

ALLIED CAPITAL CORP

Form 10-Q/A

June 12, 2002

**FORM 10-Q/A**

**SECURITIES AND EXCHANGE COMMISSION**

**WASHINGTON, DC 20549**

**QUARTERLY REPORT PURSUANT TO**

**SECTION 13 OR 15(d) OF  
THE SECURITIES EXCHANGE ACT OF 1934**

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**For The Quarterly Period**

**Ended March 31, 2002 Commission File Number:  
0-22832**

**ALLIED CAPITAL CORPORATION**

*(Exact Name of Registrant as Specified in its Charter)*

**Maryland**

*(State or Jurisdiction of*

*Incorporation or Organization) 52-1081052*

*(IRS Employer  
Identification No.)*

**1919 Pennsylvania Avenue, N.W.**

**Washington, DC 20006**

*(Address of Principal Executive Offices)*

**Registrant's telephone number, including area code: (202) 331-1112**

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Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 12 of 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter periods as the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

YES  NO

On May 2, 2002 there were 101,930,554 shares outstanding of the Registrant's common stock, \$0.0001 par value.

**EXPLANATORY NOTE**

This Form 10-Q/A amends the Registrant's quarterly report on Form 10-Q for the quarter ended March 31, 2002, as filed with the Securities and Exchange Commission on May 8, 2002, and is being filed to include a report of the Registrant's independent auditors regarding the review of the Registrant's interim financial statements. In addition, the Form 10-Q/A includes disclosure regarding the filing of several class action lawsuits against the Registrant alleging

violations of the securities laws.

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**ALLIED CAPITAL CORPORATION**

**FORM 10-Q INDEX**

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

Consolidated  
Balance Sheet as of  
March 31, 2002  
(unaudited) and  
December 31, 2001

1

Consolidated  
Statement of  
Operations For the  
Three Months Ended  
March 31, 2002 and  
2001 (unaudited)

2

Consolidated  
Statement of  
Changes in Net  
Assets For the  
Three Months Ended  
March 31, 2002 and  
2001 (unaudited)

3

Consolidated  
Statement of Cash  
Flows For the Three  
Months Ended  
March 31, 2002 and  
2001 (unaudited)

4

Consolidated  
Statement of  
Investments as of  
March 31, 2002  
(unaudited) and  
December 31, 2001

5

Notes to  
Consolidated  
Financial Statements

21

Independent  
Accountants Review  
Report

36

PART II. OTHER  
INFORMATION

Item 1. Legal  
Proceedings

37

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Item 6. Exhibits and  
Reports on  
Form 8-K  
37  
Signatures  
38

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**PART I: FINANCIAL INFORMATION****Item 1. Financial Statements****ALLIED CAPITAL CORPORATION AND SUBSIDIARIES****CONSOLIDATED BALANCE SHEET**

	<b>March 31, 2002</b>	<b>December 31, 2001</b>
	<b>(Unaudited)</b>	
(in thousands, except share amounts)		
<b>ASSETS</b>		
Portfolio at value:		
Private finance (cost: 2002-\$1,568,704; 2001-\$1,553,966)	\$1,604,891	\$1,595,072
Commercial real estate finance (cost: 2002-\$648,940; 2001-\$732,636)	649,169	734,518
	<hr/>	
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Total portfolio at value	2,254,060	2,329,590
	<hr/>	
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Other assets		
Cash and cash equivalents	142,500	130,234
	2,297	889
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Total assets	\$2,398,857	\$2,460,713
	<hr/>	
	<hr/>	
<b>LIABILITIES AND SHAREHOLDERS</b>		
<b>EQUITY</b>		
Liabilities:		
Notes payable and debentures	\$876,056	\$876,056
Revolving credit facility	57,000	144,750
Accounts payable and other liabilities		

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77,460 80,784

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Total liabilities  
1,010,516 1,101,590

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Commitments and Contingencies

Preferred stock  
7,000 7,000  
Shareholders' equity:

Common stock, \$0.0001 par value,  
200,000,000 shares authorized; 100,764,535  
and 99,607,396 shares issued and outstanding  
at March 31, 2002 and December 31, 2001,  
respectively

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Additional paid-in capital

1,380,501 1,352,688

Notes receivable from sale of common stock

(27,272) (26,028)

Net unrealized appreciation on portfolio

32,468 39,981

Distributions in excess of earnings

(4,366) (14,528)

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Total shareholders' equity

1,381,341 1,352,123

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Total liabilities and shareholders' equity

\$2,398,857 \$2,460,713

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

**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**

**CONSOLIDATED STATEMENT OF OPERATIONS**

	<b>For the Three Months Ended March 31,</b>	
	<b>2002</b>	<b>2001</b>
	<b>(unaudited)</b>	
<b>(in thousands, except per share amounts)</b>		
Interest and related portfolio income:		
Interest and dividends		
\$64,973	\$54,875	
Premiums from loan dispositions		
1,613	821	
Fees and other income		
15,805	9,375	
Total interest and related portfolio income		
82,391	65,071	
Expenses:		
Interest		
17,469	15,930	
Employee		
8,035	6,446	
Administrative		
3,018	2,967	
Total operating expenses		
28,522	25,343	
Net investment income before net realized and unrealized gains		
53,869	39,728	
Net realized and unrealized gains:		
Net realized gains		
9,605	1,154	



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Net unrealized gains (losses)

(7,513) 11,146

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Total net realized and unrealized gains

2,092 12,300

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Net increase in net assets resulting  
from operations

\$55,961 \$52,028

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Basic earnings per common share

\$0.56 \$0.61

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Diluted earnings per common share

\$0.55 \$0.60

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Weighted average common shares  
outstanding basic

99,977 85,504

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Weighted average common shares  
outstanding diluted

102,364 87,059

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

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

	<b>For the Three Months Ended March 31,</b>	
<b>(in thousands, except per share amounts)</b>	<b>2002</b>	<b>2001</b>
	<b>(unaudited)</b>	
<b>Operations:</b>		
Net investment income before net realized and unrealized gains	\$53,869	\$39,728
Net realized gains	9,605	1,154
Net unrealized gains (losses)	(7,513)	11,146
Net increase in net assets resulting from operations	55,961	52,028
<b>Shareholder distributions:</b>		
Common stock dividends	(53,259)	(42,081)
Preferred stock dividends	(55)	(55)
Net decrease in net assets resulting from shareholder distributions	(53,314)	(42,136)
<b>Capital share transactions:</b>		
Sale of common stock	19,950	9,950
Issuance of common stock upon the exercise of stock options	6,293	2,904

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Issuance of common stock in lieu of  
cash distributions

1,572 1,785

Net (increase) decrease in notes  
receivable from sale of common  
stock

(1,244) 22

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Net increase in net assets resulting  
from capital share transactions

26,571 14,661

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Total increase in net assets

\$29,218 \$24,553

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Net assets at beginning of period

\$1,352,123 \$1,029,692

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Net assets at end of period

\$1,381,341 \$1,054,245

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Net asset value per common share

\$13.71 \$12.26

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Common shares outstanding at end of  
period

100,765 85,956

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

**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**

**CONSOLIDATED STATEMENT OF CASH FLOWS**

	<b>For the Three Months Ended March 31,</b>	
	<b>2002</b>	<b>2001</b>
	<b>(unaudited)</b>	
<b>(in thousands)</b>		
Cash flows from operating activities:		
Net increase in net assets resulting from operations	\$55,961	\$52,028
Adjustments		
Portfolio investments	(80,040)	(150,758)
Repayments of investment principal	31,013	30,281
Proceeds from investment sales	125,099	35,187
Change in accrued or reinvested interest and dividends	(13,258)	(14,577)
Changes in other assets and liabilities	(10,033)	(2,060)
Amortization of loan discounts and fees	(3,883)	(2,668)
Depreciation and amortization	266	257
Realized losses	3,320	746
Net unrealized (gains) losses	7,513	(11,146)
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Net cash provided by (used in) operating activities	115,958	(62,710)
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Cash flows from financing activities:		
Sale of common stock	19,950	9,950
Collections of notes receivable from sale of common stock	217	1,501

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Common dividends and distributions paid	
(51,687) (40,296)	
Preferred stock dividends paid	
(55) (55)	
Net borrowings under notes payable and debentures	
10,628	
Net borrowings under (repayments on) revolving line of credit	
(87,750) 86,500	
Other financing activities	
4,775 1,425	

