ALLIED CAPITAL CORP
Form N-2/A
October 15, 2002

As filed with the Securities and Exchange Commission on October 15, 2002

Registration No. 333-98441

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM N-2

REGISTRATION STATEMENT

UNDER
THE SECURITIES ACT OF 1933

x **Pre-Effective Amendment No. 1**
o **Post-Effective Amendment No.**

ALLIED CAPITAL CORPORATION

(Exact Name of Registrant as Specified in Charter)

1919 Pennsylvania Avenue, N.W.

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

William L. Walton, Chairman and Chief Executive Officer

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

Copies of information to:

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

Approximate Date of Proposed Public Offering:

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

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

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

Non-Transferable Rights Offering to Purchase up to 5,250,000 Shares of Common Stock

We are granting at no cost to the holders of shares of our common stock subscription rights to purchase up to 5,250,000 shares of our common stock. The rights are non-transferable and will not be admitted for trading on the New York Stock Exchange. You will receive one right for every share of our common stock that you own as of the record date, which is October 21, 2002. For every 20 rights held you will be able to purchase one share of our common stock at the subscription price. Fractional shares will not be issued upon exercise of rights. As more fully described in this prospectus, you can also purchase shares of our common stock not acquired by other shareholders in this rights offering.

The subscription price per share will be 93% of the average of the last reported sales price of a share of our common stock on the New York Stock Exchange on November 21, 2002, which we refer to as the pricing date, and the four preceding business days. Since the close of the rights offering on the expiration date will coincide with the pricing date, shareholders who choose to exercise their rights will not know the subscription price per share at the time they exercise such rights. The offer will dilute the ownership interest and voting power of the common stock owned by shareholders who do not fully exercise their basic subscription rights. Shareholders who do not fully exercise their basic subscription rights should expect, upon completion of the rights offering, to own a smaller proportional interest in us than before the rights offering.

The rights will expire if they are not exercised by 5:00 p.m., New York City time, on November 21, 2002, the expiration date of the rights offering unless extended. We, in our sole discretion, may extend the period for exercising the rights. You will have no right to rescind your subscriptions after receipt of your payment of the estimated subscription price except as described in this prospectus.

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

We are an internally managed closed-end management investment company that has elected to be regulated as a business development company under the Investment Company Act of 1940. Our investment objective is to achieve current income and capital gains. We seek to achieve our investment objective by investing primarily in private companies in a variety of industries throughout the United States. No assurances can be given that we will continue to achieve our objective. Our common stock is traded on the New York Stock Exchange under the symbol ALD. As of October , 2002, the last reported sale price on the New York Stock Exchange for our common stock was $.

	Per Share	Total
Estimated Subscription Price(1)	$	$
Sales Load		
None None		
Proceeds to the Company(2)(3)		
$ $		

(1) Estimated, using 93% of the average of the last reported sales price of a share of our common stock on the NYSE on October , 2002.

(2) Before deduction of expenses incurred by us related to this rights offering estimated to be $750,000.

(3) The proceeds that we will receive in this rights offering assumes that all 5,250,000 shares are purchased at this estimated subscription price.

You should review the information, including the risk of leverage, set forth under Risk Factors on page 12 of this prospectus before investing in our common stock.

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

, 2002

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. You must not rely upon any information or representation not contained in this prospectus as if we had authorized it. This prospectus does not constitute an offer to sell or a solicitation of any offer to buy any security other than the registered securities to which it relates, nor does it 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 is accurate as of the date of this prospectus.

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PROSPECTUS SUMMARY

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

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

BUSINESS *(Page 69)*

We are a business development company that participates in the private equity market. We generally invest in illiquid securities through privately negotiated transactions. We provide long-term debt and equity investment capital to support the expansion of primarily private companies in a variety of industries. We have been investing in businesses for over 40 years and have financed thousands of companies nationwide. Our investment activity is generally focused in two areas:

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

Our investment portfolio generally includes:

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

We identify loans and investments through our numerous relationships with:

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

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

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

We are an internally managed diversified closed-end management investment company that has elected to be regulated as a business development company under the Investment Company Act of 1940, which we refer to as the 1940 Act. Our investment objective is to achieve current income and capital gains. We seek to achieve our investment objective by investing primarily in private businesses in a variety of industries throughout the United States.

As a business development company, we are required to meet certain regulatory tests, the most significant relating to our investments and borrowings. A business development

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company is required to invest at least 70% of its assets in eligible portfolio companies, which includes private or thinly traded public, U.S.-based entities. A business development company must also maintain a coverage ratio of assets to senior securities of at least 200%. See Certain Government Regulations.

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

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

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

During the third quarter ended September 30, 2002, private finance new investment activity totaled approximately $148 million, including loans, debt securities, and equity interests.

VALUATION OF PORTFOLIO INVESTMENTS *(Page 91)*

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

At June 30, 2002, approximately 93% of our total assets represented investments recorded at fair value. Pursuant to the requirements of the 1940 Act, we value substantially all of our investments at fair value as determined in good faith by our board of directors on a quarterly basis. Since there is typically no readily ascertainable market value for the investments in our portfolio, our board of directors determines in good faith the fair value of these investments pursuant to a valuation policy and a consistently applied valuation process.

There is no single standard for determining fair value in good faith. As a result, determining fair value requires that judgment be applied to the specific facts and circumstances of each portfolio investment while employing a consistently applied valuation process for the types of investments we make. Unlike banks, we are not permitted to provide a general reserve for anticipated loan losses; we are instead required by the 1940 Act to specifically value each individual investment 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. Conversely, we will record unrealized appreciation if we have an indication that the underlying portfolio company has appreciated in value and, therefore, our equity security has also appreciated in value, where appropriate. Without a readily ascertainable market value and because of the inherent uncertainty of valuation, the fair value of our investments determined in good faith by the board of directors may differ significantly from the values that would have been used had a ready market existed for the investments, and the differences could be material.

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

THE RIGHTS OFFERING *(Page 19)*

Rights	We will distribute to each holder of our common stock one non-transferable right to purchase our common stock for each share of our common stock owned by such holder on the record date, which is October 21, 2002. Fractional shares will not be issued upon exercise of rights.
Basic Subscription Rights	The basic subscription rights entitle you to purchase one share of our common stock at the subscription price for every 20 rights you hold. You are entitled to subscribe for all or any portion of the shares of our common stock underlying your basic subscription rights.
Over-Subscription Right	If you elect to exercise all of your rights to purchase our common stock pursuant to your basic subscription rights, you will also have an over- subscription right to subscribe for additional shares of our common stock, if any, that are not purchased by other holders of rights pursuant to their basic subscription rights as of the expiration date.
Proration of Over-Subscription Right	If there are shares of our common stock available for sale pursuant to the exercise of the over-subscription right and the number of shares is not sufficient to satisfy in full all subscriptions submitted for additional shares, we will allocate the available shares pro rata among holders who exercise their over-subscription right in proportion to the number of shares each subscriber for additional shares has elected to purchase under their basic subscription rights.
Subscription Price	The subscription price per share will be 93% of the average of the last reported sales price of a share of our common stock on the NYSE on November 21, 2002, which we refer to as the pricing date, and the four preceding business days.
Estimated Subscription Price	The estimated subscription price is $ per share. Because it is not possible to determine the subscription price until the pricing date, shareholders exercising their subscription rights will not know the subscription price per share at the time they exercise their rights. As a result, we are requiring that shareholders deliver the estimated subscription price in connection with the exercise of their basic subscription rights and, if applicable, their over-subscription right. If the actual subscription price is lower, excess payments will be refunded (without interest), and if the actual subscription price is higher, shareholders exercising their rights must make an additional payment by December 20, 2002.
Expiration Date	November 21, 2002, at 5:00 p.m., New York City time, unless we decide to extend it to some later time.

Procedure for Exercising Subscription Rights	If you wish to exercise any or all of your subscription rights, you should properly complete, sign and deliver your subscription certificate together with full payment of the estimated subscription price for each share subscribed for under your subscription rights (including shares subscribed for through the exercise of your over-subscription right), to the subscription agent on or prior to the expiration date. You may not revoke an exercise of rights.
How Rights Holders Can Exercise Rights Through Brokers, Banks or Other Nominees	If you hold shares of our common stock through a broker, bank or other nominee, we will ask your broker, bank or other nominee to notify you of the rights offering. If you wish to exercise your rights, you will need to have your broker, bank or other nominee act for you. To indicate your decision, you should complete and return to your broker, bank or other nominee the form entitled Beneficial Owner Election Form, together with full payment of the estimated subscription price for each share subscribed for under your subscription rights (including shares subscribed for through the exercise of your over-subscription right). You should receive this form from your broker, bank or other nominee with the other rights offering materials.
Amendments; Termination	We reserve the right to amend the terms and conditions of this rights offering or to terminate this rights offering prior to delivery of the common stock.
Non-Transferability of Rights	Subscription rights are being issued only to holders of our common stock as of the record date and are non-transferable. Therefore, only the underlying shares of common stock, and not the rights, will be admitted for trading on the NYSE.
Issuance of Our Common Stock	Unless requested otherwise, stock certificates will not be issued for shares of our common stock offered in this rights offering. Shareholders who are record owners will have the shares they acquire credited to their account with our transfer agent. All future dividends paid on such shares will be paid either in cash or reinvested in additional shares, depending on the election you made in connection with our dividend reinvestment plan. Shareholders whose common stock are held by a nominee will have the shares they acquire credited to the account of such nominee holder.
Dilutive Effects	This rights offering will dilute the ownership interest and voting power of shareholders who do not fully exercise their basic subscription rights.

INFORMATION AGENT

The information agent for the rights offering is:

Georgeson Shareholder Communications, Inc.

Toll-free: (866) 206-4938

Shareholders may also call us toll-free at (888) 818-5298 or contact their brokers, banks or other nominees for information with respect to the rights offering.

IMPORTANT DATES TO REMEMBER

Event	Date
Record date	October 21, 2002
Subscription Period	October 21, 2002 to November 21, 2002*
Expiration Date and Pricing Date	November 21, 2002*
Subscription Certificates and Payment for Shares Due	November 21, 2002*
Notice of Guaranteed Delivery Due	November 21, 2002*
Subscription Certificates for Guarantees of Delivery Due	November 26, 2002*
Confirmation to Participants	December 6, 2002*
Final Payment for Shares	December 20, 2002*

* Unless the rights offering is extended.

Shareholders exercising rights must deliver to the subscription agent by the expiration date either (i) the subscription certificate together with payment or (ii) a notice of guaranteed delivery together with payment.

USE OF PROCEEDS *(Page 29)*

Assuming the full exercise of the rights, the cash proceeds from the sale of the shares of our common stock will be approximately $, before payment of offering fees and expenses. We intend to use the net proceeds from the rights offering for investments in the debt or equity securities of primarily private companies or non-investment grade commercial mortgage-backed securities, and other general corporate purposes.

DISTRIBUTIONS *(Page 30)*

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.

Because we anticipate that the rights offering will be completed by no later than December 20, 2002, we expect that shares of our common stock acquired in the rights offering will be of record for the fourth quarter dividend of 2002 and, therefore, holders of such shares will be entitled to any dividend declared by us in the fourth quarter of 2002.

DIVIDEND REINVESTMENT PLAN *(Page 116)*

We maintain a dividend reinvestment plan for our common shareholders. Effective May 1, 2002, we converted from an opt out to an opt in dividend reinvestment plan. As a result, if our board of directors declares a dividend, then our new shareholders that have not opted in to our dividend reinvestment plan will receive cash dividends. New shareholders must notify our transfer agent in writing if they wish to enroll in the dividend reinvestment plan. Existing dividend reinvestment plan accounts will not be affected by this amendment.

RISK FACTORS *(Page 12)*

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

As a business development company, our portfolio includes securities primarily issued by privately held companies. These investments may involve a high degree of business and financial risk; they are illiquid, and may not produce current returns or capital gains. If we were forced to immediately liquidate some or all of the investments in the portfolio, the proceeds of such liquidation would be significantly less than the current value of such investments.

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

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

A large number of entities and individuals compete for the same kind of investment opportunities as we do. Our business of making private equity investments may be affected by current and future market conditions. The absence of an active senior lending environment may slow the amount of private equity investment activity generally. As a result, the pace of our investment activity may slow.

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

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

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

CERTAIN ANTI-TAKEOVER PROVISIONS *(Page 118)*

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

LEGAL PROCEEDINGS *(Page 82)*

A series of class action lawsuits have been filed in the United States District Court for the Southern District of New York against us, certain of our directors and officers and our former independent auditors, Arthur Andersen LLP, with respect to alleged violations of the securities laws. These lawsuits allege violations of Sections 10(b) and 20(a) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder, specifically they allege, among other things, that we purportedly misstated the value of certain portfolio investments in our financial statements, which allegedly resulted in the purchase of our common stock by purported class members at artificially inflated prices. Several of the complaints also allege state law claims for common law fraud. The complaints seek compensatory and other damages, and costs and expenses associated with the litigation. The lawsuits have been consolidated into a single proceeding captioned In re Allied Capital Corp. Securities Litigation, 02 CV 3812. We believe that the lawsuit is without merit, and we intend to defend the lawsuit vigorously. While we do not expect these matters to materially affect our financial condition or results of operations, there can be no assurance as to whether any such pending litigation will have a material adverse effect on our financial condition or results of operations in any future reporting period.

FEES AND EXPENSES

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

Shareholder Transaction Expenses	
Sales load	None
Dividend reinvestment plan fees(1)	None
Annual Expenses (as a percentage of consolidated net assets attributable to common stock)(2)	
Operating expenses(3)	3.6%
Interest payments on borrowed funds(4)	5.1%
Total annual expenses(5)	8.7%

(1) The expenses of our dividend reinvestment plan are included in Operating expenses. We have no cash 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.

(2) Consolidated net assets attributable to common stock equals net assets (*i.e.*, total consolidated assets less total consolidated liabilities and preferred stock) at June 30, 2002.

(3) Operating expenses represent our estimated operating expenses for the year ending December 31, 2002 excluding interest on indebtedness. This percentage for the year ended December 31, 2001 was 3.8%.

(4) The Interest payments on borrowed funds represents our estimated interest expenses for the year ending December 31, 2002. We had outstanding borrowings of $1,009.0 million at June 30, 2002. This percentage for the year ended December 31, 2001 was 5.5%. See Risk Factors.

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

Example

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

	1 Year	3 Years	5 Years	10 Years
You would pay the following expenses on a $1,000 investment, assuming a 5.0% annual return	$87	$261	$436	$876

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

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

may be greater or less than those shown.

SELECTED CONDENSED CONSOLIDATED FINANCIAL DATA

You should read the condensed consolidated financial information below with the Consolidated Financial Statements and Notes thereto included in this prospectus. Financial information for the years ended December 31, 2001, 2000, 1999, 1998 and 1997 has been derived from our financial statements that were audited by Arthur Andersen LLP. For important information about Arthur Andersen LLP, see the section entitled Notice Regarding Arthur Andersen LLP. Quarterly financial information is derived from unaudited financial data, but in the opinion of management, reflects all adjustments (consisting only of normal recurring adjustments) which are necessary to present fairly the results for such interim periods. Interim results at and for the six months ended June 30, 2002 are not necessarily indicative of the results that may be expected for the year ending December 31, 2002. **See Management s Discussion and Analysis of Financial Condition and Results of Operations on page 32 for more information.**

(in thousands, except per share data)	Six Months Ended June 30, 2002	Six Months Ended June 30, 2001	Year Ended December 31, 2001	Year Ended December 31, 2000	Year Ended December 31, 1999	Year Ended December 31, 1998	Year Ended December 31, 1997
	(unaudited)						
Operating Data:							
Interest and related portfolio income:							
Interest and dividends	$127,665	$113,699	$240,464	$182,307	$121,112	$80,281	$86,882
Premiums from loan dispositions	1,659	1,731	2,504	16,138	14,284	5,949	7,277
Post-merger gain on securitization of commercial mortgage loans						14,812	
Fees and other income	26,260	18,380	46,142	13,144	5,744	5,696	3,246
Total interest and related portfolio income	155,584	133,810	289,110	211,589	141,140	106,738	97,405

Expenses:

Interest
34,984 31,881 65,104 57,412 34,860 20,694 26,952
Employee
16,309 14,056 29,656 26,025 22,889 18,878 10,258
Administrative
7,861 6,027 15,299 15,435 12,350 11,921 8,970
Merger
5,159

Total operating expenses
59,154 51,964 110,059 98,872 70,099 51,493 51,339

Net investment income before income tax benefit (expense) and net realized and unrealized gains
96,430 81,846 179,051 112,717 71,041 55,245 46,066
Income tax benefit (expense)
412 (787) (1,444)

Net investment income before net realized and unrealized gains	96,430	81,846	179,463	112,717	71,041	54,458	44,622
Net realized and unrealized gains:							
Net realized gains	8,850	4,991	661	15,523	25,391	22,541	10,704
Net unrealized gains	24,135	11,297	20,603	14,861	2,138	1,079	7,209
Total net realized and unrealized gains	32,985	16,288	21,264	30,384	27,529	23,620	17,913

Income before minority interests	129,415	98,134	200,727	143,101	98,570	78,078	62,535
Minority interests							1,231
Net increase in net assets resulting from operations	$129,415	$98,134	$200,727	$143,101	$98,570	$78,078	$61,304

Per Share:

Diluted earnings per common share	$1.26	$1.10	$2.16	$1.94	$1.64	$1.50	$1.24
Dividends per common share(1)	$1.08	$0.99	$2.01	$1.82	$1.60	$1.43	$1.20
Weighted average common shares outstanding diluted(2)	102,900	88,966	93,003	73,472	60,044	51,974	49,251

(in thousands, except per share data)	At June 30,	At December 31,				
	2002	2001	2000	1999	1998	1997
	(unaudited)					
Balance Sheet Data:						
Portfolio at value	$2,380,969	$2,329,590	$1,788,001	$1,228,497	$807,119	$703,331
Portfolio at cost	2,305,252	2,286,602	1,765,895	1,222,901	803,479	697,030
Total assets	2,568,616	2,460,713	1,853,817	1,290,038	856,079	807,775
Total debt outstanding(3)	1,008,950	1,020,806	786,648	592,850	334,350	347,663
Preferred stock issued to Small Business Administration(3)	7,000	7,000	7,000	7,000	7,000	7,000
Shareholders equity	1,434,453	1,352,123	1,029,692	667,513	491,358	420,060
Shareholders equity per common share (net asset value)	$14.02	$13.57	$12.11	$10.20	$8.79	$8.07
Common shares outstanding at period end(2)	102,296	99,607	85,057	65,414	55,919	52,047

	Six Months Ended June 30,		Year Ended December 31,				
	2002	2001	2001	2000	1999	1998	1997
	(unaudited)						
Other Data:							
Investments funded	$195,455	$299,843	$680,329	$901,545	$751,871	$524,530	$364,942
Repayments	67,017	42,544	74,461	111,031	139,561	138,081	233,005
Sales	126,280	74,648	129,980	280,244	198,368	81,013	53,912
Realized gains	15,429	6,596	10,107	28,604	31,536	25,757	15,804
Realized losses	(6,579)	(1,605)	(9,446)	(13,081)	(6,145)	(3,216)	(5,100)
Return on average assets(4)			9.4%	9.1%	9.2%	10.1%	7.9%
Return on average equity(4)			17.0%	17.2%	17.5%	18.0%	14.8%

(1) Distributions are based on taxable income, which differs from income for financial reporting purposes. Dividends for 1997 exclude certain merger-related dividends of $0.51 per common share.

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

(3) See Senior Securities on page 65 for more information regarding our level of indebtedness.

(4) Return on average assets and return on average equity are only presented on an annual basis as interim period calculations may not be meaningful due to quarterly fluctuations in net increase in net assets from operations.

(in thousands, except per share data)	2002		2001				2000			
	Qtr 2	Qtr 1	Qtr 4	Qtr 3	Qtr 2	Qtr 1	Qtr 4	Qtr 3	Qtr 2	Qtr 1
Quarterly Data (unaudited):										
Total interest and related portfolio income	$73,193	$82,391	$82,666	$72,634	$68,739	$65,071	$61,735	$55,992	$49,965	$43,897
Net investment income before net realized and unrealized gains	42,561	53,869	53,016	44,189	42,118	39,728	34,725	30,719	24,700	22,573
Net increase in net assets resulting from operations	73,454	55,961	42,890	59,703	46,106	52,028	42,281	36,449	34,790	29,581
Diluted earnings per common share	0.71	0.55	0.43	0.63	0.51	0.60	0.52	0.48	0.50	0.45
Dividends declared per common share	0.55	0.53	0.51	0.51	0.50	0.49	0.46	0.46	0.45	0.45
Net asset value per common share(1)	14.02	13.71	13.57	13.42	12.79	12.26	12.11	11.56	10.96	10.44

(1) We determine net asset value per common share as of the last day of the quarter. The net asset values shown are based on outstanding shares at the end of each period, excluding common shares held in our deferred compensation trust.

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 common stock being offered by this prospectus. You may inspect the registration statement and the exhibits without charge at the SEC at 450 Fifth Street, NW, Washington, DC 20549. You may obtain copies from the SEC at prescribed rates.

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

RISK FACTORS

Investing in Allied Capital involves a number of significant risks relating to our business and investment objective. As a result, there can be no assurance that we will achieve our investment objective. In addition to the other information contained in this prospectus, you should consider carefully the following information before making an investment in our common stock.

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

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

Substantially all of our portfolio investments are recorded at fair value as determined in good faith by our board of directors and, as a result, there is uncertainty regarding the value of our portfolio investments. At June 30, 2002, approximately 93% of our total assets represented investments recorded at fair value. Pursuant to the requirements of the 1940 Act, we value substantially all of our investments at fair value as determined in good faith by our board of directors on a quarterly basis. Since there is typically no readily ascertainable market value for the investments in our portfolio, our board of directors determines in good faith the fair value of these investments pursuant to a valuation policy and a consistently applied valuation process.

There is no single standard for determining fair value in good faith. As a result, determining fair value requires that judgment be applied to the specific facts and circumstances of each portfolio investment while employing a consistently applied valuation process for the types of investments we make. Unlike banks, we are not permitted to provide a general reserve for anticipated loan losses; we are instead required by the 1940 Act to specifically value each individual investment 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. Conversely, we will record unrealized appreciation if we have an indication that the underlying portfolio company has appreciated in value and, therefore, our security has also appreciated in value, where appropriate. Without a readily ascertainable market value and because of the inherent uncertainty of valuation, fair value of our investments determined in good faith by the board of directors may differ significantly from the values that would have been used had a ready market existed for the investments, and the differences could be material.

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

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

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

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

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

Our financial results could be negatively affected if Business Loan Express fails to perform as expected. Business Loan Express, Inc. is our largest portfolio investment. Our financial results could be negatively affected if Business Loan Express, as a portfolio company, fails to perform as expected or if government funding for, or regulations related to the Small Business Administration 7(a) Guaranteed Loan Program change. At June 30, 2002, the investment totaled $251.9 million at value, or 9.8% of total assets.

In addition, as controlling shareholder of Business Loan Express, we have provided an unconditional guaranty to Business Loan Express senior credit facility lenders in an amount equal to 50% of Business Loan Express total obligations on its $124.0 million revolving credit facility. The amount we have guaranteed at June 30, 2002, was $48.1 million. This guaranty can only be called in the event of a default by Business Loan Express. We have also provided two standby letters of credit in connection with two term loan securitization transactions completed by Business Loan Express in the second quarter of 2002 totaling $10.6 million.

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

We may not borrow money unless we maintain asset coverage for indebtedness of at least 200% which may affect returns to shareholders. We must maintain asset coverage for total borrowings of at least 200%. Our ability to achieve our investment objective may depend in part on our continued ability to maintain a leveraged capital structure by borrowing from banks or other lenders on favorable terms. There can be no assurance that we will be able to maintain such leverage. If asset coverage declines to less than 200%, we may be required to sell a portion of our investments when it is disadvantageous to do so. As of June 30, 2002, our asset coverage for senior indebtedness was 256%.

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

At June 30, 2002, we had $1,009.0 million of outstanding indebtedness, bearing a weighted average annual interest cost of 7.2%. In order for us to cover these annual interest payments on indebtedness, we must achieve annual returns on our assets of at least 2.8%.

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) $2,568.6 million in total assets,

(ii) an average cost of funds of 7.2%, (iii) $1,009.0 million in debt outstanding and (iv) $1,434.5 million of shareholders equity.

Assumed Return on Our Portfolio

(net of expenses)

	-20%	**-10%**	**-5%**	**0%**	**5%**	**10%**	**20%**
Corresponding return to shareholder	-40.8%	-23.0%	-14.0%	-5.1%	3.9%	12.8%	30.7%

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

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

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

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

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

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

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

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

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

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

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

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

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

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

general economic conditions and trends;

loss of a major funding source; or

departures of key personnel.

Recently, the trading price of our common stock has been volatile. Due to the continued potential volatility of our stock price, we may be the target of securities litigation in the future. Securities litigation could result in substantial costs and divert management s attention and resources from our business. For information about current securities class action lawsuits filed against us, see Business Legal Proceedings.

If you choose not to exercise your subscription rights your interest in us will be diluted. Shareholders who do not fully exercise their basic subscription rights will, upon completion of the rights offering, own a smaller interest in us than they owned prior to the rights offering. This rights offering will dilute the ownership interest and voting power of shareholders who do not fully exercise their basic subscription rights.

Disclosure Regarding Forward-Looking Statements

Information contained in this 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 co the negative thereof or other variations or similar words or phrases. The matters described in Risk Factors and certain other factors noted throughout this prospectus and 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 should not be regarded as a representation by us that our plans and objectives will be achieved. These risks and uncertainties include those described in Risk Factors and elsewhere in this prospectus and any exhibits of the registration statement of which this prospectus is a part. You should not place undue reliance on these forward-looking statements, which apply only as of the date of this prospectus.

THE RIGHTS OFFERING

Terms of the Offer

We are issuing to our shareholders of record on the record date, October 21, 2002, non-transferable rights to subscribe for the shares of our common stock. Each shareholder is being issued one non-transferable right for each share of common stock owned on the record date. For every 20 rights held you will be able to purchase one share of our common stock at the subscription price. Rights may be exercised at any time during the subscription period, which commences on October 21, 2002 and ends at 5:00 p.m., New York City time, on November 21, 2002.

In addition, any shareholder who fully exercises all rights initially issued is entitled to subscribe for shares which were not purchased for by other shareholders pursuant to their basic subscription rights and will have an opportunity to indicate on the subscription certificate how many shares they are willing to acquire pursuant to their over-subscription right. Shares acquired pursuant to the over-subscription right are subject to proration, which is more fully discussed below under Subscription Rights Over-Subscription Right.

Rights will be evidenced by subscription certificates. The number of rights issued to each holder will be stated on the subscription certificate delivered to such holder. The method by which rights may be exercised and shares paid for is explained in the sections entitled Method of Exercise of Rights and Payment for Shares. A rights holder will have no right to rescind a purchase after the subscription agent has received the holder s subscription certificate or notice of guaranteed delivery. Shares of common stock issued pursuant to an exercise of rights will be listed on the NYSE.

The rights are non-transferable. Only the underlying shares of common stock, and not the rights, will be admitted for trading on the NYSE. Fractional shares will not be issued upon exercise of rights. Since fractional shares will not be issued, rights holders who receive, or who are left with, fewer than 20 rights will be unable to exercise such rights and will not be entitled to receive any cash in lieu of such fractional shares.

Participants in our dividend reinvestment plan will be issued rights for the common stock held in their accounts in the dividend reinvestment plan as of the record date. Participants wishing to exercise such rights must exercise such rights in accordance with the procedures set forth below in Method of Exercise of Rights and Payment for Shares. Such rights will not be exercised automatically by the dividend reinvestment plan. The rights must be exercised separately for each account and fractional shares may not be aggregated between accounts.

Purpose Of The Offer

Our board of directors has determined that this rights offering is in our best interest and in the best interests of our shareholders. The offering gives existing shareholders the right to purchase additional shares at a price that may be below market without incurring any commission or charge. The offering will increase the equity capital available for making additional investments in the debt or equity of primarily private companies or non-investment grade commercial mortgage-backed securities and other general corporate purposes. In connection with the approval of this rights offering, our board of directors considered, among other things, the following factors:

- the size of the discount to the market price;
- the increased equity capital to be available upon completion of the rights offering for making additional investments consistent with Allied Capital s investment objectives;
- the dilution to non-exercising shareholders;
- the terms and expenses of the offering;
- the size of the offering in relation to the number of shares outstanding;
- the market price of Allied Capital s common stock, both before and after the announcement of the equity offering;
- the general condition of the securities markets; and
- the use to be made of the proceeds from the offering and the return to shareholders upon such use.

There can be no assurance of the amount of dilution that a shareholder will experience or that the rights offering will be successful.

The purpose of setting the determination of the subscription price subsequent to the expiration date is to attract the maximum participation of shareholders in the offer, with minimum dilution to non-participating shareholders.

We believe the rights offering will be a low-cost method for raising additional capital since no underwriting or sales commission will be paid in respect of the shares purchased in the rights offering. We may, in the future and at our discretion, choose to make additional rights offerings of shares from time to time for a number of shares and on terms that may or may not be similar to this rights offering. Any such future offering will be made in accordance with applicable law.

The Subscription Price

The subscription price per share is 93% of the average of the last reported sales price of a share of our common stock on the NYSE on November 21, 2002, which we refer to as the pricing date, and each of the four preceding business days. The subscription price is expected to be above our net asset value. See Price Range of Common Stock and Distributions. Since the expiration date of the rights offering coincides with the pricing date, shareholders exercising their subscription rights will not know the subscription price per share at the time they exercise their subscription rights. It may be more or less than the estimated subscription price of $ per share. If the actual subscription price is lower, excess payments will be refunded (without interest), and if the actual subscription price is higher, shareholders exercising rights must make an additional payment by December 20, 2002.

Determination of the Subscription Price

The subscription price has been determined by our board of directors, and will represent a discount to the market price of our common stock based upon the average of the last reported sales price of a share of our common stock on the New York Stock Exchange on November 21, 2002, and the four preceding business days. The factors

considered, among others, by our board of directors in determining the subscription price included those factors described under Purpose Of The Offer and the following factors:

- the absence of underwriting fees or sales commission (which range from 5% to 7% of offering proceeds) in connection with rights offering;
- the pricing terms in other recently completed rights offerings; and
- desirability of ensuring significant shareholder participation in the rights offering.

Distribution Of Rights

We will issue to each holder of our common stock at no cost one non-transferable right to purchase our common stock for each share of our common stock owned by that holder as of the record date, which is October 21, 2002. No fractional rights will be issued. For every 20 rights held you will be entitled to purchase one share of common stock at the subscription price. The subscription price per share will be 93% of the average of the last reported sales price of a share of our common stock on the New York Stock Exchange on November 21, 2002, which we refer to as the pricing date, and the four preceding business days. Fractional shares will not be issued upon exercise of rights.

Subscription Rights

Your rights entitle you to the basic subscription rights and the over-subscription right.

Basic Subscription Rights. The basic subscription rights entitle you to purchase one share of our common stock at the subscription price for every 20 rights issued to you. You are entitled to subscribe for all or any portion of the shares of our common stock underlying your basic subscription rights.

Over-Subscription Right. If you elect to purchase all of the shares of our common stock that you are entitled to purchase under your basic subscription rights such that you have fewer than 20 rights remaining after such election, you will also have an over-subscription right to subscribe for additional shares of our common stock, if any, that are not purchased by other holders of rights under their basic subscription rights as of the expiration date. Although you are not limited in the number of shares you can elect to over-subscribe for, your ability to purchase the number of shares that you wish to purchase in the exercise of your over-subscription right will depend on the availability of such shares. We cannot provide any assurance that sufficient shares will be available to satisfy your request in whole or in part. If, however, the number of shares of our common stock remaining unsold after holders have exercised their basic subscription rights is sufficient to satisfy in full all subscriptions submitted for additional shares, we will allocate the shares according to the subscriptions submitted. Shares of our common stock purchased through your over-subscription right must be purchased at the subscription price.

Proration of Over-Subscription Right. If the number of shares of our common stock remaining unsold after holders have exercised their basic subscription rights is not sufficient to satisfy in full all subscriptions submitted for additional shares, we will allocate the available shares pro rata among all holders who exercise their over-subscription right based on the number of shares each subscriber for additional shares has elected to purchase under their basic subscription rights. Each holder who subscribes for additional shares will be allocated available shares of our common stock in proportion to the amount each holder elected to purchase under their basic subscription rights. We will continue this allocation process until all subscriptions are filled or all the shares of our common stock offered in this offering have been sold. The allocation process may involve a series of allocations in order to assure the total number of shares available for over-subscription is distributed on a pro rata basis. In the case of rights exercised by a nominee for a beneficial owner, the allocation described above will be based upon the number of shares of our common stock that the beneficial owner has elected to purchase under their basic subscription rights.

Full Exercise of Basic Subscription Rights. You may exercise your over-subscription right only if you exercise your basic subscription rights in full by electing to purchase all of the shares of common stock which you are entitled to purchase under your basic subscription rights such that you have fewer than 20 rights remaining after such exercise. To determine if you have fully exercised your basic subscription rights, we will consider only the basic subscription rights held by you in the same capacity. For example, suppose that you were granted rights for shares of our common stock which you own individually and shares of our common stock which you own collectively with your spouse. If you wish to exercise your over-subscription right with respect to the rights you own individually, but not with respect to the rights you own collectively with your spouse, you only need to fully exercise your basic subscription rights with respect to your individually owned rights. You do not have to subscribe for any shares under the basic subscription rights owned collectively with your spouse to exercise your individual over-subscription right.

When you complete the portion of your subscription certificate to exercise your over-subscription right, you will be representing that you have fully exercised your basic subscription rights as to shares of our common stock which you hold in that capacity. You must exercise your over-subscription right at the same time you exercise your basic subscription rights in full.

If you own shares of our common stock through your bank, broker or other nominee holder who will exercise your subscription right on your behalf, the bank, broker or other nominee holder will be required to certify to us and to the subscription agent the following information:

- the number of shares of our common stock held on your behalf on the record date;
- the number of rights exercised under your basic subscription rights;
- that your basic subscription rights held in the same capacity have been exercised in full; and
- the number of shares subscribed for under your over-subscription right.

Your bank, broker or other nominee holder may also disclose to us other information received from you.

No Fractional Rights and Shares

We will not issue fractional rights or fractional shares. Since fractional shares will not be issued, rights holders who receive, or who are left with, fewer than 20 rights will be unable to exercise such rights and will not be entitled to receive any cash in lieu of such fractional shares.

Method of Exercise of Rights

Subscription certificate(s), which evidence the subscription rights, will be mailed to shareholders of record as of the record date. Rights may be exercised by shareholders who are record owners by filling in and signing the enclosed subscription certificate(s) and mailing it in the envelope provided or delivering the completed and signed subscription certificate(s) to the subscription agent, together with required payment for the shares as described below under Payment for Shares. Rights may also be exercised by a shareholder by contacting his broker, bank or other nominee, who can arrange, on the shareholder s behalf, delivery of a properly completed and executed subscription certificate(s) and payment for the shares. A fee may be charged for this service. Unless shareholders are delivering their subscription certificates pursuant to a notice of guaranteed delivery as described below under Notice of Guaranteed Delivery, subscription certificate(s) must be received by the subscription agent prior to 5:00 p.m., New York City time, on the expiration date at the offices of the subscription agent.

Payment for Shares

Shareholders who acquire shares pursuant to the basic subscription rights or the over-subscription right must send payment for the shares to be acquired pursuant to the basic subscription rights and over-subscription right, to the subscription agent based on the estimated subscription price of $ per share. To be accepted, such payment must be made payable to American Stock Transfer & Trust Company, as subscription agent Allied Capital Corporation and received by the subscription agent prior to 5:00 p.m. New York City time on the expiration date, unless the rights offering is extended. The subscription agent will not honor any exercise of rights received by it after the expiration date. The subscription agent will deposit all bank checks, checks, money orders and wire transfers of funds received by it prior to the final payment date into a segregated interest-bearing account (which interest will be paid to us) pending proration and issuance of shares. If this offering is terminated, we will promptly arrange for the refund, without interest, of all funds received from holders of rights. **All payments by a shareholder must be made in United States dollars either (i) by bank check, money order or check and drawn on a bank located in the United States, or (ii) by wire transfer of same day funds to the account maintained by the subscription agent for this purpose at American Stock Transfer & Trust Company, Subscription Agent for Allied Capital Corporation, JP Morgan Chase, 55 Water Street, ABA# 021-000021, Account No. 323-113060.**

Unless you are delivering your subscription certificate pursuant to a notice of guaranteed delivery as described below under Notice of Guaranteed Delivery, payment of the estimated subscription price must be accompanied by a subscription certificate.

Notice of Guaranteed Delivery

If you wish to exercise your rights, but time will not permit you to cause the subscription certificate to reach the subscription agent on or prior to the expiration date, you may nevertheless exercise your rights if you meet the following conditions:

(a) you have caused payment in full of the estimated subscription price for each share being subscribed for pursuant to your basic subscription rights and your over-subscription right, if any, to be received by the subscription agent on or prior to the expiration date;

(b) the subscription agent receives, on or prior to the expiration date, a guaranteed notice, from an eligible institution, stating your name, the number of rights held, the number of shares being subscribed for pursuant to the basic subscription rights and the number of shares being subscribed for pursuant to the over-subscription right, and guaranteeing the delivery to the subscription agent of the subscription certificate at or prior to 5:00 p.m., New York City time, on the date three (3) business days following the expiration date; and

(c) the properly completed subscription certificate evidencing the rights being exercised, with any required signatures being guaranteed, are received by the subscription agent at or prior to 5:00 p.m., New York City time, on the date three (3) business days following the expiration date.

Delivery of Shares

Unless requested otherwise, stock certificates will not be issued for shares of our common stock offered in this rights offering. Shareholders who are record owners will have the shares they acquire credited to their account with our transfer agent. All future dividends paid on such shares will be paid either in cash or reinvested into additional shares, depending on the election you made in connection with our dividend reinvestment plan. Shareholders whose common stock are held by a nominee will have the shares they acquire credited to the account of such nominee holder.

Signature Guarantee May Be Required

Your signature on each subscription certificate must be guaranteed by an eligible institution such as a member firm of a registered national securities exchange or a member of the NASD, or from a commercial bank or trust company having an office or correspondent in the United States, subject to standards and procedures adopted by the subscription agent, unless:

Your subscription certificate provides that shares are to be delivered to you as record holder of those rights; or

You are an eligible institution.

Confirmation of Purchase

Within 10 business days following the expiration of the rights offering, which we refer to as the confirmation date, a confirmation will be sent by the subscription agent to each shareholder (or, if shares are held by a nominee, on the record date, to such nominee) showing: (i) the number of shares acquired through the basic subscription rights; (ii) the number of shares, if any, acquired through the over-subscription right; (iii) the per share and total subscription price for the shares; and (iv) the additional amount payable by the shareholder to us or any excess to be refunded (without interest) by us to the shareholder, in each case based on the subscription price as determined on the pricing date.

In the case of any stockholder who exercises a right to acquire shares through the over-subscription right, any excess payment which would otherwise be refunded to the shareholder will be applied by us toward payment for shares acquired through exercise of the over-subscription right. Any additional payment required from a shareholder must be received by the subscription agent within 10 business days after the confirmation date, and any excess payment to be refunded (without interest) by us to a shareholder will be mailed by the subscription agent to such shareholder as soon as practicable. All payments by a shareholder must be in U.S. dollars by (i) bank check, money order or check drawn on a bank located in the U.S. and payable to American Stock Transfer & Trust Company, as subscription agent Allied Capital Corporation, or (ii) by wire transfer of same day funds to the account maintained by the subscription agent for this purpose at American Stock Transfer & Trust Company, Subscription Agent for Allied Capital Corporation, JP Morgan Chase, 55 Water Street, ABA# 021-000021, Account No. 323-113060.

Crediting of shares acquired in this rights offering to any account is subject to collection of checks.

If a shareholder who acquires shares through the basic subscription rights or over-subscription right does not make payment of all amounts due, we reserve the right to

(i) apply any payment actually received by us toward the purchase of the greatest number of whole shares which could be acquired by such shareholder upon exercise of the basic subscription rights or over-subscription right; (ii) exercise any and all other rights or remedies to which we may be entitled; or (iii) find other purchasers for such subscribed-for shares.

Shareholders will have no right to rescind their subscription after receipt of their payment for shares by the subscription agent.

Instructions For Completing Your Subscription Certificate

You should read and follow the instructions accompanying the subscription certificates carefully. If you want to exercise your rights, you should send your subscription certificate(s) with your estimated subscription price payment to the subscription agent. **Do not send your subscription certificate(s) and estimated subscription price payment to us.**

Information Agent

Any questions or requests for assistance may be directed to the information agent at its telephone number and address listed below:

The information agent for the rights offering is:

Georgeson Shareholder Communications, Inc.

17 State Street
New York, NY 10004

Banks and Brokers Call:

(212) 440-9800

All Others Call Toll-Free:

(866) 206-4938

Shareholders may also contact their brokers, banks or other nominees for information with respect to the rights offering.

The information agent will receive a fee estimated to be approximately $25,000, which excludes reimbursement for all out-of-pocket expenses related to the rights offering, and have also agreed to indemnify the information agent against certain liabilities which it may incur in connection with this offering.

Subscription Agent

American Stock Transfer & Trust Company will act as our subscription agent to accept exercises of subscription rights for this offering. You must send the completed and signed certificate, along with payment in full of the exercise price for all shares that you wish to purchase pursuant to the basic subscription rights and over-subscription right, to American Stock Transfer & Trust Company.

We suggest, for your protection, that you deliver your subscription certificate to the subscription agent by an insured, overnight or express mail courier. If you mail your subscription certificate, we suggest that you use registered mail. If you wish to exercise your rights, you should mail or deliver your subscription certificate and payment for the estimated subscription price to the subscription agent as follows:

By Mail, Hand or Overnight Courier:

American Stock Transfer & Trust Company

59 Maiden Lane, Plaza Level
New York, New York 10038

The notice of guaranteed delivery may also be sent by facsimile to (718) 234-5001 with the originals to be sent promptly thereafter by the methods described above. Facsimiles should be confirmed by telephone to (718) 921-8200.

Delivery to an address other than as listed above, or transmission via a facsimile number other than as listed above, will not constitute valid delivery.

Any questions or requests for assistance concerning the method of subscribing for shares of our common stock or for additional copies of this prospectus or the instructions as to use of the subscription certificates can be directed to the information or subscription agent at the addresses or at the telephone numbers specified above.

We will pay the subscription agent fees and expenses of up to $35,000 and have also agreed to indemnify the subscription agent against certain liabilities which it may incur in connection with this offering.

Expiration Of The Rights Offering

You may exercise your subscription rights at any time before 5:00 p.m., New York City time, on November 21, 2002, the expiration date for this offering. We may, in our sole discretion, extend the time for exercising your rights. If you do not exercise your rights before the expiration date, your unexercised rights will be null and void. We may extend the expiration date by giving oral or written notice to the subscription agent on or before the scheduled expiration date and making a public announcement thereof no later than 9:00 a.m., New York City time, on the next business day after the previously scheduled expiration date. We will not be obligated to honor your exercise of rights if the subscription agent receives the documents relating to your exercise after the rights offering expires, regardless of when you transmitted the documents.

Calculation Of Rights Exercised

If you do not indicate the number of rights being exercised, or do not forward full payment of the total estimated subscription price payment for the number of rights that you indicate are being exercised, then you will be deemed to have exercised your basic subscription rights with respect to the maximum number of rights that may be exercised with the aggregate estimated subscription price payment you delivered to the subscription agent. If your aggregate estimated subscription price payment is greater than the amount you owe for your basic subscription and you do not indicate the number of rights being exercised, you will be deemed to have exercised your over-subscription right to purchase the maximum number of shares with your overpayment. If we do not apply your full subscription price payment to your purchase of shares of our common stock, we will return the excess amount to you by mail without interest or deduction as soon as practicable after the expiration of rights offering.

