, for which they have received or may receive customary fees and expenses.

The principal business address of Morgan Stanley & Co. Incorporated is 1585 Broadway, New York, NY 10036.

#### **LEGAL MATTERS**

Certain legal matters with respect to the validity of the shares of common stock we are offering will be passed upon for us by Sutherland Asbill & Brennan LLP, Washington, D.C. Certain legal matters related to the offering will be passed upon for the underwriter by Fried, Frank, Harris, Shriver & Jacobson LLP, Washington D.C.

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

*changes in the economy and general economic conditions;*

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

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

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

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

### **OVERVIEW**

As a business development company, we are in the private equity business. Specifically, we provide long-term debt and equity investment capital to companies in a variety of industries. Our private finance activity principally involves providing financing to middle market U.S. companies through privately negotiated long-term debt and equity investment capital. Our financing is generally used to fund buyouts, acquisitions, growth, recapitalizations, note purchases, and other types of financings. We generally invest in private companies though, from time to time, we may invest in companies that are public but lack access to additional public capital. Our investment objective is to achieve current income and capital gains.

Our portfolio composition at September 30, 2007 and 2006, and December 31, 2006, was as follows:

	September 30,		December 31,
	2007	2006	2006
Private finance	97%	97%	97%
Commercial real estate finance	3%	3%	3%

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

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



**PORTFOLIO AND INVESTMENT ACTIVITY**

The total portfolio at value, investment activity, and the yield on interest-bearing investments at and for the three and nine months ended September 30, 2007 and 2006, and at and for the year ended December 31, 2006, were as follows:

	At and for the Three Months Ended September 30,		At and for the Nine Months Ended September 30,		At and for the Year Ended December 31,
	2007	2006	2007	2006	2006
<b>(\$ in millions)</b>					
Portfolio at value	\$4,326.9	\$4,119.6	\$4,326.9	\$4,119.6	\$4,496.1
Investments funded	\$ 577.5	\$ 629.5	\$1,236.7	\$1,880.8	\$2,437.8
Change in accrued or reinvested interest and dividends <sup>(1)</sup>	\$ 5.1	\$ 7.2	\$ 22.8	\$ (1.8)	\$ 11.3
Principal collections related to investment repayments or sales <sup>(2)</sup>	\$ 351.1	\$ 116.3	\$1,086.5	\$ 885.9	\$1,055.3
Yield on interest-bearing portfolio investments <sup>(3)</sup>	11.9%	12.4%	11.9%	12.4%	11.9%

(1) Includes changes in accrued or reinvested interest related to our investments in money market securities of \$1.9 million and \$1.3 million for the three months ended September 30, 2007 and 2006, respectively, and \$6.6 million, \$3.0 million, and \$3.1 million for the nine months ended September 30, 2007 and 2006, and for the year ended December 31, 2006, respectively.

(2) Principal collections related to investment repayments or sales for the three and nine months ended September 30, 2007, included collections of \$14.8 million and \$197.2 million, respectively, related to the sale of loans to the Allied Capital Senior Debt Fund, L.P. See discussion below.

(3) The weighted average yield on interest-bearing investments is computed as the (a) annual stated interest on accruing loans and debt securities 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, plus the effective interest yield on the preferred shares/ income notes of CLOs divided by (b) total interest-bearing investments at value. The weighted average yield is computed as of the balance sheet date.

**Private Finance**

The private finance portfolio at value, investment activity, and the yield on loans and debt securities at and for the three and nine months ended September 30, 2007 and 2006, and at and for the year ended December 31, 2006, were as follows:

	At and for Three Months Ended September 30,				At and for the Nine Months Ended September 30,				At and for the Year Ended December 31, 2006	
	2007		2006		2007		2006			
	Value	Yield <sup>(1)</sup>	Value	Yield <sup>(1)</sup>	Value	Yield <sup>(1)</sup>	Value	Yield <sup>(1)</sup>	Value	Yield <sup>(1)</sup>
(\$ in millions)										
Portfolio at value:										
Loans and debt securities:										
Senior loans	\$ 481.6	9.3%	\$ 342.4	8.7%	\$ 481.6	9.3%	\$ 342.4	8.7%	\$ 405.2	8.4%
Unitranche debt	698.1	11.5%	745.8	11.2%	698.1	11.5%	745.8	11.2%	799.2	11.2%
Subordinated debt	1,927.1	12.6%	1,817.0	13.7%	1,927.1	12.6%	1,817.0	13.7%	1,980.8	12.9%
Total loans and debt securities	3,106.8	11.8%	2,905.2	12.5%	3,106.8	11.8%	2,905.2	12.5%	3,185.2	11.9%
Equity Securities:										
Preferred shares/income notes of CLOs <sup>(2)</sup>	131.5	15.1%	87.7	13.7%	131.5	15.1%	87.7	13.7%	97.2	15.5%
Other equity securities	968.8		994.9		968.8		994.9		1,095.5	
Total equity securities	1,100.3		1,082.6		1,100.3		1,082.6		1,192.7	
Total portfolio	\$ 4,207.1		\$ 3,987.8		\$ 4,207.1		\$ 3,987.8		\$ 4,377.9	
Investments funded <sup>(3)</sup>	\$ 576.1		\$ 629.2		\$ 1,219.9		\$ 1,866.6		\$ 2,423.4	
Change in accrued or reinvested interest and dividends	\$ 4.4		\$ 5.8		\$ 17.3		\$ (5.4)		\$ 7.2	

Principal collections related to investment repayments or sales <sup>(4)</sup>	\$ 346.2	\$ 115.6	\$ 1,063.3	\$ 868.0	\$ 1,015.4
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- (1) The weighted average yield on loans and debt securities is computed as the (a) annual stated interest on accruing loans and debt securities 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 on the preferred shares/income notes of CLOs is calculated as the (a) effective interest yield on the preferred shares/income notes of CLOs, divided by (b) preferred shares/income notes of CLOs at value. The weighted average yields are computed as of the balance sheet date.
- (2) Investments in the preferred shares/income notes of CLOs earn a current return that is included in interest income in the consolidated statement of operations.
- (3) Investments funded for the nine months ended September 30, 2006, and for the year ended December 31, 2006, included debt investments in certain portfolio companies received in conjunction with the sale of such companies. See Private Finance, Investments Funded below.
- (4) Includes collections from the sale or repayment of senior loans totaling \$312.6 million, \$268.3 million, and \$322.7 million for the nine months ended September 30, 2007 and 2006, and for the year ended December 31, 2006, respectively.

Our investment activity is focused on making long-term investments in the debt and equity of primarily private middle market companies. Debt investments may include senior

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

We intend to take a balanced approach to private equity investing that emphasizes a complementary mix of debt investments and buyout investments. The combination of these two types of investments provides current interest and related portfolio income and the potential for future capital gains. In addition, we may invest in funds that are managed or co-managed by us that are complementary to our business of investing in middle market companies, such as the Allied Capital Senior Debt Fund (discussed below). Investments in funds may provide current interest and related portfolio income, including management fees.

The private equity investment marketplace for middle market companies remained active through September 30, 2007. Purchase price multiples remained high and debt pricing remained competitive. We did not fund as many investments during the nine months ended September 30, 2007, as we did during the nine months ended September 30, 2006, because we believed that many new investment opportunities were mis-priced or over-leveraged, and therefore, did not present an opportunity to make a reasonable investment return. For 2006, we reviewed over \$65 billion in prospective investments and we closed on approximately 3% of the potential new investments that we reviewed. For the nine months ended September 30, 2007, we reviewed over \$67 billion in prospective investments and we closed on approximately 2% of the potential new investments we reviewed.

The level of investment activity for investments funded and principal repayments for private finance investments can vary substantially from period to period depending on the number and size of investments that we make or that we exit and many other factors, including the amount of debt and equity capital available to middle market companies, the level of merger and acquisition activity for such companies, the general economic environment, and the competitive environment for the types of investments we make.

**Investments Funded.** Investments funded and the weighted average yield on loans and debt securities funded for the nine months ended September 30, 2007 and 2006, and for the year ended December 31, 2006, consisted of the following:

**For the Nine Months Ended September 30, 2007**

	Debt Investments		Buyout Investments		Total	
	Amount	Yield <sup>(1)</sup>	Amount	Yield <sup>(1)</sup>	Amount	Yield <sup>(1)</sup>
<b>(\$ in millions)</b>						
Loans and debt securities:						
Senior loans	\$ 285.6	10.3%	\$ 83.0	10.7%	\$ 368.6	10.4%
Unitranche debt <sup>(2)</sup>	104.0	10.8%			104.0	10.8%
Subordinated debt	279.0	12.4%	186.3	12.1%	465.3	12.3%
Total loans and debt securities	668.6	11.3%	269.3	11.7%	937.9	11.4%
Equity	155.2 <sup>(4)(5)</sup>		126.8		282.0	
Total	\$ 823.8		\$ 396.1		\$ 1,219.9	

**For the Nine Months Ended September 30, 2006**

	Debt Investments		Buyout Investments		Total	
	Amount	Yield <sup>(1)</sup>	Amount	Yield <sup>(1)</sup>	Amount	Yield <sup>(1)</sup>
<b>(\$ in millions)</b>						
Loans and debt securities:						
Senior loans	\$ 202.4	9.4%	\$ 167.3	8.8%	\$ 369.7	9.1%
Unitranche debt <sup>(2)</sup>	348.7	10.6%	146.5	12.9%	495.2	11.3%
Subordinated debt <sup>(3)</sup>	508.0	13.1%	250.8	13.9%	758.8	13.3%
Total loans and debt securities	1,059.1	11.5%	564.6	12.1%	1,623.7	11.8%
Equity	62.9 <sup>(4)</sup>		180.0		242.9	
Total	\$ 1,122.0		\$ 744.6		\$ 1,866.6	

**For the Year Ended December 31, 2006**

	Debt Investments		Buyout Investments		Total	
	Amount	Yield <sup>(1)</sup>	Amount	Yield <sup>(1)</sup>	Amount	Yield <sup>(1)</sup>
<b>(\$ in millions)</b>						
Loans and debt securities:						

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Senior loans	\$ 245.4	9.4%	\$ 239.8	8.9%	\$ 485.2	9.2%
Unitranche debt <sup>(2)</sup>	471.7	10.7%	146.5	12.9%	618.2	11.3%
Subordinated debt <sup>(3)</sup>	510.7	13.0%	423.8	14.4%	934.5	13.6%
Total loans and debt securities	1,227.8	11.4%	810.1	12.5%	2,037.9	11.9%
Equity	91.4 <sup>(4)</sup>		294.1		385.5	
Total	\$ 1,319.2		\$ 1,104.2		\$ 2,423.4	

- (1) The weighted average yield on interest-bearing investments is computed as the (a) annual stated interest on accruing interest-bearing investments, divided by (b) total interest-bearing investments funded.
- (2) Unitranche debt is a single debt investment that is a blend of senior and subordinated debt terms. The yield on a unitranche investment reflects the blended yield of senior and subordinated debt.
- (3) Debt investments funded for the nine months ended September 30, 2006, and for the year ended December 31, 2006, included a \$150 million subordinated debt investment in Advantage Sales & Marketing, Inc. received in conjunction with the sale of Advantage and a \$30 million subordinated debt investment in STS Operating, Inc. received in conjunction with the sale of STS.
- (4) Equity investments for the nine months ended September 30, 2007 and 2006, and for the year ended December 31, 2006, included \$42.4 million, \$12.5 million, and \$26.1 million, respectively, in investments in the preferred shares/income notes of collateralized loan obligations (CLOs) that are managed by Callidus Capital Corporation, a portfolio company controlled by us. These CLOs primarily invest in senior debt.
- (5) Equity investments for the nine months ended September 30, 2007, included \$19.1 million invested in the Allied Capital Senior Debt Fund, L.P. See discussion below.

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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.

We may underwrite or arrange senior loans related to our portfolio investments or for other companies that are not in our portfolio. When we underwrite or arrange senior loans, we may earn a fee for such activities. Senior loans underwritten or arranged by us may or may not be funded by us at closing. When these senior loans are closed, we may fund all or a portion of the underwritten commitment pending sale of the loan to other investors, which may include loan sales to Callidus Capital Corporation (Callidus), a portfolio company controlled by us, or funds managed by Callidus or by us, including the Allied Capital Senior Debt Fund, L.P. (discussed below). After completion of loan sales, we may or may not retain a position in these senior loans. We generally earn a fee on the senior loans we underwrite or arrange whether or not we fund the underwritten commitment. In addition, we may fund most or all of the debt and equity capital upon the closing of certain buyout transactions, which may include investments in lower-yielding senior debt. Subsequent to the closing, the portfolio company may refinance all or a portion of the lower-yielding senior debt, which would reduce our investment. Principal collections include repayments of senior debt funded by us that was subsequently sold by us or refinanced or repaid by the portfolio companies.

**Allied Capital Senior Debt Fund, L.P.** AC Corp is the investment manager to the Allied Capital Senior Debt Fund, L.P. (the Fund), a private fund that generally invests in senior, unitranche and second lien debt. The Fund has closed on \$125 million in equity capital commitments. Callidus acts as special manager to the Fund. One of our affiliates is the general partner of the Fund, and AC Corp serves as collateral manager to a warehouse financing vehicle associated with the Fund. AC Corp will earn a management fee of up to 2% of the net asset value of the Fund and will pay Callidus 25% of that management fee to compensate Callidus for its role as special manager.

We are a special limited partner in the Fund, which is a portfolio investment, and have committed \$31.8 million to the Fund, of which \$19.1 million has been funded. At September 30, 2007, our investment in the Fund totaled \$19.1 million at cost and \$19.5 million at value. As a special limited partner, we expect to earn an incentive allocation of 20% of the annual net income of the Fund, subject to certain performance benchmarks. The value of our investment in the Fund is based on the net asset value of the Fund, which reflects the capital invested plus our allocation of the net earnings of the Fund, including the incentive allocation.

In connection with the Fund's formation in June 2007, we sold an initial portfolio of approximately \$183 million of seasoned assets with a weighted average yield of 10.3% to a warehouse financing vehicle associated with the Fund. In the third quarter of 2007, we sold \$14.8 million of seasoned assets with a weighted average yield of 8.6% to the warehouse financing vehicle. We may sell additional loans to the Fund or the warehouse financing vehicle. In addition, during the third quarter of 2007, we repurchased one asset totaling \$12.0 million from the Fund, which we had sold to the Fund in June 2007.

**Yield.** The weighted average yield on the private finance loans and debt securities was 11.8% at September 30, 2007, as compared to 12.5% and 11.9% at September 30, 2006, and December 31, 2006, respectively. The weighted average yield on the private finance loans and debt securities may fluctuate from period to period depending on the yield on new loans and debt securities funded, the yield on loans and debt securities repaid, the amount of loans and debt securities for which interest is not accruing (see Portfolio Asset Quality Loans and Debt Securities on Non-Accrual Status below) and the amount of lower-yielding senior or unitranche debt in the portfolio at the end of the period. Yields on loans and debt securities have been generally lower because of the supply of capital available to middle market companies.

The yield on the private finance loans and debt securities has declined partly due to our strategy to pursue investments where our position in the portfolio company capital structure is more senior, such as senior debt and unitranche investments that typically have lower yields than subordinated debt investments. In addition, during the fourth quarter of 2006, the guaranteed dividend yield on our investment in BLX's 25% Class A equity interests was placed on non-accrual status. The Class A equity interests are included in our loans and debt securities. See Business Loan Express, LLC below.

**Outstanding Investment Commitments.** At September 30, 2007, we had outstanding private finance investment commitments as follows:

	Companies More Than 25% Owned <sup>(1)</sup>	Companies 5% to 25% Owned	Companies Less Than 5% Owned	Total
<b>(\$ in millions)</b>				
Senior loans	\$ 12.4	\$ 15.0	\$ 123.0	\$ 150.4 <sup>(2)</sup>
Unitranche debt			45.4	45.4
Subordinated debt	18.0	0.1		18.1
Total loans and debt securities	30.4	15.1	168.4	213.9
Equity securities	118.5	16.1	78.1	212.7 <sup>(3)</sup>
Total	\$ 148.9	\$ 31.2	\$ 246.5	\$ 426.6

- <sup>(1)</sup> Includes various commitments to Callidus Capital Corporation (Callidus), a portfolio company controlled by us, which owns 80% (subject to dilution) of Callidus Capital Management, LLC, an asset management company that structures and manages collateralized debt obligations (CDOs), collateralized loan obligations (CLOs), and other related investments, as follows:

	Committed Amount	Amount Drawn	Amount Available to be Drawn
<b>(\$ in millions)</b>			
Revolving line of credit for working capital	\$ 4.0	\$	\$ 4.0
Subordinated debt to support warehouse facilities & warehousing activities <sup>(*)</sup>		18.0	18.0



Purchase of preferred equity in future CLO transactions (\*\*)

Total	\$	22.0	\$	\$	22.0
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(\*) Callidus has a synthetic credit facility with a third party for up to approximately \$66 million. We have agreed to designate our subordinated debt commitment for Callidus to draw upon to provide first loss capital as needed to support this facility.

(\*\*) Subsequent to September 30, 2007, we made an additional commitment to Callidus to purchase preferred equity in future CLO transactions of \$27.5 million.

(2) Includes \$133.6 million in the form of revolving senior debt facilities to 31 portfolio companies.

(3) Includes \$94.2 million to 21 private equity and venture capital funds, including \$4.3 million in co-investment commitments to one private equity fund, and \$12.7 million committed to the Allied Capital Senior Debt Fund, L.P. (see discussion above).

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In addition to these outstanding investment commitments at September 30, 2007, we may be required to fund additional amounts under earn-out arrangements primarily related to buyout transactions in the future if those companies meet agreed-upon performance targets. We also had commitments to private finance portfolio companies in the form of standby letters of credit and guarantees totaling \$319.2 million. See Financial Condition, Liquidity and Capital Resources.

**Business Loan Express, LLC.** BLX originates, sells, and services primarily real estate secured loans, including real estate secured conventional loans, loans under the SBA 7(a) Guaranteed Loan Program, and small commercial real estate loans. BLX is headquartered in New York, NY and maintains offices in other U.S. locations. We acquired BLX in 2000.

At September 30, 2007, our investment in BLX totaled \$324.6 million at cost and \$136.7 million at value, or 2.8% of our total assets, which included unrealized depreciation of \$187.9 million. See Results of Operations, Valuation of Business Loan Express, LLC for a discussion of the determination of the value of BLX at September 30, 2007. In the first half of 2007, we increased our investment in BLX by \$29.2 million by acquiring additional Class A equity interests. In addition, in the first quarter of 2007, the chief executive officer of BLX invested \$3.0 million in the form of Class A equity interests in BLX. We plan to purchase these interests from him in conjunction with a restructuring of the BLX operations as discussed below. The purpose of these additional investments was to fund payments to the SBA in the first quarter of 2007 discussed below and to provide additional equity capital to BLX.

Total interest and related portfolio income earned from our investment in BLX for the nine months ended September 30, 2007 and 2006, was as follows:

	2007	2006
<b>(\$ in millions)</b>		
Interest income on subordinated debt and Class A equity interests	\$ 4.1	\$ 11.9
Fees and other income	4.1	6.3
<b>Total interest and related portfolio income</b>	<b>\$ 4.1</b>	<b>\$ 18.2</b>

Interest and dividend income from BLX for the nine months ended September 30, 2006, included interest income of \$5.7 million, which was paid in kind. The interest paid in kind was paid to us through the issuance of additional Class A equity interests. In the fourth quarter of 2006, we placed our investment in BLX's 25% Class A equity interests on non-accrual status. As a result, there was no interest income from our investment in BLX for the nine months ended September 30, 2007, and this resulted in lower interest income from our investment in BLX for the first nine months of 2007 compared to the first nine months of 2006.

In consideration for providing a guaranty on BLX's revolving credit facility and standby letters of credit (discussed below), we earned fees of \$4.1 million and \$4.6 million for the nine months ended September 30, 2007 and 2006, respectively, which were included in fees and other income. As of September 30, 2007, BLX had not yet paid the \$4.1 million in such fees earned by us in 2007 and, as a result, such fees were included as a receivable in other assets. The remaining fees and other income in 2006 relate to management fees from BLX. We have not charged BLX management fees in 2007.

Net change in unrealized appreciation or depreciation included a net decrease of \$103.2 million for the nine months ended September 30, 2007, and a net decrease of

\$67.9 million for the nine months ended September 30, 2006. See Results of Operations, Valuation of Business Loan Express, LLC below.

BLX is a national, non-bank lender that currently participates in the SBA's 7(a) Guaranteed Loan Program and its wholly-owned subsidiary is licensed by the SBA as a Small Business Lending Company (SBLC). The Office of the Inspector General of the SBA (OIG) and the United States Secret Service are conducting ongoing investigations of allegedly fraudulently obtained SBA-guaranteed loans issued by BLX. Specifically, on or about January 9, 2007, BLX became aware of an indictment captioned as the United States v. Harrington, No. 2:06-CR-20662 pending in the United States District Court for the Eastern District of Michigan. The indictment alleged that a former BLX employee in the Detroit office engaged in the fraudulent origination of loans guaranteed, in substantial part, by the SBA. We understand that BLX is working cooperatively with the U.S. Attorney's Office and the investigating agencies with respect to this matter. On October 1, 2007, the former BLX employee pled guilty to one count of conspiracy to fraudulently originate SBA-guaranteed loans and one count of making a false statement before a grand jury. The OIG and the U.S. Department of Justice are also conducting a civil investigation of BLX's lending practices in various jurisdictions. As an SBA lender, BLX is also subject to other SBA and OIG audits, investigations, and reviews. In addition, the Office of the Inspector General of the U.S. Department of Agriculture is conducting an investigation of BLX's lending practices under the Business and Industry Loan (B&I) program. These investigations, audits and reviews are ongoing.

These investigations, audits and reviews, 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. We have considered BLX's current regulatory issues and ongoing investigations and litigation in performing the valuation of BLX at September 30, 2007. See

Results of Operations, Valuation of Business Loan Express, LLC below. We are monitoring the situation. We retained a third party to work with BLX to review BLX's internal control systems. The third party conducted the review and offered recommendations to strengthen BLX's controls, which are being implemented.

On March 6, 2007, BLX entered into an agreement with the SBA. According to the agreement, BLX remains a preferred lender in the SBA 7(a) Guaranteed Loan Program and retains the ability to sell loans into the secondary market. As part of this agreement, BLX agreed to the immediate payment of approximately \$10 million to the SBA to cover amounts paid by the SBA with respect to some of the SBA-guaranteed loans that have been the subject of the charges by the U.S. Attorney's Office for the Eastern District of Michigan against Mr. Harrington. As part of the SBA's increased oversight, the agreement provides that any loans originated and closed by BLX during the term of the agreement will be reviewed by an independent third party selected by the SBA prior to the sale of such loans into the secondary market. The agreement also requires BLX to repurchase the guaranteed portion of certain loans that default after having been sold into the secondary market, and subjects such loans to a similar third party review prior to any reimbursement of BLX by the SBA. In connection with this agreement, BLX also entered into an escrow agreement with the SBA and an escrow agent in which BLX agreed to deposit \$10 million with the escrow agent for any additional payments BLX may be obligated to pay to the SBA in the future. BLX remains subject to SBA rules and regulations and as a result may be required to make additional payments to the SBA in the ordinary course of business. The agreement states that nothing in the agreement shall affect the rights of BLX to securitize or service

its loans. Notwithstanding the foregoing, in October 2007, BLX received a notice from the SBA that outlines certain conditions to the SBA's authorization for BLX to securitize the unguaranteed portions of SBA loans.

BLX has a separate non-recourse warehouse facility to enable it to securitize the unguaranteed portion of its SBA loans. BLX has been receiving temporary extensions of the warehouse facility, and the current extension expires on December 31, 2007. BLX is in negotiations with the warehouse facility providers to renew and amend the facility. If the current facility were to expire without renewal, the warehouse facility notes would become due and payable, and substantially all collections on the unguaranteed interests that currently are in the warehouse facility would be applied to repay the outstanding amounts owing to the warehouse providers until the warehouse providers were paid in full, similar to an amortizing term loan. In this event, the warehouse providers would not have recourse to BLX for repayment of the warehouse facility notes. In addition, BLX would not have the right to sell additional unguaranteed interests in SBA loans into this facility. In the event that BLX is unable to meet the SBA's conditions for securitization of the unguaranteed portions of SBA loans discussed above or if the warehouse providers do not agree to an extension of the warehouse facility, BLX will be required to seek alternative sources of capital to finance SBA loan originations and could incur higher capital costs.

At September 30, 2007, BLX had a three-year \$500.0 million revolving credit facility provided by third-party lenders that matures in March 2009. The revolving credit facility may be expanded to \$600.0 million through new or additional commitments at BLX's option. This facility provides for a sub-facility for the issuance of letters of credit for up to an amount equal to 25% of the committed facility. Upon the closing of this revolving credit facility in January 2006, we agreed to provide an unconditional guaranty to these revolving credit facility lenders in an amount equal to 50% of the total obligations (consisting of principal, letters of credit issued under the facility, accrued interest, and other fees) of BLX under this facility. On September 27, 2007, we increased the guaranty amount to 60% of the total obligations in connection with an amendment to and waivers under the facility as discussed below. At September 30, 2007, the principal amount outstanding on the revolving credit facility was \$322.5 million and letters of credit issued under the facility were \$89.5 million. The total obligation guaranteed by us at September 30, 2007, was \$249.0 million. At September 30, 2007, we had also provided four standby letters of credit totaling \$19.0 million in connection with four term securitization transactions completed by BLX.

The guaranty on the BLX revolving line of credit facility can be called by the lenders in the event of a default, which includes the occurrence of certain defaults under our revolving credit facility. Among other requirements, the BLX facility requires that BLX maintain compliance with certain financial covenants such as interest coverage, maximum debt to net worth, asset coverage, and maintenance of certain asset quality metrics. In addition, BLX would have an event of default if BLX failed to maintain its lending status with the SBA and such failure could reasonably be expected to result in a material adverse effect on BLX, or if BLX failed to maintain certain financing programs for the sale or long-term funding of BLX's loans. In September 2007, BLX received waivers until January 31, 2008, from its lenders with respect to non-compliance with certain facility covenants, and amended certain facility covenants through January 31, 2008. In addition, BLX previously received waivers from its lenders with respect to certain other covenants to permit BLX to comply with its obligations under its agreement with the SBA. BLX's agreement with the SBA has reduced the company's liquidity due to the working capital

required to comply with the agreement. BLX is in negotiations with its lenders to amend the credit facility covenants, but there can be no assurance that such negotiations will be successful. If the credit facility lenders do not agree to amend the covenants or to waive compliance with the covenants in periods subsequent to January 31, 2008, BLX would be in default under the credit facility.

We have been working with BLX on evaluating a number of strategic alternatives for BLX and have concluded that the company needs to make a strategic shift in its business operations and de-emphasize government guaranteed lending programs. BLX plans instead to further build its conventional small business and small commercial real estate lending activity. To effect this change in strategy, Robert Tannenhauser, BLX's current CEO, will take on the role of chairman on an interim basis and John Scheurer, an Allied Capital managing director, will assume the role of interim CEO of BLX. Under its new business plan, BLX intends to reduce its annual loan origination volume by about 30% in the next fiscal year, and then over time, it plans to rebuild its loan origination volume in conventional and commercial real estate loans. The inherent risks in repositioning the business have been considered in our valuation of BLX at September 30, 2007. We continue to work with BLX on restructuring its operations and financing facilities and we plan to support the company through its transition.

On or about January 16, 2007, BLX and its subsidiary Business Loan Center LLC (BLC) became aware of a lawsuit titled, United States, ex rel James R. Brickman and Greenlight Capital, Inc. v. Business Loan Express LLC f/k/a Business Loan Express, Inc.; Business Loan Center LLC f/k/a Business Loan Center, Inc.; Robert Tannenhauser; Matthew McGee; and George Harrigan, 05-CV-3147 (JEC), that is pending in the United States District Court for the Northern District of Georgia. The complaint includes allegations arising under the False Claims Act and relating to alleged fraud in connection with SBA guarantees on shrimp vessel loans made by BLX and BLC. On April 9, 2007, BLX, BLC and the other defendants filed motions to dismiss the complaint in its entirety. The motions are pending.

**Mercury Air Centers, Inc.** At December 31, 2006, our investment in Mercury Air Centers, Inc. (Mercury) totaled \$84.3 million at cost and \$244.2 million at value, or 5.0% of our total assets, which included unrealized appreciation of \$159.9 million. We completed the purchase of a majority ownership in Mercury in April 2004.

In August 2007, we completed the sale of our majority equity interest in Mercury and realized a gain of \$259.5 million, subject to post-closing adjustments. Approximately \$11 million of our proceeds from the sale of our equity is subject to certain holdback provisions. In addition, we were repaid approximately \$51 million of subordinated debt outstanding to Mercury at closing.

Mercury owned and operated fixed base operations generally under long-term leases from local airport authorities, which consisted of terminal and hangar complexes that serviced the needs of the general aviation community. Mercury was headquartered in Richmond Heights, OH.

Total interest and related portfolio income earned from our investment in Mercury for the nine months ended September 30, 2007 and 2006, was as follows:

	2007	2006
<b>(\$ in millions)</b>		
Interest income	\$ 5.1	\$ 7.3
Fees and other income	0.2	0.4
<b>Total interest and related portfolio income</b>	<b>\$ 5.3</b>	<b>\$ 7.7</b>

Net change in unrealized appreciation or depreciation for the three months ended September 30, 2007, included the reversal of \$234.8 million of previously recorded unrealized appreciation associated with the realization of a gain on the sale of our majority equity interest in Mercury. Net change in unrealized appreciation or depreciation for the nine months ended September 30, 2007, included an increase in unrealized appreciation totaling \$74.9 million for the first half of 2007 and the reversal of \$234.8 million associated with the sale of our majority equity interest in the third quarter of 2007. Net change in unrealized appreciation or depreciation for the three and nine months ended September 30, 2006, included an increase in unrealized appreciation of \$59.8 million and \$64.1 million, respectively, related to our investment in Mercury.

**Advantage Sales & Marketing, Inc.** At December 31, 2005, our investment in Advantage totaled \$257.7 million at cost and \$660.4 million at value, or 16.4% of our total assets, which included unrealized appreciation of \$402.7 million. Advantage is a sales and marketing agency providing outsourced sales, merchandising, and marketing services to the consumer packaged goods industry. Advantage has offices across the United States and is headquartered in Irvine, CA. We completed the purchase of a majority ownership in Advantage in June 2004.

On March 29, 2006, we sold our majority equity interest in Advantage. We were repaid our \$184 million in subordinated debt outstanding and realized a gain at closing on our equity investment sold of \$433.1 million, subject to post-closing adjustments. Subsequent to closing on this sale, we realized additional gains in 2006 resulting from post-closing adjustments totaling \$1.3 million. Our realized gain was \$434.4 million for the year ended December 31, 2006, subject to post-closing adjustments and excluding any earn-out amounts. In addition, we were entitled to receive additional consideration through an earn-out payment based on Advantage's 2006 audited results. The earn-out payment totaled \$3.1 million, subject to potential post-determination adjustments, and was recorded as a realized gain in the second quarter of 2007.

As consideration for the common stock sold in the transaction, we received a \$150 million subordinated note, with the balance of the consideration paid in cash. In addition, a portion of our cash proceeds from the sale of the common stock were placed in escrow, subject to certain holdback provisions. At September 30, 2007, the amount of the escrow included in other assets on our consolidated balance sheet was approximately \$25 million. For tax purposes, the receipt of the \$150 million subordinated note as part of our consideration for the common stock sold and the hold back of certain proceeds in escrow has allowed us, through installment treatment, to defer the recognition of taxable income for a portion of our realized gain until the note or other amounts are collected.

Total interest and related portfolio income earned from our investment in Advantage while we held a majority equity interest was \$14.1 million (which included a prepayment premium of \$5.0 million), for the nine months ended September 30, 2006. In addition, we

earned structuring fees of \$2.3 million on our new \$150 million subordinated debt investment in Advantage upon the closing of the sale transaction in 2006. Net change in unrealized appreciation or depreciation for the nine months ended September 30, 2006, included the reversal of \$389.7 million of previously recorded unrealized appreciation associated with the realization of a gain on the sale of our majority equity interest in Advantage in the first quarter of 2006.

In connection with the sale transaction, we retained an equity investment in the business valued at \$15 million at closing as a minority shareholder. During the fourth quarter of 2006, Advantage made a distribution on this minority equity investment, which reduced our cost basis to zero and resulted in a realized gain of \$4.8 million.

Our investment in Advantage at September 30, 2007, which was composed of subordinated debt and a minority equity interest, totaled \$154.0 million at cost and \$165.0 million at value, which included unrealized appreciation of \$11.0 million.

***Investments in Collateralized Loan Obligations and Collateralized Debt Obligations (CLO/CDO Assets).*** At September 30, 2007, we had investments in six CLO issuances and one CDO bond, which represented 3.6% of our total assets. These CLO/CDO Assets are primarily invested in senior corporate loans. At September 30, 2007, the total face value of defaulted obligations in our CLO/ CDO Assets was \$6.4 million or approximately 0.2% of the total underlying collateral assets. During the third quarter of 2007, the debt capital markets were volatile and market yields widened. With respect to the CLO market, we believe investor demand for pricing increased. As a result, the market yields for our investments in CLO preferred shares/income notes have increased, and as a result, the fair value of our investments in total has decreased. At September 30, 2007, the market yields used to value our preferred shares/income notes were 20% to 21%, with the exception of the income notes in one CLO with a cost and value of \$18.0 million where we used a market yield of 15.9% due to the characteristics of this issuance. Net change in unrealized appreciation or depreciation for the three and nine months ended September 30, 2007, included a net decrease of \$5.9 million and \$7.5 million, respectively, related to our investments in CLO/CDO Assets. We received valuation assistance from Duff & Phelps for our investments in the CLO/CDO Assets as of September 30, 2007. See Results of Operations *Valuation Methodology Private Finance* below for further discussion of the third-party valuation assistance we received.

**Commercial Real Estate Finance**

The commercial real estate finance portfolio at value, investment activity, and the yield on interest-bearing investments at and for the three and nine months ended September 30, 2007 and 2006, and at and for the year ended December 31, 2006, were as follows:

	At and for the Three Months Ended September 30,				At and for the Nine Months Ended September 30,				At and for the Year Ended December 31, 2006	
	2007		2006		2007		2006			
	Value	Yield <sup>(1)</sup>	Value	Yield <sup>(1)</sup>	Value	Yield <sup>(1)</sup>	Value	Yield <sup>(1)</sup>	Value	Yield <sup>(1)</sup>
(\$ in millions)										
Portfolio at value:										
Commercial mortgage loans	\$ 64.2	6.4%	\$ 94.4	7.7%	\$ 64.2	6.4%	\$ 94.4	7.7%	\$ 71.9	7.5%
Real estate owned	22.0		15.3		22.0		15.3		19.6	
Equity interests	33.5		22.1		33.5		22.1		26.7	
<b>Total portfolio</b>	<b>\$ 119.7</b>		<b>\$ 131.8</b>		<b>\$ 119.7</b>		<b>\$ 131.8</b>		<b>\$ 118.2</b>	
Investments funded	\$ 1.4		\$ 0.3		\$ 16.8		\$ 14.2		\$ 14.4	
Change in accrued or reinvested interest	\$ (1.2)		\$ 0.1		(1.1)		\$ 0.6		\$ 1.0	
Principal collections related to investment repayments or sales	\$ 4.9		\$ 0.7		\$ 23.2		\$ 17.9		\$ 39.9	

<sup>(1)</sup> The weighted average yield on the interest-bearing investments is computed as the (a) annual stated interest on accruing loans 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.

At September 30, 2007, we had outstanding funding commitments related to commercial mortgage loans and equity interests of \$42.4 million, and commitments in the form of standby letters of credit and guarantees related to equity interests of \$8.2 million.

***Sale of CMBS Bonds and Collateralized Debt Obligation Bonds and Preferred Shares.*** On May 3, 2005, we completed the sale of our portfolio of commercial mortgage-backed securities (CMBS) and real estate related collateralized debt obligation (CDO) bonds and preferred shares. Under the sale agreement, we agreed not to primarily invest in CMBS and real estate-related CDOs and refrain from certain other real estate-related investing or servicing activities for a period of three years, or through May 2008, subject to certain limitations and excluding our existing



portfolio and related activities.

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**PORTFOLIO ASSET QUALITY**

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

At September 30, 2007, and December 31, 2006, our portfolio was graded as follows:

Grade	2007		2006	
	Portfolio at Value	Percentage of Total Portfolio	Portfolio at Value	Percentage of Total Portfolio
(\$ in millions)				
1	\$ 1,605.3	37.1%	\$ 1,307.3	29.1%
2	2,320.6	53.6	2,672.3	59.4
3	258.1	6.0	308.1	6.9
4	90.5	2.1	84.2	1.9
5	52.4	1.2	124.2	2.7
	\$ 4,326.9	100.0%	\$ 4,496.1	100.0%

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

Total Grade 4 and 5 portfolio assets were \$142.9 million and \$208.4 million, respectively, or were 3.3% and 4.6%, respectively, of the total portfolio value at September 30, 2007, and December 31, 2006. Grade 4 and 5 assets include loans, debt securities, and equity securities. We expect that a number of investments will be in the Grades 4 or 5 categories from time to time. Part of the private equity business is working with troubled portfolio companies to improve their businesses and protect our investment. The number and amount of investments included in Grade 4 and 5 may fluctuate from period to period. We continue to follow our historical practice of working with portfolio companies in order to recover the maximum amount of our investment.

At September 30, 2007, and December 31, 2006, \$120.4 million and \$135.9 million, respectively, of our investment in BLX at value was classified as Grade 3, which included our Class A equity interests and certain of our Class B equity interests that were not depreciated. At September 30, 2007, and December 31, 2006, \$16.3 million and \$74.8 million, respectively, of our investment in BLX at value was classified as Grade 5, which included certain of our Class B equity interests and our Class C equity interests that were depreciated. See Private Finance, Business Loan Express, LLC above.

**Loans and Debt Securities on Non-Accrual Status.** At September 30, 2007, and December 31, 2006, loans and debt securities at value not accruing interest for the total investment portfolio were as follows:

	2007	2006
<b>(\$ in millions)</b>		
Loans and debt securities in workout status (classified as Grade 4 or 5) <sup>(1)</sup>		
Private finance		
Companies more than 25% owned	\$ 51.6	\$ 51.1
Companies 5% to 25% owned	13.1	4.0
Companies less than 5% owned	20.7	31.6
Commercial real estate finance	12.4	12.2
Loans and debt securities not in workout status		
Private finance		
Companies more than 25% owned	116.2	87.1
Companies 5% to 25% owned	16.4	7.2
Companies less than 5% owned	13.0	38.9
Commercial real estate finance	6.7	6.7
<b>Total</b>	<b>\$ 250.1</b>	<b>\$ 238.8</b>
Percentage of total portfolio	5.8%	5.3%

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

In general, interest is not accrued on loans and debt securities if we have doubt about interest collection or where the enterprise value of the portfolio company may not support further accrual. In addition, interest may not accrue on loans to portfolio companies that are more than 50% owned by us depending on such company's capital requirements. To the extent interest payments are received on a loan that is not accruing interest, we may use such payments to reduce our cost basis in the investment in lieu of recognizing interest income. At September 30, 2007, and December 31, 2006, our Class A equity interests in BLX of \$95.8 million and \$66.6 million, respectively, which represented 2.2% and 1.5% of the total portfolio at value, respectively, were included in non-accruals. See Private Finance, Business Loan Express, LLC above.

**Loans and Debt Securities Over 90 Days Delinquent.** Loans and debt securities greater than 90 days delinquent at value at September 30, 2007, and December 31, 2006, were as follows:

	2007	2006
<b>(\$ in millions)</b>		
Private finance	\$ 160.8	\$ 46.5
Commercial mortgage loans	1.9	1.9
<b>Total</b>	<b>\$ 162.7</b>	<b>\$ 48.4</b>
Percentage of total portfolio	3.8%	1.1%

The amount of loans and debt securities over 90 days delinquent increased to \$162.7 million at September 30, 2007, from \$48.4 million at December 31, 2006. The increase in loans and debt securities over 90 days delinquent

primarily relates to not receiving payment on our Class A equity interests of BLX of \$95.8 million, which represented 2.2% of the total portfolio at value, at September 30, 2007. The Class A equity

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interests were placed on non-accrual during the fourth quarter of 2006. See Private Finance, Business Loan Express, LLC above.

The amount of the portfolio that is on non-accrual status or greater than 90 days delinquent may vary from period to period. Loans and debt securities on non-accrual status and over 90 days delinquent should not be added together as they are two separate measures of portfolio asset quality. Loans and debt securities that are in both categories (i.e., on non-accrual status and over 90 days delinquent) totaled \$162.7 million and \$44.3 million at September 30, 2007, and December 31, 2006, respectively.

#### **PORTFOLIO RETURNS**

Since our merger on December 31, 1997, through September 30, 2007, our combined aggregate cash flow internal rate of return, or IRR, has been approximately 21% for private finance and CMBS/ CDO investments exited during this period. The IRR is calculated using the aggregate portfolio cash flow for all investments exited over this period. For investments exited during this period, we invested capital totaling \$4.6 billion. The weighted average holding period of these investments was 37 months. Investments are considered to be exited when the original investment objective has been achieved through the receipt of cash and/or non-cash consideration upon the repayment of our debt investment or sale of an equity investment, or through the determination that no further consideration was collectible and, thus, a loss may have been realized. The aggregate cash flow IRR for private finance investments exited was approximately 21% and for CMBS/ CDO investments exited was approximately 24% for the same period. The weighted average holding period of the private finance and CMBS/ CDO investments was 47 months and 22 months, respectively, for the same period. These IRR results represent historical results. Historical results are not necessarily indicative of future results.

#### **OTHER ASSETS AND OTHER LIABILITIES**

Other assets is composed primarily of fixed assets, assets held in deferred compensation trusts, prepaid expenses, deferred financing and offering costs, and accounts receivable, which includes amounts received in connection with the sale of portfolio companies, including amounts held in escrow, and other receivables from portfolio companies. At September 30, 2007, and December 31, 2006, other assets totaled \$153.9 million and \$123.0 million, respectively. The increase since year end was primarily the result of increased prepaid expenses related to tax deposits, deferred financing costs, and escrow receivables.

Accounts payable and other liabilities is primarily composed of the liabilities related to the deferred compensation trust and accrued interest, bonus and taxes, including excise tax. At September 30, 2007, and December 31, 2006, accounts payable and other liabilities totaled \$173.4 million and \$147.1 million, respectively. The increase since year end was primarily the result of an increase in the accrued interest payable of \$18.5 million and an increase in the liability related to the deferred compensation trust of \$7.9 million. Accrued interest fluctuates from period to period depending on the amount of debt outstanding and the contractual payment dates of the interest on such debt.

**RESULTS OF OPERATIONS****Comparison of the Three and Nine Months Ended September 30, 2007 and 2006**

The following table summarizes our operating results for the three and nine months ended September 30, 2007 and 2006.