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Net cash provided by (used in) financing activities	
(114,550) 69,653	

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Net increase in cash and cash equivalents	
\$1,408 \$6,943	

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Cash and cash equivalents at beginning of period	
\$889 \$2,449	

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Cash and cash equivalents at end of period	
\$2,297 \$9,392	

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

<b>Private Finance Portfolio Company (in thousands, except number of shares)</b>	<b>Investment(2)</b>	<b>March 31, 2002</b>	
		<b>(unaudited) Cost</b>	<b>Value</b>
ACE Products, Inc.	Loans	\$ 17,164	\$ 17,164
Acme Paging, L.P.	Loan	750	750
	Debt Securities	6,993	6,993
	Limited Partnership Interest	3,640	2,184
Advantage Mayer, Inc.	Debt Securities	10,947	10,947
	Warrants		
Alderwoods Group, Inc.(1)	Debt Securities	6,129	6,129
	Common Stock (357,568 shares)	5,006	3,006
Allied Office Products, Inc.	Debt Securities	7,477	7,477
	Warrants	629	629
American Barbecue & Grill, Inc.	Warrants	125	
American Healthcare Services, Inc.	Debt Securities	40,780	40,780
	Common Stock (79,567,042 shares)	1,000	100
	Guaranty (\$915)		
American Home Care Supply, LLC	Debt Securities	6,920	6,920
	Warrants	579	1,579
Aspen Pet Products, Inc.	Loans	14,816	14,816
	Preferred Stock (2,021 shares)	1,981	1,981
	Common Stock (1,400 shares)	140	140
ASW Holding Corporation	Warrants	25	25
Autania AG(1)	Debt Securities	4,460	4,460
	Common Stock (250,000 shares)	2,193	2,193
Avborne, Inc.	Debt Securities	12,959	6,584
	Warrants	1,180	
Bakery Chef, Inc.	Loans	17,306	17,306
Blue Rhino Corporation(1)	Debt Securities	13,864	13,864
	Warrants	1,200	5,750
Border Foods, Inc.	Debt Securities	9,329	9,329
	Preferred Stock (50,919 shares)	2,000	2,000

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	Warrants	665	665
Business Loan Express, Inc.	Loan	6,000	6,000
	Debt Securities	78,481	78,481
	Preferred Stock (25,111 shares)	25,111	25,111
	Common Stock (25,503,043 shares)	104,596	120,096
	Guaranty (\$51,460 See Note 3)		
Camden Partners Strategic Fund II, L.P.	Limited Partnership Interest	1,785	1,829
CampGroup, LLC	Debt Securities	2,711	2,711
	Warrants	220	220

(1) Public company.

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

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

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Private Finance Portfolio Company (in thousands, except number of shares)	Investment(2)	March 31, 2002	
		(unaudited)	
		Cost	Value
Candlewood Hotel Company(1)	Preferred Stock (3,250 shares)	\$ 3,250	\$ 3,250
Celebrities, Inc.	Loan	240	240
	Warrants	12	550
Colibri Holding Corporation	Loans	3,471	3,471
	Preferred Stock (237 shares)	248	248
	Common Stock (3,362 shares)	1,250	1,250
	Warrants	290	290
The Color Factory Inc.	Loan	6,882	6,882
	Preferred Stock (1,000 shares)	1,000	1,000
	Common Stock (980 shares)	6,535	8,035
Component Hardware Group, Inc.	Debt Securities	10,909	10,909
	Preferred Stock (18,000 shares)	1,800	1,800
	Common Stock (2,000 shares)	200	200
Convenience Corporation of America	Debt Securities	8,355	2,738
	Preferred Stock (22,301 shares)	334	
	Warrants		
Cooper Natural Resources, Inc.	Debt Securities	1,782	1,782
	Preferred Stock (6,316 shares)	1,427	1,427
	Warrants	832	832
CorrFlex Graphics, LLC	Debt Securities	2,346	2,346
	Warrants		6,674
	Options		576
Coverall North America, Inc.	Loan	10,335	10,335
	Debt Securities	5,325	5,325
	Warrants		
CPM Acquisition Corporation	Loan	9,754	9,754
Csabai Canning Factory Rt	Hungarian Quotas (9.2%)	700	
CTT Holdings	Loan	1,432	1,432
Cumulus Media, Inc. (1)	Common Stock (397,922 shares)	7,131	7,131
	Warrants	186	186
CyberRep	Loan	1,145	1,145
	Debt Securities	14,375	14,375
	Warrants	660	3,310
The Debt Exchange Inc.	Preferred Stock (921,829 shares)	1,250	1,250



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Directory Investment Corporation	Common Stock (470 shares)	112	32
Directory Lending Corporation	Series A Common Stock (34 shares)		
	Series B Common Stock (6 shares)	8	
	Series C Common Stock (10 shares)	22	
Drilltec Patents & Technologies Company, Inc.	Loan	10,918	9,262
	Debt Securities	1,500	1,500
	Warrants		
eCentury Capital Partners, L.P.	Limited Partnership Interest	1,875	1,800

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Private Finance Portfolio Company (in thousands, except number of shares)	Investment(2)	March 31, 2002	
		(unaudited)	
		Cost	Value
EDM Consulting, LLC	Debt Securities Common Stock (140 shares)	\$ 1,875 250	\$ 443
El Dorado Communications, Inc.	Loans	306	306
Elexis Beta GmbH	Options	426	526
Elmhurst Consulting, LLC	Loan Common Stock (74 shares) Guaranty (\$2,800)	9,767 5,165	9,767 5,165
Eparfin S.A.	Loan	29	29
E-Talk Corporation	Debt Securities Warrants	8,852 1,157	4,509
Ex Terra Credit Recovery, Inc.	Preferred Stock (500 shares) Common Stock (2,500 shares) Warrants	568	318
Executive Greetings, Inc.	Debt Securities Warrants	16,658 360	16,658 360
Fairchild Industrial Products Company	Debt Securities Warrants	5,889 280	5,889 2,378
Foresite Towers, LLC	Equity Interest	15,500	15,500
Galaxy American Communications, LLC	Debt Securities Options Guaranty (\$750)	48,863	39,211
Garden Ridge Corporation	Debt Securities Preferred Stock (1,130 shares) Common Stock (188,400 shares)	27,006 1,130 613	27,006 1,130 613
GC-Sun Holdings II, LP (Kar Products, LP)	Loans	8,167	8,167
Gibson Guitar Corporation	Debt Securities Warrants	17,369 525	17,369 2,325
Ginsey Industries, Inc.	Loans Convertible Debentures Warrants	5,000 500	5,000 500 504
Global Communications, LLC	Loan Debt Securities Equity Interest	1,996 15,068 11,067	1,996 15,068 11,067

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	Options	1,639	1,639
Grant Broadcasting Systems II	Warrants	87	5,976
Grotech Partners, VI, L.P.	Limited Partnership Interest	1,463	1,029
The Hartz Mountain Corporation	Debt Securities	27,474	27,474
	Common Stock (200,000 shares)	2,000	2,000
	Warrants	2,613	2,613

(1) Public company.

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		March 31, 2002	
Private Finance Portfolio Company (in thousands, except number of shares)	Investment(2)	(unaudited)	
		Cost	Value
HealthASPex, Inc.	Preferred Stock (1,451,380 shares)	\$ 4,900	\$ 4,011
	Preferred Stock (1,000,000 shares)	731	620
	Common Stock (1,451,380 shares)	4	
The Hillman Companies Inc.	Debt Securities	40,546	40,546
	Common Stock (6,890,937 shares)	57,156	57,156
HMT, Inc.	Debt Securities	9,015	9,015
	Common Stock (300,000 shares)	3,000	3,000
	Warrants	1,155	1,155
Hotelevision, Inc.	Preferred Stock (315,100 shares)	315	315
Icon International, Inc.	Common Stock (35,228 shares)	1,219	1,519
Impact Innovations Group, LLC	Debt Securities	6,661	6,661
	Warrants	1,674	1,674
Intellirisk Management Corporation	Loans	22,568	22,568
International Fiber Corporation	Debt Securities	22,423	22,423
	Common Stock (1,029,069 shares)	5,483	6,982
	Warrants	550	700
iSolve Incorporated	Preferred Stock (14,853 shares)	874	
	Common Stock (13,306 shares)	14	
Jakel, Inc.	Loan	23,369	23,369
JRI Industries, Inc.	Debt Securities	1,977	1,977
	Warrants	74	74
Julius Koch USA, Inc.	Debt Securities	759	759
	Warrants	259	7,000
Kirker Enterprises, Inc.	Warrants	348	3,501
	Equity Interest	4	4
Kirkland s, Inc.	Debt Securities	7,200	7,200
	Preferred Stock (917 shares)	412	412
	Warrants	96	96
Kyrus Corporation	Debt Securities	7,595	7,595
	Warrants	348	348
Liberty-Pittsburgh Systems, Inc.	Debt Securities	3,491	3,491
	Common Stock (123,929 shares)	142	142

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Litterer Beteiligungs-GmbH	Debt Securities	1,070	1,070
	Equity Interest	358	358
Logic Bay Corporation	Preferred Stock (1,131,222 shares)	5,000	5,000
Love Funding Corporation	Preferred Stock (26,000 shares)	359	213
Magna Card, Inc.	Debt Securities	153	153
	Preferred Stock (1,875 shares)	94	94
	Common Stock (4,687 shares)		
Master Plan, Inc.	Loan	1,204	1,204
	Common Stock (156 shares)	42	42

(1) Public company.

