

ALLIED CAPITAL CORP
Form 10-Q
August 09, 2004

FORM 10-Q

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, DC 20549

QUARTERLY REPORT PURSUANT TO

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

**For The Quarterly Period
Ended June 30, 2004**

**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

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 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

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act) YES NO

On August 5, 2004, there were 129,126,883 shares outstanding of the Registrant's common stock, \$0.0001 par value.

ALLIED CAPITAL CORPORATION

FORM 10-Q TABLE OF CONTENTS

PART I. FINANCIAL INFORMATION	
Item 1. Financial Statements	
Consolidated Balance Sheet as of June 30, 2004 (unaudited) and December 31, 2003	1
Consolidated Statement of Operations (unaudited) For the Three and Six Months Ended June 30, 2004 and 2003	2
Consolidated Statement of Changes in Net Assets (unaudited) For the Six Months Ended June 30, 2004 and 2003	3
Consolidated Statement of Cash Flows (unaudited) For the Six Months Ended June 30, 2004 and 2003	4
Consolidated Statement of Investments as of June 30, 2004 (unaudited)	5
Notes to Consolidated Financial Statements	16
Independent Accountants Review Report	40
Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations	41
Item 3. Quantitative and Qualitative Disclosures About Market Risk	82
Item 4. Controls and Procedures	82
PART II. OTHER INFORMATION	
Item 1. Legal Proceedings	83
Item 2. Changes in Securities, Use of Proceeds and Issuer Purchases of Equity Securities	83
Item 3. Defaults Upon Senior Securities	84
Item 4. Submission of Matters to a Vote of Security Holders	84
Item 5. Other Information	85
Item 6. Exhibits and Reports on Form 8-K	86
Signatures	89

PART I: FINANCIAL INFORMATION

Item 1. Financial Statements

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEET

(in thousands, except share and per share amounts)	June 30, 2004	December 31, 2003
	(unaudited)	
ASSETS		
Portfolio at value:		
Private finance		
Companies more than 25% owned (cost: 2004-\$1,103,189; 2003-\$755,024)	\$ 1,063,677	\$ 900,317
Companies 5% to 25% owned (cost: 2004-\$164,798; 2003-\$195,600)	162,363	218,305
Companies less than 5% owned (cost: 2004-\$802,333; 2003-\$955,507)	686,426	784,050
Total private finance (cost: 2004-\$2,070,320; 2003-\$1,906,131)	1,912,466	1,902,672
Commercial real estate finance (cost: 2004-\$891,754; 2003-\$694,929)	872,348	681,927
Total portfolio at value (cost: 2004-\$2,962,074; 2003-\$2,601,060)	2,784,814	2,584,599
Deposits of proceeds from sales of borrowed Treasury securities	164,772	98,527
Accrued interest and dividends receivable	62,618	53,079
Other assets	75,401	69,498
Cash and cash equivalents	92,782	214,167
Total assets	\$ 3,180,387	\$ 3,019,870
LIABILITIES AND SHAREHOLDERS EQUITY		
Liabilities:		
Notes payable and debentures (maturing within one year: 2004-\$142,000; 2003-\$221,000)	\$ 850,280	\$ 954,200
Revolving line of credit	208,500	
Obligations to replenish borrowed Treasury securities	164,772	98,525
Accounts payable and other liabilities	52,124	46,568
Total liabilities	1,275,676	1,099,293
Commitments and contingencies		
Preferred stock		6,000
Shareholders' equity:		
Common stock, \$0.0001 par value, 200,000,000 shares authorized; 128,959,677 and 128,117,985 shares issued and outstanding at June 30, 2004, and December 31, 2003, respectively	13	13
Additional paid-in capital	2,003,904	1,985,652
Common stock held in deferred compensation trust	(6,909)	

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Notes receivable from sale of common stock	(8,617)	(18,632)
Net unrealized appreciation (depreciation) on portfolio	(191,393)	(39,055)
Undistributed (distributions in excess of) earnings	107,713	(13,401)
	<u> </u>	<u> </u>
Total shareholders' equity	1,904,711	1,914,577
	<u> </u>	<u> </u>
Total liabilities and shareholders' equity	\$3,180,387	\$3,019,870
	<u> </u>	<u> </u>
Net asset value per common share	\$ 14.77	\$ 14.94
	<u> </u>	<u> </u>