Nominee Holders

If you are a broker, bank or other nominee who holds shares of our common stock for the account of others on October 21, 2002, the record date for this offering, you should notify the respective beneficial owners of such shares of the rights offering as soon as possible to find out their intentions with respect to exercising their rights. You should obtain instructions from the beneficial owner with respect to the rights, as set forth in the instructions we have provided to you for your distribution to beneficial owners. If the beneficial owner so instructs, you should complete the appropriate documents and submit them to the subscription agent with the proper payment. If you hold shares of our common stock for the account(s) of more than one beneficial owner, you may exercise the number of rights to which all such beneficial owners in the aggregate otherwise would have been entitled had they been direct record holders of our common stock on the record date for

this rights offering, provided that you, as a nominee record holder, make a proper showing to the subscription agent.

Beneficial Owners

If you are a beneficial owner of shares of our common stock or will receive your rights through a broker, bank or other nominee, we will ask your broker, bank or other nominee to notify you of this rights offering. To indicate your decision, you should complete and return to your bank, broker or other nominee the form entitled Beneficial Owner Election Form, together with full payment of the estimated subscription price for each share subscribed for under your subscription rights (including shares subscribed for through the exercise of your over-subscription right). You should receive this form from your broker, bank or other nominee with the other offering materials.

Amendments And Waivers; Termination

We reserve the right to amend the terms and conditions of this offering, whether the amended terms are more or less favorable to you. We will comply with all applicable laws, including the federal securities laws, in connection with any such amendment.

We will decide all questions as to the validity, form and eligibility (including times of receipt, beneficial ownership and compliance with other procedural matters) in our sole discretion, and our determination shall be final and binding. The acceptance of subscription certificates and the subscription price also will be determined by us. Alternative, conditional or contingent subscriptions will not be accepted. We reserve the right to reject any exercise if such exercise is not in accordance with the terms of this rights offering or not in proper form or if the acceptance thereof or the issuance of shares of our common stock thereto could be deemed unlawful. We reserve the right to waive any deficiency or irregularity with respect to any subscription certificate. Subscriptions will not be deemed to have been received or accepted until all irregularities have been waived or cured within such time as we determine in our sole discretion. We will not be under any duty to give notification of any defect or irregularity in connection with the submission of subscription certificates or incur any liability for failure to give such notification.

We reserve the right, in our sole discretion, at any time prior to delivery of the shares of our common stock offered hereby, to terminate the rights offering by giving oral or written notice thereof to the subscription agent and making a public announcement thereof. If this offering is terminated, we will promptly arrange for the refund, without interest, of all funds received from holders of rights. All monies received by the subscription agent in connection with this offering will be held by the subscription agent, on our behalf, in a segregated interest-bearing account. All such interest shall be payable to us even if we determine to terminate the offering and return your subscription payment.

No Revocation

Once you have exercised your subscription rights, you may not revoke the exercise.

No Transfer Of Rights

All rights received by you in this offering are non-transferable and may only be exercised by a subscribing holder for his or her own account. The rights will not be admitted for trading on the NYSE. However, the shares of our common stock issued through this rights offering will be listed and admitted for trading on the NYSE.

Dilutive Effects

Any shareholder who chooses not to participate in this rights offering, should expect to own a smaller interest in us upon completion of this rights offering. This rights offering

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will dilute the ownership interest and voting power of shareholders who do not fully exercise their basic subscription rights.

Foreign Restrictions

Shareholders whose record addresses are outside the United States (for these purposes, the United States includes its territories and possessions and the District of Columbia) will receive written notice of the rights offering; however, subscription certificates will not be mailed to such shareholders. The rights to which those subscription certificates relate will be held by the subscription agent for such foreign shareholder s accounts until instructions are received to exercise the rights. If no such instructions are received by the expiration date, such rights will expire.

Employee Plan Considerations

Shareholders that are employee benefit plans subject to the Employee Retirement Income Security Act of 1974, which we refer to as ERISA (including corporate savings and 401(k) plans), profit sharing/retirement plans for self-employed individuals and Individual Retirement Accounts, which we refer to as Retirement Plans, should be aware that additional contributions of cash to the Retirement Plan (other than rollover contributions or trustee-to-trustee transfers from other Retirement Plans) in order to exercise rights would be treated as Retirement Plan contributions and therefore, when taken together with contributions previously made, may be treated as excess or nondeductible contributions subject to excise taxes. In the case of Retirement Plans qualified under Section 401(a) of the Internal Revenue Code of 1986, additional cash contributions could cause violations of the maximum contribution limitations of Section 415 of the Internal Revenue Code or other qualification rules. Retirement Plans in which contributions are so limited should consider whether there is an additional source of funds available within the Retirement Plan, including the liquidation of assets, with which to exercise the rights. Because the rules governing Retirement Plans are extensive and complex, Retirement Plans contemplating the exercise of rights should consult with their counsel prior to such exercise.

Retirement Plans and other tax exempt entities, including governmental plans, should also be aware that if they borrow in order to finance their exercise of rights, they may become subject to the tax on unrelated business taxable income under Section 511 of the Internal Revenue Code. If any portion of an Individual Retirement Account is used as security for a loan, the portion so used is treated as a distribution to the Individual Retirement Account depositor.

ERISA contains fiduciary responsibility requirements, and ERISA and the Internal Revenue Code contain prohibited transactions rules that may affect the exercise of rights. Due to the complexity of these rules and the penalties for noncompliance, Retirement Plans should consult with their counsel, regarding the consequences of their exercise of rights under ERISA and the Internal Revenue Code.

Federal Income Tax Consequences To Shareholders

For United States federal income tax purposes, neither the receipt nor the exercise of the rights will result in taxable income to you. Moreover, you will not realize a loss if you do not exercise the rights. The holding period for a share acquired upon exercise of a right begins with the date of exercise.

In general, except as provided in the following sentence, your basis in the rights received by you in this rights offering as a distribution with respect to your common stock will be zero. If, however, either (i) the aggregate fair market value of the rights as of the date they are distributed to you is equal to or greater than 15% of the aggregate fair market value on the date of distribution of the common stock with respect to which the rights are received, or (ii) you irrevocably elect, in a statement attached to your federal income tax return for the year in which the rights are received, to allocate a portion of the basis in such common stock to the rights, then, upon exercise of the rights, your basis in such common stock will be allocated between such common stock and the rights in proportion to the relative fair market values of each as of the date of distribution of the rights. If you do not exercise the rights, you will not be permitted to allocate any portion of your basis in your common stock to the rights and, therefore, you will not realize a loss on the expiration of an unexercised right.

Your basis in common stock acquired upon the exercise of a right will be equal to the sum of (i) the subscription price per share, (ii) any servicing fee charged to you by your broker, bank or trust company, and (iii) the basis, if any, in the rights that you exercised. The holding period for any common stock acquired upon exercise of a right will begin with the date of exercise. For a discussion of the consequences of holding and selling shares of our common stock, including any shares of common stock acquired upon the exercise of a right, see Tax Status below.

The foregoing is a general summary of the material United States federal income tax consequences of the receipt and exercise of the rights. The discussion is based upon applicable provisions of the Internal Revenue Code of 1986, U.S. Treasury regulations thereunder and administrative and judicial interpretations, each as of the date of this prospectus and all of which are subject to change, and does not cover state, local or foreign taxes. This summary does not discuss all aspects of federal income taxation relevant to the receipt, exercise and lapse of rights, in light of particular circumstances, or to certain types of holders subject to special treatment under federal income tax laws, including dealers in securities, pension plans and trusts and financial institutions. The Internal Revenue Code and Treasury regulations thereunder are subject to change by legislative or administrative action, possibly with retroactive effect. You should consult your tax advisors regarding specific questions as to federal, state, local or foreign taxes. You should also review the discussion of certain tax considerations affecting yourself and Allied Capital set forth under Tax Status.

USE OF PROCEEDS

Assuming full exercise of the rights, the cash proceeds from the sale of our common stock will be approximately $ before deducting the offering fees and expenses. However, there can be no assurance that all the rights will be exercised in full, and the subscription price will not be determined until the close of business on expiration date.

We intend to use the net proceeds from selling our common stock for investment in the debt or equity securities of primarily private companies or non-investment grade commercial mortgage-backed securities and other general corporate purposes.

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

PRICE RANGE OF COMMON STOCK AND DISTRIBUTIONS

Our common stock is traded on the New York Stock Exchange under the symbol ALD. The following table lists the high and low closing sales prices for our common stock, the closing sales price as a percentage of net asset value (NAV) and quarterly dividends per share. On October , 2002, the last reported closing sale price of the common stock was $ per share.

		Closing Sale Price(2)		Premium of High Sales Price to NAV	Premium of Low Sales Price to NAV	Declared
	NAV(1)	High	Low			Dividends
Year ended December 31, 2000						
First Quarter	$10.44	$19.69	$16.06	189%	154%	$0.45
Second Quarter	10.96	18.69	16.56	171	151	0.45
Third Quarter	11.56	21.13	17.44	183	151	0.46
Fourth Quarter	12.11	21.38	18.50	177	153	0.46
Year ended December 31, 2001						
First Quarter	$12.26	$24.44	$20.13	199%	164%	$0.49
Second Quarter	12.79	25.40	19.57	199	153	0.50
Third Quarter	13.42	24.83	21.50	185	160	0.51
Fourth Quarter	13.57	26.00	21.57	192	159	0.51
Year ending December 31, 2002						
First Quarter	$13.71	$28.93	$25.84	211%	188%	$0.53
Second Quarter	14.02	27.66	20.88	197	149	0.55
Third Quarter	*	24.49	18.90			0.56
Fourth Quarter (through October , 2002)	*					

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

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

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

Our common stock continues to trade in excess of net asset value. However, we cannot predict whether our shares of common stock will maintain a premium above net asset value in the future.

We intend to pay quarterly dividends to shareholders of our common stock. The amount of our quarterly dividends is determined by our board of directors. Our board of directors has established a dividend policy to review the dividend rate quarterly, and may adjust the quarterly dividend rate throughout the year. See Management s Discussion and Analysis of Financial Condition and Results of Operations Equity Capital and Dividends and Tax Status. We cannot assure that we will achieve investment results or maintain a tax status that will permit any particular level of dividend payment. Our credit facilities limit our ability to declare dividends if we default under certain provisions.

Because we anticipate that the rights offering will be completed by no later than December 20, 2002, we expect that shares of our common stock acquired in the rights offering will be of record for the fourth quarter dividend of 2002 and, therefore, holders of such shares will be entitled to any dividend declared by us in the fourth quarter of 2002.

We maintain a dividend reinvestment plan for our common shareholders. Effective May 1, 2002, we converted from an opt out to an opt in dividend reinvestment plan.

As a result, if our board of directors declares a dividend, then our new shareholders will receive cash dividends, unless they specifically opt in to the dividend reinvestment plan to reinvest their dividends and receive additional shares of common stock. Existing dividend reinvestment plan accounts will not be affected by this amendment. 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 selected condensed consolidated financial data and our consolidated financial statements and notes thereto appearing elsewhere in this prospectus.

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

OVERVIEW

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

Our portfolio composition at June 30, 2002 and December 31, 2001, 2000 and 1999 was as follows:

	At June 30, 2002	At December 31, 2001	2000	1999
Private Finance	69%	68%	72%	53%
Commercial Real Estate Finance	31%	32%	28%	42%
Small Business Finance	%	%	%	5%

Our earnings depend primarily on the level of interest and related portfolio income, fee income and net realized and unrealized gains or losses earned on our investment portfolio after deducting interest paid on borrowed capital and operating expenses. Interest income results from the stated interest rate earned on a loan and the amortization of loan origination points and discounts. The level of interest income is directly related to the balance of the interest-bearing investment portfolio multiplied by the weighted average yield. Our ability to generate interest income is dependent on economic, regulatory and competitive factors that influence new investment activity, the amount of loans for which

interest is not accruing and our ability to secure debt and equity capital for our investment activities.

PORTFOLIO AND INVESTMENT ACTIVITY

Total portfolio investment activity and yields at and for the six months ended June 30, 2002 and 2001 and at and for the years ended December 31, 2001, 2000 and 1999 were as follows:

($ in millions)	At and for the Six Months Ended June 30, 2002 (unaudited)	At and for the Six Months Ended June 30, 2001 (unaudited)	At and for the Years Ended December 31, 2001	At and for the Years Ended December 31, 2000	At and for the Years Ended December 31, 1999
Portfolio at value	$2,381.0	$2,000.6	$2,329.6	$1,788.0	$1,228.5
Investments funded	$195.5	$299.8	$680.3	$901.5	$751.9
Change in accrued or reinvested interest and dividends	$19.5	$25.5	$51.6	$32.2	$12.8
Repayments	$67.0	$42.5	$74.5	$111.0	$139.6
Sales	$126.3	$74.6	$130.0	$280.2	$198.4
Yield*	13.8%	14.2%	14.3%	14.1%	13.0%

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

Private Finance

The private finance portfolio, investment activity and yields at and for the six months ended June 30, 2002 and 2001 and at and for the years ended December 31, 2001, 2000 and 1999 were as follows:

($ in millions)	At and for the Six Months Ended June 30, 2002 (unaudited)	At and for the Six Months Ended June 30, 2001 (unaudited)	At and for the Years Ended December 31, 2001	At and for the Years Ended December 31, 2000	At and for the Years Ended December 31, 1999
Portfolio at value:					
Loans and debt securities	$1,050.8	$1,044.5	$1,107.9	$966.3	$559.7
Equity interests	584.5	360.9	487.2	316.2	87.3

Total portfolio	$1,635.3	$1,405.4	$1,595.1	$1,282.5	$647.0
Investments funded	$69.8	$113.9	$287.7	$600.9	$346.7
Change in accrued or reinvested interest and dividends	$19.1	$24.4	$48.9	$31.8	$10.1
Repayments	$56.0	$23.1	$43.8	$75.7	$83.2
Yield*	13.9%	14.6%	14.8%	14.6%	14.2%

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

Private finance new investment activity across the industry slowed during 2001, largely due to a lack of available senior debt capital and the state of the economy in general. We believe the level of merger and acquisition activity throughout the U.S. has continued to be depressed into 2002, and we have seen fewer opportunities for mezzanine or equity investment in the first six months of 2002 as compared to 2001. We believe the environment for private finance investing appears to be improving and, although the merger and acquisition environment remains slow, we are seeing more new investment opportunities related to recapitalization and growth financings. In the third quarter of 2002, we have completed two financings totaling $51 million to date. We are also beginning to see increasing activity within our own portfolio as there are several companies in the private finance portfolio that are in the process of exploring sale, initial public offering or recapitalization events. This means that we may see opportunities to continue our involvement with some of these companies by financing the buyout or recapitalization transactions. This activity could also result in additional potential realized or unrealized gains for the remainder of 2002 and into 2003.

Investments funded during the six month period ended June 30, 2002 and the years ended December 31, 2001, 2000 and 1999 consisted of the following:

($ in thousands)	Loans and Debt Securities	Equity Interests	Total
For the six months ended June 30, 2002(1)			
Companies more than 25% owned	$15,962	$3,759	$19,721
Companies 5% to 25% owned	7,494	7,046	14,540
Companies less than 5% owned	34,023	1,506	35,529
Total	$57,479	$12,311	$69,790
For the year ended December 31, 2001(1)			
Companies more than 25% owned	$47,860	$78,260	$126,120
Companies 5% to 25% owned	8,203	3,721	11,924
Companies less than 5% owned	142,144	7,548	149,692

Total	$198,207	$89,529	$287,736

For the year ended December 31, 2000(1)

Companies more than 25% owned	$10,807	$111,457	$122,264
Companies 5% to 25% owned	115,594	41,925	157,519
Companies less than 5% owned	294,969	26,108	321,077
Total	$421,370	$179,490	$600,860

For the year ended December 31, 1999(1)

Companies more than 25% owned	$	$3,750	$3,750
Companies 5% to 25% owned	2,103		2,103
Companies less than 5% owned	318,097	22,700	340,797
Total	$320,200	$26,450	$346,650

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

At June 30, 2002, we had outstanding funding commitments of $69.0 million to portfolio companies, including $31.6 million committed to private venture capital funds.

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

We may acquire more than 50% of the common stock of a company in a control buyout transaction. Control investments are generally structured such that we earn a current return through a combination of interest income on our senior loans and subordinated debt, dividends on our preferred and common stock, and management or transaction services fees to compensate us for the managerial assistance that we provide to a controlled portfolio company. In some cases for companies that are more than 50% owned, we may not accrue interest on loans and debt securities if such company is in need of additional capital and, therefore, we may defer current debt service. Our most significant investments acquired through control buyout transactions at June 30, 2002 were The Hillman Companies, Inc., (formerly SunSource, Inc.), acquired in 2001, Business Loan Express, Inc., acquired in 2000 and WyoTech Acquisition Corporation, acquired in 1998.

The Hillman Companies, Inc. During 2001, we acquired 93.2% of the common equity of SunSource, Inc. for $71.5 million in cash. Subsequently, SunSource completed the sale of its STS business unit and distributed $16.5 million in cash to us, reducing our common stock cost basis to $57.2 million at December 31, 2001. As part of the STS sale, we invested $3.2 million in the new STS. During the third quarter of 2001, we received fees from SunSource of $2.8 million related to transaction assistance for the SunSource sale and STS sale, and $1.6 million for the syndication of SunSource s senior credit facilities. In addition, we realized a gain of $2.5 million from the sale of warrants prior to the buyout transaction. During the first quarter of 2002, SunSource changed its name to The Hillman Companies, Inc., also referred to as Hillman. At June 30, 2002, our investment in Hillman totaled $131.0 million at value, or 5% of total assets. The value of our investment in Hillman increased by $32.8 million during the second quarter of 2002 as discussed below.

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

For the six months ended June 30, 2002, Hillman had total revenue of $139 million, earnings before interest, taxes, depreciation, amortization and management fees, or EBITDAM, of $23 million, and profits before taxes of $3 million. Hillman is above plan for the year and as of June 30, 2002, is projected to achieve revenues of approximately $276 million, EBITDAM of approximately $50 million, and profits before taxes of approximately $7 million for the year ending December 31, 2002. Hillman had total assets of $360 million and total debt of $141 million at June 30, 2002. Hillman is current on all of its debt obligations and is in compliance with all debt covenants.

Business Loan Express, Inc. On December 31, 2000, we acquired 94.9% of BLC Financial Services, Inc. in a going private buyout transaction for $95.2 million. We issued approximately 4.1 million shares of our common stock, or $86.1 million of new equity, and paid $9.1 million in cash to acquire BLC, which thereafter changed its name to Business Loan Express, Inc.

As part of the transaction, we recapitalized Allied Capital Express, our small business lending operation, as an independently managed private portfolio company and merged it into Business Loan Express. We contributed certain assets, including our online rules-based underwriting technology and fixed assets, and transferred 37 employees to the private portfolio company. Upon completion of the transaction, our investment in Business Loan Express as of December 31, 2000 totaled $204.1 million and consisted of $74.5 million of subordinated debt, $25.1 million of preferred stock, and $104.5 million of common stock. At June 30, 2002, our investment in Business Loan Express totaled $251.9 million at value, or 9.8% of our total assets. During the second quarter of 2002, the value of our investment in Business Loan Express increased by $19.9 million, and as of June 30, 2002, we have recorded total unrealized appreciation of $35.4 million on this investment.

Business Loan Express is the nation s second largest non-bank government guaranteed lender utilizing the Small Business Administration s 7(a) Guaranteed Loan Program and is licensed by the Small Business Administration as a Small Business Lending Company (SBLC). Therefore, changes in the laws or regulations that govern SBLCs or the Small Business Administration s 7(a) Guaranteed Loan Program or changes in government funding for this program could have a material impact on Business Loan Express or its operations. Business Loan Express is a preferred lender as designated by the Small Business Administration in 67 markets across the United States, and originates, sells and services small business loans. In addition to the 7(a) Guaranteed Loan Program, Business Loan Express originates loans under the USDA Business and Industry Guaranteed Loan Program and originates conventional small business loans. Business Loan Express has offices in 35 cities and is headquartered in New York, New York.

Unaudited financial data for Business Loan Express at and for the year ended June 30, 2002 was as follows:

($ in millions)	At and for the Year Ended June 30, 2002(1) (unaudited)
Operating Data	
Total revenue	$84.6
Profits before taxes	$3.6
Earnings before interest, taxes and management fees (EBITM)	$43.0
Balance Sheet Data	
Total assets(2)	$276.2
Total debt	$183.0
Total shareholders equity	$59.0
Other Data	
Total loan originations	$565.1
Serviced loan portfolio	$1,372.6
Number of loans	2,083
Loan delinquencies(3)	9.4%

(1) Financial results at and for the year ended June 30, 2002 are preliminary and not audited and are therefore subject to adjustment prior to completion of the audit.

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

(3) Represents the percentage of loans in the serviced portfolio that are greater than 30 days delinquent, which includes loans in workout status. Delinquencies for the types of small business loans made by BLX typically range between 8% and 12%.

The loans originated by Business Loan Express, or BLX, are generally secured by commercial real estate. Loans originated under the 7(a) Guaranteed Loan Program also require the personal guarantee of the borrower and, in many cases, the loans are also secured by additional real estate collateral. Because the loans are secured by collateral, Business Loan Express annual loan losses for its SBA 7(a) loans, computed using the unguaranteed balance of the SBA 7(a) serviced portfolio, were 0.6% on average for the last five years.

Business Loan Express sells or securitizes substantially all of the loans it originates. BLX currently sells the guaranteed piece of SBA 7(a) guaranteed loans for cash premiums of up to 10% of the guaranteed loan amount plus a retained annual servicing fee generally between 1% and 1.6% of the guaranteed loan amount. Alternatively, BLX may sell the guaranteed piece of SBA 7(a) guaranteed loans at par and retain an annual servicing spread, at current prices, of generally between 4.0% and 4.8%. BLX securitizes the unguaranteed piece of the SBA 7(a) loans and other loans it originates. Typically, BLX retains between 0% and 2.7% of the loan securitization pools and receives a spread from the excess of loan interest received on the loans sold over the interest cost on the securities issued in the securitization generally between 4.7% and 4.8%.

As a result of BLX s guaranteed loan sales and as a result of securitization transactions, BLX had assets at June 30, 2002 totaling approximately $106 million representing the residual interests in and servicing assets for loans sold or securitized, together referred to as Residual Interests. These Residual Interests represent the discounted present value of future cash flow streams to be received from loans sold or securitized after making allowances for prepayments, losses and loan delinquencies.

If loan payments on all loans were to be received as stated in the loan agreements, estimated future cash flows to BLX from loans sold or securitized would total approximately $412 million in the aggregate over the remaining term of these loans. Of the approximate $412 million, estimated cash flows for the years ended June 30, 2003, 2004, 2005, and 2006 would be approximately $33 million, $31 million, $30 million and $29 million, respectively.

Business Loan Express has a three-year $124 million revolving credit facility. As the controlling shareholder of Business Loan Express, we have provided an unconditional guaranty to the revolving credit facility lenders in an amount of up to 50% of the total obligations (consisting of principal, accrued interest and other fees) of Business Loan Express under the revolving credit facility. The amount guaranteed by us at June 30, 2002 was $48.1 million. This guaranty can be called by the lenders only in the event of a default by Business Loan Express. Business Loan Express was in compliance with the terms of the revolving credit facility at June 30, 2002. We have also provided two standby letters of credit in connection with two term securitization transactions completed by Business Loan Express in the second quarter of 2002 totaling $10.6 million.

Business Loan Express is currently contemplating a corporate restructure and recapitalization whereby the company would convert from a corporation to a limited liability company. This restructure would enable the company to have greater flexibility as it grows. Upon such restructure and recapitalization our equity interests would be converted to membership units and the earnings of Business Loan Express would pass through to its members as dividends. There can be no assurance when or if the corporate restructure and recapitalization will occur.

WyoTech Acquisition Corporation. On July 1, 2002, we sold WyoTech Acquisition Corporation for $84.4 million in cash. We acquired WyoTech in December of 1998 and owned 91% of the common equity of WyoTech. At June 30, 2002, our investment had a cost basis of $16.4 million, which represented all of the debt ($12.6 million), preferred stock ($3.7 million) and 91% of the common equity capital ($0.1 million) of WyoTech. Our total cash proceeds from the sale of WyoTech, including the repayment of debt and preferred stock and the sale of our 91% common equity ownership, were approximately $77.0 million, resulting in a realized gain of approximately $60.6 million on the transaction. At June 30, 2002, we determined the fair value of our investment in WyoTech to be $77.0 million, which resulted in an increase in fair value during the second quarter of $6.6 million. The sale of WyoTech is subject to post-closing working capital adjustments, if any, and customary indemnification provisions.

Commercial Real Estate Finance

The commercial real estate finance portfolio, investment activity and yields at and for the six months ended June 30, 2002 and 2001 and at and for the years ended December 31, 2001, 2000 and 1999 were as follows:

($ in millions)	At and for the Six Months Ended June 30, 2002	At and for the Six Months Ended June 30, 2001	At and for the Years Ended December 31, 2001	At and for the Years Ended December 31, 2000	At and for the Years Ended December 31, 1999
	(unaudited)				
Portfolio at value:					
CMBS bonds	$560.9	$405.5	$558.3	$311.3	$277.7
Collateralized debt obligations	52.5	24.9	24.2		
Total CMBS	613.4	430.4	582.5	311.3	277.7
Commercial mortgage loans	62.0	87.8	79.6	106.4	154.1
Residual interest	69.0	74.9	69.9	81.7	81.7
Real estate owned	1.3	2.1	2.5	6.1	6.5
Total Portfolio	$745.7	$595.2	$734.5	$505.5	$520.0

Investments funded	$125.7	$185.9	$392.6	$149.0	$288.7
Change in accrued or reinvested interest	$0.4	$1.1	$2.7	$1.1	$2.8
Repayments	$11.0	$19.4	$30.7	$24.3	$50.8
Sales	$126.3	$74.6	$130.0	$151.7	$86.1
Yield*	13.7%	13.6%	13.5%	13.1%	12.3%

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

Our primary commercial real estate investment activity is the investment in non-investment grade commercial mortgage-backed securities, or CMBS. In 1998, we began to take advantage of a unique market opportunity to acquire non-investment grade CMBS bonds at significant discounts from the face amount of the bonds. We believe that CMBS is an attractive asset class because of the yields that can be earned on a security that is secured by commercial mortgage loans, and ultimately commercial real estate properties. We plan to continue our CMBS investment activity, however, in order to maintain a balanced portfolio, we expect that CMBS will continue to represent approximately 20% to 25% of our total assets. Our CMBS investment activity level will be dependent upon our ability to invest in CMBS at attractive yields.

Our commercial real estate investment activity for the six months ended June 30, 2002 and for the years ended December 31, 2001, 2000 and 1999 was as follows:

	Amount Invested			
($ in millions)	**Face Amount**	**Discount**	**Amount Funded**	**Yield(1)**
For the six months ended June 30, 2002				
CMBS bonds	$181.4	$(83.8)	$97.6	14.7%
CDOs	28.0		28.0	17.5%
Commercial mortgage loans	0.1		0.1	10.0%
Total	$209.5	$(83.8)	$125.7	15.2%

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($ in millions)	Amount Invested: Face Amount	Amount Invested: Discount	Amount Invested: Amount Funded	Yield(1)
For the year ended December 31, 2001				
CMBS bonds	$661.4	$(295.6)	$365.8	14.0%
CDOs	24.6		24.6	16.9%
Commercial mortgage loans	2.2		2.2	10.0%
Total	$688.2	$(295.6)	$392.6	14.2%
For the year ended December 31, 2000				
CMBS bonds	$244.6	$(120.3)	$124.3	14.7%
Commercial mortgage loans	25.5	(0.8)	24.7	10.9%
Total	$270.1	$(121.1)	$149.0	14.1%
For the year ended December 31, 1999				
CMBS bonds	$507.9	$(262.0)	$245.9	14.6%
Commercial mortgage loans	43.4	(0.6)	42.8	10.5%

Total	$551.3	$(262.6)	$288.7	14.0%

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

CMBS Bonds. The non-investment grade and unrated tranches of the CMBS bonds in which we invest are junior in priority for payment of interest and principal to the more senior tranches of the related CMBS bond issuance. Cash flow from the underlying mortgages generally is allocated first to the senior tranches, with the most senior tranches having a priority right to the cash flow. Then, any remaining cash flow is allocated, generally, among the other tranches in order of their relative seniority. To the extent there are defaults and unrecoverable losses on the underlying mortgages resulting in reduced cash flows, our most subordinate tranche will bear this loss first. At June 30, 2002, our CMBS bonds were subordinate to 92% to 97% of the tranches of bonds issued in various CMBS transactions. Given that the non-investment grade CMBS bonds in which we invest are junior in priority for payment of principal, we invest in these CMBS bonds at an approximate discount of 50% from the face amount of the bonds.

The underlying pools of mortgage loans that are collateral for our new CMBS bond investments for the six months ended June 30, 2002 and for the years ended December 31, 2001, 2000 and 1999 had respective underwritten loan to value and underwritten debt service coverage ratios as follows:

	For the Six Months Ended June 30,		For the Year Ended December 31,					
	2002		2001		2000		1999	
Loan to Value Ranges ($ in millions)	**Amount**	**Percentage**	**Amount**	**Percentage**	**Amount**	**Percentage**	**Amount**	**Percentage**
Less than 60%	$401.9	16%	$1,259.7	15%	$577.1	14%	$813.7	11%
60-65%	178.7	7	941.6	11	402.8	10	439.6	6
65-70%	264.1	11	1,140.6	14	648.1	16	1,342.5	17
70-75%	799.5	32	2,400.4	29	1,450.9	36	2,396.0	31
75-80%	812.7	33	2,466.4	30	958.9	23	2,500.8	33
Greater than 80%	12.0	1	119.6	1	36.6	1	150.7	2

Total	$2,468.9	100%	$8,328.3	100%	$4,074.4	100%	$7,643.3	100%
Weighted average loan to value	70.4%		69.7%		70.2%		71.1%	

Debt Service Coverage Ratio(1) Ranges ($ in millions)	For the Six Months Ended June 30,		For the Year Ended December 31,					
	2002		2001		2000		1999	
	Amount	Percentage	Amount	Percentage	Amount	Percentage	Amount	Percentage
Greater than 2.00	$103.3	4%	$484.8	6%	$197.0	5%	$246.1	3%
1.76-2.00	84.2	3	158.2	2	99.1	3	182.3	2
1.51-1.75	240.3	10	855.0	10	341.8	8	893.8	12
1.26-1.50	1,631.8	66	5,008.3	60	2,204.5	54	4,452.9	58
1.00-1.25	409.3	17	1,822.0	22	1,232.0	30	1,868.2	25
Total	$2,468.9	100%	$8,328.3	100%	$4,074.4	100%	$7,643.3	100%

Weighted average debt service coverage ratio				
	1.41	1.48	1.35	1.29

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

As a part of our strategy to maximize our return on equity capital, we sold CMBS bonds rated BB+, BB and BB- during the six months ended June 30, 2002, and during 2001 and 2000 totaling $123.3 million, $124.5 million and $98.7 million, respectively. These bonds had an effective yield of 11.2%, 10.3% and 11.5%, and were sold for $128.8 million, $126.8 million and $102.5 million, respectively, resulting in realized gains on the sales. The sales of these lower-yielding bonds increased our overall liquidity. We did not sell any CMBS bonds during the second quarter of 2002.

The effective yield on our CMBS portfolio at June 30, 2002 and December 31, 2001, 2000 and 1999 was 14.6%, 14.7%, 15.4% and 14.6%, respectively. The yield on the CMBS portfolio at any point in time will vary depending on the concentration of lower yielding BB+, BB and BB- CMBS bonds held in the portfolio. At June 30, 2002, December 31, 2001, 2000 and 1999, the unamortized discount related to the CMBS portfolio was $645.0 million, $611.9 million, $364.9 million and $291.5 million, respectively. At June 30, 2002, the CMBS bond portfolio had a fair value of $560.9 million, which included net unrealized appreciation on the CMBS bonds of $23.9 million.

At June 30, 2002, the underlying pools of mortgage loans that are collateral for our CMBS bonds consisted of approximately 4,100 commercial mortgage loans with a total outstanding principal balance of $22.9 billion. At June 30, 2002, December 31, 2001 and 2000, 0.75%, 0.52% and 0.22%, respectively, of the loans in the underlying collateral pool for our CMBS bonds were over 30 days delinquent or were classified as real estate owned.

On July 31, 2002, we sold $129.8 million of face amount of CMBS bonds, with a cost basis of $82.7 million, and recognized a gain on the sale of approximately $12 million. The CMBS bonds sold represent a strip of BB+ through B from our portfolio and had a weighted average yield to maturity of 12%. The CMBS bonds were sold to institutional investors. We had recorded approximately $5 million in net unrealized appreciation, which is net of unrealized depreciation on the related hedge of approximately $1 million, related to these CMBS bonds in the second quarter of 2002. Therefore, this sale will contribute earnings of approximately $7 million to the third quarter of 2002. Upon completion of the CMBS bond sale, we continue to own $471.3 million of non-investment grade CMBS bonds at value with a yield to maturity of 15.2%.

Collateralized Debt Obligations. During the six months ended June 30, 2002, and the year ended December 31, 2001, we invested in the preferred shares of two and one, respectively, collateralized debt obligations, or CDOs, which are secured by investment grade unsecured debt issued by various real estate investment trusts, or REITs, and investment and non-investment grade CMBS bonds. The investment grade REIT debt collateral consists of $852.8 million issued by 39 REITs. The investment grade CMBS collateral consists of CMBS bonds with a face amount of $402.1 million issued in 26 separate CMBS transactions. The non-investment grade CMBS collateral consists of BB+, BB and BB- CMBS bonds with a face amount of $405.0 million that were issued in 30 separate CMBS transactions. Included in the CMBS collateral for the CDOs are $393.8 million of CMBS bonds that are senior in priority of repayment to certain lower rated CMBS bonds held by us, which were issued in 22 separate CMBS transactions. The preferred shares are junior in priority for payment of principal to the more senior tranches of debt issued by the CDOs. To the extent there are defaults and unrecoverable losses on the underlying collateral resulting in reduced cash flows, the preferred shares will bear this loss first. At June 30, 2002, our preferred shares in the CDOs were subordinate to approximately 95% of the more senior tranches of debt issued by the CDOs. The yield on the CDOs was 17.2% and 16.9% at June 30, 2002, and December 31, 2001, respectively.

Commercial Mortgage Loans. We have been liquidating much of our whole commercial mortgage loan portfolio so that we can redeploy the proceeds into higher yielding assets. For the six months ended June 30, 2002, and for the years ended December 31, 2001, 2000 and 1999, we sold $3.0 million, $5.5 million, $53.0 million and $86.1 million, respectively, of commercial mortgage loans. At June 30, 2002, our whole commercial real estate loan portfolio had been reduced to $62.0 million from $79.6 million at December 31, 2001.

Residual Interests. The residual interest primarily consists of a retained interest totaling $68.9 million from a 1998 asset securitization whereby bonds were sold in three classes rated AAA, AA and A. The residual interest represents a right to cash flows from the underlying collateral pool of loans after these senior bond obligations are satisfied. At June 30, 2002, two classes of bonds rated AAA and AA+ are outstanding, for total bonds outstanding of $29.6 million. On August 9, 2002, the bonds rated AA+ were upgraded to AAA. We have the right to call the bonds when the outstanding bond balance is less than $23.9 million. Once the bonds are fully repaid, either through the cash flows from the securitized loans or due to us calling the bonds, the remaining loans in the trust will be returned to us as payment on the residual interest. At June 30, 2002, the residual interest had a fair value of $69.0 million.

Portfolio Asset Quality

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

At June 30, 2002, and December 31, 2001 and 2000, our portfolio was graded as follows:

	2002		2001		2000	
Grade	**Portfolio at Value**	**Percentage of Total Portfolio**	**Portfolio at Value**	**Percentage of Total Portfolio**	**Portfolio at Value**	**Percentage of Total Portfolio**
($ in millions)						
1	$793.6	33.3%	$603.3	25.9%	$208.3	11.7%
2	1,400.0	58.8	1,553.8	66.7	1,461.7	81.7
3	46.7	2.0	79.5	3.4	15.4	0.9
4	43.6	1.8	44.5	1.9	76.0	4.2
5	97.1	4.1	48.5	2.1	26.6	1.5
	$2,381.0	100.0%	$2,329.6	100.0%	$1,788.0	100.0%

Total Grades 4 and 5 assets as a percentage of the total portfolio at value at June 30, 2002 and December 31, 2001 and 2000 were 5.9%, 4.0% and 5.7%, respectively. We expect that a number of portfolio companies will be in the Grades 4 or 5 categories from time to time. Part of the business of private finance is working with troubled portfolio companies to improve their businesses and protect our investment. The number of portfolio companies and related investment amount included in Grades 4 and 5 may fluctuate significantly from period to period. We continue to follow our historical practice of working with a troubled portfolio company in order to recover the maximum amount of our investment, but record unrealized depreciation for the expected full amount of the potential loss when such exposure is identified.

For the total investment portfolio, workout loans not accruing interest, or those loans in Grade 4 and 5, were $121.4 million at value at June 30, 2002, or 5.1% of the total portfolio. Included in this category at June 30, 2002, were assets valued at $8.9 million that represent receivables related to companies in liquidation and loans of $16.2 million that were secured by commercial real estate. Workout loans not accruing interest were $109.0 million and $87.4 million at value at December 31, 2001 and 2000, or 4.7% and 4.9% of the total portfolio, respectively, of which $8.9 million and $16.2 million, respectively, represented receivables related to companies in liquidation, and $15.2 million and $14.4 million, respectively, represented loans secured by commercial real estate. In addition to Grade 4 and 5 assets that are in workout, we may not accrue interest on loans to companies which are more than 50% owned by us from time to time if such companies are in need of additional capital and, therefore, we may defer current debt service. Loans and debt securities to such companies totaled $61.3 million at value at June 30, 2002. Loans greater than 90 days delinquent were $89.4 million at value at June 30, 2002, or 3.8% of the total portfolio. Included in this category are loans valued at $22.0 million that are secured by commercial real estate. Loans greater than 90 days delinquent were $39.1 million and $57.3 million at value at December 31, 2001, and December 31, 2000, or 1.7% and 3.2% of the total portfolio, respectively. Included in this category are loans valued at $14.1 million and $14.1 million, respectively, that were secured by commercial real estate.

As a provider of long-term privately negotiated investment capital, we may defer payment of principal or interest from time to time. As a result, the amount of the portfolio that is greater than 90 days delinquent or on non-accrual status may vary from quarter to quarter. The nature of our private finance portfolio company relationships frequently provide an opportunity for portfolio companies to amend the terms of payment to us or to restructure their debt and equity capital. During such restructuring, we may not receive or accrue interest or dividend payments. The investment portfolio is priced to provide current returns for shareholders assuming that a portion of the portfolio at any time may not be accruing interest currently. We also price our investments for a total return including interest or dividends plus capital gains from the sale of equity securities. Therefore, the amount of loans greater than 90 days delinquent or on non-accrual status is not necessarily an indication of future principal loss or loss of anticipated investment return. Our portfolio grading system is used as a means to assess loss of investment principal (Grade 5 assets).

At June 30, 2002, December 31, 2001 and 2000, 0.75%, 0.52% and 0.22%, respectively, of the loans in the underlying collateral pool for our CMBS bond portfolio were over 30 days delinquent or were classified as real estate owned. We closely monitor the performance of all of the loans in the underlying collateral pools securing our CMBS investments.

Other Assets and Other Liabilities

Because we invest in BB+, BB and BB- rated CMBS bonds, which are purchased at prices that are based on the 10-year Treasury rate, we have entered into transactions with financial institutions to hedge against movement in Treasury rates on certain of these CMBS bonds. These transactions involved receiving the proceeds from the sales of the borrowed Treasury securities, with the obligations to replenish the borrowed Treasury securities at a later date based on the then current market price.

The total obligations to replenish borrowed Treasury securities were $84.8 million and $47.3 million at June 30, 2002, and December 31, 2001, respectively, which included unrealized depreciation on the obligations of $2.2 million and unrealized appreciation on the obligations of $1.2 million, respectively, due to changes in the yield on the borrowed Treasury securities. The obligations have been recorded as an other liability. The proceeds related to the sales of the borrowed Treasury securities were $82.6 million and $48.5 million at June 30, 2002, and December 31, 2001, respectively, and have been recorded as an other asset.

RESULTS OF OPERATIONS

Comparison of Six Months Ended June 30, 2002 and 2001

The following table summarizes our condensed operating results for the six months ended June 30, 2002 and 2001.

($ in thousands, except per share amounts)	For the Six Months Ended June 30, 2002	2001	Change	Percent Change
	(unaudited)			
Interest and Related Portfolio Income				
Interest and dividends	$127,665	$113,699	$13,966	12%
Premiums from loan dispositions	1,659	1,731	(72)	(4%)
Fees and other income	26,260	18,380	7,880	43%
Total interest and related portfolio income	155,584	133,810	21,774	16%
Expenses				
Interest	34,984	31,881	3,103	10%
Employee	16,309	14,056	2,253	16%
Administrative	7,861	6,027	1,834	30%

Total operating expenses	59,154	51,964	7,190	14%
Net investment income before net realized and unrealized gains	96,430	81,846	14,584	18%
Net Realized and Unrealized Gains				
Net realized gains	8,850	4,991	3,859	*
Net unrealized gains	24,135	11,297	12,838	*
Total net realized and unrealized gains	32,985	16,288	16,697	*
Net increase in net assets resulting from operations	$129,415	$98,134	$31,281	32%

Diluted earnings per share	$1.26	$1.10	$0.16	15%
Weighted average shares outstanding diluted	102,900	88,966	13,934	16%

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

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

Total interest and related portfolio income. Total interest and related portfolio income includes interest income, premiums from loan dispositions and fees and other income.

($ in millions, except per share amounts)	For the Six Months Ended June 30, 2002	2001
Total Interest and Related Portfolio Income	$155.6	$133.8
Per share	$1.51	$1.50

The increase in interest income earned results primarily from the growth of our investment portfolio. Our investment portfolio, excluding non-interest bearing equity interests in portfolio companies, increased by 10% to $1,796.5 million at June 30, 2002 from $1,639.7 million at June 30, 2001. The weighted average yield on the interest-bearing investments in the portfolio at June 30, 2002 and 2001 was as follows:

	June 30, 2002	2001
Private Finance	13.9%	14.6%
Commercial Real Estate Finance	13.7%	13.6%
Total Portfolio	13.8%	14.2%

Included in net premiums from loan dispositions are prepayment premiums of $1.6 million and $1.0 million for the six months ended June 30, 2002 and 2001, respectively. While the scheduled maturities of private finance and commercial real estate loans range from five to ten years, it is not unusual for our borrowers to refinance or pay off their debts to us ahead of schedule. Because we seek to finance primarily seasoned, performing companies, such companies at times can secure lower cost financing as their balance sheets strengthen, or as more favorable interest rates become available. Therefore, we generally structure our loans to require a prepayment premium for the first three to five years of the loan.

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

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

Business Loan Express, Hillman and WyoTech are our most significant portfolio investments and together represent 17.9% of our total assets at June 30, 2002. Total interest and related portfolio income earned from these investments for the six months ended June 30, 2002 and 2001 was $28.1 million and $17.8 million, respectively. Total interest and related portfolio income earned from WyoTech for the six months ended June 30, 2002 was $3.6 million, which will no longer occur due to the sale of the investment.

Operating Expenses. Operating expenses include interest, employee and administrative expenses. Our single largest expense is interest on our indebtedness. The fluctuations in interest expense during the six months ended June 30, 2002 and 2001 are attributable to changes in the level of our borrowings under various notes payable and debentures and our revolving credit facility. Our borrowing activity and weighted average interest cost, including fees and closing costs, were as follows:

	At and for the Six Months Ended June 30,	
($ in millions)	**2002**	**2001**
Total Outstanding Debt	$1,009.0	$881.1
Average Outstanding Debt	$940.4	$801.3
Weighted Average Cost	7.2%	7.4%
BDC Asset Coverage*	256%	247%

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

Employee expenses include salaries and employee benefits. The increase in salaries and employee benefits for the periods presented reflects wage increases and the experience level of employees hired. Total employees were 103 and 101 at June 30, 2002 and 2001, respectively.