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Private Finance Portfolio Company (in thousands, except number of shares)	Investment(2)	March 31, 2002	
		(unaudited)	
		Cost	Value
Matrics, Inc.	Preferred Stock (511,876 shares) Warrants	\$ 500	\$ 500
MedAssets.com, Inc.	Debt Securities Preferred Stock (260,418 shares) Warrants	15,114 2,049 136	15,114 2,049 136
Mid-Atlantic Venture Fund IV, L.P.	Limited Partnership Interest	2,475	1,528
Midview Associates, L.P.	Warrants		
Monitoring Solutions, Inc.	Debt Securities Common Stock (33,333 shares) Warrants	1,823	153
MortgageRamp.com, Inc.	Common Stock (772,000 shares)	3,860	3,860
Morton Grove Pharmaceuticals, Inc.	Loan Preferred Stock (106,947 shares)	16,356 5,000	16,356 9,000
Most Confiserie GmbH & Co KG	Loan	943	943
MVL Group, Inc.	Loan Debt Securities Warrants	16,138 14,924 643	15,916 14,924 643
NetCare, AG	Loan Common Stock (262,784 shares)	760 230	760 230
NETtel Communications, Inc.	Debt Securities	11,334	4,334
Nobel Learning Communities, Inc.(1)	Debt Securities Preferred Stock (1,063,830 shares) Warrants	9,679 2,000 575	9,679 2,000 575
North American Archery, LLC	Loans Convertible Debentures Guaranty (\$645)	1,390 2,248	840 2,008
Northeast Broadcasting Group, L.P.	Debt Securities	295	295
Novak Biddle Venture Partners III, L.P.	Limited Partnership Interest	420	420
Nursefinders, Inc.	Debt Securities Warrants	11,373 900	11,373 1,500
Onyx Television GmbH	Preferred Units (120,000 shares)	201	201

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Opinion Research Corporation(1)	Debt Securities	14,227	14,227
	Warrants	996	996
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Oriental Trading Company, Inc.	Loan	128	128
	Debt Securities	12,788	12,788
	Preferred Equity Interest	1,500	1,822
	Common Equity Interest		
	Warrants	13	265

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(1) Public company.

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

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

Private Finance Portfolio Company (in thousands, except number of shares)	Investment(2)	March 31, 2002	
		(unaudited)	
		Cost	Value
Outsource Partners, Inc.	Debt Securities	\$24,021	\$24,021
	Warrants	826	826
Packaging Advantage Corporation	Debt Securities	11,610	11,610
	Common Stock (200,000 shares)	2,000	2,000
	Warrants	963	963
Pico Products, Inc.	Loan	1,406	1,406
Polaris Pool Systems, Inc.	Debt Securities	10,658	10,658
	Warrants	1,050	1,050
Powell Plant Farms, Inc.	Loan	18,152	18,152
Proeducation GmbH	Loan	321	321
Professional Paint, Inc.	Debt Securities	22,086	22,086
	Preferred Stock (15,000 shares)	18,309	18,309
	Common Stock (110,000 shares)	69	3,069
Progressive International Corporation	Debt Securities	3,961	3,961
	Preferred Stock (500 shares)	500	500
	Common Stock (197 shares)	13	13
	Warrants		
Prosperco Finanz Holding AG	Debt Securities	5,276	5,276
	Common Stock (1,528 shares)	1,059	1,059
	Warrants		
Raytheon Aerospace, LLC	Debt Securities	5,090	5,090
	Equity Interest		
Redox Brands, Inc.	Debt Securities	9,556	9,556
	Warrants	584	584
Schwinn Holdings Corporation	Debt Securities	10,195	1,835
Seasonal Expressions, Inc.	Preferred Stock (1,000 shares)	500	
Simula, Inc.(1)	Loan	20,223	20,223
Soff-Cut Holdings, Inc.	Debt Securities	8,587	8,587
	Preferred Stock (300 shares)	300	300
	Common Stock (2,000 shares)	200	200
	Warrants	446	446
Southwest PCS, LLC	Loan	8,401	8,401



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Spa Lending Corporation	Preferred Stock (28,672 shares)	424	367
	Common Stock (6,208 shares)	76	18
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Staffing Partners Holding Company, Inc.	Debt Securities	4,992	4,992
	Preferred Stock (414,600 shares)	2,073	2,073
	Common Stock (50,200 shares)	50	50
	Warrants	10	10
<hr/>			
Startec Global Communications Corporation(1)	Loan	22,815	22,815
	Debt Securities	21,286	10,301
	Common Stock (258,064 shares)	3,000	
	Warrants		
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Private Finance Portfolio Company (in thousands, except number of shares)	Investment(2)	March 31, 2002	
		(unaudited)	
		Cost	Value
STS Operating, Inc.	Common Stock (3,000,000 shares)	\$ 3,177	\$ 3,177
SunStates Refrigerated Services, Inc.	Loans	6,062	4,573
	Debt Securities	2,445	877
Sure-Tel, Inc.	Loan	1,207	1,207
	Preferred Stock (1,116,902 shares)	4,642	4,642
	Warrants	662	662
	Options		
Sydran Food Services II, L.P.	Debt Securities	12,973	12,973
	Equity Interest	3,909	3,909
Total Foam, Inc.	Debt Securities	262	127
	Common Stock (910 shares)	10	
Tubbs Snowshoe Company, LLC	Debt Securities	3,917	3,917
	Equity Interests	500	500
	Warrants	54	54
United Pet Group, Inc.	Debt Securities	9,017	9,017
	Warrants	15	15
Updata Venture Partners, II, L.P.	Limited Partnership Interest	2	1,492
Velocita, Inc.(1)	Debt Securities	11,718	4,318
	Warrants	3,540	
Venturehouse Group, LLC	Equity Interest	667	398
Walker Investment Fund II, LLLP	Limited Partnership Interest	1,200	943
Warn Industries, Inc.	Debt Securities	18,646	18,646
	Warrants	1,429	3,129
Williams Brothers Lumber Company	Warrants	24	322
Wilmar Industries, Inc.	Debt Securities	33,132	33,132
	Preferred Stock (199,313 shares)	1,849	1,849
	Common Stock (15,615 shares)	139	139
	Warrants	1,181	1,181
Wilshire Restaurant Group, Inc.	Debt Securities	15,368	15,368
	Warrants	735	735
Wilton Industries, Inc.	Loan	12,000	12,000

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Woodstream Corporation	Loan	572	572
	Debt Securities	7,641	7,641
	Equity Interests	1,700	4,547
	Warrants	450	1,203
<hr/>			
WyoTech Acquisition Corporation	Debt Securities	12,597	12,597
	Preferred Stock (100 shares)	3,700	3,700
	Common Stock (99 shares)	100	54,100
<hr/>			
Total private finance (133 investments)		\$ 1,568,704	\$ 1,604,891
<hr/>			

(1) Public company.