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

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENT OF OPERATIONS

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2004	2003	2004	2003
(in thousands, except per share amounts)				
	(unaudited)		(unaudited)	
Interest and Related Portfolio Income:				
Interest and dividends				
Companies more than 25% owned	\$ 15,918	\$ 12,728	\$ 31,870	\$ 27,931
Companies 5% to 25% owned	6,259	6,480	12,245	12,973
Companies less than 5% owned	51,996	47,929	103,597	91,754
	<u>74,173</u>	<u>67,137</u>	<u>147,712</u>	<u>132,658</u>
Loan prepayment premiums				
Companies more than 25% owned				108
Companies 5% to 25% owned	712	140	712	625
Companies less than 5% owned	2,355	1,497	3,305	2,025
	<u>3,067</u>	<u>1,637</u>	<u>4,017</u>	<u>2,758</u>
Fees and other income				
Companies more than 25% owned	8,306	4,304	12,795	10,013
Companies 5% to 25% owned	123	177	470	230
Companies less than 5% owned	1,831	3,959	4,271	4,685
	<u>10,260</u>	<u>8,440</u>	<u>17,536</u>	<u>14,928</u>
Total interest and related portfolio income	<u>87,500</u>	<u>77,214</u>	<u>169,265</u>	<u>150,344</u>
Expenses:				
Interest	17,983	19,358	37,096	37,280
Employee	9,031	9,258	17,893	17,379
Individual performance award	2,889		6,382	
Administrative	9,076	5,081	14,903	9,498
	<u>38,979</u>	<u>33,697</u>	<u>76,274</u>	<u>64,157</u>
Net investment income before income taxes	<u>48,521</u>	<u>43,517</u>	<u>92,991</u>	<u>86,187</u>
Income tax expense (benefit)	(469)	(1,081)	(544)	(1,081)
Net investment income	<u>48,990</u>	<u>44,598</u>	<u>93,535</u>	<u>87,268</u>
Net Realized and Unrealized Gains (Losses):				
Net realized gains (losses)				
Companies more than 25% owned	4,816	1,314	151,499	1,314
Companies 5% to 25% owned	31,068		35,696	16,688
Companies less than 5% owned	(9,281)	7,226	(12,742)	38,877
	<u>26,603</u>	<u>8,540</u>	<u>174,453</u>	<u>56,879</u>
Total net realized gains (losses)	<u>19,749</u>	<u>6,802</u>	<u>(152,338)</u>	<u>(64,334)</u>

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Net change in unrealized appreciation or depreciation				
Total net gains (losses)	46,352	15,342	22,115	(7,455)
Net increase in net assets resulting from operations	\$ 95,342	\$ 59,940	\$ 115,650	\$ 79,813
Basic earnings per common share	\$ 0.74	\$ 0.53	\$ 0.90	\$ 0.71
Diluted earnings per common share	\$ 0.73	\$ 0.52	\$ 0.88	\$ 0.71
Weighted average common shares outstanding basic	128,814	113,539	128,564	111,510
Weighted average common shares outstanding diluted	131,208	114,552	131,620	112,291

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

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

	For the Six Months Ended June 30,	
(in thousands, except per share amounts)	2004	2003
	(unaudited)	
Operations:		
Net investment income	\$ 93,535	\$ 87,268
Net realized gains	174,453	56,879
Net change in unrealized appreciation or depreciation	(152,338)	(64,334)
	115,650	79,813
Shareholder distributions:		
Common stock dividends	(146,822)	(127,474)
Preferred stock dividends	(52)	(110)
	(146,874)	(127,584)
Capital share transactions:		
Sale of common stock		145,126
Issuance of common stock for portfolio investments	3,227	
Issuance of common stock upon the exercise of stock options	12,033	2,657
Issuance of common stock in lieu of cash distributions	2,964	3,327
Net decrease in notes receivable from sale of common stock	10,015	1,719
Purchase of common stock held in deferred compensation trust	(6,909)	
Other	28	14
	21,358	152,843
Total increase (decrease) in net assets	(9,866)	105,072
Net assets at beginning of period	1,914,577	1,546,071
Net assets at end of period	\$ 1,904,711	\$ 1,651,143
Net asset value per common share	\$ 14.77	\$ 14.23
Common shares outstanding at end of period	128,960	116,034

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

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENT OF CASH FLOWS

	For the Six Months Ended June 30,	
	2004	2003
(in thousands)		
	(unaudited)	
Cash flows from operating activities:		
Net increase in net assets resulting from operations	\$ 115,650	\$ 79,813
Adjustments		
Portfolio investments	(736,343)	(526,399)
Principal collections related to investment repayments or sales	430,861	426,985
Change in accrued or reinvested interest and dividends	(26,147)	(20,405)
Amortization of discounts and fees	(3,158)	(7,233)
Changes in other assets and liabilities	(4,207)	(23,172)
Depreciation and amortization	820	826
Notes received as consideration from sale of investments	(49,117)	(3,876)
Realized losses	29,550	4,347
Net change in unrealized (appreciation) or depreciation	152,338	64,334
Net cash provided by (used in) operating activities	(89,753)	(4,780)
Cash flows from financing activities:		
Sale of common stock		145,126
Sale of common stock upon the exercise of stock options	12,033	2,657
Collections of notes receivable from sale of common stock	10,015	1,719
Borrowings under notes payable and debentures	15,212	300,000
Repayments on notes payable and debentures	(119,000)	(140,000)
Net borrowings under (repayments on) revolving line of credit	208,500	(178,750)
Redemption of preferred stock	(7,000)	
Purchase of common stock held in deferred compensation trust	(6,909)	
Other financing activities	(572)	(2,235)
Common stock dividends and distributions paid	(143,859)	(127,329)
Preferred stock dividends paid	(52)	(110)
Net cash provided by (used in) financing activities	(31,632)	1,078
Net increase (decrease) in cash and cash equivalents	(121,385)	(3,702)
Cash and cash equivalents at beginning of period	214,167	11,186
Cash and cash equivalents at end of period	\$ 92,782	\$ 7,484