(in thousands, except per share amounts)	For the Three Months Ended September 30,				For the Nine Months Ended September 30,			
	2007	2006	Change	Percent Change	2007	2006	Change	Percent Change
<b>Interest and Related Portfolio Income:</b>								
Interest and dividends	\$ 105,669	\$ 98,668	\$ 7,001	7%	\$ 310,466	\$ 282,982	\$ 27,484	10%
Fees and other income	12,699	14,715	(2,016)	(14%)	33,530	51,868	(18,338)	(35%)
Total interest and related portfolio income	118,368	113,383	4,985	4%	343,996	334,850	9,146	3%
<b>Expenses:</b>								
Interest	33,744	26,109	7,635	29%	98,368	72,455	25,913	36%
Employee	26,306	25,228	1,078	4%	76,845	67,054	9,791	15%
Employee stock options	18,312	3,649	14,663	402%	31,492	11,852	19,640	166%
Administrative	10,496	8,153	2,343	29%	38,225	29,348	8,877	30%
Total operating expenses	88,858	63,139	25,719	41%	244,930	180,709	64,221	36%
Net investment income before income taxes	29,510	50,244	(20,734)	(41%)	99,066	154,141	(55,075)	(36%)
Income tax expense (benefit), including excise tax	11,192	1,586	9,606	606%	16,073	13,988	2,085	15%
Net investment income	18,318	48,658	(30,340)	(62%)	82,993	140,153	(57,160)	(41%)

Net Realized and  
Unrealized Gains

(Losses):

Net realized gains	212,370	9,916	202,454	*	314,915	542,991	(228,076)	*
Net change in unrealized appreciation or depreciation	(327,156)	19,312	(346,468)	*	(272,132)	(471,942)	199,810	*
Total net gains (losses)	(114,786)	29,228	(144,014)	*	42,783	71,049	(28,266)	*
Net income (loss)	\$ (96,468)	\$ 77,886	\$ (174,354)	(224%)	\$ 125,776	\$ 211,202	\$ (85,426)	(40%)
Diluted earnings (loss) per common share	\$ (0.62)	\$ 0.53	\$ (1.15)	(217%)	\$ 0.81	\$ 1.47	\$ (0.66)	(45%)
Weighted average common shares outstanding diluted	155,329	147,112	8,217	6%	154,708	144,030	10,678	7%

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

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**Total Interest and Related Portfolio Income.** Total interest and related portfolio income includes interest and dividend income and fees and other income.

**Interest and Dividends.** Interest and dividend income for the three and nine months ended September 30, 2007 and 2006, was composed of the following:

(\$ in millions)	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2007	2006	2007	2006
<b>Interest:</b>				
Private finance loans and debt securities	\$ 94.1	\$ 87.9	\$ 280.4	\$ 253.8
Preferred shares/income notes of CLOs	4.3	3.0	11.5	8.3
Commercial mortgage loans	1.1	1.7	4.9	6.5
Cash, U.S. Treasury bills, money market and other securities	5.6	5.0	11.8	10.9
Total interest	105.1	97.6	308.6	279.5
<b>Dividends</b>	0.6	1.1	1.9	3.5
Total interest and dividends	\$ 105.7	\$ 98.7	\$ 310.5	\$ 283.0

The level of interest income from the portfolio, which includes interest paid in cash and in kind, is directly related to the balance of the interest-bearing investment portfolio outstanding during the period multiplied by the weighted average yield. The interest-bearing investments in the portfolio at value and the yield on the interest-bearing investments in the portfolio at September 30, 2007 and 2006, were as follows:

(\$ in millions)	2007		2006	
	Value	Yield <sup>(1)</sup>	Value	Yield <sup>(1)</sup>
<b>Loans and debt securities:</b>				
Private finance	\$ 3,106.8	11.8%	\$ 2,905.2	12.5%
Commercial mortgage loans	64.2	6.4%	94.4	7.7%
Total loans and debt securities	3,171.0	11.7%	2,999.6	12.3%
<b>Equity securities:</b>				
Preferred shares/income notes of CLOs	131.5	15.1%	87.7	13.7%
Total interest bearing securities	\$ 3,302.5	11.9%	\$ 3,087.3	12.4%

<sup>(1)</sup> The weighted average yield on loans and debt securities is computed as the (a) annual stated interest on accruing loans and debt securities 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 interest-bearing investments at value. The weighted average yield on the preferred shares/income notes of



CLOs is calculated as the (a) effective interest yield on the preferred shares/income notes of CLOs, divided by (b) preferred shares/income notes of CLOs at value. The weighted average yields are computed as of the balance sheet date.

Our interest income from our private finance loans and debt securities has increased year over year primarily as a result of the growth in this portfolio, net of the reduction in yield. The private finance loan and debt securities portfolio yield at September 30, 2007, of 11.8% as compared to the private finance loan and debt securities portfolio yield of 12.5% at September 30, 2006, reflects the mix of debt investments in the private finance loan and debt securities portfolio and an increase in non-accruing loans and debt securities. The weighted average yield varies from period to period based on the current stated interest on loans and debt securities and the amount of loans and debt securities for which interest is not accruing.

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See the discussion of the private finance portfolio yield above under the caption **Portfolio and Investment Activity Private Finance**.

Interest income also includes the effective interest yield on our investments in the preferred shares/income notes of CLOs. Interest income from these investments has increased year over year primarily as a result of the growth in these assets. The weighted average yield on the preferred shares/income notes of the CLOs has increased from 13.7% at September 30, 2006, to 15.1% at September 30, 2007.

Interest income from cash, U.S. Treasury bills, money market and other securities results primarily from interest earned on our liquidity portfolio and excess cash on hand. See **Financial Condition, Liquidity and Capital Resources** below. The value and weighted average yield of the liquidity portfolio was \$200.7 million and 5.3%, respectively, at September 30, 2007, and \$201.8 million and 5.3%, respectively, at December 31, 2006.

Dividend income results from the dividend yield on preferred equity interests, if any, or the declaration of dividends by a portfolio company on preferred or common equity interests. Dividend income will vary from period to period depending upon the timing and amount of dividends that are declared or paid by a portfolio company on preferred or common equity interests.

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

Fees and other income for the three and nine months ended September 30, 2007 and 2006, included fees relating to the following:

	<b>For the Three Months Ended September 30,</b>		<b>For the Nine Months Ended September 30,</b>	
	<b>2007</b>	<b>2006</b>	<b>2007</b>	<b>2006</b>
<b>(\$ in millions)</b>				
Structuring and diligence	\$ 7.3	\$ 9.3	\$ 15.3	\$ 28.4
Management, consulting and other services provided to portfolio companies <sup>(1)</sup>	3.2	2.6	7.3	9.1
Commitment, guaranty and other fees from portfolio companies <sup>(2)</sup>	2.0	2.1	7.0	6.7
Loan prepayment premiums	0.1	0.7	3.7	7.7
Other income	0.1		0.2	
<b>Total fees and other income</b>	<b>\$ 12.7</b>	<b>\$ 14.7</b>	<b>\$ 33.5</b>	<b>\$ 51.9</b>

<sup>(1)</sup> The nine months ended September 30, 2006, includes \$1.8 million in management fees from Advantage prior to its sale on March 29, 2006. See **Portfolio and Investment Activity** above for further discussion. The three and nine months ended September 30, 2006, included management fees from BLX of \$0.5 million and \$1.7 million, respectively. We have not charged BLX management fees in 2007. See **Private Finance, Business Loan Express, LLC** above.

<sup>(2)</sup> Includes guaranty and other fees from BLX of \$1.3 million and \$1.5 million for the three months ended September 30, 2007 and 2006, respectively, and \$4.1 million and \$4.6 million for the nine months ended

September 30, 2007 and 2006, respectively. See Private Finance, Business Loan Express, LLC above.  
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Fees and other income are generally related to specific transactions or services and therefore may vary substantially from period to period depending on the level of investment activity and types of services provided. Loan origination fees that represent yield enhancement on a loan are capitalized and amortized into interest income over the life of the loan.

Structuring and diligence fees primarily relate to the level of new investment originations. Private finance investments funded were \$1.2 billion for the nine months ended September 30, 2007, as compared to \$1.9 billion for the nine months ended September 30, 2006. This resulted in lower structuring and diligence fees in 2007 versus 2006.

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

*Mercury and BLX.* At September 30, 2007, BLX represented 2.8% of our total assets. At September 30, 2006, Mercury and BLX together represented 10.7% of our total assets. Mercury was sold in August 2007 (see above). Total interest and related portfolio income from these investments for the three and nine months ended September 30, 2007 and 2006, was as follows:

(\$ in millions)	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2007	2006	2007	2006
Mercury	\$1.0	\$2.1	\$5.3	\$ 7.7
BLX	\$1.3	\$6.1	\$4.1	\$18.2

See Portfolio and Investment Activity above for further detail on Mercury and BLX.

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

**Interest Expense.** The fluctuations in interest expense during the three and nine months ended September 30, 2007 and 2006, were primarily attributable to changes in the level of our borrowings under various notes payable and our revolving line of credit. Our borrowing activity and weighted average cost of debt, including fees and debt financing

costs, at and for the three and nine months ended September 30, 2007 and 2006, were as follows:

	At and for the Three Months Ended September 30,		At and for the Nine Months Ended September 30,	
	2007	2006	2007	2006
<b>(\$ in millions)</b>				
Total outstanding debt	\$1,922.4	\$1,590.7	\$1,922.4	\$1,590.7
Average outstanding debt	\$1,921.1	\$1,507.5	\$1,909.5	\$1,433.5
Weighted average cost <sup>(1)</sup>	6.6%	6.6%	6.6%	6.6%

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

In addition, interest expense included interest paid to the Internal Revenue Service related to installment sale gains totaling \$2.0 million and \$0.3 million for the three months ended September 30, 2007 and 2006, respectively, and \$4.3 million and \$0.7 million for the nine months ended September 30, 2007 and 2006, respectively. Installment interest expense for the year ended December 31, 2007, is estimated to be a total of \$6.4 million. See Dividends and Distributions below.

*Employee Expense.* Employee expenses for the three and nine months ended September 30, 2007 and 2006, were as follows:

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2007	2006	2007	2006
<b>(\$ in millions)</b>				
Salaries and employee benefits	\$ 23.3	\$ 19.6	\$ 65.9	\$ 54.6
Individual performance award (IPA)	2.4	2.1	7.4	6.0
IPA mark to market expense (benefit)	(2.0)	1.2	(3.6)	0.6
Individual performance bonus (IPB)	2.6	2.3	7.1	5.9
<b>Total employee expense</b>	<b>\$ 26.3</b>	<b>\$ 25.2</b>	<b>\$ 76.8</b>	<b>\$ 67.1</b>
Number of employees at end of period	178	168	178	168

The change in salaries and employee benefits reflects the effect of compensation increases, the change in mix of employees given their area of responsibility and relevant experience level and an increase in the number of employees. Salaries and employee benefits include an accrual for employee bonuses, which are generally paid annually after the completion of the fiscal year. The quarterly accrual is based upon an estimate of annual bonuses and is subject to change. The amount of the current year bonuses will be finalized by the Compensation Committee and the Board of Directors at the end of the year. Salaries and employee benefits included accrued bonuses of \$11.1 million and \$10.7 million for the three months ended September 30, 2007 and 2006, respectively, and \$32.7 million and \$27.6 million for the nine months ended September 30, 2007 and 2006, respectively.

The IPA is a long-term incentive compensation program for certain officers. The IPA, which is generally determined annually at the beginning of each year, is deposited into a deferred compensation trust generally in four equal installments, on a quarterly basis, in the form of cash. The trustee is required to use the cash to purchase shares of our common stock in the open market. The accounts of the trust are consolidated with our

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accounts. We are required to mark to market the liability of the trust and this adjustment is recorded to the IPA compensation expense. Because the IPA is deferred compensation, the cost of this award is not a current expense for purposes of computing our taxable income. The expense is deferred for tax purposes until distributions are made from the trust.

We also have an IPB, which is distributed in cash to award recipients throughout the year (beginning in February of each year) as long as the recipient remains employed by us.

The Compensation Committee and the Board of Directors have determined the IPA and the IPB for 2007 and they are currently estimated to be approximately \$10 million each; however, the Compensation Committee may adjust the IPA or IPB as needed, or make new awards as new officers are hired. If a recipient terminates employment during the year, any further cash contribution for the IPA or remaining cash payments under the IPB would be forfeited.

*Stock Options Expense.* Effective January 1, 2006, we adopted Statement No. 123 (Revised 2004), *Share-Based Payment* (SFAS 123R) using the modified prospective method of application, which required us to recognize compensation costs on a prospective basis beginning January 1, 2006. Under this method, the unamortized cost of previously awarded options that were unvested as of January 1, 2006, will be recognized over the remaining service period in the statement of operations beginning in 2006, using the fair value amounts determined for proforma disclosure under SFAS 123R. With respect to options granted on or after January 1, 2006, compensation cost based on estimated grant date fair value is recognized in the consolidated statement of operations over the service period. Our employee stock options are typically granted with ratable vesting provisions, and we amortize the compensation cost over the related service period. The stock option expense for the three and nine months ended September 30, 2007 and 2006, was as follows:

	<b>For the Three Months Ended September 30,</b>		<b>For the Nine Months Ended September 30,</b>	
	<b>2007</b>	<b>2006</b>	<b>2007</b>	<b>2006</b>
<b>(\$ in millions)</b>				
<b>Employee Stock Option Expense:</b>				
Options granted:				
Previously awarded, unvested options as of January 1, 2006	\$ 1.7	\$ 3.2	\$ 8.2	\$ 9.9
Options granted on or after January 1, 2006	2.2	0.4	8.9	2.0
<b>Total options granted</b>	<b>3.9</b>	<b>3.6</b>	<b>17.1</b>	<b>11.9</b>
Options cancelled in connection with tender offer (see below)	14.4		14.4	
<b>Total employee stock option expense</b>	<b>\$ 18.3</b>	<b>\$ 3.6</b>	<b>\$ 31.5</b>	<b>\$ 11.9</b>

*Options Granted.* In addition to the employee stock option expense for options granted, for both the nine months ended September 30, 2007 and 2006, administrative expense included \$0.2 million of expense related to options granted to directors during each respective period. Options were granted to non-officer directors in the second quarters of 2007 and 2006. Options granted to non-officer directors vest on the grant date and therefore, the full expense is recorded on the grant date.

During the second quarter of 2007, options were granted for 6.4 million shares. One-third of the options granted to employees vested on June 30, 2007, therefore, approximately one-third of the expense related to this grant, or \$5.9 million, was recorded in the second quarter of 2007. Of the remaining options granted, one-half will vest on June 30, 2008, and one-half will vest on June 30, 2009. We estimate that the employee-related stock option expense under SFAS 123R that will be recorded in our consolidated statement of operations, including the expense related to options granted in 2007 but excluding the expense related to the options cancelled in connection with the tender offer, will be approximately \$21.0 million, \$9.5 million, and \$2.8 million for the years ended December 31, 2007, 2008, and 2009, respectively, which includes approximately \$10.9 million, \$6.6 million, and \$2.8 million, respectively, related to options granted since adoption of SFAS 123R (January 1, 2006). This estimate may change if our assumptions related to future option forfeitures change. This estimate does not include any expense related to future stock option grants as the fair value of those stock options will be determined at the time of grant.

*Options Cancelled in Connection with Tender Offer.* On July 18, 2007, we completed a tender offer related to our offer to all optionees who held vested in-the-money stock options as of June 20, 2007, the opportunity to receive an option cancellation payment (OCP) equal to the in-the-money value of the stock options cancelled, determined using the Weighted Average Market Price of \$31.75, which would be paid one-half in cash and one-half in unregistered shares of our common stock. We accepted for cancellation 10.3 million vested options held by employees and non-officer directors, which in the aggregate had a weighted average exercise price of \$21.50. This resulted in a total option cancellation payment of approximately \$105.6 million, of which \$52.8 million was paid in cash and \$52.8 million was paid through the issuance of 1.7 million unregistered shares of the Company's common stock, determined using the Weighted Average Market Price of \$31.75. The Weighted Average Market Price represented the volume weighted average price of our common stock over the fifteen trading days preceding the first day of the offer period, or June 20, 2007. Our stockholders approved the issuance of the shares of our common stock in exchange for the cancellation of vested in-the-money stock options at our 2006 Annual Meeting of Stockholders. Cash payments to employee optionees were paid net of required payroll and income tax withholdings.

As discussed above, the OCP was equal to the in-the-money value of the stock options cancelled, determined using the Weighted Average Market Price of \$31.75, and was paid one-half in cash and one-half in unregistered shares of the Company's common stock. In accordance with the terms of the tender offer, the Weighted Average Market Price represented the volume weighted average price of the Company's common stock over the fifteen trading days preceding the first day of the offer period, or June 20, 2007. Because the Weighted Average Market Price at the commencement of the tender offer on June 20, 2007, was higher than the market price of our common stock at the close of the offer on July 18, 2007, SFAS 123R required us to record employee-related stock option expense of \$14.4 million and administrative expense related to stock options cancelled that were held by non-officer directors of \$0.4 million. The same amounts were recorded as an increase to additional paid-in capital and, therefore, had no effect on our net asset value. The portion of the OCP paid in cash of \$52.8 million reduced our additional paid-in capital and therefore reduced our net asset value. For income tax purposes, our tax deduction resulting from the OCP will be similar to the tax deduction that would have resulted from an exercise of stock options in the market. Any tax deduction for us resulting



from the OCP or an exercise of stock options in the market is limited by Section 162(m) of the Code for persons subject to Section 162(m).

At September 30, 2007, subsequent to the completion of the tender offer and the cancellation of the 10.3 million vested options, there were 18.5 million options outstanding and 10.7 million shares available to be granted under our Stock Option Plan. The Board of Directors adopted a target ownership program that establishes minimum ownership levels for our senior officers and continues to further align the interests of our officers with those of our stockholders.

*Administrative Expenses.* Administrative expenses include legal and accounting fees, valuation assistance fees, insurance premiums, the cost of leases for our headquarters in Washington, DC, and our regional offices, portfolio origination and development expenses, travel costs, stock record expenses, directors' fees and stock option expense, and various other expenses. Administrative expenses for the three and nine months ended September 30, 2007 and 2006, were as follows:

	For the Three Months Ending September 30,		For the Nine Months Ending September 30,	
	2007	2006	2007	2006
<b>(\$ in millions)</b>				
Administrative expenses	\$ 9.7	\$ 7.6	\$ 33.2	\$ 25.3
Investigation and litigation costs	0.8	0.6	5.0	4.0
<b>Total administrative expenses</b>	<b>\$ 10.5</b>	<b>\$ 8.2</b>	<b>\$ 38.2</b>	<b>\$ 29.3</b>

Administrative expenses, excluding investigation and litigation costs, for the nine months ended September 30, 2007, included costs of \$1.4 million incurred in the first quarter of 2007 to engage a third party to work with BLX, a portfolio company controlled by us, to conduct a review of BLX's internal control systems. See *Private Finance, Business Loan Express, LLC* above. In addition, administrative expenses for the nine months ended September 30, 2007, included \$2.5 million in placement fees related to securing equity commitments to the Allied Capital Senior Debt Fund, L.P. in the second quarter of 2007. See *Private Finance, Allied Capital Senior Debt Fund, L.P.* above.

Investigation and litigation costs include costs associated with requests for information in connection with government investigations and other legal matters. We expect that we will continue to incur legal and other costs associated with these matters. These expenses remain difficult to predict. See *Legal Proceedings* below.

*Income Tax Expense (Benefit), Including Excise Tax.* Income tax expense (benefit) for the three and nine months ended September 30, 2007 and 2006, was as follows:

	For the Three Months Ended September 30,		For the Nine Months Ending September 30,	
	2007	2006	2007	2006
<b>(\$ in millions)</b>				
Income tax expense (benefit)	\$ 2.2	\$ (0.6)	\$ (0.5)	\$ 0.2
Excise tax expense	9.0	2.2	16.6	13.8
<b>Income tax expense (benefit), including excise tax</b>	<b>\$ 11.2</b>	<b>\$ 1.6</b>	<b>\$ 16.1</b>	<b>\$ 14.0</b>



Our wholly owned subsidiary, A.C. Corporation, is a corporation subject to federal and state income taxes and records a benefit or expense for income taxes as appropriate based on its operating results in a given period.

Our estimated annual taxable income for 2007 currently exceeds our estimated dividend distributions to shareholders from such taxable income in 2007, and such estimated excess taxable income will be distributed in 2008. Therefore, we will generally be required to pay a 4% excise tax on the excess of 98% of our taxable income over the amount of actual distributions from such taxable income. We have recorded an estimated excise tax of \$9.0 million and \$16.6 million for the three and nine months ended September 30, 2007, respectively. See Dividends and Distributions. While excise tax expense is presented in the consolidated statement of operations as a reduction to net investment income, excise tax relates to both net investment income and net realized gains.

In June 2006, the FASB issued Interpretation No. 48, *Accounting for Uncertainty in Income Taxes*, which clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with FASB Statement No. 109, *Accounting for Income Taxes*. This interpretation is effective for fiscal years beginning after December 15, 2006. The adoption of this interpretation did not have a significant effect on our consolidated financial position or our results of operations.

**Realized Gains and Losses.** Net realized gains primarily result from the sale of equity securities associated with certain private finance investments and the realization of unamortized discount resulting from the sale and early repayment of private finance loans and commercial mortgage loans, offset by losses on investments. Net realized gains for the three and nine months ended September 30, 2007 and 2006, were as follows:

	<b>For the Three Months Ended September 30,</b>		<b>For the Nine Months Ended September 30,</b>	
	<b>2007</b>	<b>2006</b>	<b>2007</b>	<b>2006</b>
<b>(\$ in millions)</b>				
Realized gains	\$ 275.8	\$ 12.6	\$ 396.4	\$ 550.1
Realized losses	(63.4)	(2.7)	(81.5)	(7.1)
Net realized gains	\$ 212.4	\$ 9.9	\$ 314.9	\$ 543.0

When we exit an investment and realize a gain or loss, we make an accounting entry to reverse any unrealized appreciation or depreciation, respectively, we had previously recorded to reflect the appreciated or depreciated value of the investment. For the three months and nine months ended September 30, 2007 and 2006, we reversed previously

recorded unrealized appreciation or depreciation when gains or losses were realized as follows:

(\$ in millions)	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2007	2006	2007	2006
Reversal of previously recorded net unrealized appreciation associated with realized gains	\$ (243.9)	\$ (10.2)	\$ (330.9)	\$ (499.4)
Reversal of previously recorded net unrealized depreciation associated with realized losses	65.8	2.2	88.1	5.4
<b>Total reversal</b>	<b>\$ (178.1)</b>	<b>\$ (8.0)</b>	<b>\$ (242.8)</b>	<b>\$ (494.0)</b>

Realized gains for the three months ended September 30, 2007 and 2006, were as follows:  
(\$ in millions)

### 2007

Portfolio Company	Amount
<b>Private Finance:</b>	
Mercury Air Centers, Inc.	\$ 259.5
Woodstream Corporation	14.6
Mogas Energy, LLC	1.2
Other	0.5
<b>Total realized gains</b>	<b>\$ 275.8</b>

### 2006

Portfolio Company	Amount
<b>Private Finance:</b>	
Oriental Trading Company, Inc.	\$ 8.9
Component Hardware Group, Inc.	2.8
Advantage Sales & Marketing, Inc.	0.7
Other	0.2
<b>Total realized gains</b>	<b>\$ 12.6</b>

Realized losses for the three months ended September 30, 2007 and 2006, were as follows:  
(\$ in millions)

## 2007

<b>Portfolio Company</b>	<b>Amount</b>
<b>Private Finance:</b>	
Jakel, Inc.	\$ 24.8
Startec Global Communications Corporation	20.2
Gordian Group, Inc.	9.7
Universal Environmental Services, LLC	8.6
Other	0.1
Total realized losses	\$ 63.4

## 2006

<b>Portfolio Company</b>	<b>Amount</b>
<b>Private Finance:</b>	
Cooper Natural Resources, Inc.	\$ 2.2
Other	0.5
Total realized losses	\$ 2.7

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Realized gains for the nine months ended September 30, 2007 and 2006 were as follows:  
(\$ in million)

## 2007

Portfolio Company	Amount
<b>Private Finance:</b>	
Mercury Air Centers, Inc.	\$ 259.5
HMT, Inc.	39.9
Healthy Pet Corp.	36.6
Palm Coast Data, LLC	20.0
Woodstream Corporation	14.6
Wear Me Apparel Corporation	6.1
Mogas Energy, LLC	5.7
Tradesmen International, Inc.	3.8
ForeSite Towers, LLC	3.8
Advantage Sales & Marketing, Inc.	3.1
Geotrace Technologies, Inc.	1.1
Other	2.2
 Total realized gains	 \$ 396.4

## 2006

Portfolio Company	Amount
<b>Private Finance:</b>	
Advantage Sales & Marketing, Inc.	\$ 434.4
STS Operating, Inc.	94.8
Oriental Trading Company, Inc.	8.9
United Site Services, Inc.	3.3
Component Hardware Group, Inc.	2.8
Nobel Learning Communities, Inc.	1.5
MHF Logistical Solutions, Inc.	1.2
The Debt Exchange, Inc.	1.1
Other	1.5
 Total private finance	 549.5
<b>Commercial Real Estate:</b>	
Other	0.6
 Total commercial real estate	 0.6
 Total realized gains	 \$ 550.1

Realized losses for the nine months ended September 30, 2007 and 2006, were as follows:  
(\$ in millions)

## 2007

Portfolio Company	Amount
<b>Private Finance:</b>	
Jakel, Inc.	\$ 24.8
Startec Global Communications, Inc.	20.2
Powell Plant Farms, Inc.	11.6
Gordian Group, Inc.	9.7
Universal Environmental Services, LLC	8.6
Legacy Partners Group, LLC	5.8
Other	0.8
<b>Total realized losses</b>	<b>\$ 81.5</b>

## 2006

Portfolio Company	Amount
<b>Private Finance:</b>	
Cooper Natural Resources, Inc.	\$ 2.2
Aspen Pet Products, Inc.	1.6
Nobel Learning Communities, Inc.	1.4
Other	1.0
<b>Total private finance</b>	<b>6.2</b>
<b>Commercial Real Estate:</b>	
Other	0.9
<b>Total commercial real estate</b>	<b>0.9</b>
<b>Total realized losses</b>	<b>\$ 7.1</b>

**Change in Unrealized Appreciation or Depreciation.** We determine the value of each investment in our portfolio on a quarterly basis, and changes in value result in unrealized appreciation or depreciation being recognized in our statement of operations. Value, as defined in Section 2(a)(41) of the Investment Company Act of 1940, is (i) the market price for those securities for which a market quotation is readily available and (ii) for all other securities and assets, fair value is as determined in good faith by the Board of Directors. Since there is typically no readily available market value for the investments in our portfolio, we value substantially all of our portfolio investments at fair value as determined in good faith by the Board of Directors pursuant to our valuation policy and a consistently applied valuation process. At September 30, 2007, portfolio investments recorded at fair value were approximately 89% of our total assets. Because of the inherent uncertainty of determining the fair value of investments that do not have a readily available market value, the fair value of our investments determined in good faith by the





Board of Directors may differ significantly from the values that would have been used had a ready market existed for the investments, and the differences could be material.

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

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

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

There is no one methodology to determine enterprise value and, in fact, for any one portfolio company, enterprise value is best expressed as a range of fair values. However, we must derive a single estimate of enterprise value. To determine the enterprise value of a portfolio company, we analyze its historical and projected financial results. This financial and other information is generally obtained from the portfolio companies, and may represent unaudited, projected or pro forma financial information. 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, the entry multiple for the transaction, discounted public trading multiples or industry practices. In estimating a reasonable multiple, we consider not only the fact that our portfolio company may be a private company relative to a peer group of public comparables, but we also consider the size and scope of our portfolio company and its specific strengths and weaknesses. In some cases, the best valuation methodology may be a discounted cash flow analysis based on future projections. If a portfolio company is distressed, a liquidation analysis may provide the best indication of enterprise value.

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

CDO/CLO Assets are carried at fair value, which is based on a discounted cash flow model that utilizes prepayment, re-investment and loss assumptions based on historical experience and projected performance, economic factors, the characteristics of the underlying cash flow and comparable yields for similar bonds and preferred shares/income notes, when available. We recognize unrealized appreciation or depreciation on our CDO/CLO Assets as comparable yields in the market change and/ or based on changes in estimated cash flows resulting from changes in prepayment, re-investment or loss assumptions in the underlying collateral pool. We determine the fair value of our CDO/CLO Assets on an individual security-by-security basis. If we were to sell a group of these CDO/CLO Assets in a pool in one or more transactions, the total value received for that pool may be different than the sum of the fair values of the individual assets.

As a participant in the private equity business, we invest primarily in private middle market companies for which there is generally no publicly available information. Because of the private nature of these businesses, there is a need to maintain the confidentiality of the financial and other information that we have for the private companies in our portfolio. We believe that maintaining this confidence is important, as disclosure of such information could disadvantage our portfolio companies and could put us at a disadvantage in attracting

new investments. Therefore, we do not intend to disclose financial or other information about our portfolio companies, unless required, because we believe doing so may put them at an economic or competitive disadvantage, regardless of our level of ownership or control.

We currently intend to continue to work with third-party consultants to obtain assistance in determining fair value for a portion of the private finance portfolio each quarter. We work with these consultants to obtain assistance as additional support in the preparation of our internal valuation analysis. In addition, we may receive third-party assessments of a particular private finance portfolio company's value in the ordinary course of business, most often in the context of a prospective sale transaction or in the context of a bankruptcy process.

The valuation analysis prepared by management is submitted to our Board of Directors who is ultimately responsible for the determination of fair value of the portfolio in good faith. Valuation assistance from Duff & Phelps, LLC (Duff & Phelps) for our private finance portfolio consisted of certain limited procedures (the Procedures) we identified and requested them to perform. Based upon the performance of the Procedures on a selection of our final portfolio company valuations, Duff & Phelps concluded that the fair value of those portfolio companies subjected to the Procedures did not appear unreasonable. In addition, we also received third-party valuation assistance from Houlihan Lokey Howard and Zukin for certain private finance portfolio companies. For 2007 and 2006, we received third-party valuation assistance as follows:

	2007			2006		
	Q1	Q2	Q3	Q1	Q2	Q3
Number of private finance portfolio companies reviewed	88	92	135	78	78	105
Percentage of private finance portfolio reviewed at value	91.8%	92.1%	92.1%	87.0%	89.6%	86.5%

Professional fees for third-party valuation assistance were \$1.5 million for the year ended December 31, 2006, and are estimated to be approximately \$1.7 million for 2007.

*Net Change in Unrealized Appreciation or Depreciation.* Net change in unrealized appreciation or depreciation for the three and nine months ended September 30, 2007 and 2006, consisted of the following:

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2007 <sup>(1)</sup>	2006 <sup>(1)</sup>	2007 <sup>(1)</sup>	2006 <sup>(1)</sup>
<b>(\$ in millions)</b>				
Net unrealized appreciation (depreciation)	\$ (149.1)	\$ 27.3	\$ (29.3)	\$ 22.1
Reversal of previously recorded unrealized appreciation associated with realized gains	(243.9)	(10.2)	(330.9)	(499.4)
Reversal of previously recorded unrealized depreciation associated with realized losses	65.8	2.2	88.1	5.4
Net change in unrealized appreciation or depreciation	\$ (327.2)	\$ 19.3	\$ (272.1)	\$ (471.9)

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

**Valuation of Business Loan Express, LLC.** Our investment in BLX totaled \$324.6 million at cost and \$136.7 million at value, which included unrealized depreciation of \$187.9 million, at September 30, 2007, and \$295.3 million at cost and \$210.7 million at value, which included unrealized depreciation of \$84.6 million, at December 31, 2006. Net change in unrealized appreciation or depreciation included a net decrease of \$84.1 million and \$103.2 million for the three and nine months ended September 30, 2007, respectively. We received valuation assistance from Duff & Phelps for our investment in BLX at September 30, 2007, and December 31, 2006. See *Valuation Methodology Private Finance* above for further discussion of the third-party valuation assistance we received.

To determine the value of our investment in BLX at September 30, 2007, we performed numerous valuation analyses to determine a range of values including: (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; (4) a discounted dividend analysis; and (5) adding BLX's net asset value (adjusted for certain discounts) to the estimated value of BLX's business operations, which was determined by using a discounted cash flow model. 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 September 30, 2007, was made up of CIT Group, Inc., Financial Federal Corporation, GATX Corporation, and Marlin Business Services Corporation, which is consistent with the comparable group at both June 30, 2007, and December 31, 2006. The fair value of BLX at September 30, 2007, was within the range of values determined by these valuation analyses.

The value of BLX at September 30, 2007, reflects a strategic change in the business operations of the company. We have been working with BLX on evaluating a number of

strategic alternatives for BLX and have concluded that the company needs to make a strategic shift in its business operations and de-emphasize government guaranteed lending programs. BLX plans instead to further build its conventional small business and small commercial real estate lending activity. Under its new business plan, BLX intends to reduce its annual loan origination volume by about 30% in the next fiscal year, and then over time, it plans to rebuild its loan origination volume in conventional and commercial real estate loans. The inherent risks in repositioning the business combined with the reduction in loan origination volume in the projection period used to value BLX resulted in a decrease in the value of our investment. In addition, value was negatively impacted by a reduction in value of residual interests and the net book value of BLX. We also continued to consider BLX's current regulatory issues and ongoing investigations and litigation in performing the valuation analysis at September 30, 2007. (See Private Finance, Business Loan Express, LLC above.)

**Per Share Amounts.** All per share amounts included in the Management's Discussion and Analysis of Financial Condition and Results of Operations section have been computed using the weighted average common shares used to compute diluted earnings per share, which were 155.3 million and 147.1 million for the three months ended September 30, 2007 and 2006, respectively, and were 154.7 million and 144.0 million for the nine months ended September 30, 2007 and 2006, respectively.

#### **OTHER MATTERS**

**Regulated Investment Company Status.** We have elected to be taxed as a regulated investment company under Subchapter M of the Internal Revenue Code of 1986 (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.

Dividends are paid to shareholders from taxable income. 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 generally 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 generally results in the deferment of gains for tax purposes until notes or other amounts, including amounts held in escrow, received as consideration from the sale of investments are collected in cash. See Dividends and Distributions below.

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

distributions from such taxable income into the next tax year and pay a 4% excise tax on such income, as required. See Dividends and Distributions below.

In order to maintain our status as a regulated investment company and obtain regulated investment company tax benefits, we must, in general, (1) continue to qualify as a business development company; (2) derive at least 90% of our gross income from dividends, interest, gains from the sale of securities and other specified types of income; (3) meet asset diversification requirements as defined in the 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.

#### **DIVIDENDS AND DISTRIBUTIONS**

Dividends to common shareholders for the nine months ended September 30, 2007 and 2006, were \$293.7 million and \$255.4 million, respectively, or \$1.92 per common share for the nine months ended September 30, 2007, and \$1.80 per common share for the nine months ended September 30, 2006. An extra cash dividend of \$0.05 per common share was declared during 2006 and was paid to shareholders on January 19, 2007. An extra cash dividend of \$0.03 per common share was declared during 2005 and was paid to shareholders on January 27, 2006.

The Board of Directors has declared a dividend of \$0.65 per common share for the fourth quarter of 2007, and an extra cash dividend of \$0.07 per common share, which will be paid to shareholders on December 27, 2007.

Our Board of Directors reviews the dividend rate quarterly, and may adjust the quarterly dividend throughout the year. Dividends are declared considering our estimate of annual taxable income available for distribution to shareholders and the amount of taxable income carried over from the prior year for distribution in the current year. Our goal is to declare what we believe to be sustainable increases in our regular quarterly dividends. To the extent that we earn annual taxable income in excess of dividends paid from such taxable income for the year, we may carry over the excess taxable income into the next year and such excess income will be available for distribution in the next year as permitted under the Code (see discussion below). Such income will be treated under the Code as having been distributed during the prior year for purposes of our qualification for RIC tax treatment for such year. The maximum amount of excess taxable income that we may carry over for distribution in the next year under the Code is the total amount of dividends paid in the following year, subject to certain declaration and payment guidelines. Excess taxable income carried over and paid out in the next year is generally subject to a nondeductible 4% excise tax. We believe that carrying over excess taxable income into future periods may provide increased visibility with respect to taxable earnings available to pay the regular quarterly dividend.

Taxable income includes our taxable interest, dividend and fee income, as well as taxable net capital gains. 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 generally results in the deferment of gains for tax purposes until notes or other amounts, including amounts held in escrow, received as consideration from the sale of investments are collected in cash. Taxable income includes non-cash income, such as changes in accrued and reinvested interest and dividends, which includes contractual payment-in-kind interest, 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 annual taxable income for 2006 exceeded our dividend distributions to shareholders for 2006 from such taxable income, and, therefore, we carried over excess taxable income of \$402.8 million for distribution to shareholders in 2007. Excess taxable income for 2006 represents \$126.7 million of ordinary income and \$276.1 million of net long-term capital gains.

Dividends paid in 2007 will first be paid out of the excess taxable income carried over from 2006. For the nine months ended September 30, 2007, we paid dividends of \$293.7 million. The remainder of 2006 excess taxable income to be distributed during the fourth quarter of 2007 is approximately \$109.1 million. In accordance with regulated investment company distribution rules, we were required to declare current year dividends to be paid from carried over excess taxable income from 2006 before we filed our 2006 tax return in September 2007, and we must pay such dividends by December 31, 2007. To comply with these rules, on July 27, 2007, our Board of Directors declared a \$0.65 per share dividend for both the third and fourth quarters of 2007. Our Board of Directors also declared an extra dividend of \$0.07 per share on September 14, 2007. The third quarter dividend was paid on September 26, 2007, and the fourth quarter dividend will be paid on December 26, 2007. The extra dividend will be paid on December 27, 2007. We expect that substantially all of the 2007 dividend payments will be made from excess 2006 taxable earnings.

Given that substantially all of the 2007 dividend payments will be made from excess taxable income carried over from 2006, we currently expect to carry over substantially all of our estimated annual taxable income for 2007 for distribution to shareholders in 2008. We will generally be required to pay a nondeductible 4% excise tax on the excess of 98% of our taxable income for 2007 over the amount of actual distributions from such taxable income in 2007. For the nine months ended September 30, 2007, we have recorded an excise tax of \$16.6 million. Excise taxes are accrued based upon estimated excess taxable income as estimated taxable income is earned, therefore, the excise tax accrued to date in 2007 may be adjusted as appropriate in the remainder of 2007 to reflect changes in our estimate of the carry over amount and additional excise tax may be accrued during the remainder of 2007 as additional excess taxable income is earned, if any. Our ability to earn the estimated annual taxable income for 2007 depends on many factors, including our ability to make new investments at attractive yields, the level of repayments in the portfolio, the realization of gains or losses from portfolio exits, and the level of operating expenses incurred. See *Results of Operations* above and *Risk Factors* in the accompanying prospectus.

For the nine months ended September 30, 2007, the sum of our net investment income and net realized gains was \$397.9 million, which represents the primary components of our taxable income. Net investment income and net realized gains for the

nine months ended September 30, 2007, are not necessarily indicative of the results to be expected for the full year.

In addition, we had cumulative deferred taxable income related to installment sale gains of \$221.9 million as of December 31, 2006. These gains have been recognized for financial reporting purposes in the respective years they were realized, but will be deferred for tax purposes until the notes or other amounts received from the sale of the related investments are collected in cash. See **Other Matters** **Regulated Investment Company Status** above.

To the extent that installment sale gains are deferred for recognition in taxable income, we pay interest to the Internal Revenue Service. Installment-related interest expense for the nine months ended September 30, 2007 and 2006, was \$4.3 million and \$0.7 million, respectively. See **Results of Operations** above.

### **FINANCIAL CONDITION, LIQUIDITY AND CAPITAL RESOURCES**

At September 30, 2007, and December 31, 2006, our liquidity portfolio, cash and investments in money market and other securities, total assets, total debt outstanding, total shareholders' equity, debt to equity ratio and asset coverage for senior indebtedness were as follows:

	2007	2006
<b>(\$ in millions)</b>		
Liquidity portfolio (includes money market and other securities)	\$ 200.7	\$ 201.8
Cash and investments in money market securities (including money market and other securities: 2007-\$90.4; 2006-\$0.4)	\$ 105.2	\$ 2.1
Total assets	\$4,861.5	\$4,887.5
Total debt outstanding	\$1,922.4	\$1,899.1
Total shareholders' equity	\$2,765.8	\$2,841.2
Debt to equity ratio <sup>(1)</sup>	0.70	0.67
Asset coverage ratio <sup>(2)</sup>	244%	250%

(1) The debt to equity ratio adjusted for the liquidity portfolio and cash and investments in money market securities was 0.58 and 0.60 at September 30, 2007, and December 31, 2006, respectively, which is calculated as (a) total debt less the value of the liquidity portfolio divided by (b) total shareholders' equity.

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

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 nine months ended September 30, 2007 and 2006, was as follows:

	2007	2006
<b>(\$ in millions)</b>		
Net cash provided by (used in) operating activities	\$ 240.8	\$ (303.6)
Add: portfolio investments funded	1,236.7	1,700.8
Total cash provided by operating activities before new investments	\$ 1,477.5	\$ 1,397.2

In addition to the net cash flow provided by our operating activities before funding investments, we have sources of liquidity through our liquidity portfolio and revolving line of credit as discussed below.



At September 30, 2007, and December 31, 2006, the value and yield of the securities in the liquidity portfolio were as follows:

(\$ in millions)	2007		2006	
	Value	Yield	Value	Yield
Money market securities	\$ 200.7	5.3%	\$ 161.2	5.3%
Certificate of deposit			40.6	5.6%
<b>Total</b>	<b>\$ 200.7</b>	<b>5.3%</b>	<b>\$ 201.8</b>	<b>5.3%</b>

The liquidity portfolio was established to provide a pool of liquid assets within our balance sheet given that our investment portfolio is primarily composed of private, illiquid assets for which there is no readily available market. We assess the amount held in and the composition of the liquidity portfolio throughout the year.

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

We employ an asset-liability management approach that focuses on matching the estimated maturities of our investment portfolio to the estimated maturities of our borrowings. We use our revolving line of credit facility as a means to bridge to long-term financing in the form of debt or equity capital, which may or may not result in temporary differences in the matching of estimated maturities. Availability on the revolving line of credit, net of amounts committed for standby letters of credit issued under the line of credit facility, was \$859.0 million on September 30, 2007. We evaluate our interest rate exposure on an ongoing basis. Generally, we seek to fund our primarily fixed-rate debt portfolio and our equity 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.

During the nine months ended September 30, 2007 and 2006, and the year ended December 31, 2006, we sold new equity of \$93.8 million, \$218.9 million, and \$295.8 million, respectively, in public offerings. In addition, shareholders equity increased by \$25.9 million, \$23.2 million, and \$27.7 million through the exercise of stock options, the collection of notes receivable from the sale of common stock, and the issuance of shares through our dividend reinvestment plan for the nine months ended September 30, 2007 and 2006, and for the year ended December 31, 2006, respectively. For the nine months ended September 30, 2007, shareholders equity decreased by \$52.8 million for the cash portion of the option cancellation payment made in connection with our tender offer. See Results of Operations, Stock Option Expense, Options Cancelled in Connection with Tender Offer. See Note 12 to our consolidated financial statements for further detail on the change in shareholders equity for the period.