Administrative expenses include the leases for our headquarters in Washington, DC, and our regional offices, travel costs, stock record expenses, directors fees, legal and accounting fees, insurance premiums and various other expenses. The increase in administrative expenses as compared to the same period in 2001 includes approximately $1.2 million from legal, consulting and other fees, including costs incurred to defend against class action lawsuits alleging violations of securities laws and to respond to market activity in our stock. Administrative expenses also increased by approximately $0.1 million due to increased costs for corporate liability insurance and $0.5 million due to outsourced technology assistance.

Realized Gains and Losses. Net realized gains 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, commercial mortgage loans and CMBS bonds, offset by losses on investments. Net realized and unrealized gains and losses were as follows:

($ in millions)	For the Six Months Ended June 30, 2002	2001
Realized Gains	$15.4	$6.6
Realized Losses	(6.5)	(1.6)
Net Realized Gains	$8.9	$5.0
Net Unrealized Gains	$24.1	$11.3

Realized gains and losses for the six months ended June 30, 2002, resulted from various private finance and commercial real estate finance transactions. Realized gains for the six months ended June 30, 2002, primarily resulted from transactions involving three private finance portfolio companies, Aurora Communications, LLC ($4.9 million), Cumulus Media, Inc. ($0.5 million) and Alderwoods Group, Inc. ($0.1 million), the sale of CMBS bonds ($7.1 million, including a realized gain from the related hedge of $1.6 million) and one commercial real estate investment ($1.3 million). For the six months ended June 30, 2002 and 2001, we reversed previously recorded unrealized appreciation totaling $7.3 million and $4.0 million, respectively, when gains were realized.

Realized losses for the six months ended June 30, 2002 primarily resulted from transactions involving four private finance portfolio companies, The Loewen Group, Inc. ($2.7 million), iSolve Incorporated ($0.9 million), Sure-Tel, Inc. ($0.5 million) and Soff-Cut Holdings, Inc. ($0.5 million), and one commercial real estate investment ($1.1 million). In January 2002, The Loewen Group, Inc. emerged from bankruptcy and as a result, we exchanged our debt securities for cash, new debt securities and publicly traded common stock in the reorganized company, which resulted in a realized loss. The Loewen Group, Inc. changed its name to Alderwoods Group, Inc. For the six months ended June 30, 2002 and 2001, we reversed previously recorded unrealized depreciation totaling $5.2 million and $2.2 million, respectively, when losses were realized.

Unrealized Gains and Losses. We determine the fair value of each investment in our portfolio on a quarterly basis, and changes in fair value result in unrealized gains or losses being recognized. At June 30, 2002, approximately 93% of our total assets represented investments recorded at fair value. Value, as defined in Section 2(a)(41) of the Investment Company Act of 1940, is (i) the market price for those securities for which a market quotation is readily available and (ii) for all other securities and assets, fair value is as determined in good faith by the board of directors.

Since there is typically no readily ascertainable market value for the investments in our portfolio, we value substantially all of our investments at fair value as determined in good faith by the board of directors pursuant to a valuation policy and a consistently applied valuation process. Because of the inherent uncertainty of determining the fair value of investments that do not have a readily ascertainable 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 must determine the fair value of 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. Conversely, we will record unrealized appreciation if we have an indication that the underlying portfolio company has appreciated in value and, therefore, our equity security has also appreciated in value, where appropriate. Changes in fair value are recorded in the statement of operations as unrealized gains and losses.

As a business development company, we invest primarily in illiquid securities including debt and equity securities of private companies and non-investment grade CMBS. 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 are generally subject to restrictions on resale and generally have no established trading market. Because of the type of investments that we make and the nature of our business, our valuation process requires an analysis of various factors. Our fair value methodology includes the examination of, among other things, the underlying investment performance, financial condition and market changing events that impact valuation.

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

There is no one methodology to determine enterprise value and, in fact, for any one portfolio company, enterprise value is best expressed as a range of fair values, from which we derive a single estimate of enterprise value. To determine the enterprise value of a portfolio company, we analyze its historical and projected financial results. We generally require portfolio companies to provide annual audited and monthly unaudited financial statements, as well as annual projections for the upcoming fiscal year. Typically in the private equity business, companies are bought and sold based upon multiples of EBITDA, cash flow, net income, revenues or, in limited instances, book value. 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, or acquisition, recapitalization or restructuring related items.

In determining a multiple to use for valuation purposes, we look to private merger and acquisition statistics, discounted public trading multiples or industry practices. In estimating a reasonable multiple, we consider not only the fact that our portfolio company may be private relative to a peer group, but 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 upon future projections. If a portfolio company is distressed, a liquidation analysis may provide the best indication of enterprise value.

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

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

Net unrealized gains for the six months ended June 30, 2002 were $24.1 million, which included $121.2 million of unrealized gains and $97.1 million of unrealized losses.

Private Finance. We increased the fair value of our investment in The Hillman Companies, Inc. by $32.8 million in the six months ended June 30, 2002. The fair value of our investment in Hillman is based upon our estimate of Hillman s enterprise value of approximately $350 million, including all debt. As discussed above, there is no one methodology to determine enterprise value. As multiples or EBITDAM fluctuate over time, this may or may not impact our estimate of Hillman s enterprise value. The following is a simplified summary of the methodology that we used to determine the fair value of our investment in Hillman.

Since Hillman s results can be affected by seasonal changes, we believe using projected 2002 results for valuation purposes is most appropriate. Hillman is performing better than Hillman s originally projected 2002 revenue and EBITDAM estimates, resulting in part from the closing of a former corporate headquarters for cost savings, the completion of an acquisition and successful expansion into Canada. Hillman is above its original projections for the year as of June 30, 2002, and its 2002 revenue and EBITDA is expected to exceed revenue and EBITDA for 2001.

We believe the current enterprise value for Hillman is approximately $350 million, or approximately 7 times 2002 projected EBITDAM of $50 million. The 7 times multiple was determined by obtaining the average multiple of enterprise value to EBITDA for comparable public companies in Hillman s peer group and discounting that average multiple to arrive at a private company multiple. We then subtracted Hillman s debt (including $41.0 million of subordinated debt owed to us) and Hillman s trust preferred securities estimated to be currently outstanding to arrive at a common equity value of approximately $102 million. We then took our 78% fully diluted share of the resulting equity value and added to it the cost basis of our share of two securities, including a note receivable from GC-Sun Holdings II, LP (Kar Products, LP) and preferred stock of STS Operating, Inc., owned by Hillman that are anticipated to be distributed to us in the third quarter of 2002. We arrived at a total fair value of our common equity of approximately $90 million. We compared the $90 million fair value to our basis in Hillman s common equity of $57.2 million and recorded an unrealized gain of $32.8 million.

We increased the fair value of our investment in Business Loan Express, or BLX, by $19.9 million in the second quarter of 2002 or just slightly under 10% of the total amount invested. BLX has just completed its first full fiscal year of operations since our acquisition of the company in December 2000. During 2002, BLX achieved most of its goals including launching a conventional small business loan product. The fair value for our investment in BLX is based upon our estimate of BLX s enterprise value of approximately $390 million, including all debt. As discussed above, there is no one methodology to determine enterprise value. The following is a simplified summary of the methodology that we used to determine the fair value of our investment in BLX.

To determine the enterprise value of BLX, we determined that financial services companies are generally valued using multiples of net income. We have capitalized BLX with $87 million of subordinated debt. For purposes of valuation, we assumed in a sale transaction that a portion of this $87 million would be considered equity and that BLX would increase the size of its senior debt facility to approximately $155 million. Given this assumption, we then computed a pro forma net income for BLX taking its preliminary, unaudited 2002 earnings before interest, taxes and management fees, and subtracting pro forma interest, assuming the higher level of senior debt and no outstanding subordinated debt. We then computed taxes at a rate of 40 percent, which resulted in pro forma net income for BLX of approximately $23 million for fiscal year 2002 and a projected pro forma net income for fiscal year 2003 of approximately $26 million. We then performed three valuation analyses to determine the fair value of BLX assuming an initial public offering of BLX, assuming the sale of BLX, and, lastly, considering discounted trading ranges for similar companies in the public markets. In performing these analyses, we used a publicly traded peer group and reviewed merger and acquisition transactions that occurred in the last five years in the commercial finance sector. These analyses resulted in a range of estimated enterprise values, and we selected $390 million, which was at the low end of the range. After deducting outstanding debt and preferred stock from the enterprise value to reach an equity value, we determined the value of our 92.8% fully diluted common equity interest to be approximately $140.0 million. We compared the $140.0 million fair value to the fair value of our common equity at March 31, 2002 of $120.1 million, and recorded an unrealized gain of $19.9 million in the second quarter of 2002. As multiples or pro forma net income fluctuate over time, this may or may not impact our determination of the fair value of our investment in BLX.

During the six months ended June 30, 2002, we also increased the fair value of: WyoTech Acquisition Corporation by $16.6 million based on the proceeds received from the sale of this investment in July 2002; Blue Rhino and Kirkland s by $11.5 million and $5.7 million, respectively, based on the public market valuations of each company s stock;

and CorrFlex Graphics LLC by $11.8 million based on strong earnings growth and upon indicative valuation estimates received from third parties. In addition, we recorded unrealized appreciation totaling $14.0 million on nine other investments in our portfolio.

During the six months ended June 30, 2002, we decreased the fair value of our investment in Startec Global Communications Corporation by $10.2 million to reflect the current plan of reorganization filed with the bankruptcy court this quarter. We also decreased the fair value of our investment in Velocita, Inc. by $15.3 million. Velocita filed for bankruptcy under Chapter 11 in June 2002, and, based upon the assessment of an independent third party regarding Velocita s liquidation value, we do not expect to recover our investment. Our investment has a fair value of zero at June 30, 2002. We also decreased the value of Alderwoods Group, Inc. by $2.3 million.

We also recorded $74.8 million in unrealized losses during the six months ended June 30, 2002, largely due to conditions in the manufacturing, technology and media sectors, and the continuing effects of the events of September 11th, 2001. Portfolio companies for which unrealized depreciation was recorded this quarter include five companies in the portfolio that have been affected by weakness in the manufacturing sector for which we decreased fair value by $20.6 million; five companies that have been affected by lower levels of technology spending for which we decreased fair value by $16.7 million; two companies in the media sector that have declined in fair value due to declining values in this sector for which we decreased fair value by $7.7 million; and two companies that continued to endure difficulties during the second quarter of 2002 as a result of the attacks of September 11th that have declined in fair value by $11.3 million. As the economy improves, the financial performance of these portfolio companies may also improve. However, there can be no assurance when or if these companies performance may improve.

CMBS Bonds. We recorded a net increase in the fair value of our CMBS bond portfolio by $20.7 million in the second quarter of 2002. We determined the fair value of our CMBS bond portfolio using a discounted cash flow model based upon (i) the current performance of the underlying collateral loans, which utilizes prepayment and loss assumptions based upon historical and projected experience, economic factors and the characteristics of the underlying cash flow, and (ii) current market yields for comparable CMBS bonds, based upon Treasury rates and market spreads.

Cash flow assumptions. With respect to the cash flows of the underlying collateral loans securing the CMBS bonds, the performance of the collateral loans to date is generally consistent with our original assumptions. We continue to assume no prepayments on the collateral loans prior to maturity, as prepayments on the loans prior to maturity are generally prohibited or there are significant penalties, such as prepayment premiums, yield maintenance and/or defeasance requirements. Our credit loss assumptions for the underlying collateral loans at the time of investment in the CMBS bonds were generally estimated to assume that approximately 1% of the underlying collateral loan principal would be lost, and that one-third of the losses would be realized in year three, one-third in year six, and one-third in year nine. We believe that this is an appropriate approach to setting loss assumptions, as losses are expected to occur throughout the life of the CMBS bonds. As of June 30, 2002, total estimated losses in the underlying collateral pools over the life of the CMBS bonds were assumed to total approximately $220 million.

Through June 30, 2002, $0.5 million in actual losses have been realized, and we have specifically identified approximately $25.1 million of additional potential losses. The actual losses and potential expected losses of approximately $25.6 million to date as of June 30, 2002 are less than the losses originally estimated to have been realized by this point, which were estimated at approximately $51.8 million. While the losses identified as of June 30, 2002 are less than our originally estimated losses, we have not reduced the original estimates of the total expected losses over the life of the CMBS bonds as we continue to believe they are reasonable. Loss assumptions affecting future cash flows are updated quarterly to reflect the estimated current and expected performance of the collateral loans on a loan-by-loan basis.

Yield assumptions. During the second quarter of 2002, the overall yields on newly-issued CMBS bonds rated BB+ through B declined due to the decline in Treasury yields combined with the narrowing of spreads, resulting in market yields for these bond classes being lower than the yields-to-maturity on our CMBS bonds for the same classes. More buyers of CMBS bonds have recently entered the market, particularly buyers for BB+ through BB rated CMBS bonds, which has contributed to the decline in spreads for these bond classes during the second quarter. Historically, we have found yields on new issuances to be in the same range as the CMBS bonds we own. We confirmed our CMBS bond portfolio pricing estimates with respect to spreads for our BB+ through B rated bonds with other CMBS bond market participants. Lower yields imply an increase in the value of our BB+ through B rated CMBS bond portfolio. The yields on B- through the non-rated classes have generally remained relatively consistent with the yields on our CMBS bonds in these classes. Pricing for these deeply subordinated classes of bonds are generally much more a function of the credit quality of a single issuance than market conditions.

Fair Value. We have determined the fair value of our CMBS bonds based upon a discounted cash flow model using expected future cash flows and current market yields, as discussed above, to be approximately $560.9 million, and as a result have recorded net unrealized appreciation on the CMBS bonds of $23.9 million at June 30, 2002.

Because we invest in BB+, BB and BB- rated CMBS bonds, which are purchased at prices that are based on the 10-year Treasury rate, we have entered into transactions with financial institutions to hedge against movement in Treasury rates on certain of these CMBS bonds. These transactions involved receiving the proceeds from the sales of borrowed Treasury securities, with the obligations to replenish the borrowed Treasury securities at a later date based on the then current market price. The net proceeds related to the sales of the borrowed Treasury securities and the related obligations to replenish the borrowed Treasury securities totaled $82.6 million and $84.8 million, respectively, and have been included in other assets and other liabilities, respectively, at June 30, 2002. As of June 30, 2002, the total obligations on the hedge had increased to $84.8 million due to changes in the yield on the borrowed Treasury securities, resulting in unrealized depreciation on the obligation of $2.2 million. The decrease in the value of the hedge during the six months ended June 30, 2002 was $2.3 million and was recorded as an unrealized loss.

The net unrealized gain on the CMBS bonds of $23.9 million, net of the unrealized loss on the hedge of $3.2 million, resulted in a net unrealized gain from the CMBS bond portfolio of $21.6 million for the six months ended June 30, 2002.

Given that Treasury yields fluctuate, it is possible that there may be future adjustments to the fair value of the CMBS bonds. As a result, we have not classified the appreciated CMBS bonds as Grade 1 assets at June 30, 2002, since they may not result in any future capital gain. Therefore, CMBS bonds remain in Grade 2.

Other Matters. All per share amounts included in the Management s Discussion and Analysis of Financial Condition and Results of Operations section have been computed using the weighted average shares used to compute diluted earnings per share, which were 102.9 million and 89.0 million for the six months ended June 30, 2002 and 2001, respectively.

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

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

Comparison of the Years Ended December 31, 2001, 2000 and 1999

The following table summarizes our condensed operating results for the years ended December 31, 2001, 2000 and 1999:

	2001	2000	Change	Percent Change	2000	1999	Change	Percent Change
	(in thousands, except per share amounts)							
Interest and Related Portfolio Income								
Interest and dividends	$240,464	$182,307	$58,157	32%	$182,307	$121,112	$61,195	51%
Premiums from loan dispositions	2,504	16,138	(13,634)	(84%)	16,138	14,284	1,854	13%
Fees and other income	46,142	13,144	32,998	251%	13,144	5,744	7,400	129%
Total interest and related portfolio income	289,110	211,589	77,521	37%	211,589	141,140	70,449	50%
Expenses								

Interest	65,104	57,412	7,692	13%	57,412	34,860	22,552	65%
Employee	29,656	26,025	3,631	14%	26,025	22,889	3,136	14%
Administrative	15,299	15,435	(136)	(1%)	15,435	12,350	3,085	25%
Total operating expenses	110,059	98,872	11,187	11%	98,872	70,099	28,773	41%
Net investment income before income tax benefit and net realized and unrealized gains	179,051	112,717	66,334	59%	112,717	71,041	41,676	59%

Income tax benefit
412 412 %

Net investment income before net realized and unrealized gains
179,463 112,717 66,746 59% 112,717 71,041 41,676 59%

Net Realized and Unrealized Gains

Net realized gains (losses)
661 15,523 (14,862) * 15,523 25,391 (9,868) *

Net unrealized gains
20,603 14,861 5,742 * 14,861 2,138 12,723 *

Total net realized and unrealized gains
21,264 30,384 (9,120) * 30,384 27,529 2,855 *

Net increase in net assets resulting from operations	$200,727	$143,101	$57,626	40%	$143,101	$98,570	$44,531	45%
Diluted earnings per share	$2.16	$1.94	$0.22	11%	$1.94	$1.64	$0.30	18%
Weighted average shares outstanding diluted	93,003	73,472	19,531	27%	73,472	60,044	13,428	22%

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

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

Total interest and related portfolio income includes interest income, premiums from loan dispositions and fees and other income.

	For the Years Ended December, 31,		
($ in millions, except per share amounts)	2001	2000	1999
Total Interest and Related Portfolio Income	$289.1	$211.6	$141.1
Per share			

$3.11 $2.88 $2.35

The increase in interest income earned results primarily from continued growth of our investment portfolio and our focus on increasing our overall portfolio yield. Our investment portfolio, excluding non-interest bearing equity interests in portfolio companies, increased by 25% to $1,842.4 million at December 31, 2001 from $1,471.8 million at December 31, 2000, and increased by 29% during 2000 from $1,141.2 million at December 31, 1999. The weighted average yield on the interest bearing investments in the portfolio at December 31, 2001, 2000 and 1999 was as follows:

	December 31,		
	2001	2000	1999
Private Finance	14.8%	14.6%	14.2%
Commercial Real Estate Finance	13.5%	13.1%	12.3%
Total Portfolio	14.3%	14.1%	13.0%

Included in net premiums from loan dispositions are premiums from loan sales and premiums received on the early repayment of loans. Premiums from loan sales were $0.5 million, $13.3 million and $10.5 million for the years ended December 31, 2001, 2000 and 1999, respectively. This premium income for 2000 and 1999 was higher primarily due to the loan sale activities of Allied Capital Express prior to its merger with Business Loan Express.

Prepayment premiums were $2.0 million, $2.8 million and $3.8 million for the years ended December 31, 2001, 2000 and 1999, respectively. While the scheduled maturities of private finance and commercial real estate loans range from five to ten years, it is not unusual for our borrowers to refinance or pay off their debts to us ahead of schedule. Because we seek to finance primarily seasoned, performing companies, such companies at times can secure lower cost financing as their balance sheets strengthen, or as more favorable interest rates become available. Therefore, we generally structure our loans to require a prepayment premium for the first three to five years of the loan.

Fees and other income primarily include fees related to financial structuring, diligence, management services to portfolio companies, guaranties and other advisory services. We generate fee income for the transaction services and management services that we provide. As a business development company, we are required to make significant managerial assistance available to the companies in our investment portfolio.

Fees and other income for the year ended December 31, 2001 primarily included fees of $15.5 million related to structuring and diligence, fees of $16.6 million related to transaction services provided to portfolio companies, and fees of $13.1 million related to management services provided to portfolio companies, other advisory services and guaranty fees. Fees and other income for the years ended December 31, 2000 and 1999 primarily included structuring and diligence fees of $6.0 million and $0.3 million, respectively, and management services and advisory fees of $3.1 million and $3.2 million, respectively. Fees and other income are generally related to specific transactions or services, and therefore may vary substantially from period to period. Points or loan origination fees that represent yield enhancement on a loan are capitalized and amortized into interest income over the life of the loan.

Operating expenses include interest, employee and administrative expenses. Our single largest expense is interest on our indebtedness. The fluctuations in interest expense during 2001, 2000 and 1999 are attributable to changes in the level of our borrowings and the related interest rate charged thereon. Our borrowing activity and weighted average interest cost, including related fees and expenses, were as follows:

($ in millions)	2001	2000	1999
Total outstanding debt	$1,020.8	$786.6	$592.9
Average outstanding debt	$847.1	$707.4	$461.5
Weighted average cost	7.0%	8.3%	7.9%
Business development company asset coverage*	245%	245%	228%

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

Employee expenses include salaries and employee benefits. The increases in salaries and employee benefits for the periods presented reflect wage increases and the experience level of employees hired. Total employees were 97, 97 and 129 at December 31, 2001, 2000 and 1999, respectively. As part of the recapitalization of Allied Capital Express discussed above, 37 of our employees were transferred to Business Loan Express at the end of 2000. Expenses related to these employees are reflected in employee expense for the years ended December 31, 2000 and 1999.

Administrative expenses include the leases for our headquarters in Washington, DC and our regional offices, travel costs, stock record expenses, directors fees, legal and accounting fees and various other expenses. Administrative expenses for the years ended December 31, 2000 and 1999 included expenses related to regional offices of Allied Capital Express. The cost of these regional offices was transferred to Business Loan Express at the beginning of 2001. For the years ended December 31, 2001, 2000 and 1999, employee and administrative costs as a percentage of total interest and related portfolio income less interest expense plus net realized and unrealized gains was 18%, 19% and 21%, respectively.

Net realized gains resulted 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, commercial mortgage loans and CMBS, offset by losses on investments. Net realized and unrealized gains for the years ended December 31, 2001, 2000 and 1999 were as follows:

(in millions)	2001	2000	1999
Realized gains	$10.1	$28.6	$31.5
Realized losses	(9.4)	(13.1)	(6.1)
Net realized gains	$0.7	$15.5	$25.4

Net unrealized gains	$20.6	$14.9	$2.1

Realized gains during 2001 primarily resulted from transactions involving three private finance portfolio companies - FTI Consulting, Inc. ($4.6 million), SunSource Inc. ($2.5 million), and Southwest PCS, LLC ($0.8 million), and the sale of CMBS bonds ($1.7 million). We reversed previously recorded unrealized appreciation of $6.5 million when these gains were realized in 2001. Realized gains during 2000 and 1999 resulted primarily from transactions involving eight and six portfolio companies, respectively, and we reversed previously recorded unrealized appreciation of $7.5 million and $14.6 million, respectively, when these gains were realized.

Realized losses in 2001, 2000 and 1999 represented 0.4%, 0.7% and 0.5% of our total assets, respectively. Realized losses during 2001 resulted primarily from three private finance portfolio investments - Pico Products, Inc. ($2.9 million), Allied Office Products, Inc. ($2.5 million), and Genesis Worldwide, Inc. ($1.1 million), and the continued liquidation of our whole loan commercial real estate portfolio. Losses realized in 2001 had been recognized in net increase in net assets resulting from operations, or net income, over time as unrealized depreciation when we determined that the respective portfolio security s value had become impaired. Thus, we reversed previously recorded unrealized depreciation totaling $8.9 million, $12.0 million and $5.4 million when the related losses were realized in 2001, 2000 and 1999, respectively.

As discussed in the Portfolio and Investment Activity Private Finance section above, merger and acquisition activity for 2001 was at a slower pace than prior years. This lower level of activity is reflected in the lower amount of net realized gains in 2001 as compared to 2000 and 1999.

For a discussion of our fair value methodology and how it affects unrealized gains and losses, see Unrealized Gains and Losses included in the Comparison of Six Months Ended June 30, 2002 and 2001.

During 2001, we increased the value of our equity investment in Business Loan Express by $15.5 million and recorded unrealized appreciation. We also increased the value of our investment in WyoTech Acquisition Corporation and recorded unrealized appreciation of $37.0 million. In addition to Business Loan Express and WyoTech, we increased the value of other portfolio investments and recorded unrealized appreciation of a total of $32.9 million for the year ended December 31, 2001. These companies increased in value because of their continued positive performance and valuation data that would indicate that a valuation increase was necessary.

During the year ended December 31, 2001, we decreased the value of and recorded unrealized depreciation on our investments in Startec Global Communications Corporation by $14.9 million, Galaxy American Communications, LLC by $10.4 million, Schwinn Holdings Corporation by $8.8 million, Avborne, Inc. by $8.4 million and NETtel Communications, Inc. by $7.0 million. In addition, we recorded a net decrease in the value of other portfolio investments by a total of $18.9 million for the year ended December 31, 2001.

All per share amounts included in Management s Discussion and Analysis of Financial Condition and Results of Operations have been computed using the weighted average shares used to compute diluted earnings per share, which were 93.0 million, 73.5 million and 60.0 million for the years ended December 31, 2001, 2000 and 1999, respectively. The increases in the weighted average shares reflect the issuance of new shares.

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

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

FINANCIAL CONDITION, LIQUIDITY AND CAPITAL RESOURCES

Cash and Cash Equivalents

At June 30, 2002, and December 31, 2001, we had $4.3 million and $0.9 million, respectively, in cash and cash equivalents. We invest otherwise uninvested cash in U.S. government- or agency-issued or guaranteed securities that are backed by the full faith and credit of the United States, or in high quality, short-term repurchase agreements fully collateralized by such securities. Our objective is to manage to a low cash balance and fund new originations with our revolving line of credit.

Debt and Other Commitments

We had outstanding debt at June 30, 2002 and December 31, 2001, as follows:

($ in millions)	Facility Amount	Amount Outstanding	Annual Interest Cost(1)	Annual Portfolio Return to Cover Interest Payments(2)
At June 30, 2002				
Notes payable and debentures:				
Unsecured long-term notes	$694.0	$694.0	7.8%	2.1%
Small Business Administration debentures	101.8	94.5	8.2%	0.3%
Auction rate reset note	75.0	75.0	3.7%	0.1%
Overseas Private Investment Corporation loan	5.7	5.7	6.6%	0.0%
Total notes payable and debentures	$876.5	$869.2	7.4%	2.5%

Revolving line of credit	527.5	139.8	4.1%(3)	0.3%
Total debt	$1,404.0	$1,009.0	7.2%	2.8%
At December 31, 2001				
Notes payable and debentures:				
Unsecured long-term notes	$694.0	$694.0	7.8%	2.2%
Small Business Administration debentures	101.8	94.5	7.7%	0.3%
Auction rate reset note	81.9	81.9	3.9%	0.1%
Overseas Private Investment Corporation loan	5.7	5.7	6.6%	0.0%
Total notes payable and debentures	$883.4	$876.1	7.4%	2.6%

Revolving line of credit	497.5	144.7	3.2%(3)	0.3%
Total debt	$1,380.9	$1,020.8	7.0%	2.9%

(1) The annual interest cost includes the cost of commitment fees and other facility fees that are recognized into interest expense over the contractual life of the respective borrowings.

(2) The annual portfolio return to cover interest payments is calculated as the June 30, 2002, annualized cost of debt per class of financing divided by total assets at June 30, 2002.
(3) The current interest rate payable on the revolving line of credit was 4.1% and 3.2% at June 30, 2002 and December 31, 2001, respectively, which excludes the annual cost of commitment fees and other facility fees of $2.0 million.

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

Small Business Administration Debentures. We, through our small business investment company subsidiary, have debentures payable to the Small Business Administration with terms of ten years. The notes require payment of interest only semi-annually, and all principal is due upon maturity. Under the small business investment company program, we may borrow up to $111.7 million from the Small Business Administration. At June 30, 2002, the Small Business Administration has a commitment to lend up to an additional $7.3 million above the amount outstanding. The commitment expires on September 30, 2005.

Auction Rate Reset Note. We have an Auction Rate Reset Senior Note Series A that matures on December 2, 2002 and bears interest at the three-month London Inter-Bank Offered Rate (LIBOR) plus 1.75%, which adjusts quarterly. Interest is due quarterly, and we, at our option, may pay or defer such interest payments. The amount outstanding on the note will increase as interest due is deferred. As a means to repay the note, we have entered into an agreement with the placement agent of this note to serve as the placement agent on a future issuance of $75.0 million of debt, equity or other securities in one or more public or private transactions. Alternatively, we may repay the note in cash without conducting a capital raise. If we choose to pay in cash without conducting a capital raise, we will incur additional expense of approximately $2.1 million.

Revolving Line of Credit. As of June 30, 2002, we have a $527.5 million unsecured revolving line of credit that expires in August 2003, with the right to extend maturity for one additional year at our sole option under substantially similar terms. This facility was increased by $30.0 million during the first quarter of 2002 from $497.5 million at December 31, 2001, and may be further expanded up to $600 million. As of June 30, 2002, $382.4 million remains unused and available, net of amounts committed for standby letters of credit of $5.3 million issued under the line of credit facility. The credit facility bears interest at a rate equal to (i) the one-month LIBOR plus 1.25% or (ii) the higher of (a) the Bank of America, N.A. prime rate or (b) the Federal Funds rate plus 0.50%. The credit facility requires monthly payments of interest, and all principal is due upon maturity.

We have various financial and operating covenants required by the revolving line of credit and the notes payable and debentures. These covenants require us to maintain certain financial ratios, including debt to equity and interest coverage, and a minimum net worth. Our credit facilities limit our ability to declare dividends if we default under certain provisions. As of June 30, 2002, we were in compliance with these covenants.

The following table shows our significant contractual obligations as of June 30, 2002.

($ in millions) Contractual Obligations	Total	Payments Due By Year 2002	2003	2004	2005	2006	After 2006
Notes payable and debentures:							
Unsecured long-term notes	$694.0	$	$140.0	$214.0	$165.0	$175.0	$
Small Business Administration debentures	94.5			7.0	14.0		73.5
Auction rate reset note	75.0	75.0					
Overseas Private Investment Corporation loan	5.7					5.7	
Revolving line of credit(1)	139.8			139.8			
Operating leases	22.3	1.3	2.6	2.7	2.7	2.6	10.4
Total contractual cash obligations	$1,031.3	$76.3	$142.6	$363.5	$181.7	$183.3	$83.9

(1) The revolving line of credit expires in August 2003, and may be extended under substantially similar terms for one additional year at our sole option. We assume that we would exercise our option to extend the revolving line of credit, resulting in an assumed maturity of August 2004.

The following table shows, as of June 30, 2002, our contractual commitments that may have the effect of creating, increasing or accelerating our liabilities.

		Amount of Commitment Expiration Per Year					
($ in millions) Commitments	**Total**	**2002**	**2003**	**2004**	**2005**	**2006**	**After 2006**
Standby letters of credit	$11.3	$	$	$5.3	$	$	$6.0
Guarantees	52.2	1.0		50.3	0.2		0.7
Total commitments	$63.5	$1.0	$	$55.6	$0.2	$	$6.7

Equity Capital and Dividends

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

To support our growth during the three and six months ended June 30, 2002 and for the year ended December 31, 2001, we raised $30.0 million, $49.9 million and $286.9 million, respectively, in new equity capital through the sale of shares from our shelf registration statement. We issue equity from time to time when we have attractive investment opportunities. In addition, during the three and six months ended June 30, 2002 and for the year ended December 31, 2001, we raised $1.5 million, $3.1 million and $6.3 million, respectively, in new equity capital through the issuance of shares through our dividend reinvestment plan. At June 30, 2002, total shareholders equity had increased to $1,434.5 million.

Our board of directors reviews the dividend rate quarterly, and may adjust the quarterly dividend throughout the year. For the first and second quarters of 2002, the board of directors declared a dividend of $0.53 and $0.55 per common share, respectively.

The board of directors has recently declared a dividend of $0.56 per common share for the third quarter of 2002, which will be paid on September 27, 2002 to shareholders of record on September 13, 2002. Dividends are paid based on our taxable income, which includes our taxable interest and fee income as well as taxable net realized capital gains. Our board of directors evaluates whether to retain or distribute capital gains on an annual basis. Our dividend policy allows us to continue to distribute capital gains, but will also allow us to retain gains that exceed a normal capital gains distribution level, and therefore avoid any unusual spike in dividends in any one year. The dividend policy also enables the board of directors to selectively retain gains to support future growth.

We plan to maintain a strategy of financing our business with cash from operations, through borrowings under short- or long-term credit facilities or other debt securities, through asset sales, or through the sale or issuance of new equity capital. Cash flow from operations before new investments was $258.1 million for the six months ended June 30, 2002, and $330.8 million, $494.6 million, and $420.2 million for the years ended December 31, 2001, 2000 and 1999, respectively. Cash flow from operations before new investments has historically been sufficient to finance our operations.

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

At June 30, 2002, our debt to equity ratio was 0.70 to 1 and our weighted average cost of funds was 7.2%. We had $382.4 million available under our revolving line of credit. As a result of the receipt of $77.0 million from the sale of WyoTech on July 1, 2002 and the receipt of $94.7 million from the sale of CMBS bonds on July 31, 2002, there were no amounts drawn on the revolving line of credit as of August 1, 2002. Availability on the revolving line of credit, net of amounts committed for standby letters of credit issued under the line of credit facility, was $522.2 million on August 1, 2002. We believe that we have access to capital sufficient to fund our ongoing investment and operating activities.

CRITICAL ACCOUNTING POLICIES

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

Valuation of Portfolio Investments. As a business development company, we invest primarily in illiquid securities including debt and equity securities of private companies and non-investment grade CMBS. Our investments are generally subject to restrictions on resale and generally have no established trading market. We value substantially all of our investments at fair value as determined in good faith by the board of directors in accordance with our valuation policy. We determine fair value to be the amount for which an investment could be exchanged in an orderly disposition over a reasonable period of time between willing parties other than in a forced or liquidation sale. Our valuation policy considers the fact that no ready market exists for substantially all of the securities in which we invest. Our valuation policy is intended to provide a consistent basis for establishing 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. Conversely, we will record unrealized appreciation if we believe that the underlying portfolio company has appreciated in value and our equity security has also appreciated in value, where appropriate. The value of investments in public securities are determined using quoted market prices discounted for restrictions on resale.

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

When 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. Loans classified as Grade 4 or Grade 5 assets do not accrue interest. Loan origination fees, original issue discount and market discount are capitalized and then amortized into interest income using the effective interest method. The weighted average yield on loans and debt securities is computed as the (a) annual stated interest rate earned plus the annual amortization of loan origination fees, original issue discount and market discount earned on accruing loans and debt securities, divided by (b) total loans and debt securities at value. The weighted average yield is computed as of the balance sheet date. Prepayment premiums are recorded on loans when received.

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

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

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

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

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

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

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

Recent Developments

During the third quarter ended September 30, 2002, private finance new investment activity totaled approximately $148 million, including loans, debt securities, and equity interests.

SENIOR SECURITIES

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

Class and Year	Total Amount Outstanding Exclusive of Treasury Securities(1)	Asset Coverage Per Unit(2)	Involuntary Liquidating Preference Per Unit(3)	Average Market Value Per Unit(4)
Unsecured Long-term Notes Payable				
1992	$0	$0	$	N/A
1993	0	0		N/A
1994	0	0		N/A
1995	0	0		N/A
1996	0	0		N/A
1997	0	0		N/A
1998	180,000,000	2,734		N/A
1999	419,000,000	2,283		N/A
2000	544,000,000	2,445		N/A
2001	694,000,000	2,453		N/A
2002 (as of June 30, unaudited)	694,000,000	2,562		N/A
Small Business Administration Debentures(5)				
1992	$49,800,000	$5,789	$	N/A
1993	49,800,000	6,013		N/A
1994	54,800,000	3,695		N/A
1995	61,300,000	2,868		N/A
1996	61,300,000	2,485		N/A
1997	54,300,000	2,215		N/A
1998	47,650,000	2,734		N/A
1999	62,650,000	2,283		N/A
2000	78,350,000	2,445		N/A
2001	94,500,000	2,453		N/A
2002 (as of June 30, unaudited)				

94,500,000 2,562 N/A **Auction Rate Reset**
Note
1992
$0 $0 $ N/A
1993
0 0 N/A
1994
0 0 N/A
1995
0 0 N/A
1996
0 0 N/A
1997
0 0 N/A
1998
0 0 N/A
1999
0 0 N/A
2000
76,598,000 2,445 N/A
2001
81,856,000 2,453 N/A
2002 (as of June 30, unaudited)
75,000,000 2,562 N/A

Class and Year	Total Amount Outstanding Exclusive of Treasury Securities(1)	Asset Coverage Per Unit(2)	Involuntary Liquidating Preference Per Unit(3)	Average Market Value Per Unit(4)
Overseas Private Investment Corporation Loan				
1992	$0	$0	$	N/A
1993	0	0		N/A
1994	0	0		N/A
1995	0	0		N/A
1996	8,700,000	2,485		N/A
1997	8,700,000	2,215		N/A
1998	5,700,000	2,734		N/A
1999	5,700,000	2,283		N/A
2000	5,700,000	2,445		N/A
2001	5,700,000	2,453		N/A
2002 (as of June 30, unaudited)	5,700,000	2,562		N/A
Revolving Lines of Credit				
1992	$0	$0	$	N/A
1993	0	0		N/A
1994	32,226,000	3,695		N/A
1995	20,414,000	2,868		N/A
1996	45,099,000	2,485		N/A
1997	38,842,000	2,215		N/A
1998	95,000,000	2,734		N/A
1999	82,000,000	2,283		N/A
2000	82,000,000	2,445		N/A
2001	144,750,000	2,453		N/A
2002 (as of June 30, unaudited)	139,750,000	2,562		N/A
Master Repurchase Agreement and Master Loan and Security Agreement				
1992				

	$0	$0	$ N/A
1993	0	0	N/A
1994	23,210,000	3,695	N/A
1995	0	0	N/A
1996	85,775,000	2,485	N/A
1997	225,821,000	2,215	N/A
1998	6,000,000	2,734	N/A
1999	23,500,000	2,283	N/A
2000	0	0	N/A
2001	0	0	N/A
2002 (as of June 30, unaudited)	0	0	N/A

Class and Year	Total Amount Outstanding Exclusive of Treasury Securities(1)	Asset Coverage Per Unit(2)	Involuntary Liquidating Preference Per Unit(3)	Average Market Value Per Unit(4)
Senior Note Payable(6)				
1992	$20,000,000	$5,789	$	N/A
1993	20,000,000	6,013		N/A
1994	20,000,000	3,695		N/A
1995	20,000,000	2,868		N/A
1996	20,000,000	2,485		N/A
1997	20,000,000	2,215		N/A
1998	0	0		N/A
1999	0	0		N/A
2000	0	0		N/A
2001	0	0		N/A
2002 (as of June 30, unaudited)	0	0		N/A
Bonds Payable				
1992	$0	$0	$	N/A
1993	0	0		N/A
1994	0	0		N/A
1995	98,625,000	2,868		N/A
1996	54,123,000	2,485		N/A
1997	0	0		N/A
1998	0	0		N/A
1999	0	0		N/A
2000	0	0		N/A
2001	0	0		N/A
2002 (as of June 30, unaudited)	0	0		N/A
Redeemable Cumulative Preferred Stock(5)				
1992	$1,000,000	$526	$100	N/A
1993	1,000,000	546	100	N/A
1994				

	1,000,000	351	100	N/A
1995				
	1,000,000	277	100	N/A
1996				
	1,000,000	242	100	N/A
1997				
	1,000,000	217	100	N/A
1998				
	1,000,000	267	100	N/A
1999				
	1,000,000	225	100	N/A
2000				
	1,000,000	242	100	N/A
2001				
	1,000,000	244	100	N/A
2002 (as of June 30, unaudited)				
	1,000,000	254	100	N/A

Class and Year	Total Amount Outstanding Exclusive of Treasury Securities(1)	Asset Coverage Per Unit(2)	Involuntary Liquidating Preference Per Unit(3)	Average Market Value Per Unit(4)
Non-Redeemable Cumulative Preferred Stock(5)				
1992	$6,000,000	$526	$100	N/A
1993	6,000,000	546	100	N/A
1994	6,000,000	351	100	N/A
1995	6,000,000	277	100	N/A
1996	6,000,000	242	100	N/A
1997	6,000,000	217	100	N/A
1998	6,000,000	267	100	N/A
1999	6,000,000	225	100	N/A
2000	6,000,000	242	100	N/A
2001	6,000,000	244	100	N/A
2002 (as of June 30, unaudited)	6,000,000	254	100	N/A

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

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

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

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

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

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

BUSINESS

General

As a business development company, we generally provide long-term debt and equity investment capital to support the expansion of primarily private companies in a variety of industries. We generally invest in illiquid securities through privately negotiated transactions. We have been investing in businesses for over 40 years and have financed thousands of private companies nationwide. Today, our investment and lending activity is generally focused in two areas:

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

Our investment portfolio consists primarily of long-term unsecured loans with or without equity features, equity investments in middle market companies, which may or may not constitute a controlling equity interest, non-investment grade commercial mortgage-backed securities, and commercial mortgage loans. At June 30, 2002, our investment portfolio totaled $2.4 billion. Our investment objective is to achieve current income and capital gains.

Corporate History and Offices

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

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

In addition, we have a real estate investment trust subsidiary, Allied Capital REIT, Inc., and several subsidiaries which are single-member limited liability companies established primarily to hold real estate properties. In April 2001, we established a subsidiary, A.C. Corporation (AC Corp), which provides diligence and structuring services on private finance and commercial real estate transactions, as well as structuring, transaction, management and advisory services to Allied Capital, its portfolio companies and other third parties.

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

Private Finance

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

At June 30, 2002, 64% of the private finance portfolio consisted of loans and debt securities and 36% consisted of equity securities. In addition, at June 30, 2002, 90% of the private finance portfolio consists of junior securities including mezzanine debt, preferred equity, common equity or warrants or options to purchase preferred or common equity as shown in the table below.

	Senior Notes	Bonds	Mezzanine Debt	Preferred Stock	Warrants/ Options	Public Common Equity	Private Common Equity	Total
Dollars at Value ($ in millions)	$168.8	$ 0	$882.0	$124.7	$94.3	$ 5.1	$360.4	$1,635.3

Our private finance portfolio includes investments in a wide variety of industries, including non-durable consumer products, business services, financial services, light industrial products, retail, education, telecommunications and broadcasting and cable. The industry and geographic compositions of the private finance portfolio at value at June 30, 2002 and December 31, 2001 and 2000 were as follows:

	2002	2001	2000
Industry			
Consumer products	30%	28%	26%
Business services	24	22	24
Financial services	16	15	16
Industrial products	10	10	9
Retail	5	5	5
Education	5	5	3
Telecommunications	3	4	6
Broadcasting & cable	2	4	5
Other	5	7	6

Total	100%	100%	100%

Geographic Region

Mid-Atlantic	42%	43%	43%
West	20	19	17
Midwest	17	17	18
Southeast	14	14	12
Northeast	6	5	8
International	1	2	2
Total	100%	100%	100%

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

Capital Provider
Banks Commercial Finance Companies Private Placement/ High Yield
Private Mezzanine Funds
Allied Capital Private Equity Funds

Primary Business Focus Senior, short- term debt Asset-based lending Large credits (private > $50 mm) (public > $150 mm) Unsecured long- term debt with warrants

Preferred and common equity Unsecured long- term debt with warrants

Preferred and common equity Equity

Typical Pricing Spectrum* LIBOR+
[graphic of arrow stretching between LIBOR+ and 30%+]
30%+

* Based on our market experience.

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

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

Over our 40-year history, we have developed and maintained relationships with intermediaries including investment banks, financial services companies and private mezzanine and equity sponsors, through which we source investment opportunities. Through these relationships, especially those with equity sponsors, we have been able to strengthen our position as a long-term investor. For the transactions in which we have provided debt capital, an equity sponsor provides a reliable source of additional equity capital if the portfolio company requires additional financing. Private equity sponsors also assist us in confirming our own due diligence findings when assessing a new investment opportunity, and they provide assistance and leadership to the portfolio company s management team throughout our investment period.