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ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENT OF INVESTMENTS

Private Finance Portfolio Company (in thousands, except number of shares)	Investment ⁽¹⁾	June 30, 2004	
		Cost	Value
Companies More Than 25% Owned			
ACE Products, Inc. (Industrial Products)	Loan Common Stock (5,000 shares)	\$ 17,164	\$ 50
Acme Paging, L.P. ⁽³⁾ (Telecommunications)	Loan Equity Interests Common Stock (4,656 shares)	4,631 13,274 27	3,634 1,819
Advantage Sales & Marketing, Inc. (Business Services)	Loan Debt Securities Common Stock (18,957,011 shares)	59,700 124,000 73,472	59,700 124,000 73,472
Alaris Consulting, LLC (Business Services)	Loan Equity Interests Guaranty (\$1,100)	21,821 5,165	4,817
American Healthcare Services, Inc. (Healthcare Services)	Loan Debt Securities Common Stock (7,956,704 shares) Guaranty (\$1,009)	27,419 17,311 1,000	16,750
Avborne, Inc. (Business Services)	Loan Preferred Stock (12,500 shares) Common Stock (27,500 shares) Standby Letter of Credit (\$6,978)	1,269 14,138	1,269 3,639
Business Loan Express, LLC (Financial Services)	Loan Debt Securities Class A Equity Interests Class B Equity Interests Class C Equity Interests Guaranty (\$86,562 See Note 3) Standby Letters of Credit (\$35,550 See Note 3)	10,000 42,268 50,740 62,661 109,340	10,000 42,268 50,740 99,690 150,069
Callidus Capital Corporation (Financial Services)	Loan Debt Securities Common Stock (10 shares)	825 3,710 1,768	825 3,710 1,768
Chickasaw Sales & Marketing, Inc. (Consumer Services)	Preferred Stock (1,000,000 shares) Common Stock (37,000 shares)	1,000 2,812	
The Color Factory, Inc. (Consumer Products)	Loan Preferred Stock (1,000 shares)	16,489 1,002	1,540

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Common Stock (980 shares)	6,535
Guaranty (\$283)	

Foresite Towers, LLC (Tower Leasing)	Equity Interests	18,610	20,648
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		June 30, 2004	
Private Finance Portfolio Company (in thousands, except number of shares)	Investment ⁽¹⁾	(unaudited)	
		Cost	Value
Global Communications, LLC (Business Services)	Loan	\$ 2,755	\$ 2,755
	Debt Securities	17,832	17,832
	Preferred Equity Interest	14,067	19,060
	Options	1,639	1,639
Gordian Group, Inc. (Business Services)	Loan	11,126	11,126
	Common Stock (1,000 shares)	2,885	3,800
HealthASPex, Inc. (Business Services)	Preferred Stock (1,000,000 shares)	700	700
	Preferred Stock (1,451,380 shares)	4,900	2,171
	Common Stock (1,451,380 shares)	4	
HMT, Inc. (Energy Services)	Debt Securities	9,247	9,247
	Preferred Stock (554,052 shares)	2,488	2,488
	Common Stock (300,000 shares)	3,000	4,625
	Warrants	1,155	1,781
Housecall Medical Resources, Inc. (Healthcare Services)	Loan	15,425	15,425
	Common Stock (864,000 shares)	86	31,000
Impact Innovations Group, LLC (Business Services)	Equity Interests in Affiliate (See Note 3)	14,756	21,585
	Warrants	1,674	
Jakel, Inc. (Industrial Products)	Loan	3,840	3,840
	Debt Securities	8,083	8,083
	Preferred Stock (6,460 shares)	6,460	2,913
	Common Stock (158,061 shares)	9,347	
	Standby Letter of Credit (\$1,222)		
Legacy Partners Group, LLC (Financial Services)	Loan	2,500	2,500
	Debt Securities	1,800	1,800
	Equity Interests	2,286	2,286
Litterer Beteiligungs-GmbH ⁽³⁾ (Business Services)	Debt Securities	1,424	1,410
	Equity Interest	835	
Mercury Air Centers, Inc. (Business Services)	Loan	53,201	53,201
	Common Stock (50,000 shares)	29,516	29,516
MVL Group, Inc. (Business Services)	Loan	17,705	17,705
	Debt Securities	17,268	17,268
	Common Stock (648,661 shares)	643	3,900
Powell Plant Farms, Inc. (Consumer Products)	Loan	21,917	21,917
	Debt Securities	19,224	10,709
	Preferred Stock (1,483 shares)		
	Warrants		
Redox Brands, Inc.	Loan	3,225	3,225