We currently target a debt to equity ratio ranging between 0.50:1.00 to 0.70:1.00 because we believe that it is prudent to operate with a larger equity capital base and less leverage.

At September 30, 2007, and December 31, 2006, we had outstanding debt as follows:

	2007			2006		
	Facility Amount	Amount Outstanding	Annual Interest Cost <sup>(1)</sup>	Facility Amount	Amount Outstanding	Annual Interest Cost <sup>(1)</sup>
(\$ in millions)						
Notes payable and debentures:						
Privately issued unsecured notes payable	\$ 1,042.4	\$ 1,042.4	6.1%	\$ 1,041.4	\$ 1,041.4	6.1%
Publicly issued unsecured notes payable	880.0	880.0	6.7%	650.0	650.0	6.6%
Total notes payable and debentures	1,922.4	1,922.4	6.4%	1,691.4	1,691.4	6.3%
Revolving line of credit <sup>(4)</sup>	922.5		0%	922.5	207.7	6.4% <sup>(2)</sup>
Total debt	\$ 2,844.9	\$ 1,922.4	6.6% <sup>(3)</sup>	\$ 2,613.9	\$ 1,899.1	6.5% <sup>(3)</sup>

- (1) The weighted average annual interest cost is computed as the (a) annual stated interest on the debt plus the annual amortization of commitment fees, other facility fees and the amortization of debt financing costs that are recognized into interest expense over the contractual life of the respective borrowings, divided by (b) debt outstanding on the balance sheet date.
- (2) There were no amounts drawn on the revolving line of credit at September 30, 2007. The annual interest cost at December 31, 2006, reflects the interest rate payable for borrowings under the revolving line of credit. In addition to the current interest rate payable, there were annual costs of commitment fees, other facility fees and amortization of debt financing costs of \$4.1 million and \$3.9 million at September 30, 2007, and December 31, 2006, respectively.
- (3) The annual interest cost for total debt includes the annual cost of commitment fees and the amortization of debt financing costs on the revolving line of credit and other facility fees regardless of the amount outstanding on the facility as of the balance sheet date.
- (4) At September 30, 2007, \$859.0 million remained unused and available on the revolving line of credit, net of amounts committed for standby letters of credit of \$63.5 million issued under the credit facility.

**Privately Issued Unsecured Notes Payable.** We have privately issued unsecured long-term notes to institutional investors, primarily insurance companies. The notes have five- or seven-year maturities and fixed rates of interest. The notes require payment of interest only semi-annually, and all principal is due upon maturity. At September 30, 2007, the notes had maturities from May 2008 to May 2013. The notes may be prepaid in whole or in part, together with an interest premium, as stipulated in the note agreements.

We have 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 other unsecured notes. The Euro notes require annual interest payments and the Sterling notes require semi-annual interest payments until maturity. 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.

**Publicly Issued Unsecured Notes Payable.** At September 30, 2007, we had outstanding publicly issued unsecured notes as follows:

<b>(\$ in millions)</b>	<b>Amount</b>	<b>Maturity Date</b>
6.625% Notes due 2011	\$ 400.0	July 15, 2011
6.000% Notes due 2012	250.0	April 1, 2012
6.875% Notes due 2047	230.0	April 15, 2047
Total	\$ 880.0	

The 6.625% Notes due 2011 and the 6.000% Notes due 2012 require payment of interest only semi-annually, and all principal is due upon maturity. We have the option to

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redeem these notes in whole or in part, together with a redemption premium, as stipulated in the notes.

On March 28, 2007, we completed the issuance of \$200.0 million of 6.875% Notes due 2047 for net proceeds of \$193.0 million. In April 2007, we issued additional notes, through an over-allotment option, totaling \$30.0 million for net proceeds of \$29.1 million. Net proceeds are net of underwriting discounts and estimated offering expenses. The notes are listed on the New York Stock Exchange under the trading symbol AFC.

The 6.875% Notes due 2047 require payment of interest only quarterly, and all principal is due upon maturity. We may redeem these notes in whole or in part at any time or from time to time on or after April 15, 2012, at par and upon the occurrence of certain tax events as stipulated in the notes.

**Revolving Line of Credit.** At September 30, 2007, and December 31, 2006, we had an unsecured revolving line of credit with a committed amount of \$922.5 million that expires on September 30, 2008. At our option, borrowings under the revolving line of credit generally bear interest at a rate equal to (i) LIBOR (for the period we select) plus 1.05% or (ii) the higher of the Federal Funds rate plus 0.50% or the Bank of America N.A. prime rate. The revolving line of credit requires the payment of an annual commitment fee equal to 0.20% of the committed amount (whether used or unused). The revolving line of credit generally requires payments of interest at the end of each LIBOR interest period, but no less frequently than quarterly, on LIBOR based loans and monthly payments of interest on other loans. All principal is due upon maturity.

At September 30, 2007, there was no outstanding balance on our unsecured revolving line of credit. The amount available under the line at September 30, 2007, was \$859.0 million, net of amounts committed for standby letters of credit of \$63.5 million. Net repayments under the revolving lines of credit for the nine months ended September 30, 2007, were \$207.8 million.

We have various financial and operating covenants required by the revolving line of credit and the privately issued unsecured notes payable outstanding at September 30, 2007. These covenants require us to maintain certain financial ratios, including debt to equity and interest coverage, and a minimum net worth. These credit facilities provide for customary events of default, including, but not limited to, payment defaults, breach of representations or covenants, cross-defaults, bankruptcy events, failure to pay judgments, attachment of our assets, change of control and the issuance of an order of dissolution. Certain of these events of default are subject to notice and cure periods or materiality thresholds. Our credit facilities limit our ability to declare dividends if we default under certain provisions. As of September 30, 2007, we were in compliance with these covenants.

We have certain financial and operating covenants that are required by the publicly issued unsecured notes payable, including that we will maintain a minimum ratio of 200% of total assets to total borrowings, as required by the Investment Company Act of 1940, as amended, while these notes are outstanding. At September 30, 2007, 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 September 30, 2007.

(\$ in millions)	Payments Due By Year						
	Total	2007	2008	2009	2010	2011	After 2011
Unsecured notes payable	\$ 1,922.4	\$	\$ 153.0	\$ 269.9	\$ 408.0	\$ 472.5	\$ 619.0
Revolving line of credit <sup>(1)</sup>							
Operating leases	21.3	1.1	4.4	4.6	4.5	1.8	4.9
Total contractual obligations	\$ 1,943.7	\$ 1.1	\$ 157.4	\$ 274.5	\$ 412.5	\$ 474.3	\$ 623.9

<sup>(1)</sup> At September 30, 2007, \$859.0 million remained unused and available on the revolving line of credit, net of amounts committed for standby letters of credit of \$63.5 million issued under the credit facility.

#### Off-Balance Sheet Arrangements

In the ordinary course of business, we have issued guarantees and have extended standby letters of credit through financial intermediaries on behalf of certain portfolio companies. We have generally issued guarantees of debt, rental and lease obligations. Under these arrangements, we would be required to make payments to third-party beneficiaries if the portfolio companies were to default on their related payment obligations. The following table shows our guarantees and standby letters of credit that may have the effect of creating, increasing, or accelerating our liabilities as of September 30, 2007.

(\$ in millions)	Amount of Commitment Expiration Per Year						
	Total	2007	2008	2009	2010	2011	After 2011
Guarantees	\$ 263.9	\$ 3.0	\$ 3.0	\$ 251.5	\$	\$ 4.4	\$ 2.0
Standby letters of credit <sup>(1)</sup>	63.5		63.5				
Total commitments <sup>(2)</sup>	\$ 327.4	\$ 3.0	\$ 66.5	\$ 251.5	\$	\$ 4.4	\$ 2.0

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

<sup>(2)</sup> Our most significant commitments relate to our investment in Business Loan Express, LLC (BLX), which commitments totaled \$271.0 million at September 30, 2007. At September 30, 2007, the principal components of these guarantees included a guarantee of 60% of the outstanding total obligations on BLX's revolving line of credit, which expires in March 2009, for a total guaranteed amount of \$249.0 million and standby letters of credit totaling \$19.0 million in connection with term securitizations completed by BLX. See Private Finance, Business Loan Express, LLC above for further discussion.

In addition, we had outstanding commitments to fund investments totaling \$469.0 million at September 30, 2007. See Portfolio and Investment Activity Outstanding Commitments above. We intend to fund these commitments and prospective investment opportunities with existing cash, through cash flow from operations before new investments, through borrowings under our line of credit or other long-term debt agreements, or through the sale or issuance of new equity capital.

**CRITICAL ACCOUNTING POLICIES**

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

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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, certain revenue recognition matters and certain tax matters as discussed below.

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

See Results of Operations Change in Unrealized Appreciation or Depreciation above for more discussion on portfolio valuation.

**Loans and Debt Securities.** Our loans and debt securities generally do not trade. We typically exit our loans and debt securities upon the sale or recapitalization of the portfolio company. Therefore, we generally determine the enterprise value of the portfolio company and then allocate that value to the loans and debt securities in order of the legal priority of the contractual obligations, with the remaining value, if any, going to the portfolio company's outstanding equity securities. For loans and debt securities, fair value generally approximates cost unless the borrower's enterprise value, overall financial condition or other factors lead to a determination of fair value at a different amount. The value of loan and debt securities may be greater than our cost basis if the amount that would be repaid on the loan or debt security upon the sale or recapitalization of the portfolio company is greater than our cost basis.

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

Interest income is recorded on an accrual basis to the extent that such amounts are expected to be collected. For loans and debt securities with contractual payment-in-kind interest, which represents contractual interest accrued and added to the loan balance that generally becomes due at maturity, we will not accrue payment-in-kind interest if the portfolio company valuation indicates that the payment-in-kind interest is not collectible.

In general, interest is not accrued on loans and debt securities if we have doubt about interest collection or where the enterprise value of the portfolio company may not support further accrual. Loans in workout status do not accrue interest. In addition, interest may not accrue on loans or debt securities to portfolio companies that are more than 50% owned by us depending on such company's capital requirements. Loan origination fees, original issue discount, and market discount are capitalized and then amortized into interest income using a method that approximates the effective interest method. Upon the prepayment of a loan or debt security, any unamortized loan origination fees are recorded as interest income and any unamortized original issue discount or market discount is recorded as a realized gain.

**Equity Securities.** Our equity securities in portfolio companies for which there is no liquid public market are valued at fair value based on the enterprise value of the portfolio company, which is determined using various factors, including cash flow from operations of the portfolio company, multiples at which private companies are bought and sold, and other pertinent factors, such as recent offers to purchase a portfolio company, recent transactions involving the purchase or sale of the portfolio company's equity securities, liquidation events, or other events. The determined equity values are generally discounted when we have a minority ownership position, restrictions on resale, specific concerns about the receptivity of the capital markets to a specific company at a certain time, or other factors.

The value of our equity investments in private debt and equity funds are generally valued at the fund's net asset value. The value of our equity securities in public companies for which market quotations are readily available is based on the closing public market price on the balance sheet date. Securities that carry certain restrictions on sale are typically valued at a discount from the public market value of the security.

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

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

We recognize interest income on the preferred shares/income notes using the effective interest method, based on the anticipated yield and the estimated cash flows over the projected life of the investment. Yields are revised when there are changes in actual or estimated cash flows due to changes in prepayments and/or re-investments, credit losses or asset pricing. Changes in estimated yield are recognized as an adjustment to the estimated



yield over the remaining life of the preferred shares/income notes from the date the estimated yield was changed. CDO and CLO bonds have stated interest rates.

**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 period, net of recoveries. Net change in unrealized appreciation or depreciation primarily reflects the change in portfolio investment values during the reporting period, including the reversal of previously recorded unrealized appreciation or depreciation when gains or losses are realized. Net change in unrealized appreciation or depreciation also reflects the change in the value of U.S. Treasury bills and deposits of proceeds from sales of borrowed Treasury securities, and depreciation on accrued interest and dividends receivable and other assets where collection is doubtful.

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

**Federal and State Income Taxes and Excise Tax.** We intend to comply with the requirements of the Internal Revenue Code (Code) that are applicable to regulated investment companies (RIC) and real estate investment trusts (REIT). We and any of our subsidiaries that qualify as a RIC or a REIT intend to distribute or retain through a deemed distribution all of our annual taxable income to shareholders; therefore, we have made no provision for income taxes exclusive of excise taxes for these entities.

If we do not distribute at least 98% of our annual taxable income in the year earned, we will generally be required to pay an excise tax equal to 4% of the amount by which 98% of our annual taxable income exceeds the distributions from such taxable income during the year earned. To the extent that we determine that our estimated current year annual taxable income will be in excess of estimated current year dividend distributions from such taxable income, we accrue excise taxes on estimated excess taxable income as taxable income is earned using an annual effective excise tax rate. The annual effective excise tax rate is determined by dividing the estimated annual excise tax by the estimated annual taxable income.

Income taxes for AC Corp are accounted for under the asset and liability method. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases as well as operating loss and tax credit carryforwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled.

#### **QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK**

Our business activities contain elements of risk. We consider the principal types of market risk to be fluctuations in interest rates. We consider the management of risk

essential to conducting our businesses. Accordingly, our risk management systems and procedures are designed to identify and analyze our risks, to set appropriate policies and limits and to continually monitor these risks and limits by means of reliable administrative and information systems and other policies and programs.

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

Assuming that the balance sheet as of September 30, 2007, were to remain constant and no actions were taken to alter the existing interest rate sensitivity, a hypothetical immediate 1% change in interest rates would have affected net income by approximately 2% 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.

In addition, we may have risk regarding portfolio valuation. See Results of Operations Change in Unrealized Appreciation or Depreciation above for more discussion on portfolio valuation.

#### **LEGAL PROCEEDINGS**

On June 23, 2004, we were notified by the SEC that they were conducting an informal investigation of us. The investigation related to the valuation of securities in our private finance portfolio and other matters. On June 20, 2007, we announced that we entered into a settlement with the SEC that resolved the SEC's informal investigation. As part of the settlement and without admitting or denying the SEC's allegations, we agreed to the entry of an administrative order. In the order the SEC alleged that, between June 30, 2001, and March 31, 2003, we did not maintain books, records and accounts which, in reasonable detail, supported or accurately and fairly reflected valuations of certain securities in our private finance portfolio and, as a result, did not meet certain recordkeeping and internal controls provisions of the federal securities laws. In the administrative order, the SEC ordered us to continue to maintain certain of our current valuation-related controls. Specifically, for a period of two years, we have undertaken to: (1) continue to employ a Chief Valuation Officer, or a similarly structured officer-level employee, to oversee our quarterly valuation processes; and (2) continue to employ third-party valuation consultants to assist in our quarterly valuation processes.

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 relating to matters similar to those investigated by and settled with the SEC as discussed above. We produced materials in response to the requests from the U.S. Attorney's office and certain current and former employees were interviewed by the U.S. Attorney's Office. We have voluntarily cooperated with the investigation.

In late December 2006, we received a subpoena from the U.S. Attorney for the District of Columbia requesting, among other things, the production of records regarding the use of private investigators by us or our agents. The Board established a committee, which was advised by its own counsel, to review this matter. In the course of gathering documents responsive to the subpoena, we became aware that an agent of Allied Capital obtained what were represented to be telephone records of David Einhorn and which purport to be records of calls from Greenlight Capital during a period of time in 2005. Also, while we were gathering documents responsive to the subpoena, allegations were made that our management had authorized the acquisition of these records and that management was subsequently advised that these records had been obtained. Our management has stated that these allegations are not true. We are cooperating fully with the inquiry by the U.S. Attorney's Office.

On February 13, 2007, Rena Nadoff filed a shareholder derivative action in the Superior Court of the District of Columbia, captioned Rena Nadoff v. Walton, et al., CA 001060-07, seeking unspecified compensatory and other damages, as well as equitable relief on behalf of Allied Capital Corporation. The complaint was summarily dismissed in July 2007. The complaint alleged breach of fiduciary duty by the Board of Directors arising from internal control failures and mismanagement of Business Loan Express, LLC, an Allied Capital portfolio company. On October 5, 2007, Rena Nadoff sent a letter to our Board of Directors with substantially the same claims and a request that the Board of Directors investigate the claims and take appropriate action. The Board of Directors has established a committee, which is advised by its own counsel, to review the matter.

On February 26, 2007, Dana Ross filed a class action complaint in the U.S. District Court for the District of Columbia in which she alleges that Allied Capital Corporation and certain members of management violated Sections 10(b) and 20(a) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder. Thereafter, the court appointed new lead counsel and approved new lead plaintiffs. On July 30, 2007, plaintiffs served an amended complaint. Plaintiffs claim that, between November 7, 2005, and January 22, 2007, Allied Capital either failed to disclose or misrepresented information about our portfolio company, Business Loan Express, LLC. Plaintiffs seek unspecified compensatory and other damages, as well as other relief. We believe the lawsuit is without merit, and we intend to defend the lawsuit vigorously. On September 13, 2007, we filed a motion to dismiss the lawsuit. The motion is pending.

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

While the outcome of any of the open legal proceedings described above cannot at this time be predicted with certainty, we do not expect these matters will materially affect our financial condition or results of operations; however, there can be no assurance whether any pending legal proceedings will have a material adverse effect on our financial condition or results of operations in any future reporting period.

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

(in thousands, except per share amounts)	September 30, 2007	December 31, 2006
(unaudited)		
ASSETS		
Portfolio at value:		
Private finance		
Companies more than 25% owned (cost: 2007-\$1,571,149; 2006-\$1,578,822)	\$ 1,236,844	\$ 1,490,180
Companies 5% to 25% owned (cost: 2007-\$434,164; 2006-\$438,560)	397,930	449,813
Companies less than 5% owned (cost: 2007-\$2,601,101; 2006-\$2,479,981)	2,572,354	2,437,908
Total private finance (cost: 2007-\$4,606,414; 2006-\$4,497,363)	4,207,128	4,377,901
Commercial real estate finance (cost: 2007-\$96,115; 2006-\$103,546)	119,739	118,183
Total portfolio at value (cost: 2007-\$4,702,529; 2006-\$4,600,909)	4,326,867	4,496,084
Investments in money market and other securities	291,069	202,210
Accrued interest and dividends receivable	74,829	64,566
Other assets	153,940	122,958
Cash	14,816	1,687
Total assets	\$ 4,861,521	\$ 4,887,505
LIABILITIES AND SHAREHOLDERS EQUITY		
Liabilities:		
Notes payable and debentures (maturing within one year: 2007-\$153,000; 2006-\$ )	\$ 1,922,370	\$ 1,691,394
Revolving line of credit		207,750
Accounts payable and other liabilities	173,368	147,117
Total liabilities	2,095,738	2,046,261
Commitments and contingencies		
Shareholders equity:		
Common stock, \$0.0001 par value, 400,000 shares authorized; 154,506 and 148,575 shares issued and outstanding at September 30, 2007, and December 31, 2006, respectively	15	15
Additional paid-in capital	2,594,406	2,493,335
Common stock held in deferred compensation trust	(37,079)	(28,335)
Notes receivable from sale of common stock	(2,708)	(2,850)
Net unrealized appreciation (depreciation)	(395,216)	(123,084)
Undistributed earnings	606,365	502,163

Total shareholders equity		2,765,783		2,841,244
Total liabilities and shareholders equity	\$	4,861,521	\$	4,887,505
Net asset value per common share	\$	17.90	\$	19.12

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

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**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENT OF OPERATIONS**

	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2007	2006	2007	2006
<b>(in thousands, except per share amounts)</b>				
	<b>(unaudited)</b>		<b>(unaudited)</b>	
<b>Interest and Related Portfolio Income:</b>				
Interest and dividends				
Companies more than 25% owned	\$ 28,198	\$ 23,812	\$ 83,895	\$ 77,377
Companies 5% to 25% owned	9,374	10,977	32,111	28,046
Companies less than 5% owned	68,097	63,879	194,460	177,559
Total interest and dividends	105,669	98,668	310,466	282,982
<b>Fees and other income</b>				
Companies more than 25% owned	5,146	6,486	14,552	24,222
Companies 5% to 25% owned	19	10	518	4,008
Companies less than 5% owned	7,534	8,219	18,460	23,638
Total fees and other income	12,699	14,715	33,530	51,868
Total interest and related portfolio income	118,368	113,383	343,996	334,850
<b>Expenses:</b>				
Interest	33,744	26,109	98,368	72,455
Employee	26,306	25,228	76,845	67,054
Employee stock options	18,312	3,649	31,492	11,852
Administrative	10,496	8,153	38,225	29,348
Total operating expenses	88,858	63,139	244,930	180,709
Net investment income before income taxes	29,510	50,244	99,066	154,141
Income tax expense (benefit), including excise tax	11,192	1,586	16,073	13,988
Net investment income	18,318	48,658	82,993	140,153
<b>Net Realized and Unrealized Gains (Losses):</b>				
Net realized gains (losses)				
Companies more than 25% owned	201,582	394	267,359	528,793
Companies 5% to 25% owned	(5,475)	93	(5,171)	(324)
Companies less than 5% owned	16,263	9,429	52,727	14,522
Total net realized gains	212,370	9,916	314,915	542,991
Net change in unrealized appreciation or depreciation	(327,156)	19,312	(272,132)	(471,942)
Total net gains (losses)	(114,786)	29,228	42,783	71,049

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Net increase (decrease) in net assets resulting from operations	\$ (96,468)	\$ 77,886	\$ 125,776	\$ 211,202
Basic earnings (loss) per common share	\$ (0.63)	\$ 0.54	\$ 0.83	\$ 1.50
Diluted earnings (loss) per common share	\$ (0.62)	\$ 0.53	\$ 0.81	\$ 1.47
Weighted average common shares outstanding basic	154,025	144,163	151,979	141,002
Weighted average common shares outstanding diluted	155,329	147,112	154,708	144,030

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

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

	<b>For the Nine Months Ended September 30,</b>	
(in thousands, except per share amounts)	<b>2007</b>	<b>2006</b>
	<b>(unaudited)</b>	
<b>Operations:</b>		
Net investment income	\$ 82,993	\$ 140,153
Net realized gains	314,915	542,991
Net change in unrealized appreciation or depreciation	(272,132)	(471,942)
Net increase in net assets resulting from operations	125,776	211,202
<b>Shareholder distributions:</b>		
Common stock dividends	(293,706)	(255,430)
Net decrease in net assets resulting from shareholder distributions	(293,706)	(255,430)
<b>Capital share transactions:</b>		
Sale of common stock	93,784	218,882
Issuance of common stock in lieu of cash distributions	12,447	11,050
Issuance of common stock upon the exercise of stock options	13,307	11,108
Cash portion of option cancellation payment	(52,833)	
Stock option expense	32,069	12,088
Net decrease in notes receivable from sale of common stock	142	1,005
Purchase of common stock held in deferred compensation trust	(9,272)	(7,226)
Distribution of common stock held in deferred compensation trust	528	656
Other	2,297	
Net increase in net assets resulting from capital share transactions	92,469	247,563
Total increase (decrease) in net assets	(75,461)	203,335
Net assets at beginning of period	2,841,244	2,620,546
Net assets at end of period	\$ 2,765,783	\$ 2,823,881
Net asset value per common share	\$ 17.90	\$ 19.38
Common shares outstanding at end of period	154,506	145,722

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



**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENT OF CASH FLOWS**

	<b>For the Nine Months Ended September 30,</b>	
	<b>2007</b>	<b>2006</b>
<b>(in thousands)</b>	<b>(unaudited)</b>	
<b>Cash flows from operating activities:</b>		
Net increase in net assets resulting from operations	\$ 125,776	\$ 211,202
<b>Adjustments:</b>		
Portfolio investments	(1,236,671)	(1,700,751)
Principal collections related to investment repayments or sales	1,086,513	885,872
Change in accrued or reinvested interest and dividends	(22,812)	1,820
Net collection (amortization) of discounts and fees	(1,215)	(3,644)
Redemption of (investments in) U.S. Treasury bills		(22,875)
Redemption of (investments in) money market securities	(82,219)	7,581
Stock option expense	32,069	12,088
Changes in other assets and liabilities	13,943	33,897
Depreciation and amortization	1,540	1,303
Realized gains from the receipt of notes and other consideration from sale of investments, net of collections	(29,716)	(209,049)
Realized losses	81,456	7,063
Net change in unrealized (appreciation) or depreciation	272,132	471,942
 Net cash provided by (used in) operating activities	 240,796	 (303,551)
<b>Cash flows from financing activities:</b>		
Sale of common stock	93,784	218,882
Sale of common stock upon the exercise of stock options	13,307	11,108
Collections of notes receivable from sale of common stock	142	1,005
Borrowings under notes payable	230,000	450,000
Repayments on notes payable and debentures		(53,500)
Net borrowings under (repayments on) revolving line of credit	(207,750)	(91,750)
Cash portion of option cancellation payment	(52,833)	
Purchase of common stock held in deferred compensation trust	(9,272)	(7,226)
Other financing activities	(6,363)	(4,674)
Common stock dividends and distributions paid	(288,682)	(248,479)
 Net cash provided by (used in) financing activities	 (227,667)	 275,366
 Net increase (decrease) in cash	 13,129	 (28,185)
Cash at beginning of period	1,687	31,363
 Cash at end of period	 \$ 14,816	 \$ 3,178

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



**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENT OF INVESTMENTS**

September 30, 2007

<b>Private Finance Portfolio Company (in thousands, except number of shares)</b>	<b>Investment<sup>(1)(2)</sup></b>	<b>Principal</b>	<b>Cost</b>	<b>Value</b>
<b>(unaudited)</b>				
<b>Companies More Than 25% Owned</b>				
Alaris Consulting, LLC (Business Services)	Senior Loan (16.5%, Due 12/05 12/07) <sup>9</sup> Equity Interests Guaranty (\$1,100)	\$27,055	\$ 26,987 5,189	\$
AllBridge Financial, LLC (Financial Services)	Equity Interests Standby Letter of Credit (\$30,000)		2,300	2,300
Allied Capital Senior Debt Fund, L.P. <sup>(5)</sup> (Private Debt Fund)	Equity Interests (See Note 3)		19,080	19,535
Avborne, Inc. <sup>(7)</sup> (Business Services)	Preferred Stock (12,500 shares) Common Stock (27,500 shares)		611	850
Avborne Heavy Maintenance, Inc. <sup>(7)</sup> (Business Services)	Preferred Stock (1,568 shares) Common Stock (2,750 shares) Guaranty (\$2,401)		2,401	973
Aviation Properties Corporation (Business Services)	Common Stock (100 shares) Guaranty (\$1,000)		65	
Border Foods, Inc. (Consumer Products)	Preferred Stock (100,000 shares) Common Stock (148,838 shares)		12,721 3,847	2,473
Business Loan Express, LLC (Financial Services)	Class A Equity Interests (25.0% See Note 3) <sup>9</sup> Class B Equity Interests Class C Equity Interests Guaranty (\$252,007 See Note 3) Standby Letters of Credit (\$19,000 See Note 3)	95,822	95,822 119,436 109,301	95,822 40,888
Calder Capital Partners, LLC <sup>(5)</sup>	Senior Loan (8.5%, Due 5/09) <sup>(6)</sup>	2,218	2,218	2,218

(Financial Services)	Equity Interests		2,235	347
Callidus Capital Corporation (Financial Services)	Subordinated Debt (18.0%, Due 10/08) Common Stock (100 shares)	6,575	6,575 2,067	6,575 42,640
Coverall North America, Inc. (Business Services)	Unitranche Debt (12.0%, Due 7/11) Subordinated Debt (15.0%, Due 7/11) Common Stock (884,880 shares)	35,054	34,914 5,977 16,648	34,914 5,977 23,018
CR Holding, Inc. (Consumer Products)	Subordinated Debt (16.6%, Due 2/13) Common Stock (37,200,551 shares)	40,602	40,452 33,321	40,452 41,034
Direct Capital Corporation (Financial Services)	Subordinated Debt (16.0%, Due 3/13) Common Stock (2,097,234 shares)	37,676	37,515 19,250	37,515 6,923
Financial Pacific Company (Financial Services)	Subordinated Debt (17.4%, Due 2/12 8/12) Preferred Stock (10,964 shares) Common Stock (14,735 shares)	72,668	72,475 10,276 14,819	72,475 18,454 47,022
ForeSite Towers, LLC (Tower Leasing)	Equity Interest			881

- (1) Interest rates represent the weighted average annual stated interest rate on loans and debt securities, which are presented by nature of indebtedness for a single issuer. The maturity dates represent the earliest and the latest maturity dates.
- (2) Common stock, preferred stock, warrants, options, and equity interests are generally non-income producing and restricted.
- (3) Public company.
- (4) Non-U.S. company or principal place of business outside the U.S.
- (5) Non-registered investment company.
- (6) Loan or debt security is on non-accrual status and therefore is considered non-income producing.
- (7) Avborne, Inc. and Avborne Heavy Maintenance, Inc. are affiliated companies.

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

**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENT OF INVESTMENTS (Continued)**

September 30, 2007

Private Finance Portfolio Company (in thousands, except number of shares)	Investment <sup>(1)(2)</sup>	Principal	Cost	Value
			(unaudited)	
Global Communications, LLC (Business Services)	Senior Loan (10.7%, Due 9/02 11/07) <sup>9</sup> Subordinated Debt (17.0%, Due 12/03 9/05) <sup>9</sup> Preferred Equity Interest Options	\$15,957 11,339	\$15,957 11,336 14,067 1,639	\$ 7,576
Gordian Group, Inc. (Business Services)	Senior Loan (10.0%, Due 12/08) <sup>(6)</sup> Common Stock (1,000 shares)	2,625	2,625 6,942	
Hot Stuff Foods, LLC (Consumer Products)	Senior Loan (8.6%, Due 2/11-2/12) Subordinated Debt (13.8%, Due 8/12 2/13) Subordinated Debt (16.0%, Due 2/13) <sup>(6)</sup> Common Stock (1,147,453 shares)	49,550 61,532 20,841	49,351 61,301 20,750 56,187	49,351 42,191
Huddle House, Inc. (Retail)	Subordinated Debt (15.0%, Due 12/12) Common Stock (415,328 shares)	59,401	59,149 41,533	59,149 44,262
Impact Innovations Group, LLC (Business Services)	Equity Interests in Affiliate			320
Insight Pharmaceuticals Corporation (Consumer Products)	Subordinated Debt (15.0%, Due 9/12) Subordinated Debt (19.0%, Due 9/12) <sup>(6)</sup> Preferred Stock (25,000 shares) Common Stock (620,000 shares)	44,257 16,181	44,129 16,130 25,000 6,325	44,804 16,626 1,845
Jakel, Inc. (Industrial Products)	Subordinated Debt (15.5%, Due 3/08) <sup>(6)</sup>	1,575	1,575	1,575
Legacy Partners Group, Inc. (Financial Services)	Senior Loan (14.0%, Due 5/09) <sup>(6)</sup> Equity Interests	3,843	3,843 4,261	3,843 1,271

Litterer Beteiligungs-GmbH <sup>(4)</sup> (Business Services)	Subordinated Debt (8.0%, Due 3/07) Equity Interest	748	748 1,809	748 1,585
MVL Group, Inc. (Business Services)	Senior Loan (12.0%, Due 6/09 7/09) Subordinated Debt (14.5%, Due 6/09 7/09) Common Stock (648,661 shares)	30,674	30,633 39,651 643	30,633 39,651 4,961
Old Orchard Brands, LLC (Consumer Products)	Subordinated Debt (18.0%, Due 7/14) Equity Interests	19,433	19,342 18,767	19,342 19,602
Penn Detroit Diesel Allison, LLC (Business Services)	Subordinated Debt (15.5%, Due 8/13) Equity Interests	39,038	38,880 21,128	38,880 28,795
Powell Plant Farms, Inc. (Consumer Products)	Senior Loan (15.0%, Due 12/07) <sup>(6)</sup>	1,350	1,350	1,350

- (1) Interest rates represent the weighted average annual stated interest rate on loans and debt securities, which are presented by nature of indebtedness for a single issuer. The maturity dates represent the earliest and the latest maturity dates.
- (2) Common stock, preferred stock, warrants, options, and equity interests are generally non-income producing and restricted.
- (3) Public company.
- (4) Non-U.S. company or principal place of business outside the U.S.
- (5) Non-registered investment company.
- (6) Loan or debt security is on non-accrual status and therefore is considered non-income producing.

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

**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENT OF INVESTMENTS (Continued)**

September 30, 2007

Private Finance Portfolio Company (in thousands, except number of shares)	Investment <sup>(1)(2)</sup>	Principal	Cost	Value
			(unaudited)	
Service Champ, Inc. (Business Services)	Subordinated Debt (15.5%, Due 4/12) Common Stock (63,888 shares)	\$ 28,262	\$ 28,165 13,662	\$ 28,165 26,355
Staffing Partners Holding Company, Inc. (Business Services)	Subordinated Debt (13.5%, Due 1/07) <sup>(6)</sup>	541	541	544
Startec Equity, LLC (Telecommunications)	Equity Interests		230	440
Sweet Traditions, Inc. (Retail)	Senior Loan (9.0%, Due 9/08 8/11) <sup>(9)</sup> Preferred Stock (961 Shares) Common Stock (10,000 Shares)	39,692	36,052 950 50	36,673
Triview Investments, Inc. <sup>(8)</sup> (Broadcasting & Cable/Business Services/Consumer Products)	Senior Loan (10.0%, Due 12/07) Subordinated Debt (12.9%, Due 1/10 6/17) Subordinated Debt (12.5%, Due 11/07 3/08) <sup>(9)</sup> Common Stock (202 shares) Guaranty (\$900) Standby Letter of Credit (\$200)	433 42,784 1,400	433 42,590 1,400 119,836	433 42,590 1,534 82,777
Worldwide Express Operations, LLC (Business Services)	Subordinated Debt (14.0%, Due 2/14) Equity Interests Warrants	2,800	2,624 12,900 163	2,624 12,900 163
Total companies more than 25% owned			\$1,571,149	\$1,236,844
<b>Companies 5% to 25% Owned</b>				
Advantage Sales & Marketing, Inc. (Business Services)	Subordinated Debt (12.0%, Due 3/14) Equity Interests	\$154,642	\$ 154,041	\$ 154,041 11,000

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Air Medical Group Holdings LLC (Healthcare Services)	Senior Loan (7.9%, Due 3/11) Equity Interests	1,920	1,866 3,470	1,866 10,800
Alpine ESP Holdings, Inc. (Business Services)	Preferred Stock (622 shares) Common Stock (13,513 shares)		622 14	719 300
Amerex Group, LLC (Consumer Products)	Subordinated Debt (12.0%, Due 1/13) Equity Interests	8,400	8,400 3,509	8,400 15,657
BB&T Capital Partners/Windsor Mezzanine Fund, LLC <sup>(5)</sup> (Private Equity Fund)	Equity Interests		5,873	5,607
Becker Underwood, Inc. (Industrial Products)	Subordinated Debt (14.5%, Due 8/12) Common Stock(5,073 shares)	24,707	24,636 5,813	24,636 4,200
BI Incorporated (Business Services)	Subordinated Debt (13.5%, Due 2/14) Common Stock (40,000 shares)	30,615	30,495 4,000	30,495 7,400

- (1) Interest rates represent the weighted average annual stated interest rate on loans and debt securities, which are presented by nature of indebtedness for a single issuer. The maturity dates represent the earliest and the latest maturity dates.
- (2) Common stock, preferred stock, warrants, options, and equity interests are generally non-income producing and restricted.
- (3) Public company.
- (4) Non-U.S. company or principal place of business outside the U.S.
- (5) Non-registered investment company.
- (6) Loan or debt security is on non-accrual status and therefore is considered non-income producing.
- (8) Triview Investments, Inc. has a cost basis of \$164.3 million and holds investments in Longview Cable & Data, LLC (Broadcasting & Cable) with a value of \$6.9 million, Triax Holdings, LLC (Consumer Products) with a value of \$62.2 million, and Crescent Hotels & Resorts, LLC and affiliates (Business Services) with a value of \$58.2 million.

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



**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENT OF INVESTMENTS (Continued)**

September 30, 2007

Private Finance Portfolio Company (in thousands, except number of shares)	Investment <sup>(1)(2)</sup>	Principal	Cost	Value
			(unaudited)	
CitiPostal, Inc. and Affiliates (Business Services)	Senior Loan (11.1%, Due 8/13-11/14) Equity Interests	\$22,208	\$ 22,115 4,543	\$ 22,115 6,900
Creative Group, Inc. (Business Services)	Subordinated Debt (14.0%, Due 9/13) <sup>(6)</sup> Warrant	15,000	13,686 1,387	9,259
Drew Foam Companies, Inc. (Business Services)	Preferred Stock (722 shares) Common Stock (7,287 shares)		722 7	396
MedBridge Healthcare, LLC (Healthcare Services)	Senior Loan (8.0%, Due 8/09) <sup>(6)</sup> Subordinated Debt (10.0%, Due 8/14) <sup>(6)</sup> Convertible Subordinated Debt (2.0%, Due 8/14) <sup>(6)</sup> Equity Interests	7,164 5,184 2,970	7,164 5,184 984 1,416	7,164 1,723
MHF Logistical Solutions, Inc. (Business Services)	Subordinated Debt (11.5%, Due 6/12) <sup>(6)</sup> Subordinated Debt (18.0%, Due 6/13) <sup>(6)</sup> Common Stock (20,934 shares) <sup>(12)</sup> Warrants <sup>(12)</sup>	33,600 11,211	33,448 11,154 20,942	10,585
Multi-Ad Services, Inc. (Business Services)	Unitranche Debt (11.3%, Due 11/11) Equity Interests	19,850	19,748 2,000	19,748 942
PresAir LLC (Industrial Products)	Senior Loan (7.5%, Due 12/10) <sup>(6)</sup> Equity Interests	5,702	5,384 1,341	800
Progressive International Corporation (Consumer Products)	Subordinated Debt (16.0%, Due 12/09) Preferred Stock (500 shares) Common Stock (197 shares) Warrants	3,985	3,970 500 13	3,970 1,017 5,100
	Senior Loan (11.1%, Due 6/12)	500	484	484

Regency Healthcare Group, LLC (Healthcare Services)	Unitranche Debt (11.1%, Due 6/12) Equity Interests	12,000	11,953 1,500	11,953 1,685
SGT India Private Limited <sup>(4)</sup> (Business Services)	Common Stock (109,524 shares)		4,098	2,625
Soteria Imaging Services, LLC (Healthcare Services)	Subordinated Debt (12.0%, Due 11/10) Equity Interests	14,500	13,702 2,170	13,702 2,641
Universal Environmental Services, LLC (Business Services)	Equity Interests		1,810	
Total companies 5% to 25% owned			\$434,164	\$397,930

#### Companies Less Than 5% Owned

3SI Security Systems, Inc. (Consumer Products)	Subordinated Debt (14.5%, Due 8/13)	\$27,651	\$ 27,547	\$ 27,547
AgData, L.P. (Consumer Services)	Senior Loan (10.3%, Due 7/12)	526	496	496
Axium Healthcare Pharmacy, Inc. (Healthcare Services)	Unitranche Debt (12.0%, Due 12/12) Common Stock (26,500 shares)	10,950	10,877 2,650	10,877 1,100
Baird Capital Partners IV Limited Partnership <sup>(5)</sup> (Private Equity Fund)	Limited Partnership Interest		1,967	1,856

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- (12) Common stock is non-voting. In addition to non-voting stock ownership, the Company has an option to acquire a majority of the voting securities of the portfolio company at fair market value.

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



**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENT OF INVESTMENTS (Continued)**

September 30, 2007

Private Finance Portfolio Company (in thousands, except number of shares)	Investment <sup>(1)(2)</sup>	Principal	Cost	Value
			(unaudited)	
BenefitMall, Inc. (Business Services)	Unitranche Debt (13.3%, Due 8/12) Common Stock (45,528,000 shares) <sup>(12)</sup> Warrants <sup>(12)</sup> Standby Letters of Credit (\$7,986)	\$ 110,030	\$ 109,699 45,528	\$ 109,699 60,376
Broadcast Electronics, Inc. (Business Services)	Senior Loan (9.4%, Due 7/12)	4,925	4,897	4,897
Bushnell, Inc. (Consumer Products)	Subordinated Debt (12.3%, Due 2/14)	41,325	39,685	39,685
Callidus Debt Partners CDO Fund I, Ltd. <sup>(4)(10)</sup> (CDO/CLO)	Class C Notes (12.9%, Due 12/13) Class D Notes (17.0%, Due 12/13)	18,800 9,400	18,935 9,467	18,988 9,494
Callidus Debt Partners CLO Fund III, Ltd. <sup>(4)(10)</sup> (CDO/CLO)	Preferred Shares (23,600,000 shares, 15.0%) <sup>(11)</sup>		21,980	20,702
Callidus Debt Partners CLO Fund IV, Ltd. <sup>(4)(10)</sup> (CDO/CLO)	Income Notes (13.5%) <sup>(11)</sup>		12,373	10,758
Callidus Debt Partners CLO Fund V, Ltd. <sup>(4)(10)</sup> (CDO/CLO)	Income Notes (20.0%) <sup>(11)</sup>		13,988	14,649
Callidus Debt Partners CLO Fund VI, Ltd. <sup>(4)(10)</sup> (CDO/CLO)	Income Notes (19.8%) <sup>(11)</sup>		25,662	25,662
Callidus MAPS CLO Fund I LLC <sup>(10)</sup> (CDO/CLO)	Class E Notes (10.7%, Due 12/17) Income Notes (8.7%) <sup>(11)</sup>	17,000	17,000 50,090	16,401 41,673
Callidus MAPS CLO Fund II, Ltd. <sup>(4)(10)</sup> (CDO/CLO)	Income Notes (14.8%) <sup>(11)</sup>		18,061	18,061

Camden Partners Strategic Fund II, L.P. <sup>(5)</sup> (Private Equity Fund)	Limited Partnership Interest		997	2,382
Carlisle Wide Plank Floors, Inc. (Consumer Products)	Unitranche Debt (10.0%, Due 6/11)	3,161	3,123	3,123
	Preferred Stock (400,000 Shares)		400	500
Catterton Partners V, L.P. <sup>(5)</sup> (Private Equity Fund)	Limited Partnership Interest		3,510	4,038
Catterton Partners VI, L.P. <sup>(5)</sup> (Private Equity Fund)	Limited Partnership Interest		1,795	1,656
Centre Capital Investors IV, LP <sup>(5)</sup> (Private Equity Fund)	Limited Partnership Interest		2,079	2,170

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- (10) The fund is managed by Callidus Capital, a portfolio company of Allied Capital.
- (11) Represents the effective interest yield earned on the cost basis of these preferred equity investments and income notes. The yield is included in interest income from companies less than 5% owned in the consolidated statement of operations.
- (12) Common stock is non-voting. In addition to non-voting stock ownership, the Company has an option to acquire a majority of the voting securities of the portfolio company at fair market value.