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

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

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(in thousands, except number of loans)	Stated Interest	Face	March 31, 2002	
			(unaudited) Cost	Value
<b>Commercial Real Estate Finance</b>				
<b>CMBS</b>				
CMBS Bonds				
Mortgage Capital Funding, Series 1998-MC3				
5.5% \$54,491 \$27,051 \$27,051				
Morgan Stanley Capital I, Series 1999-RM1				
6.4% 51,046 21,536 21,536				
COMM 1999-1				
5.6% 74,879 36,016 36,016				
Morgan Stanley Capital I, Series 1999-FNV1				
6.1% 37,762 16,780 16,780				
DLJ Commercial Mortgage Trust 1999-CG2				
6.1% 83,718 36,672 36,672				
Commercial Mortgage Acceptance Corp., Series 1999-C1				
6.8% 34,856 16,324 16,324				
LB Commercial Mortgage Trust, Series 1999-C2				
6.7% 29,005 11,463 11,463				
Chase Commercial Mortgage Securities Corp., Series 1999-2				
6.5% 37,430 16,566 16,566				
FUNB CMT, Series 1999-C4				
6.5% 43,372 18,243 18,243				
Heller Financial, HFCMC Series 2000 PH-1				
6.8% 45,456 18,544 18,544				
SBMS VII, Inc., Series 2000-NL1				
7.2% 20,804 10,747 10,747				
DLJ Commercial Mortgage Trust, Series 2000-CF1				
7.0% 38,685 18,274 18,274				
Deutsche Bank Alex. Brown, Series Comm 2000-C1				
6.9% 39,379 17,485 17,485				
LB-UBS Commercial Mortgage Trust, Series 2000-C4				
6.9% 34,967 12,651 12,651				
Credit Suisse First Boston Mortgage Securities Corp., Series 2001-CK1				
5.9% 43,288 18,041 18,041				
JP Morgan-CIBC-Deutsche 2001				
5.8% 46,326 19,705 19,705				
Lehman Brothers-UBS Warburg 2001-C4				
6.4% 49,582 21,891 21,891				
SBMS VII, Inc., Series 2001-C1				
6.1% 41,109 15,974 15,974				
GE Capital Commercial Mortgage Securities Corp., Series 2001-2				
6.1% 45,218 19,835 19,835				
Credit Suisse First Boston Mortgage Securities Corp., Series 2001-CKN5				
5.2% 59,602 28,062 28,062				
JP Morgan Chase Commercial Mortgage Securities Corp., Series 2001-C1				
5.6% 42,747 16,100 16,100				
SBMS VII, Inc., Series 2001-C2				

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6.2% 47,353 21,960 21,960  
 FUNB CMT, Series 2002-C1  
 6.0% 38,238 16,491 16,491  
 Collateralized Debt Obligations

Crest 2001-1, Ltd.  
 24,153 24,153 24,153

Crest 2002-1, Ltd.  
 23,104 23,104 23,104

Total CMBS  
 \$1,086,570 \$503,668 \$503,668

	Interest Rate Ranges	Number of Loans	Cost	Value
<b>Commercial Mortgage Loans</b>				
	Up to 6.99%	10	\$ 8,096	\$ 9,518
	7.00%- 8.99%	24	27,096	28,903
	9.00%-10.99%	13	12,072	12,071
	11.00%-12.99%	13	10,054	10,053
	13.00%-14.99%	7	12,500	12,293
	15.00% and above	1	55	55
Total commercial mortgage loans		68	\$ 69,873	\$72,893
<b>Residual Interest</b>			\$ 69,680	\$ 69,380
<b>Real Estate Owned</b>				
	5,719	3,228		
Total commercial real estate finance				
	\$648,940	\$649,169		
Total portfolio				
	\$2,217,644	\$2,254,060		

(1) Public company.

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

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
Ability One Corporation	Loans	\$ 10,657	\$ 10,657
ACE Products, Inc.	Loans	16,875	16,875
Acme Paging, L.P.	Debt Securities	6,992	6,992
	Limited Partnership Interest	3,640	2,184
Advantage Mayer, Inc.	Debt Securities Warrants	10,945	10,945
Allied Office Products, Inc.	Debt Securities	7,491	7,491
	Warrants	629	629
American Barbecue & Grill, Inc.	Warrants	125	
American Home Care Supply, LLC	Debt Securities	6,906	6,906
	Warrants	579	1,579
American Physicians Services, Inc. (formerly Physicians Speciality Corporation)	Debt Securities	40,194	40,194
	Common Stock (79,567,042 shares)	1,000	100
	Guaranty (\$195)		
Aspen Pet Products, Inc.	Loans	14,576	14,576
	Preferred Stock (1,860 shares)	1,981	1,981
	Common Stock (1,400 shares)	140	140
ASW Holding Corporation	Warrants	25	25
Aurora Communications, LLC	Loans	15,809	15,809
	Equity Interest	2,461	6,050
Autania AG(1)	Debt Securities	4,762	4,762
	Common Stock (250,000 shares)	2,261	2,261
Avborne, Inc.	Debt Securities	12,750	6,375
	Warrants	1,180	
Bakery Chef, Inc.	Loans	17,018	17,018
Blue Rhino Corporation(1)	Debt Securities	13,816	13,816
	Warrants	1,200	2,000
Border Foods, Inc.	Debt Securities	9,313	9,313
	Preferred Stock (50,919 shares)	2,000	2,000
	Warrants	665	665

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Business Loan Express, Inc.	Loan	6,000	6,000
	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)		
Camden Partners Strategic Fund II, L.P.	Limited Partnership Interest	1,295	1,295
CampGroup, LLC	Debt Securities	2,702	2,702
	Warrants	220	220

(1) Public company.

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

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

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Private Finance Portfolio Company (in thousands, except number of shares)	Investment(2)	December 31, 2001	
		Cost	Value
Candlewood Hotel Company(1)	Preferred Stock (3,250 shares)	\$ 3,250	\$ 3,250
Celebrities, Inc.	Loan Warrants	244 12	244 550
Classic Vacation Group, Inc.(1)	Loan	6,399	6,399
Colibri Holding Corporation	Loans Preferred Stock (237 shares) Common Stock (3,362 shares) Warrants	3,464 237 1,250 290	3,464 237 1,250 290
The Color Factory Inc.	Loan Preferred Stock (600 shares) Common Stock (980 shares) Guaranty (\$476)	5,346 788 6,535	5,346 788 8,035
Component Hardware Group, Inc.	Debt Securities Preferred Stock (18,000 shares) Common Stock (2,000 shares)	10,774 1,800 200	10,774 1,800 200
Convenience Corporation of America	Debt Securities Preferred Stock (31,521 shares) Warrants	8,355 334	2,738
Cooper Natural Resources, Inc.	Debt Securities Preferred Stock (6,316 shares) Warrants	1,750 1,427 832	1,750 1,427 832
CorrFlex Graphics, LLC	Debt Securities Warrants Options	2,312	2,312 6,674 576
Coverall North America, Inc.	Loan Debt Securities Warrants	10,309 5,324	10,309 5,324
CPM Acquisition Corporation	Loan	9,604	9,604
Csabai Canning Factory Rt	Hungarian Quotas (9.2%)	700	
CTT Holdings	Loan	1,388	1,388
CyberRep	Loan Debt Securities Warrants	1,109 14,209 660	1,109 14,209 3,310
The Debt Exchange Inc.	Preferred Stock (921,829 shares)	1,250	1,250
Directory Investment Corporation	Common Stock (470 shares)	112	32



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Directory Lending Corporation	Series A Common Stock (34 shares)		
	Series B Common Stock (6 shares)		8
	Series C Common Stock (10 shares)		22
Drilltec Patents & Technologies Company, Inc.	Loan	10,918	9,262
	Debt Securities	1,500	1,500
	Warrants		
eCentury Capital Partners, L.P.	Limited Partnership Interest	1,875	1,800

(1) Public company.