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

- Management teams with meaningful equity ownership
- Dominant or defensible market position
- High return on invested capital
- Revenues of $50 million to $500 million
- Stable operating margins
- EBITDA of at least $5 million
- Solid cash flow margins
- Sound balance sheets

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

Industries Targeted

Less Cyclical/Cash Flow Intensive/ High Return on Capital
Consumer products
Business services
Financial services
Light industrial products
Broadcasting/Cable

Industries Not Targeted

Cyclical/Capital Intensive/ Low Return on Capital
Heavy equipment
Natural resources
Commodity retail
Low value-add distribution
Agriculture
Transportation

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

Our private finance mezzanine investments are generally structured as an unsecured, subordinated loan that carries a relatively high contractual fixed interest rate generally in excess of 12%, to provide interest income. Approximately 97% of the loans and debt securities in the private finance portfolio have fixed rates of interest. The loans generally have interest-only payments in the early years and payments of both principal and interest in the later years, with maturities of five to ten years, although debt maturities and principal amortization schedules vary. Such payments are generally made to us quarterly.

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

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

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

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

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

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

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

Commercial Real Estate Finance

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

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

As a non-investment grade CMBS investor, we recognize that non-investment grade bonds have a higher degree of risk than do investment-grade bonds. Non-investment grade securities are considered speculative, and their capacity to pay principal and interest in accordance with the terms of their issue is not ensured. They tend to be less liquid, may have a higher risk of default, and may be more difficult to value. We invest in non-investment grade CMBS bonds represented by the BB+ to non-rated tranches of a CMBS issuance. The non-investment grade CMBS bonds in which we invest are junior in priority for payment of principal and interest to the more senior tranches of the related CMBS bond issuance. Cash flow from the underlying mortgages generally is allocated first to the senior tranches, with the most senior tranches having a priority right to the cash flow. Then, any remaining cash flow is allocated generally, among the other tranches in order of their relative seniority. To the extent there are defaults and unrecoverable losses on the underlying mortgages resulting in reduced cash flows, our most subordinate tranch will bear this loss first. At June 30, 2002, our CMBS bonds were subordinate to 92% to 97% of the tranches of bonds issued in various CMBS transactions.

To mitigate the risks associated with a CMBS investment discussed above, we perform extensive due diligence prior to each investment in CMBS. The underwriting procedures and criteria used to underwrite each of the commercial mortgage loans in each collateral pool are described in detail below. We will only invest in CMBS when we believe, as a result of our underwriting procedures, that the underlying mortgage pool adequately secures our position. At June 30, 2002, the underlying pools of mortgage loans that are collateral for our CMBS bonds consisted of approximately 4,100 commercial mortgage loans with a total outstanding principal balance of $22.9 billion. These mortgage loans are secured by properties located in diverse geographic locations across the United States, and include a variety of property types such as retail, multi-family housing, office, and hospitality.

The property types and the geographic composition of the underlying mortgage loans securing the CMBS bonds calculated using the outstanding principal balance at June 30, 2002 and December 31, 2001 and using the underwritten principal balance at December 31, 2000 were as follows:

	2002	2001	2000
Property Type			
Retail	31%	31%	32%
Housing	27	27	30
Office	21	22	21
Hospitality	7	7	8
Other	14	13	9
Total	100%	100%	100%
Geographic Region			
West	31%	32%	31%
Mid-Atlantic	25	24	23
Midwest	22	21	22

Southeast	17	17	19
Northeast	5	6	5
Total	100%	100%	100%

In addition to our CMBS bond investments, we have invested in the preferred shares of three collateralized debt obligations, or CDOs, secured by investment grade unsecured debt issued by various real estate investment trusts, or REITs, and non-investment grade CMBS bonds. The preferred shares are junior in priority for payment of principal to the more senior tranches of debt issued by the CDOs. To the extent there are defaults and unrecoverable losses on the underlying collateral resulting in reduced cash flows, the preferred shares will bear this loss first. At June 30, 2002, our preferred shares in the CDOs were subordinate to approximately 95% of the more senior tranches of debt issued by the CDOs. The yield on the CDOs at June 30, 2002 was 17.2%.

Our CMBS investing activity complements our private finance activity because it provides a steady stream of recurring interest income. In addition, given the depth of our commercial real estate experience and the due diligence that we perform prior to an investment in CMBS, we have from time to time received structuring and diligence fees upon the investment in CMBS bonds. These fees are separately negotiated for each transaction. In order to maintain a balanced investment portfolio, we expect to limit our investment in CMBS to approximately 20% to 25% of total assets.

Investment Advisory Services

We are a registered investment adviser, pursuant to the Investment Advisers Act of 1940, and have a wholly owned subsidiary that has an investment advisory agreement to manage a private investment fund. The revenue generated from this agreement is not material to our operations.

Investment Sourcing

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

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

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

Investment Approval and Underwriting Procedures

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

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

- Initial investment screening
- Presentation of investment to investment professionals at weekly meeting
- Initial approval of the investment by the investment committee
- Due diligence completed and investment structured
- Independent internal peer review of the investment completed
- Final approval of the investment by the investment committee

Approval of the investment by the executive committee of the board of directors (for all investments greater than $10 million)

Investment is funded

In a typical private financing, we thoroughly review, analyze and substantiate, through due diligence, the business plan and operations of the potential portfolio company. We perform financial due diligence, often with assistance of an accounting firm; perform operational due diligence, often with the assistance of an industry consultant; study the industry and competitive landscape; and conduct numerous reference checks with current and former employees, customers, suppliers and competitors.

Private finance transactions are approved by an investment committee consisting of our most senior officers and chaired by our Chairman and Chief Executive Officer, William L. Walton. The private finance approval process benefits from the experience of the investment committee members and from the experience of our other investment professionals who have significant professional experience. For every transaction of $10 million or greater, we also require approval from the executive committee of the board of directors in addition to the investment committee approval. Even after all such approvals are received, due diligence must be successfully completed with final investment committee approval before funds are disbursed to a portfolio company.

CMBS. We receive extensive packages of information regarding the mortgage loans comprising a CMBS pool. We work with the issuer, the investment bank, and the rating agencies in performing our diligence on a CMBS investment. The typical CMBS investment takes between two to three months to complete because of the breadth and depth of our diligence procedures. The key steps in our CMBS investment process are as follows:

Review initial loan collateral pool data

Prepare and submit a preliminary bid letter to purchase non-investment grade bonds

Commence underwriting process for loans in collateral pool including physical site inspection

Review re-underwriting data for the entire pool

Submit bond purchase to investment committee for approval

Submit bond purchase to executive committee of the board of directors for approval

Complete final pricing and structuring of investment

Fund investment

We re-underwrite the underlying commercial mortgage loans securing the CMBS. We challenge the estimate of underwriteable cash flow and challenge necessary carve-outs, such as replacement reserves. We study the trends of the industry and geographic location of each property, and independently assess our own estimate of the anticipated cash flow over the period of the loan. Our loan officers and consultants physically inspect the collateral properties, and assess appraised values based on our own opinion of comparable market values.

Based on the findings of our diligence procedures, we may reject certain mortgage loans from inclusion in the pool. We then formulate our negotiated price and discount to achieve an effective loss-adjusted yield on our investment over a ten-year period to approximate 13% to 16%.

CMBS transactions are approved by an investment committee consisting of our most senior officers and chaired by our Chairman and Chief Executive Officer, William L. Walton. CMBS transactions over $10 million are reviewed and approved by the executive committee of the board of directors.

Portfolio Management

Portfolio Diversity. We monitor the portfolio to maintain industry diversity. We currently do not have a policy with respect to concentrating (i.e., investing 25% or of our total assets) in any industry or group of industries and currently our portfolio is not concentrated. We may or may not concentrate in any industry or group of industries in the future.

Loan Servicing. Our loan servicing staff is responsible for routine loan servicing, which includes:

delinquency monitoring;

payment processing;

borrower inquiries;

escrow analysis and processing;

third-party reporting; and

insurance and tax administration.

In addition, our staff is responsible for special servicing activities including delinquency monitoring and collection, workout administration and management of foreclosed assets.

Portfolio Monitoring and Valuation

We use a grading system in order to help us monitor the credit quality of our portfolio and the potential for capital gains.

Grading System. The grading system assigns grades to investments from 1 to 5, and the portfolio was graded at June 30, 2002 as follows:

Grade	Description	Portfolio at Value	Percentage of Total Portfolio
		(in millions)	
1	Probable capital gain	$ 793.6	33.3%
2	Performing security	1,400.0	58.8
3	Close monitoring no loss of principal or interest expected	46.7	2.0
4	Workout Some loss of current interest expected	43.6	1.8
5	Workout Some loss of principal expected	97.1	4.1
		$2,381.0	100.0%

Valuation Methodology. We determine the fair value of each investment in our portfolio on a quarterly basis. At June 30, 2002, approximately 93% of our total assets represented investments recorded at fair value. Value, as defined in Section 2(a)(41) of the Investment Company Act of 1940, is (i) the market price for those securities for which a market quotation is readily available and (ii) for all other securities and assets, fair value is as determined in good faith by the board of directors. Since there is typically no readily ascertainable market value for the investments in our portfolio, we value substantially all of our investments at fair value as determined in good faith by the board of directors pursuant to a valuation policy and a consistently applied valuation process. Because of the inherent uncertainty of determining the fair value of investments that do not have a readily ascertainable 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 must determine the fair value of 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. Conversely, we will record unrealized appreciation if we have an indication that the underlying portfolio company has appreciated in value and, therefore, our equity security has also appreciated in value, where appropriate. Changes in fair value are recorded in the statement of operations as unrealized gains and losses.

As a business development company, we invest primarily in illiquid securities including debt and equity securities of private companies and non-investment grade CMBS. 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 are generally subject to restrictions on resale and generally have no established trading market. Because of the type of investments that we make and the nature of our business, our valuation process requires an analysis of various factors. Our fair value methodology includes the examination of, among other things, the underlying investment performance, financial condition and market changing events that impact valuation.

Valuation Methodology Private Finance. Our process for determining the fair value of a private finance investment begins with determining the enterprise value of the portfolio company. The fair value of our investment is based upon 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, recapitalization or, in some cases, the initial public offering of the portfolio company.

There is no one methodology to determine enterprise value and, in fact, for any one portfolio company, enterprise value is best expressed as a range of fair values, from which we derive a single estimate of enterprise value. To determine the enterprise value of a portfolio company, we analyze its historical and projected financial results of the portfolio company. We generally require portfolio companies to provide annual audited and monthly unaudited financial statements, as well as annual projections for the upcoming fiscal year. Typically in the private equity business, companies are bought and sold based upon multiples of EBITDA, cash flow, net income, revenues or in limited instances book value. 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, or acquisition, recapitalization or restructuring related items.

In determining a multiple to use for valuation purposes, we look to private merger and acquisition statistics, discounted public trading multiples or industry practices. In estimating a reasonable multiple, we consider not only the fact that our portfolio company may be private relative to a peer group, but 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 upon future projections. If a portfolio company is distressed, a liquidation analysis may provide the best indication of enterprise value.

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

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

Valuation Process. The following is a description of the steps we take each quarter to determine the fair value of our portfolio.

Our quarterly valuation process begins with each portfolio company or investment being initially valued by the investment professionals responsible for the portfolio investment, led by the Managing Director who is responsible for the relationship.

Preliminary valuation conclusions are then discussed and documented in a valuation write-up and/ or worksheet and then discussed with our portfolio management team under the supervision of the Chief Financial Officer.

The investment committee, consisting of our most senior officers and chaired by our Chairman and Chief Executive Officer, William L. Walton, meets to discuss valuations as preliminarily determined and documented by each deal team, questions the valuation data and conclusions, and arrives at an investment committee view of valuation.

The investment committee provides comments on the preliminary valuation and the deal team and portfolio management team respond and supplement the documentation based upon those comments.

The valuation documentation is updated and distributed to our board of directors and the audit committee of the board of directors.

The audit committee meets in advance of the board of directors to discuss the valuations and supporting documentation.

The board of directors meets to discuss valuations and review the input of the audit committee and management.

To the extent changes or additional information is deemed necessary, a follow-up board meeting, executive committee meeting or audit committee meeting may take place.

The board of directors determines the final fair value of the portfolio in good faith.

Portfolio Monitoring. We monitor loan delinquencies in order to assess the appropriate course of action and overall portfolio quality. With respect to our private finance portfolio, investment professionals closely monitor the status and performance of each individual investment throughout each quarter. This portfolio company monitoring process includes discussions with the senior management team of the company s financial performance, the review of current financial statements and generally includes attendance at portfolio company board meetings. Through the process, investments that may require closer monitoring are generally detected early, and for each such investment, an appropriate course of action is determined. For the private finance portfolio, loan delinquencies or payment default is not necessarily an indication of credit quality or the need to pursue active workout of a portfolio investment. Because we are a provider of long-term privately negotiated investment capital, it is not atypical for us to defer payment of principal or interest from time to time. As a result, the amount of our private finance portfolio that is delinquent at any one time may vary. The nature of our private finance portfolio relationships frequently provide an opportunity for us to restructure the debt and equity capital of the portfolio company. During such restructuring, we may not receive or accrue interest or dividend payments. Our senior investment professionals actively work with the portfolio company in these instances to negotiate an appropriate course of action.

The investment portfolio is priced to provide current returns for shareholders assuming that a portion of the portfolio at any time may not be accruing interest currently. We also price our investments for a total return including current interest or dividends plus capital gains from sale of equity securities. Therefore, the amount of loans that are delinquent is not necessarily an indication of future principal loss or loss of anticipated investment return. Our portfolio grading system is used as a means to assess loss of current interest (Grade 4 assets) or loss of investment principal (Grade 5 assets). We expect that a certain number of portfolio companies will be in the Grade 4 or 5 categories from time to time. Part of the business of private finance is working with troubled portfolio companies to improve their businesses and protect our investment. The number of portfolio companies and related investment amount included in Grades 4 and 5 may fluctuate significantly from quarter to quarter. We continue to follow our historical practice of working with a troubled portfolio company in order to recover the maximum amount of our investment, but record unrealized depreciation for the full amount of the expected loss when such exposure is identified.

With respect to our CMBS portfolio, we monitor the performance of the individual loans in the underlying collateral pool through market data and discussions with the pool master servicers and special servicers. The master servicers are responsible for the day-today loan servicing functions, including billing, payment processing, collections on loans less than 60 days past due, tax and insurance escrow processing, and property inspections. The special servicers are responsible for collections on loans greater than 60 days past due, including workout administration and management of foreclosed properties. We discuss the status of past due or underperforming loans with the master servicers on a monthly basis. When a loan moves to a special servicer, a workout plan is formulated by the special servicer and generally reviewed by us as the directing certificate holder. Once reviewed by us, the special servicer carries out the workout plan, updating us on the status. We have the ability to replace the named special servicer at any time. With respect to our collateralized debt obligation, or CDO investments, we act as the disposition consultant with respect to two of the CDOs, which allows us to approve disposition plans for individual collateral securities. For these services, we collect annual fees based on the outstanding collateral pool balance.

Employees

At June 30, 2002, we employed 103 individuals including investment and portfolio management professionals, operations professionals and administrative staff. The majority of these individuals are located in the Washington, DC office. We believe that our relations with our employees are excellent.

Legal Proceedings

A series of class action lawsuits have been filed in the United States District Court for the Southern District of New York against us, certain of our directors and officers and our former independent auditors, Arthur Andersen LLP, with respect to alleged violations of the securities laws. These lawsuits allege violations of Sections 10(b) and 20(a) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder, specifically they allege, among other things, that we purportedly misstated the value of certain portfolio investments in our financial statements, which allegedly resulted in the purchase of our common stock by purported class members at artificially inflated prices. Several of the complaints also allege state law claims for common law fraud. The complaints seek compensatory and other damages, and costs and expenses associated with the litigation. The lawsuits have been consolidated into a single proceeding captioned In re Allied Capital Corp. Securities Litigation, 02 CV 3812. We believe that the lawsuit is without merit, and we intend to defend the lawsuit vigorously. While we do not expect these matters to materially affect our financial condition or results of operations, there can be no assurance as to whether any such pending litigation will have a material adverse effect on our financial condition or results of operations in any future reporting period.

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

PORTFOLIO COMPANIES

The following is a listing of our portfolio companies in which we had an equity investment at June 30, 2002. The portfolio companies are presented in three categories companies more than 25% owned which represent portfolio companies where we directly or indirectly own more than 25% of the outstanding voting securities of such portfolio company and, therefore, are deemed controlled by us under the 1940 Act; companies owned 5% to 25% which represent portfolio companies where we directly or indirectly own 5% to 25% of the outstanding voting securities of such portfolio company or where we hold one or more seats on the portfolio company s board of directors and, therefore, are deemed to be an affiliated person under the 1940 Act; and companies less than 5% owned which represent portfolio companies where we directly or indirectly own less than 5% of the outstanding voting securities of such portfolio company and where we have no other affiliations with such portfolio company.

We make available significant managerial assistance to our portfolio companies. We generally receive rights to observe the meetings of our portfolio companies board of directors, and may have one or more voting seats on their boards. For information relating to the amount and nature of our investments in portfolio companies, see our consolidated statement of investments at June 30, 2002 at pages F-6 to F-14.

Name and Address of Portfolio Company	Nature of its Principal Business	Title of Securities Held by the Company	Percentage of Class Held(1)
Companies More Than 25% Owned			
Acme Paging, L.P.(2)(3) 6080 SW 40th Street, Suite 3 Miami, FL 33155	Paging Services	Equity Interests Equity Interests in Affiliate	1.8% 76.9%
American Healthcare Services, Inc. (formerly Physicians Specialty Services Provider Corporation)(2)(3) 1150 Lake Hearn Drive Atlanta, GA 30342	Consumer Health	Common Stock	80.3%
Business Loan Express, Inc.(2)(3) 645 Madison Ave. 19th Floor New York, NY 10022	Small Business Lender	Preferred Stock Common Stock	100.0% 94.9%

The Color Factory
Inc.(2)(3)
Cosmetic Manufacturer
Preferred Stock 100.0%
11312 Penrose Street
Common
Stock 100.0%
Sun Valley, CA 91352

Directory Investment
Corporation(2)(3)
Telephone Directories
Common Stock 50.0%
1919 Pennsylvania Avenue,
N.W.

Washington, DC 20006

Directory Lending
Corporation(2)(3)
Telephone Directories
Common Stock 50.0%
1919 Pennsylvania Avenue,
N.W.

Washington, DC 20006

EDM Consulting, LLC
Environmental Equity
Interest 25.0%
14 Macopin Avenue
Consulting
Montclair, NJ 07043

Elmhurst Consulting,
LLC(2)(3)
Consulting Firm Equity
Interest 100% 360 W.
Butterfield Road,
Common Stock in Suite
400 Controlled
Company 95.0%
Elmhurst, IL 60126

Foresite Towers, LLC(2)(3)
Tower Common Equity
Interest 70.0%
22 Iverness Center Parkway
Leasing Series A
Preferred
Suite 50
Equity Interest 100.0%
Birmingham, AL 35242
Series B Preferred
Equity Interest 100.0%

Name and Address of Portfolio Company	Nature of its Principal Business	Title of Securities Held by the Company	Percentage of Class Held(1)
Gordian Group, Inc.(2)(3) 499 Park Avenue 5th Floor New York, NY 10022	Financial Advisory Services	Common Stock	100.0%

HealthASPex,
Inc.(2)(3)
Third Party Class A
Convertible
2812 Trinity Square
Drive
Administrator
Preferred
Stock 69.9%
Carrollton, TX 75006
Class B
Convertible
Preferred
Stock 67.3%
Common
Stock 45.8%
The Hillman
Companies, Inc.
(formerly SunSource
Inc.)(2)(3)
Merchandiser of
Retail Common
Stock 93.2%
One Logan Square
Hardware
Supplies
Philadelphia, PA
19013

HMT, Inc.
Storage Tank
Convertible
Preferred
1422 FM 1960 W.
Maintenance &
Stock 36.4%
Suite 350
Repair Common
Stock 26.1%
Houston, TX 77068
Warrants to
Purchase
Common
Stock 10.0%
Monitoring Solutions,
Inc.

Air Emissions
Common
Stock 25.0%
4303 South High
School Road
Monitoring
Warrants to
Purchase
Indianapolis, IN
46241
Common
Stock 50.0%
MVL Group,
Inc.(2)(3)
Market Research
Common
Stock 63.7%
1061 E. Indiantown
Road
Services
Suite 300

Jupiter, FL 33477

Spa Lending
Corporation(2)(3)
Health Spas
Series A Preferred
Stock 100.0%
1919 Pennsylvania
Avenue, N.W.
Series B Preferred
Stock 68.4%
Washington, DC
20006
Series C Preferred
Stock 46.3%
Common
Stock 62.1%
STS Operating, Inc.
(d/b/a SunSource
Technology
Services, Inc.)(3)
Engineering Design
and Common
Stock 42.2%
2301 Windsor Court
Services
Addison, IL 60101

Sure-Tel, Inc.(3)
Prepaid Telephone
Preferred
Stock 50.0%
5 North McCormick
Services Company
Common
Stock 37.0%

Oklahoma City, OK
73127

Total Foam, Inc.
Packaging Systems
Common
Stock 49.0%
P.O. Box 688

Ridgefield, CT 06877

WyoTech Acquisition
Corporation(2)(3)(4)
Vocational School
Preferred
Stock 100.0%
4373 N. 3rd Street
Common
Stock 99.0%
Laramie, WY 82072

Companies 5% to 25% Owned

Aspen Pet Products,
Inc.
Pet Product Series B
Preferred
Stock 40.8%
11701 East 53rd Ave.
Provider Series A
Common
Stock 4.7%
Denver, CO 80239

Autania AG
Machine and Tool
Common
Stock 6.2%
Industriestrasse 7
Manufacturer
65779 Kelkheim

Germany

Colibri Holding
Corporation
Outdoor Living
Products Preferred
Stock 5.9%
2201 S. Walbash
Street
Common
Stock 4.2%
Denver, CO 80231
Warrants to
Purchase
Common Stock 2.4%

CorrFlex Graphics, LLC(3)
Packaging Manufacturer
Warrants to Purchase 4.8%
P.O. Box 1337
Common Stock
Monroe, NC 28110
Options to Purchase 7.0%
Common Stock

Name and Address of Portfolio Company	Nature of its Principal Business	Title of Securities Held by the Company	Percentage of Class Held(1)
Csabai Canning Factory Rt. 5600 Békéscasba Békís: vt 52-54 Hungary	Food Processing	Hungarian Quotas	9.2%

CyberRep(4)
Operator of Call
Service Warrants to
Purchase 31.7%
8300 Greensboro Drive,
6th Floor
Centers Common
Stock
McLean, VA 22102

The Debt Exchange,
Inc.
Online Sales of
Series B
Convertible 40.0%
101 Arch Street, Suite
410
Distressed Assets
Preferred Stock
Boston, MA 02110

Gibson Guitar
Corporation(3)
Guitar Manufacturer
Warrants to
Purchase 3.0%
1818 Elm Hill Pike
Common Stock
Nashville, TN 37210

International Fiber
Corporation
Cellulose and Fiber
Common
Stock 11.7%
50 Bridge Street
Producer Warrants to
Purchase
North Tonawanda, NY
14120
Common
Stock 3.0%
Liberty-Pittsburgh
Systems, Inc.
Business Forms
Printing Common
Stock 17.2%
265 Executive Drive

Plainview, NY 11803

Litterer
Beteiligungs-GmbH
Scaffolding Company
Equity Interest 15.0%
Uhlandstrasse 1

69493 Hirschberg

Germany

Logic Bay Corporation
Computer-Based
Series C
Redeemable 29.4%
7900 International
Drive
Training Developer
Preferred Stock
Suite 750

Minneapolis, MN
55425

Magna Card, Inc.
Magnet Packager
Preferred Stock 6.3%
10315 South Dolifield
Rd.
and Distributor
Common Stock 5.4%
Owings Mills, MD
21117

Master Plan, Inc.
Healthcare
Outsourcing Common
Stock 8.5%
21540 Plummer Street

Chatsworth, CA 91311

MortgageRamp.com,
Inc.(3)
Internet Based Class
A Common 7.7%
116 Welsh Road
Loan Origination
Stock
Horsham, PA 19044
Service Platform
Morton Grove
Pharmaceuticals, Inc.
Generic Drug
Convertible 23.9%
6451 West Main Street

Manufacturer
Preferred Stock
Morton Grove, IL
60053

Nobel Learning
Communities, Inc.
Educational Services
Series D
Convertible 100.0%
1400 N. Providence
Road,
Preferred Stock
Suite 3055
Warrants to
Purchase 11.6%
Media, PA 19063
Common Stock
North American
Archery, LLC(3)
Sporting Equipment
Debentures
Convertible 26.9%
1733 Gunn Highway
Manufacturer into
LLC Equity
Odessa, FL 33556
Interest
Packaging Advantage
Corporation
Personal Care,
Common
Stock 11.4%
4633 Downey Road
Household and
Warrants to
Purchase 5.5%
Los Angeles, CA 90058
Disinfectant Product
Common Stock
Packager
Professional Paint, Inc.
Paint Manufacturer
Series A-1
Senior 100.0%
3900 Joliet Street
Exchangeable
Preferred
Denver, CO 80239
Stock Common
Stock 13.8%
Progressive
International

Corporation
Retail Kitchenware
Series A

Redeemable 6.3%
6111 S. 228th Street
Preferred Stock
P.O. Box 97045
Common
Stock 0.6%
Kent, WA 98064
Warrants to
Purchase 32.0%
Common Stock

Name and Address of Portfolio Company	Nature of its Principal Business	Title of Securities Held by the Company	Percentage of Class Held(1)
Redox Brands, Inc.(3) 9100 Centre Point Drive Suite 200 West Chester, OH 45069	Household Cleaning Products	Series A Convertible Preferred Stock	100.0%
		Warrants to Purchase Class A Common Stock	3.5%
Staffing Partners Holding Company, Inc. 104 Church Lane #100 Baltimore, MD 21208	Temporary Employee Services	Redeemable Preferred Stock	48.3%
		Class A-1 Common Stock	50.0%
		Class A-2 Common Stock	24.4%
		Class B Common Stock	24.0%
Companies Less Than 5% Owned			
Advantage Mayer, Inc. 3444 Memorial Highway Tampa, FL 33607	Regional Food Broker	Warrants to Purchase Common Stock	4.5%
Alderwoods Group, Inc. 311 Elm Street, Suite 1000 Cincinnati, OH 45202	Death Care Services	Common Stock	0.9%
Allied Office Products, Inc.			

Office Products
Warrants to
Purchase 0.0%
75 Route 17 South
Common Stock
Hasbrouck Heights,
NJ 07604

American
Barbecue & Grill,
Inc.
Restaurant Chain
Warrants to
Purchase 17.3%
7300 W. 110th
Street, Suite 570
Common Stock
Overland Park, KS
66210

American HomeCare
Supply, LLC
Home Medical
Warrants to 2.5%
One First Avenue
Equipment
Purchase Class A
Suite 100
Provider Common
Units
Conshohocken, PA
19428

ASW Holding
Corporation
Steel Wool
Manufacturer
Warrants to
Purchase 5.0%
2825 W. 31st Street
Common Stock
Chicago, IL 60623

Avborne, Inc.
Aviation Services
Warrants to
Purchase 3.5%
c/o Trivest, Inc.
Common Stock
5300 NW 36th Street

Miami, FL 33152

Blue Rhino
Corporation
Propane Cylinder
Warrants to
Purchase 12.8%

104 Cambridge Plaza
Drive
Exchange
Common Stock
Winston-Salem, NC
27104

Border Foods, Inc.
Mexican Ingredient
& Series A
Convertible 9.4%
J Street
Food Product
Preferred Stock
Deming Industrial
Park
Manufacturer
Warrants to
Purchase 88.6%
Deming, NM 88030
Common Stock
Camden Partners
Strategic Fund II,
L.P.
Private Equity
Fund Limited
Partnership 4.2%
One South Street
Interest
Suite 2150

Baltimore, MD
21202

Candlewood Hotel
Company
Extended Stay
Series A
Convertible 5.0%
9342 East Central
Facilities Preferred
Stock
Wichita, KS 67206

Celebrities, Inc.
Radio Stations
Warrants to
Purchase 25.0%
408-412 W. Oakland
Park
Common
Stock
Boulevard

Ft. Lauderdale, FL
33311-1712

Component
Hardware Group,
Inc.
Designer &
Developer Class A
Preferred
Stock 9.1%
1890 Swarthmore
Ave.
of Hardware
Common
Stock 8.2%
P.O. Box 2020
Components
Lakewood, NJ 08701

Name and Address of Portfolio Company	Nature of its Principal Business	Title of Securities Held by the Company	Percentage of Class Held(1)
Convenience Corporation of America 711 N. 108th Court Omaha, NE 68154	Convenience Store Chain	Series A Preferred Stock Warrants to Purchase Senior Preferred Stock	10.0% 4.0%

Cooper Natural Resources, Inc.

Sodium Sulfate

Producer Series A Convertible 100.0%
P.O. Box 1477

Preferred Stock

Seagraves, TX 79360

Warrants to

Purchase 46.7%

Series A Convertible Preferred Stock
Warrants to Purchase 2.5%

Common Stock
Cumulus Media, Inc.

Radio Stations

Common Stock 0.0%
111 Kilbourne Avenue

Suite 2700

Milwaukee, WI 53202

Drilltec Patents & Technologies Company, Inc.

Drill Pipe Packager

Warrants to Purchase 15.0%
10875 Kempwood Drive, Suite 2

Common Stock

Houston, TX 77043

eCentury Capital Partners, L.P.

Private Equity Fund

Limited Partnership 25.0%
1101 Connecticut Ave, NW

Interest

7th Floor

Washington, DC 20036

Elexis Beta GmbH
Distance
Measurement Options
to Purchase 9.8%
Ulmenstraße 22
Device Shares
60325 Frankfurt am
Main
Manufacturer
Germany

E-Talk Corporation
Telecommunications
Warrants to
Purchase 5.5%
4425 Cambridge Road
Software Provider
Common Stock
Fort Worth, TX
76155-2692

Executive Greetings,
Inc.
Personalized Business
Warrants to
Purchase 0.9%
120 Industrial Park
Access Road
Products Common
Stock
New Hartford, CT
06057

ExTerra Credit
Recovery, Inc.
Consumer Finance
Series A Preferred
Stock 0.9%
35 Lennon Lane, Suite
200
Receivable
Collections Common
Stock 0.7%
Walnut Creek, CA
94598
Warrants to
Purchase 0.7%
Common Stock
Fairchild Industrial
Products Company
Industrial Controls
Warrants to
Purchase 20.0%
3920 Westpoint
Boulevard
Manufacturer
Common Stock

Winston-Salem, NC
27013

Galaxy American
Communications, LLC
Cable Television
Options to
Purchase 51.0%
1220 N. Main Street
Operator Common
LLC Interest
Sikeston, MO 63801

Garden Ridge
Corporation
Home Decor Retailer
Series A Preferred
Stock 2.6%
650 Madison Avenue
Common
Stock 4.8%
New York, NY 10022

Ginsey Industries, Inc.
Bathroom
Accessories
Convertible
Debentures 8.3%
281 Benigno Boulevard
Manufacturer
Warrants to
Purchase 17.1%
Bellmawr, NJ 08031
Common Stock
Global
Communications, LLC
Muzak Franchisee
Preferred Equity
Interest 59.3%
201 East 69th Street
Options for
Common 59.3%
New York, NY 10021
Membership
Interest
Grant Broadcasting
Systems II
Television Stations
Warrants to
Purchase 25.0%
919 Middle River
Drive,
Common Stock
Suite 409
Warrants to
Purchase 25.0%
Ft. Lauderdale, FL
33304

Common Stock in
Affiliate Company

Name and Address of Portfolio Company	Nature of its Principal Business	Title of Securities Held by the Company	Percentage of Class Held(1)
Grotech Partners VI, L.P. c/o Grotech Capital Group 9690 Deereco Road Suite 800 Timonium, MD 21093	Private Equity Fund	Limited Partnership Interest	3.1%

The Hartz Mountain Corporation
Pet Supply
Common Stock 2.0%
400 Plaza Drive
Manufacturer
Warrants to Purchase 4.3%
Secaucus, NJ 07094
Common Stock
Hotelevision, Inc.
Hotel Cable-TV
Series 3 16.2%
599 Lexington Avenue
Network Preferred Stock
Suite 2300

New York, NY 10022

Icon International, Inc.
Corporate Barter
Class A Common Stock 0.8%
281 Tressor Boulevard
Services Class C Common Stock 0.2%
8th Floor

Stamford, CT 06901

Impact Innovations Group, LLC
Information Technology
Warrants to Purchase 4.0%
5825 Glenridge Drive

Services Provider
Common Stock
Building II, Suite
107

Atlanta, GA 30328

Interline Brands,
Inc.
Repair and
Maintenance Senior
Preferred
Stock 0.9%
(also know as
Wilmar Industries,
Product Distributor
Common
Stock 0.9%
Inc.)
Warrants to
Purchase 1.3%
303 Harper Drive
Common Stock
Moorestown, NJ
08057

JRI Industries, Inc.
Machinery
Manufacturer
Warrants to
Purchase 7.5%
2958 East Division
Common Stock
Springfield, MO
65803

Julius Koch USA,
Inc.
Mini-Blind Cord
Warrants to
Purchase 39.6%
387 Church Street
Manufacturer
Common Stock
New Bedford, MA
02745

Kirker Enterprises,
Inc.
Nail Enamel
Warrants to
Purchase 22.5%
55 East 6th Street
Manufacturer
Series B Common
Stock
Paterson, NJ 07524

Equity Interest in Affiliate Company 22.5%
Kirkland s, Inc.
Home Furnishing
Series D Preferred Stock 3.3%
P.O. Box 7222
Retailer Warrants to Purchase 4.2%
Jackson, TN 38308-7222
Common Stock
Kyrus Corporation
Value-Added
Reseller, Warrants to Purchase 13.0%
25 Westridge Market Place
Computer Systems
Common Stock
Chandler, NC 28715

Love Funding Corporation
Mortgage Services
Series D Preferred Stock 26.0%
1220 19th Street, NW, Suite 801

Washington, DC 20036

Matrics, Inc.
Radio Frequency
Series B Convertible 5.5%
8850 Stanford Boulevard
Identification Technology
Preferred Stock
Suite 3000
Warrants 0.5%
Columbia, MD 21045

MedAssets.com, Inc.
Healthcare Outsourcing
Series B Convertible 6.4%
21540 Plummer Street
Preferred Stock
Chatsworth, CA 91311

Warrants to
Purchase 0.2%
Common Stock
Mid-Atlantic Venture
Fund IV, L.P.
Private Equity
Fund Limited
Partnership 7.3%
128 Goodman Drive
Interest
Bethlehem, PA
18015

Midview Associates,
L.P.
Residential Land
Warrants to
Purchase 35.0%
2 Eaton Street,
Suite 1101
Development
Partnership
Interests
Hampton, VA 23669

Name and Address of Portfolio Company		Nature of its Principal Business	Title of Securities Held by the Company	Percentage of Class Held(1)
NetCare, AG	Platenstrasse 46 90441 Nuremberg Germany	Equipment Maintenance Services	Common Stock	2.0%

Novak Biddle Venture Partners III, L.P.
Private Equity
Fund Limited
Partnership 2.9%
1750 Tysons Boulevard
Interest
Suite 1190

McLean, VA 22102

Nursefinders, Inc.
Healthcare
Warrants to
Purchase 4.1%
1200 Copeland Road, Suite 200
Services Common
Stock
Arlington, TX 76011

Onyx Television GmbH
Cable Television
Preferred
Units 12.0%
Immedia Park 6b

50670 Koln

Germany

Opinion Research Corporation
Corporate
Marketing Warrants
to Purchase 7.6%
P.O. Box 183
Research Firm
Common Stock
Princeton, NJ 08542

Oriental Trading Company, Inc.
Direct Marketer

Redeemable
Preferred 1.7%
108th Street, 4206
South
of Toys Stock
Omaha, NE 68137
Class A Common
Stock 1.7%
Warrants to
Purchase 1.3%
Common Stock
Outsource Partners,
Inc.
Outsourced
Facility Warrants to
Purchase 4.0%
200 Mansell Court
East
Services Provider
Preferred Stock
Suite 500
Warrants to
Purchase 4.0%
Roswell, GA 30076
Common Stock
Polaris Pool
Systems, Inc.
Pool Cleaner
Warrants to
Purchase 4.6%
P.O. Box 1149
Manufacturer
Common Stock
San Marcos, CA
92079-1149

Prosperco Finanz
Holding AG
Financial Services
Debt Convertible
into 8.5%
Schützengasse 25
Common
Stock
CH-8001 Zürich
Common
Stock 2.6%
Switzerland
Warrants to
Purchase 5.0%
Common Stock
Raytheon Aerospace,
LLC
Aviation
Maintenance and
Class B LLC
Interest 6.7%

555 Industrial Drive
South
Logistics
Madison, MS 39110

Seasonal
Expressions, Inc.
Decorative Ribbon
Series A Preferred
Stock 50.0%
230 5th Avenue,
Suite 1007
Manufacturer
New York, NY
10001

Soff-Cut Holdings,
Inc.
Concrete Sawing
Series A Preferred
Stock 4.0%
1112 Olympic Drive
Equipment
Manufacturer
Common
Stock 2.7%
Corona, CA 91719

Startec Global
Communications
Corporation
Integrated
Common
Stock 1.3%
10411 Motor City
Drive
Communications
Warrants to 0.9%
Bethesda, MD 20852
Service Provider
Purchase Common
Stock
Sydran Food
Services II, L.P.
Fast Food
Franchise Class A
Preferred
Units 3.4%
Bishop Ranch 8
Class B Common
Units 1.7%
3000 Executive
Parkway
Warrants to
Purchase 12.0%
Ste. 515
Class B Common
Units

San Ramon, CA
94583-4254

Tubbs Snowshoe
Company, LLC
Snowshoe
Manufacturer
Equity Interests
in 10.9%
52 River Road
Affiliate
Company
Stowe, VT 05672
Warrants to
Purchase 22.2%
Common Units
United Pet Group,
Inc.
Manufacturer of
Pet Warrants to
Purchase 2.0%
125 High Street
Products Common
Stock
Boston, MA 02110

Name and Address of Portfolio Company	Nature of its Principal Business	Title of Securities Held by the Company	Percentage of Class Held(1)
Updata Venture Partners II, L.P. 11600 Sunrise Valley Drive Reston, VA 20191	Private Equity Fund	Limited Partnership Interest	16.1%

Velocita, Inc.
Fiber Optic
Network Warrants
to Purchase 6.7%
677 Washington
Blvd.
Common
Stock
Stamford, CT 06912

Venturehouse
Group, LLC
Private Equity
Fund Common
Equity
Interest 2.3%
1780 Tysons Blvd.,
Suite 400

McLean, VA 22102

Walker Investment
Fund II, LLLP
Private Equity
Fund Limited
Partnership 5.1%
3060 Washington
Road
Interest
Suite 200

Glenwood, MD
21738

Warn Industries,
Inc.
Sport Utility
Accessories
Warrants to
Purchase 53.8%
12900 S.E. Capps
Rd.
Manufacturer
Common Stock
Clackamas, OR
97015

Williams Brothers
Lumber

Company
Builders Supplies
Warrants to Purchase 14.1%
3165 Pleasant Hill Road
Common Stock
Duluth, GA 30136

Wilshire Restaurant Group, Inc.
Restaurant Chain
Warrants to Purchase 2.0%
1100 Town & Country Road
Common Stock
Suite 1300
Warrants to Purchase 2.0%
Orange, CA 92868-4654
Preferred Stock
Woodstream Corporation
Pest Control
Equity Interest in 13.8%
69 North Locust Street
Manufacturer
Affiliate Company
Lititz, PA 17543
Warrants to Purchase 7.2%
Common Stock

(1) Percentages shown for securities held by us represent percentage of the class owned and do not necessarily represent voting ownership. Percentages shown for equity securities other than warrants or options represent the actual percentage of the class of security held before dilution. Percentages shown for warrants and options held represent the percentage of class of security we may own, on a fully diluted basis, assuming we exercise our warrants or options.
(2) We directly or indirectly own more than 50% of the voting securities of the company, or control the board of directors, or are the controlling member.
(3) The portfolio company is deemed to be an affiliated person under the 1940 Act because we hold one or more seats on the portfolio company s board of directors, are the general partner, or are the managing member.
(4) WyoTech was sold on July 1, 2002. After the exercise of outstanding options for common stock, we owned 91.35% of the common stock of WyoTech at the time of sale.

DETERMINATION OF NET ASSET VALUE

We determine the net asset value per share of our common stock quarterly. The net asset value per share is equal to the value of our total assets minus liabilities and preferred stock divided by the total number of common shares outstanding.

At June 30, 2002, approximately 93% of our total assets represented investments recorded at fair value. Value, as defined in Section 2(a)(41) of the Investment Company Act of 1940, is (i) the market price for those securities for which a market quotation is readily available and (ii) for all other securities and assets, fair value is as determined in good faith by the board of directors. Since there is typically no readily ascertainable market value for the investments in our portfolio, we value substantially all of our investments at fair value as determined in good faith by the board of directors pursuant to a valuation policy and a consistently applied valuation process. Because of the inherent uncertainty of determining the fair value of investments that do not have a readily ascertainable 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 must determine the fair value of 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. Conversely, we will record unrealized appreciation if we have an indication that the underlying portfolio company has appreciated in value and, therefore, our equity security has also appreciated in value, where appropriate.

As a business development company, we invest primarily in illiquid securities including debt and equity securities of private companies and non-investment grade CMBS. 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 are generally subject to restrictions on resale and generally have no established trading market. Because of the type of investments that we make and the nature of our business, our valuation process requires an analysis of various factors. Our fair value methodology includes the examination of, among other things, the underlying investment performance, financial condition and market changing events that impact valuation.

Determination of fair value in good faith by the board of directors involves subjective judgments that cannot be substantiated by auditing procedures. Accordingly, the accountants opinion on our 2001 financial statements included herein refers to the uncertainty with respect to the possible effect on the financial statements of such 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 upon the enterprise value at which the portfolio company could be sold in an orderly disposition over a reasonable period of time between willing parties other than in a forced or liquidation sale. The liquidity event whereby we exit a private finance investment is generally the sale, the recapitalization or, in some cases, the initial public offering of the portfolio company.

There is no one methodology to determine enterprise value and, in fact, for any one portfolio company, enterprise value is best expressed as a range of fair values, from which we derive a single estimate of enterprise value. To determine the enterprise value of a portfolio company, we analyze its historical and projected financial results of the portfolio company. We generally require portfolio companies to provide annual audited and monthly unaudited financial statements, as well as annual projections for the upcoming fiscal year. Typically in the private equity business, companies are bought and sold based upon multiples of EBITDA, cash flow, net income, revenues or in limited instances book value. 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, or acquisition, recapitalization or restructuring related items.

In determining a multiple to use for valuation purposes, we look to private merger and acquisition statistics, discounted public trading multiples or industry practices. In estimating a reasonable multiple, we consider not only the fact that our portfolio company may be private relative to a peer group, but 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 upon future projections. If a portfolio company is distressed, a liquidation analysis may provide the best indication of enterprise value.

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

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

Loans and Debt Securities

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

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

Interest income is recorded on an accrual basis to the extent that such amounts are expected to be collected. For loans and debt securities with contractual payment-in-kind interest, which represents contractual interest accrued and added to the loan balance that generally becomes due at maturity, we will not accrue payment-in-kind interest if the portfolio company valuation indicates that the payment-in-kind interest is not collectible. Loans classified as Grade 4 or Grade 5 assets do not accrue interest. Loan origination fees, original issue discount and market discount are capitalized and then amortized into interest income using the effective interest method. The weighted average yield on loans and debt securities is computed as the (a) annual stated interest rate earned plus the annual amortization of loan origination fees, original issue discount and market discount earned on accruing loans and debt securities, divided by (b) total loans and debt securities at value. The weighted average yield is computed as of the balance sheet date. Prepayment premiums are recorded on loans when received.