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

**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENT OF INVESTMENTS (Continued)**

September 30, 2007

Private Finance Portfolio Company (in thousands, except number of shares)	Investment <sup>(1)(2)</sup>	Principal	Cost	Value
			(unaudited)	
CK Franchising, Inc. (Consumer Services)	Senior Loan (11.0%, Due 7/12) Subordinated Debt (15.0%, Due 7/17) Preferred Stock (1,486,004 shares) Common Stock (8,793,408 shares)	\$ 30,150  1,000	\$ 29,959  1,000 1,486 8,793	\$ 29,959  1,000 1,486 8,793
Commercial Credit Group, Inc. (Financial Services)	Subordinated Debt (14.8%, Due 2/11) Preferred Stock (74,978 shares) Warrants	12,000	12,025 18,018	12,025 19,469
Community Education Centers, Inc. (Education Services)	Subordinated Debt (13.5%, Due 11/13)	34,878	34,800	34,800
Compass Group Diversified Holdings, LLC <sup>(3)</sup> (Financial Services)	Senior Loan (8.0%, Due 11/11)	2,000	1,896	1,896
Component Hardware Group, Inc. (Industrial Products)	Subordinated Debt (13.5%, Due 1/13)	18,363	18,290	18,290
Cook Inlet Alternative Risk, LLC (Business Services)	Unitranche Debt (10.8%, Due 4/13) Equity Interests	100,000	99,507 640	99,507 1,700
Cortec Group Fund IV, L.P. <sup>(5)</sup> (Private Equity)	Limited Partnership Interest		3,383	2,906
CSAV, Inc. (Business Services)	Subordinated Debt (11.7%, Due 6/13)	37,500	37,500	37,500
Diversified Mercury Communications, LLC (Business Services)	Senior Loan (9.0%, Due 3/13)	233	217	217
Digital VideoStream, LLC	Unitranche Debt (11.0%, Due 2/12)	17,677	17,586	17,586

(Business Services)	Convertible Subordinated Debt (10.0%, Due 2/16)	4,017	4,003	4,100
Distant Lands Trading Co. (Consumer Products)	Senior Loan (10.3%, Due 11/11) Unitranche Debt (11.0%, Due 11/11) Common Stock (4,000 shares)	10,000 42,375	9,963 42,216 4,000	9,963 42,216 2,652
Driven Brands, Inc. (Consumer Services) d/b/a Meineke and Econo Lube	Senior Loan (8.9%, Due 6/11)  Subordinated Debt (12.1%, Due 6/12 6/13) Common Stock (11,675,331 shares) <sup>(12)</sup> Warrants <sup>(12)</sup>	36,070  83,000	35,942  82,736 29,455	35,942  82,736 17,977
Dynamic India Fund IV <sup>(4)(5)</sup> (Private Equity Fund)	Equity Interests		6,050	6,215
EarthColor, Inc. (Business Services)	Subordinated Debt (15.0%, Due 11/13) Common Stock (73,540 shares) <sup>(12)</sup> Warrants <sup>(12)</sup>	127,000	126,440 73,540	126,440 42,884
eCentury Capital Partners, L.P. <sup>(5)</sup> (Private Equity Fund)	Limited Partnership Interest		6,899	2,615

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**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENT OF INVESTMENTS (Continued)**

September 30, 2007

Private Finance Portfolio Company (in thousands, except number of shares)	Investment <sup>(1)(2)</sup>	Principal	Cost	Value
			(unaudited)	
Elexis Beta GmbH <sup>(4)</sup> (Industrial Products)	Options		\$ 426	\$ 50
Farley s & Sathers Candy Company, Inc. (Consumer Products)	Subordinated Debt (11.4%, Due 3/11)	\$ 8,000	7,978	7,978
FCP-BHI Holdings, LLC d/b/a Bojangles (Consumer Products)	Subordinated Debt (12.8%, Due 9/13) Equity Interests	24,000	23,882 1,000	23,882 1,000
Fidus Mezzanine Capital, L.P. <sup>(5)</sup> (Private Equity Fund)	Limited Partnership Interest		3,294	3,294
Frozen Specialties, Inc. (Consumer Products)	Warrants		435	230
Garden Ridge Corporation (Retail)	Subordinated Debt (7.0%, Due 5/12) <sup>(6)</sup>	20,500	20,500	20,500
Geotrace Technologies, Inc. (Energy Services)	Subordinated Debt (10.0%, Due 6/09) Warrants	7,347	7,167 2,350	7,167 3,000
Grant Broadcasting Systems II (Broadcasting & Cable)	Subordinated Debt (5.0%, Due 6/11)	3,005	3,005	3,005
Grotech Partners, VI, L.P. <sup>(5)</sup> (Private Equity Fund)	Limited Partnership Interest		8,808	6,970
Havco Wood Products LLC (Industrial Products)	Senior Loan (9.9%, Due 8/11) Unitranche Debt (11.5%, Due 8/11) Equity Interests	1,150 7,600	1,134 6,740 1,055	1,134 6,740 3,200
Haven Eldercare of New England, LLC (Healthcare Services)	Subordinated Debt (12.0%, Due 8/09)	1,927	1,927	1,927
HealthASPex Services Inc.	Senior Loan (8.0%, Due 7/08) <sup>(6)</sup>	500	500	133



(Business Services)

Higginbotham Insurance Agency, Inc. (Business Services)	Senior Loan (7.9%, Due 8/12)	15,196	15,099	15,099
	Subordinated Debt (13.6%, Due 8/13 - 8/14)	46,855	46,626	46,626
	Common Stock (28,277 shares) <sup>(12)</sup>		26,522	26,522
	Warrant <sup>(12)</sup>			
The Hillman Companies, Inc. <sup>(3)</sup> (Consumer Products)	Subordinated Debt (10.0%, Due 9/11)	44,580	44,450	44,450
The Homax Group, Inc. (Consumer Products)	Senior Loan (9.1%, Due 10/12)	11,027	11,027	11,027
	Subordinated Debt (12.0%, Due 4/14)	14,000	13,225	13,225
	Preferred Stock (89 shares)		89	74
	Common Stock (28 shares)		6	
	Warrants		1,106	909
Ideal Snacks Corporation (Consumer Products)	Senior Loan (9.5%, Due 6/10)	35	35	35
Integrity Interactive Corporation (Business Services)	Unitranche Debt (10.5%, Due 2/12)	12,434	12,331	12,331
International Fiber Corporation (Industrial Products)	Subordinated Debt (14.0%, Due 6/12)	24,447	24,354	24,354
	Preferred Stock (25,000 shares)		2,500	2,200

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**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENT OF INVESTMENTS (Continued)**

September 30, 2007

Private Finance Portfolio Company (in thousands, except number of shares)	Investment <sup>(1)(2)</sup>	Principal	Cost	Value
			(unaudited)	
Jones Stephens Corporation (Consumer Products)	Senior Loan (8.9%, Due 9/12)	\$ 5,558	\$ 5,545	\$ 5,545
K2 Advisors Subsidiary Holdings, LLC (Business Services)	Senior Loan (8.7%, Due 4/13)	9,836	9,836	9,836
Kodiak Fund LP <sup>(5)</sup> (Private Equity Fund)	Equity Interests		9,423	2,853
Line-X, Inc. (Consumer Products)	Senior Loan (12.0%, Due 8/11) Unitranche Debt (12.0% Due 8/11) Standby Letter of Credit (\$1,500)	1,100 48,355	1,084 48,185	1,084 48,185
MedAssets, Inc. (Business Services)	Preferred Stock (227,865 shares) Common Stock (50,000 shares)		2,049	3,845 100
Mid-Atlantic Venture Fund IV, L.P. <sup>(5)</sup> (Private Equity Fund)	Limited Partnership Interest		6,975	2,861
NetShape Technologies, Inc. (Industrial Products)	Senior Loan (8.9%, Due 2/13)	5,661	5,630	5,630
Network Hardware Resale, Inc. (Business Services)	Unitranche Debt (10.5%, Due 12/11)  Convertible Subordinated Debt (9.8%, Due 12/15)	20,805  13,242	20,913  13,304	20,913  14,959
Norwesco, Inc. (Industrial Products)	Subordinated Debt (12.6%, Due 1/12 7/12) Common Stock (559,603 shares) <sup>(12)</sup> Warrants <sup>(12)</sup>	82,812	82,546 38,313	82,546 118,118
Novak Biddle Venture Partners III, L.P. <sup>(5)</sup> (Private Equity Fund)	Limited Partnership Interest		1,910	1,983

Oahu Waste Services, Inc. (Business Services)	Stock Appreciation Rights		239	1,000
Odyssey Investment Partners Fund III, LP <sup>(5)</sup> (Private Equity Fund)	Limited Partnership Interest		1,542	2,162
Passport Health Communications, Inc. (Healthcare Services)	Preferred Stock (651,381 shares) Common Stock (19,680 shares)		2,000 48	2,398 48
Pendum, Inc. (Business Services)	Subordinated Debt (17.0%, Due 1/11) <sup>(6)</sup> Preferred Stock (82,715 shares) Warrants	34,028	34,028	
Performant Financial Corporation (Business Services)	Common Stock (478,816 shares)		734	

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**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENT OF INVESTMENTS (Continued)**

September 30, 2007

Private Finance Portfolio Company (in thousands, except number of shares)	Investment <sup>(1)(2)</sup>	Principal	Cost	Value
			(unaudited)	
Postle Aluminum Company, LLC (Industrial Products)	Unitranche Debt (11.0%, Due 10/12)	\$61,750	\$61,489	\$61,489
	Equity Interests		2,500	3,100
Pro Mach, Inc. (Industrial Products)	Subordinated Debt (13.0%, Due 6/12)	14,525	14,466	14,466
	Equity Interests		1,500	1,600
Promo Works, LLC (Business Services)	Unitranche Debt (10.3%, Due 12/11) Guaranty (\$600)	26,215	25,995	25,995
S.B. Restaurant Company (Retail)	Unitranche Debt (9.8%, Due 4/11)	29,001	28,739	28,739
	Preferred Stock (54,125 shares)		135	135
	Warrants		619	2,100
	Standby Letters of Credit (\$2,540)			
SBBUT, LLC (Consumer Products)	Equity Interests			
Service Center Metals, LLC (Industrial Products)	Subordinated Debt (15.5%, Due 9/11)	5,000	4,980	4,980
	Equity Interests		313	337
Snow Phipps Group, L.P. <sup>(5)</sup> (Private Equity Fund)	Limited Partnership Interest		2,317	2,317
SPP Mezzanine Funding, L.P. <sup>(5)</sup> (Private Equity Fund)	Limited Partnership Interest		2,364	2,928
SPP Mezzanine Funding II, L.P. <sup>(5)</sup> (Private Equity Fund)	Limited Partnership Interest		2,750	2,409
Stag-Parkway, Inc. (Business Services)	Unitranche Debt (10.8%, Due 7/12)	51,000	50,799	50,799

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STS Operating, Inc. (Industrial Products)	Subordinated Debt (11.0%, Due 1/13)	30,386	30,268	30,268
Summit Energy Services, Inc. (Business Services)	Senior Loan (10.4%, Due 8/13) Common Stock (89,406 shares)	60,000	59,824 2,000	59,824 2,000
Tappan Wire and Cable Inc. (Business Services)	Senior Loan (15.0%, Due 8/14) Common Stock (15,000 shares) <sup>(12)</sup> Warrant <sup>(12)</sup>	24,100	23,970 2,250	23,970 2,250
The Step2 Company, LLC (Consumer Products)	Unitranche Debt (11.0%, Due 4/12) Equity Interests	96,041	95,672 2,483	95,672 3,003
Tradesmen International, Inc. (Business Services)	Subordinated Debt (12.0%, Due 12/09)	9,136	8,668	8,668
TransAmerican Auto Parts, LLC (Consumer Products)	Subordinated Debt (14.0%, Due 11/12)  Equity Interests	23,955	23,746 1,198	23,746 1,016
Trover Solutions, Inc. (Business Services)	Senior Loan (11.3%, Due 5/12 11/12)	77,000	76,725	76,725
Universal Air Filter Company (Industrial Products)	Senior Loan (12.0%, Due 11/12)	14,875	14,810	14,810

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**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENT OF INVESTMENTS (Continued)**

September 30, 2007

Private Finance Portfolio Company (in thousands, except number of shares)	Investment <sup>(1)(2)</sup>	Principal	Cost (unaudited)	Value
Udata Venture Partners II, L.P. <sup>(5)</sup> (Private Equity Fund)	Limited Partnership Interest		\$ 4,727	\$ 6,148
Venturehouse-Cibernet Investors, LLC (Business Services)	Equity Interest			54
Venturehouse Group, LLC <sup>(5)</sup> (Private Equity Fund)	Equity Interest			1,381
VICORP Restaurants, Inc. (Retail)	Warrants		33	
Walker Investment Fund II, LLLP <sup>(5)</sup> (Private Equity Fund)	Limited Partnership Interest		1,330	358
WMA Equity Corporation and Affiliates d/b/a Wear Me Apparel (Consumer Products)	Subordinated Debt (13.6%, Due 4/13)	\$125,000	123,971	123,971
	Subordinated Debt (9.0%, Due 4/14) <sup>(6)</sup>	13,033	13,033	13,033
	Common Stock (100 shares)		46,046	14,428
Webster Capital II, L.P. <sup>(5)</sup> (Private Equity Fund)	Limited Partnership Interest		538	538
Woodstream Corporation (Consumer Products)	Subordinated Debt (12.0%, Due 2/15)	90,000	89,560	89,560
	Common Stock (7,500 shares)		7,500	7,500
	Warrants			
York Insurance Services Group, Inc. (Business Services)	Subordinated Debt (14.5%, Due 1/14)	44,916	44,734 1,500	44,734 2,000

Common Stock (15,000 shares)				
Other companies	Other debt investments <sup>(6)</sup>	6,516	6,516	6,511
	Other equity investments		8	
Total companies less than 5% owned			\$2,601,101	\$2,572,354
Total private finance (151 portfolio investments)			\$4,606,414	\$4,207,128

- (1) Interest rates represent the weighted average annual stated interest rate on loans and debt securities, which are presented by nature of indebtedness for a single issuer. The maturity dates represent the earliest and the latest maturity dates.
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- (3) Public company.
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- (5) Non-registered investment company.
- (6) Loan or debt security is on non-accrual status and therefore is considered non-income producing.

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

**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENT OF INVESTMENTS (Continued)**

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

			September 30, 2007	
Interest Rate Ranges	Number of Loans	(unaudited)		
		Cost	Value	
<b>Commercial Mortgage Loans</b>				
Up to 6.99%	3	\$ 20,388	\$ 19,838	
7.00% 8.99%	8	21,623	21,623	
9.00% 10.99%	3	8,371	8,371	
11.00% 12.99%	1	10,453	10,453	
15.00% and above	2	3,970	3,970	
Total commercial mortgage loans <sup>(13)</sup>		17	\$ 64,805	\$ 64,255
<b>Real Estate Owned</b>			\$ 15,568	\$ 21,979
<b>Equity Interests<sup>(2)</sup> Companies more than 25% owned</b>			\$ 15,742	\$ 33,505
Guarantees (\$6,871)				
Standby Letter of Credit (\$1,295)				
Total commercial real estate finance			\$ 96,115	\$ 119,739
<b>Total portfolio</b>			\$4,702,529	\$4,326,867

	Yield	Cost	Value
<b>Liquidity Portfolio<sup>(14)</sup></b>			
American Beacon Money Market Select FD Fund	5.4%	\$126,410	\$126,410
American Beacon Money Market Fund	5.2%	40,102	40,102
SEI Daily Income Tr Prime Obligation Fund	5.2%	34,151	34,151
Total liquidity portfolio		\$200,663	\$200,663
<b>Other Investments in Money Market Securities<sup>(14)</sup></b>			
Columbia Treasury Reserves Money Market Fund	5.3%	\$ 90,406	\$ 90,406



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- (5) Non-registered investment company.
- (13) Commercial mortgage loans totaling \$19.1 million at value were on non-accrual status and therefore were considered non-income producing.
- (14) Included in investments in money market and other securities on the accompanying Consolidated Balance Sheet.

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

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**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**  
**(Information at and for the three and nine months ended**  
**September 30, 2007 and 2006 is unaudited)**

**Note 1. Organization**

Allied Capital Corporation, a Maryland corporation, is a closed-end, non-diversified management investment company that has elected to be regulated as a business development company ( BDC ) under the Investment Company Act of 1940 ( 1940 Act ). Allied Capital Corporation ( ACC ) has a real estate investment trust subsidiary, Allied Capital REIT, Inc. ( Allied REIT ), and several subsidiaries that are single member limited liability companies established for specific purposes, including holding real estate properties. ACC also has a subsidiary, A.C. Corporation ( AC Corp ), that generally provides diligence and structuring services, as well as transaction, management, consulting, and other services, including underwriting and arranging senior loans, to the Company and its portfolio companies.

ACC and its subsidiaries, collectively, are referred to as the Company. The Company consolidates the results of its subsidiaries for financial reporting purposes.

Pursuant to Article 6 of Regulation S-X, the financial results of the Company s portfolio investments are not consolidated in the Company s financial statements. Portfolio investments are held for purposes of deriving investment income and future capital gains.

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

**Note 2. Summary of Significant Accounting Policies**

***Basis of Presentation***

The consolidated financial statements include the accounts of ACC and its subsidiaries. All intercompany accounts and transactions have been eliminated in consolidation. Certain reclassifications have been made to the 2006 balances to conform with the 2007 financial statement presentation.

The accompanying unaudited consolidated financial statements of the Company have been prepared in accordance with U.S. generally accepted accounting principles ( GAAP ) for interim financial information. Accordingly, they do not include all of the information and footnotes required by GAAP for complete consolidated financial statements. In the opinion of management, the unaudited consolidated financial results of the Company included herein contain all adjustments (consisting of only normal recurring accruals) necessary to present fairly the financial position of the Company as of September 30, 2007, the results of operations for the three and nine months ended September 30, 2007 and 2006, and changes in net assets and cash flows for the nine months ended September 30, 2007 and 2006. The results of operations for the three and nine months ended September 30, 2007, are not necessarily indicative of the operating results to be expected for the full year.

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

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

**Note 2. Summary of Significant Accounting Policies, continued**

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

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

***Valuation of Portfolio Investments***

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

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

**Note 2. Summary of Significant Accounting Policies, continued**

***Loans and Debt Securities***

The Company's loans and debt securities generally do not trade. The Company typically exits its loans and debt securities upon the sale or recapitalization of the portfolio company. Therefore, the Company generally determines the enterprise value of the portfolio company and then allocates that value to the loans and debt securities in order of the legal priority of contractual obligations, with the remaining value, if any, going to the portfolio company's outstanding equity securities. For loans and debt securities, fair value generally approximates cost unless the borrower's enterprise value, overall financial condition or other factors lead to a determination of fair value at a different amount. The value of loan and debt securities may be greater than the Company's cost basis if the amount that would be repaid on the loan or debt security upon the sale or recapitalization of the portfolio company is greater than the Company's cost basis.

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

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

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

***Equity Securities***

The Company's equity securities in portfolio companies for which there is no liquid public market are valued at fair value based on the enterprise value of the portfolio

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

**Note 2. Summary of Significant Accounting Policies, continued**

company, which is determined using various factors, including cash flow from operations of the portfolio company, multiples at which private companies are bought and sold, and other pertinent factors, such as recent offers to purchase a portfolio company, recent transactions involving the purchase or sale of the portfolio company's equity securities, liquidation events, or other events. The determined equity values are generally discounted when the company has a minority ownership position, restrictions on resale, specific concerns about the receptivity of the capital markets to a specific company at a certain time, or other factors.

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

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

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

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

The Company recognizes interest income on the preferred shares/income notes using the effective interest method, based on the anticipated yield and the estimated cash flows over the projected life of the investment. Yields are revised when there are changes in actual or estimated cash flows due to changes in prepayments and/or re-investments, credit losses or asset pricing. Changes in estimated yield are recognized as an adjustment to the estimated yield over the remaining life of the preferred share/income notes from the date the estimated yield was changed. CDO and CLO bonds have stated interest rates.

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

**Note 2. Summary of Significant Accounting Policies, continued**

***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 period, net of recoveries. Net change in unrealized appreciation or depreciation primarily reflects the change in portfolio investment values during the reporting period, including the reversal of previously recorded unrealized appreciation or depreciation when gains or losses are realized. Net change in unrealized appreciation or depreciation also reflects the change in the value of U.S. Treasury bills and deposits of proceeds from sales of borrowed Treasury securities, and depreciation on accrued interest and dividends receivable and other assets where collection is doubtful.

***Fee Income***

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

***Guarantees***

Guarantees meeting the characteristics described in FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others* (the Interpretation) and issued or modified after December 31, 2002, are recognized at fair value at inception. Guarantees made on behalf of portfolio companies are considered in determining the fair value of the Company's investments. See Note 5.

***Financing Costs***

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

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

**Note 2. Summary of Significant Accounting Policies, continued**

***Dividends to Shareholders***

Dividends to shareholders are recorded on the record date.

***Stock Compensation Plans***

The Company has a stock-based employee compensation plan. See Note 9. Effective January 1, 2006, the Company adopted the provisions of FASB Statement No. 123 (Revised 2004), *Share-Based Payment* (the SFAS 123R). The SFAS 123R was adopted using the modified prospective method of application, which required the Company to recognize compensation costs on a prospective basis beginning January 1, 2006. Accordingly, the Company did not restate prior year financial statements. Under this method, the unamortized cost of previously awarded options that were unvested as of January 1, 2006, is recognized over the remaining service period in the statement of operations beginning in 2006, using the fair value amounts determined for pro forma disclosure under the SFAS 123R. With respect to options granted on or after January 1, 2006, compensation cost based on estimated grant date fair value is recognized over the related service period in the consolidated statement of operations. The stock option expense for the three and nine months ended September 30, 2007 and 2006, was as follows:

	<b>For the Three Months Ended September 30,</b>		<b>For the Nine Months Ended September 30,</b>	
	<b>2007</b>	<b>2006</b>	<b>2007</b>	<b>2006</b>
<b>(\$ in millions, except per share amounts)</b>				
<b>Employee Stock Option Expense:</b>				
<b>Options granted:</b>				
Previously awarded, unvested options as of January 1, 2006	\$ 1.7	\$ 3.2	\$ 8.2	\$ 9.9
Options granted on or after January 1, 2006	2.2	0.4	8.9	2.0
<b>Total options granted</b>	<b>3.9</b>	<b>3.6</b>	<b>17.1</b>	<b>11.9</b>
Options cancelled in connection with tender offer (see Note 9)	14.4		14.4	
<b>Total employee stock option expense</b>	<b>\$ 18.3</b>	<b>\$ 3.6</b>	<b>\$ 31.5</b>	<b>\$ 11.9</b>
Per basic share	\$ 0.12	\$ 0.03	\$ 0.21	\$ 0.08
Per diluted share	\$ 0.12	\$ 0.02	\$ 0.20	\$ 0.08

***Options Granted.*** In addition to the employee stock option expense for options granted, for both the nine months ended September 30, 2007 and 2006, administrative expense included \$0.2 million of expense related to options granted to directors during each respective period. Options were granted to non-officer directors in the second quarters of 2007 and 2006. Options granted to non-officer directors vest on the grant date and therefore, the full expense is recorded on the grant date.

The stock option expense for options granted shown in the table above was based on the underlying value of the options granted by the Company. The fair value of each option grant was estimated on the date of grant using the Black-Scholes option pricing model and expensed over the vesting period. The following weighted average assumptions were used

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

**Note 2. Summary of Significant Accounting Policies, continued**

to calculate the fair value of options granted during the three and nine months ended September 30, 2007 and 2006:

	<b>For the Three Months Ended September 30,</b>		<b>For the Nine Months Ended September 30,</b>	
	<b>2007</b>	<b>2006</b>	<b>2007</b>	<b>2006</b>
Expected term (in years)	5.0	5.0	5.0	5.0
Risk-free interest rate	4.6%	4.7%	4.6%	4.8%
Expected volatility	24.4%	26.8%	26.4%	29.1%
Dividend yield	8.9%	9.0%	8.9%	9.0%
Weighted average fair value per option	\$2.51	\$3.12	\$2.96	\$3.47

The expected term of the options granted represents the period of time that such options are expected to be outstanding. To determine the expected term of the options, the Company used historical data to estimate option exercise time frames, including considering employee terminations. The risk free rate was based on the U.S. Treasury bond yield curve at the date of grant. Expected volatilities were determined based on the historical volatility of the Company's common stock over a historical time period consistent with the expected term. The dividend yield was determined based on the Company's historical dividend yield over a historical time period consistent with the expected term.

To determine the stock options expense for options granted, the calculated fair value of the options granted is applied to the options granted, net of assumed future option forfeitures. The Company estimates that the employee-related stock option expense under SFAS 123R that will be recorded in the Company's statement of operations, excluding the expense related to the options cancelled in connection with the tender offer, will be approximately \$21.0 million, \$9.5 million, and \$2.8 million for the years ended December 31, 2007, 2008, and 2009, respectively, which includes approximately \$10.9 million, \$6.6 million, and \$2.8 million, respectively, related to options granted since adoption of SFAS 123R (January 1, 2006). This estimate may change if the Company's assumptions related to future option forfeitures change. This estimate does not include any expense related to future stock option grants as the fair value of those stock options will be determined at the time of grant. The aggregate total stock option expense remaining as of September 30, 2007, is expected to be recognized over an estimated weighted-average period of 1.2 years.

**Options Cancelled in Connection with Tender Offer.** As discussed in Note 9, the Company completed a tender offer in July 2007, whereby the Company accepted for cancellation 10.3 million vested options held by employees and non-officer directors of the Company in exchange for an option cancellation payment ( OCP ). The OCP was equal to the in-the-money value of the stock options cancelled, determined using the Weighted Average Market Price of \$31.75, and was paid one-half in cash and one-half in unregistered shares of the Company's common stock. In accordance with the terms of the tender offer, the Weighted Average Market Price represented the volume weighted average price of the Company's common stock over the fifteen trading days preceding the first day of the offer period, or June 20, 2007. Because the Weighted Average Market Price at the



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

**Note 2. Summary of Significant Accounting Policies, continued**

commencement of the tender offer on June 20, 2007, was higher than the market price of the Company's common stock at the close of the offer on July 18, 2007, SFAS 123R required the Company to record employee-related stock option expense of \$14.4 million and administrative expense related to stock options cancelled that were held by non-officer directors of \$0.4 million. The same amounts were recorded as an increase to additional paid-in capital and, therefore, had no effect on the Company's net asset value. The portion of the OCP paid in cash of \$52.8 million reduced the Company's additional paid-in capital and therefore reduced the Company's net asset value. For income tax purposes, the Company's tax deduction resulting from the OCP will be similar to the tax deduction that would have resulted from an exercise of stock options in the market. Any tax deduction for the Company resulting from the OCP or an exercise of stock options in the market is limited by Section 162(m) of the Code for persons subject to Section 162(m).

***Federal and State Income Taxes and Excise Tax***

The Company intends to comply with the requirements of the Internal Revenue Code ( Code ) that are applicable to regulated investment companies ( RIC ) and real estate investment trusts ( REIT ). ACC and any subsidiaries that qualify as a RIC or a REIT intend to distribute or retain through a deemed distribution all of their annual taxable income to shareholders; therefore, the Company has made no provision for income taxes exclusive of excise taxes for these entities.

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

Income taxes for AC Corp are accounted for under the asset and liability method. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases as well as operating loss and tax credit carryforwards. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled.

***Per Share Information***

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

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

**Note 2. Summary of Significant Accounting Policies, continued**

***Use of Estimates in the Preparation of Financial Statements***

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

The consolidated financial statements include portfolio investments at value of \$4.3 billion and \$4.5 billion at September 30, 2007, and December 31, 2006, respectively. At September 30, 2007, and December 31, 2006, 89% and 92%, respectively, of the Company's total assets represented portfolio investments whose fair values had been determined by the Board of Directors in good faith in the absence of readily available market values. Because of the inherent uncertainty of valuation, the Board of Directors' determined values may differ significantly from the values that would have been used had a ready market existed for the investments, and the differences could be material.

***Recent Accounting Pronouncements***

In June 2006, the FASB issued Interpretation No. 48, *Accounting for Uncertainty in Income Taxes*, which clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with FASB Statement No. 109, *Accounting for Income Taxes*. This interpretation is effective for fiscal years beginning after December 15, 2006. The adoption of this interpretation did not have a significant effect on the Company's consolidated financial position or its results of operations.

In September 2006, the FASB issued Statement No. 157, *Fair Value Measurements*. This statement defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. This statement is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. The Company is currently analyzing the effect of adoption of this statement on its consolidated financial position and results of operations.

In February 2007, the FASB issued Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities - Including an Amendment of FASB Statement No. 115*. This statement permits an entity to choose to measure many financial instruments and certain other items at fair value. This statement applies to all reporting entities, and contains financial statement presentation and disclosure requirements for assets and liabilities reported at fair value as a consequence of the election. This statement is effective for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. The Company is currently analyzing the effect of adoption of this statement on its consolidated financial position and results of operations.

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

**Note 3. Portfolio***Private Finance*

At September 30, 2007, and December 31, 2006, the private finance portfolio consisted of the following:

	2007			2006		
	Cost	Value	Yield <sup>(1)</sup>	Cost	Value	Yield <sup>(1)</sup>
<b>(\$ in millions)</b>						
<b>Loans and debt securities:</b>						
Senior loans	\$ 523.9	\$ 481.6	9.3%	\$ 450.0	\$ 405.2	8.4%
Unitranche debt <sup>(2)</sup>	698.1	698.1	11.5%	800.0	799.2	11.2%
Subordinated debt	2,052.7	1,927.1	12.6%	2,038.3	1,980.8	12.9%
<b>Total loans and debt securities<sup>(3)</sup></b>	<b>3,274.7</b>	<b>3,106.8</b>	<b>11.8%</b>	<b>3,288.3</b>	<b>3,185.2</b>	<b>11.9%</b>
<b>Equity securities:</b>						
Preferred shares/income notes of CLOs <sup>(4)</sup>	142.2	131.5	15.1%	101.1	97.2	15.5%
Other equity securities	1,189.5	968.8		1,108.0	1,095.5	
<b>Total equity securities</b>	<b>1,331.7</b>	<b>1,100.3</b>		<b>1,209.1</b>	<b>1,192.7</b>	
<b>Total</b>	<b>\$ 4,606.4</b>	<b>\$ 4,207.1</b>		<b>\$ 4,497.4</b>	<b>\$ 4,377.9</b>	

(1) The weighted average yield on loans and debt securities is computed as the (a) annual stated interest on accruing loans and debt securities plus the annual amortization of loan origination fees, original issue discount, and market discount on accruing loans and debt securities less the annual amortization of loan origination costs, divided by (b) total loans and debt securities at value. At September 30, 2007, and December 31, 2006, the cost and value of subordinated debt included the Class A equity interests in BLX and the guaranteed dividend yield on these equity interests, to the extent it was accrued, was included in interest income. During the fourth quarter of 2006, the Class A equity interests were placed on non-accrual status. The weighted average yield on the preferred shares/income notes of CLOs is calculated as the (a) effective interest yield on the preferred shares/income notes of CLOs, divided by (b) total preferred shares/income notes of CLOs at value. The weighted average yields are computed as of the balance sheet date. The yield on the CLO assets represents the yield used for recording interest income. The market yield used in the valuation of the CLO assets may be different than the interest yields.

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

(3) The total principal balance outstanding on loans and debt securities was \$3,298.5 million and \$3,322.3 million at September 30, 2007, and December 31, 2006, respectively. The difference between principal and cost is represented by unamortized loan origination fees and costs, original issue discounts, and market discounts totaling \$23.8 million and \$34.0 million at September 30, 2007, and December 31, 2006, respectively.

(4)

Investments in the preferred shares/income notes of CLOs earn a current return that is included in interest income in the accompanying consolidated statement of operations.

The Company's private finance investment activity principally involves providing financing through privately negotiated long-term debt and equity investments. The Company's private finance debt and equity investments are generally issued by private companies and are generally illiquid and may be subject to certain restrictions on resale.

The Company's private finance debt investments are generally structured as loans and debt securities that carry a relatively high fixed rate of interest, which may be combined with equity features, such as conversion privileges, or warrants or options to purchase a portion of the portfolio company's equity at a pre-determined strike price, which is generally a nominal price for warrants or options in a private company. The annual stated interest rate

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

**Note 3. Portfolio, continued**

is only one factor in pricing the investment relative to the Company's rights and priority in the portfolio company's capital structure, and will vary depending on many factors, including if the Company has received nominal cost equity or other components of investment return, such as loan origination fees or market discount. The stated interest rate may include some component of contractual payment-in-kind interest, which represents contractual interest accrued and added to the loan balance that generally becomes due at maturity.

At September 30, 2007, and December 31, 2006, 89% and 86%, respectively, of the private finance loans and debt securities had a fixed rate of interest and 11% and 14%, respectively, had a floating rate of interest. Senior loans may carry a fixed rate of interest or a floating rate of interest, usually set as a spread over LIBOR, and may require payments of both principal and interest throughout the life of the loan. Senior loans generally have contractual maturities of three to six years and interest is generally paid to the Company monthly or quarterly. Unitranche debt generally carries a fixed rate of interest and may require payments of both principal and interest throughout the life of the loan. Unitranche debt generally has contractual maturities of five to six years and interest is generally paid to the Company quarterly. Subordinated debt generally carries a fixed rate of interest generally with contractual maturities of five to ten years and generally has interest-only payments in the early years and payments of both principal and interest in the later years, although maturities and principal amortization schedules may vary. Interest is generally paid to the Company quarterly.

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

***Business Loan Express, LLC.*** BLX originates, sells, and services primarily real estate secured loans, including real estate secured conventional loans, loans under the Small Business Administration's 7(a) Guaranteed Loan Program, and small commercial real estate loans. BLX is headquartered in New York, NY.

The Company's investment in BLX totaled \$324.6 million at cost and \$136.7 million at value, which included unrealized depreciation of \$187.9 million, at September 30, 2007, and \$295.3 million at cost and \$210.7 million at value, which included unrealized depreciation of \$84.6 million, at December 31, 2006. In the first half of 2007, the

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

**Note 3. Portfolio, continued**

Company increased its investment in BLX by \$29.2 million by acquiring additional Class A equity interests. In addition, in the first quarter of 2007, the chief executive officer of BLX invested \$3.0 million in the form of Class A equity interests in BLX. The Company plans to purchase these interests from him in conjunction with a restructuring of BLX's operations. The purpose of these additional investments was to fund payments to the SBA in the first quarter of 2007 discussed below and to provide additional equity capital to BLX.

Total interest and related portfolio income earned from the Company's investment in BLX for the three and nine months ended September 30, 2007 and 2006, was as follows:

	<b>For the Three Months Ended September 30,</b>		<b>For the Nine Months Ended September 30,</b>	
	<b>2007</b>	<b>2006</b>	<b>2007</b>	<b>2006</b>
<b>(\$ in millions)</b>				
Interest income on subordinated debt and Class A equity interests	\$	\$ 4.1	\$	\$ 11.9
Fees and other income	1.3	2.0	4.1	6.3
<b>Total interest and related portfolio income</b>	<b>\$ 1.3</b>	<b>\$ 6.1</b>	<b>\$ 4.1</b>	<b>\$ 18.2</b>

Interest and dividend income from BLX for the three and nine months ended September 30, 2006, included interest income of \$2.0 million and \$5.7 million, respectively, which was paid in kind. The interest paid in kind was paid to the Company through the issuance of additional Class A equity interests. In the fourth quarter of 2006, the Company placed its investment in BLX's 25% Class A equity interests on non-accrual status. As a result, there was no interest income from the Company's investment in BLX for the three or nine months ended September 30, 2007.

In consideration for providing a guaranty on BLX's revolving credit facility and standby letters of credit (discussed below), the Company earned fees of \$1.3 million and \$4.1 million for the three and nine months ended September 30, 2007, respectively, and \$1.5 million and \$4.6 million for the three and nine months ended September 30, 2006, respectively, which were included in fees and other income. As of September 30, 2007, BLX had not yet paid the \$4.1 million in such fees earned by the Company in 2007 and, as a result, such fees were included as a receivable in other assets. The remaining fees and other income in 2006 relate to management fees from BLX. The Company has not charged BLX management fees in 2007.

Net change in unrealized appreciation or depreciation included a net decrease of \$84.1 million and \$103.2 million for the three and nine months ended September 30, 2007, respectively. Net change in unrealized appreciation or depreciation for the three and nine months ended September 30, 2006, included a net decrease of \$34.3 million and \$67.9 million, respectively, on the Company's investment in BLX.

BLX is a national, non-bank lender that currently participates in the SBA's 7(a) Guaranteed Loan Program and its wholly-owned subsidiary is licensed by the SBA as a Small Business Lending Company (SBLC). The Office of the Inspector General of the

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

**Note 3. Portfolio, continued**

SBA (OIG) and the United States Secret Service are conducting ongoing investigations of allegedly fraudulently obtained SBA-guaranteed loans issued by BLX. Specifically, on or about January 9, 2007, BLX became aware of an indictment captioned as the United States v. Harrington, No. 2:06-CR-20662 pending in the United States District Court for the Eastern District of Michigan. The indictment alleged that a former BLX employee in the Detroit office engaged in the fraudulent origination of loans guaranteed, in substantial part, by the SBA. The Company understands that BLX is working cooperatively with the U.S. Attorney's Office and the investigating agencies with respect to this matter. On October 1, 2007, the former BLX employee pled guilty to one count of conspiracy to fraudulently originate SBA-guaranteed loans and one count of making a false statement before a grand jury. The OIG and the U.S. Department of Justice are also conducting a civil investigation of BLX's lending practices in various jurisdictions. As an SBA lender, BLX is also subject to other SBA and OIG audits, investigations, and reviews. In addition, the Office of the Inspector General of the U.S. Department of Agriculture is conducting an investigation of BLX's lending practices under the Business and Industry Loan (B&I) program. These investigations, audits and reviews are ongoing.

These investigations, audits and reviews, 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 the Company's financial results. The Company has considered BLX's current regulatory issues and ongoing investigations and litigation in performing the valuation of BLX at September 30, 2007. The Company is monitoring the situation.

On March 6, 2007, BLX entered into an agreement with the SBA. According to the agreement, BLX remains a preferred lender in the SBA 7(a) Guaranteed Loan Program and retains the ability to sell loans into the secondary market. As part of this agreement, BLX agreed to the immediate payment of approximately \$10 million to the SBA to cover amounts paid by the SBA with respect to some of the SBA-guaranteed loans that have been the subject of the charges by the U.S. Attorney's Office for the Eastern District of Michigan against Mr. Harrington. As part of the SBA's increased oversight, the agreement provides that any loans originated and closed by BLX during the term of the agreement will be reviewed by an independent third party selected by the SBA prior to the sale of such loans into the secondary market. The agreement also requires BLX to repurchase the guaranteed portion of certain loans that default after having been sold into the secondary market, and subjects such loans to a similar third party review prior to any reimbursement of BLX by the SBA. In connection with this agreement, BLX also entered into an escrow agreement with the SBA and an escrow agent in which BLX agreed to deposit \$10 million with the escrow agent for any additional payments BLX may be obligated to pay to the SBA in the future. BLX remains subject to SBA rules and regulations and as a result may be required to make additional payments to the SBA in the ordinary course of business. The agreement states that nothing in the agreement shall affect the rights of BLX to securitize or service its loans. Notwithstanding the foregoing, in October 2007, BLX received a notice from the SBA that outlines certain conditions to the SBA's authorization for BLX to securitize the unguaranteed portions of SBA loans.

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

**Note 3. Portfolio, continued**

BLX has a separate non-recourse warehouse facility to enable it to securitize the unguaranteed portion of its SBA loans. BLX has been receiving temporary extensions of the warehouse facility, and the current extension expires on December 31, 2007. BLX is in negotiations with the warehouse facility providers to renew and amend the facility. If the current facility were to expire without renewal, the warehouse facility notes would become due and payable, and substantially all collections on the unguaranteed interests that currently are in the warehouse facility would be applied to repay the outstanding amounts owing to the warehouse providers until the warehouse providers were paid in full, similar to an amortizing term loan. In this event, the warehouse providers would not have recourse to BLX for repayment of the warehouse facility notes. In addition, BLX would not have the right to sell additional unguaranteed interests in SBA loans into this facility. In the event that BLX is unable to meet the SBA's conditions for securitization of the unguaranteed portions of SBA loans discussed above or if the warehouse providers do not agree to an extension of the warehouse facility, BLX will be required to seek alternative sources of capital to finance SBA loan originations and could incur higher capital costs.

At September 30, 2007, BLX had a three-year \$500.0 million revolving credit facility provided by third-party lenders that matures in March 2009. The revolving credit facility may be expanded to \$600.0 million through new or additional commitments at BLX's option. This facility provides for a sub-facility for the issuance of letters of credit for up to an amount equal to 25% of the committed facility. Upon the closing of this revolving credit facility in January 2006, the Company agreed to provide an unconditional guaranty to these revolving credit facility lenders in an amount equal to 50% of the total obligations (consisting of principal, letters of credit issued under the facility, accrued interest, and other fees) of BLX under this facility. On September 27, 2007, the Company increased the guaranty amount to 60% of the total obligations in connection with an amendment to and waivers under the facility as discussed below. At September 30, 2007, the principal amount outstanding on the revolving credit facility was \$322.5 million and letters of credit issued under the facility were \$89.5 million. The total obligation guaranteed by the Company at September 30, 2007, was \$249.0 million. At September 30, 2007, the Company had also provided four standby letters of credit totaling \$19.0 million in connection with four term securitization transactions completed by BLX.

The guaranty on the BLX revolving line of credit facility can be called by the lenders in the event of a default, which includes the occurrence of certain defaults under the Company's revolving credit facility. Among other requirements, the BLX facility requires that BLX maintain compliance with certain financial covenants such as interest coverage, maximum debt to net worth, asset coverage, and maintenance of certain asset quality metrics. In addition, BLX would have an event of default if BLX failed to maintain its lending status with the SBA and such failure could reasonably be expected to result in a material adverse effect on BLX, or if BLX failed to maintain certain financing programs for the sale or long-term funding of BLX's loans. In September 2007, BLX received waivers until January 31, 2008, from its lenders with respect to non-compliance with certain facility covenants, and amended certain facility covenants through January 31, 2008. In addition, BLX previously received waivers from its lenders with respect to certain other covenants to permit BLX to comply with its obligations under its agreement with the



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

**Note 3. Portfolio, continued**

SBA. BLX's agreement with the SBA has reduced BLX's liquidity due to the working capital required to comply with the agreement. BLX is in negotiations with its lenders to amend the credit facility covenants, but there can be no assurance that such negotiations will be successful. If the credit facility lenders do not agree to amend the covenants or to waive compliance with the covenants in periods subsequent to January 31, 2008, BLX would be in default under the credit facility.

On or about January 16, 2007, BLX and its subsidiary Business Loan Center LLC (BLC) became aware of a lawsuit titled, United States, ex rel James R. Brickman and Greenlight Capital, Inc. v. Business Loan Express LLC f/k/a Business Loan Express, Inc.; Business Loan Center LLC f/k/a Business Loan Center, Inc.; Robert Tannenhauser; Matthew McGee; and George Harrigan, 05-CV-3147 (JEC), that is pending in the United States District Court for the Northern District of Georgia. The complaint includes allegations arising under the False Claims Act and relating to alleged fraud in connection with SBA guarantees on shrimp vessel loans made by BLX and BLC. On April 9, 2007, BLX, BLC and the other defendants filed motions to dismiss the complaint in its entirety. The motions are pending.