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(Consumer Products)	Debt Securities	10,454	10,454
	Preferred Stock (2,726,444 shares)	7,903	11,196
	Warrants	584	475
	Guaranty (\$125)		

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		June 30, 2004	
Private Finance Portfolio Company (in thousands, except number of shares)	Investment ⁽¹⁾	(unaudited)	
		Cost	Value
Staffing Partners Holding Company, Inc. (Business Services)	Debt Securities	\$ 6,084	\$ 6,084
	Preferred Stock (439,600 shares)	4,968	2,765
	Common Stock (69,773 shares)	50	
	Warrants	10	
Startec Global Communications Corporation (Telecommunications)	Loan	14,722	14,722
	Common Stock (19,180,000 shares)	37,255	11,548
STS Operating, Inc. (Industrial Products)	Preferred Stock (5,769,424 shares)	6,818	6,818
	Common Stock (3,000,000 shares)	3,177	3,700
	Options		
Total companies more than 25% owned		\$ 1,103,189	\$ 1,063,677
Companies 5% to 25% Owned			
Aspen Pet Products, Inc. (Consumer Products)	Loans	\$ 18,221	\$ 18,221
	Preferred Stock (2,602 shares)	2,154	1,416
	Common Stock (1,400 shares)	140	
	Warrants		
Border Foods, Inc. (Consumer Products)	Loan	3,000	3,000
	Debt Securities	9,481	9,481
	Preferred Stock (50,919 shares)	2,000	2,000
	Common Stock (1,810 shares)	45	45
	Warrants	665	665
The Debt Exchange Inc. (Business Services)	Preferred Stock (921,875 shares)	1,250	1,369
EDM Consulting, LLC (Business Services)	Debt Securities	1,800	200
	Equity Interests	250	
GFC Holdings, LLC (Business Services)	Warrants	800	900
Liberty-Pittsburgh Systems, Inc. (Business Services)	Debt Securities	3,972	1,326
	Common Stock (123,929 shares)	142	
MasterPlan, Inc. (Business Services)	Loan	959	1,204
	Common Stock (1,350 shares)	42	235
MortgageRamp, Inc. (Business Services)	Common Stock (772,000 shares)	3,860	1,320
Nexcel Synthetics, LLC (Consumer Products)	Loan	10,027	10,027
	Equity Interests	1,690	1,541

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Nobel Learning Communities, Inc. ⁽²⁾ (Education)	Preferred Stock (1,214,356 shares) Warrants	2,764 575	2,764
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		June 30, 2004	
Private Finance Portfolio Company (in thousands, except number of shares)	Investment ⁽¹⁾	(unaudited)	
		Cost	Value
Packaging Advantage Corporation (Business Services)	Debt Securities Common Stock (232,168 shares) Warrants	\$ 14,731 2,386 963	\$ 14,365
Pres Air Trol LLC (Industrial Products)	Loan Debt Securities Equity Interests	49 6,253 1,323	49 6,253 1,323
Professional Paint, Inc. (Consumer Products)	Loan Debt Securities Preferred Stock (15,000 shares) Common Stock (110,000 shares)	5,135 25,025 23,596 69	5,135 25,025 23,596 8,800
Progressive International Corporation (Consumer Products)	Loan Preferred Stock (500 shares) Common Stock (197 shares) Warrants	7,173 500 13	7,173 784 480
Total Foam, Inc. (Industrial Products)	Debt Securities Common Stock (164 shares)	142 10	73
Universal Environmental Services, LLC (Business Services)	Loan Equity Interests	12,093 1,500	12,093 1,500
Total companies 5% to 25% owned		\$ 164,798	\$ 162,363
Companies Less Than 5% Owned			
Alderwoods Group, Inc. ⁽²⁾ (Consumer Services)	Common Stock (357,568 shares)	\$ 5,006	\$ 4,362
American Barbecue & Grill, Inc. (Retail)	Warrants	125	
Apogen Technologies, Inc. (Business Services)	Debt Securities Preferred Stock (270,008 shares) Common Stock (1,256,452 shares) Warrants	4,980 2,700 50	4,980 2,700 1,747 3
Aviation Technologies, Inc. (Industrial Products)	Loan	20,627	20,627
Benchmark Medical, Inc. (Healthcare Services)	Debt Securities Warrants	13,579 18	13,579 18
Camden Partners Strategic Fund II, L.P. ⁽⁴⁾ (Private Equity Fund)	Limited Partnership Interest	2,463	2,606