Equity Securities

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

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

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

Commercial Mortgage-Backed Securities (CMBS)

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

Residual Interest

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

MANAGEMENT

Our board of directors supervises our management. The responsibilities of each director include, among other things, the oversight of the investment approval process, the quarterly valuation of our assets, and oversight of our financing arrangements. The board of directors maintains an executive committee, audit committee, compensation committee, and nominating committee, and may establish additional committees in the future. Some or all of our directors also serve as directors of our subsidiaries.

Our investment decisions in each business area are made by investment committees composed of our most senior investment professionals. No one person is primarily responsible for making recommendations to a committee.

We are internally managed and our investment professionals manage our portfolio and the portfolios of companies for which we serve as investment adviser. These investment professionals have extensive experience in managing investments in private businesses in a variety of industries, and are familiar with our approach of lending and investing. Because we are internally managed, we pay no investment advisory fees, but instead we pay the operating costs associated with employing investment management professionals.

Structure of Board of Directors

The board of directors is classified into three approximately equal classes with three-year terms, with only one of the three classes expiring each year. Directors serve until their successors are elected and qualified.

Directors

Information regarding the board of directors is as follows:

Name	Age	Position	Director Since(1)	Expiration of Term
Interested Directors(2)				
William L. Walton	52	Chairman, Chief Executive Officer and President	1986	2004
George C. Williams, Jr.	76	Chairman Emeritus	1964	2004
Robert E. Long	71	Director	1972	2004
Independent Directors				
Brooks H. Browne	53	Director	1990	2004
John D. Firestone	58	Director	1993	2005
Anthony T. Garcia	46	Director	1991	2005
Lawrence I. Hebert	55	Director	1989	2005
John I. Leahy	72	Director	1994	2003
Warren K. Montouri	73	Director	1986	2003

Guy T. Steuart II			
71	Director	1984	2003
T. Murray Toomey, Esq			
78	Director	1959	2003
Laura W. van Roijen			
50	Director	1992	2005

(1) Includes service as a director of any of the predecessor companies.

(2) Interested persons of Allied Capital, as defined in the Investment Company Act of 1940.

Each director has the same address as Allied Capital, 1919 Pennsylvania Avenue, N.W., Washington, D.C. 20006.

Executive Officers

Information regarding our executive officers is as follows:

Name	Age	Position
William L. Walton	52	Chairman, Chief Executive Officer and President
Joan M. Sweeney	42	Chief Operating Officer
Penni F. Roll	36	Chief Financial Officer
Scott S. Binder	47	Managing Director
Robert D. Long	45	Managing Director
Edward H. Ross	36	Managing Director
John M. Scheurer	50	Managing Director
John D. Shulman	39	Managing Director
Paul R. Tanen	35	Managing Director
Thomas H. Westbrook	39	Managing Director
G. Cabell Williams, III	48	Managing Director
Scott A. Somer	34	Director of Financial Operations
Suzanne V. Sparrow	36	Executive Vice President and Secretary

Each executive officer has the same address as Allied Capital, 1919 Pennsylvania Avenue, N.W., Washington, D.C. 20006.

Biographical Information

Directors

Interested Directors

Our directors have been divided into two groups interested directors and independent directors. Interested directors are interested persons as defined in the Investment Company Act of 1940.

William L. Walton has been the Chairman, Chief Executive Officer and President of Allied Capital since 1997. He has served on Allied Capital s board of directors since 1986, and was named Chairman and CEO in February 1997. Mr. Walton previously served as Managing Director of New York-based Butler Capital Corporation, a mezzanine and buyout firm, and was the personal venture capital advisor for William S. Paley, founder and Chairman of CBS. In addition, he was a Senior Vice President in Lehman Brother Kuhn Loeb s Investment Banking Group. Mr. Walton has also worked to bring about improvements in education through private sector educational initiatives including Success

Lab, Inc. and Language Odyssey. Mr. Walton is a director of Riggs National Corporation and the National Venture Capital Association.

George C. Williams, Jr. is Chairman Emeritus of Allied Capital. Mr. Williams was an officer of the predecessor companies from the later of 1959 or the inception of the relevant entity and President or Chairman and Chief Executive Officer of the predecessor companies from the later of 1964 or each entity s inception until 1991. Mr. Williams is the father of G. Cabell Williams III, an executive officer of Allied Capital.

Robert E. Long has been the CEO and Director of Goodwyn, Long & Black Investment Management, Inc. since 1997, and has been the Chairman of Emerald City

Radio Partners, LLC since 1997. Mr. Long was the President of Business News Network, Inc. from 1995 to 1998, the Chairman and Chief Executive Officer of Southern Starr Broadcasting Group, Inc. from 1991 to 1995, and a director and the President of Potomac Asset Management, Inc. from 1983 to 1991. Mr. Long is a director of AmBase Corporation, CSC Scientific, Inc., Advanced Solutions International, Inc. and Graphic Computer Solutions, Inc. Mr. Long is the father of Robert D. Long, an executive officer of Allied Capital.

Independent Directors

Brooks H. Browne has been a consultant since 2002. Mr. Browne was the President of Environmental Enterprises Assistance Fund from 1993 to 2002. Mr. Browne is a director of SEAF, Solar Development Capital , and Yayasan Bina Usaha Lingkungan (Indonesia) (environmental nonprofit or investment funds).

John D. Firestone has been a Partner of Secor Group (venture capital) since 1978. Mr. Firestone is a director of Security Storage Company of Washington, DC, Tudor Place Foundation, National Rehabilitation Hospital and the National Organization on Disability, and he serves as a Trustee of The Washington Ballet. He was a director of Bryn Mawr Bank Corporation from 1998 to 2001.

Anthony T. Garcia has been the Vice President of Finance of Formity Systems, Inc., a developer of software products for business management of data networks, since January 2002. Mr. Garcia was a private investor from 2000 to 2001, the General Manager of Breen Capital Group (investor in tax liens) from 1997 to 2000, and a Senior Vice President of Lehman Brothers Inc. from 1985 to 1996.

Lawrence I. Hebert has been a director and President and Chief Executive Officer of Riggs Bank N.A. (a subsidiary of Riggs National Corporation) since February 2001, and has served as a director of Riggs National Corporation since 1988. He also serves as director of Riggs Investment Management Corporation and Riggs Bank Europe Limited (both indirect subsidiaries of Riggs National Corporation). Mr. Hebert is the President and a director Perpetual Corporation (owner of Allbritton Communications Company and ALLNEWSCO, Inc.). Mr. Hebert is a director of ALLNEWSCO, Inc. (news programming service), the President of Westfield News Advertiser, Inc. (owner of a television station and newspapers), Trustee of The Allbritton Foundation and Vice Chairman of Allbritton Communications Company. Mr. Hebert previously served as Vice Chairman (1983 to 1998), President (1984 to 1998) and Chairman and Chief Executive Officer (1998 to 2001) of Allbritton Communications Company.

John I. Leahy has been the President of Management and Marketing Associates, a management consulting firm, since 1986. Mr. Leahy was the President and Group Executive Officer, Western Hemisphere of Black & Decker Corporation from 1982 to 1985. Mr. Leahy is a director of Kar Kraft Systems, Inc., and The Wills Group, and is Chairman of Gallagher Fluid Seals, Inc.

Warren K. Montouri has been a Partner of Montouri & Roberson (real estate investment firm) since 1980. Mr. Montouri was a director of C&S/Sovran Bank from 1970 to 1990, a director of Sovran Financial Corporation from 1989 to 1990, a director of NationsBank, N.A. from 1990 to 1996, a director of BB&T Bank (formerly Franklin National Bank) from 1996 to 2000, a Trustee of Suburban Hospital from 1991 to 1994, and a Trustee of The Audubon Naturalist Society from 1979 to 1985.

Guy T. Steuart II has been a director and President of Steuart Investment Company, which manages, operates, and leases real and personal property and holds stock in operating subsidiaries engaged in various businesses, since 1960. Mr. Steuart is Trustee Emeritus of Washington and Lee University.

T. Murray Toomey, Esq. has been an attorney at law since 1949. Mr. Toomey is a director of The National Capital Bank of Washington and Federal Center Plaza Corporation. He is also a Trustee Emeritus of The Catholic University of America.

Laura W. van Roijen has been a private real estate investor since 1992. Ms. van Roijen was the Chairman of CWV & Associates (RTC qualified contracting firm) from 1991 to 1994, a director and the Treasurer of Black Possum Inc. (retail concern) from 1994 to 1996, the President of Volta Place, Inc. (real estate advisory firm) from 1991 to 1994, and Vice President (from 1986 to 1991) and Market Director (from 1989 to 1991) of Citicorp Real Estate, Inc.

Executive Officers who are not Directors

Joan M. Sweeney, Chief Operating Officer, has been employed by Allied Capital since 1993. Ms. Sweeney oversees Allied Capital s daily operations. Prior to joining Allied Capital, Ms. Sweeney was employed by Ernst & Young, Coopers & Lybrand and the SEC Division of Enforcement.

Penni F. Roll, Chief Financial Officer, has been employed by Allied Capital since 1995. Ms. Roll is responsible for Allied Capital s financial operations. Prior to joining Allied Capital, Ms. Roll was an Audit Manager at KPMG.

Scott S. Binder, Managing Director, has worked with our private finance investment group since 1991. Prior to joining Allied Capital, Mr. Binder formed and was President of Overland Communications Group. He also has worked in the specialty finance and leasing industry.

Robert D. Long, Managing Director, joined the private finance investment group in 2002. Prior to joining Allied Capital, Mr. Long was Managing Director and Head of Investment Banking at C.E. Unterberg from 2001 to 2002, and Managing Director at E*OFFERING/Wit SoundView from 2000 to 2001. He also held management positions at Bank of America (Montgomery Securities), from 1996 to 2000, and Nomura Securities International, from 1992 to 1996, and prior to that he served as a Managing Director at CS First Boston.

Edward H. Ross, Managing Director, joined the private finance investment group in 2002. Prior to joining Allied Capital, Mr. Ross co-founded and served as a Managing Director of Leveraged Capital at Wachovia Securities (previously First Union Securities) from 1998 to 2002, a merchant banking arm for the firm. He also held management positions in First Union s Leveraged Finance group from 1994 to 1998.

John M. Scheurer, Managing Director, has been employed by Allied Capital in the commercial real estate investment group since 1991. Prior to joining Allied Capital, Mr. Scheurer worked with Capital Recovery Advisors, Inc. and First American Bank. He also started his own company, The Scheurer Company, and co-founded Hunter Associates, a leasing and consulting real estate firm in the Washington, DC area.

John D. Shulman, Managing Director, has been employed by Allied Capital in the private finance investment group since 2001. Prior to joining Allied Capital, Mr. Shulman served as the President and CEO of Onyx International, LLC from 1995 to 2001. He currently serves as a Director of ChemLink Laboratories LLC and as a member of the investment committee of Taiwan Mezzanine Funds.

Paul R. Tanen, Managing Director, has been employed by Allied Capital in the private finance investment group since 2000. Prior to joining Allied Capital, Mr. Tanen served as a Managing Director at Ridgefield Partners and was a Founding Member of the private equity group at Charter Oak Partners.

Thomas H. Westbrook, Managing Director, has been employed by Allied Capital in the private finance investment group since 1991. Prior to joining Allied Capital, Mr. Westbrook worked with North Carolina Enterprise Fund and was a Lending Officer in NationsBank s corporate lending unit.

G. Cabell Williams, III, Managing Director, has been employed by Allied Capital in the private finance investment group since 1981. Mr. Williams has served in many capacities during his tenure with Allied Capital.

Scott A. Somer, Director of Financial Operations, has been employed by Allied Capital since 1998. Mr. Somer is responsible for managing the accounting and loan servicing activities. Prior to joining Allied Capital, Mr. Somer was an Audit Manager at KPMG.

Suzanne V. Sparrow, Executive Vice President and Corporate Secretary, has been employed with Allied Capital since 1987. Ms. Sparrow manages our investor relations activities.

Committees of the Board of Directors

Our board of directors has established an executive committee, an audit committee, a compensation committee and a nominating committee.

The executive committee has and may exercise those rights, powers and authority that the board of directors from time to time grants to it, except where action by the full board is required by statute, an order of the SEC or our charter or bylaws. The executive committee also reviews and approves all investments of $10 million or more. The executive committee met 23 times during 2001. The executive committee consists of Messrs. Walton, Browne, Hebert, Leahy, Long, Steuart, and Williams.

The audit committee operates pursuant to a charter approved by the board of directors, a copy of which was included as Exhibit A to our proxy statement for the 2001 Annual Meeting of Stockholders. The charter sets forth the responsibilities of the audit committee. Generally, the audit committee recommends the selection of independent public accountants for Allied Capital, reviews with such independent public accountants the planning, scope and results of their audit of our financial statements and the fees for services performed, reviews with the independent public accountants the adequacy of internal control systems, reviews our annual financial statements and receives our audit reports and financial statements. The audit committee met five times during 2001. The audit committee consists of Messrs. Browne, Leahy and Garcia and Ms. van Roijen, all of whom are considered independent under the rules promulgated by the New York Stock Exchange.

The compensation committee determines the compensation for our executive officers and the amount of salary and bonus to be included in the compensation package for each of our officers and employees. In addition, the compensation committee approves stock option grants for our officers under our stock option plan. The compensation committee met four times during 2001. The compensation committee consists of Messrs. Firestone, Browne, and Garcia.

The nominating committee recommends candidates for election as directors to the board of directors. The nominating committee met once during 2001. The nominating committee consists of Messrs. Firestone and Hebert.

COMPENSATION OF EXECUTIVE OFFICERS AND DIRECTORS

Under SEC rules applicable to business development companies, we are required to set forth certain information regarding the compensation of certain executive officers and directors. The following table sets forth compensation paid by us in all capacities during the year ended December 31, 2001 to all of our directors and our three highest paid executive officers, collectively, the Compensated Persons . Our directors have been divided into two groups interested directors and independent directors. Interested directors are interested persons as defined in the Investment Company Act of 1940.

Compensation Table

Name and Position	Aggregate Compensation from the Company(1, 2)	Securities Underlying Options/ SARs(5)	Pension or Retirement Benefits Accrued as Part of Company Expenses(2)	Directors Fees Paid by the Company(6)
Interested Directors				
William L. Walton, *Chairman and CEO*	$2,441,642	254,274		$0
George C. Williams, Jr., *Director and Chairman Emeritus*(3)	160,000	20,000		28,000
Robert E. Long, *Director*	35,000	5,000		35,000
Independent Directors				
Brooks H. Browne, *Director*	23,000	5,000		23,000
John D. Firestone, *Director*	17,000	5,000		17,000
Anthony T. Garcia, *Director*	17,000	5,000		17,000
Lawrence I. Hebert, *Director*	26,000	5,000		26,000
John I. Leahy, *Director*	33,000	5,000		33,000
Warren K. Montouri, *Director*	23,000	5,000		23,000
Guy T. Steuart II, *Director*	29,000	5,000		29,000
T. Murray Toomey, *Director*	14,000	5,000		14,000

Laura W. van Roijen, *Director*			
	15,000	5,000	15,000
Executive Officers (who are not directors)			
Joan M. Sweeney, *Chief Operating Officer*			
	1,621,162	151,722	0
John M. Scheurer, *Managing Director*			
	1,459,569	110,517	0

(1) There were no perquisites paid by us in excess of the lesser of $50,000 or 10% of the Compensated Person s total salary and bonus for the year.

(2) The following table provides detail as to aggregate compensation paid during 2001 as to our three highest paid executive officers:

	Salary	Bonus and Awards	Other Benefits
Mr. Walton	$446,538	$1,937,500	$57,604
Ms. Sweeney	296,654	1,289,525	34,983
Mr. Scheurer	273,577	1,152,998	32,994

Included for each executive officer in Bonus and Awards is an annual bonus, Retention Awards, and Cut-Off Award paid, if any. Included for each executive officer in Other Benefits is an employer contribution to the 401(k) Plan, life insurance premiums, and a contribution to the Deferred Compensation Plan. See also Employment Agreements .

(3) In addition to director s fees, Mr. Williams received $132,000 in consulting fees.

(4) See Stock Option Awards for terms of options granted in 2001. We do not maintain a restricted stock plan or a long- term incentive plan.

(5) Consists only of directors fees paid by us during 2001. Such fees are also included in the column titled Aggregate Compensation from the Company.

Compensation of Directors

During 2001, each director received a $10,000 annual retainer in lieu of per meeting fees; directors who serve on the executive committee received a $25,000 annual retainer in lieu of per meeting fees. Members of each committee other than the executive committee received $1,000 for each committee meeting attended during the year. In addition, the chairpersons of the audit and compensation committees each received a $3,000 annual retainer for their additional services in these capacities. Our Chairman and CEO, William L. Walton, does not receive directors fees.

Non-officer directors are eligible for stock option awards under our stock option plan pursuant to an exemptive order from the SEC. The terms of the order, which was granted in September 1999, provided for a one-time grant of 10,000 options to each non-officer director on the date that the order was issued, or on the date that any new director is elected to the board. Thereafter, each non-officer director will receive 5,000 options each year on the date of the annual meeting of shareholders at the fair market value on the date of grant. See Stock Option Plan.

Stock Option Awards

The following table sets forth the details relating to option grants in 2001 to Compensated Persons under our stock option plan, and the potential realizable value of each grant, as prescribed to be calculated by the SEC. See Stock Option Plan.

Options Grants During 2001

	Number of Securities Underlying Options	Percent of Total Options Granted	Exercise Price Per	Expiration	Potential Realizable Value at Assumed Annual Rates Of Stock Appreciation Over 10-Year Term(3)

Name	Granted(1)	In 2000(2)	Share	Date	5%	10%
Interested Directors						
William L. Walton	254,274	9.08%	$21.59	9/20/11	$3,452,490	$8,749,289
Robert E. Long	5,000	0.18%	22.78	5/8/11	71,631	181,527
Independent Directors						
Brooks H. Browne	5,000	0.18%	22.78	5/8/11	71,631	181,527
John D. Firestone	5,000	0.18%	22.78	5/8/11	71,631	181,527
Anthony T. Garcia	5,000	0.18%	22.78	5/8/11	71,631	181,527
Lawrence I. Hebert	5,000	0.18%	22.78	5/8/11	71,631	181,527

Name	Number of Securities Underlying Options Granted(1)	Percent of Total Options Granted In 2000(2)	Exercise Price Per Share	Expiration Date	Potential Realizable Value at Assumed Annual Rates Of Stock Appreciation Over 10-Year Term(3) 5%	10%
John I. Leahy	5,000	0.18%	22.78	5/8/11	71,631	181,527
Warren K. Montouri	5,000	0.18%	22.78	5/8/11	71,631	181,527
Guy T. Steuart II	5,000	0.18%	22.78	5/8/11	71,631	181,527
T. Murray Toomey	5,000	0.18%	22.78	5/8/11	71,631	181,527
Laura W. van Roijen	5,000	0.18%	22.78	5/8/11	71,631	181,527
Executive Officers (who are not directors)						
Joan M. Sweeney	151,722	5.42%	21.59	9/20/11	2,060,056	5,220,587
John M. Scheurer	110,517	3.95%	21.59	9/20/11	1,500,582	3,802,768

(1) Options granted to officers in 2001 generally vest in three equal installments beginning on the first anniversary date of the grant, with full vesting occurring on the third anniversary of the grant date or change of control of Allied Capital. Options granted to non-officer directors vest immediately.

(2) In 2001, we granted options to purchase a total of 2,800,323 shares.

(3) Potential realizable value is calculated on 2001 options granted, and is net of the option exercise price but before any tax liabilities that may be incurred. These amounts represent certain assumed rates of appreciation, as mandated by the SEC. Actual gains, if any, or stock option exercises are dependent on the future performance of the shares, overall market conditions, and the continued employment by us of the option holder. The potential realizable value will not necessarily be realized.

The following table sets forth the details of option exercises by Compensated Persons during 2001 and the values of those unexercised options at December 31, 2001.

Option Exercises and Year-End Option Values

Name	Shares Acquired on Exercise	Value Realized(1)	Number of Securities Underlying Unexercised Options as of 12/31/01 Exercisable	Unexercisable	Value of Unexercised In-the-Money Options as of 12/31/01(2) Exercisable	Unexercisable
Interested Directors						
William L. Walton						

	0	$0	792,109	1,052,574	$5,176,606	$7,374,067
George C. Williams, Jr.	0	0	148,063	23,332	708,129	115,272
Robert E. Long	0	0	20,000		97,970	
Independent Directors						
Brooks H. Browne	0	0	20,000		97,970	
John D. Firestone	0	0	20,000		97,970	
Anthony D. Garcia	0	0	20,000		97,970	
Lawrence I. Hebert	0	0	20,000		97,970	
John I. Leahy	0	0	20,000		97,970	
Warren K. Montouri	5,000	30,400	15,000		55,470	
Guy T. Steuart II	0	0	20,000		97,970	
T. Murray Toomey	5,000	34,950	15,000		55,470	
Laura W. van Roijen	0	0	20,000		97,970	
Executive Officers (who are not directors)						
Joan M. Sweeney	0	0	384,175	502,333	2,484,071	3,349,806
John M. Scheurer	9,368	50,447	309,125	344,963	1,820,297	2,113,379

(1) Value realized is calculated as the closing market price on the date of exercise, net of option exercise price, but before any tax liabilities or transaction costs. This is the deemed market value, which may actually be realized only if the shares are sold at that price.

(2) Value of unexercised options is calculated as the closing market price on December 31, 2001 ($26.00), net of the option exercise price, but before any tax liabilities or transaction costs. In-the-Money Options are options with an exercise price that is less than the market price as of December 31, 2001.

Employment Agreements

We have entered into employment agreements with six of our senior executives, including William L. Walton, our Chairman and CEO, Joan M. Sweeney, Chief Operating Officer, and John M. Scheurer, Managing Director. Each of the agreements provides for a three-year term, with annual renewals thereafter, and specifies each executive s compensation during the term of the agreement, in accordance with the achievement of certain performance standards.

The annual base salary on the effective date of the employment agreements of Mr. Walton, Ms. Sweeney, and Mr. Scheurer was $405,000, $256,500, and $256,500, respectively. The board of directors has the right to increase the base salary during the term of the employment agreement. In addition, each employment agreement states that the board of directors may provide, at their sole discretion, an annual cash bonus. This bonus is to be determined with reference to each executive s performance in accordance with performance criteria to be determined by the board in its sole discretion. Under each agreement, each executive also is entitled to participate in our stock option plan, and to receive all other awards and benefits previously granted to each executive including life insurance premiums.

In addition, each employment agreement provides for a long-term cash retention award for the performance period from 2001 through 2003. The long-term cash retention award will vest and be payable in six equal installments on June 30th and December 31st of each year from 2001 through 2003. Mr. Walton will be eligible for a long-term cash retention award of $3,375,000, or $1,125,000 per year, over the performance period; Ms. Sweeney will be eligible for $2,550,000, or $850,000 per year; and Mr. Scheurer will be eligible for $2,115,000, or $705,000 per year.

Employment will terminate if the term of the agreement expires without written agreement of both parties. The executive has the right to voluntarily terminate employment at any time with 30 days notice, and in such case, the employee will not receive any severance pay. Among other things, the employment agreements prohibit the solicitation of our employees in the event of an executive s departure for a period of two years.

If employment is terminated with cause, the employee will not receive any severance pay. If employment is terminated without cause during the term of the agreement, the executive shall be entitled to severance pay for a period not to exceed 36 months for Mr. Walton; 30 months for Ms. Sweeney; and 24 months for Mr. Scheurer. Severance pay shall include the continuation of the employee s base salary, and the greater of (a) the average of the annual bonuses paid during the preceding three years, or (b) the amount of the last annual bonus paid to the employee. In addition, the executive shall be entitled to receive any payments under the long-term cash retention award that would have vested and been payable during the severance period. However, stock options would cease to vest during the severance period.

If, within 12 months after a change of control (as defined in the employment agreements), termination of employment occurs either by the executive officer or us, the executive officer shall not be entitled to severance pay, but will instead be entitled to lump sum compensation as well as certain other benefits. For Mr. Walton, this lump sum is equal to three years of base salary and bonus (as calculated for severance pay), plus an amount equal to $5,565,000. For Ms. Sweeney, this lump sum is equal to two and a half years of base salary and bonus, plus an amount equal to $2,600,000. For Mr. Scheurer, this lump sum is equal to two years of base salary and bonus, plus an amount equal to $2,350,000. Under the terms of these agreements, we would also provide compensation to offset any applicable excise tax penalties imposed on the executive under section 4999 of the Internal Revenue Code.

Certain other executive officers have employment agreements that carry terms substantially similar to those of Mr. Scheurer s agreement, as described herein.

Compensation Plans

Stock Option Plan

Our stock option plan is intended to encourage stock ownership in the Company by officers and directors, thus giving them a proprietary interest in our performance. The stock option plan was approved by shareholders at the Special Meeting of Shareholders on November 26, 1997. On May 7, 2002, our shareholders approved an amendment to increase the number of authorized shares issuable under the stock option plan to 25,950,000.

The compensation committee s principal objective in awarding stock options to our eligible officers is to align each optionee s interests with our success and the financial interests of our shareholders by linking a portion of such optionee s compensation with the performance of our stock and the value delivered to shareholders.

Stock options are granted under the stock option plan at a price not less than the prevailing market value and will have value only if our stock price increases. The compensation committee determines the amount and features of the stock options, if any, to be awarded to optionees. The compensation committee evaluates a number of criteria, including the past service of each such optionee to Allied Capital, the present and potential contributions of such optionee to the success of Allied Capital and such other factors as the compensation committee shall deem relevant in connection with accomplishing the purposes of the stock option plan, including the recipient s current stock holdings, years of service, position with Allied Capital and other factors. The compensation committee does not apply a formula assigning specific weights to any of these factors when making its determination. The compensation committee awards stock options on a subjective basis and such awards depend in each case on the performance of the officer under consideration.

For the six months ended June 30, 2002, a total of 695,000 options were granted, including grants made by our compensation committee to certain officers. These options generally vest over a three-year period.

On September 8, 1999, we received approval from the SEC to grant options under the stock option plan to non-officer directors. On that date, each incumbent non-officer director received options to purchase 10,000 shares, and pursuant to the SEC order, each will receive options to purchase 5,000 shares each year thereafter on the date of the annual meeting of shareholders. New directors will receive options to purchase 10,000 shares upon election to the board, and options to purchase 5,000 shares each year thereafter on the date of the annual meeting.

The stock option plan is designed to satisfy the conditions of Section 422 of the Internal Revenue Code so that options granted under the stock option plan may qualify as incentive stock options. To qualify as incentive stock options, options may not become exercisable for the first time in any year if the number of incentive options first exercisable in that year multiplied by the exercise price exceeds $100,000.

401(k) Plan

We maintain a 401(k) plan. All full-time employees who are at least 21 years of age have the opportunity to contribute pre-tax salary deferrals into the 401(k) plan of up to $11,000 annually for the 2002 plan year, and to direct the investment of these contributions. In addition, participants who have reached the age of 50 or will reach the age of 50 during the 2002 plan year, may contribute up to an additional $1,000 per year into the 401(k) plan. The 401(k) plan allows eligible participants to invest in shares of our common stock, among other investment options. In addition, we expect to contribute to each eligible participant (i.e., employees with one hour of service) up to 5% of each participant s cash compensation for the year, up to a maximum compensation of $170,000, to each participant s plan account on the participant s behalf, which fully vests at the time of contribution. Employer contributions that exceed $8,500 (5% of $170,000 cash compensation) are directed to the participant s deferred compensation plan account. On June 30, 2002, the 401(k) plan held less than 1% of our outstanding shares.

Deferred Compensation Plan

We maintain a deferred compensation plan. The deferred compensation plan is an unfunded plan as defined by the Internal Revenue Code that provides for the deferral of compensation by our employees and consultants. Our employees and consultants are eligible to participate in the plan at such time and for such period as designated by the board of directors. The deferred compensation plan is administered through a trust, and we fund this plan through cash contributions.

CONTROL PERSONS AND PRINCIPAL HOLDERS OF SECURITIES

As of October 2, 2002, there were no persons that owned 25% or more of our outstanding voting securities, and no person would be deemed to control us, as such term is defined in the 1940 Act.

The following table sets forth, as of October 2, 2002, information with respect to the beneficial ownership of our common stock by the shareholders who own more than 5% of our outstanding shares of common stock, each current director and each executive officer and our executive officers and directors as a group. Unless otherwise indicated, we believe that each beneficial owner set forth in the table has sole voting and investment power. Beneficial ownership is determined in accordance with the rules of the Securities and Exchange Commission and includes voting or investment power with respect to the securities. Ownership information for those persons who beneficially own 5% or more of our shares of common stock is based upon schedules filed by such persons with the Securities and Exchange Commission.

Our directors have been divided into two groups interested directors and non-interested directors. Interested directors are interested persons as defined in the 1940 Act.

Name of Beneficial Owner	Number of Shares Owned Beneficially(9)	Percentage of Class(1)	Dollar Range of Equity Securities Beneficially Owned by Directors(10)
Capital Research and Management Company 333 South Hope Street, 55th Floor Los Angeles, CA 90071-1447	5,263,000	5.14%	
Interested Directors:			
William L. Walton	1,885,745(2,4,8)	1.82%	over $100,000
Robert E. Long	31,796(2,3)	*	over $100,000
George C. Williams, Jr.	440,782(2,3)	*	over $100,000
Independent Directors:			
Brooks H. Browne	68,713(3)	*	over $100,000
John D. Firestone	55,130(3,8)	*	over $100,000
Anthony T. Garcia	83,112(3)	*	over $100,000
Lawrence I. Hebert	41,800(3)	*	over $100,000
John I. Leahy	41,818(3)	*	over $100,000
Warren K. Montouri	251,182(3)	*	over $100,000
Guy T. Steuart II	343,180(3,5)	*	over $100,000
T. Murray Toomey, Esq.	57,966(3,6)	*	over $100,000
Laura W. van Roijen	54,043(3,8)	*	over $100,000
Executive Officers:			

Scott S. Binder	441,727(2,8)	*
Robert D. Long	11,159(2,11)	*
Penni F. Roll	213,168(2)	*
John M. Scheurer	745,192(2)	*
Edward H. Ross	0	
John D. Shulman	109,351(2)	*
Scott A. Somer	13,886(2)	*
Suzanne V. Sparrow	146,183(2)	*
Joan M. Sweeney	867,310(2)	*
Paul R. Tanen	168,000(2)	*

Name of Beneficial Owner	Number of Shares Owned Beneficially	Percentage of Class(1)
Thomas H. Westbrook	463,961(2,8)	*
G. Cabell Williams III	976,705(2,4)	*
All directors and executive officers as a group (24 in number)	7,210,997(7)	6.77%

* Less than 1%

(1) Based on a total of 102,467,934 shares of our common stock issued and outstanding on October 2, 2002 and 3,994,504 shares of our common stock issuable upon the exercise of immediately exercisable stock options held by each individual executive officer and non-officer director.

(2) Share ownership for the following directors and executive officers includes:

	Owned Directly	Options Exercisable Within 60 Days of October 2, 2002	Allocated to 401(k) Plan Account as of 9/30/02
Interested Directors:			
William L. Walton	432,961	1,219,264	3,558
George C. Williams, Jr.	286,052	154,730	0
Robert E. Long	11,796	20,000	0
Executive Officers:			
Robert D. Long	11,000	0	159
Scott S. Binder	74,409	365,805	1,513
Penni F. Roll	81,596	125,963	5,609
Edward H. Ross	0	0	0
John M. Scheurer	277,936	440,068	28,188
John D. Shulman	4,571	104,780	0
Scott A. Somer	600	12,979	307
Suzanne V. Sparrow	78,115	47,813	20,255
Joan M. Sweeney	293,507	561,442	12,361
Paul R. Tanen	5,161	162,839	0
Thomas H. Westbrook	190,041	273,920	0

G. Cabell Williams III			
	438,284	304,901	87,487

(3) Beneficial ownership includes exercisable options to purchase 25,000 shares, except Messrs. Long and Toomey who each have 20,000 shares and Mr. Montouri who has 5,000 shares.

(4) Includes 221,527 shares held by the 401(k) Plan, of which Messrs. Walton and Williams III are co-trustees. Messrs. Walton and Williams III disclaim beneficial ownership of such shares.

(5) Includes 276,691 shares held by a corporation for which Mr. Steuart II serves as an executive officer.

(6) Shares are held by a trust for the benefit of Mr. Toomey and his wife.

(7) Includes a total of 3,994,504 shares underlying stock options exercisable within 60 days of October 2, 2002, which are assumed to be outstanding for the purpose of calculating the group s percentage ownership, and 233,520 shares held by the 401(k) Plan.

(8) Includes certain shares held in IRA or Keogh accounts: Walton 10,618 shares; Firestone 2,669 shares; van Roijen 4,587 shares; Binder 273 shares; Westbrook 15,865 shares; Somer 200 shares.

(9) Beneficial ownership has been determined in accordance with Rule 13d-3 of the Securities Exchange Act of 1934.

(10) Beneficial ownership has been determined in accordance with Rule 16-1(a)(2) of the Securities Exchange Act of 1934.

(11) Includes 1,000 shares held by a trust for the benefit of Mr. Long s children, and 10,000 shares held in an IRA account.

CERTAIN RELATIONSHIPS AND TRANSACTIONS

The table below sets forth certain information, as of June 30, 2002, regarding loans in excess of $60,000 we made to our directors and executive officers to enable them to exercise their stock options. The loans are required to be fully collateralized as full recourse against the borrower, have varying terms not exceeding ten years and bear interest at the applicable federal rate on the date of the loan.

As a business development company under the Investment Company Act of 1940, we are entitled to provide loans to our employees in connection with the exercise of options. However, as a result of provisions of the Sarbanes-Oxley Act of 2002, we are prohibited from making new loans to our executive officers in the future.

Name and Position with Company	Highest Amount Outstanding During 2002	Range of Interest Rates	Amount Outstanding at June 30, 2002
Interested Directors(1):			
William L. Walton *Chairman and CEO*	$2,997,228	4.45% - 6.24%	$2,997,228
George C. Williams, Jr. *Director, Chairman Emeritus*	1,850,386	5.89% - 6.24%	1,850,386
Executive Officers:			
Joan M. Sweeney *Chief Operating Officer*	2,231,157	4.45% - 6.63%	2,231,157
Penni F. Roll *Chief Financial Officer*	1,273,294	4.45% - 6.24%	1,273,924
Scott S. Binder *Managing Director*	979,492	4.66% - 5.89%	979,492
John M. Scheurer *Managing Director*	2,537,259	4.73% - 6.63%	2,537,259
John D. Shulman *Managing Director*	99,991	2.85%	99,991
Paul R. Tanen *Managing Director*	99,994	3.91%	99,994
Thomas H. Westbrook *Managing Director*	2,405,138	4.98% - 6.24%	2,405,138
G. Cabell Williams III			

3,742,209	4.77%	-	6.24%	3,742,209

Managing Director

Suzanne V. Sparrow

873,112	4.45%	-	6.18%	873,112

Executive Vice President and Secretary

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(1) Interested directors are interested persons as defined by the Investment Company Act of 1940.

TAX STATUS

The following discussion is a general summary of the material United States federal income tax considerations applicable to us and to an investment in our common stock. This summary does not purport to be a complete description of the income tax considerations applicable to such an investment. The discussion is based upon the Internal Revenue Code, Treasury Regulations, and administrative and judicial interpretations, each as of the date of this prospectus and all of which are subject to change. You should consult your own tax advisor with respect to tax considerations that pertain to your purchase of our common stock.

This summary is intended to apply to investments in our common stock and assumes that investors hold our common stock as capital assets. This summary does not discuss all aspects of federal income taxation relevant to holders of our common stock in light of particular circumstances, or to certain types of holders subject to special treatment under federal income tax laws, including dealers in securities, pension plans and trusts and financial institutions. This summary does not discuss any aspects of U.S. estate and gift tax or foreign, state or local tax. It does not discuss the special treatment under federal income tax laws that could result if we invested in tax-exempt securities or certain other investment assets.

Except as specifically indicated herein, this summary is intended to apply to U.S. Stockholders (as defined below) and does not purport to discuss all U.S. federal income tax consequences to persons who are not U.S. Stockholders (Non-U.S. Stockholders) from an investment in the common stock. (A U.S. Stockholder is a stockholder who is (i) a citizen or resident of the United States, (ii) a corporation, partnership or other entity created in or organized under the laws of the United States or any political subdivision thereof, (iii) an estate, the income of which is subject to United States federal income taxation regardless of its source, or (iv) a trust subject to the supervision of a court within the United States and the control of a United States person.) Non-U.S. Stockholders should consult their own tax advisors to discuss the consequences of an investment in our common stock.

Taxation as a Regulated Investment Company

We intend to be treated for tax purposes as a regulated investment company under Subchapter M of the Internal Revenue Code. If we (i) qualify as a regulated investment company and (ii) distribute to stockholders in a timely manner at least 90% of our investment company taxable income, as defined in the Internal Revenue Code (i.e., net investment income, including accrued original issue discount, and net short-term capital gain) (the 90% Distribution Requirement) each year, we will not be subject to federal income tax on the portion of our investment company taxable income and net capital gain (i.e., net long-term capital gain in excess of net short-term capital loss) we distribute (or treat as deemed distributed) to stockholders. In addition, if we distribute in a timely manner an amount at least equal to the sum of (i) 98% of our ordinary income for each calendar year, (ii) 98% of our capital gain net income for the one-year period ending December 31 in that calendar year, and (iii) any income not distributed in prior years, we will not be subject to the 4% nondeductible federal excise tax on certain undistributed income of regulated investment companies (the Excise Tax Avoidance Requirements). We generally will endeavor to distribute (or treat as deemed distributed) to stockholders all of our investment company taxable income and our net capital gains, if any, for each taxable year so that we will not incur federal income or excise taxes on our earnings. We will be subject to federal income tax at the regular corporate rate for any amounts of investment company taxable income or net capital gain not distributed (or deemed distributed) to our stockholders.

In order to qualify as a regulated investment company for federal income tax purposes, we must, among other things: (a) continue to qualify as a business development company under the 1940 Act, (b) derive in each taxable year at least 90% of our gross income from dividends, interest, payments with respect to securities loans, gains from the sale of stock or other securities, or other income derived with respect to our business of investing in such stock or securities (the 90% Income Test); and (c) diversify our holdings so that at the end of each quarter of the taxable year (i) at least 50% of the value of our assets consists of cash, cash items, U.S. government securities, securities of other regulated investment companies, and other securities if such other securities of any one issuer do not represent more than 5% of our assets or more than 10% of the outstanding voting securities of the issuer, and (ii) no more than 25% of the value of our assets is invested in the securities (other than U.S. government securities or securities of other regulated investment companies) of any one issuer or of two or more issuers that are controlled (as determined under applicable Internal Revenue Code rules) by us and are engaged in the same or similar or related trades or businesses (the Diversification Tests). The failure of one or more of our subsidiaries to continue to qualify as regulated investment companies could adversely affect our ability to satisfy the Diversification Tests.

If we acquire or are deemed to have acquired debt obligations that were issued originally at a discount or that otherwise are treated under applicable tax rules as having original issue discount, we must include in income each year a portion of the original issue discount that accrues over the life of the obligation regardless of whether cash representing such income is received by us in the same taxable year. Any amount accrued as original issue discount will be included in our investment company taxable income for the year of accrual and may have to be distributed to the stockholders in order to satisfy the 90% Distribution Requirement or the Excise Tax Avoidance Requirements even though we have not received any cash representing such income.

Although we do not currently intend to do so, if we were to invest in certain options, futures, or forward contracts, we may be required to report income from such investments on a mark-to-market basis, which could result in us recognizing unrealized gains and losses for federal income tax purposes even though we may not realize such gains and losses when we ultimately dispose of such investments. We could also be required to treat such gains and losses as 60% long-term capital gain or loss and 40% short-term capital gain or loss regardless of our holding period for the investments. In addition, if we were to engage in certain hedging transactions, including hedging transactions in options, future contracts, and straddles, or other similar transactions, we will be subject to special tax rules (including constructive sale, mark-to-market, straddle, wash sale, and short sale rules), the effect of which may be to accelerate our income, defer our losses, cause adjustments in the holding periods of our securities, convert long-term capital gains into short-term capital gains or convert short-term capital losses into long-term capital losses. These rules could affect our investment company taxable income or net capital gain for a taxable year and thus affect the amounts that we would be required to distribute to our stockholders pursuant to the 90% Distribution Requirement and the Excise Tax Avoidance Requirements for such year.

Although we do not presently expect to do so, we are authorized to borrow funds and to sell assets in order to satisfy distribution requirements. However, under the 1940 Act, we are not permitted to make distributions to stockholders while our debt obligations and other senior securities are outstanding unless certain asset coverage tests are met. Moreover, our ability to dispose of assets to meet our distribution requirements may be limited by other requirements relating to our status as a regulated investment company, including the Diversification Tests. If we dispose of assets in order to meet the 90% Distribution Requirement or the Excise Tax Avoidance Requirements, we may make such dispositions at times that, from an investment standpoint, are not advantageous.

If we fail to satisfy the 90% Distribution Requirement or otherwise fail to qualify as a regulated investment company in any taxable year, we will be subject to tax in that year on all of our taxable income, regardless of whether we make any distributions to our stockholders. In that case, all of our distributions to our stockholders will be characterized as ordinary income (to the extent of our current and accumulated earnings and profits). In contrast, as is explained below, if we qualify as a regulated investment company, a portion of our distributions or deemed distributions may be characterized as long-term capital gain in the hands of stockholders.

The remainder of this summary assumes that we qualify as a regulated investment company and satisfy the 90% Distribution Requirement.

Taxation of Stockholders

Our distributions generally are taxable to stockholders as ordinary income or capital gains. Our distributions of investment company taxable income will be taxable as ordinary income to stockholders to the extent of our current or accumulated earnings and profits, whether paid in cash or reinvested in additional common stock (including any dividends reinvested through our dividend reinvestment plan). Our distributions of net capital gains properly designated by us as capital gain dividends will be taxable to a stockholder as long-term capital gains regardless of the stockholder s holding period for his or her common stock and regardless of whether paid in cash or reinvested in additional common stock (including any dividends reinvested through our dividend reinvestment plan). Distributions in excess of the Company s earnings and profits first will reduce a stockholder s adjusted tax basis in such stockholder s common stock and, after the adjusted basis is reduced to zero, will constitute capital gains to such stockholder.

At our option, we may elect to retain some or all of our net capital gains for a tax year, but designate the retained amount as a deemed distribution. In that case, among other consequences, we will pay tax on the retained amount for the benefit of our stockholders, the stockholders will be required to report their share of the deemed distribution on their tax returns as if it had been distributed to them, and the stockholders will report a credit for the tax paid thereon by us. The amount of the deemed distribution net of such tax will be added to the stockholder s cost basis for his or her common stock. Since we expect to pay tax on any retained net capital gains at our regular corporate capital gain tax rate, and since that rate is in excess of the maximum rate currently payable by individuals on long-term capital gains, the amount of tax that individual stockholders will be treated as having paid and for which they will receive a credit will exceed the amount of tax that such stockholders would be required to pay on the retained net capital gains. Such excess generally will be available to offset other tax liabilities of the stockholders. A stockholder that is not subject to U.S. federal income tax should be able to file a return on the appropriate form or a claim for refund that allows such stockholder to recover the taxes paid on his or her behalf. In the event we select this option, we must provide written notice to the stockholders prior to the expiration of 60 days after the close of the relevant tax year.

Any dividend declared by us in October, November, or December of any calendar year, payable to stockholders of record on a specified date in such a month and actually paid during January of the following year, will be treated as if it had been received by the stockholders on December 31 of the year in which the dividend was declared.

You should consider the tax implications of buying common stock just prior to a distribution. Even if the price of the common stock includes the amount of the forthcoming distribution, you may be taxed upon receipt of the distribution and will not be entitled to offset the distribution against the tax basis in your common stock.