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

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

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Private Finance Portfolio Company (in thousands, except number of shares)	Investment(2)	December 31, 2001	
		Cost	Value
EDM Consulting, LLC	Debt Securities Common Stock (100 shares)	\$ 1,875 250	\$ 443
El Dorado Communications, Inc.	Loans	306	306
Elexis Beta GmbH	Options	426	526
Elmhurst Consulting, LLC	Loan Common Stock (74 shares) Guaranty (\$2,800)	7,762 5,157	7,762 5,157
Eparfin S.A.	Loan	29	29
E-Talk Corporation	Debt Securities Warrants	8,852 1,157	6,509
Ex Terra Credit Recovery, Inc.	Preferred Stock (500 shares) Common Stock (2,500 shares) Warrants	568	318
Executive Greetings, Inc.	Debt Securities Warrants	15,938 360	15,938 360
Fairchild Industrial Products Company	Debt Securities Warrants	5,872 280	5,872 2,378
Foresite Towers, LLC	Equity Interest	15,500	15,500
FTI Consulting, Inc.(1)	Warrants		510
Galaxy American Communications, LLC	Debt Securities Options Guaranty (\$750)	48,869	39,217
Garden Ridge Corporation	Debt Securities Preferred Stock (1,130 shares) Common Stock (471 shares)	26,948 1,130 613	26,948 1,130 613
Gibson Guitar Corporation	Debt Securities Warrants	17,175 525	17,175 2,325
Ginsey Industries, Inc.	Loans Convertible Debentures Warrants	5,000 500	5,000 500 504
Global Communications, LLC	Loan Debt Securities Equity Interest Options	1,990 14,884 11,067 1,639	1,990 14,884 11,067 1,639

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Grant Broadcasting Systems II	Warrants	87	5,976
Grant Television II LLC	Options	492	492
Grotech Partners, VI, L.P.	Limited Partnership Interest	1,463	1,060
The Hartz Mountain Corporation	Debt Securities	27,408	27,408
	Common Stock (200,000 shares)	2,000	2,000
	Warrants	2,613	2,613

(1) Public company.

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

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

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Private Finance Portfolio Company (in thousands, except number of shares)	Investment(2)	December 31, 2001	
		Cost	Value
HealthASPex, Inc.	Preferred Stock (1,036,700 shares)	\$ 4,752	\$ 3,890
	Preferred Stock (414,680 shares)	760	622
	Common Stock (1,451,380 shares)	4	
HMT, Inc.	Debt Securities	8,995	8,995
	Common Stock (300,000 shares)	3,000	3,000
	Warrants	1,155	1,155
Hotelevision, Inc.	Preferred Stock (315,100 shares)	315	315
Icon International, Inc.	Common Stock (37,821 shares)	1,219	1,519
Impact Innovations Group, LLC	Debt Securities	6,598	6,598
	Warrants	1,674	1,674
Intellirisk Management Corporation	Loans	22,334	22,334
International Fiber Corporation	Debt Securities	22,257	22,257
	Common Stock (1,029,068 shares)	5,483	6,982
	Warrants	550	700
iSolve Incorporated	Preferred Stock (14,853 shares)	874	
	Common Stock (13,306 shares)	14	
Jakel, Inc.	Loan	22,291	22,291
JRI Industries, Inc.	Debt Securities	1,972	1,972
	Warrants	74	74
Julius Koch USA, Inc.	Debt Securities	1,066	1,066
	Warrants	259	7,000
Kirker Enterprises, Inc.	Warrants	348	3,501
	Equity Interest	4	4
Kirkland s, Inc.	Debt Securities	7,676	7,676
	Preferred Stock (917 shares)	412	412
	Warrants	96	96
Kyrus Corporation	Debt Securities	7,810	7,810
	Warrants	348	348
Liberty-Pittsburgh Systems, Inc.	Debt Securities	3,487	3,487
	Common Stock (64,535 shares)	142	142
The Loewen Group, Inc.(1)	High-Yield Senior Secured Debt	15,150	12,440
Logic Bay Corporation	Preferred Stock (1,131,222 shares)	5,000	5,000

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Love Funding Corporation	Preferred Stock (26,000 shares)	359	213
Magna Card, Inc.	Debt Securities	153	153
	Preferred Stock (1,875 shares)	94	94
	Common Stock (4,687 shares)		
Master Plan, Inc.	Loan	1,204	1,204
	Common Stock (156 shares)	42	2,042
Matrics, Inc.	Preferred Stock (511,876 shares)	500	500

(1) Public company.

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

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

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Private Finance Portfolio Company (in thousands, except number of shares)	Investment(2)	December 31, 2001	
		Cost	Value
MedAssets.com, Inc.	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.	Limited Partnership Interest	2,475	1,586
Midview Associates, L.P.	Warrants		
Monitoring Solutions, Inc.	Debt Securities	1,823	153
	Common Stock (33,333 shares)		
	Warrants		
MortgageRamp.com, Inc.	Common Stock (800,000 shares)	3,860	3,860
Morton Grove Pharmaceuticals, Inc.	Loan	16,150	16,150
	Preferred Stock (106,947 shares)	5,000	9,000
Most Confiserie GmbH & Co KG	Loan	933	933
MVL Group, Inc.	Loan	1,856	1,856
	Debt Securities	14,806	14,806
	Warrants	643	643
	Guaranty (\$1,357)		
NetCare, AG	Loan	811	811
NETtel Communications, Inc.	Debt Securities	11,334	4,334
Nobel Learning Communities, Inc.(1)	Debt Securities	9,656	9,656
	Preferred Stock (265,957 shares)	2,000	2,000
	Warrants	575	575
North American Archery, LLC	Loans	1,390	840
	Convertible Debentures	2,248	2,008
	Guaranty (\$270)		
Northeast Broadcasting Group, L.P.	Debt Securities	310	310
Novak Biddle Venture Partners III, L.P.	Limited Partnership Interest	330	330
Nursefinders, Inc.	Debt Securities	11,341	11,341
	Warrants	900	1,500
Onyx Television GmbH	Preferred Units (600,000 shares)	201	201
Opinion Research Corporation(1)	Debt Securities	14,186	14,186
	Warrants	996	996
Oriental Trading Company, Inc.	Loan	128	128

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	Debt Securities	12,719	12,719
	Preferred Equity Interest	1,500	1,793
	Common Equity Interest		
	Warrants	13	295
<hr/>			
Outsource Partners, Inc.	Debt Securities	23,994	23,994
	Warrants	826	826
<hr/>			

(1) Public company.

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

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

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Private Finance Portfolio Company (in thousands, except number of shares)	Investment(2)	December 31, 2001	
		Cost	Value
Packaging Advantage Corporation	Debt Securities	\$ 11,586	\$ 11,586
	Common Stock (200,000 shares)	2,000	2,000
	Warrants	963	963
Pico Products, Inc.	Loan	1,406	1,406
Polaris Pool Systems, Inc.	Debt Securities	6,581	6,581
	Warrants	1,050	1,050
Powell Plant Farms, Inc.	Loan	16,993	16,993
Proeducation GmbH	Loan	206	206
Professional Paint, Inc.	Debt Securities	21,409	21,409
	Preferred Stock (15,000 shares)	17,215	17,215
	Common Stock (110,000 shares)	69	3,069
Progressive International Corporation	Debt Securities	3,958	3,958
	Preferred Stock (500 shares)	500	500
	Common Stock (197 shares)	13	13
	Warrants		
Prosperco Finanz Holding AG	Debt Securities	4,899	4,899
	Common Stock (1,528 shares)	956	956
	Warrants		
Raytheon Aerospace, LLC	Debt Securities	5,051	5,051
	Equity Interest		
Redox Brands, Inc.	Debt Securities	9,462	9,462
	Warrants	584	584
Schwinn Holdings Corporation	Debt Securities	10,195	1,835
Seasonal Expressions, Inc.	Preferred Stock (1,000 shares)	500	
Simula, Inc.(1)	Loan	19,914	19,914
Soff-Cut Holdings, Inc.	Debt Securities	8,569	8,569
	Preferred Stock (300 shares)	300	300
	Common Stock (2,000 shares)	200	200
	Warrants	446	446
Southwest PCS, LLC	Loan	8,243	8,243
Spa Lending Corporation	Preferred Stock (28,625 shares)	485	375
	Common Stock (6,208 shares)	25	18
Staffing Partners Holding	Debt Securities	4,992	4,992



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Company, Inc.	Preferred Stock (414,600 shares)	2,073	2,073
	Common Stock (50,200 shares)	50	50
	Warrants	10	10
<hr/>			
Startec Global Communications Corporation(1)	Loan	22,815	22,815
	Debt Securities	21,286	10,301
	Common Stock (258,064 shares)	3,000	
	Warrants		
<hr/>			
STS Operating, Inc.	Common Stock (3,000,000 shares)	3,177	3,177
<hr/>			

(1) Public company.