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Catterton Partners V, L.P. ⁽⁴⁾ (Private Equity Fund)	Limited Partnership Interest	684	549
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		June 30, 2004	
Private Finance Portfolio Company (in thousands, except number of shares)	Investment ⁽¹⁾	(unaudited)	
		Cost	Value
Colibri Holding Corporation (Consumer Products)	Debt Securities	\$ 3,506	\$ 3,506
	Preferred Stock (459 shares)	523	695
	Common Stock (3,362 shares)	1,250	812
	Warrants	290	188
Community Education Centers, Inc. (Education Services)	Loan	15,198	15,198
Component Hardware Group, Inc. (Industrial Products)	Preferred Stock (18,000 shares)	2,503	2,503
	Common Stock (2,000 shares)	200	600
Cooper Natural Resources, Inc. (Industrial Products)	Loan	120	120
	Debt Securities	2,000	2,000
	Preferred Stock (6,316 shares)	1,427	
	Warrants	832	
Coverall North America, Inc. (Business Services)	Loan	15,309	15,309
	Debt Securities	7,914	7,914
CTT Holdings (Consumer Products)	Loan	1,125	1,125
DCS Business Services, Inc. (Business Services)	Debt	21,132	21,132
	Preferred Stock (478,816 shares)	1,239	2,070
Drilltec Patents & Technologies Company, Inc. (Energy Services)	Loan	10,918	
	Debt Securities	1,500	
eCentury Capital Partners, L.P. ⁽⁴⁾ (Private Equity Fund)	Limited Partnership Interest	4,375	248
Elexis Beta GmbH ⁽³⁾ (Industrial Products)	Options	426	245
E-Talk Corporation (Business Services)	Preferred Stock (133 shares)	10,009	
	Common Stock (8,656 shares)		
Fairchild Industrial Products Company (Industrial Products)	Loan	7,145	7,145
	Debt Securities	5,954	2,944
	Warrants	280	
Frozen Specialties, Inc. (Consumer Products)	Debt Securities	10,435	10,435
	Warrants	435	470
Galaxy American Communications, LLC (Broadcasting & Cable)	Loan	995	995
	Debt Securities	49,702	6,794
	Common Stock (100 shares)	1,350	

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Guaranty (\$800)
Standby Letter of Credit (\$200)

Garden Ridge Corporation (Retail)	Debt Securities	27,271	18,300
	Preferred Stock (1,130 shares)	1,130	
	Common Stock (847,800 shares)	613	

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		June 30, 2004	
Private Finance Portfolio Company (in thousands, except number of shares)	Investment ⁽¹⁾	(unaudited)	
		Cost	Value
Geotrace Technologies, Inc. (Energy Services)	Debt Securities Warrants	\$ 16,132 2,350	\$ 16,132 2,350
Ginsey Industries, Inc. (Consumer Products)	Loans Convertible Debentures Warrants	4,880 500	4,880 684 1,966
Grant Broadcasting Systems II (Broadcasting & Cable)	Warrants	87	2,750
Griffith Energy, Inc. (Energy Services)	Loan	16,742	16,742
Grotech Partners, VI, L.P. ⁽⁴⁾ (Private Equity Fund)	Limited Partnership Interest	4,013	2,602
Haven Eldercare of New England, LLC (Healthcare Services)	Loans	46,665	47,076
HealthMarket, Inc. (Health Insurance)	Debt Securities Warrants	9,997 439	9,997 439
The Hillman Companies, Inc. ⁽²⁾ (Consumer Products)	Loan	42,311	42,311
Homax Holdings, Inc. (Consumer Products)	Debt Warrants	10,055 927	10,055 927
Icon International, Inc. (Business Services)	Common Stock (25,707 shares)	76	
Interline Brands, Inc. (Business Services)	Preferred Stock (199,313 shares) Common Stock (15,615 shares) Warrants	1,849 139 1,181	3,194
International Fiber Corporation (Industrial Products)	Debt Securities Preferred Stock (25,000 shares)	20,895 2,500	20,895 2,500
JRI Industries, Inc. (Industrial Products)	Debt Securities Warrants	1,565 74	1,565 39
Kirker Enterprises, Inc. (Industrial Products)	Equity Interest Warrants	4 348	4 1,096
Love Funding Corporation (Financial Services)	Preferred Stock (26,000 shares)	359	359
Matrics, Inc.	Preferred Stock (511,876 shares)	500	771

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(Industrial Products)	Warrants		
MedAssets, Inc. (Business Services)	Preferred Stock (227,865 shares) Warrants	2,049 136	2,648
Mercury Air Group, Inc. ⁽²⁾ (Business Services)	Warrants	427	

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(2) Public company.

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(4) Non-registered investment company.