At December 31, 2006, the Company held all of BLX's Class A and Class B equity interests, and 94.9% of the Class C equity interests. At September 30, 2007, the Company held 97.1% of the Class A equity interests, all of the Class B equity interests and 94.9% of the Class C equity interests. BLX has an equity appreciation rights plan for management that may dilute the value available to the Class C equity interest holders. 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. BLX's taxable income is first allocated to the Class A equity interests to the extent that guaranteed dividends are paid in cash or in kind on such interests, with the remainder being allocated to the Class B and C equity interests.

At the time of the corporate reorganization of BLX, Inc. from a C corporation to a limited liability company in 2003, for tax purposes BLX had a built-in gain representing the aggregate fair market value of its assets in excess of the tax basis of its assets. As a RIC, the Company will be subject to special built-in gain rules on the assets of BLX. Under these rules, taxes will be payable by the Company at the time and to the extent that the built-in gains on BLX's assets at the date of reorganization are recognized in a taxable disposition of such assets in the 10-year period following the date of the reorganization. At such time, the built-in gains realized upon the disposition of these assets will be included in the Company's taxable income, net of the corporate level taxes paid by the Company on the built-in gains. At the date of BLX's reorganization, the Company estimated that its future tax liability resulting from the built-in gains may total up to a maximum of \$40 million. However, if these assets are disposed of after the 10-year period, there will be no corporate level taxes on these built-in gains. While the Company has no obligation to pay the built-in gains tax until these assets or its interests in BLX are disposed of in the future, it may be necessary to record a liability for these taxes, if any, in the future should the Company intend to sell the assets of or its interests in BLX within

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

**Note 3. Portfolio, continued**

the 10-year period. At September 30, 2007, and December 31, 2006, the Company considered the impact on the fair value of its investment in BLX due to BLX's tax attributes as an LLC and has also considered the impact on the fair value of its investment due to estimated built-in gain taxes, if any, in determining the fair value of its investment in BLX.

**Mercury Air Centers, Inc.** In April 2004, the Company completed the purchase of a majority ownership in Mercury Air Centers, Inc. (Mercury).

At December 31, 2006, the Company's investment in Mercury totaled \$84.3 million at cost and \$244.2 million at value, which included unrealized appreciation of \$159.9 million.

In August 2007, the Company completed the sale of its majority equity interest in Mercury and realized a gain of \$259.5 million, subject to post-closing adjustments. Approximately \$11 million of the Company's proceeds from the sale of its equity is subject to certain holdback provisions. In addition, the Company was repaid approximately \$51 million of subordinated debt outstanding to Mercury at closing.

Mercury owned and operated fixed base operations generally under long-term leases from local airport authorities, which consisted of terminal and hangar complexes that serviced the needs of the general aviation community. Mercury was headquartered in Richmond Heights, OH.

Total interest and related portfolio income earned from the Company's investment in Mercury for the three and nine months ended September 30, 2007 and 2006, was as follows:

	<b>For the Three Months Ended September 30,</b>		<b>For the Nine Months Ended September 30,</b>	
	<b>2007</b>	<b>2006</b>	<b>2007</b>	<b>2006</b>
<b>(\$ in millions)</b>				
Interest income	\$ 1.0	\$ 2.0	\$ 5.1	\$ 7.3
Fees and other income		0.1	0.2	0.4
<b>Total interest and related portfolio income</b>	<b>\$ 1.0</b>	<b>\$ 2.1</b>	<b>\$ 5.3</b>	<b>\$ 7.7</b>

Net change in unrealized appreciation or depreciation for the three months ended September 30, 2007, included the reversal of \$234.8 million of previously recorded unrealized appreciation associated with the realization of a gain on the sale of the Company's majority equity interest in Mercury. Net change in unrealized appreciation or depreciation for the nine months ended September 30, 2007, included an increase in unrealized appreciation totaling \$74.9 million for the first half of 2007 and the reversal of \$234.8 million associated with the sale of the Company's majority equity interest in the third quarter of 2007. Net change in unrealized appreciation or depreciation for the three and nine months ended September 30, 2006, included an increase in unrealized appreciation of \$59.8 million and \$64.1 million, respectively, related to the Company's investment in Mercury.

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

**Note 3. Portfolio, continued**

*Advantage Sales and Marketing, Inc.* In June 2004, the Company completed the purchase of a majority voting ownership in Advantage, which was subject to dilution by a management option pool. Advantage is a sales and marketing agency providing outsourced sales, merchandising, and marketing services to the consumer packaged goods industry. Advantage has offices across the United States and is headquartered in Irvine, CA.

On March 29, 2006, the Company sold its majority equity interest in Advantage. The Company was repaid its \$184 million in subordinated debt outstanding and realized a gain at closing on its equity investment sold of \$433.1 million, subject to post-closing adjustments. Subsequent to closing on this sale, the Company realized additional gains in 2006 resulting from post-closing adjustments totaling \$1.3 million. The Company's realized gain was \$434.4 million for the year ended December 31, 2006, subject to post-closing adjustments and excluding any earn-out amounts. In addition, the Company was entitled to receive additional consideration through an earn-out payment based on Advantage's 2006 audited results. The earn-out payment totaled \$3.1 million, subject to potential post-determination adjustments, and was recorded as a realized gain in the second quarter of 2007.

As consideration for the common stock sold in the transaction, the Company received a \$150 million subordinated note, with the balance of the consideration paid in cash. In addition, a portion of the Company's cash proceeds from the sale of the common stock were placed in escrow, subject to certain holdback provisions. At September 30, 2007, the amount of the escrow included in other assets in the accompanying consolidated balance sheet was approximately \$25 million.

Total interest and related portfolio income earned from the Company's investment in Advantage while the Company held a majority equity interest for the nine months ended September 30, 2006, was \$14.1 million. Net change in unrealized appreciation or depreciation for the nine months ended September 30, 2006, included the reversal of \$389.7 million of previously recorded unrealized appreciation associated with the realization of a gain on the sale of the Company's majority equity interest in Advantage in the first quarter of 2006.

In connection with the sale transaction, the Company retained an equity investment in the business valued at \$15 million at closing as a minority shareholder. During the fourth quarter of 2006, Advantage made a distribution on this minority equity investment, which reduced the Company's cost basis to zero and resulted in a realized gain of \$4.8 million.

The Company's investment in Advantage, which was composed of subordinated debt and a minority equity interest, totaled \$154.0 million at cost and \$165.0 million at value at September 30, 2007, and \$151.6 million at cost and \$162.6 million at value at December 31, 2006. This investment was included in companies 5% to 25% owned in the consolidated financial statements as the Company continues to hold a seat on Advantage's board of directors.

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

**Note 3. Portfolio, continued**

*Collateralized Loan Obligations ( CLOs ) and Collateralized Debt Obligations ( CDOs ).* At September 30, 2007, and December 31, 2006, the Company owned bonds and preferred shares/income notes in CLOs and a CDO as follows:

	2007			2006		
	Cost	Value	Yield <sup>(1)</sup>	Cost	Value	Yield <sup>(1)</sup>
<b>(\$ in millions)</b>						
<i>Bonds<sup>(2)</sup>:</i>						
Callidus Debt Partners CDO Fund I, Ltd.	\$ 28.4	\$ 28.5	14.2%	\$ 28.4	\$ 28.4	14.3%
Callidus MAPS CLO Fund I LLC	17.0	16.4	11.1%	17.0	17.2	10.8%
Total bonds	45.4	44.9	13.1%	45.4	45.6	12.9%
<i>Preferred Shares/ Income Notes<sup>(3)</sup>:</i>						
Callidus Debt Partners CLO Fund III, Ltd.	22.0	20.7	15.9%	23.3	23.0	12.8%
Callidus Debt Partners CLO Fund IV, Ltd.	12.4	10.8	15.6%	13.0	13.0	13.8%
Callidus Debt Partners CLO Fund V, Ltd.	14.0	14.6	19.1%	13.8	13.8	15.8%
Callidus MAPS CLO Fund I LLC	50.1	41.7	10.4%	51.0	47.4	17.1%
Callidus MAPS CLO Fund II, Ltd.	18.0	18.0	14.8%			
Callidus Debt Partners CLO Fund VI, Ltd.	25.7	25.7	19.8%			
Total preferred shares/ income notes	142.2	131.5	15.1%	101.1	97.2	15.5%
<b>Total</b>	<b>\$ 187.6</b>	<b>\$ 176.4</b>		<b>\$ 146.5</b>	<b>\$ 142.8</b>	

(1) The yield on these debt and equity securities is included in interest income in the accompanying consolidated statement of operations. The weighted average yield is calculated as the (a) annual stated interest on the accruing bonds or the effective interest yield on the preferred shares/income notes, divided by (b) CLO and CDO assets at value. The market yield used in the valuation of the CLO and CDO assets may be different than the interest yields shown above.

(2) These securities are included in private finance subordinated debt.

(3) These securities are included in private finance equity securities.

The initial yields on the cost basis of the CLO preferred shares and income notes are based on the estimated future cash flows from the underlying collateral assets expected to be paid to these CLO classes. As each CLO preferred share or income note ages, the estimated future cash flows are updated based on the estimated performance of the underlying collateral assets, and the respective yield on the cost basis is adjusted as necessary. As future cash flows are subject to uncertainties and contingencies that are difficult to predict and are subject to future events that may alter current assumptions, no assurance can be given that the anticipated yields to maturity will be achieved.

The bonds, preferred shares and income notes of the CLOs and CDO in which the Company has invested are junior in priority for payment of interest and principal to the more senior notes issued by the CLOs and CDO. Cash flow from the underlying collateral assets in the CLOs and CDO is generally allocated first to the senior bonds in

order of priority, then any remaining cash flow is generally distributed to the preferred shareholders and income note holders. To the extent there are defaults and unrecoverable losses on the underlying collateral assets that result in reduced cash flows, the preferred shares/income

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

**Note 3. Portfolio, continued**

notes will bear this loss first and then the subordinated bonds would bear any loss after the preferred shares/income notes.

At September 30, 2007, and December 31, 2006, the face value of the CLO and CDO bonds held by the Company were subordinate to approximately 82% to 84% and 82% to 85%, respectively, of the face value of the securities issued in these CLOs and CDO. At September 30, 2007, and December 31, 2006, the face value of the CLO preferred shares/income notes held by the Company were subordinate to approximately 86% to 94% and 86% to 92%, respectively, of the face value of the securities issued in these CLOs.

At September 30, 2007, and December 31, 2006, the underlying collateral assets of these CLO and CDO investments, consisting primarily of senior debt, were issued by 486 issuers and 465 issuers, respectively, and had balances as follows:

(\$ in millions)	2007	2006
Bonds	\$ 273.3	\$ 245.4
Syndicated loans	2,471.8	1,769.9
Cash <sup>(1)</sup>	33.1	59.5
 Total underlying collateral assets	 \$ 2,778.2	 \$ 2,074.8

<sup>(1)</sup> Includes undrawn liability amounts.

At September 30, 2007, there was one defaulted obligor that was included in the underlying collateral assets of Callidus Debt Partners CLO Fund III, Ltd., Callidus Debt Partners CLO Fund IV, Ltd. and Callidus MAPS CLO Fund I LLC. At December 31, 2006, there was one defaulted obligor in the underlying collateral assets of Callidus MAPS CLO Fund I LLC. There were no other delinquencies in the underlying collateral assets in the other CLO and CDO issuances owned by the Company. At September 30, 2007, and December 31, 2006, the total face value of defaulted obligations was \$6.4 million and \$9.6 million, respectively, or approximately 0.2% and 0.5% of the total underlying collateral assets, respectively.

**Allied Capital Senior Debt Fund, L.P.** The Company is a special limited partner in the Allied Capital Senior Debt Fund, L.P. (the Fund), a private fund that generally invests in senior, unitranche and second lien debt. The Company has committed \$31.8 million to the Fund, which is a portfolio company, of which \$19.1 million has been funded. At September 30, 2007, the Company's investment in the Fund totaled \$19.1 million at cost and \$19.5 million at value. The Fund has closed on \$125 million in equity capital commitments. As a special limited partner, the Company expects to earn an incentive allocation of 20% of the annual net income of the Fund, subject to certain performance benchmarks. The value of the Company's investment in the Fund is based on the net asset value of the Fund, which reflects the capital invested plus its allocation of the net earnings of the Fund, including the incentive allocation.

AC Corp is the investment manager to the Fund. Callidus Capital Corporation, a portfolio investment controlled by the Company, acts as special manager to the Fund. An affiliate of the Company is the general partner of the Fund, and AC Corp serves as

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

**Note 3. Portfolio, continued**

collateral manager to a warehouse financing vehicle associated with the Fund. AC Corp will earn a management fee of up to 2% of the net asset value of the Fund and will pay Callidus 25% of that management fee to compensate Callidus for its role as special manager.

In connection with the Fund's formation in June 2007, the Company sold an initial portfolio of approximately \$183 million of seasoned assets with a weighted average yield of 10.3% to a warehouse financing vehicle associated with the Fund. In the third quarter of 2007, the Company sold \$14.8 million of seasoned assets with a weighted average yield of 8.6% to the warehouse financing vehicle. The Company may sell additional loans to the Fund or the warehouse financing vehicle. In addition, during the third quarter of 2007, the Company repurchased one asset totaling \$12.0 million from the Fund, which the Company had sold to the Fund in June 2007.

**Loans and Debt Securities on Non-Accrual Status.** At September 30, 2007, and December 31, 2006, private finance loans and debt securities at value not accruing interest were as follows:

(\$ in millions)	2007	2006
<b>Loans and debt securities in workout status</b>		
Companies more than 25% owned	\$ 51.6	\$ 51.1
Companies 5% to 25% owned	13.1	4.0
Companies less than 5% owned	20.7	31.6
<b>Loans and debt securities not in workout status</b>		
Companies more than 25% owned	116.2	87.1
Companies 5% to 25% owned	16.4	7.2
Companies less than 5% owned	13.0	38.9
<b>Total</b>	<b>\$ 231.0</b>	<b>\$ 219.9</b>

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

**Note 3. Portfolio, continued**

*Industry and Geographic Compositions.* The industry and geographic compositions of the private finance portfolio at value at September 30, 2007, and December 31, 2006, were as follows:

	2007	2006
<b>Industry</b>		
Business services	37%	39%
Consumer products	24	20
Industrial products	11	9
Financial services	10	9
Retail	5	6
Consumer services	4	6
CLO/CDO <sup>(1)</sup>	4	3
Healthcare services	2	3
Energy services		2
Other	3	3
Total	100%	100%
<b>Geographic Region<sup>(2)</sup></b>		
Mid-Atlantic	36%	31%
Midwest	29	30
Southeast	19	18
West	14	17
Northeast	2	4
Total	100%	100%

<sup>(1)</sup> These funds invest in senior debt representing a variety of industries and are managed by Callidus Capital, a portfolio company of Allied Capital.

<sup>(2)</sup> The geographic region for the private finance portfolio depicts the location of the headquarters for the Company's portfolio companies. The portfolio companies may have a number of other locations in other geographic regions.

**Commercial Real Estate Finance**

At September 30, 2007, and December 31, 2006, the commercial real estate finance portfolio consisted of the following:

	2007			2006		
	Cost	Value	Yield <sup>(1)</sup>	Cost	Value	Yield <sup>(1)</sup>
<b>(\$ in millions)</b>						
Commercial mortgage loans	\$ 64.8	\$ 64.2	6.4%	\$ 72.6	\$ 71.9	7.5%
Real estate owned	15.6	22.0		15.7	19.6	



Equity interests	15.7	33.5	15.2	26.7
Total	\$ 96.1	\$ 119.7	\$ 103.5	\$ 118.2

(1) The weighted average yield on the commercial mortgage loans is computed as the (a) annual stated interest on accruing loans 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.

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

**Note 3. Portfolio, continued**

**Commercial Mortgage Loans and Equity Interests.** The commercial mortgage loan portfolio contains loans that were originated by the Company or were purchased from third-party sellers. At September 30, 2007, and December 31, 2006, approximately 87% and 96%, respectively, of the Company's commercial mortgage loan portfolio was composed of fixed rate loans and approximately 13% and 4%, respectively, was composed of adjustable rate loans. At September 30, 2007, and December 31, 2006, loans with a value of \$19.1 million and \$18.9 million, respectively, were not accruing interest. Loans greater than 120 days delinquent generally do not accrue interest.

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

The property types and the geographic composition securing the commercial mortgage loans and equity interests at value at September 30, 2007, and December 31, 2006, were as follows:

	2007	2006
<b>Property Type</b>		
Hospitality	44%	45%
Office	21	20
Retail	19	19
Recreation	14	1
Housing		13
Other	2	2
Total	100%	100%
<b>Geographic Region</b>		
Southeast	36%	36%
Mid-Atlantic	31	35
Midwest	25	21
Northeast	8	8
West		
Total	100%	100%

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

**Note 4. Debt**

At September 30, 2007, and December 31, 2006, the Company had the following debt:

	2007			2006		
	Facility Amount	Amount Drawn	Annual Interest Cost <sup>(1)</sup>	Facility Amount	Amount Drawn	Annual Interest Cost <sup>(1)</sup>
<b>(\$ in millions)</b>						
<b>Notes payable and debentures:</b>						
Privately issued unsecured notes payable	\$1,042.4	\$1,042.4	6.1%	\$1,041.4	\$1,041.4	6.1%
Publicly issued unsecured notes payable	880.0	880.0	6.7%	650.0	650.0	6.6%
Total notes payable and debentures	1,922.4	1,922.4	6.4%	1,691.4	1,691.4	6.3%
Revolving line of credit <sup>(4)</sup>	922.5		9%	922.5	207.7	6.4% <sup>(2)</sup>
Total debt	\$2,844.9	\$1,922.4	6.6% <sup>(3)</sup>	\$2,613.9	\$1,899.1	6.5% <sup>(3)</sup>

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

(2) There were no amounts drawn on the revolving line of credit at September 30, 2007. The annual interest cost at December 31, 2006, reflects the interest rate payable for borrowings under the revolving line of credit. In addition to the current interest payable, there were annual costs of commitment fees, other facility fees and amortization of debt financing costs of \$4.1 million and \$3.9 million at September 30, 2007, and December 31, 2006, respectively.

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

(4) At September 30, 2007, \$859.0 million remained unused and available on the revolving line of credit, net of amounts committed for standby letters of credit of \$63.5 million issued under the credit facility.

**Notes Payable and Debentures**

**Privately Issued Unsecured Notes Payable.** The Company has privately issued unsecured long-term notes to institutional investors. The notes have five- or seven-year maturities and have fixed rates of interest. The notes require payment of interest only semi-annually, and all principal is due upon maturity. At September 30, 2007, the notes had maturities from May 2008 to May 2013. The notes may be prepaid in whole or in part, together with an interest premium, as stipulated in the note agreements.

The Company also has privately 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 the Company's other unsecured notes. The Euro notes require annual interest payments and the Sterling notes require semi-annual interest payments until maturity. Simultaneous with issuing the notes, the Company entered into a cross currency swap with a financial institution which fixed the Company's interest and principal payments in U.S. dollars for the life of the debt.

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

**Note 4. Debt, continued**

**Publicly Issued Unsecured Notes Payable.** At September 30, 2007, the Company had outstanding publicly issued unsecured notes as follows:

(\$ in millions)	Amount	Maturity Date
6.625% Notes due 2011	\$ 400.0	July 15, 2011
6.000% Notes due 2012	250.0	April 1, 2012
6.875% Notes due 2047	230.0	April 15, 2047
Total	\$ 880.0	

The 6.625% Notes due 2011 and the 6.000% Notes due 2012 require payment of interest only semi-annually, and all principal is due upon maturity. The Company has the option to redeem these notes in whole or in part, together with a redemption premium, as stipulated in the notes.

On March 28, 2007, the Company completed the issuance of \$200.0 million of 6.875% Notes due 2047 for net proceeds of \$193.0 million. In April 2007, the Company issued additional notes, through an over-allotment option, totaling \$30.0 million for net proceeds of \$29.1 million. Net proceeds are net of underwriting discounts and estimated offering expenses.

The 6.875% Notes due 2047 require payment of interest only quarterly, and all principal is due upon maturity. The Company may redeem these notes in whole or in part at any time or from time to time on or after April 15, 2012, at par and upon the occurrence of certain tax events as stipulated in the notes.

**Scheduled Maturities.** Scheduled future maturities of notes payable at September 30, 2007, were as follows:

Year	Amount Maturing
	(\$ in millions)
2007	\$
2008	153.0
2009	269.9
2010	408.0
2011	472.5
Thereafter	619.0
Total	\$ 1,922.4

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

**Note 4. Debt, continued**

***Revolving Line of Credit***

At September 30, 2007, and December 31, 2006, the Company had an unsecured revolving line of credit with a committed amount of \$922.5 million that expires on September 30, 2008. At the Company's option, borrowings under the revolving line of credit generally bear interest at a rate equal to (i) LIBOR (for the period the Company selects) plus 1.05% or (ii) the higher of the Federal Funds rate plus 0.50% or the Bank of America, N.A. prime rate. The revolving line of credit requires the payment of an annual commitment fee equal to 0.20% of the committed amount (whether used or unused). The revolving line of credit generally requires payments of interest at the end of each LIBOR interest period, but no less frequently than quarterly, on LIBOR based loans and monthly payments of interest on other loans. All principal is due upon maturity.

The annual cost of commitment fees, other facility fees and amortization of debt financing costs was \$4.1 million and \$3.9 million at September 30, 2007, and December 31, 2006, respectively.

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

The average debt outstanding on the revolving line of credit was \$62.3 million and \$137.3 million, respectively, for the nine months ended September 30, 2007 and 2006. The maximum amount borrowed under this facility and the weighted average stated interest rate for the nine months ended September 30, 2007 and 2006, were \$225.5 million and 6.4%, respectively, and \$540.3 million and 6.3%, respectively. At September 30, 2007, the amount available under the revolving line of credit was \$859.0 million, net of amounts committed for standby letters of credit of \$63.5 million issued under the credit facility.

***Covenant Compliance***

The Company has various financial and operating covenants required by the privately issued unsecured notes payable and the revolving line of credit outstanding at September 30, 2007, and December 31, 2006. These covenants require the Company to maintain certain financial ratios, including debt to equity and interest coverage, and a minimum net worth. These credit facilities provide for customary events of default, including, but not limited to, payment defaults, breach of representations or covenants, cross-defaults, bankruptcy events, failure to pay judgments, attachment of the Company's assets, change of control and the issuance of an order of dissolution. Certain of these events of default are subject to notice and cure periods or materiality thresholds. The Company's credit facilities limit its ability to declare dividends if the Company defaults under certain provisions. As of September 30, 2007, and December 31, 2006, the Company was in compliance with these covenants.

The Company has certain financial and operating covenants that are required by the publicly issued unsecured notes payable, including that the Company will maintain a

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

**Note 4. Debt, continued**

minimum ratio of 200% of total assets to total borrowings, as required by the Investment Company Act of 1940, as amended, while these notes are outstanding. As of September 30, 2007, and December 31, 2006, the Company was in compliance with these covenants.

**Note 5. Guarantees and Commitments**

In the ordinary course of business, the Company has issued guarantees and has extended standby letters of credit through financial intermediaries on behalf of certain portfolio companies. All standby letters of credit have been issued through Bank of America, N.A. As of September 30, 2007, and December 31, 2006, the Company had issued guarantees of debt, rental obligations, and lease obligations aggregating \$263.9 million and \$202.1 million, respectively, and had extended standby letters of credit aggregating \$63.5 million and \$41.0 million, respectively. Under these arrangements, the Company would be required to make payments to third-party beneficiaries if the portfolio companies were to default on their related payment obligations. The maximum amount of potential future payments was \$327.4 million and \$243.1 million at September 30, 2007, and December 31, 2006, respectively.

As of September 30, 2007, the guarantees and standby letters of credit expired as follows:

	Total	2007	2008	2009	2010	2011	After 2011
<b>(in millions)</b>							
Guarantees	\$ 263.9	\$ 3.0	\$ 3.0	\$ 251.5	\$	\$ 4.4	\$ 2.0
Standby letters of credit <sup>(1)</sup>	63.5		63.5				
<b>Total<sup>(2)</sup></b>	<b>\$ 327.4</b>	<b>\$ 3.0</b>	<b>\$ 66.5</b>	<b>\$ 251.5</b>	<b>\$</b>	<b>\$ 4.4</b>	<b>\$ 2.0</b>

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

<sup>(2)</sup> The Company's most significant commitments relate to its investment in Business Loan Express, LLC (BLX), which commitments totaled \$271.0 million at September 30, 2007. At September 30, 2007, the principal components of these guarantees included a guarantee of 60% of the outstanding total obligations on BLX's revolving line of credit, which expires in March 2009, for a total guaranteed amount of \$249.0 million and standby letters of credit totaling \$19.0 million in connection with term securitizations completed by BLX. See Note 3.

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

At September 30, 2007, the Company had outstanding commitments to fund investments totaling \$469.0 million, including \$426.6 million related to private finance investments and \$42.4 related to commercial real estate finance investments.

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

**Note 6. Shareholders' Equity**

Sales of common stock for the nine months ended September 30, 2007 and 2006, were as follows:

<b>(in millions)</b>	<b>2007</b>	<b>2006</b>
Number of common shares	3,325	8,175
Gross proceeds	\$ 97,256	\$ 229,804
Less costs, including underwriting fees	(3,472)	(10,922)
Net proceeds	\$ 93,784	\$ 218,882

The Company issued 0.5 million shares of common stock upon the exercise of stock options during both the nine months ended September 30, 2007 and 2006. In addition, in July 2007, the Company issued 1.7 million unregistered shares of common stock upon the cancellation of stock options pursuant to a tender offer. See Note 9.

The Company has a dividend reinvestment plan, whereby the Company may buy shares of its common stock in the open market or issue new shares in order to satisfy dividend reinvestment requests. If the Company issues new shares, the issue price is equal to the average of the closing sale prices reported for the Company's common stock for the five consecutive trading days immediately prior to the dividend payment date. For the nine months ended September 30, 2007 and 2006, the Company issued new shares in order to satisfy dividend reinvestment requests. Dividend reinvestment plan activity for the nine months ended September 30, 2007 and 2006, was as follows:

<b>(in millions, except per share amounts)</b>	<b>For the Nine Months Ended September 30,</b>	
	<b>2007</b>	<b>2006</b>
Shares issued	0.4	0.4
Average price per share	\$30.05	\$29.95



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

**Note 7. Earnings Per Common Share**

Earnings per common share for the three and nine months ended September 30, 2007 and 2006, were as follows:

	<b>For the Three Months Ended September 30,</b>		<b>For the Nine Months Ended September 30,</b>	
	<b>2007</b>	<b>2006</b>	<b>2007</b>	<b>2006</b>
<b>(in millions, except per share amounts)</b>				
Net increase (decrease) in net assets resulting from operations	\$ (96.5)	\$ 77.9	\$ 125.8	\$ 211.2
Weighted average common shares outstanding basic	154.0	144.2	152.0	141.0
Dilutive options outstanding	1.3	2.9	2.7	3.0
Weighted average common shares outstanding diluted	155.3	147.1	154.7	144.0
Basic earnings (loss) per common share	\$ (0.63)	\$ 0.54	\$ 0.83	\$ 1.50
Diluted earnings (loss) per common share	\$ (0.62)	\$ 0.53	\$ 0.81	\$ 1.47

**Note 8. Employee Compensation Plans**

The Company has deferred compensation plans. Amounts deferred by participants under the deferred compensation plans are funded to a trust, which is managed by a third-party trustee. The accounts of the deferred compensation trust are consolidated with the Company's accounts. The assets of the trust are classified as other assets and the liability to the plan participants is included in other liabilities in the accompanying financial statements. The deferred compensation plan accounts at September 30, 2007, and December 31, 2006, totaled \$21.6 million and \$18.6 million, respectively.

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

The IPA is generally determined annually at the beginning of each year but may be adjusted throughout the year. The IPA is deposited in the trust in four equal installments, generally on a quarterly basis, in the form of cash. The Compensation Committee of the Board of Directors designed the DCP II to require the trustee to use the cash to purchase shares of the Company's common stock in the open market. During the nine months ended September 30, 2007 and 2006, 0.3 million and 0.2 million shares were purchased in the DCP II, respectively.

All amounts deposited and then credited to a participant's account in the trust, based on the amount of the IPA received by such participant, are credited solely for purposes of accounting and computation and remain assets of the Company and subject to the claims

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

**Note 8. Employee Compensation Plans, continued**

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

During any period of time in which a participant has an account in the DCP II, any dividends declared and paid on shares of the Company's common stock allocated to the participant's account shall be reinvested in shares of the Company's common stock.

The IPA amounts are contributed into the DCP II trust and invested in the Company's common stock. The accounts of the DCP II are consolidated with the Company's accounts. The common stock is classified as common stock held in deferred compensation trust in the accompanying financial statements and the deferred compensation obligation, which represents the amount owed to the employees, is included in other liabilities. Changes in the value of the Company's common stock held in the deferred compensation trust are not recognized. However, the liability is marked to market with a corresponding charge or credit to employee compensation expense. At September 30, 2007, and December 31, 2006, common stock held in DCP II was \$37.1 million and \$28.3 million, respectively, and the IPA liability was \$38.9 million and \$33.9 million, respectively. At September 30, 2007, and December 31, 2006, the DCP II held 1.3 million shares and 1.0 million shares, respectively, of the Company's common stock.

The IPA expense for the three and nine months ended September 30, 2007 and 2006, was as follows:

	<b>For the Three Months Ended September 30,</b>		<b>For the Nine Months Ended September 30,</b>	
	<b>2007</b>	<b>2006</b>	<b>2007</b>	<b>2006</b>
<b>(\$ in millions)</b>				
IPA contributions	\$ 2.4	\$ 2.1	\$ 7.4	\$ 6.0
IPA mark to market expense (benefit)	(2.0)	1.2	(3.6)	0.6
<b>Total IPA expense (benefit)</b>	<b>\$ 0.4</b>	<b>\$ 3.3</b>	<b>\$ 3.8</b>	<b>\$ 6.6</b>

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

**Note 8. Employee Compensation Plans, continued**

The Company also has an individual performance bonus ( IPB ), which is distributed in cash to award recipients throughout the year (beginning in February of each year) as long as the recipient remains employed by the Company. If a recipient terminates employment during the year, any remaining cash payments under the IPB would be forfeited. For the three months ended September 30, 2007 and 2006, the IPB expense was \$2.6 million and \$2.3 million, respectively. For the nine months ended September 30, 2007 and 2006, the IPB expense was \$7.1 million and \$5.9 million, respectively. The IPA and IPB expenses are included in employee expenses.

**Note 9. Stock Option Plan**

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

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

At December 31, 2006, there were 32.2 million shares authorized under the Option Plan. On May 15, 2007, the Company's stockholders voted to increase the number of shares of common stock authorized for issuance to 37.2 million shares.

On July 18, 2007, the Company completed a tender offer related to the Company's offer to all optionees who held vested in-the-money stock options as of June 20, 2007, the opportunity to receive an option cancellation payment ( OCP ) equal to the in-the-money value of the stock options cancelled, determined using the Weighted Average Market Price of \$31.75, which would be paid one-half in cash and one-half in unregistered shares of the Company's common stock. The Company accepted for cancellation 10.3 million vested options, which in the aggregate had a weighted average exercise price of \$21.50. This resulted in a total option cancellation payment of approximately \$105.6 million, of which \$52.8 million was paid in cash and \$52.8 million was paid through the issuance of 1.7 million unregistered shares of the Company's common stock, determined using the Weighted Average Market Price of \$31.75. The Weighted Average Market Price represented the volume weighted average price of the Company's common stock over the fifteen trading days preceding the first day of the offer period, or June 20, 2007. See Note 2 Stock Compensation Plans.

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

**Note 9. Stock Option Plan, continued**

At September 30, 2007, (subsequent to the completion of the tender offer) and December 31, 2006, the number of shares available to be granted under the Option Plan was 10.7 million and 1.6 million, respectively.

Information with respect to options granted, exercised, cancelled in tender offer and forfeited under the Option Plan for the nine months ended September 30, 2007, was as follows:

	Shares	Weighted Average Exercise Price Per Share	Weighted Average Contractual Remaining Term (Years)	Aggregate Intrinsic Value at September 30, 2007 <sup>(1)</sup>
<b>(in millions, except per share amounts)</b>				
Options outstanding at January 1, 2007	23.2	\$24.92		
Granted	6.6	\$29.52		
Exercised	(0.5)	\$25.19		
Cancelled in tender offer <sup>(2)</sup>	(10.3)	\$21.50		
Forfeited	(0.5)	\$28.94		
Options outstanding at September 30, 2007	18.5	\$28.36	6.82	\$21.2
Exercisable at September 30, 2007 <sup>(3)</sup>	11.8	\$27.99	6.78	\$17.5
Exercisable and expected to be exercisable at September 30, 2007 <sup>(4)</sup>	18.0	\$28.34	6.82	\$20.9

(1) Represents the difference between the market value of the options at September 30, 2007, and the cost for the option holders to exercise the options.

(2) See description of the tender offer above.

(3) Represents vested options.

(4) The amount of options expected to be exercisable at September 30, 2007, is calculated based on an estimate of expected forfeitures.

During the nine months ended September 30, 2006, 1.8 million options were granted, 0.5 million options were exercised and 0.3 million options were forfeited.

The fair value of the shares vested during the nine months ended September 30, 2007 and 2006, was \$21.6 million and \$16.1 million, respectively. The total intrinsic value of the options exercised during the nine months ended September 30, 2007 and 2006, was \$2.6 million and \$3.4 million, respectively.

**Note 10. Dividends and Distributions and Taxes**

The Company's Board of Directors declared and the Company paid a dividend of \$0.63, \$0.64 and \$0.65 per common share for the first, second and third quarters of 2007,

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

**Note 10. Dividends and Distributions and Taxes, continued**

respectively, and \$0.59, \$0.60 and \$0.61 per common share for the first, second and third quarters of 2006, respectively. These dividends totaled \$293.7 million and \$255.4 million for the nine months ended September 30, 2007 and 2006, respectively. The Company declared an extra cash dividend of \$0.05 per share during 2006 and this was paid to shareholders on January 19, 2007. The Company declared an extra cash dividend of \$0.03 per share during 2005, which was paid to shareholders on January 27, 2006.

The Company's Board of Directors declared a dividend of \$0.65 per common share for the fourth quarter of 2007, and an extra cash dividend of \$0.07 per share.

At December 31, 2006, the Company had excess taxable income of \$402.8 million available for distribution to shareholders in 2007. Excess taxable income for 2006 represents \$126.7 million of ordinary income and \$276.1 million of net long-term capital gains.

Dividends paid in 2007 will first be paid out of the excess taxable income carried over from 2006. For the first, second and third quarters of 2007, the Company paid dividends of \$293.7 million. The remainder of 2006 excess taxable income to be distributed during the fourth quarter of 2007 is \$109.1 million. In accordance with regulated investment company distribution rules, the Company was required to declare current year dividends to be paid from carried over excess taxable income from 2006 before the Company filed its 2006 tax return in September 2007, and the Company must pay such dividends by December 31, 2007. To comply with these rules, on July 27, 2007, the Company's Board of Directors declared a \$0.65 per share dividend for both the third and fourth quarters of 2007. The Company's Board of Directors also declared an extra dividend of \$0.07 per share on September 14, 2007. The third quarter dividend was paid on September 26, 2007, and the fourth quarter dividend will be paid on December 26, 2007. The extra dividend will be paid on December 27, 2007. The Company expects that substantially all of the 2007 dividend payments will be made from excess 2006 taxable earnings.

Given that substantially all of the 2007 dividend payments will be made from excess taxable income carried over from 2006, the Company currently expects to carry over substantially all of its estimated annual taxable income for 2007 for distribution to shareholders in 2008. The Company will generally be required to pay a nondeductible excise tax equal to 4% of the amount by which 98% of the Company's annual taxable income exceeds the distributions from such taxable income during the year. The Company accrues an excise tax on the estimated excess taxable income earned for the respective periods. For the three and nine months ended September 30, 2007, the Company recorded an excise tax of \$9.0 million and \$16.6 million, respectively. For the three and nine months ended September 30, 2006, the Company recorded an excise tax of \$2.5 million and \$14.1 million, respectively.

In addition to excess taxable income carried forward, the Company has cumulative deferred taxable income related to installment sale gains of \$221.9 million as of December 31, 2006. These gains have been recognized for financial reporting purposes in the respective years they were realized, but are generally deferred for tax purposes until the

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

**Note 10. Dividends and Distributions and Taxes, continued**

notes or other amounts received from the sale of the related investments are collected in cash.

The Company's consolidated subsidiary, AC Corp, is subject to federal and state income taxes. For the three months ended September 30, 2007 and 2006, the income tax expense was \$2.2 million and the income tax benefit was \$0.6 million, respectively, and for the nine months ended September 30, 2007 and 2006, the income tax benefit was \$0.5 million and the income tax expense was \$0.2 million, respectively.

**Note 11. Supplemental Disclosure of Cash Flow Information**

The Company paid interest of \$81.2 million and \$50.1 million, respectively, for the nine months ended September 30, 2007 and 2006.

Non-cash operating activities for the nine months ended September 30, 2007 and 2006, totaled \$58.4 million and \$308.1 million, respectively. Non-cash operating activities for the nine months ended September 30, 2006, included a note received as consideration from the sale of the Company's equity investment in Advantage of \$150.0 million and a note received as consideration from the sale of the Company's equity investment in STS Operating, Inc. of \$30.0 million.

Non-cash financing activities included the issuance of common stock in lieu of cash distributions totaling \$12.4 million and \$11.1 million, for the nine months ended September 30, 2007 and 2006, respectively. Non-cash financing activities for the nine months ended September 30, 2007, also included the payment of one-half of the value of the option cancellation payment in connection with the tender offer, or \$52.8 million, through the issuance of 1.7 million unregistered shares of the Company's common stock. See Notes 2 and 9.

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

**Note 12. Financial Highlights**

	At and for the Nine Months Ended September 30,		At and for the Year Ended December 31,
	2007 <sup>(1)</sup>	2006	2006
	(unaudited)		
<b>Per Common Share Data</b>			
Net asset value, beginning of period	\$ 19.12	\$ 19.17	\$ 19.17
Net investment income <sup>(2)</sup>	0.54	0.97	1.30
Net realized gains <sup>(2)(3)</sup>	2.03	3.77	3.66
Net investment income plus net realized gains <sup>(2)</sup>	2.57	4.74	4.96
Net change in unrealized appreciation or depreciation <sup>(2)(3)</sup>	(1.76)	(3.27)	(3.28)
Net increase in net assets resulting from operations <sup>(2)</sup>	0.81	1.47	1.68
Decrease in net assets from shareholder distributions	(1.92)	(1.80)	(2.47)
Net increase in net assets from capital share transactions <sup>(2)(4)</sup>	0.23	0.54	0.74
Decrease in net assets from the cash portion of the option cancellation payment <sup>(2)(5)</sup>	(0.34)		
Net asset value, end of period	\$ 17.90	\$ 19.38	\$ 19.12
Market value, end of period	\$ 29.39	\$ 30.21	\$ 32.68
Total return <sup>(6)</sup>	(4.2)%	9.2%	20.6%
<b>Ratios and Supplemental Data</b>			
(\$ and shares in thousands, except per share amounts)			
Ending net assets	\$ 2,765.8	\$ 2,823.9	\$ 2,841.2
Common shares outstanding at end of period	154.5	145.7	148.6
Diluted weighted average common shares outstanding	154.7	144.0	145.6
Employee, employee stock option and administrative expenses/average net assets <sup>(7)</sup>	5.06%	3.99%	5.38%
Total operating expenses/average net assets <sup>(7)</sup>	8.46%	6.65%	9.05%
Net investment income/average net assets <sup>(7)</sup>	2.87%	5.16%	6.90%
Net increase in net assets resulting from operations/average net assets <sup>(7)</sup>	4.35%	7.78%	8.94%
Portfolio turnover rate <sup>(7)</sup>	24.43%	23.61%	27.05%
Average debt outstanding	\$ 1,909.5	\$ 1,433.5	\$ 1,491.0
Average debt per share <sup>(2)</sup>	\$ 12.34	\$ 9.95	\$ 10.24

(1)

The results for the nine months ended September 30, 2007, are not necessarily indicative of the operating results to be expected for the full year.

- (2) Based on diluted weighted average number of common shares outstanding for the period.
- (3) Net realized gains and net change in unrealized appreciation or depreciation can fluctuate significantly from period to period. As a result, quarterly comparisons may not be meaningful.
- (4) Excludes capital share transactions related to the cash portion of the option cancellation payment.
- (5) See Notes 2 and 9 to the consolidated financial statements above for further discussion.
- (6) Total return assumes the reinvestment of all dividends paid for the periods presented.
- (7) The ratios for the nine months ended September 30, 2007 and 2006, do not represent annualized results.

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

**Note 13. Litigation**

On June 23, 2004, the Company was notified by the SEC that the SEC was conducting an informal investigation of the Company. The investigation related to the valuation of securities in the Company's private finance portfolio and other matters. On June 20, 2007, the Company announced that it entered into a settlement with the SEC that resolved the SEC's informal investigation. As part of the settlement and without admitting or denying the SEC's allegations, the Company agreed to the entry of an administrative order. In the order the SEC alleged that, between June 30, 2001, and March 31, 2003, the Company did not maintain books, records and accounts which, in reasonable detail, supported or accurately and fairly reflected valuations of certain securities in the Company's private finance portfolio and, as a result, did not meet certain recordkeeping and internal controls provisions of the federal securities laws. In the administrative order, the SEC ordered the Company to continue to maintain certain of its current valuation-related controls. Specifically, for a period of two years, the Company has undertaken to: (1) continue to employ a Chief Valuation Officer, or a similarly structured officer-level employee, to oversee its quarterly valuation processes; and (2) continue to employ third-party valuation consultants to assist in its quarterly valuation processes.

On December 22, 2004, the Company received letters from the U.S. Attorney for the District of Columbia requesting the preservation and production of information regarding the Company and Business Loan Express, LLC in connection with a criminal investigation relating to matters similar to those investigated by and settled with the SEC as discussed above. The Company produced materials in response to the requests from the U.S. Attorney's office and certain current and former employees were interviewed by the U.S. Attorney's Office. The Company has voluntarily cooperated with the investigation.

In late December 2006, the Company received a subpoena from the U.S. Attorney for the District of Columbia requesting, among other things, the production of records regarding the use of private investigators by the Company or its agents. The Board established a committee, which was advised by its own counsel, to review this matter. In the course of gathering documents responsive to the subpoena, the Company became aware that an agent of the Company obtained what were represented to be telephone records of David Einhorn and which purport to be records of calls from Greenlight Capital during a period of time in 2005. Also, while the Company was gathering documents responsive to the subpoena, allegations were made that the Company's management had authorized the acquisition of these records and that management was subsequently advised that these records had been obtained. The Company's management has stated that these allegations are not true. The Company is cooperating fully with the inquiry by the U.S. Attorney's Office.