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

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

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Private Finance Portfolio Company (in thousands, except number of shares)	Investment(2)	December 31, 2001	
		Cost	Value
SunSource Inc. (The Hillman Companies, Inc.)	Debt Securities	\$ 40,071	\$ 40,071
	Common Stock (6,890,937 shares)	57,156	57,156
SunStates Refrigerated Services, Inc.	Loans	6,062	4,573
	Debt Securities	2,445	877
Sure-Tel, Inc.	Loan	1,207	1,207
	Preferred Stock (1,116,902 shares)	4,642	4,642
	Warrants	662	662
	Options		
Sydran Food Services II, L.P.	Debt Securities	12,973	12,973
	Equity Interest	3,909	3,909
Total Foam, Inc.	Debt Securities	263	127
	Common Stock (910 shares)	10	
Tubbs Snowshoe Company, LLC	Debt Securities	3,913	3,913
	Equity Interests	500	500
	Warrants	54	54
United Pet Group, Inc.	Debt Securities	4,965	4,965
	Warrants	15	15
Updata Venture Partners, II, L.P.	Limited Partnership Interest	2,300	3,865
Velocita, Inc.(1)	Debt Securities	11,677	11,677
	Warrants	3,540	3,540
Venturehouse Group, LLC	Equity Interest	667	398
Walker Investment Fund II, LLLP	Limited Partnership Interest	1,000	743
Warn Industries, Inc.	Debt Securities	18,624	18,624
	Warrants	1,429	3,129
Williams Brothers Lumber Company	Warrants	24	322
Wilmar Industries, Inc.	Debt Securities	32,839	32,839
	Warrants	3,169	3,169
Wilshire Restaurant Group, Inc.	Debt Securities	15,106	15,106
	Warrants	735	735
Wilton Industries, Inc.	Loan	12,000	12,000
Woodstream Corporation	Loan	572	572
	Debt Securities	7,631	7,631

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	Equity Interests	1,700	4,547
	Warrants	450	1,203
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WyoTech Acquisition Corporation	Debt Securities	12,588	12,588
	Preferred Stock (100 shares)	3,700	3,700
	Common Stock (99 shares)	100	44,100
<hr/>			
Total private finance (135 investments)		\$1,553,966	\$1,595,072
<hr/>			

(1) Public company.

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

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

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(in thousands, except number of loans)	Stated Interest	Face	December 31, 2001	
			Cost	Value
<b>Commercial Real Estate Finance</b>				
<b>CMBS</b>				
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
Crest 2001-1, Ltd. (collateralized debt obligation)		24,207	24,207	24,207
<b>Total CMBS</b>		<b>\$ 1,194,479</b>	<b>\$ 582,553</b>	<b>\$ 582,553</b>

	Interest Rate Ranges	Number of Loans	Cost	Value
<b>Commercial Mortgage Loans</b>				
	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
<b>Total commercial mortgage loans</b>		<b>76</b>	<b>\$ 76,120</b>	<b>\$ 79,597</b>
Residual Interest			\$ 70,179	\$ 69,879
Real Estate Owned			3,784	2,489

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Total commercial real estate finance	\$ 732,636	\$ 734,518
<hr/>		
Total portfolio	\$2,286,602	\$2,329,590
<hr/>		

(1) Public company.

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

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

**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**  
**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**(Information at and for the three months ended March 31, 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.

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 in private and undervalued public companies and commercial mortgage-backed securities ( CMBS ) in a variety of industries and in diverse geographic locations.

**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 balances to conform with the 2002 financial statement presentation.

The accompanying unaudited consolidated financial statements of the Company have been prepared in accordance with accounting principles generally accepted in the United States of America ( GAAP ) for interim financial information. Accordingly, they do not include all of the information and footnotes required by GAAP for complete consolidated financial statements. In the opinion of management, the unaudited consolidated financial results of the Company included herein contain all adjustments (consisting of only normal recurring accruals) necessary to present fairly the financial position of the Company as of March 31, 2002 and the results of operations, changes in net assets, and cash flows for the three months ended March 31, 2002 and 2001. The results of operations for the three months ended March 31, 2002 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 2. Summary of Significant Accounting Policies, continued**

***Valuation of Portfolio Investments***

The Company, as a BDC, invests primarily in illiquid securities including the debt and equity 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 its securities at fair value as determined in good faith by the Company's 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 privately negotiated securities increase in value over a long period of time, that the Company does not intend to trade the securities, and that no ready market exists. 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 asset has been impaired and full collection for the loan or realization of an equity security is doubtful. Conversely, the Company will record unrealized appreciation if it has a clear indication that the underlying portfolio company has appreciated in value and, therefore, the Company's security has also appreciated in value. Under its valuation policy, the Company does not consider temporary changes in the capital markets, such as interest rate movements or changes in the public equity markets, in order to determine whether an investment in a private company has been impaired or whether a private investment has increased in value. The value of investments in public securities are determined using quoted market prices discounted for illiquidity and restrictions on resale.

***Loans and Debt Securities***

For loans and debt securities, value normally corresponds to cost unless the borrower's condition or external factors lead to a determination of value at a lower 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. 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***

Equity interests in portfolio companies for which there is no liquid public market are valued based on various factors, including cash flow from operations and other pertinent factors such as





**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

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

recent offers to purchase a portfolio company's securities or other liquidation events. The determined values are generally discounted to account for liquidity issues and minority control positions.

The value of the Company's equity interests in public companies for which market prices are readily available is based upon the average of the closing public market price for the last three trading days up to and including 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. Fair value is based upon a discounted cash flow model which utilizes prepayment and loss assumptions based upon historical experience, 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 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, and 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 depreciation on its CMBS whenever it determines that the value of its CMBS is less than the cost basis. The Company generally invests in CMBS bonds with the intention of holding the bonds to their maturity.

***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 spread is carried at fair value based on discounted estimated future cash flows. The Company recognizes income from the residual interest spread 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***

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.

**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

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

***Deferred Financing Costs***

Financing costs are based on actual costs incurred in obtaining 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.

***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.

***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.



**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**Note 3. Portfolio**

*Private Finance*

At March 31, 2002 and December 31, 2001, the private finance portfolio consisted of the following:

	2002			2001		
	Cost	Value	Yield	Cost	Value	Yield
(\$ in thousands)						
Loans and debt securities	\$ 1,174,491	\$ 1,105,798	14.3%	\$ 1,169,673	\$ 1,107,890	14.8%
Equity interests						
394,213 499,093 384,293 487,182						
<b>Total</b>	<b>\$1,568,704</b>	<b>\$1,604,891</b>		<b>\$1,553,966</b>	<b>\$1,595,072</b>	

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.

Debt securities typically 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.

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 for investment appreciation and ultimate gain on sale.

At March 31, 2002 and December 31, 2001, the Company had an investment totaling \$229,688,000 and \$227,449,000, 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 March 31, 2002 was \$51,460,000. 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 March 31, 2002. In consideration for providing this guaranty, BLX will pay the Company an annual guaranty fee of \$3,100,000 in 2002. BLX is headquartered in New York, NY.

At March 31, 2002, the Company had an investment in The Hillman Companies, Inc. (formerly SunSource, Inc.) totaling \$97,702,000. 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 to hardware retailers, and its primary operations are located in Cincinnati, Ohio.

At March 31, 2002 and December 31, 2001, approximately 98% of the Company 's private finance loan portfolio was composed of fixed interest rate loans. At March 31, 2002 and December 31, 2001, loans and debt securities with a value of \$111,291,000 and \$93,744,000, respectively, were not accruing interest. Loans greater than 120 days delinquent generally do not accrue interest.