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

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		June 30, 2004	
Private Finance Portfolio Company (in thousands, except number of shares)	Investment ⁽¹⁾	(unaudited)	
		Cost	Value
Mid-Atlantic Venture Fund IV, L.P. ⁽⁴⁾ (Private Equity Fund)	Limited Partnership Interest	\$ 5,850	\$ 3,057
Midview Associates, L.P. (Housing)	Warrants		
Mogas Energy, LLC (Energy Services)	Debt Securities Warrants	16,118 1,774	16,118 2,300
Norstan Apparel Shops, Inc. (Retail)	Debt Securities Common Stock (29,663 shares) Warrants	12,960 4,750 655	11,647
Novak Biddle Venture Partners III, L.P. ⁽⁴⁾ (Private Equity Fund)	Limited Partnership Interest	1,590	1,286
Nursefinders, Inc. (Healthcare Services)	Loan Debt Securities Warrants	48 11,389 900	48 11,389 611
Oahu Waste Services, Inc. (Business Services)	Debt Securities Stock Appreciation Rights	8,776 239	8,776 445
Onyx Television GmbH ⁽³⁾ (Broadcasting & Cable)	Preferred Units	201	
Opinion Research Corporation ⁽²⁾ (Business Services)	Loan Warrants	21,894 996	21,894 595
Oriental Trading Company, Inc. (Consumer Products)	Common Stock (13,820 shares)	10	3,412
Polaris Pool Systems, Inc. (Consumer Products)	Debt Securities Warrants	11,170 1,145	11,170 1,700
Prosperco Finanz Holding AG ⁽³⁾ (Financial Services)	Convertible Debentures Common Stock (1,528 shares) Warrants	8,131 1,059	50
RadioVisa Corporation (Broadcasting & Cable)	Loan	25,191	25,191
Resun Leasing, Inc. (Business Services)	Loan	30,000	30,000
S.B. Restaurant Company (Retail)	Debt Securities Preferred Stock (54,125 shares) Warrants	9,491 135 619	9,491 135 619

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SBBUT, LLC (Consumer Products)	Equity Interests Warrants	421 54	421 54
Soff-Cut Holdings, Inc. (Industrial Products)	Debt Securities Preferred Stock (300 shares) Common Stock (2,000 shares)	10,440 300 200	10,440 294

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		June 30, 2004	
Private Finance Portfolio Company (in thousands, except number of shares)	Investment ⁽¹⁾	(unaudited)	
		Cost	Value
SPP Mezzanine Fund, L.P. ⁽⁴⁾ (Private Equity Fund)	Limited Partnership Interest	\$ 725	\$ 618
SunStates Refrigerated Services, Inc. (Warehouse Facilities)	Loans Debt Securities	4,466 2,445	1,500
Sydran Food Services II, L.P. (Retail)	Debt Securities Equity Interests Warrants	12,973 3,747 162	50
United Pet Group, Inc. (Consumer Products)	Debt Securities Warrants	9,260 85	9,260 3,100
United Site Services, Inc. (Business Services)	Loan	26,646	26,646
Updatea Venture Partners II, L.P. ⁽⁴⁾ (Private Equity Fund)	Limited Partnership Interest	3,375	3,202
U.S. Security Holdings, Inc. (Business Services)	Warrants	826	2,000
Venturehouse-Cibernet Investors, LLC (Business Services)	Equity Interest	34	34
Venturehouse Group, LLC ⁽⁴⁾ (Private Equity Fund)	Equity Interest	1,000	402
VICORP Restaurants, Inc. (Retail)	Warrants	33	191
Walker Investment Fund II, LLLP ⁽⁴⁾ (Private Equity Fund)	Limited Partnership Interest	1,330	374
Wear Me Apparel Corporation (Consumer Products)	Debt Securities Warrants	48,725 1,219	48,725 1,219
Weston Solutions, Inc. (Business Services)	Loan	7,319	7,319
Wilshire Restaurant Group, Inc. (Retail)	Debt Securities Warrants	17,221 735	17,115
Wilton Industries, Inc. (Consumer Products)	Loan	9,600	9,600
Woodstream Corporation	Loan	253	253

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(Consumer Products)	Debt Securities	16,723	16,723
	Common Stock (180 shares)	1,800	2,300
	Warrants	587	751
Total companies less than 5% owned		\$ 802,333	\$ 686,426
Total private finance (116 portfolio companies)		\$2,070,320	\$1,912,466