On February 13, 2007, Rena Nadoff filed a shareholder derivative action in the Superior Court of the District of Columbia, captioned Rena Nadoff v. Walton, et al., CA 001060-07, seeking unspecified compensatory and other damages, as well as equitable relief on behalf of Allied Capital Corporation. The complaint was summarily dismissed in July 2007. The complaint alleged breach of fiduciary duty by the Board of Directors arising from internal control failures and mismanagement of Business Loan Express, LLC, an Allied Capital portfolio company. On October 5, 2007, Rena Nadoff sent a letter to the

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

**Note 13. Litigation, continued**

Company's Board of Directors with substantially the same claims and a request that the Board of Directors investigate the claims and take appropriate action. The Board of Directors has established a committee, which is advised by its own counsel, to review the matter.

On February 26, 2007, Dana Ross filed a class action complaint in the U.S. District Court for the District of Columbia in which she alleges that Allied Capital Corporation and certain members of management violated Sections 10(b) and 20(a) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder. Thereafter, the court appointed new lead counsel and approved new lead plaintiffs. On July 30, 2007, plaintiffs served an amended complaint. Plaintiffs claim that, between November 7, 2005, and January 22, 2007, Allied Capital either failed to disclose or misrepresented information about its portfolio company, Business Loan Express, LLC. Plaintiffs seek unspecified compensatory and other damages, as well as other relief. The Company believes the lawsuit is without merit, and intends to defend the lawsuit vigorously. On September 13, 2007, the Company filed a motion to dismiss the lawsuit. The motion is pending.

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

While the outcome of any of the open legal proceedings described above cannot at this time be predicted with certainty, the Company does not expect these matters will materially affect its financial condition or results of operations.

**Report of Independent Registered Public Accounting Firm**

The Board of Directors and Shareholders

Allied Capital Corporation:

We have reviewed the accompanying consolidated balance sheet of Allied Capital Corporation and subsidiaries, including the consolidated statement of investments, as of September 30, 2007, the related consolidated statements of operations, for the three- and nine-month periods ended September 30, 2007 and 2006, and the consolidated statements of changes in net assets and cash flows and the financial highlights (included in Note 12) for the nine-month periods ended September 30, 2007 and 2006. These consolidated financial statements and financial highlights are the responsibility of the Company's management.

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

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

We have previously audited, in accordance with standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheet of Allied Capital Corporation and subsidiaries, including the consolidated statement of investments, as of December 31, 2006, and the related consolidated statements of operations, changes in net assets and cash flows (not presented herein), and the financial highlights, for the year then ended; and in our report dated February 28, 2007, we expressed an unqualified opinion on those consolidated financial statements. In our opinion, the information set forth in the accompanying condensed consolidated balance sheet including the consolidated statement of investments as of December 31, 2006, is fairly stated, in all material respects, in relation to the consolidated balance sheet from which it has been derived.

Washington, D.C.

November 7, 2007

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

PRIVATE FINANCE Portfolio Company (in thousands)	Investment <sup>(1)</sup>	Amount of Interest or Dividends		December 31, 2006	Gross	Gross	September 30, 2007
		Credited to Income <sup>(6)</sup>	Other <sup>(2)</sup>	Value	Additions <sup>(3)</sup>	Reductions <sup>(4)</sup>	Value

**Companies More Than 25% Owned**

Alaris Consulting, LLC (Business Services)	Senior Loan <sup>(5)</sup>			\$	\$ 572	\$ (572)	\$
	Equity Interests				1,025	(1,025)	
AllBridge Financial, LLC (Financial Services)	Equity Interests				2,300		2,300
Allied Capital Senior Debt Fund, L.P. (Private Debt Fund)	Equity Interests				19,535		19,535
Avborne, Inc. (Business Services)	Preferred Stock			918		(68)	850
	Common Stock						
Avborne Heavy Maintenance, Inc. (Business Services)	Preferred Stock				973		973
	Common Stock						
Aviation Properties Corporation (Business Services)	Common Stock				65	(65)	

Border Foods, Inc. (Consumer Products)	Preferred Stock			2,473		2,473
	Common Stock					
Business Loan Express, LLC (Financial Services)	Class A Equity					
	Interests <sup>(5)</sup>		66,622	29,200		95,822
	Class B Equity Interests		79,139		(38,251)	40,888
	Class C Equity Interests		64,976		(64,976)	
Calder Capital Partners, LLC (Financial Services)	Senior Loan <sup>(5)</sup>	\$ 33	975	1,326	(83)	2,218
	Equity Interests		2,076	159	(1,888)	347
Callidus Capital Corporation (Financial Services)	Senior Loan	\$ 42		2,100	(2,100)	
	Subordinated Debt	850	5,762	813		6,575
	Common Stock		22,550	20,090		42,640
Coverall North America, Inc. (Business Services)	Unitranche Debt	3,240	36,333	27	(1,446)	34,914
	Subordinated Debt	687	5,972	5		5,977
	Common Stock		19,619	3,399		23,018
CR Holding, Inc. (Consumer Products)	Subordinated Debt	5,092	39,401	1,051		40,452
	Common Stock		25,738	15,296		41,034
Direct Capital Corporation (Financial Services)	Subordinated Debt	3,451		37,515		37,515
	Common Stock			19,250	(12,327)	6,923
Financial Pacific Company (Financial Services)	Subordinated Debt	9,473	71,362	1,113		72,475
	Preferred Stock		15,942	2,512		18,454
	Common Stock		65,186		(18,164)	47,022
	Equity Interest	1,269	12,290		(11,409)	881

ForeSite Towers, LLC (Tower Leasing)						
Global Communications, LLC (Business Services)						
	Senior Loan <sup>(5)</sup>		15,957		(8,381)	7,576
	Subordinated Debt <sup>(5)</sup>		11,237		(11,237)	
	Preferred Equity Interest Options					
Gordian Group, Inc. (Business Services)						
	Senior Loan <sup>(5)</sup>	(11)		9,169	(9,169)	
	Common Stock					
Healthy Pet Corp. (Consumer Services)						
	Senior Loan	1,309	27,038	6,350	(33,388)	
	Subordinated Debt	2,893	43,579	580	(44,159)	
	Common Stock		28,921	1,221	(30,142)	
HMT, Inc. (Energy Services)						
	Preferred Stock		2,637		(2,637)	
	Common Stock Warrants		8,664 3,336		(8,664) (3,336)	
Hot Stuff Foods, LLC <sup>(7)</sup> (Consumer Products)						
	Senior Loan	3,106		49,681	(330)	49,351
	Subordinated Debt	5,601		61,302	(19,111)	42,191
	Subordinated Debt <sup>(5)</sup>			8,461	(8,461)	
	Common Stock					
Huddle House, Inc. (Retail)						
	Senior Loan	426	19,950		(19,950)	
	Subordinated Debt	6,731	58,196	1,131	(178)	59,149
	Common Stock		41,662	2,729	(129)	44,262

See related footnotes at the end of this schedule.

PRIVATE FINANCE Portfolio Company (in thousands)	Investment <sup>(1)</sup>	Amount of Interest or Dividends		December 31, 2006 Value	Gross Additions <sup>(3)</sup>	Gross Reductions <sup>(4)</sup>	September 30, 2007 Value
		Credited to Income <sup>(6)</sup>	Other <sup>(2)</sup>				
Impact Innovations Group, LLC (Business Services)	Equity Interests in Affiliate			\$ 873		(553)	320
Insight Pharmaceuticals Corporation (Consumer Products)	Subordinated Debt	\$ 4,406		43,884	\$ 920	\$	\$ 44,804
	Subordinated Debt <sup>(5)</sup>			15,966	660		16,626
	Preferred Stock			7,845		(6,000)	1,845
	Common Stock						
Jakel, Inc. (Industrial Products)	Subordinated Debt <sup>(5)</sup>	1		6,655	9,037	(14,117)	1,575
	Preferred Stock				9,347	(9,347)	
	Common Stock				6,460	(6,460)	
Legacy Partners Group, Inc. (Financial Services)	Senior Loan <sup>(5)</sup>			4,843	2,804	(3,804)	3,843
	Subordinated Debt				2,952	(2,952)	
	Equity Interests				1,271		1,271
Litterer Beteiligungs-GmbH (Business Services)	Subordinated Debt	32		692	56		748
	Equity Interest			1,199	386		1,585
Mercury Air Centers, Inc. (Business Services)	Subordinated Debt	5,054		49,217	1,654	(50,871)	
	Common Stock			195,019		(195,019)	
MVL Group, Inc. (Business Services)	Senior Loan	2,743		27,245	3,388		30,633
	Subordinated Debt	4,408		35,478	4,173		39,651

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	Common Stock			4,961		4,961
Old Orchard Brands, LLC (Consumer Products)	Senior Loan	347		23,500	(23,500)	
	Subordinated Debt	1,498		19,342		19,342
	Equity Interests			19,602		19,602
Penn Detroit Diesel Allison, LLC (Business Services)	Subordinated Debt	4,525	37,994	886		38,880
	Equity Interests		25,949	2,846		28,795
Powell Plant Farms, Inc. (Consumer Products)	Senior Loan <sup>(5)</sup>		26,192	3,950	(28,792)	1,350
	Subordinated Debt <sup>(5)</sup>		962	18,261	(19,223)	
	Preferred Stock Warrants					
Service Champ, Inc. (Business Services)	Subordinated Debt	3,317	27,619	546		28,165
	Common Stock		16,786	9,569		26,355
Staffing Partners Holding Company, Inc. (Business Services)	Subordinated Debt <sup>(5)</sup>		486	58		544
Startec Global Communications Corporation (Telecommunications)	Senior Loan	723	15,965		(15,965)	
	Common Stock		11,232	26,023	(37,255)	
Startec Equity, LLC (Telecommunications)	Equity Interests			440		440
Sweet Traditions, Inc. (Retail)	Senior Loan <sup>(5)</sup>	1,088	35,172	1,501		36,673
	Preferred Stock		400	550	(950)	
	Common Stock		50		(50)	
	Senior Loan	966	14,747	11	(14,325)	433



Triview Investments, Inc. (Broadcasting & Cable/ Business Services/ Consumer Products)	Subordinated Debt	9,934	56,008	32,009	(45,427)	42,590
	Subordinated Debt <sup>(5)</sup>	592	4,342	792	(3,600)	1,534
	Common Stock	37	31,322	53,458	(2,003)	82,777
Worldwide Express Operations, LLC (Business Services)	Subordinated Debt	65		2,800	(176)	2,624
	Equity Interests			12,900		12,900
	Warrants			163		163
<b>Total companies more than 25% owned</b>		<b>\$83,895</b>	<b>\$1,490,180</b>			<b>\$1,236,844</b>
<b>Companies 5% to 25% Owned</b>						
Advantage Sales & Marketing, Inc. (Business Services)	Subordinated Debt	\$14,002	\$ 151,648	\$ 2,393	\$	\$ 154,041
	Equity Interests		11,000			11,000
Air Medical Group Holdings LLC (Healthcare Services)	Senior Loan	167	1,763	5,233	(5,130)	1,866
	Subordinated Debt	1,931	35,128	318	(35,446)	
	Equity Interests		5,950	4,850		10,800
Alpine ESP Holdings, Inc. (Business Services)	Preferred Stock		602	117		719
	Common Stock			300		300
Amerex Group, LLC (Consumer Products)	Subordinated Debt	764	8,400			8,400
	Equity Interests		13,823	1,872	(38)	15,657

See related footnotes at the end of this schedule.

PRIVATE FINANCE Portfolio Company	Investment <sup>(1)</sup>	Amount of Interest or Dividends		December 31,	Gross	Gross	September 30,
		Credited to Income <sup>(6)</sup>	Other <sup>(2)</sup>	2006			2007
(in thousands)				Value	Additions <sup>(3)</sup>	Reductions <sup>(4)</sup>	Value
BB&T Capital Partners/Windsor Mezzanine Fund, LLC (Private Equity Fund)	Equity Interests			\$ 5,554	\$ 53	\$	\$ 5,607
Becker Underwood, Inc. (Industrial Products)	Subordinated Debt Common Stock	\$ 2,711		24,163	473		24,636
				3,700	500		4,200
BI Incorporated  (Business Services)	Subordinated Debt Common Stock	3,137		30,135	360		30,495
				4,100	3,300		7,400
CitiPostal, Inc. and Affiliates (Business Services)	Senior Loan Equity Interests	1,754		20,569	2,326	(780)	22,115
				4,700	2,287	(87)	6,900
Creative Group, Inc. (Business Services)	Subordinated Debt <sup>(5)</sup> Warrant	480		13,656	30	(4,427)	9,259
				1,387		(1,387)	
Drew Foam Companies, Inc. (Business Services)	Preferred Stock Common Stock			722		(326)	396
				7		(7)	
MedBridge Healthcare, LLC (Healthcare Services)	Senior Loan <sup>(5)</sup> Subordinated Debt <sup>(5)</sup> Convertible			7,164			7,164
				1,813		(90)	1,723

	Subordinated Debt <sup>(5)</sup>			110	(110)	
	Equity Interests					
MHF Logistical Solutions, Inc <sup>(8)</sup> (Business Services)	Subordinated Debt <sup>(5)</sup>			27,518	(16,933)	10,585
	Subordinated Debt <sup>(5)</sup>					
	Common Stock Warrants					
Multi-Ad Services, Inc. (Business Services)	Unitranche Debt	1,716	19,879	19	(150)	19,748
	Equity Interests		2,000		(1,058)	942
Nexcel Synthetics, LLC (Consumer Products)	Subordinated Debt	611	10,978	199	(11,177)	
	Equity Interests		1,486	269	(1,755)	
PresAir LLC (Industrial Products)	Senior Loan <sup>(5)</sup>	\$ 27	2,206		(1,406)	800
	Equity Interests			5	(5)	
Progressive International Corporation (Consumer Products)	Subordinated Debt	842	7,533	121	(3,684)	3,970
	Preferred Stock		1,024		(7)	1,017
	Common Stock Warrants		2,300	2,800		5,100
Regency Healthcare Group, LLC (Healthcare Services)	Senior Loan	88	1,232	2	(750)	484
	Unitranche Debt	1,448	19,908	45	(8,000)	11,953
	Equity Interests		1,616	69		1,685
SGT India Private Limited (Business Services)	Common Stock		3,346	155	(876)	2,625
Soteria Imaging Services, LLC	Subordinated Debt	1,645	17,569	1,133	(5,000)	13,702

(Healthcare Services)	Equity Interests		2,541	100		2,641
Universal Environmental Services, LLC	Unitranche Debt	815	10,211	777	(10,988)	
(Business Services)	Equity Interests			15	(15)	
<b>Total companies 5% to 25% owned</b>		<b>\$32,111</b>	<b>\$449,813</b>			<b>\$397,930</b>

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

- (1) Common stock, preferred stock, warrants, options, and equity interests are generally non-income producing and restricted. The principal amount for loans and debt securities and the number of shares of common stock and preferred stock is shown in the consolidated statement of investments as of September 30, 2007.
- (2) Other includes interest, dividend, or other income which was applied to the principal of the investment and therefore reduced the total investment. These reductions are also included in the Gross Reductions for the investment, as applicable.
- (3) Gross additions include increases in the cost basis of investments resulting from new portfolio investments, paid-in-kind interest or dividends, the amortization of discounts and closing fees, the exchange of one or more existing securities for one or more new securities and the movement of an existing portfolio company into this category from a different category. Gross additions also include net increases in unrealized appreciation or net decreases in unrealized depreciation.
- (4) Gross reductions include decreases in the cost basis of investments resulting from principal collections related to investment repayments or sales, the exchange of one or more existing securities for one or more new securities and the movement of an existing portfolio company out of this category into a different category. Gross reductions also include net increases in unrealized depreciation or net decreases in unrealized appreciation.
- (5) Loan or debt security is on non-accrual status at September 30, 2007, and is therefore considered non-income producing. Loans or debt securities on non-accrual status at the end of the period may or may not have been on non-accrual status for the full period.
- (6) Represents the total amount of interest or dividends credited to income for the portion of the year an investment was included in the companies more than 25% owned or companies 5% to 25% owned categories, respectively.
- (7) In the first quarter of 2007, the Company exercised its option to acquire a majority of the voting securities of Hot Stuff Foods, LLC (Hot Stuff) at fair market value. Therefore, Hot Stuff was reclassified to companies more than 25% owned in the first quarter of 2007. At December 31, 2006, the Company's investment in Hot Stuff was included in the companies less than 5% owned category.
- (8) In the second quarter of 2007, the Company obtained a seat on the board of directors of MHF Logistical Solutions, Inc. (MHF). Therefore, MHF was reclassified to companies 5% to 25% owned in the second quarter of 2007. At

December 31, 2006, the Company's investment in MHF was included in the companies less than 5% owned category.

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**NOTICE REGARDING INDEPENDENT PUBLIC ACCOUNTANTS  
REVIEW REPORT**

With respect to the unaudited interim financial information as of September 30, 2007, and for the three-month and nine-month periods ended September 30, 2007 and 2006, included herein, KPMG LLP has reported that they applied limited procedures in accordance with professional standards for a review of such information. However, their separate report included herein states that they did not audit and they do not express an opinion on that interim financial information. Accordingly, the degree of reliance on their report on such information should be restricted in light of the limited nature of the review procedures applied. The accountants are not subject to the liability provisions of Section 11 of the Securities Act of 1933 for their report on the unaudited interim financial information because that report is not a report or a part of the registration statement prepared or certified by the accountants within the meaning of Sections 7 and 11 of the Securities Act of 1933.

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PROSPECTUS

50,000,000 Shares

**Common Stock**

We may offer, from time to time, up to 50,000,000 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.

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

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

Please read this prospectus and the accompanying prospectus supplement, if any, 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 with the Securities and Exchange Commission. This information is available free of charge by contacting us at 1919 Pennsylvania Avenue, N.W., Washington, DC, 20006 or by telephone at (202) 721-6100 or on our website at [www.alliedcapital.com](http://www.alliedcapital.com). The SEC also maintains a website at [www.sec.gov](http://www.sec.gov) that contains such information.

Our common stock is traded on the New York Stock Exchange under the symbol ALD. As of August 17, 2007, the last reported sale price on the New York Stock Exchange for the common stock was \$29.58.

**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 representation 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.**

August 23, 2007

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

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## ABOUT THIS PROSPECTUS

This prospectus is part of a registration statement that we have filed with the Securities and Exchange Commission using the shelf registration process. Under the shelf registration process, which constitutes a delayed offering in reliance on Rule 415 under the Securities Act of 1933, as amended, we may offer, from time to time, up to 50,000,000



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. A prospectus supplement may also add, update or change information contained in this prospectus. Please carefully read this prospectus and any such supplements together with the additional information described under **Where You Can Find Additional Information** in the **Prospectus Summary** and **Risk Factors** sections before you make an investment decision.

A prospectus supplement may also add to, update or change information contained in this prospectus.

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## PROSPECTUS SUMMARY

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

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

### **BUSINESS** (Page 83)

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

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

We primarily invest in the American entrepreneurial economy. At June 30, 2007, our private finance portfolio included investments in 143 companies that generate aggregate annual revenues of over \$12 billion and employ more than 85,000 people.

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

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

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

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

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

We provide managerial assistance to our portfolio companies, including, but not limited to, management and consulting services related to corporate finance, marketing, human resources, personnel and board member recruiting, business operations, corporate governance, risk management and other general business matters.

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. Assuming that we qualify as a regulated investment company, we generally will not be subject to corporate level income taxation on income we timely distribute to our stockholders as dividends. See Tax Status. We pay regular quarterly dividends based upon an estimate of annual taxable income available for distribution to shareholders and the amount of taxable income carried over from the prior year for distribution in the current year. Since 1963, our portfolio has provided sufficient ordinary taxable income and realized net capital gains to sustain or grow our dividends over time.

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

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

Our executive offices are located at 1919 Pennsylvania Avenue, N.W., Washington, DC, 20006-3434 and our telephone number is (202) 721-6100. In addition, we have regional offices in New York, Chicago, and Los Angeles.

Our Internet website address is [www.alliedcapital.com](http://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 109)**

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

Pursuant to the requirements of the 1940 Act, we value substantially all of our portfolio investments at fair value as determined in good faith by the Board of Directors on

a quarterly basis. Since there is typically no readily available market value for the investments in our portfolio, our Board of Directors determines in good faith the fair value of these portfolio investments pursuant to our valuation policy and consistently applied valuation process.

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

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

#### **PLAN OF DISTRIBUTION** *(Page 168)*

We may offer, from time to time, up to 50,000,000 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 20)*

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.

Any supplement to this prospectus relating to any offering of common stock will more fully identify the use of the proceeds from such offering.

**PRICE RANGE OF COMMON STOCK AND DISTRIBUTIONS** *(Page 21)*

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 157)*

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 shares of our common stock involves a number of significant risks relating to our business and our investment objective that you should consider before purchasing shares of our 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 could be significantly less than the current value of such investments. We may be required to liquidate some or all of our portfolio investments to meet our debt service obligations or in the event we are required to fulfill our obligations under agreements pursuant to which we guarantee the repayment of indebtedness by third parties.

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

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

We may not borrow money unless we maintain asset coverage for indebtedness of at least 200%, which may affect returns to shareholders. We borrow funds to make

investments. As a result, we are exposed to the risks of leverage, which may be considered a speculative investment technique. Borrowings, also known as leverage, magnify the potential for gain and loss on amounts invested and therefore increase the risks associated with investing in our securities.

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

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

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

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

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

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

**CERTAIN ANTI-TAKEOVER PROVISIONS** *(Page 161)*

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.

<b>Shareholder Transaction Expenses</b>	
Sales load (as a percentage of offering price) <sup>(1)</sup>	%
Dividend reinvestment plan fees <sup>(2)</sup>	None
<b>Annual Expenses (as a percentage of consolidated net assets attributable to common stock)<sup>(3)</sup></b>	
Operating expenses <sup>(4)</sup>	5.97%
Interest payments on borrowed funds <sup>(5)</sup>	4.61%
Acquired fund fees and expenses <sup>(6)</sup>	%
 Total annual expenses <sup>(7)(8)</sup>	 10.58%

**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.

	<b>1 Year</b>	<b>3 Years</b>	<b>5 Years</b>	<b>10 Years</b>
You would pay the following expenses on a \$1,000 investment, assuming a 5.0% annual return	\$ 105	\$ 311	\$ 512	\$ 993

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.**

- (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 June 30, 2007, was \$3.0 billion.
- (4) Operating expenses represent our estimated operating expenses for the year ending December 31, 2007, excluding interest on indebtedness. This percentage for the year ended December 31, 2006, was 5.19%. See Management's

Discussion and Analysis of Financial Condition and Results of Operations, Management and Compensation of Executive Officers and Directors.

- (5) The Interest payments on borrowed funds represents our estimated interest expense for the year ending December 31, 2007, including estimated interest related to usage under our revolving line of credit and new debt issuances that we anticipate during the remainder of 2007. We had outstanding borrowings of \$1.9 billion at June 30, 2007. See Risk Factors. This percentage for the year ended December 31, 2006, was 3.54%.
- (6) See our Consolidated Statement of Investments as of June 30, 2007, on pages F-75 through F-85 for our investments in funds.
- (7) 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 6.27% of consolidated total assets.
- (8) 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.



**SELECTED CONDENSED CONSOLIDATED FINANCIAL DATA**

You should read the condensed consolidated financial information below with the Consolidated Financial Statements and Notes thereto included herein. Financial information at and for the years ended December 31, 2006, 2005, 2004, 2003, and 2002, has been derived from our financial statements that were audited by KPMG LLP. Quarterly financial information is derived from unaudited financial data, but in the opinion of management, reflects all adjustments (consisting only of normal recurring adjustments) which are necessary to present fairly the results for such interim periods. Interim results at and for the six months ended June 30, 2007, are not necessarily indicative of the results that may be expected for the year ending December 31, 2007. See **Management's Discussion and Analysis of Financial Condition and Results of Operations** and **Senior Securities** below for more information.

(in thousands, except per share data)	At and for the Six Months Ended June 30,		At and for the Year Ended December 31,				
	2007	2006	2006	2005	2004	2003	2002
	(unaudited)						
<b>Operating Data:</b>							
Interest and related portfolio income:							
Interest and dividends	\$ 204,797	\$ 184,314	\$ 386,427	\$ 317,153	\$ 319,642	\$ 290,719	\$ 264,042
Fees and other income	20,831	37,153	66,131	56,999	47,448	38,510	45,886
Total interest and related portfolio income	225,628	221,467	452,558	374,152	367,090	329,229	309,928
Expenses:							
Interest	64,624	46,346	100,600	77,352	75,650	77,233	70,443
Employee	50,539	41,826	92,902	78,300	53,739	36,945	33,126
Employee stock options <sup>(1)</sup>	13,180	8,203	15,599				
Administrative	27,729	21,195	39,005	69,713	34,686	22,387	21,504
Total operating expenses	156,072	117,570	248,106	225,365	164,075	136,565	125,073
Net investment income before income taxes	69,556	103,897	204,452	148,787	203,015	192,664	184,855
Income tax expense (benefit), including excise tax	4,881	12,402	15,221	11,561	2,057	(2,466)	930
Net investment income	64,675	91,495	189,231	137,226	200,958	195,130	183,925
Net realized and unrealized gains (losses):							
Net realized gains	102,545	533,075	533,301	273,496	117,240	75,347	44,937
Net change in unrealized appreciation or depreciation	55,024	(491,254)	(477,409)	462,092	(68,712)	(78,466)	(571)

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Total net gains (losses)	157,569	41,821	55,892	735,588	48,528	(3,119)	44,366
Net increase in net assets resulting from operations	\$ 222,244	\$ 133,316	\$ 245,123	\$ 872,814	\$ 249,486	\$ 192,011	\$ 228,291
<b>Per Share:</b>							
Diluted earnings per common share	\$ 1.44	\$ 0.94	\$ 1.68	\$ 6.36	\$ 1.88	\$ 1.62	\$ 2.20
Net investment income plus net realized gains per share <sup>(2)</sup>	\$ 1.08	\$ 4.38	\$ 4.96	\$ 2.99	\$ 2.40	\$ 2.28	\$ 2.21
Dividends per common share <sup>(2)</sup>	\$ 1.27	\$ 1.19	\$ 2.47	\$ 2.33	\$ 2.30	\$ 2.28	\$ 2.23
Weighted average common shares outstanding diluted	154,446	142,466	145,599	137,274	132,458	118,351	103,574

(in thousands, except per share data)	At and for the Six Months Ended June 30,		At and for the Year Ended December 31,			
	2007	2006	2005	2004	2003	2002
	(unaudited)					
<b>Balance Sheet Data:</b>						
Portfolio at value	\$ 4,471,060	\$ 4,496,084	\$ 3,606,355	\$ 3,013,411	\$ 2,584,599	\$ 2,488,167
Total assets	5,045,488	4,887,505	4,025,880	3,260,998	3,019,870	2,794,319
Total debt outstanding <sup>(3)</sup>	1,921,815	1,899,144	1,284,790	1,176,568	954,200	998,450
Undistributed (distributions in excess of earnings	476,015	502,163	112,252	12,084	(13,401)	(15,830)
Shareholders' equity	2,991,134	2,841,244	2,620,546	1,979,778	1,914,577	1,546,071
Shareholders' equity per common share (net asset value) <sup>(4)</sup>	\$ 19.59	\$ 19.12	\$ 19.17	\$ 14.87	\$ 14.94	\$ 14.22
Common shares outstanding at end of period	152,652	148,575	136,697	133,099	128,118	108,698
Asset coverage ratio <sup>(5)</sup>	256%	250%	309%	280%	322%	270%
Debt to equity ratio	0.64	0.67	0.49	0.59	0.50	0.65
<b>Other Data:</b>						
Investments funded	\$ 659,141	\$ 2,437,828	\$ 1,675,773	\$ 1,524,523	\$ 931,450	\$ 506,376
Principal collections related to investment repayments or sales	735,441	1,055,347	1,503,388	909,189	788,328	356,641
Realized gains	120,602	557,470	343,061	267,702	94,305	95,562
Realized losses	(18,057)	(24,169)	(69,565)	(150,462)	(18,958)	(50,625)

(in thousands, except per share data)	2007			2006			2005			
	Qtr 2	Qtr 1	Qtr 4	Qtr 3	Qtr 2	Qtr 1	Qtr 4	Qtr 3	Qtr 2	Qtr 1
<b>Quarterly Data (unaudited):</b>										
Total interest and related portfolio income	\$ 117,676	\$ 107,952	\$ 117,708	\$ 113,383	\$ 110,456	\$ 111,011	\$ 98,169	\$ 94,857	\$ 86,207	\$ 94,911
Net investment income	25,175	39,500	49,078	48,658	50,195	41,300	37,073	46,134	15,267	38,750
Net increase in net assets resulting from operations	89,158	133,086	33,921	77,886	33,729	99,587	328,140	113,168	311,885	119,620
Diluted earnings per common share	0.57	0.87	0.23	0.53	0.24	0.70	2.36	0.82	2.29	0.80

Dividends declared per common share <sup>(6)</sup>	0.64	0.63	0.67	0.61	0.60	0.59	0.61	0.58	0.57	0.5
Net asset value per common share <sup>(4)</sup>	19.59	19.58	19.12	19.38	19.17	19.50	19.17	17.37	17.01	15.2

- (1) Effective January 1, 2006, we adopted the provisions of Statement No. 123 (Revised 2004), *Share-Based Payment*. See Management's Discussion and Analysis of Financial Condition and Results of Operations below.
- (2) Dividends are based on taxable income, which differs from income for financial reporting purposes. Net investment income and net realized gains are the most significant components of our annual taxable income from which dividends are paid. At December 31, 2006, we had estimated excess taxable income of \$397.1 million carried over for distribution to shareholders in 2007. See Management's Discussion and Analysis of Financial Condition and Results of Operations and Dividends and Distributions below.
- (3) See Senior Securities and Management's Discussion and Analysis of Financial Condition and Results of Operations 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) As a business development company, we are generally required to maintain a minimum ratio of 200% of total assets to total borrowings.
- (6) Dividends declared per common share for the fourth quarter of 2006 included the regular quarterly dividend of \$0.62 per common share and an extra dividend of \$0.05 per common share. Dividends declared per common share for the fourth quarter of 2005 included the regular quarterly dividend of \$0.58 per common share and an extra dividend of \$0.03 per common share.

**WHERE YOU CAN FIND  
ADDITIONAL INFORMATION**

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

We file annual, quarterly and current reports, proxy statements and other information with the SEC under the Securities Exchange Act of 1934. You can inspect any materials we file with the SEC, without charge, at the SEC's Public Reference Room at 100 F Street, N.E., Washington, D.C. 20549. Please call the SEC at 1-800-SEC-0330 for further information on the Public Reference Room. The information we file with the SEC is available free of charge by contacting us at 1919 Pennsylvania Avenue, N.W., Washington, DC, 20006-3434, or by telephone at (202) 721-6100 or on our website at [www.alliedcapital.com](http://www.alliedcapital.com). The SEC also maintains a website that contains reports, proxy statements and other information regarding registrants, including us, that file such information electronically with the SEC. The address of the SEC's website is [www.sec.gov](http://www.sec.gov). Information contained on our website or on the SEC's website about us is not incorporated into this prospectus and you should not consider information contained on our website or on the SEC's website to be part of this prospectus.

## RISK FACTORS

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

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

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

**Substantially all of our portfolio investments, which are generally illiquid, 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 June 30, 2007, portfolio investments recorded at fair value were 89% 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. In determining fair value in good faith, we generally obtain financial and other information from portfolio companies, which may represent unaudited, projected or proforma financial information. Unlike banks, we are not

permitted to provide a general reserve for anticipated loan losses; we are instead required by the 1940 Act to specifically value each individual investment on a quarterly basis and record unrealized depreciation for an investment that we believe has become impaired, including where collection of a loan or realization of an equity security is doubtful, or when the enterprise value of the portfolio company does not currently support the cost of our debt or equity investment. Enterprise value means the entire value of the company to a potential buyer, including the sum of the values of debt and equity securities used to capitalize the enterprise at a point in time. We will record unrealized appreciation if we believe that the underlying portfolio company has appreciated in value and/or our equity security has appreciated in value. Without a readily available market value and because of the inherent uncertainty of valuation, the fair value of our investments determined in good faith by the Board of Directors may differ significantly from the values that would have been used had a ready market existed for the investments, and the differences could be material. Our net asset value could be affected if our determination of the fair value of our investments is materially different than the value that we ultimately realize.

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

**Economic recessions or downturns could impair our portfolio companies and harm our operating results.**

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

Our business of making private equity investments and positioning them for liquidity events also may be affected by current and future market conditions. The absence of an active senior lending environment or a slowdown in middle market merger and acquisition activity may slow the amount of private equity investment activity generally. As a result, the pace of our investment activity may slow. In addition, significant changes in the capital markets could have an effect on the valuations of private companies, which may negatively affect the value of our investments, 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, may be highly leveraged and may be unable to obtain financing from traditional sources. Numerous factors may affect a borrower's ability to repay its loan, including the failure to meet its business plan, a downturn in its industry, or negative economic conditions. A portfolio company's failure to satisfy financial or operating covenants imposed by us or other lenders could lead to defaults and, potentially, termination of its loans or foreclosure on its secured assets, which could trigger cross defaults under other agreements and jeopardize our portfolio company's ability to meet its obligations under the loans or debt securities that we hold. In addition,

our portfolio companies may have, or may be permitted to incur, other debt that ranks senior to or equally with our securities. This means that payments on such senior-ranking securities may have to be made before we receive any payments on our subordinated loans or debt securities. Deterioration in a borrower's financial condition and prospects may be accompanied by deterioration in any related collateral and may have a negative effect on our financial results.

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

**Our financial results could be negatively affected if a significant portfolio investment fails to perform as expected.** Our total investment in companies may be significant individually or in the aggregate. As a result, if a significant investment in one or more companies fails to perform as expected, our financial results could be more negatively affected and the magnitude of the loss could be more significant than if we had made smaller investments in more companies. At June 30, 2007, our largest investments at value were in Mercury Air Centers, Inc. and Business Loan Express, LLC (BLX), which represented 6.3% and 4.4% of our total assets, respectively, and 1.9% and 1.2% of our total interest and related portfolio income, respectively, for the six months ended June 30, 2007.

BLX is a national, non-bank lender that participates in the Small Business Administration's (SBA) 7(a) Guaranteed Loan Program and is licensed by the SBA as a Small Business Lending Company (SBLC). The Office of the Inspector General of the SBA (OIG) and the United States Secret Service are conducting an ongoing investigation of allegedly fraudulently obtained SBA-guaranteed loans issued by BLX. The OIG and the U.S. Department of Justice are also conducting a civil investigation of BLX's lending practices in various jurisdictions. In addition, the Office of the Inspector General of the U.S. Department of Agriculture is conducting an investigation of BLX's lending practices under the Business and Industry Loan program. These investigations are ongoing.

As an SBA lender, BLX is also subject to other SBA and OIG audits, investigations, and reviews. These investigations, audits and reviews, 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.

The current market conditions for small business loans remain very competitive, and as a result, BLX continues to experience high loan prepayments in its securitized loan portfolio. This competitive environment combined with BLX's liquidity constraints has restrained BLX's ability to grow its loan origination volume. Due to the changes in BLX's operations, the status of its current financing facilities and the effect of BLX's current regulatory issues, ongoing investigations and litigation, we are in the process of working with BLX with respect to various potential strategic alternatives including, but not limited to, recapitalization, restructuring, joint venture or sale or divestiture of BLX or some or all of its assets. The ultimate resolution of these matters could have a material adverse impact on BLX's financial condition, and, as a result, our financial results could be negatively



affected. See Management's Discussion and Analysis of Financial Condition and Results of Operations Private Finance, Business Loan Express, LLC.

**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 or investors. Holders of these senior securities have fixed dollar claims on our consolidated assets that are superior to the claims of our common shareholders. If the value of our consolidated assets increases, then leveraging would cause the net asset value attributable to our common stock to increase more sharply than it would have had we not leveraged. Conversely, if the value of our consolidated assets decreases, leveraging would cause net asset value to decline more sharply than it otherwise would have had we not leveraged. Similarly, any increase in our consolidated income in excess of consolidated interest payable on the borrowed funds would cause our net income to increase more than it would without the leverage, while any decrease in our consolidated income would cause net income to decline more sharply than it would have had we not borrowed. Such a decline could negatively affect our ability to make common stock dividend payments. Leverage is generally considered a speculative investment technique. We and, indirectly, our stockholders will bear the cost associated with our leverage activity. Our revolving line of credit and notes payable contain financial and operating covenants that could restrict our business activities, including our ability to declare dividends if we default under certain provisions. Breach of any of those covenants could cause a default under those instruments. Such a default, if not cured or waived, could have a material adverse effect on us.

At June 30, 2007, we had \$1.9 billion of outstanding indebtedness bearing a weighted average annual interest cost of 6.6% and a debt to equity ratio of 0.64 to 1.00. We may incur additional debt in the future. If our portfolio of investments fails to produce adequate returns, we may be unable to make interest or principal payments on our indebtedness when they are due. In order for us to cover annual interest payments on indebtedness, we must have achieved annual returns on our assets of at least 2.5% as of June 30, 2007, which returns were achieved.

*Illustration.* The following table illustrates the effect of leverage on returns from an investment in our common stock assuming various annual returns, net of expenses. The calculations in the table below are hypothetical and actual returns may be higher or lower than those appearing below. The calculation assumes (i) \$5,045.5 million in total assets, (ii) an average cost of funds of 6.6%, (iii) \$1,921.8 million in debt outstanding and (iv) \$2,991.1 million of shareholders' equity.

	<b>Assumed Return on Our Portfolio (net of expenses)</b>						
	<b>-20%</b>	<b>-10%</b>	<b>-5%</b>	<b>0%</b>	<b>5%</b>	<b>10%</b>	<b>20%</b>
Corresponding return to shareholder	-37.98%	-21.11%	-12.67%	-4.24%	4.19%	12.63%	29.50%

**We may not borrow money unless we maintain asset coverage for indebtedness of at least 200%, which may affect returns to shareholders.** Under the 1940 Act and the covenants applicable to our public debt, we must maintain asset coverage for total

borrowings of at least 200%. Our ability to achieve our investment objective may depend in part on our continued ability to maintain a leveraged capital structure by borrowing from banks, insurance companies or other lenders or investors on favorable terms. There can be no assurance that we will be able to maintain such leverage. If asset coverage declines to less than 200%, we may be required to sell a portion of our investments when it is disadvantageous to do so. As of June 30, 2007, our asset coverage for senior indebtedness was 256%.

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

Assuming that the balance sheet as of June 30, 2007, were to remain constant and no actions were taken to alter the existing interest rate sensitivity, a hypothetical immediate 1% change in interest rates would have affected net income by approximately 1% over a one year horizon. Although management believes that this measure is indicative of our sensitivity to interest rate changes, it does not adjust for potential changes in credit quality, size and composition of the assets on the balance sheet and other business developments that could affect net increase in net assets resulting from operations, or net income. Accordingly, no assurances can be given that actual results would not differ materially from the potential outcome simulated by this estimate.

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

**Loss of regulated investment company tax treatment would substantially reduce net assets and income available for debt service and dividends.** We have operated so as to qualify as a regulated investment company under Subchapter M of the Code. If we meet

source of income, asset diversification, and distribution requirements, we generally 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 stockholders because in certain cases we may recognize income before or without receiving cash representing such income. If we fail to qualify as a regulated investment company, we will have to pay corporate-level taxes on all of our income whether or not we distribute it, which would substantially reduce the amount of income available for debt service and distributions to our stockholders. Even if we qualify as a regulated investment company, we generally will be subject to a corporate-level income tax on the income we do not distribute. If we do not distribute at least 98% of our annual taxable income in the year earned, we generally will be required to pay an excise tax on amounts carried over and distributed to shareholders in the next year equal to 4% of the amount by which 98% of our annual taxable income exceeds the distributions from such income for the current year.

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

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

**There are potential conflicts of interest between us and the Allied Capital Senior Debt Fund, L.P.** Certain of our officers serve or may serve in an investment management capacity to the Allied Capital Senior Debt Fund, L.P. (the Fund), a fund that generally invests in senior, unitranche and second lien debt. Specifically, the credit committee for

the Fund includes certain of our officers who serve in similar roles for us. These investment professionals intend to allocate such time and attention as is deemed appropriate and necessary to carry out the operations of the Fund effectively. In this respect, they may experience diversions of their attention from us and potential conflicts of interest between their work for us and their work for the Fund in the event that the interests of the Fund run counter to our interests. Accordingly, they may have obligations to investors in the Fund, the fulfillment of which might not be in the best interests of us or our shareholders.

We have sold assets to the Fund and, as part of our investment strategy, we may offer to sell additional assets to the Fund or we may purchase assets from the Fund. While assets may be sold or purchased at prices that are consistent with those that could be obtained from third parties in the marketplace, there is an inherent conflict of interest in such transactions between us and the Fund.

Although the Fund has a different primary investment objective than we do, the Fund may, from time to time, invest in the same or similar asset classes that we target. These investments may be made at the direction of the same individuals acting in their capacity on behalf of us and the Fund. As a result, such individuals may face conflicts in the allocation of investment opportunities between us and the Fund. To the extent the Fund invests in the same or similar asset classes, the scope of opportunities otherwise available to us may be adversely affected. We may also have the same or similar conflicts of interest with one or more financing vehicles associated with the Fund.

**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. In addition, changes in the laws or regulations that govern business development companies, regulated investment companies, and real estate investment trusts 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.

**Failure to invest a sufficient portion of our assets in qualifying assets could preclude us from investing in accordance with our current business strategy.** As a business development company, we may 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. See Certain Government Regulations. Therefore, we may be precluded from investing in what we believe are attractive investments if such investments are not qualifying assets for purposes of the 1940 Act. If we do not invest a sufficient portion of our assets in qualifying assets, we could lose our status as a business development company, which would have a material adverse effect on our business, financial condition and results of operations. Similarly, these rules could prevent us from making additional investments in existing portfolio companies, which could result in the dilution of our position, or could require us to dispose of investments at inopportune times in order to comply with the 1940 Act. If we were forced to sell nonqualifying investments

in the portfolio for compliance purposes, the proceeds from such sale could be significantly less than the current value of such investments.

**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, changes in the accrual status of our loans and debt securities, variations in timing of prepayments, variations in and the timing of the recognition of net realized gains or losses and changes in unrealized appreciation or depreciation, the level of our expenses, the degree to which we encounter competition in our markets, and general economic conditions.

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

price and volume fluctuations in the overall stock market from time to time;

significant volatility in the market price and trading volume of securities of business development companies or other financial services companies;

volatility resulting from trading in derivative securities related to our common stock including puts, calls, long-term equity anticipation securities, or LEAPs, or short trading positions;

changes in laws or regulatory policies or tax guidelines with respect to business development companies or regulated investment companies;

actual or anticipated changes in our earnings or fluctuations in our operating results or changes in the expectations of securities analysts;

general economic conditions and trends;

loss of a major funding source; or

departures of key personnel.