You may recognize taxable gain or loss if you sell or exchange your common stock. The amount of the gain or loss will be measured by the difference between your adjusted tax basis in your common stock and the amount of the proceeds you receive in exchange for such stock. Any gain or loss arising from (or, in the case of distributions in excess of earnings and profits, treated as arising from) the sale or exchange of common stock generally will be a capital gain or loss. This capital gain or loss normally will be treated as a long-term capital gain or loss if you have held your common stock for more than one year; otherwise, it will be classified as short-term capital gain or loss. However, any capital loss arising from the sale or exchange of common stock held for six months or less generally will be treated as a long-term capital loss to the extent of the amount of capital gain dividends received (or treated as deemed distributed) with respect to such stock and, for this purpose, the special rules of Section 852(b)(4)(C) of the Internal Revenue Code generally apply in determining the holding period of such stock. In addition, all or a portion of any loss realized upon a taxable disposition of common stock may be disallowed if other shares of our common stock are purchased (under our dividend reinvestment plan or otherwise) within 30 days before or after the disposition.

In general, non-corporate stockholders currently are subject to a maximum federal income tax rate on their net long-term capital gain (the excess of net long-term capital gain over net short-term capital loss) for a taxable year (including a long-term capital gain derived from an investment in our common stock) that is lower than the maximum rate for other income. Corporate taxpayers currently are subject to federal income tax on net capital gains at a maximum rate equal to the maximum rate applied to ordinary income. Non-corporate stockholders with net capital losses for a year (i.e., capital losses in excess of capital gains) generally may deduct up to $3,000 of such losses against their ordinary income each year; any net capital losses of a non-corporate stockholder in excess of $3,000 generally may be carried forward and used in subsequent years as provided in Section 1212(b) of the Internal Revenue Code. Corporate stockholders generally may not deduct any net capital losses for a year, but may carryback such losses for three years or carry forward such losses for five years.

We will send to each of our stockholders, as promptly as possible after the end of each calendar year, a notice detailing, on a per share and per distribution basis, the amounts includible in such stockholder s taxable income for such year as ordinary income and as long-term capital gain. In addition, the federal tax status of each year s distributions generally will be reported to the IRS. Distributions may also be subject to additional state, local, and foreign taxes depending on a stockholder s particular situation. Our ordinary income dividends to corporate stockholders may, if certain conditions are met, qualify for the dividends received deduction to the extent that we have received qualifying dividend income during the taxable year; capital gain dividends distributed by us are not eligible for the dividends received deduction.

A Non-U.S. Stockholder may be subject to withholding of U.S. federal tax at a 30% rate (or lower applicable treaty rate) on distributions (including certain redemptions of common stock) from us. Accordingly, investment in us is likely to be appropriate for a Non-U.S. Stockholder only if such person can utilize a foreign tax credit or corresponding tax benefit in respect of such withholding tax. Non-U.S. Stockholders should consult their own tax advisors with respect to the U.S. federal income and withholding tax, and state, local, and foreign tax, consequences of an investment in our common stock.

We may be required to withhold U.S. federal income tax (backup withholding) from all taxable distributions payable to (i) any stockholder who fails to furnish us with its correct taxpayer identification number or a certificate that the stockholder is exempt from backup withholding, and (ii) any stockholder with respect to whom the IRS notifies us that the stockholder has failed to properly report certain interest and dividend income to the IRS and to respond to notices to that effect. We may be required to report annually to the IRS and to each Non-U.S. Stockholder the amount of dividends paid to such stockholder and the amount, if any, of tax withheld pursuant to the backup withholding rules with respect to such dividends. This information may also be made available to the tax authorities in the Non-U.S. Stockholder s country of residence. Backup withholding is not an additional tax. Any amounts withheld under the backup withholding rules from payments made to a stockholder may be refunded or credited against such stockholder s United States federal income tax liability, if any, provided that the required information is furnished to the IRS.

You should consult your own tax advisor with respect to the particular tax consequences to you of an investment in us, including the possible effect of any pending legislation or proposed regulation.

CERTAIN GOVERNMENT REGULATIONS

We operate in a highly regulated environment. The following discussion generally summarizes certain government regulations.

Business Development Company. A business development company is defined and regulated by the 1940 Act. A business development company must be organized in the United States for the purpose of investing in or lending to primarily private companies and making managerial assistance available to them. A business development company may use capital provided by public shareholders and from other sources to invest in long-term, private investments in businesses. A business development company provides shareholders the ability to retain the liquidity of a publicly traded stock, while sharing in the possible benefits, if any, of investing in primarily privately owned companies.

As a business development company, we may not acquire any asset other than qualifying assets unless, at the time we make the acquisition, the value of our qualifying assets represent at least 70% of the value of our total assets. The principal categories of qualifying assets relevant to our business are:

Securities purchased in transactions not involving any public offering, the issuer of which is an eligible portfolio company. An eligible portfolio company is defined to include any issuer that

is organized and has its principal place of business in the United States, is not an investment company other than a small business investment company wholly owned by a business development company (our investment in Allied Investment and certain other subsidiaries generally are Qualifying Assets),

does not have any class of securities with respect to which a broker may extend margin credit, and

is controlled by the business development company as provided in the 1940 Act;

Securities received in exchange for or distributed with respect to securities described in the bullet above or pursuant to the exercise of options, warrants, or rights relating to such securities; and

Cash, cash items, government securities, or high quality debt securities (within the meaning of the 1940 Act), maturing in one year or less from the time of investment.

To include certain securities described above as qualifying assets for the purpose of the 70% test, a business development company must make available to the issuer of those securities significant managerial assistance such as providing significant guidance and counsel concerning the management, operations, or business objectives and policies of a portfolio company, or making loans to a portfolio company. We offer to provide managerial assistance to each of our portfolio companies.

As a business development company, we are entitled to issue senior securities in the form of stock or senior securities representing indebtedness, including debt securities and preferred stock, as long as each class of senior security has an asset coverage of at least 200% immediately after each such issuance. This limitation is not applicable to borrowings by our small business investment company subsidiary, and therefore any borrowings by these subsidiaries are not included in this asset coverage test. See Risk Factors. We may sell shares of common stock in a rights offering at a price below our net asset value without shareholder approval under the 1940 Act.

We may also be prohibited under the 1940 Act from knowingly participating in certain transactions with our affiliates without the prior approval of our board of directors who are not interested persons and, in some cases, prior approval by the SEC. We have been granted an exemptive order by the SEC permitting us to engage in certain transactions that would be permitted if we and our subsidiaries were one company and permitting certain transactions among our subsidiaries, subject to certain conditions and limitations.

We are periodically examined by the SEC for compliance with the 1940 Act.

As with other companies regulated by the 1940 Act, a business development company must adhere to certain substantive regulatory requirements. A majority of our directors must be persons who are not interested persons, as that term is defined in the 1940 Act. Additionally, we are required to provide and maintain a bond issued by a reputable fidelity insurance company to protect the business development company. Furthermore, as a business development company, we are prohibited from protecting any director or officer against any liability to the company or our shareholders arising from willful misfeasance, bad faith, gross negligence or reckless disregard of the duties involved in the conduct of such person s office.

We maintain a code of ethics that establishes procedures for personal investment and restricts certain transactions by our personnel. Our code of ethics generally does not permit investment by our employees in securities that may be purchased or held by us. The code of ethics is filed as an exhibit to the registration statement of which this prospectus is a part. You may read and copy the code of ethics at the SEC s Public Reference Room in Washington, D.C. You may obtain information on operations of the Public Reference Room by calling the SEC at 1-202-942-8090. In addition, the code of ethics is available on the EDGAR Database on the SEC Internet site at http://www.sec.gov. You may obtain copies of the code of ethics, after paying a duplicating fee, by electronic request at the following email address: publicinfo@sec.gov, or by writing to the SEC s Public Reference Section, 450 5th Street, NW, Washington, D.C. 20549.

As a business development company under the 1940 Act, we are entitled to provide loans to our employees in connection with the exercise of options. However, as a result of provisions of the Sarbanes-Oxley Act of 2002, we are prohibited from making new loans to our executive officers in the future.

We may not change the nature of our business so as to cease to be, or withdraw our election as, a business development company unless authorized by vote of a majority of the outstanding voting securities, as defined in the 1940 Act, of our shares. A majority of the outstanding voting securities of a company is defined under the 1940 Act as the lesser of: (i) 67% or more of such company s shares present at a meeting if more than 50% of the outstanding shares of such company are present and represented by proxy, or (ii) more than 50% of the outstanding shares of such company. Since we made our business development company election, we have not made any substantial change in the nature of our business.

Small Business Administration Regulations. Allied Investment, a wholly owned subsidiary of Allied Capital, is licensed by the Small Business Administration as a small business investment company under Section 301(c) of the Small Business Investment Act of 1958, and has elected to be regulated as a business development company.

Small business investment companies are authorized to stimulate the flow of private equity capital to eligible small businesses. Under present Small Business Administration regulations, eligible small businesses include businesses that have a net worth not exceeding $18 million and have average annual fully taxed net income not exceeding $6 million for the most recent two fiscal years. In addition, a small business investment company must devote 20% of its investment activity to smaller concerns as defined by the Small Business Administration. A smaller concern is one that has a net worth not exceeding $6 million and has average annual fully taxed net income not exceeding $2 million for the most recent two fiscal years. Small Business Administration regulations also provide alternative size standard criteria to determine eligibility, which depend on the industry in which the business is engaged and are based on such factors as the number of employees and gross sales. According to Small Business Administration regulations, small business investment companies may make long-term loans to small businesses, invest in the equity securities of such businesses, and provide them with consulting and advisory services. Allied Investment provides long-term loans to qualifying small businesses; equity investments and consulting and advisory services are typically provided only in connection with such loans.

Allied Investment is periodically examined and audited by the Small Business Administration s staff to determine its compliance with small business investment company regulations.

Allied Investment has the opportunity to sell to the Small Business Administration subordinated debentures with a maturity of up to ten years, up to an aggregate principal amount of $111.7 million. This limit generally applies to all financial assistance provided by the Small Business Administration to any licensee and its associates, as that term is defined in Small Business Administration regulations. Historically, a small business investment company was also eligible to sell preferred stock to the Small Business Administration. Allied Investment had received $94.5 million of subordinated debentures and $7.0 million of preferred stock from the Small Business Administration at June 30, 2002; as a result of the $111.7 million limit, Allied Investment is limited on its ability to apply for additional financing from the Small Business Administration. Interest rates on the Small Business Administration debentures currently outstanding have a weighted average interest cost of 8.2%.

DIVIDEND REINVESTMENT PLAN

We currently maintain a dividend reinvestment plan that provides for reinvestment of our distributions on behalf of our shareholders by our transfer agent. Effective May 1, 2002, the dividend reinvestment plan was converted from an opt out to an opt in plan. As a result, if our board of directors declares a cash dividend, then our new shareholders that have not opted in to our dividend reinvestment plan will receive cash dividends, rather than reinvesting dividends in additional shares of common stock. Existing dividend reinvestment plan accounts will not be affected by this amendment and no existing instructions, either to receive cash dividends or to reinvest dividends, will be changed.

To enroll in the dividend reinvestment plan, each shareholder must complete an enrollment status form and return it to the plan agent. The plan agent shall then automatically reinvest any dividend in additional shares of common stock. You may change your status in the dividend reinvestment plan at any time by contacting our transfer agent and plan administrator in writing.

A shareholder s ability to participate in a dividend reinvestment plan may be limited according to how the shares of common stock are held. A nominee may preclude beneficial owners holding shares in street name from participating in the dividend reinvestment plan. Shareholders who wish to participate in a dividend reinvestment plan may need to hold their shares of common stock in their own name. Shareholders will be informed of their right to opt into the dividend reinvestment plan in our annual and quarterly reports to shareholders. Shareholders who hold shares in the name of a nominee should contact the nominee for details.

All distributions to investors who do not participate (or whose nominee elects not to participate) in the dividend reinvestment plan will be paid directly, or through the nominee, to the record holder by or under the discretion of the plan agent. The plan agent is American Stock Transfer and Trust Company, 59 Maiden Lane, New York, New York 10038. Their telephone number is 800-937-5449.

Under the dividend reinvestment plan, we may issue new shares unless the market price of the outstanding shares of common stock is less than 110% of the last reported net asset value. Alternatively, the plan agent may buy shares of common stock in the market. We value newly issued shares of common stock for the dividend reinvestment plan at the average of the reported last sale prices of the outstanding shares of common stock on the last five trading days prior to the payment date of the distribution, but not less than 95% of the opening bid price on such date. The price in the case of shares bought in the market will be the average actual cost of such shares of common stock, including any brokerage commissions. There are no other fees charged to shareholders in connection with the dividend reinvestment plan. Any distributions reinvested under the plan will nevertheless remain taxable to the shareholders.

DESCRIPTION OF CAPITAL STOCK

The following summary of our capital stock and other securities does not purport to be complete and is subject to, and qualified in its entirety by, our Restated Articles of Incorporation, which we sometimes refer to as our charter. Reference is made to the charter for a detailed description of the provisions summarized below.

Our authorized capital stock is 200,000,000 shares, $0.0001 par value. Our board of directors may classify and reclassify any unissued shares of our capital stock by setting or changing in one or more respects the preferences, conversion or other rights, voting powers, restrictions, limitations as to dividends, qualifications, terms or conditions or redemption or other rights of such shares of capital stock.

Common Stock

At October 2, 2002, there were 102,467,934 shares of common stock outstanding and 24,160,743 shares of common stock reserved for issuance under our amended stock option plan. The following are the outstanding classes of securities of Allied Capital as of October 2, 2002:

	(1) Title of Class	(2) Amount Authorized	(3) Amount Held by Us or for Our Account	(4) Amount Outstanding Exclusive of Amounts Shown Under(3)
Allied Capital Corporation	Common Stock	200,000,000		102,467,934

All shares of common stock have equal rights as to earnings, assets, dividends and voting privileges and all outstanding shares of common stock are fully paid and non-assessable. Distributions may be paid to the holders of common stock if and when declared by our board of directors out of funds legally available therefore. Our common stock has no preemptive, conversion, or redemption rights and is freely transferable. In the event of liquidation, each share of common stock is entitled to share ratably in all of our assets that are legally available for distributions after payment of all debts and liabilities and subject to any prior rights of holders of preferred stock, if any, then outstanding. Each share of common stock is entitled to one vote and does not have cumulative voting rights, which means that holders of a majority of the shares, if they so choose, could elect all of the directors, and holders of less than a majority of the shares would, in that case, be unable to elect any director. All shares of common stock offered hereby will be, when issued and paid for, fully paid and non-assessable.

Preferred Stock

In addition to shares of common stock, our charter authorizes the issuance of preferred stock. Our board of directors is authorized to provide for the issuance of preferred stock with such preferences, powers, rights and privileges as the board deems appropriate; except that, such an issuance must adhere to the requirements for the 1940 Act. The 1940 Act requires, among other things, that (i) immediately after issuance

and before any distribution is made with respect to common stock, the preferred stock, together with all other senior securities, must not exceed an amount equal to 50% of our total assets and (ii) the holders of shares of preferred stock, if any are issued, must be entitled as a class to elect two directors at all times and to elect a majority of the directors if dividends on the preferred stock are in arrears by two years or more. We believe the availability of such stock will provide us with increased flexibility in structuring future financings and acquisitions.

Limitation on Liability of Directors

We have adopted provisions in our charter and bylaws limiting the liability of our directors and officers for monetary damages. The effect of these provisions in the charter and bylaws is to eliminate the rights of Allied Capital and its shareholders (through shareholders derivative suits on our behalf) to recover monetary damages against a director or officer for breach of the fiduciary duty of care as a director or officer (including breaches resulting from negligent or grossly negligent behavior) except in certain limited situations. These provisions do not limit or eliminate the rights of Allied Capital or any shareholder to seek non-monetary relief such as an injunction or rescission in the event of a breach of a director s or officer s duty of care. These provisions will not alter the liability of directors or officers under federal securities laws.

Certain Anti-Takeover Provisions

Our charter and bylaws and certain statutory and regulatory requirements contain certain provisions that could make more difficult the acquisition of Allied Capital by means of a tender offer, a proxy contest or otherwise. These provisions are expected to discourage certain types of coercive takeover practices and inadequate takeover bids and to encourage persons seeking to acquire control of us to negotiate first with the board of directors. We believe that the benefits of these provisions outweigh the potential disadvantages of discouraging such proposals because, among other things, negotiation of such proposals might result in an improvement of their terms. The description set forth below is intended as a summary only and is qualified in its entirety by reference to our charter and the bylaws.

Classified Board of Directors

Our charter provides for our board of directors to be divided into three classes of directors serving staggered three-year terms, with each class to consist as nearly as possible of one-third of the directors then elected to the board. A classified board may render more difficult a change in control of Allied Capital or removal of incumbent management. We believe, however, that the longer time required to elect a majority of a classified board of directors helps to ensure continuity and stability of our management and policies.

Issuance of Preferred Stock

Our board of directors, without shareholder approval, has the authority to reclassify authorized but unissued common stock as preferred stock and to issue preferred stock. Such stock could be issued with voting, conversion or other rights designed to have an anti-takeover effect.

Maryland Corporate Law

We are subject to the Maryland Business Combination Statute and the Control Share Acquisition Statute, as defined below. The partial summary of the foregoing statutes contained in this prospectus is not intended to be complete and reference is made to the full text of such statutes for their entire terms.

Business Combination Statute. Certain provisions of the Maryland General Corporation Law establish special requirements with respect to business combinations between Maryland corporations and interested shareholders unless exemptions are applicable (the Business Combination Statute). Among other things, the Business Combination Statute prohibits for a period of five years a merger or other specified transactions between a company and an interested shareholder and requires a supermajority vote for such transactions after the end of such five-year period.

Interested shareholders are all persons owning beneficially, directly or indirectly, 10% or more of the outstanding voting stock of a Maryland corporation. Business combinations include certain mergers or similar transactions subject to a statutory vote and additional transactions involving transfer of assets or securities in specified amounts to interested shareholders or their affiliates.

Unless an exemption is available, a business combination may not be consummated between a Maryland corporation and an interested shareholder or its affiliates for a period of five years after the date on which the shareholder first became an interested shareholder and thereafter may not be consummated unless recommended by the board of directors of the Maryland corporation and approved by the affirmative vote of at least 80% of the votes entitled to be cast by all holders of outstanding shares of voting stock and 66 2/3% of the votes entitled to be cast by all holders of outstanding shares of voting stock other than the interested shareholder or its affiliates or associates, unless, among other things, the corporation s shareholders receive a minimum price (as defined in the Business Combination Statute) for their shares and the consideration is received in cash or in the same form as previously paid by the interested shareholder for its shares.

A business combination with an interested shareholder which is approved by the board of directors of a Maryland corporation at any time before an interested shareholder first becomes an interested shareholder is not subject to the five-year moratorium or special voting requirements. An amendment to a Maryland corporation charter electing not to be subject to the foregoing requirements must be approved by the affirmative vote of at least 80% of the votes entitled to be cast by all holders of outstanding shares of voting stock and 66 2/3% of the votes entitled to be cast by holders of outstanding shares of voting stock who are not interested shareholders. Any such amendment is not effective until 18 months after the vote of shareholders and does not apply to any business combination of a corporation with a shareholder who became an interested shareholder on or prior to the date of such vote.

Control Share Acquisition Statute. The Maryland General Corporation Law imposes limitations on the voting rights of shares acquired in a control share acquisition. The control share statute defines a control share acquisition to mean the acquisition, directly or indirectly, of control shares subject to certain exceptions. Control shares of a Maryland corporation are defined to be voting shares of stock which, if aggregated with all other shares of stock previously acquired by the acquiror, would entitle the acquiror to exercise voting power in electing directors with one of the following ranges of voting power:

(1) one-tenth or more but not less than one-third;

(2) one-third or more but less than a majority; or

(3) a majority of all voting power.

Control shares do not include shares which the acquiring person is entitled to vote as a result of having previously obtained shareholder approval. Control shares of a Maryland corporation acquired in a control share acquisition have no voting rights except to the extent approved by a vote of two-thirds of the votes entitled to be cast by shareholders in the election of directors, excluding shares of stock as to which the acquiring person, officers of the corporation and directors of the corporation who are employees of the corporation are entitled to exercise or direct the exercise of the voting power of the shares in the election of the directors.

The control share statute also requires Maryland corporations to hold a special meeting at the request of an actual or proposed control share acquiror generally within 50 days after a request is made with the submission of an acquiring person statement, but only if the acquiring person:

(1) gives a written undertaking and, if required by the directors of the issuing corporation, posts a bond for the cost of the meeting; and

(2) submits definitive financing agreements for the acquisition of the control shares to the extent that financing is not provided by the acquiring person.

In addition, unless the issuing corporation s charter or bylaws provide otherwise, the control share statute provides that the issuing corporation, within certain time limitations, shall have the right to redeem control shares (except those for which voting rights have previously been approved) for fair value as determined pursuant to the control share statue in the event:

(1) there is a shareholder vote and the grant of voting rights is not approved; or

(2) an acquiring person statement is not delivered to the target within 10 days following a control share acquisition.

Moreover, unless the issuing corporation s charter or bylaws provide otherwise, the control share statute provides that if, before a control share acquisition occurs, voting rights are accorded to control shares which result in the acquiring person having majority voting power, then all shareholders other than the acquiring person have appraisal rights as provided under the Maryland General Corporation Law. An acquisition of shares may be exempted from the control share statute provided that a charter or bylaw provision is adopted for such purpose prior to the control share acquisition by any person with respect to Allied Capital. The control share acquisition statute does not apply to shares acquired in a merger, consolidation or share exchange to which the corporation is a party.

Regulatory Restrictions

Allied Investment, our wholly owned subsidiary, is a small business investment company. The Small Business Administration prohibits, without prior Small Business Administration approval, a change of control or transfers which would result in any person (or group of persons acting in concert) owning 10% or more of any class of capital stock of a small business investment company. A change of control is any event which would result in a transfer of the power, direct or indirect, to direct the management and policies of a small business investment company, whether through ownership, contractual arrangements or otherwise.

LEGAL MATTERS

The legality of the shares of common stock offered hereby will be passed upon for Allied Capital by Sutherland Asbill & Brennan LLP, Washington, D.C.

SAFEKEEPING, TRANSFER AND DIVIDEND PAYING AGENT AND REGISTRAR

Our investments are held in safekeeping by Riggs Bank, N.A. at 808 17th Street, N.W., Washington, D.C. 20006, as well as by LaSalle National Bank, located at 25 Northwest Point Boulevard, Suite 800, Elk Grove Village, Illinois 60007. American Stock Transfer and Trust Company, 59 Maiden Lane, New York, New York 10038 acts as our transfer, dividend paying and reinvestment plan agent and registrar.

BROKERAGE ALLOCATION AND OTHER PRACTICES

Since we generally acquire and dispose of our investments in privately negotiated transactions, we infrequently use brokers in the normal course of business.

INDEPENDENT PUBLIC ACCOUNTANTS

The audited financial statements and schedules included in this prospectus and elsewhere in the registration statement to the extent and for the periods indicated in their reports have been audited by Arthur Andersen LLP, independent public accountants, and are included herein in reliance upon the authority of said firm as experts in giving said reports. For important information about Arthur Andersen LLP, see Notice Regarding Arthur Andersen LLP below.

On March 29, 2002, we selected KPMG LLP, 2001 M Street N.W., Washington, DC 20036, to serve as our independent public accountants for the fiscal year ending December 31, 2002. We dismissed Arthur Andersen LLP as our independent accountants effective upon completion of the December 31, 2001 audit. The decision to change accountants was approved by our audit committee and board of directors and was ratified by our shareholders on May 7, 2002.

In connection with the audits for the two most recent fiscal years and through April 3, 2002, (1) there were no disagreements with Arthur Andersen on any matter of accounting principle or practice, financial statement disclosure, auditing scope or procedure, whereby such disagreements, if not resolved to the satisfaction of Arthur Andersen, would have caused them to make reference thereto in their report on the financial statements for such years; and (2) there has been no reportable events (as defined in Item 304(a)(1)(v) of Regulation S-K).

The reports of Arthur Andersen on our financial statements for the past two years contained no adverse opinion or disclaimer of opinion and were not qualified or modified as to uncertainty, audit scope or accounting principle, except for the emphasis of matter related to the inherent uncertainty of determining the value of investments whose values have been estimated by the board of directors in good faith in the absence of readily ascertainable market values.

We have not consulted with KPMG during the last two years or the period from January 1, 2002 through April 3, 2002 on either the application of accounting principles to a specified transaction either completed or proposed or the type of audit opinion KPMG might issue on our financial statements.

We requested that Arthur Andersen furnish a letter addressed to the SEC stating whether or not Arthur Andersen agrees with the above statements. A copy of such letter to the SEC was included as Exhibit 16.1 to a Form 8-K we filed with the SEC on April 3, 2002.

With respect to the unaudited interim financial information as of and for the six-month period ended June 30, 2002, included herein, KPMG 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 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 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.

NOTICE REGARDING ARTHUR ANDERSEN LLP

Section 11(a) of the Securities Act provides that if any part of a registration statement at the time it becomes effective contains an untrue statement of a material fact or an omission to state a material fact required to be stated therein or necessary to make the statements therein not misleading, any person acquiring a security pursuant to such registration statement, unless it is proved that at the time of such acquisition such person knew of such untruth or omission, may sue, among others, every accountant who has consented to be named as having prepared or certified any part of the registration statement or as having prepared or certified any report or valuation which is used in connection with the registration statement with respect to the statement in such registration statement, report or valuation which purports to have been prepared or certified by the accountant.

Our consolidated financial statements as of December 31, 2002 and 2000 and for each of the three years in the three-year period ended December 31, 2002 included in this prospectus were audited by our former independent auditor, Arthur Andersen. However, we have not been able to obtain, after reasonable efforts, the written consent of Arthur Andersen with respect to the inclusion of such consolidated financial statements in this prospectus. Under these circumstances, Rule 437a under the Securities Act permits us to file this registration statement without a consent of Arthur Andersen LLP. As a result, you will not be able to sue Arthur Andersen pursuant to Section 11(a) of the Securities Act and therefore your right of recovery under that section may be limited as a result of the lack of the written consent.

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

CONSOLIDATED FINANCIAL STATEMENTS

INDEX TO FINANCIAL STATEMENTS

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEET

(in thousands, except share and per share amounts)	June 30, 2002	December 31, 2001	December 31, 2000
	(unaudited)		
ASSETS			
Portfolio at value:			
Private finance			
Companies more than 25% owned (cost: 2002-$512,468; 2001-$451,705; 2000-$258,747)	$632,560	$505,620	$262,907
Companies 5% to 25% owned (cost: 2002-$235,879; 2001-$211,030; 2000-$220,634)	264,691	232,399	220,896
Companies less than 5% owned (cost: 2002-$832,665; 2001-$891,231; 2000-$783,148)	738,008	857,053	798,664
Total private finance	1,635,259	1,595,072	1,282,467
Commercial real estate finance (cost: 2002-$724,240; 2001-$732,636; 2000-$503,366)	745,710	734,518	505,534
Total portfolio at value	2,380,969	2,329,590	1,788,001
Other assets	183,328	130,234	63,367
Cash and cash equivalents	4,319	889	2,449

Total assets	$2,568,616	$2,460,713	$1,853,817
LIABILITIES AND SHAREHOLDERS EQUITY			
Liabilities:			
Notes payable and debentures	$869,200	$876,056	$704,648
Revolving credit facility	139,750	144,750	82,000
Accounts payable and other liabilities	118,213	80,784	30,477
Total liabilities	1,127,163	1,101,590	817,125
Commitments and Contingencies			
Preferred stock	7,000	7,000	7,000
Shareholders equity:			
Common stock, $0.0001 par value, 200,000,000 shares authorized; 102,296,392, 99,607,396 and 85,291,696 shares issued and outstanding at June 30, 2002, December 31, 2001 and 2000, respectively	10	10	9
Additional paid-in capital	1,417,356	1,352,688	1,043,653
Notes receivable from sale of common stock	(28,190)	(26,028)	(25,083)
Net unrealized appreciation on portfolio	64,118	39,981	19,378
Distributions in excess of earnings	(18,841)	(14,528)	(8,265)

Total shareholders equity	1,434,453	1,352,123	1,029,692
Total liabilities and shareholders equity	$2,568,616	$2,460,713	$1,853,817
Net asset value per common share	$14.02	$13.57	$12.11

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

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENT OF OPERATIONS

(in thousands, except per share amounts)	For the Six Months Ended June 30,		For the Years Ended December 31,		
	2002	2001	2001	2000	1999
	(unaudited)				
Interest and related portfolio income:					
Interest and dividends					
Companies more than 25% owned	$18,806	$10,888	$25,264	$3,106	$1,923
Companies 5% to 25% owned	14,385	12,911	26,711	17,144	8,835
Companies less than 5% owned	94,474	89,900	188,489	162,057	110,354
Total interest and dividends	127,665	113,699	240,464	182,307	121,112
Premiums from loan dispositions					
Companies more than 25% owned		511	1,011		
Companies 5% to 25% owned			400	380	
Companies less than 5% owned	1,659	1,220	1,093	15,758	14,284
Total premiums from loan dispositions	1,659	1,731	2,504	16,138	14,284
Fees and other income					
Companies more than 25% owned	13,865	8,113	24,817	2,000	150
Companies 5% to 25% owned					

	476	150	199	133	
Companies less than 5% owned	11,919	10,117	21,126	11,011	5,594
Total fees and other income	26,260	18,380	46,142	13,144	5,744
Total interest and related portfolio income	155,584	133,810	289,110	211,589	141,140
Expenses:					
Interest	34,984	31,881	65,104	57,412	34,860
Employee	16,309	14,056	29,656	26,025	22,889
Administrative	7,861	6,027	15,299	15,435	12,350
Total operating expenses	59,154	51,964	110,059	98,872	70,099

Net investment income before income tax benefit and net realized and unrealized gains (losses)	96,430	81,846	179,051	112,717	71,041
Income tax benefit			412		
Net investment income before net realized and unrealized gains (losses)	96,430	81,846	179,463	112,717	71,041
Net realized and unrealized gains (losses):					
Net realized gains (losses)					
Companies more than 25% owned	(630)	(731)	1,893	(1,272)	109
Companies 5% to 25% owned	718	4,571	1,639	1,218	12,489
Companies less than 5% owned	8,762	1,151	(2,871)	15,577	12,793

Total net realized gains	8,850	4,991	661	15,523	25,391
Net unrealized gains	24,135	11,297	20,603	14,861	2,138
Total net realized and unrealized gains	32,985	16,288	21,264	30,384	27,529
Net increase in net assets resulting from operations	$129,415	$98,134	$200,727	$143,101	$98,570
Basic earnings per common share	$1.28	$1.12	$2.19	$1.95	$1.64
Diluted earnings per common share	$1.26	$1.10	$2.16	$1.94	$1.64

Weighted average common shares outstanding basic	100,822	87,441	91,564	73,165	59,877
Weighted average common shares outstanding diluted	102,900	88,966	93,003	73,472	60,044

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

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENT OF CHANGES IN NET ASSETS

(in thousands, except per share amounts)	For the Six Months Ended June 30, 2002	For the Six Months Ended June 30, 2001	For the Years Ended December 31, 2001	For the Years Ended December 31, 2000	For the Years Ended December 31, 1999
	(unaudited)				
Operations:					
Net investment income before income tax benefit and net realized and unrealized gains	$96,430	$81,846	$179,051	$112,717	$71,041
Income tax benefit			412		
Net realized gains	8,850	4,991	661	15,523	25,391
Net unrealized gains	24,135	11,297	20,603	14,861	2,138
Net increase in net assets resulting from operations	129,415	98,134	200,727	143,101	98,570
Shareholder distributions:					
Common stock dividends	(109,482)	(87,836)	(186,157)	(135,795)	(97,941)
Preferred stock dividends	(110)	(110)	(230)	(230)	(230)

Net decrease in net assets resulting from shareholder distributions	(109,592)	(87,946)	(186,387)	(136,025)	(98,171)
Capital share transactions:					
Sale of common stock	49,920	123,262	286,888	250,912	164,269
Issuance of common stock for portfolio investments			5,157	86,076	
Issuance of common stock upon the exercise of stock options	11,626	6,258	10,660	3,309	5,920
Issuance of common stock in lieu of cash distributions	3,123	3,415	6,331	4,773	4,610
Net (increase) decrease in notes receivable from sale of common stock	(2,162)	(1,154)	(945)	4,378	(5,725)
Net decrease in common stock held in deferred compensation trust				6,218	6,972
Other				(563)	(290)
Net increase in net assets resulting from capital share transactions	62,507	131,781	308,091	355,103	175,756

Total increase in net assets	$82,330	$141,969	$322,431	$362,179	$176,155
Net assets at beginning of period	$1,352,123	$1,029,692	$1,029,692	$667,513	$491,358
Net assets at end of period	$1,434,453	$1,171,661	$1,352,123	$1,029,692	$667,513
Net asset value per common share	$14.02	$12.79	$13.57	$12.11	$10.20
Common shares outstanding at end of period	102,296	91,578	99,607	85,057	65,414

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

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENT OF CASH FLOWS

(in thousands)	For the Six Months Ended June 30, 2002	2001	For the Years Ended December 31, 2001	2000	1999
	(unaudited)				
Cash flows from operating activities:					
Net increase in net assets resulting from operations	$129,415	$98,134	$200,727	$143,101	$98,570
Adjustments					
Portfolio investments	(195,455)	(299,843)	(675,172)	(827,025)	(751,871)
Repayments of investment principal	67,017	42,544	74,461	111,031	139,561
Proceeds from investment sales	126,280	74,648	129,980	280,244	198,368
Change in accrued or reinvested interest and dividends	(19,463)	(25,493)	(51,554)	(32,245)	(12,842)
Changes in other assets and liabilities	(18,982)	(7,374)	1,290	3,472	2,376
Amortization of loan discounts and fees	(9,284)	(7,722)	(13,929)	(10,101)	(10,674)
Depreciation and amortization	657	479	994	925	788
Realized losses	6,579	1,605	9,446	13,081	6,145
Net unrealized gains	(24,135)	(11,297)	(20,603)	(14,861)	(2,138)
Net cash provided by (used in) operating activities	62,629	(134,319)	(344,360)	(332,378)	(331,717)

Cash flows from financing activities:					
Sale of common stock	49,920	123,262	286,888	250,912	164,269
Sale of common stock upon the exercise of stock options	9,245	2,103	5,428	319	103
Collections of notes receivable from sale of common stock	220	3,002	5,090	6,363	195
Common dividends and distributions paid	(106,359)	(84,422)	(179,826)	(131,022)	(95,031)
Preferred stock dividends paid	(110)	(110)	(230)	(230)	(230)
Net borrowings under (repayments on) notes payable and debentures	(6,856)	11,666	166,150	217,298	254,000
Net borrowings under (repayments on) revolving line of credit	(5,000)	82,750	62,750	(23,500)	4,500
Other	(259)	(2,948)	(3,450)	(3,468)	(3,009)
Net cash provided by (used in) financing activities	(59,199)	135,303	342,800	316,672	324,797
Net increase (decrease) in cash and cash equivalents	$3,430	$984	$(1,560)	$(15,706)	$(6,920)
Cash and cash equivalents at beginning of period	$889	$2,449	$2,449	$18,155	$25,075

Cash and cash equivalents at end of period	$4,319	$3,433	$889	$2,449	$18,155

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ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENT OF INVESTMENTS

Private Finance Portfolio Company (in thousands, except number of shares)	Investment(2)	June 30, 2002 (unaudited) Cost	Value

Companies More Than 25% Owned
Acme Paging, L.P.
Loan $3,200 $3,200
(Telecommunications)
Debt
Securities 7,005 7,005
Equity Interests 3,717 2,261

American Healthcare Services, Inc.
Debt
Securities 41,362 41,362
(Healthcare)
Common Stock (79,567,042
shares) 1,000 100 Guaranty ($915)

Business Loan Express, Inc.
Loan 6,000 6,000
(Financial Services)
Debt
Securities 80,809 80,809
Preferred Stock (25,111
shares) 25,111 25,111
Common Stock (25,503,043
shares) 104,641 140,000
Guaranty ($48,126 See
Note 3) Standby Letters of Credit ($10,550 See Note 3)

The Color Factory Inc.
Loan 7,439 7,439
(Consumer Products)
Preferred Stock (1,000
shares) 1,002 1,002
Common Stock (980
shares) 6,535 8,035

Directory Investment Corporation
Common Stock (470
shares) 112 32

(Publishing)

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

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

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

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

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

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

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

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(1) Public company.
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(3) Non-U.S. company.

(4) Non-registered investment company.

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

Private Finance Portfolio Company (in thousands, except number of shares)		Investment(2)	June 30, 2002 (unaudited) Cost	Value
HMT, Inc.		Debt Securities	$ 9,036	$ 9,036
	(Business Services)	Preferred Stock (519,484 shares)	2,078	2,078
		Common Stock (300,000 shares)	3,000	1,694
		Warrants	1,155	651
Monitoring Solutions, Inc.		Debt Securities	1,823	153
	(Business Services)	Common Stock (33,333 shares)		
		Warrants		
MVL Group, Inc.		Loan	16,963	16,963
	(Business Services)	Debt Securities	16,116	16,116
		Common Stock (650,000 shares)	643	643
Spa Lending Corporation		Preferred Stock (28,625 shares)	409	288
	(Recreation)	Common Stock (6,208 shares)		
STS Operating, Inc.		Common Stock (3,000,000 shares)	3,177	3,177
	(Industrial Products)			
Sure-Tel, Inc.		Preferred Stock (1,000,000 shares)	1,000	1,000
	(Consumer Services)	Common Stock (37,000 shares)	5,018	5,018
Total Foam, Inc.		Debt Securities	260	125
	(Industrial Products)	Common Stock (910 shares)	10	
WyoTech Acquisition		Debt Securities	12,638	12,638
	Corporation	Preferred Stock (100 shares)	3,700	3,700
	(Education)	Common Stock (99 shares)	100	60,670

Total companies more than 25%
owned $512,468 $632,560

Companies 5% to 25% Owned

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

Autania AG(1,3)
Debt Securities 4,487 4,487
(Industrial Products)

Common Stock (250,000 shares) 2,169 2,169

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

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

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

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

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

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

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Private Finance Portfolio Company (in thousands, except number of shares)		Investment(2)	June 30, 2002 (unaudited) Cost	Value
Progressive International		Debt Securities	$3,963	$3,963
	Corporation	Preferred Stock (500 shares)	500	500
	(Consumer Products)	Common Stock (197 shares)	13	13
		Warrants		
Redox Brands, Inc.		Debt Securities	9,649	9,649
	(Consumer Products)	Preferred Stock (2,404,086 shares)	6,974	6,974
		Warrants	584	584
Staffing Partners Holding		Loan	2,500	2,500
	Company, Inc.	Debt Securities	4,992	4,992
	(Business Services)	Preferred Stock (414,600 shares)	2,073	2,073
		Common Stock (50,200 shares)	50	50
		Warrants	10	10

Total companies 5% to 25% owned $235,879 $264,691

Companies Less Than 5% Owned

ACE Products, Inc.
Loans $17,164 $15,839
(Industrial Products)

Advantage Mayer, Inc.
Debt Securities 10,654 10,654
(Business Services)
Warrants 382 1,455

Alderwoods Group, Inc.(1)
Common Stock (357,568 shares) 5,006 2,739
(Consumer Services)

Allied Office Products, Inc.
Debt Securities 7,628 50
(Business Services)
Warrants 629

American Barbecue & Grill, Inc.
Warrants 125
(Retail)

American Home Care Supply,

Debt
Securities 6,935 6,935
LLC
Warrants 579 1,579
(Consumer Products)

ASW Holding Corporation
Warrants 25 25
(Industrial Products)

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

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

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

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

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

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Private Finance Portfolio Company (in thousands, except number of shares)	Investment(2)	June 30, 2002 (unaudited) Cost	Value
Candlewood Hotel Company(1) (Hospitality)	Preferred Stock (3,250 shares)	$ 3,250	$ 1,300
Celebrities, Inc. (Broadcasting & Cable)	Loan	230	230
	Warrants	12	492
Component Hardware Group, Inc. (Industrial Products)	Debt Securities	11,032	11,032
	Preferred Stock (18,000 shares)	1,800	1,800
	Common Stock (2,000 shares)	200	200
Convenience Corporation of America (Retail)	Debt Securities	8,355	2,738
	Preferred Stock (22,301 shares)	334	
	Warrants		
Cooper Natural Resources, Inc. (Industrial Products)	Loan	299	299
	Debt Securities	1,815	1,815
	Preferred Stock (6,316 shares)	1,427	1,427
	Warrants	832	832
Coverall North America, Inc. (Business Services)	Loan	10,418	10,418
	Debt Securities	5,740	5,740
CPM Acquisition Corporation (Industrial Products)	Loan	9,902	9,902
CTT Holdings (Consumer Products)	Loan	1,478	1,478
Cumulus Media, Inc. (1) (Broadcasting & Cable)	Common Stock (11,037 shares)	198	152
Drilltec Patents & Technologies Company, Inc. (Industrial Products)	Loan	10,918	348
	Debt Securities	1,500	1,500
	Warrants		
eCentury Capital Partners, L.P.(4) (Private Equity Fund)	Limited Partnership Interest	1,875	1,691
El Dorado Communications, Inc. (Broadcasting & Cable)	Loans	306	306
Elexis Beta GmbH(3) (Industrial Products)	Options	426	426
Eparfin S.A.(3) (Consumer Products)	Loan	29	29
E-Talk Corporation (Business Services)	Debt Securities	8,852	1,000
	Warrants	1,157	

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

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Private Finance Portfolio Company (in thousands, except number of shares)	Investment(2)	June 30, 2002 (unaudited) Cost	Value
Fairchild Industrial Products Company (Industrial Products)	Debt Securities	$ 5,906	$ 5,906
	Warrants	280	1,100
Galaxy American Communications, LLC (Broadcasting & Cable)	Debt Securities	48,433	34,010
	Options		
	Standby Letter of Credit ($750)		
Garden Ridge Corporation (Retail)	Debt Securities	27,070	27,070
	Preferred Stock (1,130 shares)	1,130	1,130
	Common Stock (188,400 shares)	613	613
GC-Sun Holdings II, LP (Kar Products, LP) (Business Services)	Loans	8,167	8,167
Ginsey Industries, Inc. (Consumer Products)	Loans	5,000	5,000
	Convertible Debentures	500	500
	Warrants		1,500
Global Communications, LLC (Business Services)	Loan	1,997	1,997
	Debt Securities	15,262	15,262
	Equity Interest	11,067	11,067
	Options	1,639	1,639
Grant Broadcasting Systems II (Broadcasting & Cable)	Warrants	87	3,000
Grotech Partners, VI, L.P.(4) (Private Equity Fund)	Limited Partnership Interest	1,832	1,398
The Hartz Mountain Corporation (Consumer Products)	Debt Securities	27,544	27,544
	Common Stock (200,000 shares)	2,000	2,000
	Warrants	2,613	2,613
Hotelevision, Inc. (Broadcasting & Cable)	Preferred Stock (315,100 shares)	315	315
Icon International, Inc. (Business Services)	Common Stock (35,228 shares)	1,219	2,712
Impact Innovations Group, LLC (Business Services)	Debt Securities	6,727	3,436
	Warrants	1,674	
Intellirisk Management Corporation (Business Services)	Loans	22,796	22,796
Interline Brands, Inc. (Business Services)	Debt Securities	33,431	33,431
	Preferred Stock (199,313 shares)	1,849	1,849
	Common Stock (15,615 shares)	139	139

	Warrants	1,181	1,181
Jakel, Inc. (Industrial Products)	Loan	23,307	16,047

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Private Finance Portfolio Company (in thousands, except number of shares)	Investment(2)	June 30, 2002 (unaudited) Cost	Value
JRI Industries, Inc.	Debt Securities	$ 1,981	$ 1,981
(Industrial Products)	Warrants	74	74
Julius Koch USA, Inc.	Debt Securities	453	453
(Industrial Products)	Warrants	259	8,000
Kirker Enterprises, Inc.	Warrants	348	3,501
(Industrial Products)	Equity Interest	4	4
Kirkland s, Inc.	Debt Securities	6,387	6,387
(Retail)	Preferred Stock (917 shares)	412	412
	Warrants	96	5,816
Kyrus Corporation	Debt Securities	7,380	7,380
(Business Services)	Warrants	348	348
Love Funding Corporation	Preferred Stock (26,000 shares)	359	213
(Financial Services)			
Matrics, Inc.	Preferred Stock (511,876 shares)	500	500
(Business Services)	Warrants		
MedAssets.com, Inc.	Debt Securities	15,363	15,363
(Business Services)	Preferred Stock (260,417 shares)	2,049	2,049
	Warrants	136	136
Mid-Atlantic Venture Fund IV, L.P.(4)	Limited Partnership Interest	2,475	1,479
(Private Equity Fund)			
Midview Associates, L.P.	Warrants		
(Housing)			
Most Confiserie GmbH & Co KG(3)	Loan	950	50
(Consumer Products)			
NetCare, AG(3)	Loan	760	50
(Business Services)	Common Stock (262,784 shares)	230	
NETtel Communications, Inc.	Debt Securities and Receivables	11,334	4,334
(Telecommunications)			
Northeast Broadcasting Group, L.P.	Debt Securities	289	289
(Broadcasting & Cable)			
Novak Biddle Venture Partners III, L.P.(4)	Limited Partnership Interest	420	420
(Private Equity Fund)			
Nursefinders, Inc.	Debt Securities	11,151	11,151
(Business Services)	Warrants	900	3,060

Onyx Television GmbH(3) (Broadcasting & Cable)	Preferred Units (120,000 shares)	201	8

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

Private Finance Portfolio Company (in thousands, except number of shares)	Investment(2)	June 30, 2002 (unaudited) Cost	Value
Opinion Research Corporation(1)	Debt Securities	$ 14,269	$ 14,269
(Business Services)	Warrants	996	881
Oriental Trading Company, Inc.	Debt Securities	12,920	12,920
(Consumer Products)	Preferred Equity Interest	1,500	1,500
	Common Equity Interest		2,000
	Warrants	13	2,300
Outsource Partners, Inc.	Debt Securities	24,048	24,048
(Business Services)	Warrants	826	826
Pico Products, Inc.	Loan	1,406	1,406
(Industrial Products)			
Polaris Pool Systems, Inc.	Debt Securities	10,630	10,630
(Consumer Products)	Warrants	1,145	1,145
Powell Plant Farms, Inc.	Loan	19,095	14,087
(Consumer Products)			
Proeducation GmbH(3)	Loan	321	321
(Education)			
Prosperco Finanz Holding AG(3)	Convertible Debentures	5,492	5,492
(Financial Services)	Common Stock (1,528 shares)	1,059	1,059
	Warrants		
Raytheon Aerospace, LLC	Debt Securities	5,130	5,130
(Business Services)	Equity Interest		
Schwinn Holdings Corporation	Debt Securities	10,195	1,835
(Consumer Products)			
Seasonal Expressions, Inc.	Preferred Stock (504 shares)	500	
(Consumer Products)			
Simula, Inc.(1)	Loan	20,539	20,539
(Industrial Products)			
Soff-Cut Holdings, Inc.	Debt Securities	8,807	8,807
(Industrial Products)	Preferred Stock (300 shares)	300	300
	Common Stock (2,000 shares)	200	200
Southwest PCS, LLC	Loan	6,059	6,059
(Telecommunications)			
Startec Global Communications	Loan	23,815	23,815
Corporation(1)	Debt Securities	21,432	245
(Telecommunications)	Common Stock (258,064 shares)	3,000	

	Warrants		
SunStates Refrigerated Services, Inc. (Warehouse Facilities)	Loans	6,062	4,188
	Debt Securities	2,445	

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(4) Non-registered investment company.