**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**Note 3. Portfolio, continued**

The geographic and industry compositions of the private finance portfolio at value at March 31, 2002 and December 31, 2001 were as follows:

	<u>2002</u>	<u>2001</u>
<b>Geographic Region</b>		
Mid-Atlantic		
41%	43%	
West		
20	19	
Midwest		
18	17	
Southeast		
14	14	
Northeast		
6	5	
International		
1	2	
<hr/>		
<hr/>		
Total		
100%	100%	
<hr/>		
<hr/>		
<b>Industry</b>		
Consumer products		
28%	28%	
Business services		
23	22	
Financial services		
15	15	
Industrial products		
11	10	
Retail		
5	5	
Education		
5	5	
Telecommunications		
4	4	
Broadcasting & cable		
3	4	
Other		
6	7	



\_\_\_\_\_  
 \_\_\_\_\_  
 Total  
 100% 100%

**Commercial Real Estate Finance**

At March 31, 2002 and December 31, 2001, the commercial real estate finance portfolio consisted of the following:

	2002			2001		
	Cost	Value	Yield	Cost	Value	Yield
<b>(\$ in thousands)</b>						
CMBS	\$503,668	\$503,668	15.9%	\$582,553	\$582,553	14.8%
Loans						
69,873 72,893 8.3% 76,120 79,597 7.7%						
Residual interest						
69,680 69,380 9.4% 70,179 69,879 9.4%						
Real estate owned						
5,719 3,228 3,784 2,489						
<b>Total</b>	<b>\$648,940</b>	<b>\$649,169</b>		<b>\$732,636</b>	<b>\$734,518</b>	

**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**Note 3. Portfolio, continued**

**CMBS**

At March 31, 2002 and December 31, 2001, the CMBS portfolio consisted of the following:

	2002		2001	
	Cost	Value	Cost	Value
<b>(in thousands)</b>				
CMBS bonds	\$456,411	\$456,411	\$558,346	\$558,346
Collateralized debt obligations				
47,257 47,257 24,207 24,207				
<hr/>				
<hr/>				
<hr/>				
<hr/>				
Total	\$503,668	\$503,668	\$582,553	\$582,553
<hr/>				
<hr/>				
<hr/>				
<hr/>				

**CMBS Bonds.** At March 31, 2002 and December 31, 2001, the CMBS bonds, which were purchased from the original issuer, consisted of the following:

	2002	2001
<b>(\$ in thousands)</b>		
Face	\$1,039,313	\$1,170,272
Original issue discount		
(582,902) (611,926)		
<hr/>		
<hr/>		
Cost		

\$456,411 \$558,346

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Value

\$456,411 \$558,346

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Yield

15.7% 14.7%

The non-investment grade and unrated tranches of the CMBS bonds in which the Company invests are junior in priority for payment of 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 tranche will bear this loss first. At March 31, 2002, the Company's CMBS bonds were subordinate to 93% to 97% of the tranches of various CMBS bond issuances. At March 31, 2002, 0.56% of the underlying collateral loans were over 30 days delinquent.

**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**Note 3. Portfolio, continued**

The underlying rating classes of the CMBS at March 31, 2002 and December 31, 2001 were as follows:

	2002		2001	
	Value	Percentage of Total	Value	Percentage of Total
<b>(\$ In Thousands)</b>				
BB+	\$4,493	1.0%	\$24,785	4.4%
BB	16,373	3.6	69,404	12.4
BB-	21,372	4.7	67,460	12.1
B+	108,699	23.8	103,560	18.6
B	137,574	30.1	131,362	23.5
B-	76,161	16.7	73,572	13.2
CCC	9,073	2.0	8,893	1.6
Unrated	82,666	18.1	79,310	14.2
<hr/>				
<hr/>				
<hr/>				
<hr/>				
Total	\$456,411	100.0%	\$558,346	100.0%
<hr/>				
<hr/>				
<hr/>				
<hr/>				

At March 31, 2002 and December 31, 2001, the CMBS bonds were secured by approximately 4,000 and 3,800 commercial mortgage loans with a total outstanding principal balance of \$21.2 billion and \$20.5 billion, respectively. The geographic composition and the property types of the underlying mortgage loans securing the CMBS calculated using the outstanding principal balance at March 31, 2002 and December 31, 2001 were as follows:

	<u>2002</u>	<u>2001</u>
<b>Geographic Region</b>		
West		
32%	32%	
Mid-Atlantic		
24	24	
Midwest		
21	21	
Southeast		
17	17	
Northeast		
6	6	
<hr/>		
<hr/>		
Total		
100%	100%	
<hr/>		
<hr/>		

**Property Type**

Retail		
31%	31%	
Housing		
27	27	
Office		
21	22	
Hospitality		
7	7	
Other		
14	13	
<hr/>		
<hr/>		
Total		
100%	100%	
<hr/>		
<hr/>		

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,



**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**Note 3. Portfolio, continued**

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 March 31, 2002, the Company owned preferred shares in two collateralized debt obligations ( CDOs ) secured by investment grade unsecured debt issued by various real estate investment trusts ( REITs ) and non-investment grade CMBS bonds. The investment grade REIT debt collateral consists of \$631,855,000 issued by 36 REITs. The non-investment grade CMBS collateral consists of BB+, BB and BB- CMBS bonds with a face amount of \$368,145,000 that were issued in 28 separate CMBS transactions ( CMBS Collateral ). Included in the CMBS Collateral for the CDO, \$323,183,000 of these CMBS bonds 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 March 31, 2002, the Company's preferred shares in the CDOs were subordinate to approximately 92% of the more senior tranches of debt issued by the CDOs. The yield on the CDOs at March 31, 2002 was 17.3%.

The Company acts as the disposition consultant with respect to the CDOs, which allows the Company to approve disposition plans for individual collateral securities. For these services, the Company collects annual fees based on the outstanding collateral pool balance, and for the quarter ended March 31, 2002, this fee totaled \$37,000.

**Loans**

The commercial mortgage loan portfolio contains loans that were originated by the Company or were purchased from third-party sellers.

At March 31, 2002 and December 31, 2001, approximately 75% and 25% and 76% and 24% of the Company's commercial mortgage loan portfolio was composed of fixed and adjustable interest rate loans, respectively. As of March 31, 2002 and December 31, 2001, loans with a value of \$10,556,000 and \$15,241,000, respectively, were not accruing interest. Loans greater than 120 days delinquent generally do not accrue interest.

The geographic composition and the property types securing the commercial mortgage loan portfolio at value at March 31, 2002 and December 31, 2001 were as follows:

	<u>2002</u>	<u>2001</u>
<b>Geographic Region</b>		
Southeast		
36% 36%		
Mid-Atlantic		

24 23  
West  
19 20  
Midwest  
16 16  
Northeast  
5 5

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Total  
100% 100%

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**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**Note 3. Portfolio, continued**

**Property Type**

Office  
 37% 34%  
 Hospitality  
 25 25  
 Retail  
 20 21  
 Recreation  
 4 4  
 Other  
 14 16

Total  
 100% 100%

***Residual Interest***

At March 31, 2002 and December 31, 2001, the residual interest consisted of the following:

	2002		2001	
	Cost	Value	Cost	Value
<b>(in thousands)</b>				
Residual interest	\$68,853	\$68,853	\$68,853	\$68,853
Residual interest spread				
827 527 1,326 1,026				
<b>Total</b>	<b>\$69,680</b>	<b>\$69,380</b>	<b>\$70,179</b>	<b>\$69,879</b>



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.

The Company sold \$295 million of loans, and received cash proceeds, net of costs, of approximately \$223 million. The Company retained a trust certificate for its residual interest in the 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 March 31, 2002 and December 31, 2001, the mortgage loan pool had an approximate weighted average stated interest rate of 9.3%. The three bond classes sold had an aggregate weighted average interest rate of 6.7% and 6.6% as of March 31, 2002 and December 31, 2001, 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's perception of risk of comparable assets.

**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**Note 4. Debt**

The Company records debt at cost. At March 31, 2002 and December 31, 2001, the Company had the following debt:

	2002		2001	
	Facility Amount	Amount Drawn	Facility Amount	Amount Drawn
<b>(in thousands)</b>				
Notes payable and debentures:				
Unsecured long-term notes payable	\$694,000	\$694,000	\$694,000	\$694,000
SBA debentures	101,800	94,500	101,800	94,500
Auction rate reset note	81,856	81,856	81,856	81,856
OPIC loan	5,700	5,700	5,700	5,700
<hr/>				
<hr/>				
<hr/>				
<hr/>				
Total notes payable and debentures	883,356	876,056	883,356	876,056
<hr/>				
<hr/>				
<hr/>				
<hr/>				
Revolving line of credit	527,500	57,000	497,500	144,750
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<hr/>				
<hr/>				
<hr/>				
Total				

\$1,410,856 \$933,056 \$1,380,856 \$1,020,806

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**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 March 31, 2002, the notes had remaining maturities of one to four years. The weighted average fixed interest rate on the notes was 7.6% at March 31, 2002 and December 31, 2001. The notes may be prepaid in whole or in part, together with an interest premium, as stipulated in the note agreement.

**SBA Debentures.** At March 31, 2002 and December 31, 2001, 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% and 2.4% to 8.2%, respectively. At March 31, 2002, the debentures had remaining maturities of three to ten years. The weighted average interest rate was 7.0% and 6.7% at March 31, 2002 and December 31, 2001, 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.