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

the time remaining to the maturity of these debt securities;

the outstanding principal amount of debt securities with terms identical to these debt securities;

the supply of debt securities trading in the secondary market, if any;

the redemption or repayment features, if any, of these debt securities;

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

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

There also may be a limited number of buyers for our debt securities. This too may materially adversely affect the market value of the debt securities or the trading market for the debt securities.

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

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

### **Disclosure Regarding Forward-Looking Statements**

Information contained or incorporated by reference in this prospectus, and any prospectus supplement accompanying this prospectus contains forward-looking statements. These statements include the plans and objectives of management for future operations and financial objectives and can be identified by the use of forward-looking terminology such as may, will, expect, intend, anticipate, estimate or continue or the 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 any prospectus supplement accompanying this prospectus and in any exhibits to the registration statement of which this prospectus is a part, constitute cautionary statements identifying important factors with respect to any such forward-looking statements, including certain risks and uncertainties, that could cause actual results to differ materially from those in such forward-looking statements.

Although we believe that the assumptions on which these forward-looking statements are based are reasonable, any of those assumptions could prove to be inaccurate, and as a result, the forward-looking statements based on those assumptions also could be incorrect. Important assumptions include our ability to originate new investments, maintain certain margins and levels of profitability, access the capital markets for debt and equity capital, the ability to meet regulatory requirements and the ability to maintain certain debt to asset ratios. In light of these and other uncertainties, the inclusion of a projection or forward-looking statement in this prospectus and any prospectus supplement accompanying this prospectus should not be regarded as a representation by us that our plans and objectives will be achieved. You should not place undue reliance on these forward-looking statements, which apply only as of the date of this prospectus and the date on the cover of any such supplements with respect to such supplements. The forward-looking statements contained in this prospectus and any accompanying prospectus supplement are excluded from the safe harbor protection provided by Section 27A of the Securities Act of 1933.

### **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 primarily middle-market companies, we are continuously identifying, reviewing and, to the extent consistent with our investment objective, funding new investments. As a result, we typically raise capital as we deem appropriate to fund such new investments. Any 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 or in any prospectus supplement accompanying this prospectus, 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, high quality debt securities maturing in one year or less from the time of investment or other qualifying investments. Our ability to achieve our investment objective may be limited to the extent that the net proceeds of any offering, pending full investment, are held in lower-yielding time deposits and other short-term instruments.



**PRICE RANGE OF COMMON STOCK AND DISTRIBUTIONS**

Our common stock is traded on the New York Stock Exchange under the symbol ALD. The following table lists the high and low closing sales prices for our common stock, the closing sales price as a percentage of net asset value (NAV) and quarterly dividends per share. On August 17, 2007, the last reported closing sale price of our common stock was \$29.58 per share.

	NAV <sup>(1)</sup>	Closing Sales Price		Premium of High Sales Price to NAV <sup>(2)</sup>	Premium of Low Sales Price to NAV <sup>(2)</sup>	Declared Dividends
		High	Low			
<b>Year ended December 31, 2005</b>						
First Quarter	\$ 15.22	\$ 27.84	\$ 24.89	183%	164%	\$ 0.57
Second Quarter	\$ 17.01	\$ 29.29	\$ 25.83	172%	152%	\$ 0.57
Third Quarter	\$ 17.37	\$ 29.17	\$ 26.92	168%	155%	\$ 0.58
Fourth Quarter	\$ 19.17	\$ 30.80	\$ 26.11	161%	136%	\$ 0.58
Extra Dividend						\$ 0.03
<b>Year ended December 31, 2006</b>						
First Quarter	\$ 19.50	\$ 30.68	\$ 28.51	157%	146%	\$ 0.59
Second Quarter	\$ 19.17	\$ 31.32	\$ 28.77	163%	150%	\$ 0.60
Third Quarter	\$ 19.38	\$ 30.88	\$ 27.30	159%	141%	\$ 0.61
Fourth Quarter	\$ 19.12	\$ 32.70	\$ 29.99	171%	157%	\$ 0.62
Extra Dividend						\$ 0.05
<b>Year ended December 31, 2007</b>						
First Quarter	\$ 19.58	\$ 32.98	\$ 28.05	168%	143%	\$ 0.63
Second Quarter	\$ 19.59	\$ 32.96	\$ 28.90	168%	148%	\$ 0.64
Third Quarter (through August 17, 2007)	*	\$ 32.87	\$ 27.10	*	*	\$ 0.65 <sup>(3)</sup>
Fourth Quarter	*	*	*	*	*	\$ 0.65 <sup>(3)</sup>

(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.

(3) On July 27, 2007, our Board of Directors declared a \$0.65 per share dividend for both the third and fourth quarters of 2007. See Management's Discussion and Analysis and Results of Operations - Dividends and Distributions below.

\* 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 - Dividends and Distributions and Tax Status. There

can be no assurance that we will achieve investment results or maintain a tax status that will permit any particular level of dividend payment. Certain of our credit facilities limit our ability to declare dividends if we default under certain provisions.

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

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

*The information contained in this section should be read in conjunction with our Consolidated Financial Statements and the Notes thereto. In addition, this prospectus contains certain forward-looking statements. These statements include the plans and objectives of management for future operations and financial objectives and can be identified by the use of forward-looking terminology such as may, will, expect, intend, anticipate, estimate, or continue or the negative thereof or other variations thereon or comparable terminology. These forward-looking statements are subject to the inherent uncertainties in predicting future results and conditions. Certain factors that could cause actual results and conditions to differ materially from those projected in these forward-looking statements are set forth in Risk Factors above. 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 this financial information presented may represent unaudited, projected or pro forma financial information, and therefore may not be indicative of actual results. In addition, the private equity industry uses financial measures such as EBITDA or EBITDAM (Earnings Before Interest, Taxes, Depreciation, Amortization and, in some instances, Management fees) in order to assess a portfolio company's financial performance and to value a portfolio company. EBITDA and EBITDAM are not intended to represent cash flow from operations as defined by U.S. generally accepted accounting principles and such information should not be considered as an alternative to net income, cash flow from operations or any other measure of performance prescribed by U.S. generally accepted accounting principles.*

**OVERVIEW**

As a business development company, we are in the private equity business. Specifically, we provide long-term debt and equity investment capital to companies in a variety of industries. Our private finance activity principally involves providing financing to middle market U.S. companies through privately negotiated long-term debt and equity investment capital. Our financing is generally used to fund buyouts, acquisitions, growth, recapitalizations, note purchases, and other types of financings. We generally invest in private companies though, from time to time, we may invest in companies that are public but lack access to additional public capital. Our investment objective is to achieve current income and capital gains.

Our portfolio composition at June 30, 2007 and 2006, and at December 31, 2006, 2005, and 2004, was as follows:

	June 30,		December 31,		
	2007	2006	2006	2005	2004
Private finance	97%	96%	97%	96%	76%
Commercial real estate finance <sup>(1)</sup>	3%	4%	3%	4%	24%

<sup>(1)</sup> On May 3, 2005, we completed the sale of our portfolio of non-investment grade commercial mortgage-backed securities and real estate related collateralized debt obligation bonds and preferred shares investments. Upon the completion of this transaction, our lending and investment activity has been focused primarily on private finance investments.

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

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

**PORTFOLIO AND INVESTMENT ACTIVITY**

The total portfolio at value, investment activity, and the yield on interest-bearing investments at and for the six months ended June 30, 2007 and 2006, and at and for the years ended December 31, 2006, 2005, and 2004, were as follows:

	At and for the Six Months Ended June 30,		At and for the Years Ended December 31,		
	2007	2006	2006	2005	2004
<b>(\$ in millions)</b>					
Portfolio at value	\$ 4,471.1	\$ 3,593.5	\$ 4,496.1	\$ 3,606.4	\$ 3,013.4
Investments funded <sup>(1)</sup>	\$ 659.1	\$ 1,251.2	\$ 2,437.8	\$ 1,675.8	\$ 1,524.5
Change in accrued or reinvested interest and dividends <sup>(2)</sup>	\$ 17.7	\$ (9.1)	\$ 11.3	\$ 6.6	\$ 52.2
Principal collections related to investment repayments or sales <sup>(3)</sup>	\$ 735.4	\$ 769.6	\$ 1,055.3	\$ 1,503.4	\$ 909.2
Yield on interest-bearing investments <sup>(4)</sup>	11.6%	12.6%	11.8%	12.8%	14.0%

(1) Investments funded included investments acquired through the issuance of our common stock as consideration totaling \$7.2 million and \$3.2 million, respectively, for the years ended December 31, 2005 and 2004. See also Private Finance below.

(2) Includes changes in accrued or reinvested interest related to our investments in money market securities of \$4.7 million and \$1.7 million, respectively, for the six months ended June 30, 2007 and 2006, and \$3.1 million for the year ended December 31, 2006.

(3) Principal collections related to investment repayments or sales for the six months ended June 30, 2007, included collections of \$182.4 million related to the sale of loans to the Allied Capital Senior Debt Fund, L.P. in the second quarter of 2007. See discussion below.

(4) The weighted average yield on interest-bearing investments is computed as the (a) annual stated interest on accruing loans and debt securities 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 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 six months ended June 30, 2007 and 2006, and at and for the years ended December 31, 2006, 2005, and 2004, were as follows:

	At and for the Six Months Ended June 30,				At and for the Years Ended December 31,					
	2007		2006		2006		2005		2004	
	Value	Yield <sup>(2)</sup>	Value	Yield <sup>(2)</sup>	Value	Yield <sup>(2)</sup>	Value	Yield <sup>(2)</sup>	Value	Yield <sup>(2)</sup>
(\$ in millions)										
Portfolio at value:										
Loans and debt securities:										
Senior loans	\$ 409.8	8.3%	\$ 275.9	9.5%	\$ 405.2	8.4%	\$ 239.8	9.5%	\$ 234.6	8.5%
Unitranche debt	681.4	11.4%	515.0	10.7%	799.2	11.2%	294.2	11.4%	43.9	14.8%
Subordinated debt	1,892.2	12.5%	1,700.3	13.9%	1,980.8	12.9%	1,560.9	13.8%	1,324.4	14.9%
Total loans and debt securities	2,983.4	11.7%	2,491.2	12.7%	3,185.2	11.9%	2,094.9	13.0%	1,602.9	13.9%
Equity securities	1,364.9		969.2		1,192.7		1,384.4		699.2	
Total portfolio	\$ 4,348.3		\$ 3,460.4		\$ 4,377.9		\$ 3,479.3		\$ 2,302.1	
Investments funded <sup>(1)</sup>	\$ 643.7		\$ 1,237.3		\$ 2,423.4		\$ 1,462.3		\$ 1,140.8	
Change in accrued or reinvested interest and dividends	\$ 12.9		\$ (11.3)		\$ 7.2		\$ 24.6		\$ 45.6	
Principal collections related to investment repayments or sales <sup>(3)</sup>	\$ 717.0		\$ 752.4		\$ 1,015.4		\$ 703.9		\$ 551.9	

<sup>(1)</sup> Investments funded for the six months ended June 30, 2006, and for the years ended December 31, 2006 and 2004, included debt investments in certain portfolio companies received in conjunction with the sale of such companies.

See Private Finance, Investments Funded below.

- (2) The weighted average yield on loans and debt securities is computed as the (a) annual stated interest on accruing loans and debt securities 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.
- (3) Includes collections from the sale or repayment of senior loans totaling \$236.2 million and \$228.2 million for the six months ended June 30, 2007 and 2006, respectively, and \$322.7 million, \$301.8 million, and \$35.6 million for the years ended December 31, 2006, 2005, and 2004, respectively. Principal collections also included the principal repayment of our \$15 million subordinated debt investment in Drilltec Patents & Technologies Company, Inc. There was no realized gain or loss resulting from the Drilltec repayment.

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

We intend to take a balanced approach to private equity investing that emphasizes a complementary mix of debt investments and buyout investments. The combination of these two types of investments provides current interest and related portfolio income and the potential for future capital gains. The private equity investment marketplace remained very active through June 30, 2007. Purchase price multiples remained high and debt pricing was very competitive. We did not fund as many investments in the first half of 2007 as we did

in the first half of 2006, because we believed that many new investment opportunities were mis-priced or over-leveraged, and therefore, did not present an opportunity to make a reasonable investment return. For 2006 and 2005, we reviewed over \$65 billion and \$45 billion, respectively, in prospective investments and we closed on approximately 3% of the potential new investments that we reviewed for both years. For the first half of 2007, we reviewed over \$42 billion in prospective investments and we closed on approximately 1% of the potential new investments we reviewed.

The level of investment activity for investments funded and principal repayments for private finance investments can vary substantially from period to period depending on the number and size of investments that we make or that we exit and many other factors, including the amount of debt and equity capital available to middle market companies, the level of merger and acquisition activity for such companies, the general economic environment, and the competitive environment for the types of investments we make. Since June 30, 2007, the debt capital markets in general have become volatile. To the extent that financing for middle market companies becomes more restricted, we may see improved conditions for our investing activities. If these conditions persist, we may be able to deploy debt capital at more attractive yields and on more favorable terms than we have seen in the first two quarters.



**Investments Funded.** Investments funded and the weighted average yield on loans and debt securities funded for the six months ended June 30, 2007, and for the years ended December 31, 2006, 2005, and 2004, consisted of the following:

**For the Six Months Ended June 30, 2007**

	Debt Investments		Buyout Investments		Total	
	Amount	Yield <sup>(1)</sup>	Amount	Yield <sup>(1)</sup>	Amount	Yield <sup>(1)</sup>
<b>(\$ in millions)</b>						
Loans and debt securities:						
Senior loans	\$ 177.0	10.2%	\$ 40.0	9.4%	\$ 217.0	10.0%
Unitranche debt <sup>(2)</sup>	57.1	10.7%			57.1	10.7%
Subordinated debt	114.4	12.5%	103.2	10.9%	217.6	11.8%
Total loans and debt securities	348.5	11.0%	143.2	10.5%	491.7	10.9%
Equity	99.1 <sup>(5)(6)</sup>		52.9		152.0	
Total	\$ 447.6		\$ 196.1		\$ 643.7	

**2006 Investments Funded**

	Debt Investments		Buyout Investments		Total	
	Amount	Yield <sup>(1)</sup>	Amount	Yield <sup>(1)</sup>	Amount	Yield <sup>(1)</sup>
<b>(\$ in millions)</b>						
Loans and debt securities:						
Senior loans	\$ 245.4	9.4%	\$ 239.8	8.9%	\$ 485.2	9.2%
Unitranche debt <sup>(2)</sup>	471.7	10.7%	146.5	12.9%	618.2	11.3%
Subordinated debt <sup>(3)</sup>	510.7	13.0%	423.8	14.4%	934.5	13.6%
Total loans and debt securities	1,227.8	11.4%	810.1	12.5%	2,037.9	11.9%
Equity	91.4 <sup>(5)</sup>		294.1		385.5	
Total	\$ 1,319.2		\$ 1,104.2		\$ 2,423.4	

**2005 Investments Funded**

	Debt Investments		Buyout Investments		Total	
	Amount	Yield <sup>(1)</sup>	Amount	Yield <sup>(1)</sup>	Amount	Yield <sup>(1)</sup>
<b>(\$ in millions)</b>						
Loans and debt securities:						

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Senior loans	\$ 76.8	10.0%	\$ 250.2	6.4%	\$ 327.0	7.2%
Unitranche debt <sup>(2)</sup>	259.5	10.5%			259.5	10.5%
Subordinated debt	296.9 <sup>(4)</sup>	12.3%	330.9	12.5%	627.8	12.4%
Total loans and debt securities	633.2	11.3%	581.1	9.9%	1,214.3	10.6%
Equity	82.5 <sup>(5)</sup>		165.5		248.0	
Total	\$ 715.7		\$ 746.6		\$ 1,462.3	

2004 Investments Funded

	Debt Investments		Buyout Investments		Total	
	Amount	Yield <sup>(1)</sup>	Amount	Yield <sup>(1)</sup>	Amount	Yield <sup>(1)</sup>
(\$ in millions)						
Loans and debt securities:						
Senior loans	\$ 25.1	9.1%	\$ 140.8	7.2%	\$ 165.9	7.5%
Unitranche debt <sup>(2)</sup>	18.9	13.0%			18.9	13.0%
Subordinated debt <sup>(3)</sup>	396.4	13.4%	320.1	15.5%	716.5	14.4%
Total loans and debt securities	440.4	13.2%	460.9	13.0%	901.3	13.1%
Equity	72.3 <sup>(5)</sup>		167.2		239.5	
Total	\$ 512.7		\$ 628.1		\$ 1,140.8	

- (1) The weighted average yield on interest-bearing investments is computed as the (a) annual stated interest on accruing interest-bearing investments, divided by (b) total interest-bearing investments funded.
- (2) Unitranche debt is a single debt investment that is a blend of senior and subordinated debt terms. The yield on a unitranche investment reflects the blended yield of senior and subordinated debt combined.
- (3) Debt investments funded for the year ended December 31, 2006, included a \$150 million subordinated debt investment in Advantage Sales & Marketing, Inc. received in conjunction with the sale of Advantage and a \$30 million subordinated debt investment in STS Operating, Inc. received in conjunction with the sale of STS. Debt investments funded for the year ended December 31, 2004, included a \$47.5 million subordinated debt investment in The Hillman Companies, Inc. received in conjunction with the sale of Hillman.
- (4) Subordinated debt investments for the year ended December 31, 2005, included \$45.5 million in investments in the bonds of collateralized loan obligations (CLOs) and collateralized debt obligations (CDOs) that are managed by Callidus Capital Corporation (Callidus), a portfolio company controlled by us. These CLOs and CDOs primarily invest in senior debt.
- (5) Equity investments for the six months ended June 30, 2007, and for the years ended December 31, 2006, 2005, and 2004, included \$17.2 million, \$26.1 million, \$47.9 million, and \$23.6 million, respectively, in investments in the preferred shares/income notes of CLOs and CDOs that are managed by Callidus. These CDOs and CLOs primarily

invest in senior debt.

- (6) Equity investments for the six months ended June 30, 2007, included \$19.1 million invested in the Allied Capital Senior Debt Fund, L.P. See discussion below.

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.

We may underwrite or arrange senior loans related to our portfolio investments or for other companies that are not in our portfolio. When we underwrite or arrange senior loans, we may earn a fee for such activities. Senior loans underwritten or arranged by us may or may not be funded by us at closing. When these senior loans are closed, we may fund all or a portion of the underwritten commitment pending sale of the loan to other investors, which may include loan sales to Callidus Capital Corporation (Callidus), a portfolio company controlled by us, or funds managed by Callidus or by us, including the Allied Capital Senior Debt Fund, L.P. (see below). After completion of loan sales, we may or may not retain a position in these senior loans. We generally earn a fee on the senior loans we underwrite or arrange whether or not we fund the underwritten commitment. In addition, we may fund most or all of the debt and equity capital upon the closing of certain buyout transactions, which may include investments in lower-yielding senior debt. Subsequent to the closing, the portfolio company may refinance all or a portion of the lower-yielding senior debt, which would reduce our investment. Repayments include repayments of senior debt funded by us that was subsequently sold by us or refinanced or repaid by the portfolio companies.

**Allied Capital Senior Debt Fund, L.P.** AC Corp is the investment manager to the Allied Capital Senior Debt Fund, L.P. (the Fund), a fund that generally invests in senior, unitranche and second lien debt. The Fund has closed on \$125 million in equity capital commitments. Callidus acts as special manager to the Fund. One of our affiliates is the general partner of the Fund, and AC Corp serves as collateral manager to a warehouse financing vehicle associated with the Fund. AC Corp will earn a management fee of up to 2% of the net asset value of the Fund and will pay Callidus 25% of that management fee to compensate Callidus for its role as special manager.

We are a special limited partner in the Fund, which is a portfolio investment, and have committed \$31.8 million to the Fund, of which \$19.1 million has been funded. At June 30, 2007, our investment in the Fund totaled \$19.1 million at cost and \$19.3 million at value. As a special limited partner, we expect to earn an incentive allocation of 20% of the annual net income of the Fund, subject to certain performance benchmarks. The value of our investment in the Fund is based on the net asset value of the Fund, which reflects the capital invested plus our allocation of the net earnings of the Fund, including the incentive allocation.

In connection with the Fund's formation in June 2007, we sold an initial portfolio of approximately \$183 million of seasoned assets with a weighted average yield of 10.3% to a warehouse financing vehicle associated with the Fund. We may sell additional loans to the Fund or the warehouse financing vehicle.

**Yield.** The weighted average yield on the private finance loans and debt securities was 11.7% at June 30, 2007, as compared to 12.7%, 11.9%, 13.0% and 13.9% at June 30, 2006, and December 31, 2006, 2005, and 2004, respectively. The weighted average yield on the private finance loans and debt securities may fluctuate from period to period depending

on the yield on new loans and debt securities funded, the yield on loans and debt securities repaid, the amount of loans and debt securities for which interest is not accruing (see Portfolio Asset Quality Loans and Debt Securities on Non-Accrual Status below) and the amount of lower-yielding senior or unitranche debt in the portfolio at the end of the period. Yields on senior and subordinated debt investments have been generally lower because of the supply of capital available to middle market companies.

The yield on the private finance portfolio has declined partly due to our strategy to pursue investments where our position in the portfolio company capital structure is more senior, such as senior debt and unitranche investments that typically have lower yields than subordinated debt investments. In addition, during the fourth quarter of 2006, the guaranteed dividend yield on our investment in BLX's 25% Class A equity interests was placed on non-accrual status, and remained on non-accrual status in the first half of 2007. The Class A equity interests are included in our loans and debt securities. See Business Loan Express, LLC below.

**Outstanding Investment Commitments.** At June 30, 2007, we had outstanding private finance investment commitments as follows:

	Companies More Than 25% Owned <sup>(1)</sup>	Companies 5% to 25% Owned	Companies Less Than 5% Owned	Total
<b>(\$ in millions)</b>				
Senior loans	\$ 14.6	\$ 16.0	\$ 113.6	\$ 144.2 <sup>(2)</sup>
Unitranche debt			45.4	45.4
Subordinated debt	44.0	0.1		44.1
Total loans and debt securities	58.6	16.1	159.0	233.7
Equity securities	83.3	16.0	73.4	172.7 <sup>(3)</sup>
Total	\$ 141.9	\$ 32.1	\$ 232.4	\$ 406.4

<sup>(1)</sup> Includes various commitments to Callidus Capital Corporation (Callidus), a portfolio company controlled by us, which owns 80% (subject to dilution) of Callidus Capital Management, LLC, an asset management company that structures and manages collateralized debt obligations (CDOs), collateralized loan obligations (CLOs), and other related investments, as follows:

	Committed Amount	Amount Drawn	Amount Available to be Drawn
<b>(\$ in millions)</b>			
Revolving line of credit for working capital	\$ 4.0	\$ (0.7)	\$ 3.3
Subordinated debt to support warehouse facilities & warehousing activities <sup>(*)</sup>	44.0		44.0
Purchase of preferred equity in future CLO transactions	13.2		13.2
Total	\$ 61.2	\$ (0.7)	\$ 60.5

- (\*) Callidus had a secured warehouse credit facility with a third party for up to \$360 million. The facility was used primarily to finance the acquisition of loans pending securitization through a CDO or CLO. In addition, Callidus has a synthetic credit facility with a third party for up to \$50 million. We have agreed to designate our subordinated debt commitment for Callidus to draw upon to provide first loss capital as needed to support these facilities.
- (2) Includes \$125.0 million in the form of revolving senior debt facilities to 30 companies.
- (3) Includes \$89.4 million to 20 private equity and venture capital funds, including \$4.3 million in co-investment commitments to one private equity fund, and \$12.7 million to the Allied Capital Senior Debt Fund, L.P. (see discussion above).

In addition to these outstanding investment commitments at June 30, 2007, we may be required to fund additional amounts under earn-out arrangements primarily related to

buyout transactions in the future if those companies meet agreed-upon performance targets. We also had commitments to private finance portfolio companies in the form of standby letters of credit and guarantees totaling \$249.2 million. See Financial Condition, Liquidity and Capital Resources.

**Mercury Air Centers, Inc.** At June 30, 2007, our investment in Mercury Air Centers, Inc. (Mercury) totaled \$85.3 million at cost and \$320.1 million at value, or 6.3% of our total assets, which included unrealized appreciation of \$234.8 million. At December 31, 2006, our investment in Mercury totaled \$84.3 million at cost and \$244.2 million at value, which included unrealized appreciation of \$159.9 million.

Mercury owns and operates fixed base operations generally under long-term leases from local airport authorities, which consist of terminal and hangar complexes that service the needs of the general aviation community. Mercury is headquartered in Richmond Heights, OH. We completed the purchase of a majority ownership in Mercury in April 2004.

Total interest and related portfolio income earned from our investment in Mercury for the six months ended June 30, 2007 and 2006, and for the years ended December 31, 2006, 2005, and 2004, was as follows:

	Six Months Ended June 30,		Year Ended December 31,		
	2007	2006	2006	2005	2004
(\$ in millions)					
Interest income	\$ 4.1	\$ 5.3	\$ 9.3	\$ 8.8	\$ 5.5
Fees and other income	0.2	0.3	0.6	0.7	1.9
Total interest and related portfolio income	\$ 4.3	\$ 5.6	\$ 9.9	\$ 9.5	\$ 7.4

Interest income from Mercury for the six months ended June 30, 2007 and 2006, and for the years ended December 31, 2006, 2005, and 2004, included interest income of \$1.0 million, \$1.0 million, \$2.0 million, \$1.6 million, and \$1.0 million, respectively, which was paid in kind. The interest paid in kind was paid to us through the issuance of additional debt.

Net change in unrealized appreciation or depreciation included a net increase in unrealized appreciation on our investment in Mercury of \$74.9 million and \$4.3 million for the six months ended June 30, 2007 and 2006, respectively, and \$106.1 million, \$53.8 million, and zero for the years ended December 31, 2006, 2005, and 2004, respectively.

On August 9, 2007, Mercury was sold for an enterprise value of approximately \$452 million, subject to post-closing adjustments. We realized a gain on our majority equity interest of approximately \$259 million, subject to post-closing adjustments. Approximately \$11 million of our proceeds from the sale of our equity is subject to certain holdback provisions. In addition, we were repaid approximately \$51 million of subordinated debt outstanding to Mercury at closing.

**Business Loan Express, LLC.** BLX originates, sells, and services primarily real estate secured loans, including real estate secured conventional small business loans, SBA 7(a) loans, and small investment real estate loans. BLX has offices across the United States and is headquartered in New York, NY. We acquired BLX in 2000.

At June 30, 2007, our investment in BLX totaled \$324.6 million at cost and \$220.8 million at value, or 4.4% of our total assets, which included unrealized depreciation of \$103.8 million. At December 31, 2006, our investment in BLX totaled \$295.3 million at cost and \$210.7 million at value, or 4.3% of our total assets, which included unrealized depreciation of \$84.6 million. In the first six months of 2007, we increased our investment in BLX by \$29.2 million by acquiring additional Class A equity interests. In addition, in the first quarter of 2007, the chief executive officer of BLX invested \$3.0 million in the form of Class A equity interests in BLX. We agreed to purchase these interests for cash at fair value in the event that BLX amends or otherwise restructures its existing senior credit facility or he is terminated for any reason. The purpose of these additional investments was to fund payments to the SBA in the first quarter of 2007 discussed below and to provide additional equity capital to BLX.

Total interest and related portfolio income earned from our investment in BLX for the six months ended June 30, 2007 and 2006, and for the years ended December 31, 2006, 2005, and 2004, was as follows:

	Six Months Ended June 30,		Year Ended December 31,		
	2007	2006	2006	2005	2004
<b>(\$ in millions)</b>					
Interest income	\$	\$ 7.8	\$ 11.9	\$ 14.3	\$ 23.2
Dividend income				14.0	14.8
Fees and other income	2.8	4.3	7.8	9.2	12.0
 Total interest and related portfolio income	 \$ 2.8	 \$ 12.1	 \$ 19.7	 \$ 37.5	 \$ 50.0

Interest and dividend income from BLX for the six months ended June 30, 2006, and for the years ended December 31, 2006, 2005, and 2004, included interest and dividend income of \$3.7 million, \$5.7 million, \$8.9 million, and \$25.4 million, respectively, which was paid in kind. The interest and dividends paid in kind were paid to us through the issuance of additional debt or equity interests. In the fourth quarter of 2006, we placed our investment in BLX's 25% Class A equity interests on non-accrual status. As a result, there was no interest income from our investment in BLX for the six months ended June 30, 2007, and this resulted in lower interest income from our investment in BLX for the first six months of 2007 as compared to the first six months of 2006, as well as for 2006 as compared to 2005.

In consideration for providing a guaranty on BLX's revolving credit facility and standby letters of credit (discussed below), we earned fees of \$2.8 million and \$3.1 million for the six months ended June 30, 2007 and 2006, respectively, and \$6.1 million, \$6.3 million, and \$6.0 million for the years ended December 31, 2006, 2005, and 2004, respectively, which were included in fees and other income above. Other assets included a receivable from BLX of \$2.8 million related to these fees at June 30, 2007. At December 31, 2006, accrued interest and fees due from BLX totaled \$1.7 million, which was paid in cash in the first quarter of 2007. The remaining fees and other income relate to management fees from BLX. We did not charge a management fee to BLX in the fourth quarter of 2006 or in the first or second quarter of 2007.

Net change in unrealized appreciation or depreciation included a net increase in unrealized depreciation on our investment in BLX of \$19.1 million for the six months ended June 30, 2007, a net decrease in unrealized appreciation of \$33.6 million for the six months ended June 30, 2006, a net decrease of \$142.3 million and \$32.3 million for the



years ended December 31, 2006 and 2004, respectively, and a net increase of \$2.9 million for the year ended December 31, 2005. See Results of Operations, Valuation of Business Loan Express, LLC below.

BLX is a national, non-bank lender that participates in the SBA's 7(a) Guaranteed Loan Program and is licensed by the SBA as a Small Business Lending Company (SBLC). The Office of the Inspector General of the SBA (OIG) and the United States Secret Service are conducting an ongoing investigation of allegedly fraudulently obtained SBA-guaranteed loans issued by BLX. Specifically, on or about January 9, 2007, BLX became aware of an indictment captioned as the United States v. Harrington, No. 2:06-CR-20662 pending in the United States District Court for the Eastern District of Michigan. The indictment alleges that a former BLX employee in the Detroit office engaged in the fraudulent origination of loans guaranteed, in substantial part, by the SBA. We understand that BLX is working cooperatively with the U.S. Attorney's Office and the investigating agencies with respect to this matter. The OIG and the U.S. Department of Justice are also conducting a civil investigation of BLX's lending practices in various jurisdictions. In addition, the Office of the Inspector General of the U.S. Department of Agriculture is conducting an investigation of BLX's lending practices under the Business and Industry Loan (B&I) program. These investigations are ongoing.

As an SBA lender, BLX is also subject to other SBA and OIG audits, investigations, and reviews. These investigations, audits and reviews, 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. We have considered BLX's current regulatory issues and ongoing investigations and litigation in performing the valuation of BLX at June 30, 2007. See Results of Operations, Valuation of Business Loan Express, LLC below. We are monitoring the situation. We have retained a third party to work with BLX to review BLX's current internal control systems. The third party conducted the review and offered recommendations to strengthen BLX's controls, which are being implemented.

On March 6, 2007, BLX entered into an agreement with the SBA. According to the agreement, BLX remains a preferred lender in the SBA 7(a) Guaranteed Loan Program and retains the ability to sell loans into the secondary market. As part of this agreement, BLX agreed to the immediate payment of approximately \$10 million to the SBA to cover amounts paid by the SBA with respect to some of the SBA-guaranteed loans that have been the subject of inquiry by the United States Attorney's Office for the Eastern District of Michigan. As part of the SBA's increased oversight, the agreement provides that any loans originated and closed by BLX during the term of the agreement will be reviewed by an independent third party selected by the SBA prior to the sale of such loans into the secondary market. The agreement also requires BLX to repurchase the guaranteed portion of certain loans that default after having been sold into the secondary market, and subjects such loans to a similar third party review prior to any reimbursement of BLX by the SBA. In connection with this agreement, BLX also entered into an escrow agreement with the SBA and an escrow agent in which BLX agreed to deposit \$10 million with the escrow agent for any additional payments BLX may be obligated to pay to the SBA in the future. BLX remains subject to SBA rules and regulations and as a result may be required to make additional payments to the SBA in the ordinary course of business. The agreement states that nothing in the agreement shall affect the rights of BLX to securitize or service its loans. Notwithstanding the foregoing, BLX and the SBA are conducting ongoing

discussions with respect to BLX's ability to securitize the unguaranteed portions of SBA loans in accordance with the requirements of the SBA regulations.

BLX has a separate non-recourse warehouse facility to enable it to securitize the unguaranteed portion of its SBA loans. BLX has been receiving temporary extensions of the warehouse facility, and the current extension expires on August 30, 2007. BLX is in negotiations with the warehouse facility providers to renew and amend the facility for an additional one-year term, subject to satisfactory conclusion of discussions with the SBA with respect to BLX's ability to securitize the unguaranteed portions of SBA loans. If the current facility were to expire without renewal, the warehouse facility notes would become due and payable, and substantially all collections on the unguaranteed interests that currently are in the warehouse facility would be applied to repay the outstanding amounts owing to the warehouse providers until the warehouse providers were paid in full, similar to an amortizing term loan. In this event, the warehouse providers would not have recourse to BLX for repayment of the warehouse facility notes. In addition, BLX would not have the right to sell additional unguaranteed interests in SBA loans into this facility. In the event that BLX is unable to reach agreement with the SBA on BLX's ability to securitize the unguaranteed portions of SBA loans or if the warehouse providers do not agree to an extension of the warehouse facility, BLX will be required to seek alternative sources of capital to finance SBA loan originations and could incur higher capital costs.

At June 30, 2007, BLX had a three-year \$500.0 million revolving credit facility provided by third-party lenders that matures in March 2009. The revolving credit facility may be expanded to \$600.0 million through new or additional commitments at BLX's option. This facility provides for a sub-facility for the issuance of letters of credit for up to an amount equal to 25% of the committed facility. We have provided an unconditional guaranty to these revolving credit facility lenders in an amount equal to 50% of the total obligations (consisting of principal, letters of credit issued under the facility, accrued interest, and other fees) of BLX under this facility. At June 30, 2007, the principal amount outstanding on the revolving credit facility was \$357.7 million and letters of credit issued under the facility were \$52.9 million. The total obligation guaranteed by us at June 30, 2007, was \$205.8 million. At June 30, 2007, we had also provided four standby letters of credit totaling \$20.0 million in connection with four term securitization transactions completed by BLX.

The guaranty on the BLX revolving line of credit facility can be called by the lenders in the event of a default, which includes certain defaults under our revolving credit facility. Among other requirements, the BLX facility requires that BLX maintain compliance with certain financial covenants such as interest coverage, maximum debt to net worth, asset coverage, and maintenance of certain asset quality metrics. In addition, BLX would have an event of default if BLX failed to maintain its lending status with the SBA and such failure could reasonably be expected to result in a material adverse effect on BLX, or if BLX failed to maintain certain financing programs for the sale or long-term funding of BLX's loans. In June, 2007, BLX received waivers until September 30, 2007, from its lenders with respect to (i) non-compliance with certain facility covenants and (ii) the requirement for BLX to maintain certain financing programs for SBA loans. The waivers regarding financing programs for SBA loans provide that BLX may retain unguaranteed portions of SBA loans on its balance sheet until September 30, 2007. In addition, BLX previously received waivers from its lenders with respect to certain other covenants to permit BLX to comply with its obligations under its agreement with the SBA. BLX's agreement with the SBA has reduced the company's liquidity due to the working capital

required to comply with the agreement. BLX is in negotiations with its lenders to amend the credit facility covenants, but there can be no assurance that such negotiations will be successful. If the credit facility lenders do not agree to amend the covenants or to waive compliance with the covenants at subsequent quarter ends, BLX would be in default under the credit facility.

The current market conditions for small business loans remain very competitive, and as a result, BLX continues to experience high loan prepayments in its securitized loan portfolio. This competitive environment combined with BLX's liquidity constraints has restrained BLX's ability to grow its loan origination volume. Due to the changes in BLX's operations, the status of its current financing facilities and the effect of BLX's current regulatory issues, ongoing investigations and litigation, we are in the process of working with BLX with respect to various potential strategic alternatives including, but not limited to, recapitalization, restructuring, joint venture or sale or divestiture of BLX or some or all of its assets. The ultimate resolution of these matters could have a material adverse impact on BLX's financial condition, and, as a result, our financial results could be negatively affected.

On or about January 16, 2007, BLX and Business Loan Center LLC (BLC) became aware of a lawsuit titled, United States, ex rel James R. Brickman and Greenlight Capital, Inc. v. Business Loan Express LLC f/k/a Business Loan Express, Inc.; Business Loan Center LLC f/k/a Business Loan Center, Inc.; Robert Tannenhauser; Matthew McGee; and George Harrigan, 05-CV-3147 (JEC), that is pending in the United States District Court for the Northern District of Georgia. The complaint includes allegations arising under the False Claims Act and relating to alleged fraud in connection with SBA guarantees on shrimp vessel loans made by BLX and BLC. On April 9, 2007, BLX, BLC and the other defendants filed motions to dismiss the complaint in its entirety. The motions are pending.

**Advantage Sales & Marketing, Inc.** At December 31, 2005, our investment in Advantage totaled \$257.7 million at cost and \$660.4 million at value, or 16.4% of our total assets, which included unrealized appreciation of \$402.7 million. Advantage is a sales and marketing agency providing outsourced sales, merchandising, and marketing services to the consumer packaged goods industry. Advantage has offices across the United States and is headquartered in Irvine, CA. We completed the purchase of a majority ownership in Advantage in June 2004.

On March 29, 2006, we sold our majority equity interest in Advantage. We were repaid our \$184 million in subordinated debt outstanding and realized a gain at closing on our equity investment sold of \$433.1 million, subject to post-closing adjustments. Subsequent to closing on this sale, we realized additional gains in 2006 resulting from post-closing adjustments totaling \$1.3 million. Our realized gain was \$434.4 million for the year ended December 31, 2006, subject to post-closing adjustments and excluding any earn-out amounts. In addition, we are entitled to receive additional consideration through an earn-out payment based on Advantage's 2006 audited results. The earn-out payment totaled \$3.1 million, subject to potential post-determination adjustments, and was recorded as a realized gain in the second quarter of 2007.

As consideration for the common stock sold in the transaction, we received a \$150 million subordinated note, with the balance of the consideration paid in cash. In addition, a portion of our cash proceeds from the sale of the common stock were placed in escrow, subject to certain holdback provisions. At June 30, 2007, the amount of the escrow

included in other assets on our consolidated balance sheet was approximately \$24 million. For tax purposes, the receipt of the \$150 million subordinated note as part of our consideration for the common stock sold and the hold back of certain proceeds in escrow has allowed us, through installment treatment, to defer the recognition of taxable income for a portion of our realized gain until the note or other amounts are collected.

Total interest and related portfolio income earned from our investment in Advantage while we held a majority equity interest was \$14.1 million (which included a prepayment premium of \$5.0 million) for the six months ended June 30, 2006, and for the year ended December 31, 2006, and \$37.4 million and \$21.3 million, for the years ended December 31, 2005 and 2004, respectively. In addition, we earned structuring fees of \$2.3 million on our new \$150 million subordinated debt investment in Advantage upon the closing of the sale transaction in the first quarter of 2006. Net change in unrealized appreciation or depreciation for the six months ended June 30, 2006, and for the year ended December 31, 2006, included the reversal of \$389.7 million of previously recorded unrealized appreciation associated with the realization of a gain on the sale of our majority equity interest in Advantage in the first quarter of 2006.

In connection with the sale transaction, we retained an equity investment in the business valued at \$15 million at closing as a minority shareholder. During the fourth quarter of 2006, Advantage made a distribution on this minority equity investment, which reduced our cost basis to zero and resulted in a realized gain of \$4.8 million.

Our investment in Advantage at June 30, 2007, which was composed of subordinated debt and a minority equity interest, totaled \$153.2 million at cost and \$164.2 million at value, which included unrealized appreciation of \$11.0 million.

***Investments in CLOs and Other Similar Funds.*** Subsequent to June 30, 2007, the debt capital markets have shown volatility and yield spreads have widened. With respect to the CLO market, investor demand for pricing has increased. As a result, we believe that the market yields for our investments in CLOs and other similar funds, which primarily invest in senior corporate loans, may have increased subsequent to June 30, 2007, and as a result, the fair value of our investments may have decreased. At June 30, 2007, these investments represented less than 3.3% of our total assets.

**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 six months ended June 30, 2007 and 2006, and at and for the years ended December 31, 2006, 2005, and 2004, were as follows:

	At and for the Six Months Ended June 30,				At and for the Years Ended December 31,					
	2007		2006		2006		2005		2004	
	Value	Yield <sup>(1)</sup>	Value	Yield <sup>(1)</sup>	Value	Yield <sup>(1)</sup>	Value	Yield <sup>(1)</sup>	Value	Yield <sup>(1)</sup>
<b>(\$ in millions)</b>										
Portfolio at value:										
CMBS bonds	\$		\$		\$		\$		\$ 373.8	14.6%
CDO bonds and preferred shares									212.6	16.8%
Commercial mortgage loans	68.7	6.6%	96.5	8.1%	71.9	7.5%	102.6	7.6%	95.0	6.8%
Real estate owned	20.4		14.6		19.6		13.9		16.9	
Equity interests	33.7		22.0		26.7		10.6		13.0	
<b>Total portfolio</b>	<b>\$ 122.8</b>		<b>\$ 133.1</b>		<b>\$ 118.2</b>		<b>\$ 127.1</b>		<b>\$ 711.3</b>	
Investments funded	\$ 15.4		\$ 13.9		\$ 14.4		\$ 213.5		\$ 383.7	
Change in accrued or reinvested interest	\$ 0.1		\$ 0.5		\$ 1.0		\$ (18.0)		\$ 6.6	
Principal collections related to investment repayments or sales <sup>(2)</sup>	\$ 18.4		\$ 17.2		\$ 39.9		\$ 799.5		\$ 357.3	

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

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

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

(\$ in millions)	Face Amount	Discount	Amount Funded
<b><i>For the Year Ended December 31, 2006</i></b>			
Commercial mortgage loans	\$ 8.0	\$	\$ 8.0
Equity interests	6.4		6.4
Total	\$ 14.4	\$	\$ 14.4
<b><i>For the Year Ended December 31, 2005</i></b>			
CMBS bonds <sup>(1)</sup>	\$ 211.5	\$ (90.5)	\$ 121.0
Commercial mortgage loans	88.5	(0.8)	87.7
Equity interests	4.8		4.8
Total	\$ 304.8	\$ (91.3)	\$ 213.5
<b><i>For the Year Ended December 31, 2004</i></b>			
CMBS bonds	\$ 419.1	\$ (183.7)	\$ 235.4
CDO bonds and preferred shares	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

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

At June 30, 2007, we had outstanding funding commitments related to commercial mortgage loans and equity interests of \$43.8 million, and commitments in the form of standby letters of credit and guarantees related to equity interests of \$8.2 million.