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

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

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(4) Non-registered investment company.

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

	Interest Rate Ranges	Number of Loans	Cost

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

(3) Non-U.S. company.

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

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENT OF INVESTMENTS

Private Finance Portfolio Company (in thousands, except number of shares)	Investment(2)	December 31, 2001	
		Cost	Value

Companies More Than 25% Owned

Acme Paging, L.P.
Debt
Securities $6,992 $6,992
(Telecommunications)
Equity
Interests 3,640 2,184

American Healthcare Services,
Debt
Securities 40,194 40,194
Inc.
Common Stock (79,567,042
shares) 1,000 100
(Healthcare)
Guaranty ($195)

Business Loan Express, Inc.
Loan 6,000 6,000
(Financial Services)
Debt
Securities 76,242 76,242
Preferred Stock (25,111
shares) 25,111 25,111
Common Stock (25,503,043
shares) 104,596 120,096
Guaranty ($51,350 See
Note 3)

The Color Factory Inc.
Loan 5,346 5,346
(Consumer Products)
Preferred Stock (600
shares) 788 788 Common
Stock (980
shares) 6,535 8,035

Directory Investment
Corporation
Common Stock (470
shares) 112 32
(Publishing)

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

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

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

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

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

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

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

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

shares)	Warrants

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

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

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

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

Companies 5% to 25% Owned

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

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

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

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

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

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

The Debt Exchange Inc.
Preferred Stock (921,829
shares) 1,250 1,250
(Business Services)

FTI Consulting, Inc.(1)
Warrants 510
(Business Services)

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

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

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

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

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

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(4) Non-registered investment company.

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Private Finance Portfolio Company (in thousands, except number of shares)	Investment(2)	December 31, 2001	
		Cost	Value

Companies Less Than 5% Owned

Ability One Corporation
Loans $10,657 $10,657
(Consumer Products)

ACE Products, Inc.
Loans 16,875 16,875
(Industrial Products)

Advantage Mayer, Inc.
Debt
Securities 10,945 10,945
(Business Services)
Warrants

Allied Office Products, Inc.
Debt
Securities 7,491 7,491
(Business Services)
Warrants 629 629

American Barbecue & Grill, Inc.
Warrants 125
(Retail)

American Home Care Supply, LLC
Debt
Securities 6,906 6,906
(Consumer Products)
Warrants 579 1,579

ASW Holding Corporation
Warrants 25 25
(Industrial Products)

Aurora Communications, LLC
Loans 15,809 15,809
(Broadcasting & Cable)
Equity Interest 2,461 6,050

Avborne, Inc.

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

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

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

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

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

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

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

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

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

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

(Industrial Products)			
Galaxy American Communications, LLC (Broadcasting & Cable)	Debt Securities Options Standby Letter of Credit ($750)	48,869	39,217

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

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

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

(Broadcasting & Cable)

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(4) Non-registered investment company.

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

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

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

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

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

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

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

Total private finance (135 portfolio companies) $1,553,966 $1,595,072

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

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

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

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

	15.00% and above	2	84	60
	Total commercial mortgage loans	76	$76,120	$79,597
Residual Interest			$70,179	$69,879
Real Estate Owned			3,784	2,489
Total commercial real estate finance			**$732,636**	**$734,518**
Total portfolio			**$2,286,602**	**$2,329,590**

(3) Non-U.S. company.

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

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Information at June 30, 2002 and 2001 and for the six months ended June 30, 2002 and 2001 is unaudited)

Note 1. Organization

Allied Capital Corporation, a Maryland corporation, is a closed-end management investment company that has elected to be regulated as a business development company (BDC) under the Investment Company Act of 1940 (1940 Act). Allied Capital Corporation (ACC) has a subsidiary that has also elected to be regulated as a BDC, Allied Investment Corporation (Allied Investment), which is licensed under the Small Business Investment Act of 1958 as a Small Business Investment Company (SBIC). In addition, ACC has a real estate investment trust subsidiary, Allied Capital REIT, Inc. (Allied REIT), and several subsidiaries which are single-member limited liability companies established primarily to hold real estate properties. In April 2001, ACC established a subsidiary, A.C. Corporation (AC Corp), which provides diligence and structuring services on private finance and commercial real estate transactions, as well as structuring, transaction, management and advisory services to the Company, its portfolio companies and other third parties.

ACC also owned Allied Capital SBLC Corporation (Allied SBLC), a BDC licensed by the Small Business Administration (SBA) as a Small Business Lending Company and a participant in the SBA Section 7(a) Guaranteed Loan Program. On December 31, 2000, ACC acquired BLC Financial Services, Inc. as a private portfolio company, which then changed its name to Business Loan Express, Inc. (BLX). As a part of the transaction, Allied SBLC was recapitalized as an independently managed, private portfolio company on December 28, 2000 and ceased to be a consolidated subsidiary of the Company at that time. Allied SBLC was then subsequently merged into BLX. The results of the operations of Allied SBLC are included in the consolidated financial results of ACC and its subsidiaries for 1999 and for 2000 through December 27, 2000.

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

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

The investment objective of the Company is to achieve current income and capital gains. In order to achieve this objective, the Company invests primarily in private companies in a variety of industries and non-investment grade commercial mortgage-backed securities (CMBS).

Note 2. Summary of Significant Accounting Policies

Basis of Presentation

The consolidated financial statements include the accounts of the Company and its subsidiaries. All intercompany accounts and transactions have been eliminated in consolidation. Certain reclassifications have been made to the 2001, 2000 and 1999 balances to conform with the 2002 financial statement presentation.

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ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 2. Summary of Significant Accounting Policies, continued

The accompanying unaudited consolidated financial statements of the Company have been prepared in accordance with accounting principles generally accepted in the United States of America (GAAP) for interim financial information. Accordingly, the interim financial information does not include all of the information and footnotes required by GAAP for complete consolidated financial statements. In the opinion of management, the unaudited consolidated financial statements of the Company included herein contain all adjustments (consisting of only normal recurring accruals) necessary to present fairly the financial position of the Company as of June 30, 2002 and December 31, 2001 and the results of operations for the six months ended June 30, 2002 and 2001, and changes in net assets and cash flows for the six months ended June 30, 2002 and 2001. The results of operations for the six months ended June 30, 2002 are not necessarily indicative of the operating results to be expected for the full year.

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

Valuation of Portfolio Investments

The Company, as a BDC, invests primarily in illiquid securities including debt and equity securities of private companies and non-investment grade CMBS. The Company s investments are generally subject to restrictions on resale and generally have no established trading market. The Company values substantially all of its investments at fair value as determined in good faith by the board of directors in accordance with the Company s valuation policy. The Company determines fair value to be the amount for which an investment could be exchanged in an orderly disposition over a reasonable period of time between willing parties other than in a forced or liquidation sale. The Company s valuation policy considers the fact that no ready market exists for substantially all of the securities in which it invests. The Company s valuation policy is intended to provide a consistent basis for establishing the fair value of the portfolio. The Company will record unrealized depreciation on investments when it believes that an investment has become impaired, including where collection of a loan or realization of an equity security is doubtful. Conversely, the Company will record unrealized appreciation if it believes that the underlying portfolio company has appreciated in value and the Company s equity security has also appreciated in value, where appropriate. The value of investments in public securities are determined using quoted market prices discounted for restrictions on resale.

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 2. Summary of Significant Accounting Policies, continued

Loans and Debt Securities

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

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

Interest income is recorded on an accrual basis to the extent that such amounts are expected to be collected. For loans and debt securities with contractual payment-in-kind interest, which represents contractual interest accrued and added to the loan balance that generally becomes due at maturity, the Company will not accrue payment-in-kind interest if the portfolio company valuation indicates that the payment-in-kind interest is not collectible. Loans classified as Grade 4 or Grade 5 assets do not accrue interest. Loan origination fees, original issue discount and market discount are capitalized and then amortized into interest income using the effective interest method. Prepayment premiums are recorded on loans when received.

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

Equity Securities

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

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

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

Commercial Mortgage-Backed Securities (CMBS)

CMBS are carried at fair value, which is based upon a discounted cash flow model that utilizes prepayment and loss assumptions based upon historical experience and projected performance, economic factors and the characteristics of the underlying cash flow. The Company s assumption with regard to discount rate is based upon the yield of comparable securities. The Company recognizes

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 2. Summary of Significant Accounting Policies, continued

income from the amortization of original issue discount using the effective interest method, using the anticipated yield over the projected life of the investment. Yields are revised when there are changes in estimates of future credit losses, actual losses incurred, or actual and estimated prepayment speeds. Changes in estimated yield are recognized as an adjustment to the estimated yield over the remaining life of the CMBS from the date the estimated yield is changed. The Company recognizes unrealized appreciation or depreciation on its CMBS, as comparable yields in the market change and/or whenever it determines that the value of its CMBS is less than the cost basis due to impairment in the underlying collateral pool.

Residual Interest

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

Net Realized and Unrealized Gains or Losses

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

Fee Income

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

Deferred Financing Costs

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

Derivative Financial Instruments

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

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 2. Summary of Significant Accounting Policies, continued

Cash and Cash Equivalents

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

Dividends to Shareholders

Dividends to shareholders are recorded on the record date.

Stock Compensation Plans

The Company applies the intrinsic value-based method of accounting prescribed by Accounting Principles Board (APB) Opinion No. 25, Accounting for Stock Issued to Employees, and related interpretations to account for its stock compensation plans. Under this method, the Company records compensation expense for awards of stock options to employees only if the market price of the stock on the grant date exceeds the amount the employee is required to pay to acquire the stock. Information concerning the pro forma effects on net earnings and earnings per share of using an optional fair value-method (rather than the intrinsic value method) to account for stock compensation plans is presented in Note 9.

Federal and State Income Taxes

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

Per Share Information

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

Use of Estimates in the Preparation of Financial Statements

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

The consolidated financial statements include investments at value of $2,380,969,000, $2,329,590,000 and $1,788,001,000 as of June 30, 2002, December 31, 2001 and 2000, respectively, (93%, 95% and 96%, respectively, of total assets). Substantially all of these investments represent investments whose fair values have been determined by the board of directors in good faith in the absence of readily ascertainable market values. Because of the inherent uncertainty of valuation, the

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 2. Summary of Significant Accounting Policies, continued

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

Note 3. Portfolio

Private Finance

At June 30, 2002 and December 31, 2001 and 2000, the private finance portfolio consisted of the following:

	2002			2001			
	Cost	Value	Yield	Cost	Value	Yield	Cost
rities	$1,183,308	$1,050,752	13.9%	$1,169,673	$1,107,890	14.8%	$983,887

384,293 487,182 278,642 316,210

259 $1,553,966 $1,595,072 $1,262,529 $1,282,467

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

Loans and debt securities generally have a maturity of five to ten years, with interest-only payments in the early years and payments of both principal and interest in the later years, although debt maturities and principal amortization schedules vary. At June 30, 2002 and December 31, 2001 and 2000, approximately 97%, 98% and 98%, respectively, of the Company s private finance loan portfolio was composed of fixed interest rate loans.

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

At June 30, 2002 and December 31, 2001 and 2000, the Company had an investment at value totaling $251,920,000, $227,449,000 and $204,080,000, respectively, in Business Loan Express, Inc. (BLX), a small business lender that participates in the SBA Section 7(a) Guaranteed Loan Program. The Company owns 94.9% of BLX s common stock. As the controlling shareholder of BLX, the Company has provided an unconditional guaranty to the BLX credit facility lenders in an amount up to 50% of the total obligations (consisting of principal, accrued interest and other fees) on BLX s 3-year unsecured revolving credit facility for $124,000,000. The amount guaranteed by the Company at June 30, 2002 was $48,126,000. This guaranty can be called by the lenders only in the event of a default by BLX. BLX was in compliance with the terms of its credit facility at June 30, 2002. In consideration for providing this guaranty, BLX will pay the Company an annual guaranty fee of approximately $3,100,000 in 2002. BLX is headquartered in New York, NY. The Company has also provided two standby letters of credit in connection with two term securitization transactions completed by BLX in the second quarter of 2002 totaling $10,550,000.

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 3. Portfolio, continued

At June 30, 2002 and December 31, 2001, the Company had an investment in The Hillman Companies, Inc. (formerly SunSource, Inc.) totaling $131,012,000 and $97,227,000 at value, respectively. The Company owns 93.2% of Hillman s common stock. Hillman is a leading manufacturer of key making equipment and distributor of key blanks, fasteners, signage and other small hardware components and operates in multiple channels of the retail marketplace such as hardware stores, national and regional home centers and mass merchants. Hillman s primary operations are located in Cincinnati, Ohio.

At June 30, 2002 and December 31, 2001 and 2000, the Company had an investment in WyoTech Acquisition Corporation at value totaling $77,008,000, $60,388,000 and $26,477,000, respectively. The Company owned 91.35% of WyoTech s common stock. WyoTech is a proprietary trade school and its primary operations are in Laramie, Wyoming. WyoTech was sold on July 1, 2002. See Note 18 for the subsequent event.

At June 30, 2002 and December 31, 2001 and 2000, Grade 4 and 5 loans and debt securities that were not accruing interest at value were as follows:

(in thousands)	2002	2001	2000
Companies more than 25% owned	$721	$930	$713
Companies 5% to 25% owned	899	2,848	14,661
Companies less than 5% owned	103,562	89,966	57,592
	$105,182	$93,744	$72,966

Included in Grade 4 and 5 loans and debt securities not accruing interest were assets valued at $8.9 million, $8.9 million and $16.2 million at June 30, 2002 and December 31, 2001, and 2000, respectively, that represented receivables related to companies in liquidation. In addition to Grade 4 and 5 assets that are in workout, the Company may not accrue interest on loans to companies that are more than 50% owned by the Company if such companies are in need of additional capital and, therefore, the Company may defer current debt service. Loans and debt securities to such companies totaled $61,331,000 at value at June 30, 2002.

The industry and geographic compositions of the private finance portfolio at value at June 30, 2002 and December 31, 2001 and 2000 were as follows:

	2002	2001	2000
Industry			
Consumer products	30%	28%	26%
Business services	24	22	24
Financial services	16	15	16
Industrial products	10	10	9
Retail	5	5	5
Education	5	5	3
Telecommunications	3	4	6
Broadcasting & cable	2	4	5
Other	5	7	6
Total	100%	100%	100%

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 3. Portfolio, continued

	2002	2001	2000
Geographic Region			
Mid-Atlantic	42%	43%	43%
West	20	19	17
Midwest	17	17	18
Southeast	14	14	12
Northeast	6	5	8
International	1	2	2
Total	100%	100%	100%

Commercial Real Estate Finance

At June 30, 2002 and December 31, 2001 and 2000, the commercial real estate finance portfolio consisted of the following:

	2002			2001			2000	
nds)	Cost	Value	Yield	Cost	Value	Yield	Cost	Valu
	$589,558	$613,423	14.8%	$582,553	$582,553	14.8%	$310,887	$311,3

2,001 7.9% 76,120 79,597 7.7% 102,957 106,413 9.1%
erest
9,042 9.3% 70,179 69,879 9.4% 82,020 81,720 9.5%
owned
44 3,784 2,489 7,502 6,081

745,710	$732,636	$734,518	$503,366	$505,534	

CMBS

At June 30, 2002 and December 31, 2001 and 2000, the CMBS portfolio consisted of the following:

	2002			2001			2000	
nds)	Cost	Value	Yield	Cost	Value	Yield	Cost	Value
ds	$537,025	$560,890	14.6%	$558,346	$558,346	14.7%	$310,887	$311,32
ed debt obligations								
		2,533	17.2%	24,207	24,207	16.9%		
		$613,423		$582,553	$582,553		$310,887	$311,320

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 3. Portfolio, continued

CMBS Bonds. At June 30, 2002 and December 31, 2001 and 2000, the CMBS bonds, which were purchased from the original issuer, consisted of the following:

($ in thousands)	2002	2001	2000
Face	$1,181,989	$1,170,272	$675,764
Original issue discount	(644,964)	(611,926)	(364,877)
Cost	$537,025	$558,346	$310,887
Value	$560,890	$558,346	$311,320
Yield	14.6%	14.7%	15.4%

The non-investment grade and unrated tranches of the CMBS bonds in which the Company invests are junior in priority for payment of interest and principal to the more senior tranches of the related CMBS bond issuance. Cash flow from the underlying mortgages generally is allocated first to the senior tranches, with the most senior tranches having a priority right to the cash flow. Then, any remaining cash flow is allocated, generally, among the other tranches in order of their relative seniority. To the extent there are defaults and unrecoverable losses on the underlying mortgages resulting in reduced cash flows, the Company s most subordinate tranch will bear this loss first. At June 30, 2002, the Company s CMBS bonds were subordinate to 92% to 97% of the tranches of bonds issued in various CMBS transactions. Given that the non-investment grade CMBS bonds in which the Company invests are junior in priority for payment of principal, the Company invests in these CMBS bonds at an approximate discount of 50% from the face amount of the bonds.

The underlying rating classes of the CMBS bonds at value at June 30, 2002 and December 31, 2001 and 2000 were as follows:

($ in thousands)	2002		2001		2000	
	Value	Percentage of Total	Value	Percentage of Total	Value	Percentage of Total
BB+	$28,668	5.1%	$24,785	4.4%	$	%
BB	40,701	7.3	69,404	12.4	8,472	2.7
BB-	33,452	6.0	67,460	12.1	37,061	11.9
B+	123,056	21.9	103,560	18.6	59,827	19.3
B	158,035	28.2	131,362	23.5	89,999	28.9
B-	79,664	14.2	73,572	13.2	56,665	18.2
CCC	9,119	1.6	8,893	1.6	7,857	2.5
Unrated	88,195	15.7	79,310	14.2	51,439	16.5
Total	$560,890	100.0%	$558,346	100.0%	$311,320	100.0%

At June 30, 2002 and December 31, 2001 and 2000, the underlying pools of mortgage loans that are collateral for the Company s CMBS bonds consisted of approximately 4,100, 3,800 and 2,600 commercial mortgage loans with a total outstanding principal balance of $22.9 billion, $20.5 billion and $12.7 billion, respectively. At June 30, 2002, December 31, 2001 and 2000, 0.75%, 0.52% and 0.22%, respectively, of the mortgage loans in the underlying collateral pool for the Company s CMBS bonds were over 30 days delinquent or were classified as real estate owned. The property types and the geographic composition of the underlying mortgage loans in the underlying collateral pool

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 3. Portfolio, continued

calculated using the outstanding principal balance at June 30, 2002 and December 31, 2001 and using the underwritten principal balance at December 31, 2000 were as follows:

	2002	2001	2000
Property Type			
Retail	31%	31%	32%
Housing	27	27	30
Office	21	22	21
Hospitality	7	7	8
Other	14	13	9
Total	100%	100%	100%
Geographic Region			
West	31%	32%	31%
Mid-Atlantic	25	24	23
Midwest	22	21	22
Southeast	17	17	19
Northeast	5	6	5

Total	100%	100%	100%

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

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

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 3. Portfolio, continued

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

Loans

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

At June 30, 2002 and December 31, 2001 and 2000, approximately 75% and 25%, 76% and 24%, and 69% and 31% of the Company s commercial mortgage loan portfolio was composed of fixed and adjustable interest rate loans, respectively. As of June 30, 2002 and December 31, 2001 and 2000, workout loans, or those loans in Grade 4 and 5, with a value of $15,860,000, $15,241,000 and $14,433,000, respectively, were not accruing interest.

In December 2000, the Company purchased commercial mortgage loans with a face amount of $6,538,000 for $5,427,000 from Business Mortgage Investors, Inc., a company managed by ACC.

The property types and the geographic composition securing the commercial mortgage loan portfolio at value at June 30, 2002 and December 31, 2001 and 2000 were as follows:

	2002	2001	2000
Property Type			
Office	28%	34%	30%
Hospitality	28	25	28
Retail	24	21	19
Recreation	3	4	9
Other	17	16	14
Total	100%	100%	100%

Geographic Region			
Southeast	40%	36%	39%
Mid-Atlantic	17	23	22
West	23	20	20
Midwest	13	16	14
Northeast	7	5	5
Total	100%	100%	100%

Residual Interest

At June 30, 2002 and December 31, 2001 and 2000, the residual interest consisted of the following:

	2002		**2001**		**2000**	
(in thousands)	**Cost**	**Value**	**Cost**	**Value**	**Cost**	**Value**
Residual interest	$68,853	$68,853	$68,853	$68,853	$78,723	$78,723
Residual interest spread	488	189	1,326	1,026	3,297	2,997

Total	$69,341	$69,042	$70,179	$69,879	$82,020	$81,720

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 3. Portfolio, continued

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

The Company sold $295 million of loans, and received cash proceeds, net of costs, of approximately $223 million in January 1998. The Company retained a trust certificate for its residual interest in a loan pool sold, and will receive interest income from this residual interest as well as the residual interest spread (Residual) from the interest earned on the loans sold less the interest paid on the bonds over the life of the bonds. As of June 30, 2002 and December 31, 2001 and 2000, the mortgage loan pool had an approximate weighted average stated interest rate of 9.3%. The outstanding bond classes sold had an aggregate weighted average interest rate of 6.7%, 6.6% and 6.5% as of June 30, 2002 and December 31, 2001 and 2000, respectively.

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

Small Business Finance

The Company, through its former subsidiary, Allied SBLC, participated in the SBA s Section 7(a) Guaranteed Loan Program. As discussed in Note 1, Allied SBLC was no longer a subsidiary of the Company at December 31, 2000. As a result, the Company s small business portfolio had no balance at December 31, 2000.

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 4. Debt

The Company records debt at cost. At June 30, 2002 and December 31, 2001 and 2000, the Company had the following debt:

	2002		2001		2000	
(in thousands)	**Facility Amount**	**Amount Drawn**	**Facility Amount**	**Amount Drawn**	**Facility Amount**	**Amount Drawn**
Notes payable and debentures:						
Unsecured long-term notes payable	$694,000	$694,000	$694,000	$694,000	$544,000	$544,000
SBA debentures	101,800	94,500	101,800	94,500	87,350	78,350
Auction rate reset note	75,000	75,000	81,856	81,856	76,598	76,598
OPIC loan	5,700	5,700	5,700	5,700	5,700	5,700
Total notes payable and debentures	876,500	869,200	883,356	876,056	713,648	704,648
Revolving line of credit	527,500	139,750	497,500	144,750	417,500	82,000

Total	$1,404,000	$1,008,950	$1,380,856	$1,020,806	$1,131,148	$786,648

Notes Payable and Debentures

Unsecured Long-Term Notes Payable. The Company issued unsecured long-term notes to private institutional investors. The notes require semi-annual interest payments until maturity and have original terms of five or seven years. At June 30, 2002, the notes had remaining maturities of one to four years. The weighted average fixed interest rate on the notes was 7.6%, 7.6% and 7.8% at June 30, 2002 and December 31, 2001 and 2000, respectively. The notes may be prepaid in whole or in part, together with an interest premium, as stipulated in the note agreement.

SBA Debentures. At June 30, 2002 and December 31, 2001 and 2000, the Company had debentures payable to the SBA with terms of ten years and at fixed interest rates ranging from 5.9% to 8.2%, 2.4% to 8.2% and 6.6% to 9.6%, respectively. At June 30, 2002, the debentures had remaining maturities of three to ten years. The weighted average interest rate was 7.0%, 6.7% and 7.6% at June 30, 2002 and December 31, 2001 and 2000, respectively. The debentures require semi-annual interest-only payments with all principal due upon maturity. The SBA debentures are subject to prepayment penalties if paid prior to maturity. At June 30, 2002, the Company has a commitment from the SBA to borrow up to an additional $7,300,000 above the amount outstanding. The commitment expires on September 30, 2005.

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

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 4. Debt, continued

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

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

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

Revolving Line of Credit

The Company has an unsecured revolving line of credit for $527,500,000. The facility may be expanded up to $600,000,000 at the Company s option. The facility bears interest at a rate equal to (i) the one-month LIBOR plus 1.25% or (ii) the higher of (a) the Bank of America, N.A. prime rate or (b) the Federal Funds rate plus 0.50%. The interest rate adjusts at the beginning of each new interest period, usually every thirty days. The interest rates were 4.1%, 3.2% and 7.9% at June 30, 2002 and December 31, 2001 and 2000, respectively, and the facility requires an annual commitment fee equal to 0.25% of the committed amount. The line expires in August 2003, and may be extended under substantially similar terms for one additional year at the Company s sole option. The line of credit requires monthly interest payments and all principal is due upon its expiration.

The average debt outstanding on the revolving line of credit was $67,710,000, $106,338,000 and $154,853,000 for the six months ended June 30, 2002 and for the years ended December 31, 2001 and 2000, respectively. The maximum amount borrowed under this facility and the weighted average interest rate for the six months ended June 30, 2002 and for the years ended December 31, 2001 and 2000, were $145,250,000, $213,500,000 and

$257,000,000, and 3.2%, 5.4% and 7.6%, respectively.

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

Note 5. Preferred Stock

Allied Investment has outstanding a total of 60,000 shares of $100 par value, 3% cumulative preferred stock and 10,000 shares of $100 par value, 4% redeemable cumulative preferred stock issued

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 5. Preferred Stock, continued

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

Note 6. Shareholders Equity

Sales of common stock for the six months ended June 30, 2002, and the years ended December 31, 2001, 2000 and 1999 were as follows:

(in thousands)	2002	2001	2000	1999
Number of common shares	1,946	13,286	14,812	8,659
Gross proceeds	$51,800	$301,539	$263,460	$172,539
Less costs including underwriting fees	(1,880)	(14,651)	(12,548)	(8,270)
Net proceeds	$49,920	$286,888	$250,912	$164,269

In addition, the Company issued 204,855 shares of common stock with a value of $5,157,000 to acquire one portfolio investment in a stock-for-stock exchange during 2001. The Company also issued 4,123,407 shares of common stock with a value of $86,076,000 to acquire BLC Financial Services, Inc. in a stock-for-stock exchange on December 31, 2000.

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

Dividend reinvestment plan activity for the six months ended June 30, 2002 and for the years ended December 31, 2001, 2000 and 1999 was as follows:

(in thousands, except per share amounts)	2002	2001	2000	1999
Shares issued	128	271	254	233
Average price per share	$24.34	$23.32	$18.79	$19.43

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 7. Earnings Per Common Share

Earnings per common share for the six months ended June 30, 2002 and 2001 and for the years ended December 31, 2001, 2000 and 1999 were as follows:

	For the Six Months Ended June 30,				
(in thousands, except per share amounts)	2002	2001	2001	2000	1999
Net increase in net assets resulting from operations	$129,415	$98,134	$200,727	$143,101	$98,570
Less preferred stock dividends	(110)	(110)	(230)	(230)	(230)
Income available to common shareholders	$129,305	$98,024	$200,497	$142,871	$98,340
Basic shares outstanding	100,822	87,441	91,564	73,165	59,877
Dilutive options outstanding to officers	2,078	1,525	1,439	307	167

Diluted shares outstanding	102,900	88,966	93,003	73,472	60,044
Basic earnings per common share	$1.28	$1.12	$2.19	$1.95	$1.64
Diluted earnings per common share	$1.26	$1.10	$2.16	$1.94	$1.64

Note 8. Employee Stock Ownership Plan, 401(k) Plan and Deferred Compensation Plan

The Company had an employee stock ownership plan (ESOP) through 1999. Pursuant to the ESOP, the Company was obligated to contribute 5% of each eligible participant s total cash compensation for the year to a plan account on the participant s behalf, which vested over a two-year period. ESOP contributions were used to purchase shares of the Company s common stock.

As of December 31, 1999, the ESOP held 303,210 shares of the Company s common stock, all of which had been allocated to participants accounts. The plan was funded annually and the total ESOP contribution expense for the year ended December 31, 1999, was $641,000 net of forfeitures of $4,100. In 1999, the Company established a 401(k) plan (see below) and elected to terminate the ESOP Plan in 2000. During 2000, the ESOP assets were transferred into the

401(k) plan.

The Company s 401(k) retirement investment plan is open to all of its full-time employees who are at least 21 years of age. The employees may elect voluntary wage deferrals ranging from 0% to 20% of eligible compensation for the year. In 2000, the Company began making contributions to the 401(k) plan equal to 5% of each eligible participant s total cash compensation for the year up to a maximum compensation of $170,000, which fully vests at the time of contribution. Employer contributions that exceed $8,500 (5% of $170,000 cash compensation) are directed to the participant s deferred compensation plan account (see below). Total 401(k) contribution expense for the years ended December 31, 2001 and 2000, was $560,000 and $590,000, respectively.

The Company also has a deferred compensation plan. Eligible participants in the deferred compensation plan may elect to defer some of their compensation and have such compensation credited to a participant account. All amounts credited to a participant s account shall be credited solely for purposes of accounting and computation and remain assets of the Company and subject to the claims of the Company s general creditors. Amounts credited to participants under the deferred compensation plan are at all times 100% vested and non-forfeitable. A participant s account shall become distributable upon his or her separation from service, retirement, disability, death or at a future determined date. All deferred compensation plan accounts will be distributed in the event of a

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 8. Employee Stock Ownership Plan, 401(k) Plan and Deferred Compensation Plan, continued
change of control of the Company or in the event of the Company s insolvency. Amounts deferred by participants under the deferred compensation plan are funded to a trust, which is administered by a Company-appointed trustee.

Note 9. Stock Option Plan

The 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. On May 7, 2002, the Company s shareholders amended the Option Plan to increase the authorized shares under the plan to 25,950,000. At June 30, 2002, the number of shares available to be granted under the Option Plan was 14,265,147.

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.

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.

Information with respect to options granted, exercised and forfeited under the Option Plan for the six months ended June 30, 2002 and for the years ended December 31, 2001, 2000 and 1999 is as follows:

(in thousands, except per share amounts)	**Shares**	**Weighted Average Option Price Per Share**
Options outstanding at January 1, 1999	5,114	$20.14
Granted	1,288	19.75
Exercised	(318)	19.07
Forfeited	(195)	20.00
Options outstanding at December 31, 1999	5,889	$20.12
Granted	4,162	17.02
Exercised	(195)	17.68

Forfeited	(950)	19.81
Options outstanding at December 31, 2000	8,906	$18.76
Granted	2,800	21.82
Exercised	(553)	19.09
Forfeited	(673)	17.66
Options outstanding at December 31, 2001	10,480	$19.63
Granted	695	26.34
Exercised	(615)	18.91
Forfeited	(567)	19.29
Options outstanding at June 30, 2002	9,993	$20.16

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 9. Stock Option Plan, continued

The following table summarizes information about stock options outstanding at June 30, 2002:

Range of Exercise Prices	Total Number Outstanding	Weighted Average Remaining Contractual Life (years)	Weighted Average Exercise Price	Total Number Exercisable	Weighted Average Exercise Price
(in thousands, except per share amounts and years)					
$16.81	2,873	7.90	$16.81	1,900	$16.81
$17.50-$19.94	1,286	7.28	$18.43	545	$18.33
$21.38	2,306	5.53	$21.38	1,947	$21.38
$21.59	2,164	9.22	$21.59		
$21.88-$27.38	1,364	9.12	$24.51	360	$22.97
$16.81-$27.38	9,993	7.73	$20.16	4,752	$19.32

The Company accounts for its stock options as required by the Accounting Principles Board Opinion No. 25 Accounting for Stock Issued to Employees, and accordingly no compensation cost has been recognized as the exercise price equals the market price on the date of grant. Had compensation cost for the plan been determined consistent with SFAS No. 123 Accounting for Stock Based Compensation, which records options at fair value on the date of issuance and amortizes that amount over the vesting period of the option, the Company s net increase in net assets resulting from operations and basic and diluted earnings per common share would have been reduced to the following pro forma amounts:

(in thousands, except per share amounts)	**2001**	**2000**	**1999**
Net increase in net assets resulting from operations:			
As reported	$200,727	$143,101	$98,570

Pro forma	$193,520	$137,716	$94,510
Basic earnings per common share:			
As reported	$2.19	$1.95	$1.64
Pro forma	$2.11	$1.88	$1.58
Diluted earnings per common share:			
As reported	$2.16	$1.94	$1.64
Pro forma	$2.08	$1.87	$1.57

Pro forma expenses are based on the underlying value of the options granted by the Company. The fair value of each option grant is estimated on the date of grant using the Black-Scholes option pricing model, with the following weighted average assumptions for grants: risk-free interest rate of 4.0%, 6.5% and 5.9% for 2001, 2000 and 1999, respectively; expected life of approximately five years for all options granted; expected volatility of 33%, 34% and 37% for 2001, 2000 and 1999, respectively; and dividend yield of 8.0%, 8.7% and 9.0% for 2001, 2000 and 1999, respectively. The weighted average fair value of options granted for the years ended December 31, 2001, 2000, and 1999, were $3.24, $3.02, and $3.39, respectively.

Notes Receivable from the Sale of Common Stock

The Company provides loans to officers for the exercise of options. The loans are full recourse, have varying terms not exceeding ten years, bear interest at the applicable federal interest rate in

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 9. Stock Option Plan, continued

effect at the date of issue and have been recorded as a reduction to shareholders equity. At June 30, 2002, December 31, 2001, 2000 and 1999, the Company had outstanding loans to officers of $28,190,000, $26,028,000, $25,083,000 and $29,461,000, respectively. Officers with outstanding loans repaid principal of $220,000, $5,090,000, $6,363,000 and $195,000 for the six months ended June 30, 2002 and for the years ended December 31, 2001, 2000 and 1999, respectively. The Company recognized interest income from these loans of $775,000, $1,524,000, $1,712,000 and $1,539,000, respectively, during these same periods. This interest income is included in interest and dividends for companies less than 5% owned.

As a business development company under the Investment Company Act of 1940, the Company is entitled to provide loans to the Company s employees in connection with the exercise of options. However, as a result of provisions of the Sarbanes-Oxley Act of 2002, the Company is prohibited from making new loans to its executive officers in the future.

Note 10. Formula Award

In 1997, the Company established a Formula Award to compensate employees from the point when their unvested options would cease to appreciate in value (the merger announcement date), up until the time at which they would be able to receive option awards in ACC post-merger. The amount of the Formula Award as computed at December 30, 1997, was $18,994,000. This amount was contributed to the Company s deferred compensation trust under the deferred compensation plan (see Note 8) and was used to purchase shares of the Company s stock (included in common stock held in deferred compensation trust). The Formula Award vested equally in three installments on December 31, 1998, 1999 and 2000, and was expensed as a component of employee expense in each year in which it vested. For the years ended December 31, 2000 and 1999, $5,648,000 and $6,221,000, respectively, was expensed as a result of the Formula Award. Vested Formula Awards have been distributed to recipients by the Company, however, sale of the Company s stock by the recipients is restricted.

Note 11. Dividends and Distributions

The Company s Board of Directors declared and the Company paid dividends of $0.53 and $0.55 per common share for the first and second quarters of 2002, respectively. The dividends totaled $109,482,000 for the six months ended June 30, 2002, respectively. The Company s Board of Directors also declared a dividend of $0.56 per common share for the third quarter of 2002.

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 11. Dividends and Distributions, continued

For the years ended December 31, 2001, 2000 and 1999, the Company declared the following distributions:

	2001		2000		1999	
(in thousands, except per share amounts)	**Total Amount**	**Total Per Share**	**Total Amount**	**Total Per Share**	**Total Amount**	**Total Per Share**
First quarter	$42,080	$0.49	$30,715	$0.45	$23,286	$0.40
Second quarter	45,755	0.50	33,150	0.45	23,746	0.40
Third quarter	47,866	0.51	34,751	0.46	24,768	0.40
Fourth quarter	50,456	0.51	37,179	0.46	26,141	0.40
Total distributions to common shareholders	$186,157	$2.01	$135,795	$1.82	$97,941	$1.60

For income tax purposes, distributions for 2001, 2000 and 1999 were composed of the following:

(in thousands, except per share amounts)	2001 Total Amount	2001 Total Per Share	2000 Total Amount	2000 Total Per Share	1999 Total Amount	1999 Total Per Share
Ordinary income	$183,957	$1.99	$116,321	$1.56	$76,948	$1.26
Long-term capital gains	2,200	0.02	19,474	0.26	20,993	0.34
Total distributions to common shareholders	$186,157	$2.01	$135,795	$1.82	$97,941	$1.60

The following table summarizes the differences between financial statement net income and taxable income for the years ended December 31, 2001, 2000 and 1999:

(in thousands)	2001	2000	1999
Financial statement net income	$200,727	$143,101	$98,570
Adjustments:			
Net unrealized gains			

	(20,603)	(14,861)	(2,138)
Interest income from securitized commercial mortgage loans	3,327	3,149	4,640
Gains from disposition of portfolio assets		5,202	(4,547)
Formula award	(4,383)	1,374	2,158
Other expenses not deductible for tax	3,230	1,197	1,053
Amortization of loan discount	635	233	129
Other	5,040	(1,012)	(1,492)
Income tax benefit	(412)		
Taxable income	$187,561	$138,383	$98,373

The Company must distribute at least 90% of its RIC ordinary taxable income to qualify for pass through tax treatment and maintain its RIC status. At December 31, 2001, the Company had recorded a tax benefit of $412,000 for which it expects to realize the benefit in future years through AC Corp being in a net taxable income position.

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 12. Cash and Cash Equivalents

The Company places its 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.

At June 30, 2002 and December 31, 2001 and 2000, cash and cash equivalents consisted of the following:

(in thousands)	June 30, 2002	December 31, 2001	December 31, 2000
Cash and cash equivalents	$8,392	$5,337	$11,337
Less escrows held	(4,073)	(4,448)	(8,888)
Total cash and cash equivalents	$4,319	$889	$2,449

Note 13. Supplemental Disclosure of Cash Flow Information

For the six months ended June 30, 2002 and 2001 and for the years ended December 31, 2001, 2000 and 1999, the Company paid $34,055,000, $31,916,000, $63,237,000, $54,112,000 and $21,092,000, respectively, for interest. For the six months ended June 30, 2002 and 2001 and for the years ended December 31, 2001, 2000 and 1999, the Company s non-cash financing activities totaled $5,498,000, $7,569,000, $17,523,000, $92,835,000 and $10,241,000, respectively, and includes stock option exercises and dividend reinvestment. The non-cash financing activities for the years ended December 31, 2001 and 2000 includes the issuance of $5,157,000 and $86,076,000 of the Company s common stock to acquire portfolio investments.

Note 14. Hedging Activities

The Company invests in BB+, BB and BB- rated CMBS bonds, which are purchased at prices that are based on the 10-year Treasury rate. The Company has entered into transactions with two financial institutions to hedge against movement in Treasury rates on certain of these CMBS bonds. These transactions involved the Company receiving the proceeds from the sale of the borrowed Treasury securities, with the obligation to replenish the borrowed Treasury securities at a later date based on

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 14. Hedging Activities, continued

the then current market price. Borrowed Treasury securities as of June 30, 2002 and December 31, 2001 consisted of the following:

(in thousands) Description of Issue	June 30, 2002		December 31, 2001	
	Cost	Value	Cost	Value
10-year Treasury, due August 2011	$2,074	$2,008	$19,175	$17,989
10-year Treasury, due August 2011	1,010	1,040	5,693	5,656
10-year Treasury, due August 2011	7,585	7,917	23,636	23,618
5-year Treasury, due February 2006	5,590	5,746		
10-year Treasury, due August 2011	19,404	19,903		
10-year Treasury, due February 2012	2,624	2,665		
10-year Treasury, due February 2012	25,351	26,445		
10-year Treasury, due February 2012	18,990	19,065		
	$82,628	$84,789	$48,504	$47,263

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

June 30, 2002 and December 31, 2001, respectively.