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	Stated Interest	Face	June 30, 2004	
			(unaudited) Cost	Value
Commercial Real Estate Finance				
(in thousands)				
Commercial Mortgage-Backed Securities				
Mortgage Capital Funding, Series 1998-MC3	5.5%	\$ 53,100	\$ 35,025	\$ 29,010
Morgan Stanley Capital I, Series 1999-RM1	6.4%	28,865	9,872	9,872
COMM 1999-1	5.7%	56,477	27,817	26,348
Morgan Stanley Capital I, Series 1999-FNV1	6.1%	31,786	18,585	14,081
DLJ Commercial Mortgage Trust 1999-CG2	6.1%	43,131	14,096	13,508
Commercial Mortgage Acceptance Corp., Series 1999-C1	6.8%	18,643	5,002	5,002
LB Commercial Mortgage Trust, Series 1999-C2	6.7%	11,603	1,677	1,748
Chase Commercial Mortgage Securities Corp., Series 1999-2	6.5%	20,950	5,460	5,455
FUNB CMT, Series 1999-C4	6.5%	21,125	7,980	7,067
Heller Financial, HFCMC Series 2000 PH-1	6.6%	24,040	9,191	8,658
SBMS VII, Inc., Series 2000-NL1	7.2%	8,289	4,616	4,047
DLJ Commercial Mortgage Trust, Series 2000-CF1	7.0%	26,708	11,160	11,136
Deutsche Bank Alex. Brown, Series Comm 2000-C1	6.9%	18,068	4,286	2,935
LB-UBS Commercial Mortgage Trust, Series 2000-C4	6.9%	16,665	3,612	4,424
Credit Suisse First Boston Mortgage Securities Corp., Series 2001-CK1	5.9%	17,502	4,567	5,308
JP Morgan-CIBC-Deutsche 2001	5.8%	25,398	7,274	7,258
Lehman Brothers-UBS Warburg 2001-C2	6.4%	23,426	6,802	9,057
SBMS VII, Inc., Series 2001-C1	6.1%	20,333	4,392	2,182
GE Capital Commercial Mortgage Securities Corp., Series 2001-2	6.1%	21,799	7,018	7,005
Credit Suisse First Boston Mortgage Securities Corp., Series 2001-CKN5	5.2%	22,292	6,865	6,790
JP Morgan Chase Commercial Mortgage Securities Corp., Series 2001-C1	5.6%	25,050	6,110	6,097
SBMS VII, Inc., Series 2001-C2	6.2%	23,217	7,152	7,082
FUNB CMT, Series 2002-C1	6.0%	22,097	9,058	8,036
GE Capital Commercial Mortgage Corp., Series 2002-1	6.2%	40,325	17,501	19,116
GMAC Commercial Mortgage Securities, Inc., Series 2002-C2	5.8%	27,926	10,927	11,177
GE Capital Commercial Mortgage Corp., Series 2002-3	5.1%	38,047	13,362	13,539
Morgan Stanley Dean Witter Capital I Trust 2002-IQ3	6.0%	15,919	3,790	3,790
LB-UBS Commercial Mortgage Trust 2003-C1	4.6%	37,896	12,359	12,370
GS Mortgage Securities Corporation II Series 2003-C1	4.7%	26,189	9,190	9,190
J.P. Morgan Chase Commercial Mortgage Securities Corp., Series 2003-ML1	4.9%	2,947	2,313	2,336
Credit Suisse First Boston Mortgage Securities Corp., Series 2003-CK2	4.9%	56,680	28,378	28,699
COMM 2003-LNB1	4.4%	24,324	5,750	5,750
Wachovia Bank Commercial Mortgage Trust, Series 2003-C5	4.3%	48,202	17,731	17,575
GE Commercial Mortgage Corporation, Series 2003-C1	5.1%	9,389	7,563	7,781
GMAC Commercial Mortgage Securities, Inc., Series 2003-C2	5.5%	56,441	25,245	25,832
GMAC Commercial Mortgage Securities, Inc., Series 2003-C3	5.3%	6,535	5,461	5,576
LB-UBS Commercial Mortgage Trust 2003-C8	5.4%	12,999	10,413	10,759
Wachovia Bank Commercial Mortgage Trust, Series 2003-C9	5.3%	46,793	22,621	22,727
COMM 2004-LNB2	5.0%	4,770	3,490	3,426
GE Commercial Mortgage Corporation, Series 2004-C1	5.0%	48,049	21,891	21,806
LB-UBS Commercial Mortgage Trust 2004-C1	4.9%	35,400	14,839	14,793
MezzCapp Commercial Mortgage Trust, Series 2004-C1	10.0%	1,990	821	821
Wachovia Bank Commercial Mortgage Trust, Series 2004-C10	5.0%	7,110	5,307	5,302

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COMM 2004-LNB3	5.3%	46,785	25,265	25,375
GE Commercial Mortgage Corporation, Series 2004-C2	5.3%	14,287	12,249	11,929
GMAC Commercial Mortgage Securities, Inc. Series 2004-C1	5.3%	40,671	25,495	24,921
GS Mortgage Securities Corporation II, Series 2004-C1	4.6%	39,613	24,324	24,100
Total commercial mortgage-backed securities (47 issuances)		\$1,269,851	\$543,902	\$530,796

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

	June 30, 2004	
	(unaudited)	
	Cost	Value
Commercial Real Estate Finance		
(in thousands, except number of loans)		
Collateralized Debt Obligations		
Crest 2001-1, Ltd. ⁽³⁾	\$ 22,409	\$ 22,409
Crest 2002-1, Ltd. ⁽³⁾	24,026	24,026
Crest 2002-IG, Ltd. ⁽³⁾	4,332	4,332
Crest Clarendon Street 2002-1, Ltd. ⁽³⁾	940	940
Crest 2003-1, Ltd. ⁽³⁾	92,330	92,330
Crest 2003-2, Ltd. ⁽³⁾	26,052	26,052
TIAA Real Estate CDO 2003-1, Ltd. ⁽³⁾	1,826	1,852
Crest Exeter Street Solar 2004-1, Ltd. ⁽³⁾	3,730	3,667
Total collateralized debt obligations	\$ 175,645	\$ 175,608