**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 and capitalize such interest payments. The amount outstanding on the note will increase as interest due is deferred and capitalized.

As a means to repay the note, the Company has entered into an agreement to issue debt, equity or other securities in one or more public or private transactions in an amount at least equal to the outstanding principal balance, or prepay the note, on or before August 31, 2002. If the note is prepaid, the Company will pay a fee equal to 0.5% of the aggregate amount of the note outstanding.

## ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

**Note 4. Debt, continued**

Scheduled future maturities of notes payable and debentures at March 31, 2002, are as follows:

Year	Amount Maturing (in thousands)
2002	\$81,856
2003	
140,000	
2004	
221,000	
2005	
179,000	
2006	
180,700	
Thereafter	
73,500	
<hr/>	
Total	
\$876,056	

***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 rate was 3.2% at March 31, 2002 and December 31, 2001, 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 \$62,292,000 and \$106,338,000 for the three months ended March 31, 2002 and for the year ended December 31, 2001, respectively. The maximum amount borrowed under this facility and the weighted average interest rate for the three months ended March 31, 2002 and for the year ended December 31, 2001, were \$145,250,000 and \$213,500,000, and 3.2% and 5.4%, 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. As of March 31, 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 to the SBA pursuant to Section 303(c) of the Small Business Investment Act of 1958, as amended. The 3% cumulative preferred stock does not have a required redemption date. Allied Investment has the option to redeem in whole or in part the preferred stock by paying the SBA the par value of such securities and any dividends accumulated and unpaid to the date of redemption. The 4% redeemable cumulative preferred stock has a required redemption date in June 2005.

## ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

## Note 6. Shareholders Equity

Sales of common stock for the three months ended March 31, 2002, and the year ended December 31, 2001 were as follows:

(\$ in thousands)	<u>2002</u>	<u>2001</u>
Number of common shares	785	13,286
Gross proceeds		
\$20,600 \$301,539		
Less costs including underwriting fees		
(650) (14,651)		
<hr/>		
<hr/>		
Net proceeds		
\$19,950 \$286,888		
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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 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 three months ended March 31, 2002 and for the year ended December 31, 2001 was as follows:

(in thousands, except per share amounts)	<u>2002</u>	<u>2001</u>
Shares issued	57	271
Average price per share		
\$27.64 \$23.32		

## Note 7. Earnings Per Common Share

Earnings per common share for the three months ended March 31, 2002 and 2001 were as follows:

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	For the Three Months Ended March 31,	
	2002	2001
(in thousands, except per share amounts)		
Net increase in net assets resulting from operations	\$55,961	\$52,028
Less preferred stock dividends (55) (55)		
<hr/>		
<hr/>		
Income available to common shareholders		
\$55,906 \$51,973		
<hr/>		
<hr/>		
Basic shares outstanding		
99,977 85,504		
Dilutive options outstanding to officers		
2,387 1,555		
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<hr/>		
Diluted shares outstanding		
102,364 87,059		
<hr/>		
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Basic earnings per common share		
\$0.56 \$0.61		
<hr/>		
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Diluted earnings per common share		
\$0.55 \$0.60		
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**Note 8. Dividends and Distributions**

The Company's Board of Directors declared and the Company paid a \$0.53 per common share dividend, or \$53,259,000, for the three months ended March 31, 2002.



## ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

## Note 9. Financial Highlights

	At and for the Three Months Ended March 31, 2002	At and for the Year Ended December 31, 2001
<b>Per Common Share Data</b>		
Net asset value, beginning of period	\$13.57	\$12.11
<hr/>		
<hr/>		
Net investment income before net realized and unrealized gains*	0.53	1.92
Net realized and unrealized gains*	0.02	0.23
Income tax benefit*	0.00	0.01
<hr/>		
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Net increase in net assets resulting from operations	0.55	2.16
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Net decrease in net assets from shareholder distributions	(0.53)	(2.01)
Net increase in net assets from capital share transactions	0.12	1.31
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<hr/>		
Net asset value, end of period	\$13.71	\$13.57
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Market value, end of period  
 \$27.50 \$26.00  
 Total return  
 7.85% 35.43%

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\* Based on diluted weighted average number of shares outstanding for the period.

	<b>At and for the Three Months Ended March 31, 2002</b>	<b>At and for the Year Ended December 31, 2001</b>
<b>Ratios and Supplemental Data</b>		
Ending net assets		
	\$1,381,341	\$1,352,123
Common shares outstanding at end of period		
	100,765	99,607
Diluted weighted average shares outstanding		
	102,364	93,003
Employee and administrative expenses/ average net assets		
	0.81%	3.80%
Total expenses/average net assets		
	2.09%	9.31%
Net investment income/ average net assets		
	3.94%	15.15%
Portfolio turnover rate		
	3.49%	10.04%
Average debt outstanding		
	\$938,347	\$847,121
Average debt per share		
	\$9.17	\$9.11

**Note 10. Supplemental Disclosure of Cash Flow Information**

For the three months ended March 31, 2002 and for the year ended December 31, 2001 the Company paid \$5,860,000 and \$63,237,000, respectively, for interest. For the three months ended March 31, 2002 and for the year ended December 31, 2001, the Company's non-cash financing activities totaled \$3,029,000 and \$17,523,000, respectively, and includes the issuance of common stock related to the acquisition of portfolio investments, stock option exercises and dividend reinvestment. The non-cash financing activities for the year ended December 31, 2001 includes the issuance of \$5,157,000 of the Company's common stock to acquire portfolio investments.

**ALLIED CAPITAL CORPORATION AND SUBSIDIARIES**

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**Note 11. Hedging Activities**

The Company invests in BB+, BB and BB- CMBS bonds, which are purchased at prices that are based on the 10-year Treasury rate. The Company has entered into transactions with a financial institution 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 borrowed Treasury securities, with the obligation to replenish the borrowed Treasury securities at a later date based on the then current market price. The Company recorded the proceeds of the sale of the borrowed Treasury securities of \$39,010,000 as an other asset, and the related obligation to replenish the borrowed Treasury securities of \$38,012,000, which represents the fair value of the obligation, as an other liability at March 31, 2002. The difference between the sales proceeds and the related obligation of \$998,000 was recorded as an unrealized gain in the first quarter of 2002.

**Note 12. Subsequent Events**

As of June 10, 2002, we are aware of five purported class action lawsuits that 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. We have not yet been formally served with the complaints in connection with these lawsuits. 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 we 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 lawsuits seek compensatory and other damages, and costs and expenses associated with the litigation. We believe that each of the lawsuits is without merit, and we intend to defend each of these lawsuits vigorously. While we do not expect these matters to materially affect our financial condition or results of operations, there can be no assurance of any particular outcome.

**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 March 31, 2002, and the related consolidated statements of operations, changes in net assets and cash flows for the three-month period ended March 31, 2002, and financial highlights (included in Note 9) for the three months ended March 31, 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.

The consolidated balance sheet of Allied Capital Corporation and subsidiaries, including the statement of investments, as of December 31, 2001, and financial highlights (included in note 9) for the year then ended, were audited by other auditors whose report dated February 20, 2002 expressed an unqualified opinion on those statements.

/s/ KPMG LLP

Washington, D.C.

April 22, 2002, except as to note 12 which is  
as of June 10, 2002

**PART II. OTHER INFORMATION**

**Item 1. Legal Proceedings**

As of June 10, 2002, we are aware of five purported class action lawsuits that 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. We have not yet been formally served with the complaints in connection with these lawsuits. 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 we 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 lawsuits seek compensatory and other damages, and costs and expenses associated with the litigation. We believe that each of the lawsuits is without merit, and we intend to defend each of these lawsuits vigorously. While we do not expect these matters to materially affect our 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 proceedings 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.

**Item 6. Exhibits and Reports on Form 8-K**

(a) List of Exhibits

Exhibit Number	Description
15	Letter from KPMG LLP dated June 10, 2002

(b) Reports on Form 8-K.

On April 3, 2002, Allied Capital filed a Form 8-K reporting that it had selected KPMG LLP to serve as its independent public accountants for the fiscal year December 31, 2002 and dismissed Arthur Andersen LLP as its public accountants effective upon completion of the December 31, 2001 audit.

**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunder duly authorized.

ALLIED CAPITAL CORPORATION

By: /s/ PENNI F. ROLL

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Penni F. Roll  
Chief Financial Officer

Dated: June 12, 2002