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 15. Financial Highlights

	At and for the Six Months Ended June 30,		At and for the Years Ended December 31,				
	2002(5)	2001(5)	2001	2000	1999	1998	1997
Per Common Share Data							
Net asset value, beginning of period	$13.57	$12.11	$12.11	$10.20	$8.79	$8.07	$8.34
Net investment income before income tax benefit (expense) and net realized and unrealized gains(1)	0.94	0.92	1.92	1.53	1.18	1.06	0.94
Income tax benefit (expense)(1)		0.01		(0.01)	(0.03)		
Net realized and unrealized gains(1)	0.32	0.18	0.23	0.41	0.46	0.45	0.36
Minority interests(1)				(0.03)			

Net increase in net assets resulting from operations	1.26	1.10	2.16	1.94	1.64	1.50	1.24
Net decrease in net assets from shareholder distributions(2)	(1.08)	(0.99)	(2.01)	(1.82)	(1.60)	(1.43)	(1.71)
Net increase in net assets from capital share transactions	0.27	0.57	1.31	1.79	1.37	0.65	0.20
Net asset value, end of period	$14.02	$12.79	$13.57	$12.11	$10.20	$8.79	$8.07
Market value, end of period							

$22.65 $23.15 $26.00 $20.88 $18.31 $17.31 $22.25
Total return
(9.18)% 15.56% 35.43% 25.47% 14.99% (15.74)% 77.76%

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

Ending net assets
$1,434,453 $1,171,661 $1,352,123 $1,029,692 $667,513 $491,358 $420,060
Common shares outstanding at end of period(3)
102,296 91,578 99,607 85,057 65,414 55,919 52,047
Diluted weighted average shares outstanding
102,900 88,966 93,003 73,472 60,044 51,974 49,251
Employee and administrative expenses/ average net assets
1.74% 1.85% 3.80% 4.98% 6.25% 7.09% 4.66%
Total expenses/average net assets(4)
4.26% 4.79% 9.31% 11.88% 12.44% 11.86% 12.43%
Net investment income/ average net assets(4)
6.94% 7.54% 15.15% 13.55% 12.61% 12.72% 11.15%
Portfolio turnover rate
8.33% 6.27% 10.04% 28.92% 34.19% 63.53% 42.72%
Average debt outstanding
$940,357 $812,500 $847,121 $707,400 $461,500 $261,300 $336,800
Average debt per share
$9.14 $9.13 $9.11 $9.63 $7.69 $5.03 $6.84

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

(2) For the year ended December 31, 1997, shareholder distributions include $0.51 of merger-related dividends.

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

(4) For the purpose of calculating the ratios, total expenses and net investment income for the year ended December 31, 1997 exclude merger expenses of $5,159,000.

(5) The results for the six months ended June 30, 2002 and 2001, respectively, are not necessarily indicative of the operating results to be expected for the full year.

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 16. Selected Quarterly Data (Unaudited)

	2001			
(in thousands, except per share amounts)	**Qtr 1**	**Qtr 2**	**Qtr 3**	**Qtr 4**
Total interest and related portfolio income	$65,071	$68,739	$72,634	$82,666
Net investment income before net realized and unrealized gains	$39,728	$42,118	$44,189	$53,016
Net increase in net assets resulting from operations	$52,028	$46,106	$59,703	$42,890
Basic earnings per common share	$0.61	$0.52	$0.64	$0.44
Diluted earnings per common share	$0.60	$0.51	$0.63	$0.43

	2000			
	Qtr 1	**Qtr 2**	**Qtr 3**	**Qtr 4**
Total interest and related portfolio income	$43,897	$49,965	$55,992	$61,735
Net investment income before net realized and unrealized gains	$22,573	$24,700	$30,719	$34,725
Net increase in net assets resulting from operations	$29,581	$34,790	$36,449	$42,281
Basic earnings per common share	$0.45	$0.50	$0.48	$0.52
Diluted earnings per common share	$0.45	$0.50	$0.48	$0.52

Note 17. Litigation

As of August 13, 2002, the Company is aware of seven class action lawsuits that have been filed in the United States District Court for the Southern District of New York against the Company, certain of its directors and officers and the Company s former independent auditors, Arthur Andersen LLP, with respect to alleged violations of the securities laws. All of the actions essentially duplicate one another, pleading essentially the same allegations. The complaints filed in the lawsuits allege violations of Sections 10(b) and 20(a) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder, specifically alleging, among other things, that the Company misstated the value of certain portfolio investments in its financial statements, which allegedly resulted in the purchase of the Company s common stock by purported class members at artificially inflated prices. Several of the complaints also allege state law claims for common law fraud. The lawsuits seek compensatory and other damages, and costs and expenses associated with the litigation. The Company believes that each of the lawsuits is without merit, and the Company intends to defend each of these lawsuits vigorously. While the Company does not expect these matters to materially affect its financial condition or results of operations, there can be no assurance of any particular outcome.

The Company also is party to certain other lawsuits in the normal course of business. While the outcome of these legal proceeding cannot at this time be predicted with certainty, the Company does not expect that these proceedings will have a material effect upon the Company s financial condition or results of operations.

Note 18. Subsequent Events

On July 1, 2002, the Company completed the sale of WyoTech Acquisition Corporation for approximately $84.4 million in cash. The Company s total cash proceeds from the sale of WyoTech, including the repayment of debt and preferred stock and the sale of the Company s 91% common equity ownership, were approximately $77.0 million, resulting in a realized gain of $60.6 million in

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 18. Subsequent Events, continued

the third quarter of 2002 on the transaction. The sale of WyoTech is subject to post-closing working capital adjustments, if any, and customary indemnification provisions. Total interest and related portfolio income earned from WyoTech for the three months ended June 30, 2002 was $1.8 million, which will no longer occur due to the sale of the investment on July 1, 2002.

On July 31, 2002, the Company completed the sale of $82.7 million of CMBS, which resulted in a realized gain of approximately $12 million. The bonds sold had an effective yield of 12%. Additionally, the Company reversed previously recorded net unrealized appreciation of approximately $5 million related to these bonds.

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

CONSOLIDATING BALANCE SHEET

	December 31, 2001				
	Allied Capital	Allied Investment	Others	Eliminations	Consolidated Total
	(in thousands)				
ASSETS					
Portfolio at value:					
Private finance	$1,414,411	$165,161	$15,500	$	$1,595,072
Commercial real estate finance	649,283	3,764	81,471		734,518
Investments in subsidiaries	152,659			(152,659)	
Total portfolio at value	2,216,353	168,925	96,971	(152,659)	2,329,590
Intercompany notes and receivables	57,176	3,195	8,916	(69,287)	
Other assets	104,344	8,244	17,646		130,234
Cash and cash equivalents	690	173	26		889
Total assets	$2,378,563	$180,537	$123,559	$(221,946)	$2,460,713

LIABILITIES AND SHAREHOLDERS EQUITY

Liabilities:

Notes payable and debentures	$781,556	$94,500	$	$	$876,056
Revolving credit facilities	144,750				144,750
Accounts payable and other liabilities	66,692	2,219	11,873		80,784
Intercompany notes and payables	31,058	415	37,818	(69,291)	
Total liabilities	1,024,056	97,134	49,691	(69,291)	1,101,590
Commitments and contingencies					
Preferred stock		7,000			7,000
Shareholders equity:					
Common stock	10		1	(1)	10
Additional paid-in capital	1,352,688	49,673	77,494	(127,167)	1,352,688
Notes receivable from sale of common stock	(23,645)		(2,383)		(26,028)
Net unrealized appreciation (depreciation) on portfolio	39,982	10,027	(1,801)	(8,227)	39,981
Undistributed (distributions in excess of) earnings	(14,528)	16,703	557	(17,260)	(14,528)

Total shareholders equity	1,354,507	76,403	73,868	(152,655)	1,352,123
Total liabilities and shareholders equity	$2,378,563	$180,537	$123,559	$(221,946)	$2,460,713

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

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

CONSOLIDATING STATEMENT OF OPERATIONS

	December 31, 2001				
(in thousands)	Allied Capital	Allied Investment	Others	Eliminations	Consolidated Total
Interest and Related Portfolio Income					
Interest and dividends	$217,392	$16,059	$7,013	$	$240,464
Intercompany interest	588			(588)	
Premiums from loan dispositions	2,504				2,504
Income from investments in wholly owned subsidiaries	11,416			(11,416)	
Fees and other income	25,920	389	19,833		46,142
Total interest and related portfolio income	257,820	16,448	26,846	(12,004)	289,110
Expenses					
Interest	58,066	7,038			65,104
Intercompany interest		41	547	(588)	
Employee	14,851		14,805		29,656
Administrative	8,811	146	6,342		15,299

Total operating expenses	81,728	7,225	21,694	(588)	110,059
Net investment income before income tax benefit and net realized and unrealized gains	176,092	9,223	5,152	(11,416)	179,051
Income tax benefit			412		412
Net investment income before net realized and unrealized gains	176,092	9,223	5,564	(11,416)	179,463

Net Realized and Unrealized Gains					
Net realized gains (losses)	4,032	(2,762)	(609)		661
Net unrealized gains (losses)	20,603	2,794	(80)	(2,714)	20,603
Total net realized and unrealized gains (losses)	24,635	32	(689)	(2,714)	21,264
Net increase in net assets resulting from operations	$200,727	$9,255	$4,875	$(14,130)	$200,727

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

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

CONSOLIDATING STATEMENT OF CASH FLOWS

	December 31, 2001				
	Allied Capital	Allied Investment	Others	Eliminations	Consolidated Total
(in thousands)					
Cash Flows from Operating Activities					
Net increase in net assets resulting from operations	$200,727	$9,255	$4,875	$(14,130)	$200,727
Adjustments					
Portfolio investments	(651,001)	(18,449)	(5,722)		(675,172)
Repayments of investment principal	64,786	9,675			74,461
Proceeds from investment sales	129,980				129,980
Change in accrued or reinvested interest and dividends	(49,138)	(2,416)			(51,554)
Net change in intercompany investments	7,352	(7,006)	(11,762)	11,416	
Changes in other assets and liabilities	(649)	(7,734)	9,673		1,290
Amortization of loan discounts and fees	(12,937)	(992)			(13,929)
Depreciation and amortization	327	667			994
Realized losses	4,925	3,902	619		9,446
Net unrealized (gains) losses	(20,603)	(2,794)	80	2,714	(20,603)
Net cash used in operating activities	(326,231)	(16,559)	(1,570)		(344,360)

Cash Flows from Financing Activities

Sale of common stock	286,888				286,888
Sale of common stock upon the exercise of stock options	5,428				5,428
Collections of notes receivable from sale of common stock	5,090				5,090
Common dividends and distributions paid	(179,826)				(179,826)
Preferred stock dividends paid		(220)	(10)		(230)
Net borrowings under notes payable and debentures	150,000	16,150			166,150
Net borrowings under revolving lines of credit	62,750				62,750
Other	(3,450)				(3,450)
Net cash provided by (used in) financing activities	326,880	15,930	(10)		342,800
Net increase (decrease) in cash and cash equivalents	$649	$(629)	$(1,580)	$	$(1,560)
Cash and cash equivalents at beginning of year	$41	$802	$1,606	$	$2,449

Cash and cash equivalents at end of year	$690	$173	$26	$	$889

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

NOTE: THIS IS A COPY OF A REPORT PREVIOUSLY ISSUED BY ARTHUR ANDERSEN LLP, ALLIED CAPITAL CORPORATION S FORMER INDEPENDENT ACCOUNTANTS. THIS REPORT HAS NOT BEEN REISSUED BY ARTHUR ANDERSEN LLP IN CONNECTION WITH FILING OF THE REGISTRATION STATEMENT OF WHICH THIS PROSPECTUS IS A PART.

REPORT OF INDEPENDENT PUBLIC ACCOUNTANTS

To the Shareholders and Board of Directors

of Allied Capital Corporation and Subsidiaries:

We have audited the accompanying consolidated balance sheets of Allied Capital Corporation and subsidiaries as of December 31, 2001 and 2000, including the consolidated statement of investments as of December 31, 2001, and the related consolidated statements of operations, changes in net assets and cash flows for each of the three years in the period then ended, and the financial highlights (included in Note 15) for the year ended December 31, 2001. These consolidated financial statements, financial highlights and the supplementary consolidating financial information referred to below are the responsibility of the Company s management. Our responsibility is to express an opinion on these consolidated financial statements, financial highlights and the supplementary consolidating financial information referred to below based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements and financial highlights are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. Our procedures included physical counts of investments. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As discussed in Note 2, the consolidated financial statements include investments valued at $2,329,590,000 as of December 31, 2001 and $1,788,001,000 as of December 31, 2000 (172 percent and 174 percent, respectively, of net assets) whose values have been estimated by the board of directors in the absence of readily ascertainable market values. However, because of the inherent uncertainty of valuation, the board of directors estimated values may differ significantly from the values that would have been used had a ready market existed for the investments, and the differences could be material.

In our opinion, the consolidated financial statements and financial highlights referred to above present fairly, in all material respects, the financial position of Allied Capital Corporation and subsidiaries as of December 31, 2001 and 2000, and the consolidated results of their operations, changes in net assets and cash flows for each of the three years in the period then ended, and the financial highlights for the year ended December 31, 2001 in conformity with accounting principles generally accepted in the United States.

Our audit was made for the purpose of forming an opinion on the consolidated financial statements taken as a whole. The supplementary consolidating balance sheet and related consolidating statements of operations and cash flows are presented for purposes of additional analysis of the consolidated financial statements rather than to present balance sheet, statement of operations and cash flows of the individual companies and are not a required part of the consolidated financial statements. This information has been subjected to the auditing procedures applied in our audit of the consolidated financial statements and in our opinion, is fairly stated in all material respects in relation to the consolidated financial statements taken as a whole.

Vienna, Virginia

February 20, 2002

Independent Accountants Review Report

The Board of Directors and Shareholders
Allied Capital Corporation and Subsidiaries:

We have reviewed the accompanying consolidated balance sheet of Allied Capital Corporation and subsidiaries, including the consolidated statement of investments, as of June 30, 2002, and the related consolidated statements of operations, changes in net assets and cash flows for the six-month period then ended, and financial highlights (included in Note 15) for the six-month period ended June 30, 2002. These consolidated financial statements and financial highlights are the responsibility of the Company s management.

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

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

/s/ KPMG LLP

Washington, D.C.
July 22, 2002, except as to notes 17 and 18 which are
as of August 13, 2002 and July 31, 2002, respectively

QUESTIONS AND ANSWERS ABOUT THE RIGHTS OFFERING

1. What Is A Rights Offering?

A rights offering allows you to purchase additional shares of our common stock at a discounted market price and in an amount substantially proportional to your interests. This rights offering enables you to substantially maintain and possibly increase your current percentage ownership in us.

2. Why Is Allied Capital Making A Rights Offering?

Our board of directors has determined that this rights offering is in our best interest and in the best interests of our shareholders. We are distributing the rights to allow our common shareholders to participate in our issuance of $ million in additional equity in proportion to their ownership interest in our voting stock. The offering gives existing shareholders the right to purchase additional shares at a price below market without incurring any commission or charge. The rights offering permits our existing common shareholders to maintain their proportionate interest in us. In addition, since no underwriting or sales commission will be paid by us in respect of the shares purchased in the rights offering, we believe the rights offering will be a low-cost method for raising additional capital.

We are distributing the rights to purchase common stock as part of our plan to raise up to $ million in additional equity capital. We intend to use the proceeds from this rights offering for investments in the debt or equity securities of primarily private companies or non-investment grade commercial mortgage-backed securities and other general corporate purposes.

3. What Is Allied Capital Distributing?

We are distributing to you, at no charge, non-transferable rights to purchase additional shares of our common stock. We have granted those persons who were our shareholders on October 21, 2002, one right for every share of common stock owned by them at that time, either as a holder of record or, in the case of shares held of record by brokers, banks or other nominees, on their behalf as a beneficial owner of such shares.

For every 20 rights held you will be entitled to purchase one share of our common stock. We refer to this entitlement as the basic subscription rights. For example, if you owned 1,000 shares on the record date, you have the right to purchase 50 additional shares of our common stock at the subscription price.

4. What Is The Subscription Price?

The subscription price per share will be 93% of the average of the last reported sales price of a share of our common stock on the New York Stock Exchange on November 21, 2002, which we refer to as the pricing date, and the four preceding business days. The subscription price is expected to be above our net asset value. See Price Range of Common Stock and Distributions. Because it is not possible to determine the subscription price until the pricing date, shareholders exercising their subscription rights will not know the subscription price per share at the time they exercise their rights. As a result, we are requiring that shareholders deliver the estimated subscription price per share of $ in connection with such exercise.

The estimated subscription price is based on 93% of the last reported sale price per share on the New York Stock Exchange on October , 2002. The actual subscription price may be more or less than the estimated subscription price per share of $. If the actual subscription price is lower, excess payments will be refunded (without interest), and if the actual subscription price is higher, shareholders exercising their rights must make an additional payment by December 20, 2002.

5. How Is Allied Capital Making The Offering?

This rights offering is being made directly by us. We will not pay any underwriting discounts or commissions, finders fees or other remuneration in connection with any distribution of the rights offered by this prospectus, other than the fees paid to the information and subscription agents. We estimate that the expenses of the offering will total approximately $750,000.

6. Will I Receive Fractional Shares?

No. Fractional shares will not be issued upon the exercise of rights. Since fractional shares will not be issued, rights holders who receive, or who are left with, fewer than 20 rights will be unable to exercise such rights and will not be entitled to receive any cash in lieu of such fractional shares.

7. Can I Subscribe For Any Number Of Shares Less Than All Of My Rights?

Yes. You can subscribe for any whole number of shares exercising less than all of your basic subscription rights.

8. Has The Board Of Directors Made A Recommendation Regarding The Exercise Of Your Rights?

Our board of directors makes no recommendation to you about whether you should exercise any rights.

9. How Soon Must I Act?

The rights expire on November 21, 2002, at 5:00 p.m., New York City time. The subscription agent must actually receive all required documents and payments before that date and time. Although we have the option of extending the expiration date, we presently do not intend to do so.

10. May I Transfer My Rights?

No. The rights are non-transferable. Therefore, only the underlying shares of common stock, and not the rights, will be admitted for trading on the New York Stock Exchange.

11. Is There An Over-Subscription Right?

Yes. If you fully exercise your basic subscription rights and other shareholders do not fully exercise all of their basic subscription rights, you may elect to purchase additional shares on a pro rata basis. Fully exercising your basic subscription rights means that you have fewer than 20 rights remaining after such exercise. This is your over-subscription right.

We do not expect that all of our shareholders will exercise all of their basic subscription rights. By extending an over-subscription right to our shareholders, we are

(ii)

providing for the purchase of those shares that are not purchased through exercise of basic subscription rights. If you fully exercise your basic subscription rights, the over-subscription right entitles you to subscribe for additional shares of our common stock, to the extent they are available, at the same subscription price that applies to your basic subscription rights.

12. What Are The Limitations On The Over-Subscription Right?

We will be able to satisfy your exercise of the over-subscription right only if our other participating shareholders do not elect to purchase all of the shares offered under their basic subscription rights and you have fully exercised your basic subscription rights. We will honor over-subscription requests in full to the extent sufficient shares are available following the exercise of rights under the basic subscription rights. If over-subscription requests exceed shares available, we will allocate the available shares pro rata among those who oversubscribed based on the number of shares each subscriber for additional shares has elected to purchase under their basic subscription rights. You will have to make payment for any oversubscribed shares at the time that you exercise your basic subscription rights.

13. Am I Required To Subscribe In The Rights Offering?

No. You are not required to exercise any rights, purchase any new shares, or otherwise take any action in response to this rights offering.

14. May I Change Or Cancel My Exercise Of Rights After I Send In The Required Forms?

No. All exercises of rights are irrevocable.

15. Is Exercising My Subscription Rights Risky?

The exercise of your subscription rights involves certain risks. Exercising your subscription rights means buying additional shares of our common stock, and should be carefully considered as you would view other equity investments. Among other things, you should carefully consider the risks described under the heading Risk Factors, beginning on page 12 of this prospectus.

16. What Happens If I Choose Not To Exercise My Subscription Rights?

You will retain your current number of shares of our common stock even if you do not exercise your subscription rights. To the extent that you do not exercise your subscription rights and shares are purchased by other shareholders in this rights offering, your ownership interest and voting power will be diluted.

17. Can Allied Capital Terminate The Rights Offering?

Yes. We may terminate the rights offering at any time before the expiration of the subscription period for any reason. If we terminate the rights offering, your money will be refunded, without interest, promptly following termination. All monies received by the subscription agent in connection with this offering will be held by the subscription agent, on our behalf, in a segregated, interest-bearing account. All such interest shall be payable to us and will be used to defray offering expenses.

18. What Should I Do If I Want To Participate In The Rights Offering, But My Shares Are Held In The Name Of My Bank, Broker or Other Nominee?

If you hold shares of our common stock through a bank, broker or other nominee, we will ask your bank, broker or other nominee to notify you of the rights offering. If you wish to exercise your rights, you will need to have your bank, broker or other nominee act for you. To indicate your decision, you should complete and return to your bank, broker or other nominee the form entitled Beneficial Owner Election Form , together with full payment of the estimated subscription price for each share subscribed for under your subscription rights (including shares subscribed for through the exercise of your over-subscription right). You should receive this form from your bank, broker or other nominee with the other rights offering materials.

19. What Are The Federal Income Tax Consequences Of Exercising My Subscription Rights?

The receipt and exercise of your subscription rights are intended to be nontaxable. However, you should seek specific tax advice from your personal tax advisor with respect to your particular circumstances and tax situation.

20. When Do I Receive My New Shares?

Unless requested otherwise, stock certificates will not be issued for shares of our common stock offered in this rights offering. Shareholders who are record owners will have the shares they acquire credited to their account with our transfer agent. Shareholders whose shares of common stock are held by a nominee will have the shares they acquire credited to the account of such nominee holder.

21. What Fees Or Charges Apply If I Purchase Shares?

We are not charging any fee or sales commission to issue rights to you or to issue shares to you if you exercise rights. If you exercise rights through a record holder of your shares, you are responsible for paying any fees which that person may charge.

22. How Do I Exercise My Rights? What Forms And Payment Are Required To Purchase Shares?

As a holder of our common stock on October 21, 2002, you are receiving this prospectus, a subscription certificate and instructions on how to purchase shares. If you wish to participate in this rights offering, then before your rights expire, you must:

deliver the estimated subscription price (including payment for all shares which you wish to purchase pursuant to the over-subscription procedure) (i) by bank check, money order or check drawn on a bank located in the U.S. that clears before expiration of the rights, or (ii) by wire transfer to the subscription agent; and

deliver a properly completed subscription certificate with any required signature guarantees or other supplemental documentation.

23. What Should I Do If I Have Other Questions?

If you have questions, need additional copies of offering documents or otherwise need assistance, you should contact Georgeson Shareholder Communications, Inc. toll-free at (866) 206-4938. You may also contact us at 1-888-818-5298 or contact your bank, broker or other nominee for information with respect to this rights offering.

PART C

OTHER INFORMATION

Item 24. Financial Statements and Exhibits

1. Financial Statements.

The following financial statements of Allied Capital Corporation (the Company or the Registrant) are included in this registration statement in Part A: Information Required in a Prospectus :

2. Exhibits

Exhibit Number	Description
a.1	Restated Articles of Incorporation. *(Incorporated by reference to Exhibit a.1 filed with Allied Capital s Post-Effective Amendment No. 2 to registration statement on Form N-2 (File No. 333-67336) filed on March 22, 2002).*
b.	Amended and Restated Bylaws. *(Incorporated by reference to Exhibit b. filed with Allied Capital s Post-Effective Amendment No. 2 to registration statement on Form N-2 (File No. 333-67336) filed on March 22, 2002).*
c.	Not applicable.
d.1	Specimen Certificate of Allied Capital s Common Stock, par value $0.0001 per share. *(Incorporated by reference to Exhibit d. filed with Allied Capital s registration statement on Form N-2 (File No. 333-51899) filed on May 6, 1998).*
d.2*	Form of Instructions for Use of Subscription Certificates.
d.3*	Form of Notice to Shareholders Who are Record Holders.
d.4*	Form of Notice to Shareholders Who are Beneficial Holders.
d.5*	Form of Notice to Clients of Shareholders Who are Beneficial Holders.
d.6*	Form of Subscription Certificate.

d.7*	Form of Nominee Holder Certification Form.
d.8*	Form of Beneficial Owner Election Form.
d.9*	Form of Nominee Holder Over-Subscription Exercise Form.
d.10*	Form of Notice of Guaranteed Delivery.

Exhibit Number	Description
d.11*	Subscription Agent Agreement between Allied Capital and American Stock Transfer & Trust Company.
d.12*	Information Agent Agreement between Allied Capital and Georgeson Shareholder Communications, Inc.
e.	Dividend Reinvestment Plan, as amended. *(Incorporated by reference to Exhibit e. filed with Allied Capital s registration statement on Form N-2 (File No. 333-87862) filed on May 8, 2002).*
f.1	Form of debenture between certain subsidiaries of Allied Capital and the U.S. Small Business Administration. *(Incorporated by reference to Exhibit 4.2 filed by a predecessor entity to Allied Capital on Form 10-K for the year ended December 31, 1996).*
f.2	Second Amended and Restated Credit Agreement, dated August 3, 2001. *(Incorporated by reference to Exhibit f.2.g filed with Allied Capital s registration statement on Form N-2 (File No. 333-67336) filed on August 10, 2001).*
f.3	Note Agreement, dated as of April 30, 1998. *(Incorporated by reference to Exhibit 10.2 filed with Allied Capital s Form 10-Q for the period ended June 30, 1998).*
f.4	Loan Agreement between a predecessor entity to Allied Capital and Overseas Private Investment Corporation, dated April 10, 1995. *(Incorporated by reference to Exhibit f.7 filed by a predecessor entity to Allied Capital to Pre-Effective Amendment No. 2 to the registration statement on Form N-2 (File No. 33-64629) filed on January 24, 1996).* Letter, dated December 11, 1997, evidencing assignment of Loan Agreement from the predecessor entity of Allied Capital to Allied Capital. *(Incorporated by reference to Exhibit 10.3 of Allied Capital s Form 10-K for the year ended December 31, 1997).*
f.5	Note Agreement, dated as of May 1, 1999. *(Incorporated by reference to Exhibit 10.5 filed with Allied Capital s Form 10-Q for the period ended June 30, 1999).*
f.6	Amendment and Consent Agreement, dated December 11, 2000, to the Amended and Restated Credit Agreement, dated May 17, 2000. *(Incorporated by reference to Exhibit f.6 filed with Allied Capital s Post-Effective Amendment No. 2 to registration statement on Form N-2 (File No. 333-43534) filed on March 21, 2001).*
f.7.	Sale and Servicing Agreement, dated as of January 1, 1998, among Allied Capital CMT, Inc., Allied Capital Commercial Mortgage Trust 1998-1, Allied Capital Corporation, LaSalle National Bank and ABN AMRO Bank N.V. *(Incorporated by reference to Exhibit f.7.a filed with Allied Capital s registration statement on Form N-2 (File No. 333-51899) filed on May 6, 1998).*
f.8	Indenture, dated as of January 1, 1998, between Allied Capital Commercial Mortgage Trust 1998-1 and LaSalle National Bank. *(Incorporated by reference to Exhibit f.7.b filed with Allied Capital s registration statement on Form N-2 (File No. 333-51899) filed on May 6, 1998).*
f.9	Amended and Restated Trust Agreement, dated January 1, 1998, between Allied Capital CMT, Inc., LaSalle National Bank Inc. and Wilmington Trust Company. *(Incorporated by reference to Exhibit f.7.c filed with Allied Capital s registration statement on Form N-2 (File No. 333-51899) filed on May 6, 1998).*

Exhibit Number	Description
f.10	Guaranty, dated as of January 1, 1998, by Allied Capital. *(Incorporated by reference to Exhibit f.7.d filed with Allied Capital s registration statement on Form N-2 (File No. 333-51899) filed on May 6, 1998).*
f.11	Note Agreement, dated as of November 15, 1999. *(Incorporated by reference to Exhibit 10.4a of Allied Capital s Form 10-K for the year ended December 31, 1999).*
f.12	Note Agreement, dated as of October 15, 2000. *(Incorporated by reference to Exhibit 10.4b filed with Allied Capital s Form 10-Q for the period ended September 30, 2000).*
f.13	Note Agreement, dated as of October 15, 2001. *(Incorporated by reference to Exhibit f.10 filed with Allied Capital s Post-Effective Amendment No. 1 to registration statement on Form N-2 (File No. 333-67336) filed on November 14, 2001).*
f.14	Auction Rate Reset Note Agreement, dated as of August 31, 2000, between Allied Capital and Intrepid Funding Master Trust; Forward Issuance Agreement, dated as of August 31, 2000, between Allied Capital and Banc of America Securities LLC; Remarketing and Contingency Purchase Agreement, dated as of August 31, 2000, between Allied Capital and Banc of America Securities LLC. *(Incorporated by reference to Exhibit f.12 filed with Allied Capital s Pre-Effective Amendment No. 1 to registration statement on Form N-2 (File No. 333-43534) filed on September 12, 2000).*
f.15	Control Investor Guaranty Agreement, dated as of March 28, 2001, between Allied Capital and Fleet National Bank and Business Loan Express, Inc. *(Incorporated by reference to Exhibit f.14 filed with Allied Capital s Post-Effective Amendment No. 3 to registration statement on Form N-2 (File No. 333-43534) filed on May 15, 2001).*
g.	Not applicable.
h.	Not applicable.
i.1	Amended and Restated Deferred Compensation Plan, dated December 30, 1998. *(Incorporated by reference to Exhibit 10.11 of Allied Capital s Form 10-K for the year ended December 31, 1998).*
i.2	Amendment to Deferred Compensation Plan, dated October 18, 2000. *(Incorporated by reference to Exhibit i.2.a filed with Allied Capital s Post-Effective Amendment No. 1 to registration statement on Form N-2 (File No. 333-43534) filed on January 19, 2001).*
i.3	Amended and Restated Deferred Compensation Plan, dated May 15, 2001. *(Incorporated by reference to Exhibit i.2.b filed with Allied Capital s Post-Effective Amendment No. 1 to registration statement on Form N-2 (File No. 333-67336) filed on November 14, 2001).*
i.4	Amended Stock Option Plan. *(Incorporated by reference to Exhibit A of Allied Capital s definitive proxy statement for Allied Capital s 2002 Annual Meeting of Stockholders filed on April 3, 2002).*
i.5	Allied Capital Corporation 401(k) Plan, dated September 1, 1999. *(Incorporated by reference to Exhibit 4.4 filed with Allied Capital s registration statement on Form S-8 (File No. 333-88681) filed on October 8, 1999).*

Exhibit Number	Description
i.6	Amendment to Allied Capital Corporation 401(k) Plan, dated December 31, 2000. *(Incorporated by reference to Exhibit i.5.a filed with Allied Capital s Post-Effective Amendment No. 1 to registration statement on Form N-2 (File No. 333-43534) filed on January 19, 2001).*
i.7	Employment Agreement, dated June 15, 2000, between Allied Capital and William L. Walton. *(Incorporated by reference to Exhibit f.9 filed with Allied Capital s registration statement on Form N-2 (File No. 333-43534) filed on August 11, 2000).*
i.8	Employment Agreement, dated June 15, 2000, between Allied Capital and Joan M. Sweeney. *(Incorporated by reference to Exhibit f.10 filed with Allied Capital s registration statement on Form N-2 (File No. 333-43534) filed on August 11, 2000).*
i.9	Employment Agreement, dated June 15, 2000, between Allied Capital and John M. Scheurer. *(Incorporated by reference to Exhibit f.10 filed with Allied Capital s Post-Effective Amendment No. 2 to registration statement on Form N-2 (File No. 333-43534) filed on March 21, 2001).*
j.1	Form of Custody Agreement with Riggs Bank N.A. *(Incorporated by reference to Exhibit j.1 filed with Allied Capital s registration statement on Form N-2 (File No. 333-51899) filed on May 6, 1998).*
j.2	Form of Custody Agreement with LaSalle National Bank. *(Incorporated by reference to Exhibit j.2 filed with Allied Capital s registration statement on Form N-2 (File No. 333-51899) filed on May 6, 1998).*
j.3	Custodian Agreement with LaSalle National Bank Association dated July 9, 2001. *(Incorporated by reference to Exhibit j.3 filed with Allied Capital s registration statement on Form N-2 (File No. 333-67336) filed on August 10, 2001).*
l.*	Opinion of counsel and consent to its use.
m.	Not applicable.
n.1*	Consent of Sutherland Asbill & Brennan LLP. *(Contained in Exhibit l.)*
n.2.	Consent of Arthur Andersen LLP *(Omitted in reliance on Rule 437a of the Securities Act of 1933).*
n.3.*	Letter regarding Unaudited Interim Financial Information.
o.	Not applicable.
p.	Not applicable.
q.	Not applicable.
r.	Code of Ethics. *(Incorporated by reference to Exhibit r. filed with Allied Capital s Pre-Effective Amendment No. 1 to the registration statement on Form N-2 (File No. 333-43534) on September 12, 2000).*

* Filed herewith.

Item 25. Marketing Arrangements

Not applicable.

Item 26. Other Expenses of Issuance and Distribution*

Commission registration fee	$11,278*
Information Agent Fees	25,000
Subscription Agent Fees	35,000
New York Stock Exchange Additional Listing Fee	5,000
Accounting fees and expenses	50,000
Legal fees and expenses	150,000
Printing and engraving	425,000
Miscellaneous fees and expenses	48,722
Total	$750,000

* Estimated for filing purposes and excludes fees previously paid.

Item 27. Persons Controlled by or Under Common Control

Direct Subsidiaries

The following list sets forth each of our subsidiaries, the state or country under whose laws the subsidiary is organized, and the percentage of voting securities or membership interests owned by us in such subsidiary:

Allied Investment Corporation (Maryland)	100%
Allied Capital REIT, Inc. (Allied REIT) (Maryland)	100%
A.C. Corporation (Delaware)	100%
Allied Capital Holdings, LLC (Delaware)	100%
Allied Capital Beteiligungsberatung GmbH (Germany)	100%

Each of our subsidiaries are consolidated for financial reporting purposes, except as noted below.

Indirect Subsidiaries

We indirectly control the entities set forth below through Allied REIT. Allied REIT owns either all of the membership interests (in the case of a limited liability company, LLC) or all of the outstanding voting stock (in the case of a corporation) of each entity. The following list sets forth each of Allied REIT s subsidiaries, the state under whose laws the subsidiary is organized, and the percentage of voting securities or membership interests owned by Allied REIT of such subsidiary:

Allied Capital Property LLC (Delaware)	100%
Allied Capital Equity LLC (Delaware)	100%
9586 I-25 East Frontage Road, Longmont, CO 80504 LLC (Delaware)	100%
Allied Capital CMT, Inc. (Delaware)	100%

Allied REIT also indirectly owns Allied Capital Commercial Mortgage Trust 1998-1, a Delaware business trust that is wholly owned by Allied Capital CMT, Inc. (CMT). Each subsidiary of Allied REIT and CMT is not required to maintain financial and other reports required under the Securities Act because each does not have a class of securities registered under the Securities Act.

We indirectly control Allied Investment Holdings LLC (Delaware) through Allied Investment Corporation, which owns 100% of the membership interests.

Other Entities Deemed to be Controlled by the Company

We provide investment advisory services or loan servicing services to the certain entities and therefore may be deemed to control such entities and their respective subsidiaries. The following list sets forth each such entity and its respective subsidiaries and the state under whose laws the entity or subsidiary is organized:

Allied Capital Germany Fund LLC (Delaware)(1 and 2)

We have also established certain limited purpose entities in order to facilitate certain portfolio transactions. In addition, we may be deemed to control certain portfolio companies. See Portfolio Companies in the prospectus.

(1) By so including these entities herein, the Registrant does not concede that it controls such entities.
(2) Subsidiary does not consolidate for financial reporting purposes.

Item 28. Number of Holders of Securities

The following table sets forth the approximate number of record holders of our common stock at October 2, 2002.

Title of Class	Number of Record Holders
Common stock, $0.0001 par value	5,151

We have privately issued long-term debt securities to 23 institutional lenders, primarily insurance companies.

Item 29. Indemnification

Section 2-418 of the Maryland General Corporation Law provides that a Maryland corporation may indemnify any director of the corporation and any person who, while a director of the corporation, is or was serving at the request of the corporation as a director, officer, partner, trustee, employee, or agent of another foreign or domestic corporation, partnership, joint venture, trust, other enterprise or employee benefit plan, made a party to any proceeding by reason of service in that capacity unless it is established that the act or omission of the director was material to the matter giving rise to the proceeding and was committed in bad faith or was the result of active and deliberate dishonesty; or the director actually received an improper personal benefit in money, property or services; or, in the case of any criminal proceeding, the director had reasonable cause to believe that the act or omission was unlawful. Indemnification may be made against judgments, penalties, fines, settlements, and reasonable expenses actually incurred by the director in connection with the proceeding, but if the proceeding was one by or in the right of the corporation, indemnification may not be made in respect of any proceeding in which the director shall have been adjudged to be liable to the corporation. Such indemnification may not be made unless authorized for a specific proceeding after a determination has been made, in the manner prescribed by the law, that indemnification is permissible in the circumstances because the director has met the applicable standard of conduct. On the other hand, the director must be indemnified for expenses if he or she has been successful in the defense of the proceeding or as otherwise ordered by a court. The law also prescribes the circumstances under which the corporation may advance expenses to, or obtain insurance or similar cover for, directors.

The law also provides for comparable indemnification for corporate officers and agents.

The Restated Articles of Incorporation of Allied Capital provide that its directors and officers shall, and its agents in the discretion of the board of directors may be indemnified to the fullest extent permitted from time to time by the laws of Maryland (with such power to indemnify officers and directors limited to the scope provided for in Section 2-418 as currently in force), provided, however, that such indemnification is limited by the Investment Company Act of 1940 or by any valid rule, regulation or order of the Securities and Exchange Commission thereunder. Allied Capital s Bylaws, however, provide that Allied Capital may not indemnify any director or officer against liability to Allied Capital or its security holders to which he or she might otherwise be subject by reason of such person s willful misfeasance, bad faith, gross negligence or reckless disregard of the duties involved in the conduct of his or her office unless a determination is made by final decision of a court, by vote of a majority of a quorum of directors who are disinterested, non-party directors or by independent legal counsel that the liability for which indemnification is sought did not arise out of such disabling conduct.

Insofar as indemnification for liabilities arising under the Securities Act of 1933 may be permitted to directors, officers and controlling persons of Allied Capital pursuant to the provisions described above, or otherwise, Allied Capital has been advised that in the opinion of the Securities and Exchange Commission such indemnification is against public policy as expressed in the Act and is, therefore, unenforceable. In the event that a claim for indemnification against such liabilities (other than the payment by Allied Capital of expenses incurred or paid by a director, officer or controlling person in the successful defense of an action, suit or proceeding) is asserted by a director, officer or controlling person in connection with the securities being registered, Allied Capital will, unless in the opinion of its counsel the matter has been settled by controlling precedent, submit to a court of appropriate jurisdiction the question whether such indemnification by it is against public policy as expressed in the Act and will be governed by the final adjudication of the court of the issue.

Allied Capital carries liability insurance for the benefit of its directors and officers on a claims-made basis of up to $50,000,000, subject to a $500,000 retention and the other terms thereof.

The Agreement and Plan of Merger (the Merger Agreement) by and among Allied Capital Advisers, Allied Capital Corporation, Allied Capital Corporation II, Allied Capital Lending Corporation and Allied Capital Commercial Corporation provides that, from and after consummation of the merger Allied Capital shall indemnify any person who at the date of the Merger Agreement, or had been at any time prior to such date or who becomes prior to the effective time of the merger, an officer or director of the companies noted above other than Allied Capital Lending Corporation, or any of their respective subsidiaries, from any and all liabilities resulting from their acts and omissions prior to the effective time of the merger to the full extent permitted by Section 2-418 of the Maryland General Corporation Law and the 1940 Act, including but not limited to acts and omissions arising out of or pertaining to the merger, and shall maintain in effect for at least 72 months directors and officers liability insurance policies with respect to matters occurring prior to the effective time of the merger.

Item 30. Business and Other Connections of Investment Adviser

Not applicable.

Item 31. Location of Accounts and Records

We maintain at our principal office physical possession of each account, book or other document required to be maintained by Section 31(a) of the 1940 Act and the rules thereunder.

Item 32. Management Services

Not applicable.

Item 33. Undertakings

We hereby undertake:

(1) to suspend the offering of shares until the prospectus is amended if subsequent to the effective date of this registration statement, our net asset value declines more than ten percent from our net asset value as of the effective date of this registration statement or (2) our net asset value increases to an amount greater than our net proceeds as stated in the prospectus;

(2) in the event that the securities being registered are to be offered to existing stockholders pursuant to warrants or rights, and any securities are to be offered to the public, to supplement the prospectus, after the expiration of the subscription period, to set forth the results of the subscription offer, the transactions by underwriters during the subscription period, the amount of unsubscribed securities to be purchased by underwriters, and the terms of any subsequent reoffering thereof. We further undertake that if any public offering by the underwriters of the securities being registered is to be made on terms differing from those set forth on the cover page of the prospectus, we shall file a post-effective amendment to set forth the terms of such offering.

(3) to file, during any period in which offers or sales are being made, a post-effective amendment to this registration statement:

(i) to include any prospectus required by Section 10(a)(3) of the Securities Act of 1933;

(ii) to reflect in the prospectus any facts or events arising after the effective date of the registration statement (or the most recent post-effective amendment thereof) which, individually or in the aggregate, represent a fundamental change in the information set forth in the registration statement. Notwithstanding the foregoing, any increase or decrease in volume of securities offered (if the total dollar value of securities offered would not exceed that which was registered) and any deviation from the low or high end of the estimated maximum offering range may be reflected in the form of prospectus filed with the Commission pursuant to Rule 424(b) under the Securities Act of 1933 if, in the aggregate, the changes in volume and price represent no more than a 20% change in the maximum aggregate offering price set forth in the Calculation of Registration Fee table in the effective registration statement; and

(iii) to include any material information with respect to the plan of distribution not previously disclosed in the registration statement or any material change to such information in the registration statement.

(4) that, for the purpose of determining any liability under the Securities Act of 1933, the information omitted from the form of prospectus filed as part of this registration statement in reliance upon Rule 430A and contained in a form of

prospectus filed by us under Rule 497(h) under the Securities Act of 1933 shall be deemed to be part of this registration statement as of the time it was declared effective;

(5) to remove from registration by means of a post-effective amendment any of the securities being registered which remain unsold at the termination of the offering; and

(6) that, for the purpose of determining any liability under the Securities Act of 1933, each post effective amendment that contains a form of prospectus shall be deemed to be a new registration statement relating to the securities offered therein, and the offering of the securities at that time shall be deemed to be the initial bona fide offering thereof.

SIGNATURES

Pursuant to the requirements of the Securities Act of 1933, the Registrant has duly caused this registration statement to be signed on its behalf by the undersigned, thereunto duly authorized, in the City of Washington, in the District of Columbia, on the 15th day of October, 2002.

ALLIED CAPITAL CORPORATION

By: /s/ WILLIAM L. WALTON

William L. Walton,
Chairman of the Board, Chief
Executive Officer and
President

Pursuant to the requirements of the Securities Act of 1933, this Registration Statement has been signed by the following persons in the capacities indicated on October 15, 2002.

Signature	Title
/s/ WILLIAM L. WALTON William L. Walton	Chairman of the Board, Chief Executive Officer, and President
* Brooks H. Browne	Director
* John D. Firestone	Director
* Anthony T. Garcia	Director
* Lawrence I. Hebert	Director
* John I. Leahy	Director
* Robert E. Long	Director
* Warren K. Montouri	Director
*	Director

Guy T. Steuart II

*	Director
T. Murray Toomey	

Signature	Title
* Laura W. van Roijen	Director
* George C. Williams, Jr.	Director
/s/ PENNI F. ROLL Penni F. Roll	Chief Financial Officer (Principal Financial and Accounting Officer)

* Signed by William L. Walton pursuant to a power of attorney signed by each individual and filed with this registration statement on August 20, 2002.

INDEX TO EXHIBITS

Exhibit Number	Description
Ex - 99.d.2	Form of Instructions for Use of Subscription Certificates
Ex - 99.d.3	Form of Notice to Shareholders Who are Record Holders
Ex - 99.d.4	Form of Notice to Shareholders Who are Beneficial Holders
Ex - 99.d.5	Form of Notice to Clients of Shareholders Who are Beneficial Holders
Ex - 99.d.6	Form of Subscription Certificate
Ex - 99.d.7	Form of Nominee Holder Certification Form
Ex - 99.d.8	Form of Beneficial Owner Election Form
Ex - 99.d.9	Form of Nominee Holder Over-Subscription Exercise Form
Ex - 99.d.10	Form of Notice of Guaranteed Delivery
Ex - 99.d.11	Subscription Agent Agreement between Allied Capital and American Stock Transfer & Trust Company
Ex - 99.d.12	Information Agent Agreement between Allied Capital and Georgeson Shareholder Communications, Inc.
Ex - 99.1	Opinion of counsel and consent to its use
Ex - 99.n.3	Letter regarding Unaudited Interim Financial Information