During the fourth quarter of 2006, we sold commercial mortgage loans with a total outstanding principal balance of \$21.1 million and realized a gain of \$0.7 million. As these loans were purchased at prices that were based in part on comparable Treasury rates, we had a related hedge in place to protect against movements in Treasury rates. Upon the loan sale, we settled the related hedge, which resulted in a realized gain of \$0.5 million, which was included in the realized gain on the sale of \$0.7 million. At June 30, 2007, we did not have any similar hedges in place.

***Sale of CMBS Bonds and Collateralized Debt Obligation Bonds and Preferred Shares.*** On May 3, 2005, we completed the sale of our portfolio of commercial mortgage-backed securities (CMBS) and real estate related collateralized debt obligation (CDO) bonds and preferred shares to affiliates of Caisse de dépôt et placement du Québec (the Caisse) for cash proceeds of \$976.0 million and a net realized gain of \$227.7 million, after transaction and other costs of \$7.8 million. Transaction costs included investment banking fees, legal and other professional fees, and other transaction costs. The CMBS and CDO assets sold had a cost basis at closing of \$739.8 million, including accrued interest of \$21.7 million. Upon the closing of the sale, we settled all the hedge positions relating to these assets, which resulted in a net realized loss of \$0.7 million, which was included in the net realized gain on the sale. Under the sale agreement, we agreed not to primarily invest in CMBS and real estate-related CDOs and refrain from certain other real estate-related investing or servicing activities for a period of three years, or through May 2008,

subject to certain limitations and excluding our existing portfolio and related activities.

**PORTFOLIO ASSET QUALITY**

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

At June 30, 2007, and December 31, 2006 and 2005, our portfolio was graded as follows:

Grade	2007		2006		2005	
	Portfolio at Value	Percentage of Total Portfolio	Portfolio at Value	Percentage of Total Portfolio	Portfolio at Value	Percentage of Total Portfolio
(\$ in millions)						
1	\$ 1,727.2	38.6%	\$ 1,307.3	29.1%	\$ 1,643.0	45.6%
2	2,207.0	49.4	2,672.3	59.4	1,730.8	48.0
3	359.4	8.0	308.1	6.9	149.1	4.1
4	72.8	1.6	84.2	1.9	26.5	0.7
5	104.7	2.4	124.2	2.7	57.0	1.6
	\$ 4,471.1	100.0%	\$ 4,496.1	100.0%	\$ 3,606.4	100.0%

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

Total Grade 4 and 5 portfolio assets were \$177.5 million, \$208.4 million and \$83.5 million, respectively, or were 4.0%, 4.6% and 2.3%, respectively, of the total portfolio value at June 30, 2007, and December 31, 2006 and 2005. Grade 4 and 5 assets include loans, debt securities, and equity securities. We expect that a number of investments will be in the Grades 4 or 5 categories from time to time. Part of the private equity business is working with troubled portfolio companies to improve their businesses and protect our investment. The number and amount of investments included in Grade 4 and 5 may fluctuate from period to period. We continue to follow our historical practice of working with portfolio companies in order to recover the maximum amount of our investment.

At June 30, 2007, and December 31, 2006, \$165.2 million and \$135.9 million, respectively, of our investment in BLX at value was classified as Grade 3, which included our Class A equity interests and certain of our Class B equity interests that were not depreciated. At June 30, 2007, and December 31, 2006, \$55.6 million and \$74.8 million, respectively, of our investment in BLX at value was classified as Grade 5, which included certain of our Class B equity interests and our Class C equity interests that were depreciated. At December 31, 2005, our investment in BLX of \$357.1 million at value was classified as Grade 1. See Private Finance, Business Loan Express, LLC above.



**Loans and Debt Securities on Non-Accrual Status.** At June 30, 2007, and December 31, 2006 and 2005, loans and debt securities at value not accruing interest for the total investment portfolio were as follows:

	2007	2006	2005
<b>(\$ in millions)</b>			
Loans and debt securities in workout status (classified as Grade 4 or 5) <sup>(1)</sup>			
Private finance			
Companies more than 25% owned	\$ 20.4	\$ 51.1	\$ 15.6
Companies 5% to 25% owned	27.5	4.0	
Companies less than 5% owned	22.7	31.6	11.4
Commercial real estate finance	12.3	12.2	12.9
Loans and debt securities not in workout status			
Private finance			
Companies more than 25% owned	171.0	87.1	58.0
Companies 5% to 25% owned	18.3	7.2	0.5
Companies less than 5% owned	19.1	38.9	49.5
Commercial real estate finance	6.8	6.7	7.9
<b>Total</b>	<b>\$ 298.1</b>	<b>\$ 238.8</b>	<b>\$ 155.8</b>
Percentage of total portfolio	6.7%	5.3%	4.3%

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

In general, interest is not accrued on loans and debt securities if we have doubt about interest collection or where the enterprise value of the portfolio company may not support further accrual. In addition, interest may not accrue on loans to portfolio companies that are more than 50% owned by us depending on such company's capital requirements. To the extent interest payments are received on a loan that is not accruing interest, we may use such payments to reduce our cost basis in the investment in lieu of recognizing interest income. At June 30, 2007, and December 31, 2006, our Class A equity interests in BLX of \$95.8 million and \$66.6 million, respectively, which represented 2.1% and 1.5% of the total portfolio at value, respectively, were included in non-accruals. The BLX 25% Class A equity interests were placed on non-accrual status during the fourth quarter of 2006. See Private Finance, Business Loan Express, LLC above.

**Loans and Debt Securities Over 90 Days Delinquent.** Loans and debt securities greater than 90 days delinquent at value at June 30, 2007, and December 31, 2006 and 2005, were as follows:

	2007	2006	2005
<b>(\$ in millions)</b>			
Private finance	\$ 136.1	\$ 46.5	\$ 74.6
Commercial mortgage loans	1.9	1.9	6.1
<b>Total</b>	<b>\$ 138.0</b>	<b>\$ 48.4</b>	<b>\$ 80.7</b>
Percentage of total portfolio	3.1%	1.1%	2.2%

The amount of loans and debt securities over 90 days delinquent increased to \$138.0 million at June 30, 2007, from \$48.4 million at December 31, 2006. The increase in loans and debt securities over 90 days delinquent primarily relates to not receiving payment on our Class A equity interests of BLX of \$95.8 million, which represented 2.1% of the total portfolio at value. The Class A equity interests were placed on non-accrual during the fourth quarter of 2006. See Private Finance, Business Loan Express, LLC above.

The amount of the portfolio that is on non-accrual status or greater than 90 days delinquent may vary from period to period. Loans and debt securities on non-accrual status and over 90 days delinquent should not be added together as they are two separate measures of portfolio asset quality. Loans and debt securities that are in both categories (i.e., on non-accrual status and over 90 days delinquent) totaled \$138.0 million, \$44.3 million, and \$60.7 million at June 30, 2007, and December 31, 2006 and 2005, respectively.

**OTHER ASSETS AND OTHER LIABILITIES**

Other assets is composed primarily of fixed assets, assets held in deferred compensation trusts, prepaid expenses, deferred financing and offering costs, and accounts receivable, which includes amounts received in connection with the sale of portfolio companies, including amounts held in escrow, and other receivables from portfolio companies. At June 30, 2007, and December 31, 2006 and 2005, other assets totaled \$153.5 million, \$123.0 million, and \$87.9 million, respectively. The increase from December 31, 2006, to June 30, 2007, was primarily the result of increased prepaid expenses related to tax deposits and deferred financing costs. The increase since December 31, 2005, was primarily the result of amounts received in connection with the sale of Advantage and certain other portfolio companies that are being held in escrow. See Private Finance above.

Accounts payable and other liabilities is primarily composed of the liabilities related to the deferred compensation trust and accrued interest, bonus and taxes, including excise tax. At June 30, 2007, December 31, 2006 and 2005, accounts payable and other liabilities totaled \$132.5 million, \$147.1 million, and \$102.9 million, respectively. The decrease from December 31, 2006, to June 30, 2007, was primarily the result of the payment of liabilities at December 31, 2006, in the first quarter of 2007 related to accrued 2006 bonuses of \$38.0 million, excise tax of \$15.4 million and an extra dividend of \$7.5 million, offset by an increase in liabilities for 2007 related to accrued 2007 bonuses and excise taxes totaling \$28.7 million, an increase in the liability related to the deferred compensation trust of \$7.3 million, and an increase in accrued interest payable of \$7.0 million. The increase from December 31, 2005 to December 31, 2006, was primarily the result of an increase in the liability related to the deferred compensation trust of \$13.6 million, accrued bonus of \$11.3 million, accrued interest payable of \$10.3 million, and accrued excise tax of \$9.2 million. Accrued interest fluctuates from period to period depending on the amount of debt outstanding and the contractual payment dates of the interest on such debt.

**RESULTS OF OPERATIONS****Comparison of the Three and Six Months Ended June 30, 2007 and 2006**

The following table summarizes our operating results for the three and six months ended June 30, 2007 and 2006.

	For the Three Months Ended June 30,				For the Six Months Ended June 30,			
	2007	2006	Change	Percent Change	2007	2006	Change	Percent Change
<b>(in thousands, except per share amounts)</b>								
<b>Interest and Related Portfolio Income:</b>								
Interest and dividends	\$ 102,814	\$ 95,433	\$ 7,381	8%	\$ 204,797	\$ 184,314	\$ 20,483	11%
Fees and other income	14,862	15,023	(161)	(1%)	20,831	37,153	(16,322)	(44%)
Total interest and related portfolio income	117,676	110,456	7,220	7%	225,628	221,467	4,161	2%
<b>Expenses:</b>								
Interest	34,336	21,861	12,475	57%	64,624	46,346	18,278	39%
Employee	28,611	20,398	8,213	40%	50,539	41,826	8,713	21%
Employee stock options	9,519	4,597	4,922	107%	13,180	8,203	4,977	61%
Administrative	14,505	9,861	4,644	47%	27,729	21,195	6,534	31%
Total operating expenses	86,971	56,717	30,254	53%	156,072	117,570	38,502	33%
Net investment income before income taxes	30,705	53,739	(23,034)	(43%)	69,556	103,897	(34,341)	(33%)
Income tax expense (benefit), including excise tax	5,530	3,544	1,986	56%	4,881	12,402	(7,521)	(61%)
Net investment income	25,175	50,195	(25,020)	(50%)	64,675	91,495	(26,820)	(29%)
<b>Net Realized and Unrealized Gains (Losses):</b>								
Net realized gains	74,879	100,240	(25,361)	*	102,545	533,075	(430,530)	*
Net change in unrealized	(10,896)	(116,706)	105,810	*	55,024	(491,254)	(546,278)	*

appreciation or  
depreciation

Total net gains (losses)	63,983	(16,466)	80,449	*	157,569	41,821	115,748	*
Net income	\$ 89,158	\$ 33,729	\$ 55,429	164%	\$ 222,244	\$ 133,316	\$ 88,928	67%
Diluted earnings per common share	\$ 0.57	\$ 0.24	\$ 0.33	138%	\$ 1.44	\$ 0.94	\$ 0.50	54%
Weighted average common shares outstanding diluted	156,051	143,213	12,838	9%	154,446	142,466	11,980	8%

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

**Total Interest and Related Portfolio Income.** Total interest and related portfolio income includes interest and dividend income and fees and other income.

**Interest and Dividends.** Interest and dividend income for the three and six months ended June 30, 2007 and 2006, was composed of the following:

(\$ in millions)	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2007	2006	2007	2006
<b>Interest</b>				
Private finance loans and debt securities	\$ 96.9	\$ 88.6	\$ 193.5	\$ 171.2
Commercial mortgage loans	2.5	2.1	3.8	4.8
Cash, U.S. Treasury bills, money market and other securities	3.4	2.9	6.2	5.9
<b>Total interest</b>	<b>102.8</b>	<b>93.6</b>	<b>203.5</b>	<b>181.9</b>
<b>Dividends</b>		1.8	1.3	2.4
<b>Total interest and dividends</b>	<b>\$ 102.8</b>	<b>\$ 95.4</b>	<b>\$ 204.8</b>	<b>\$ 184.3</b>

The level of interest income from the portfolio, which includes interest paid in cash and in kind, is directly related to the balance of the interest-bearing investment portfolio outstanding during the period multiplied by the weighted average yield. The interest-bearing investments in the portfolio at value and the yield on the interest-bearing investments in the portfolio at June 30, 2007 and 2006, were as follows:

(\$ in millions)	2007		2006	
	Value	Yield <sup>(1)</sup>	Value	Yield <sup>(1)</sup>
Private finance loans and debt securities	\$ 2,983.4	11.7%	\$ 2,491.2	12.7%
Commercial mortgage loans	68.7	6.6%	96.5	8.1%
<b>Total</b>	<b>\$ 3,052.1</b>	<b>11.6%</b>	<b>\$ 2,587.7</b>	<b>12.6%</b>

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

Our interest income from our private finance loans and debt securities has increased year over year primarily as a result of the growth in this portfolio, net of the reduction in yield. The private finance portfolio yield at June 30, 2007, of 11.7% as compared to the private finance portfolio yield of 12.7% at June 30, 2006, reflects the mix of debt investments in the private finance portfolio. The weighted average yield varies from period to period based on the current stated interest on loans and debt securities and the amount of loans and debt securities for which interest is not accruing. See the discussion of the private finance portfolio yield above under the caption Portfolio and Investment

Activity Private Finance.

Interest income from cash, U.S. Treasury bills, money market and other securities results primarily from interest earned on our liquidity portfolio. See Financial Condition, Liquidity and Capital Resources below. The value and weighted average yield of the

liquidity portfolio was \$200.7 million and 5.3%, respectively, at June 30, 2007, and \$201.8 million and 5.3%, respectively, at December 31, 2006.

Dividend income results from the dividend yield on preferred equity interests, if any, or the declaration of dividends by a portfolio company on preferred or common equity interests. Dividend income will vary from period to period depending upon the timing and amount of dividends that are declared or paid by a portfolio company on preferred or common equity interests.

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

Fees and other income for the three and six months ended June 30, 2007 and 2006, included fees relating to the following:

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2007	2006	2007	2006
<b>(\$ in millions)</b>				
Structuring and diligence	\$ 6.2	\$ 8.0	\$ 7.9	\$ 19.0
Management, consulting and other services provided to portfolio companies <sup>(1)</sup>	2.3	2.4	4.1	6.6
Commitment, guaranty and other fees from portfolio companies <sup>(2)</sup>	2.9	2.9	5.0	4.6
Loan prepayment premiums	3.4	1.7	3.6	7.0
Other income	0.1		0.2	
 Total fees and other income	 \$ 14.9	 \$ 15.0	 \$ 20.8	 \$ 37.2

<sup>(1)</sup> The six months ended June 30, 2006 includes \$1.8 million in management fees from Advantage prior to its sale on March 29, 2006. See [Portfolio and Investment Activity](#) above for further discussion.

<sup>(2)</sup> Includes guaranty and other fees from BLX of \$1.3 million and \$1.6 million for the three months ended June 30, 2007 and 2006, respectively, and \$2.8 million and \$3.1 million for the six months ended June 30, 2007 and 2006, respectively. See [Private Finance, Business Loan Express, LLC](#) above.

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

Structuring and diligence fees primarily relate to the level of new investment originations. Private finance investments funded were \$643.7 million for the six months ended June 30, 2007, as compared to \$1.2 billion for the six months ended June 30, 2006.

Loan prepayment premiums for the six months ended June 30, 2006, included \$5.0 million related to the repayment of our subordinated debt in connection with the sale of our majority equity interest in Advantage on March 29, 2006. See [Portfolio and Investment Activity](#) above for further discussion. While the scheduled maturities



of

private finance and commercial real estate loans generally range from five to ten years, it is not unusual for our borrowers to refinance or pay off their debts to us ahead of schedule. Therefore, we generally structure our loans to require a prepayment premium for the first three to five years of the loan. Accordingly, the amount of prepayment premiums will vary depending on the level of repayments and the age of the loans at the time of repayment.

*Mercury and BLX.* Mercury and BLX were our largest investments at value at June 30, 2007, and together represented 10.7% and 11.4% of our total assets at June 30, 2007 and 2006, respectively.

Total interest and related portfolio income from these investments for the three and six months ended June 30, 2007 and 2006, was as follows:

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2007	2006	2007	2006
(\$ in millions)				
Mercury	\$ 2.2	\$ 2.5	\$ 4.3	\$ 5.6
BLX	\$ 1.3	\$ 6.0	\$ 2.8	\$ 12.1

See Portfolio and Investment Activity above for further detail on Mercury and BLX.

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

*Interest Expense.* The fluctuations in interest expense during the three and six months ended June 30, 2007 and 2006, were primarily attributable to changes in the level of our borrowings under various notes payable and our revolving line of credit. Our borrowing activity and weighted average cost of debt, including fees and debt financing costs, at and for the three and six months ended June 30, 2007 and 2006, were as follows:

	At and for the Three Months Ended June 30,		At and for the Six Months Ended June 30,	
	2007	2006	2007	2006
(\$ in millions)				
Total outstanding debt	\$ 1,921.8	\$ 1,208.9	\$ 1,921.8	\$ 1,208.9
Average outstanding debt	\$ 1,965.6	\$ 1,301.1	\$ 1,904.4	\$ 1,395.8
Weighted average cost <sup>(1)</sup>	6.6%	6.6%	6.6%	6.6%

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

In addition, interest expense included interest paid to the Internal Revenue Service related to installment sale gains totaling \$2.0 million and \$0.2 million for the three months ended June 30, 2007 and 2006, respectively, and \$2.3 million and \$0.4 million for the six months ended June 30, 2007 and 2006, respectively. Installment interest expense for the year ended December 31, 2007, is estimated to be a total of \$6.4 million. See Dividends and Distributions below.

*Employee Expense.* Employee expenses for the three and six months ended June 30, 2007 and 2006, were as follows:

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2007	2006	2007	2006
<b>(\$ in millions)</b>				
Salaries and employee benefits	\$ 21.2	\$ 17.6	\$ 42.6	\$ 35.0
Individual performance award (IPA)	2.4	2.1	4.9	3.8
IPA mark to market expense (benefit)	2.4	(1.5)	(1.6)	(0.6)
Individual performance bonus (IPB)	2.6	2.2	4.6	3.6
<b>Total employee expense</b>	<b>\$ 28.6</b>	<b>\$ 20.4</b>	<b>\$ 50.5</b>	<b>\$ 41.8</b>
Number of employees at end of period	173	166	173	166

The change in salaries and employee benefits reflects the effect of compensation increases, the change in mix of employees given their area of responsibility and relevant experience level and an increase in the number of employees. Salaries and employee benefits include an accrual for employee bonuses, which are generally paid annually after the completion of the fiscal year. The quarterly accrual is based upon an estimate of annual bonuses and is subject to change. The amount of the current year bonuses will be finalized by the Compensation Committee and the Board of Directors at the end of the year. Salaries and employee benefits included accrued bonuses of \$11.2 million and \$9.0 million for the three months ended June 30, 2007 and 2006, respectively, and \$21.7 million and \$16.9 million for the six months ended June 30, 2007 and 2006, respectively.

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

We also have an IPB, which is distributed in cash to award recipients equally throughout the year (beginning in February of each year) as long as the recipient remains employed by us.

The Compensation Committee and the Board of Directors have determined the IPA and the IPB for 2007 and they are currently estimated to be approximately \$10 million each; however, the Compensation Committee may adjust the IPA or IPB as needed, or make new awards as new officers are hired. If a recipient terminates employment during the year, any further cash contribution for the IPA or remaining cash payments under the IPB would be forfeited.

*Option Cancellation Payment.* On July 18, 2007, we completed a tender offer related to our offer to all optionees who held vested in-the-money stock options as of June 20, 2007, the opportunity to receive an option cancellation payment (OCP) equal to the in-the-money value of the stock options cancelled, which would be paid one-half in cash and

one-half in unregistered shares of our common stock. We accepted for cancellation 10.3 million vested options, which in the aggregate had a weighted average exercise price of \$21.50. This resulted in a total option cancellation payment of approximately \$105.6 million, of which \$52.8 million was paid in cash and \$52.8 million was paid through the issuance of 1.7 million unregistered shares of the Company's common stock, determined using the Weighted Average Market Price of \$31.75. The Weighted Average Market Price represented the volume weighted average price of our common stock over the fifteen trading days preceding the first day of the offer period, or June 20, 2007. Our stockholders approved the issuance of the shares of our common stock in exchange for the cancellation of vested in-the-money stock options at our 2006 Annual Meeting of Stockholders. Cash payments to optionees were paid net of required payroll and income tax withholdings.

As the consideration paid by us for the OCP did not exceed the cancellation date fair value of the options, no expense will be recorded for the transaction in accordance with the guidance in FASB Statement No. 123 (Revised 2004). However, the portion of the OCP paid in cash of \$52.8 million will reduce our paid in capital and will therefore reduce our net asset value in the third quarter of 2007. For income tax purposes, our tax deduction resulting from the OCP will be similar to the tax deduction that would have resulted from an exercise of stock options in the market. Any tax deduction for us resulting from the OCP or an exercise of stock options in the market is limited by Section 162(m) of the Code for persons subject to Section 162(m).

Subsequent to the completion of the tender offer and the cancellation of the 10.3 million vested options, there were 18.3 million options outstanding and 11.0 million shares available to be granted under our Stock Option Plan. As part of this initiative, the Board of Directors adopted a target ownership program that establishes minimum ownership levels for our senior officers and continues to further align the interests of our officers with those of our stockholders.

*Stock Options Expense.* In December 2004, the FASB issued Statement No. 123 (Revised 2004), Share-Based Payment (the Statement), which requires companies to recognize the grant-date fair value of stock options and other equity-based compensation issued to employees in the income statement. The Statement was effective January 1, 2006, and it applies to our stock option plan. Our employee stock options are typically granted with ratable vesting provisions, and we amortize the compensation cost over the related service period. The Statement was adopted using the modified prospective method of application, which required us to recognize compensation costs on a prospective basis beginning January 1, 2006. Under this method, the unamortized cost of previously awarded options that were unvested as of January 1, 2006, is recognized over the remaining service period in the statement of operations beginning in 2006, using the fair value amounts determined for proforma disclosure under the Statement. With respect to options granted on or after January 1, 2006, compensation cost based on estimated grant date fair value is

recognized in the consolidated statement of operations over the service period. The stock option expense for the three and six months ended June 30, 2007 and 2006, was as follows:

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2007	2006	2007	2006
<b>(\$ in millions)</b>				
Employee Stock Option Expense:				
Previously awarded, unvested options as of January 1, 2006	\$ 3.3	\$ 3.3	\$ 6.5	\$ 6.7
Options granted on or after January 1, 2006	6.2	1.3	6.7	1.5
Total employee stock option expense	\$ 9.5	\$ 4.6	\$ 13.2	\$ 8.2

In addition to the employee stock option expense, for the three and six months ended June 30, 2007 and 2006, administrative expense included \$0.2 million of expense related to options granted to directors during each respective period. Options granted to non-officer directors vest on the grant date and therefore, the full expense is recorded on the grant date.

During the second quarter of 2007, options were granted for 6.4 million shares. One-third of the options granted to employees vested on June 30, 2007, therefore, approximately one-third of the expense related to this grant, or \$5.9 million, was recorded in the second quarter of 2007. Of the remaining options granted, one-half will vest on June 30, 2008, and one-half will vest on June 30, 2009. We estimate that the employee-related stock option expense under the Statement that will be recorded in our consolidated statement of operations, including the expense related to the options granted in the second quarter of 2007, will be approximately \$20.3 million, \$9.2 million, and \$2.6 million for the years ended December 31, 2007, 2008, and 2009, respectively, which includes approximately \$10.9 million, \$6.3 million, and \$2.6 million, respectively, related to options granted since adoption of the Statement (January 1, 2006). This estimate may change if our assumptions related to future option forfeitures change. This estimate does not include any expense related to future stock option grants as the fair value of those stock options will be determined at the time of grant.

*Administrative Expense.* Administrative expenses include legal and accounting fees, valuation assistance fees, insurance premiums, the cost of leases for our headquarters in Washington, DC, and our regional offices, portfolio origination and development expenses, travel costs, stock record expenses, directors fees and stock option expense, and various other expenses. Administrative expenses for the three and six months ended June 30, 2007 and 2006, were as follows:

	For the Three Months Ending June 30,		For the Six Months Ending June 30,	
	2007	2006	2007	2006
<b>(\$ in millions)</b>				
Administrative expenses	\$ 13.6	\$ 9.4	\$ 23.5	\$ 17.8
Investigation and litigation costs	0.9	0.5	4.2	3.4
Total administrative expenses	\$ 14.5	\$ 9.9	\$ 27.7	\$ 21.2

Administrative expenses, excluding investigation and litigation costs, for the six months ended June 30, 2007, included costs of \$1.4 million incurred in the first quarter of

2007 to engage a third party to work with BLX, a portfolio company controlled by us, to conduct a review of BLX's internal control systems. See Private Finance, Business Loan Express, LLC above. In addition, administrative expenses for the three and six months ended June 30, 2007, included \$2.5 million in placement fees related to securing equity commitments to the Allied Capital Senior Debt Fund, L.P. See Private Finance, Allied Capital Senior Debt Fund, L.P. above.

Investigation and litigation costs include costs associated with requests for information in connection with government investigations and other legal matters. We expect that we will continue to incur legal and other costs associated with these matters. These expenses remain difficult to predict. See Legal Proceedings below.

**Income Tax Expense (Benefit), Including Excise Tax.** Income tax expense (benefit) for the three and six months ended June 30, 2007 and 2006, was as follows:

(\$ in millions)	For the Three Months Ended June 30,		For the Six Months Ending June 30,	
	2007	2006	2007	2006
Income tax expense (benefit)	\$ 1.5	\$ 0.3	\$ (2.7)	\$ 0.8
Excise tax expense	4.0	3.2	7.6	11.6
Income tax expense (benefit), including excise tax	\$ 5.5	\$ 3.5	\$ 4.9	\$ 12.4

Our wholly owned subsidiary, A.C. Corporation, is a corporation subject to federal and state income taxes and records a benefit or expense for income taxes as appropriate based on its operating results in a given period.

Our estimated annual taxable income for 2007 currently exceeds our estimated dividend distributions to shareholders from such taxable income in 2007, and such estimated excess taxable income will be distributed in 2008. Therefore, we will generally be required to pay a 4% excise tax on the excess of 98% of our taxable income over the amount of actual distributions from such taxable income. We have recorded an estimated excise tax of \$4.0 million and \$7.6 million for the three and six months ended June 30, 2007, respectively. See Dividends and Distributions. While excise tax expense is presented in the Consolidated Statement of Operations as a reduction to net investment income, excise tax relates to both net investment income and net realized gains.

In June 2006, the FASB issued Interpretation No. 48, *Accounting for Uncertainty in Income Taxes*, which clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements in accordance with FASB Statement No. 109, *Accounting for Income Taxes*. This interpretation is effective for fiscal years beginning after December 15, 2006. The adoption of this interpretation did not have a significant effect on our consolidated financial position or our results of operations.

**Realized Gains and Losses.** Net realized gains primarily result from the sale of equity securities associated with certain private finance investments and the realization of unamortized discount resulting from the sale and early repayment of private finance loans

and commercial mortgage loans, offset by losses on investments. Net realized gains for the three and six months ended June 30, 2007 and 2006, were as follows:

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2007	2006	2007	2006
<b>(\$ in millions)</b>				
Realized gains	\$ 87.4	\$ 101.0	\$ 120.6	\$ 537.5
Realized losses	(12.5)	(0.8)	(18.1)	(4.4)
Net realized gains	\$ 74.9	\$ 100.2	\$ 102.5	\$ 533.1

When we exit an investment and realize a gain or loss, we make an accounting entry to reverse any unrealized appreciation or depreciation, respectively, we had previously recorded to reflect the appreciated or depreciated value of the investment. For the three months and six months ended June 30, 2007 and 2006, we reversed previously recorded unrealized appreciation or depreciation when gains or losses were realized as follows:

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2007	2006	2007	2006
<b>(\$ in millions)</b>				
Reversal of previously recorded net unrealized appreciation associated with realized gains	\$ (55.0)	\$ (95.6)	\$ (87.0)	\$ (489.2)
Reversal of previously recorded net unrealized depreciation associated with realized losses	16.6	0.5	22.3	3.2
Total reversal	\$ (38.4)	\$ (95.1)	\$ (64.7)	\$ (486.0)

Realized gains for the three months ended June 30, 2007 and 2006, were as follows:

**(\$ in millions)**

**2007**

Portfolio Company	Amount
<b>Private Finance:</b>	
HMT, Inc.	\$ 39.9
Healthy Pet Corp.	36.6
Wear Me Apparel Corporation	6.1
Advantage Sales & Marketing, Inc.	3.1
Geotrace Technologies, Inc.	1.1
Other	0.6



Total realized gains \$ 87.4

**2006**

<b>Portfolio Company</b>	<b>Amount</b>
<b>Private Finance:</b>	
STS Operating, Inc.	\$ 94.8
United Site Services, Inc.	3.3
MHF Logistical Solutions, Inc.	1.2
Advantage Sales & Marketing, Inc.	0.6
Other	1.1
Total realized gains	\$ 101.0

Realized losses for the three months ended June 30, 2007 and 2006, were as follows:  
(\$ in millions)

## 2007

Portfolio Company	Amount
<b>Private Finance:</b>	
Powell Plant Farms, Inc.	\$ 11.5
Alaris Consulting, LLC	1.0
Total realized losses	\$ 12.5

## 2006

Portfolio Company	Amount
<b>Private Finance:</b>	
Other	\$ 0.3
Total private finance	0.3
<b>Commercial Real Estate:</b>	
Other	0.5
Total commercial real estate	0.5
Total realized losses	\$ 0.8

Realized gains for the six months ended June 30, 2007 and 2006 were as follows:  
(\$ in million)

## 2007

Portfolio Company	Amount
<b>Private Finance:</b>	
HMT, Inc.	\$ 39.9
Healthy Pet Corp.	36.6
Palm Coast Data, LLC	20.0
Wear Me Apparel Corporation	6.1
Mogas Energy, LLC	4.5
Tradesmen International, Inc.	3.8
ForeSite Towers, LLC	3.8
Advantage Sales & Marketing, Inc.	3.1
Geotrace Technologies, Inc.	1.1
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Other	1.7
Total realized gains	\$ 120.6

## 2006

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

Realized losses for the six months ended June 30, 2007 and 2006, were as follows:  
(\$ in millions)

## 2007

Portfolio Company	Amount
<b>Private Finance:</b>	
Powell Plant Farms, Inc.	\$ 11.5
Legacy Partners Group, LLC	5.8
Alaris Consulting, LLC	1.0
Other	(0.2)
Total realized losses	\$ 18.1

## 2006

Portfolio Company	Amount
<b>Private Finance:</b>	

Aspen Pet Products, Inc.	\$ 1.6
Nobel Learning Communities, Inc.	1.4
Other	0.6
<b>Total private finance</b>	<b>3.6</b>
<b>Commercial Real Estate:</b>	
Other	0.8
<b>Total commercial real estate</b>	<b>0.8</b>
<b>Total realized losses</b>	<b>\$ 4.4</b>

***Change in Unrealized Appreciation or Depreciation.*** We determine the value of each investment in our portfolio on a quarterly basis, and changes in value result in unrealized appreciation or depreciation being recognized in our statement of operations. Value, as defined in Section 2(a)(41) of the Investment Company Act of 1940, is (i) the market

price for those securities for which a market quotation is readily available and (ii) for all other securities and assets, fair value is as determined in good faith by the Board of Directors. Since there is typically no readily available market value for the investments in our portfolio, we value substantially all of our portfolio investments at fair value as determined in good faith by the Board of Directors pursuant to our valuation policy and a consistently applied valuation process. At June 30, 2007, portfolio investments recorded at fair value were approximately 89% of our total assets. Because of the inherent uncertainty of determining the fair value of investments that do not have a readily available market value, the fair value of our investments determined in good faith by the Board of Directors may differ significantly from the values that would have been used had a ready market existed for the investments, and the differences could be material.

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

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

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

There is no one methodology to determine enterprise value and, in fact, for any one portfolio company, enterprise value is best expressed as a range of fair values. However, we

must derive a single estimate of enterprise value. To determine the enterprise value of a portfolio company, we analyze its historical and projected financial results. This financial and other information is generally obtained from the portfolio companies, and may represent unaudited, projected or pro forma financial information. 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, the entry multiple for the transaction, discounted public trading multiples or industry practices. In estimating a reasonable multiple, we consider not only the fact that our portfolio company may be a private company relative to a peer group of public comparables, but we also consider the size and scope of our portfolio company and its specific strengths and weaknesses. In some cases, the best valuation methodology may be a discounted cash flow analysis based on future projections. If a portfolio company is distressed, a liquidation analysis may provide the best indication of enterprise value.

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

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

CDO/CLO Assets on an individual security-by-security basis. If we were to sell a group of these CDO/CLO Assets in a pool in one or more transactions, the total value received for that pool may be different than the sum of the fair values of the individual assets.

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

We currently intend to continue to work with third-party consultants to obtain assistance in determining fair value for a portion of the private finance portfolio each quarter. We work with these consultants to obtain assistance as additional support in the preparation of our internal valuation analysis. In addition, we may receive third-party assessments of a particular private finance portfolio company's value in the ordinary course of business, most often in the context of a prospective sale transaction or in the context of a bankruptcy process.

The valuation analysis prepared by management is submitted to our Board of Directors who is ultimately responsible for the determination of fair value of the portfolio in good faith. Valuation assistance from Duff & Phelps, LLC (Duff & Phelps) for our private finance portfolio consisted of certain limited procedures (the Procedures) we identified and requested them to perform. Based upon the performance of the Procedures on a selection of our final portfolio company valuations, Duff & Phelps concluded that the fair value of those portfolio companies subjected to the Procedures did not appear unreasonable. In addition, we also received third-party valuation assistance from Houlihan Lokey Howard and Zukin for certain private finance portfolio companies. For 2007 and 2006, we received third-party valuation assistance as follows:

	2007		2006	
	Q1	Q2	Q1	Q2
Number of private finance portfolio companies reviewed	88	92	78	78
Percentage of private finance portfolio reviewed at value	91.8%	92.1%	87.0%	89.6%

Professional fees for third-party valuation assistance were \$1.5 million for the year ended December 31, 2006, and are estimated to be approximately \$1.6 million for 2007.

*Net Change in Unrealized Appreciation or Depreciation.* Net change in unrealized appreciation or depreciation for the three and six months ended June 30, 2007 and 2006, consisted of the following:

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2007 <sup>(1)</sup>	2006 <sup>(1)</sup>	2007 <sup>(1)</sup>	2006 <sup>(1)</sup>
<b>(\$ in millions)</b>				
Net unrealized appreciation (depreciation)	\$ 27.5	\$ (21.6)	\$ 119.7	\$ (5.3)
Reversal of previously recorded unrealized appreciation associated with realized gains	(55.0)	(95.6)	(87.0)	(489.2)
Reversal of previously recorded unrealized depreciation associated with realized losses	16.6	0.5	22.3	3.2
Net change in unrealized appreciation or depreciation	\$ (10.9)	\$ (116.7)	\$ 55.0	\$ (491.3)

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

**Valuation of Mercury Air Centers, Inc.** In April 2007, we signed a definitive agreement to sell our majority equity interest in Mercury. Based on this definitive agreement, which was amended in June 2007 to increase the sales price, Mercury was expected to sell for an enterprise value of approximately \$451 million, subject to pre- and post-closing adjustments. See Note 3 Portfolio to our June 30, 2007, consolidated financial statements. At June 30, 2007, we estimated the enterprise value of Mercury to be \$406 million given that the closing of the transaction was subject to certain closing conditions, including regulatory approvals, and the sales price was subject to pre- and post-closing adjustments and certain holdback provisions. Using the enterprise value at June 30, 2007, of \$406 million we determined the value of our investments in Mercury to be \$320.1 million, which included unrealized appreciation of \$234.8 million at June 30, 2007. This is an increase in unrealized appreciation of \$18.2 million for the three months ended June 30, 2007, and \$74.9 million for the six months ended June 30, 2007. Net change in unrealized appreciation or depreciation included a decrease in unrealized appreciation of \$0.4 million and a net increase in unrealized appreciation of \$4.3 million for the three and six months ended June 30, 2006, respectively, on our investment in Mercury. We received valuation assistance from Duff & Phelps for our investment in Mercury at June 30, 2007, and December 31, 2006. The transaction was expected to close in the third quarter of 2007, upon satisfying certain closing conditions, including regulatory approvals. See *Valuation Methodology Private Finance* above for further discussion of the third-party valuation assistance we received.

**Valuation of Business Loan Express, LLC.** Our investment in BLX totaled \$324.6 million at cost and \$220.8 million at value at June 30, 2007, and \$295.3 million at cost and \$210.7 million at value at December 31, 2006. To determine the value of our investment in BLX at June 30, 2007, we performed numerous valuation analyses to determine a range of values including: (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; (4) a discounted



dividend analysis; and (5) adding BLX's net asset value (adjusted for certain discounts) to the estimated value of BLX's business operations, which was determined by using a discounted cash flow model. In performing the valuation analyses at June 30, 2007, we continued to consider the impact of various changes in BLX's business model due to the competitive environment. We also continued to consider BLX's current regulatory issues and ongoing investigations and litigation as well as various strategic alternatives. (See Private Finance, Business Loan Express, LLC above.) We received valuation assistance from Duff & Phelps for our investment in BLX at June 30, 2007, and December 31, 2006. See *Valuation Methodology Private Finance* above for further discussion of the third-party valuation assistance we received.

With respect to the analysis of comparable public company trading multiples and the analysis of BLX's value assuming an initial public offering, we compute a median trailing and forward price earnings multiple to apply to BLX's pro-forma net income adjusted for certain capital structure changes that we believe would likely occur should the company be sold. Each quarter we evaluate which public commercial finance companies should be included in the comparable group. The comparable group at June 30, 2007, was made up of CIT Group, Inc., Financial Federal Corporation, GATX Corporation, and Marlin Business Services Corporation, which is consistent with the comparable group at both March 31, 2007, and December 31, 2006.

Our investment in BLX at June 30, 2007, was valued at \$220.8 million. This fair value was within the range of values determined by our valuation analyses discussed above. Unrealized depreciation on our investment was \$103.8 million at June 30, 2007. Net change in unrealized appreciation or depreciation included a net decrease of \$19.1 million for both the three and six months ended June 30, 2007, and a net decrease of \$10.9 million and \$33.6 million for the three and six months ended June 30, 2006, respectively.

**Per Share Amounts.** All per share amounts included in the Management's Discussion and Analysis of Financial Condition and Results of Operations section have been computed using the weighted average common shares used to compute diluted earnings per share, which were 156.1 million and 143.2 million for the three months ended June 30, 2007 and 2006, respectively, and were 154.4 million and 142.5 million for the six months ended June 30, 2007 and 2006, respectively.

**Comparison of the Years Ended December 31, 2006, 2005, and 2004**

The following table summarizes our operating results for the years ended December 31, 2006, 2005, and 2004.

(in thousands, except per share amounts)	2006	2005	Change	Percent Change	2005	2004	Change	Percent Change
<b>Interest and Related Portfolio Income</b>								
Interest and dividends	\$ 386,427	\$ 317,153	\$ 69,274	22%	\$ 317,153	\$ 319,642	\$ (2,489)	(1)%
Fees and other income	66,131	56,999	9,132	16%	56,999	47,448	9,551	20%
Total interest and related portfolio income	452,558	374,152	78,406	21%	374,152	367,090	7,062	2%
<b>Expenses</b>								
Interest	100,600	77,352	23,248	30%	77,352	75,650	1,702	2%
Employee	92,902	78,300	14,602	19%	78,300	53,739	24,561	46%
Employee stock options	15,599		15,599					
Administrative	39,005	69,713	(30,708)	(44)%	69,713	34,686	35,027	101%
Total operating expenses	248,106	225,365	22,741	10%	225,365	164,075	61,290	37%
Net investment income before income taxes	204,452	148,787	55,665	37%	148,787	203,015	(54,228)	(27)%
Income tax expense (benefit), including excise tax	15,221	11,561	3,660	32%	11,561	2,057	9,504	462%
Net investment income	189,231	137,226	52,005	38%	137,226	200,958	(63,732)	(32)%
<b>Net Realized and Unrealized Gains (Losses)</b>								
Net realized gains	533,301	273,496	259,805	95%	273,496	117,240	156,256	133%
Net change in unrealized appreciation or depreciation	(477,409)	462,092	(939,501)	*	462,092	(68,712)	530,804	*

Total net gains (losses)	55,892	735,588	(679,696)	*	735,588	48,528	687,060	*
Net income	\$ 245,123	\$ 872,814	\$ (627,691)	(72)%	\$ 872,814	\$ 249,486	\$ 623,328	250%
Diluted earnings per common share	\$ 1.68	\$ 6.36	\$ (4.68)	(74)%	\$ 6.36	\$ 1.88	\$ 4.48	238%
Weighted average common shares outstanding	145,599	137,274	8,325	6%	137,274	132,458	4,816	4%
diluted								

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

**Total Interest and Related Portfolio Income.** Total interest and related portfolio income includes interest and dividend income and fees and other income.

**Interest and Dividends.** Interest and dividend income for the years ended December 31, 2006, 2005, and 2004, was composed of the following:

	2006	2005	2004
<b>(\$ in millions)</b>			
<b>Interest</b>			
Private finance loans and debt securities	\$ 359.9	\$ 251.0	\$ 195.2
CMBS and CDO portfolio		29.4	93.3
Commercial mortgage loans	8.3	7.6	9.4
Cash, U.S. Treasury bills, money market and other securities	14.0	9.4	3.1
<b>Total interest</b>	<b>382.2</b>	<b>297.4</b>	<b>301.0</b>
<b>Dividends</b>			
	4.2	19.8	18.6
<b>Total interest and dividends</b>	<b>\$ 386.4</b>	<b>\$ 317.2</b>	<b>\$ 319.6</b>

The level of interest income, which includes interest paid in cash and in kind, is directly related to the balance of the interest-bearing investment portfolio outstanding during the period multiplied by the weighted average yield. The interest-bearing investments in the portfolio at value and the yield on the interest-bearing investments in the portfolio at December 31, 2006, 2005, and 2004, were as follows:

<b>(\$ in millions)</b>	2006		2005		2004	
	Value	Yield <sup>(1)</sup>	Value	Yield <sup>(1)</sup>	Value	Yield <sup>(1)</sup>
Private finance loans and debt securities	\$ 3,185.2	11.9%	\$ 2,094.9	13.0%	\$ 1,602.9	13.9%
CMBS and CDO					586.4	15.4%
Commercial mortgage loans	71.9	7.5%	102.6	7.6%	95.0	6.8%
<b>Total</b>	<b>\$ 3,257.1</b>	<b>11.8%</b>	<b>\$ 2,197.5</b>	<b>12.8%</b>	<b>\$ 2,284.3</b>	<b>14.0%</b>

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

Our interest income from our private finance loans and debt securities has increased year over year primarily as a result of the growth in this portfolio, net of the reduction in yield. The private finance portfolio yield at December 31, 2006, of 11.9% as compared to the private finance portfolio yield of 13.0% and 13.9% at December 31, 2005 and 2004, res