	Interest Rate Ranges	Number of Loans		
Commercial Mortgage Loans				
	Up to 6.99%	16	\$ 13,799	\$ 14,190
	7.00% 8.99%	36	84,505	84,505
	9.00% 10.99%	8	33,047	32,845
	11.00% 12.99%	6	10,941	8,933
	13.00% 14.99%	2	4,158	2,546
	15.00% and above	1	3,932	3,932
Total commercial mortgage loans		69	\$ 150,382	\$ 146,951
Real Estate Owned			16,074	14,444
Equity Interests (Guarantees \$2,731)			5,751	4,549
Total commercial real estate finance			\$ 891,754	\$ 872,348
Total portfolio			\$2,962,074	\$2,784,814

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ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Information at and for the three and six months ended June 30, 2004 and 2003, is unaudited)

Note 1. Organization

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

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

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

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

Note 2. Summary of Significant Accounting Policies

Basis of Presentation

The consolidated financial statements include the accounts of ACC and its subsidiaries. All intercompany accounts and transactions have been eliminated in consolidation. Certain reclassifications have been made to the 2003 balances to conform with the 2004 financial statement presentation.

The accompanying unaudited consolidated financial statements of the Company have been prepared in accordance with accounting principles generally accepted in the United States of America (GAAP) for interim financial information. Accordingly, they do not include all of the information and footnotes required by GAAP for complete consolidated financial statements. In the opinion of management, the unaudited consolidated financial results of the Company included herein contain all adjustments (consisting of only normal recurring accruals) necessary to present fairly the financial position of the Company as of June 30, 2004, the results of operations for the three and six months ended June 30, 2004 and 2003, and changes in net assets and cash flows for the six months ended June 30, 2004 and 2003. The results of operations for the three and six months ended June 30, 2004, are not necessarily indicative of the operating results to be expected for the full year.

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

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 2. Summary of Significant Accounting Policies, continued

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

Valuation Of Portfolio Investments

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

Loans and Debt Securities

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

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

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

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 2. Summary of Significant Accounting Policies, continued

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

The weighted average yield on loans and debt securities is computed as the (a) annual stated interest rate plus the annual amortization of loan origination fees, original issue discount, and market discount 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, recent transactions involving the purchase or sale of the portfolio company's equity securities, or other liquidation events. The determined equity values are generally discounted to account for restrictions on resale and minority ownership positions.

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

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

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

CMBS bonds and CDO bonds and preferred shares are carried at fair value, which is based on a discounted cash flow model that utilizes prepayment and loss assumptions based on historical experience and projected performance, economic factors, the characteristics of the underlying cash flow, and comparable yields for similar CMBS bonds and CDO bonds and preferred shares. The Company recognizes unrealized appreciation or depreciation on its CMBS bonds and CDO bonds and preferred shares as comparable yields in the market change and/or based on changes in estimated cash flows resulting from changes in prepayment or loss assumptions in the underlying collateral pool.

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 2. Summary of Significant Accounting Policies, continued

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 actual and estimated prepayment speeds or actual and estimated credit losses. Changes in estimated yield are recognized as an adjustment to the estimated yield over the remaining life of the CMBS bonds and CDO bonds and preferred shares from the date the estimated yield is changed.

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

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

Fee Income

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

Guarantees

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

Financing Costs

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

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.

ALLIED CAPITAL CORPORATION AND SUBSIDIARIES

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Note 2. Summary of Significant Accounting Policies, continued

Dividends to Shareholders

Dividends to shareholders are recorded on the record date.

Stock Compensation Plans

The Company has a stock-based employee compensation plan. The Company accounts for this plan under the recognition and measurement principles of APB Opinion No. 25, *Accounting for Stock Issued to Employees*, and related interpretations. No stock-based employee compensation cost is reflected in net increase in net assets resulting from operations, as all options granted under this plan had an exercise price equal to the market value of the underlying common stock on the date of grant. The following table illustrates the effect on net increase in net assets resulting from operations and earnings per share if the Company had applied the fair value recognition provisions of FASB Statement No. 123, *Accounting for Stock-Based Compensation*, to stock-based employee compensation for the three and six months ended June 30, 2004 and 2003.

	For the Three Months Ended June 30,		For the Six Months Ended June 30,	
	2004	2003	2004	2003
(in thousands, except per share amounts)				
Net increase in net assets resulting from operations as reported	\$95,342	\$59,940	\$115,650	\$79,813
Less total stock-based employee compensation expense determined under fair value based method for all awards, net of related tax effects	(7,543)	(3,849)	(10,596)	(8,078)
Pro forma net increase in net assets resulting from operations	87,799	56,091	105,054	